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Major Events

The world and U.S. economies slow, triggering growing recession concerns

Zero job growth in August

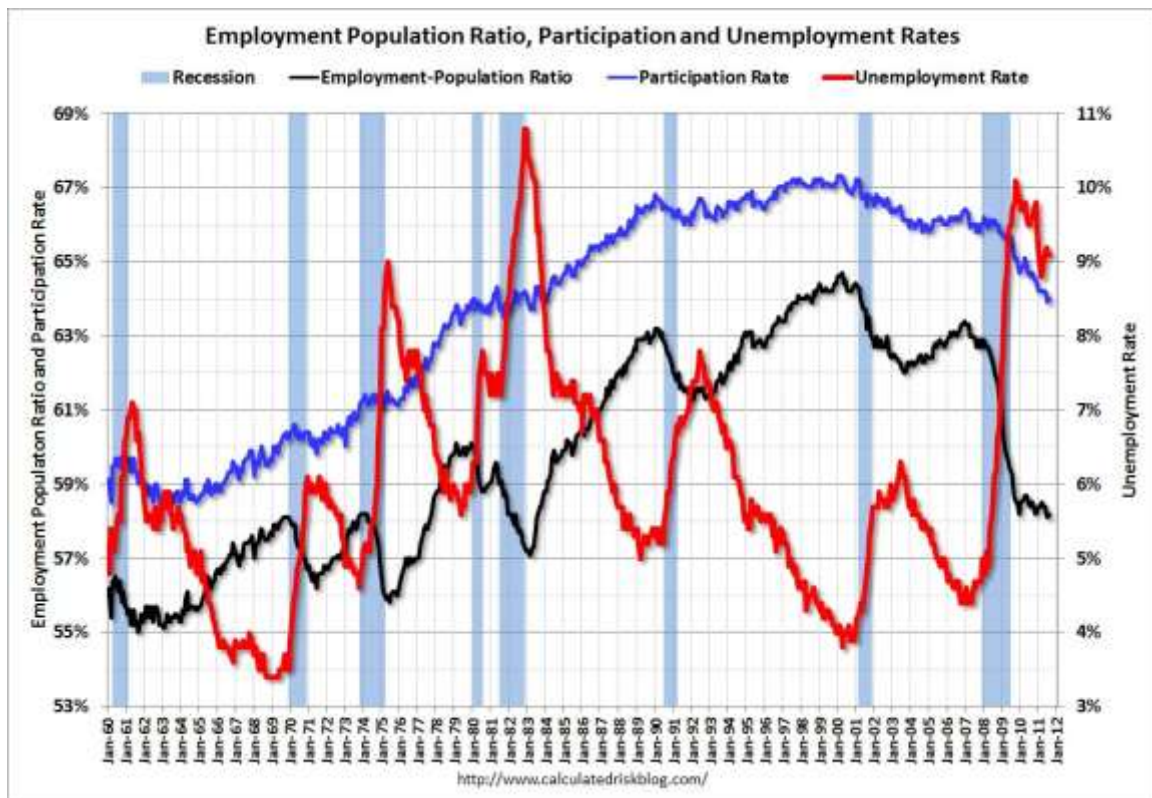
President Obama to announce job growth initiatives at joint session of Congress

S&P downgrades the United States—the first downgrade in the nation's history

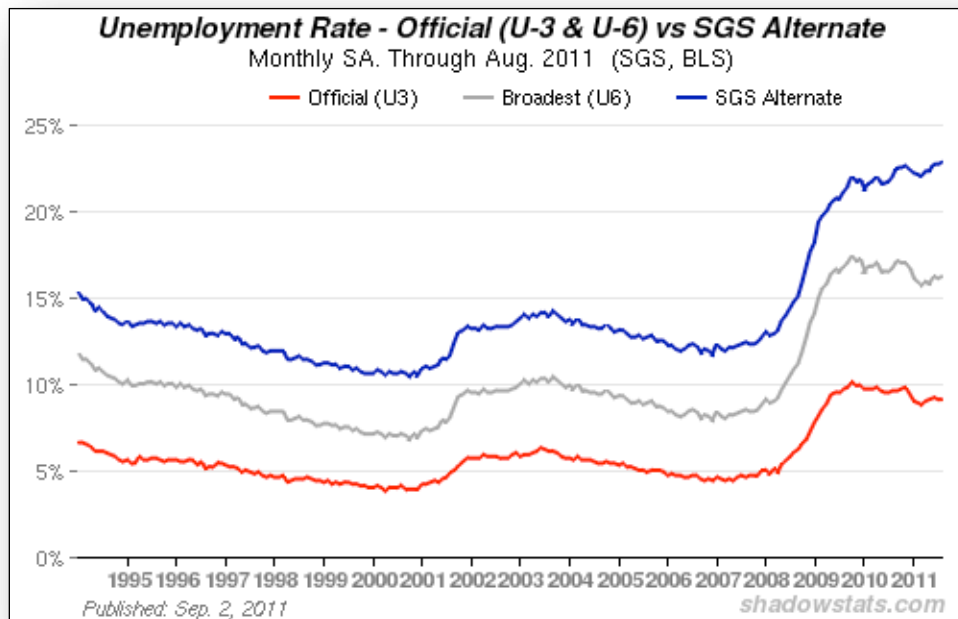
The EU crisis deepens

Zero job growth in August

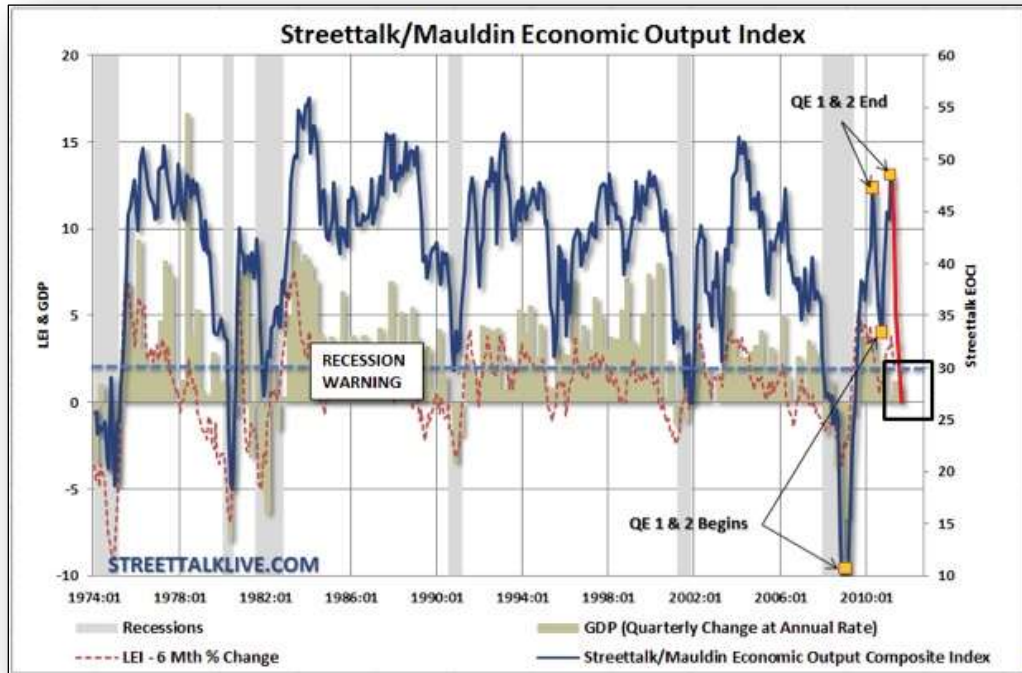
- A gut-wrenching August employment report, ratcheted up market concerns about recession, as the government announced that zero jobs were created during the month and 58,000 fewer jobs were created in June and July than had been previously been announced. For the people who had jobs, their average hourly earnings and weekly hours both contracted, which will further contract consumer purchasing power. Unemployment held steady at 9.1%. (*Weekly Economic & Financial Commentary*, Wells Fargo Securities' Economic Group, 09/02/11)



- Recent disappointing economic signposts include:
 - A steady erosion in the pace of job creation has occurred over recent months, along with a contraction in household employment, particularly full-time employment. Unemployment has remained stubbornly above 9% over the last 25 out of 27 months. The declining momentum in job data is reminiscent of the preceding months of the recessions of 1990-1991, 2000, and 2007.



- Real personal income, including government transfers, remains 5% lower than at its peak in March 2008—two years into the “economic recovery.” Ditto for employment, production and retail business sales—marking the first time *ever* that all four critical variables may head into the next recession without ever having achieved a new peak.
- Downshifts in regional manufacturing indexes from the Philly Fed, New York Empire Index and Richmond Fifth District—not just down, but sharply negative—has raised fears that business spending is sputtering.
- The StreetTalk/Mauldin Economic Output Index (EOI), comprised of a weighted average of the six regional and national indices and one national survey (NIFB), illustrates the risk of recession, when the indicator falls below “30.” The red at the end of the EOI chart reflects the recent drop in manufacturing activity, indicating that the economy appears to be on the cusp of recession territory.



- Deterioration in the U.S. economic data appears to be longer lasting and more widespread with the risk of recession rising over the near term. (*Breakfast with Dave*, David A. Rosenberg, 08/26/11; *Thoughts from the Frontline*, John Mauldin, 08/20/11; *Breakfast with Dave*, David A. Rosenberg, 08/31/11)

President Obama to announce job growth initiatives at joint session of Congress

- On September 8, President Obama will propose a major jobs initiative to stimulate employment and economic growth before a joint session of Congress. The President plans to “lay out a series of bi-partisan proposals that Congress can take immediately to rebuild the American economy” and to “[help] Americans get back to work.” The president’s proposals will likely include:
 - an extension of the payroll tax credit scheduled to expire at year-end 2011;
 - the creation of a new “Returning Heroes Tax Credit” for hiring unemployed veterans (maximum credit of \$2,400 for every short-term unemployed hire and \$4,800 for every long-term unemployed hire) and a “Wounded Warriors Tax Credit” which will increase the existing tax credit for firms that hire veterans with service-connected disabilities who have been unemployed long-term (maximum credit of \$9,600 per veteran) and continue the existing

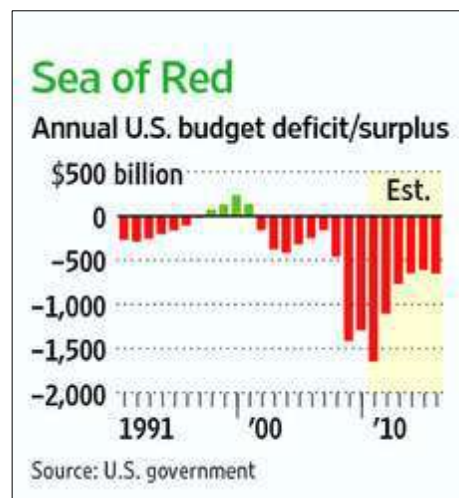
credit for all other veterans with a service-connected disability (maximum credit of \$4,800);

- the creation of a Job Training Plan that would allow training while a trainee receives unemployment and a stipend for expenses such as travel, and at the end of a 6-8 week period the employer may or may not hire the employee;
 - an extension of unemployment benefits; and
 - the creation of new tax credit for net job hiring.
- In advance of his speech, President Obama announced that he has asked the EPA to withdraw an air-quality rule that Republicans and business groups said would cost millions of jobs. The EPA had estimated the tighter air quality standard would save 12,000 lives each year at a cost to the economy of as much as \$90 billion annually. The President has also identified six other regulations—three proposed by the EPA and three proposed by Department of Transportation—that would cost more than \$1 billion each.
 - Republican lawmakers have indicated they will pursue jobs proposals in September, which will include (i) the elimination of the 3% withholding provision on sales to federal, state and local governments; (ii) a 20% small business tax deduction; and (iii) the repeal of ten government regulations, which destroy jobs. The regulations that Republican lawmakers have targeted for repeal include those governing (i) NLRB’s Boeing Ruling; (ii) utility MACT and CSAPR; (iii) boiler MACT; (iv) cement MACT; (v) coal ash; (vi) grandfathered health plans; (vii) ozone; (viii) farm dust; (ix) greenhouse gas; and (x) NLRB’s union elections. (*BlogUpdate for the Marjority Leader*; Representative Eric Cantor; 08/29/11; *Wall Street Journal*, Deborah Solomon and Tennille Tracy, 09/03/11; *The Hill’s On the Money Blog*, Erik Wasson, 08/30/11; *Washington Roundup Update*, Canfield Press, 08/26/11)

S&P downgrades the United States—the first downgrade in the nation’s history

- After Congress passed a debt ceiling agreement, S&P acted alone in downgrading the U.S. credit rating to AA+, the first downgrade in our nation’s history. S&P utilized a different methodology in determining its rating, placing significant emphasis on “political factors.” The fact that S&P made a \$2 trillion error from a mistaken assumption on future expenditure growth also helped soften the market’s reaction to the downgrade. Moody’s and Fitch re-affirmed their AAA-rating for the U.S. and indicated that they would reassess the nation’s rating only after the results are in from the actions of the joint congressional committee on deficit reduction and the 2012 elections.

- Standard & Poor’s downgraded Fannie Mae and Freddie Mac from AAA to AA+, citing the GSEs’ “direct reliance” on the federal government for their funding needs. The rating agency also downgraded 10 Federal Home Loan Banks to AA+, as a lockstep move in line with the nation’s rating. (Previously, S&P had downgraded two FHLBs to AA+.) While in theory the ratings downgrade could intensify pressure to wind down Fannie Mae and Freddie Mac, the GSEs’ integral role in the U.S. housing finance system will likely forestall GSE reform for the foreseeable future.
- Since the U.S. can print its own money, the S&P downgrade is viewed by many as more symbolic than “real”—particularly with the split rating. Moreover, the downgrading process cannot possibly stop with the U.S., given the deteriorating situation in Europe. The initial impact of S&P’s downgrade has been more negative for the equity markets than the Treasury market to date. Historically, downgrades tend to light a fire under policymakers, triggering belt tightening, which, in turn, adversely impacts demand growth and corporate profits. (*CQ Today*, John Cranford, 08/06/11; *Wall Street Journal*, Damian Paletta and Matt Phillips, 08/06/11; *CQ Today*, John Cranford and Paul M. Krawzak, 08/07/11)
- “Despite S&P’s opinion, there is no chance that America will default on its debts.” wrote the *Wall Street Journal* in an August 8 editorial. “The real importance of the downgrade will depend on the political reaction it inspires. If the response is denial and blaming the credit raters, then the U.S. will continue on its current road to more downgrades and eventually to Greece. What has already become a half-decade of lost growth will turn into a lost decade or more. If the response is to escape the debt trap by the stealth route of inflation—a path now advocated by many of the same economists who promoted the failed spending stimulus of 2009—then the U.S. could spur a dollar crisis and jeopardize its reserve currency status.
- “The better answer—the only road back to fiscal sanity and AAA status—is to reverse the economic policies of the late Bush and Obama years. The financial crisis followed by the Keynesian and statist revival of the last four years have brought the U.S. to this downgrade and will lead to inevitable decline. The only solution is to return to the classical, pro-growth economic ideas that have revived America at other moments of crisis.” (*Wall Street Journal*, 08/08/11)
- CBO projects a FY2011 budget deficit of \$1.3 trillion, the third largest deficit in 65 years. CBO estimates that cumulative deficits will total \$3.5 trillion over the FY2012-FY2021 period, down some 66% from its previous deficit projection of \$6.7 trillion, as a result of the Budget Control Act. Importantly, the CBO analysis did not incorporate the economic developments in July, in particular the



government's lowering of GDP estimates for 2011. "Incorporating that news would have led CBO to temper its near term forecast for economic growth," wrote the agency. CBO estimated GDP growth of 2.3% and 2.7% in FY2011 and FY2012, respectively, based upon unemployment levels of 8.9% and 8.5% for the fourth quarters of 2011 and 2012, respectively. [The agency expects unemployment to remain above 8% through 2013.] Interestingly, GDP growth in the last six months of this year will have to top 3.2% to achieve CBO's 2.3% projection for 2011—something unlikely to occur in today's economic environment. (*The Budget and Economic Outlook: An Update*, Congressional Budget Office, August 2011)

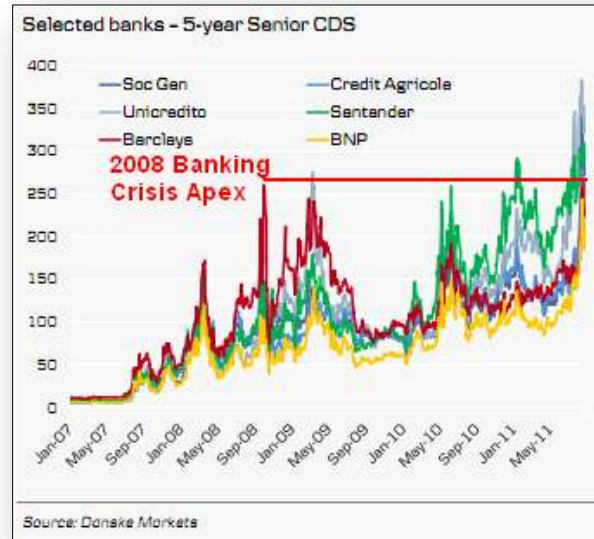
The EU crisis deepens

- Globally, the economy is slowing at a much faster rate than last year, as bureaucrats and politicians attempt to get ahead of the latest iteration of the global debt crisis through "belt tightening." In this leg of the cycle, the economic deterioration is far more entrenched globally and across GDP sectors as the European economy stagnates, the U.S. economy slows to stall speed, and the Asian economy cools off, placing even more stress on Europe's sovereign debt crisis.
- ECB announced an expansion of its secondary market purchases of Italian and Spanish bonds of 880 million euros, a radical expansion of the central bank's balance sheet with risky bonds. While the ECB's emergency efforts have helped keep the continent's crisis at bay by keeping borrowing costs for several large countries under control for the short term, the cost of taking these step—in terms of money and political compromise—is placing even more stress on Europe's struggling experiment with a common currency.
- The success of the EU's bailout efforts will be tested this fall, when the European Financial Stability Facility (EFSF), a rescue fund to be backed by 16 European governments that has yet to be approved by all the countries' parliaments, begins to make purchases in the bond markets. The EFSF will attempt to keep down the borrowing costs of struggling Eurozone countries through the sale of its own AAA-rated bonds. Already, more than half of the EFSF's 440 million euro capacity has been committed to Greece, Portugal and Ireland. Analysts contend that the seeds of the *next* EU crisis are "baked into" the EFSF structure, arguing that at least \$1 trillion is needed to stabilize the euro-zone economies. The region's political leaders will likely face conflicts concerning where to direct the EFSF funds and pressure to expand the intervention in the bond markets. "You'll have the ECB putting pressure to increase the EFSF and the politicians resisting," concluded Royal Bank of Scotland analyst Jacques Cailloux, who believes that the EFSF will be in dire need of additional funds by year-end.
- The underlying problem is the excessive level of Eurozone debt, much held by Europe's thinly-capitalized big banks, which cannot be repaid. For example, two French banks—Credit Agricole and BNP Paribas—have combined deposits of more

than 1 trillion euros, yet hold assets of 2.5 trillion euros, equal to France's entire GDP. That's just two French banks. Today, a number of the European banks' tangible capital ratios have fallen to levels suggesting that they are probably insolvent, including Italy's UniCredit (4.42% tangible capital), Germany's Deutsche Bank (1.92%), and France's BNP Paribas (2.85%) and Credit Agricole (1.41%).

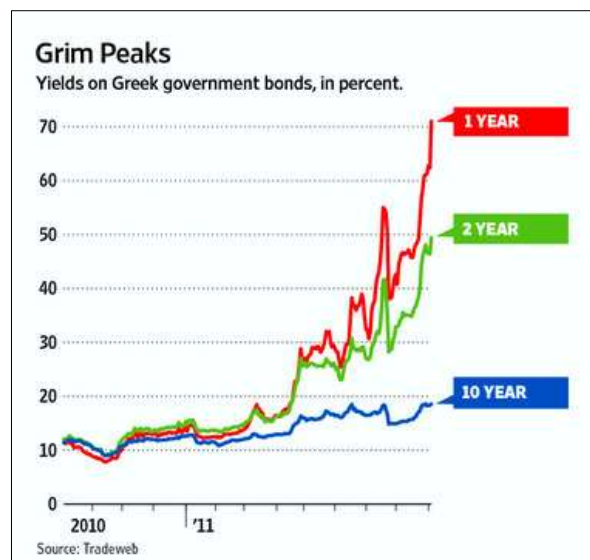
- “These banks have long been instruments of state policy in Europe,” wrote Porter Stansberry in *Investment Advisory*. “They’ve funded all kinds of government projects and favored industries. Making loans is far more popular with politicians than demanding repayment for loans. As a result, these banks are left with nothing in the kitty to repay depositors. If there’s a run on these banks (and there will be), how will they come up with money that’s owed?” Analysts estimate that European banks need a 150 billion euro capital raise to remain solvent—a need that central banks are *not* equipped to handle.
- Over recent weeks, U.S. money market funds have reduced their exposure in the Eurozone and shortened the maturity of their EU funds, adding more stress on the Eurozone banks’ liquidity. European bank paper accounted for 47% of U.S. money market fund assets on July 31, marking the lowest level since 2008, according to Fitch Ratings. From July 31 through August 19, the rolling average of 80 days or more maturity financial commercial issuance declined more than 50% from \$17 billion to \$8 billion, while the one- to four-day maturity paper increased 52% to \$44 billion and five- to nine-day maturity sales rose 75% to \$13.5 billion, according to Fed data.
- At the Jackson Hole Economic Symposium, IMF Director Christine Lagarde called on policymakers to pursue urgent action, including forcing European banks to enact a “mandatory substantial recapitalization” to prevent the descent into a worldwide recession. Lagarde urged the Group of 20 leading economies to address the Eurozone’s economic crisis and deal with strains at European banks at their November meeting. The new IMF chief called for the euro banks to be recapitalized through private channels if possible; otherwise, a Europe-wide funding source, such as the EFSF, should be used to provide the banks new capital, said Lagarde. Shoring up the European banks’ capital is the key to “cutting the chains of contagion” in EU’s spreading debt crisis, she added.
- “It is obvious that many [EU banking] organizations will not survive in the event of having to reassess their portfolios of sovereign debt at market prices,” said Josef Ackermann, CEO of Deutsche Bank, in a September 4 speech. Ackerman views the turmoil facing the EU financial sector as reminiscent of the 2008 crisis after the collapse of Lehman Brothers. Although European banks are now much better capitalized and less dependent on short-term financing term, the industry faces a long period of difficulties, because some institutions still “have not provided convincing answers to the crisis,” while the prospects for revenue growth are “limited to some extent,” said Ackerman.

- On balance, the total volume of money that the 91 Eurozone banks have raised in the wholesale and interbank markets is approximately 8 trillion euros, of which 58% must be rolled over in the next two years, while some 47% of the funding has a duration of 12 months or less. Risk aversion towards European bank credit has increased, as reflected in rising rates on CDS for six of the largest banks in Europe.



- “[T]he key tactical point is whether markets are going to afford Germany the time to allow for the slow but steady expansion of the role of the EFSF to deal with the simmering crisis,” said Christopher Wood with CLSA Asia-Pacific Markets, who expressed his doubts. “In this respect, the key fault line is funding tensions in the European banking sector which remains the epicentre of systemic risk globally.”
- “It won’t take much for the interbank market to collapse,” warned Lars Frisell, chief economist for the Swedish banking system. “It’s not that serious at the moment, but it feels like it could easily become that way and ...everything will freeze.”

- Talks over new bailout funds for Greece were suspended September 2, amid disagreements over how to fill a government-deficit gap, raising renewed doubts about the country’s ability to refinance a record 62 billion euros in September and triggering renewed nervousness in financial markets across Europe. “I expect a hard default [by Greece] before March, maybe this year, and it could come with this program review,” said an unnamed senior IMF economist, who is tracking the Greece crisis. “The chances of a second program are slim.” A hard default means a messy one that could have serious domino effect, pushing banks into bankruptcy and bond yields of other countries much higher.



- “If there is a sovereign debt crisis in Europe, it is entirely possible that 80% of Europe’s banks will be technically insolvent, depending on the level of the crisis,” wrote John Mauldin. “...The entire world economy now swings on the German voters [which oppose the creation of eurobonds by 5 to 1] and whether they will take on all of Europe’s debt, risking their own AAA status and putting themselves at serious risk. Supposedly, Finland wants collateral from Greece if it contributes its portion of a guarantee. Think every other country will not want some of that action? ...[T]his is VERY serious.” [Emphasis provided.]
- “It is only a matter of time until Europe has a true crisis, which will happen faster – BANG! – than any of us can now imagine,” wrote Mauldin in his August 27 newsletter, *Thoughts from the Frontline*. “Think Lehman on steroids. The U.S. gave Europe our subprime woes. Europe gets to repay the favor with an even more severe banking crisis that, given that the U.S. is at best at stall speed, will tip us into a long and serious recession.” (*Wall Street Journal*, Alkman Granitsas, Stelios Bouras and Costas Paris, 09/03/11; *eleconomista.es / Europa Press*, 09/05/11; ; *Outside the Box*, John Mauldin, 08/20/11 *Mish’s Global Economic Analysis*, Mike Shedlock, 09/05/11; *Breakfast with Dave*, Dave A. Rosenberg, 09/02/11; *Outside the Box*, John Mauldin, 08/29/11)
- The simmering market upheavals in Europe and the U.S. likely marks the end of a seven-decade Keynesian experiment, which viewed massive doses of deficit spending as the only possible cure for global economic collapse. Today, the markets highlight a fundamental shortcoming of Keynes’s ideas—his assumption that governments will always be able to borrow. “It is not clear that the bond markets or voters who have called an end to Keynesianism have a clear vision of what lies ahead,” concluded James MacDonald in *Foreign Policy*. “The former know only that they are no longer willing to lend [particularly in the Eurozone periphery], the latter that they are no longer willing to borrow. The great debt experiment has left the Western world with a problem that has no easy solution. The outcome is harder to predict, but in the end it is likely to involve the reduction of both private and public debts to levels that the markets consider sustainable—whether by debt write-offs or through inflation. One thing seems clear: For the first time in decades, borrowing will not form part of the solution.” (*Foreign Policy*, James MacDonald, 08/18/11)

Mounting wave of litigation over mortgage losses hits U.S. banks

FHFA sues 17 banks over GSEs' losses on private-label mortgage-backed securities

Goldman Sachs reaches settlement with the Federal Reserve and New York Regulators to facilitate the sale of its mortgage servicers

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Stress testing Bank of America

FHFA sues 17 banks over GSEs' losses on private-label mortgage-backed securities

- The Federal Housing Finance Agency filed lawsuits against 17 of the nation's largest financial institutions, alleging violations of federal securities law and common law in the sale of residential private-label mortgage-backed securities to Fannie Mae and Freddie Mac. The complaints, which were filed in the federal or state court of New York or the federal Court in Connecticut, seek damages and civil penalties under the Securities Act of 1933 and compensatory damages for negligent misrepresentation. Certain complaints also allege securities law violations or common law fraud.
- The following table provides a list of the banks, along with the amount of loans purchased by the GSEs from each institution. Bank of America, along with its Countrywide Financial and Merrill Lynch subsidiaries, sold approximately \$57.5 billion of private-label MBSs to Fannie and Freddie, representing approximately 29% of the GSEs' private-label MBS purchases.

<u>Name</u>	<u>Amount</u> <u>(\$Billions)</u>
Ally Financial/GMAC	\$6.000
Bank of America	6.000
Barclays Bank	4.900
Citigroup	3.500
Countrywide Financial	26.600
Credit Suisse Holdings	14.100
Deutsche Bank	14.200
First Horizon National Corporation	0.883
General Electric Company	0.549
Goldman Sachs	11.100

HSBC North America Holdings	6.200
JPMorgan Chase	33.000
Merrill Lynch	24.853
Morgan Stanley	10.580
Nomura Holding America	2.000
The Royal Bank of Scotland	30.400
Société Générale	<u>1.300</u>
Total	\$196.165

- FHFA’s actions represent the most sweeping mortgage lawsuits filed to date from a federal regulator or any private investor. The total number of named defendants here, including various different individuals and corporate entities, is a whopping 268, including a small amount of double-counting. Notably, Wells Fargo Bank is not currently one of the institutions sued. According to *Reuters*, Wells Fargo “entered a ‘tolling’ agreement waiving its right to claim the FHFA waited too long to sue... Wells Fargo might have done this to give it time to negotiate its own settlement.” (*Reuters*, 09/02/11)
- In July, FHFA filed a similar lawsuit against UBS, seeking to recover at least \$900 million in losses related to private-label MBS purchased by the GSEs. (*Reuters*, Felix Salmon, 09/02/11; *New York Times*, Nelson D. Schwartz, 09/01/11; *Wall Street Journal*, Nick Timiraos, 09/03/11)
- “The U.S. government is suing 17 banks to recoup \$196 billion (Dh719 billion) spent on mortgage-backed securities by Fannie Mae and Freddie Mac, the agencies it used to support the housing market in the country,” wrote *The [Arab] Gulf News*, published by Al Nisr Publishing. “The agencies purchased the securities from the biggest banks in the world, which had wrapped up sub-prime loans into the investment products. When the US housing market collapsed, sparking the global financial meltdown, the losses incurred by Fannie Mae and Freddie Mac were so huge they had to be taken over by the government. Now, the Federal Housing Finance Agency wants the courts to rescind the transactions and award damages. It is difficult not to believe the administration is doing little more than trying to ensure that the banks remain the target of popular anger, at a time when the economy remains unable to create jobs and is still under threat of recession.”
- “While the banks seemingly did not make it clear how vulnerable the securities were, as investors, Fannie Mae and Freddie Mac had a responsibility to ensure that they understood the products they were buying. The US regulatory authorities and credit rating agencies also failed to adequately warn of the dangers of the investments. While the banks are by no means innocent, they should not stand alone in the dock.” (*The Gulf News*, 09/05/11)

Goldman Sachs reaches settlement with the Federal Reserve and New York Regulators to facilitate the sale of its mortgage servicers

- Goldman Sachs entered into agreements with the Federal Reserve Board and the New York Banking Department, regarding the sale of its Litton Loan Servicing subsidiary to Ocwen Loan Servicing, headquartered in Atlanta, GA. The Federal Reserve determined that Goldman's loan servicing unit had engaged in "a pattern of misconduct and negligence" in its handling of home mortgages, which included the engagement in robo-signing and took actions in bankruptcies and foreclosures "without always confirming that documentation was in order." Goldman entered into an agreement with the Federal Reserve that agreed to (i) make changes to Litton's mortgage servicing practices as outlined in a 62-point mortgage servicing practices agreement, which Litton and Ocwen committed to implement; (ii) retain an independent consultant to review foreclosures that were pending in 2009 and 2010 and "provide remediation to borrowers who suffered financial injury as a result of wrongful foreclosure or other deficiencies;" and (iii) paying unspecified monetary damages.
- Goldman's agreement with the New York Banking Department calls for (i) Ocwen to provide borrowers a single-point of contact and adequate loan servicing staffing; and (ii) a review of each loan modification request that is denied. Goldman agreed to a write-down \$13 million in loan principal for certain New York state borrowers who are behind in their payments and whose loans Goldman owns. The New York Banking Department had additional leverage in working with Goldman, since the regulator served as a reviewer of the Litton sale to Ocwen.
- "Our agreement sets a new higher standard for residential mortgage servicing, whose troubling foreclosure and servicing practices we have been investigating along with other regulators across the country," said New York Banking Superintendent Benjamin Lawsky. "Goldman Sachs, Ocwen and Litton have now all agreed to put the rights of homeowners ahead of their profit margins by implementing these changes."
- In June, Goldman announced its plans to sell Litton to Ocwen for \$264 million, well below the \$428 million that the investment banker spent to acquire the loan servicer in 2007. (*Wall Street Journal*, Liz Rappaport, 09/01/11; *American Banker*, Kevin Wack, 09/01/11; *Bureau of National Affairs*, Stephen Joyce, 09/02/11 *Wall Street Journal*, Ruth Simon, 09/02/11)

Bank of America faces a deluge of mortgage-related law suits, while its stock gives up some of its Berkshire/Hathaway "bounce"

- Bank of America faced a host of recent legal filings related to the bank's announced \$8.5 billion settlement of Countrywide MBS noteholders' breach-of-warranty claims

with Bank of New York Mellon, the MBS trustee, on behalf of a group of 22 major investors. Related filings included:

- A “revolutionary” filing by the New York Attorney General, Eric Schneiderman (D), who is seeking to intervene in the proposed \$8.5 billion settlement. Specifically, Schneiderman countersued Bank of New York Mellon (BNYM), alleging three causes of action. First, Schneiderman accused BNYM of breaching its fiduciary duty and said that Bank of America (BoFA) may have aided and abetted the breach. Specifically, he claimed that BNYM breached its duty because the settlement includes indemnification for the trustee—a “direct financial benefit” for BNYM. Second, BNYM let MBS investors down long before the proposed settlement by failing to inform them that the underlying Countrywide mortgages were in default. Finally, Schneiderman accused BNYM of securities fraud under the state’s Martin Act. Schneiderman filed counterclaims against BNYM, along with his intervention motion. (www.reutersblog.com, Alison Frankel, 08/05/11)
- Joseph Biden III, Delaware’s Attorney General, moved to intervene in BoFA’s proposed \$8.5 billion settlement. “Is it possible to reach a settlement with investors?” asked Delaware Deputy AG Ian McConel. “You do that by including more than the trustee, the underwriter, and 22 investors. A settlement has to be done in a holistic way [by including the regulators].” (www.reutersblog.com, Alison Frankel, 08/10/11)
- A \$10 billion fraud lawsuit filed by AIG and the insurer’s simultaneous motion to intervene in opposition to the proposed \$8.5 billion settlement. AIG’s lawsuit pursues claims of fraud, as opposed to underwriting deficiencies, to avoid having to show that it meets the threshold of controlling 25% of the voting rights in a securitization case. BoFA’s proposed settlement is expressed limited to breach of warranty claims and doesn’t resolve security fraud claims. (www.reutersblog.com, Alison Frankel, 08/09/11)
- Four homeowners filed suit in Federal District Court in Manhattan, seeking to block the BoFA \$8.5 billion settlement. “There is growing realization that this settlement needs more scrutiny,” said Keith Fleishman, a lawyer representing the homeowners. “It needs to address the housing crisis itself.” (*New York Times Dealbook*, Nelson Schwartz, 08/30/11)
- Graus & Ellsworth, the lawfirm leading the fight against BoFA’s \$8.5 billion settlement for MBS investors, filed a motion to remove the case from the New York State Supreme Court to the federal court. “The purpose of removal is to make sure that this proceeding is adjudicated in the proper forum,” wrote Graus & Ellsworth. “We believe in good faith that this proceeding is subject to federal jurisdiction as a mass action under the Class Action Fairness Act.” To date, the proceeding had been handled under Article 77 of the New York rules of civil procedure, which gives broad leeway to trustees, who are presumed to be acting

in the interest of trust beneficiaries unless someone can show they acted unreasonably. (www.reutersblog.com, Alison Frankel, 08/26/11)

- Other intervention filings against BofA's proposed \$8.5 billion settlement included (i) the Federal Deposit Insurance Corporation, as receiver for numerous banks and owner of certificates issued by many of the trusts that would be covered by the settlement; (ii) the Federal Housing Finance Agency, as receiver for Fannie Mae and Freddie Mac; (iii) six Federal Home Loan Banks, (iv) Goldman Sachs; (v) American Fidelity Assurance; (vi) Waterfall Eden Master Fund; and (vii) Talcott Franklin of Investors Clearinghouse, on behalf of nearly three dozen Countrywide MBS noteholders, largely consisting of insurance companies, hedge funds and small- and medium-sized banks. (www.reutersblog.com, Alison Frankel, 08/30/11; *HousingWire*, Kerri Panchuk, 08/31/11)
- U.S. Bancorp, serving as trustee of \$1.75 billion portion of a mortgage pool originated by Countrywide in 2005, sued BofA to force the repurchase of the underlying loans. U.S. Bancorp contends that the loans were made without proper documents and did not conform to underwriting standards. (*American Banker*, Jeff Horowitz, 08/31/11)
- The State of Nevada amended its complaint against Countrywide Financial, accusing the lender of a "pattern and practice of deceptive conduct ... [with] misconduct cutting across virtually every aspect of Defendant's operations—from originating to servicing, and all too often, to foreclosing on loans and homes of Nevada consumers." This filing dramatically expanded the state's lawsuit against BofA, turning the narrow case addressing loan modification issues that was filed late last year into a broad filing, targeting virtually all aspects of the bank's mortgage operations. "Taken together and separately, [BofA's] deceptive practices have resulted in an explosion of delinquencies and unauthorized and unnecessary foreclosures in the State of Nevada," the lawsuit alleges. (*New York Times*, Gretchen Morgenson, 08/31/11; *ProPublica*, Paul Kiel, 09/02/11)
- New York has a six-year statute of limitations on fraud and contract claims, while other states have narrower windows for such claims. The FHFA cases were reportedly filed to comply with a three-year statute, "It's clear that deadlines are coming," said Peter Calamari with Quinn Emanuel Urquhart & Sullivan, LLP. (www.reutersblog.com, Alison Frankel, 09/02/11)
- The Federal Reserve recently asked Bank of America's management to provide them a list of options that the bank might take to raise capital if the company's financial condition worsens, said people familiar with the matter. Management provided the regulators a list of options, which included the issue of a separate class of shares tied to the performance of Merrill Lynch Securities subsidiary. On August 22, BofA raised \$5 billion of preferred stock through a private placement with Warren Buffett's Berkshire Hathaway Inc. The bank also reached an agreement to sell half of its

shares in China Construction Bank Corp, generating a \$3.3 billion profit. BofA continues to operate under a non-public memorandum of understanding with its regulators, that it entered into in May 2009. (*Dow Jones*, 09/02/11)

Stress testing Bank of America

- “How much cost and uncertainty can government impose on a U.S. bank before it buckles under the strain?” asked the *Wall Street Journal* in an August 26 editorial. “Federal and state officials are now running this experiment at Bank of America. Call it the new method of stress-testing in the era of Dodd-Frank—seeing how much of the tab for bad housing policy can be imposed on shareholders before a bank is once again in need of help from taxpayers.”
- “...Regulators seem to have forgotten how they cheered BofA when it agreed to acquire the troubled mortgage lender in the midst of the financial panic. The alternative then was letting Countrywide fail, triggering more panic, or a taxpayer bailout. Now the federal seers seem intent on using the Countrywide deal as leverage to force the bank to eat the costs of the Obama Administration's foreclosure-prevention policies.”
- “Former White House consumer-financial czar Elizabeth Warren and a pack of state attorneys general have ignored the fact that investigations into ‘robo-signing’ and other foreclosure paperwork problems failed to uncover actual victims of harm. Unable to find new anecdotes of borrowers who were current on their mortgages and still subjected to foreclosure, government lawyers have demanded tens of billions of dollars from banks anyway, as well as costly process changes to assist delinquent borrowers and slow foreclosures. Thanks to its Countrywide blunder, BofA would be liable for perhaps the largest share of any such settlement.”
- “A specific problem in New York might be called the Schneiderman Short. New York Attorney General Eric Schneiderman is so eager to keep plundering the financial industry that he's making the other politicians driving the robo-signing cases look moderate. This week he was kicked off the negotiating committee by the other state AGs because he wouldn't agree not to launch similar suits if the banks settle the pending ones. He also intervened recently to disrupt a private mortgage settlement between Bank of America and Bank of New York Mellon because he wanted BofA to pay more. Delaware AG Beau Biden, son of America's Vice President and future Senate candidate, has also tried to derail a nationwide settlement because he too doesn't want the mortgage litigation party to end.”
- “Surveying this bleak landscape and eyeing continued weakness in the housing market and the economy, Bank of America's equity investors fear that the bank might need to raise more capital and therefore dilute their investments. This fear would be diminished if investors were more optimistic about the bank's ability to post higher earnings.”

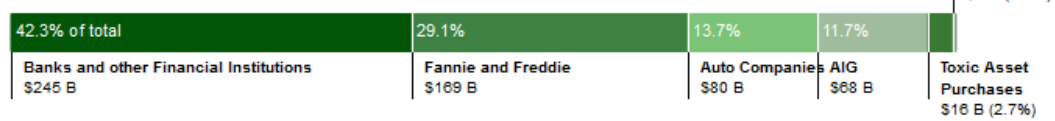
- “But Dodd-Frank and other legislation signed by President Obama have reduced the ability of all banks to earn money from credit and debit cards, among other lines of business. Since its business is concentrated in the United States, BofA is also particularly vulnerable to the failures of Obamanomics. Throw in the burdens being developed at the new Consumer Financial Protection Bureau inspired by Mrs. Warren, and the fear quotient rises that earnings alone may not be able to pay for bad mortgages and worse housing policy.”
- “Investors seem to have decided for the moment that Bank of America has so much capital and liquidity that it can continue to afford government-created mortgage uncertainty. And Mr. Buffett says that he is ‘impressed with the profit-generating abilities of this franchise.’ But if he and the bank's common stockholders are wrong, Dodd-Frank ensures that BofA and other big banks can be bailed out again with emergency loans from the Federal Reserve, as long as the Treasury Secretary approves.”
- “Here's a better idea: Make bank shareholders pay for the mistakes made by their management, not by Washington. Let banks foreclose on borrowers who don't meet their contractual obligations, and let banks fail if they still can't make a profit. If regulators are afraid that an institution like Bank of America is too big to fail, then break it up. But stop using it as a piggy bank to fund destructive policies that will only prolong the housing downturn.” (*Wall Street Journal*, 08/26/11)



TARP

The State of the Bailout

OUTFLOWS: \$580 billion This includes money that has actually been **spent, invested, or loaned**.



INFLOWS: \$343 billion Money returned and paid to Treasury as interest, dividends, fees or to repurchase their stock warrants.



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

AIG Financial Products Division turns profitable in the final days of its wind down

AIG plans offering of ILFC Holdings

U.S. Court of Appeals vacates convictions of former Gen Reinsurance Corp. and AIG executives

AIG Financial Products Division turns profitable in the final days of its wind down

- Against all odds, the AIG Financial Products Division (AIGFP) which nearly brought down the insurer turned into a profit center in the aftermath of the 2008 financial crisis. Since the start of 2009, AIG generated \$4 billion in operating profits, as the bulk of the AIGFP's derivative trades were unwound, said company executives. AIGFP has about 2,200 derivatives trades that remain outstanding with a notational value of \$198.4 billion, following tear-ups of sales of 90% of AIGFP's open positions before the crisis. The remaining trades are predominantly "of low complexity, low risk, supportive of AIG's risk-management objectives, or not economically appropriate to unwind" at this time, said the insurer. (*Wall Street Journal*, Serena Ng, 08/06/11)

AIG plans offering of ILFC Holdings

- AIG plans to sell more than 20% of its ILFC Holdings Inc. plane-leasing subsidiary in an initial public offering, as part of the insurer's efforts to divest at least 80% of the unit over three years. "AIG has determined that ILFC is not one of its core businesses," said the insurer. "The IPO is the first step in AIG's plan to monetize its

interest in ILFC.” Details on the offering, including the number of shares offered, price and timing, haven’t been determined, said AIG in an SEC filing.

- ILFC, the world’s largest independent aircraft lessor, may be worth about \$3 billion, said Sandler O’Neal analyst Paul Newsome. “One of the problems with the offering of ILFC is there’s a very wide range of valuations,” said Newsome. “My sense is investors will probably take the most pessimistic view until it’s completed.” (*Bloomberg News*, Andrew Frye and Julie Alnwick, 09/02/11)

U.S. Court of Appeals vacates convictions of former Gen Reinsurance Corp. and AIG executives

- The U.S. Court of Appeals of the Second Circuit vacated the convictions of four former General Reinsurance Corp. Executives and one former AIG executive, stemming from their alleged roles in a fraudulent reinsurance transaction to manipulate AIG’s financial statements. The appeals court ruled that the convictions must be vacated because the district court abused its decision in admitting certain stock price data, and because it issued a jury instruction that directed the verdict on causation. The five former executives had been convicted of conspiracy, securities fraud, and other charges related to their alleged roles in the controversy and had been sentenced to prison terms ranging from one- to four-years. (*Bureau of National Affairs*, 08/03/11)

GM reports strong auto sales in August—with the exception of the Volt

GM announces plans to sell a Cadillac EV in 2014

What are taxpayers getting for their money at GM?

Washington Post: “When will the Obama administration sell GM?”

GM reports strong auto sales in August—with the exception of the Volt

- General Motors reported an 18% increase in sales in August with solid results across the board, including (i) sales of the Chevrolet Cruze exceeding 20,000 for the fifth month in a row; (ii) strong sales in SUVs and crossovers with big jumps in sales for the Terrain and Acadia and Chevy’s large Suburban and Tahoe SUVs; and (iii) sale of trucks up 18% overall.
- However, August sales for the Chevy’s Volt were disappointing with only 302 units sold [versus 1,362 Nissan Leaf sales for the month]. During a conference call with analysts, GM officials faced questions about the Volt’s sagging sales. GM responded

that it would take another month or two to fill retail inventory and that it would not know where the ultimate demand for the vehicle would be until the second quarter of 2012. “The GM response actually drew laughs [from the analyst asking the question],” wrote Mark Modica, an associate fellow with the National League and Policy Center. GM officials remain confident that the Volt will meet expectations, saying that the EV does not require wide appeal to reach its sales target of 40,000 in 2012 for both the Volt and its European version, the Amerpa

- A new CNW study concluded that potential buyers for the Volt are rapidly losing interest in Chevy’s EV. The study concluded that the number of those likely or very likely to consider the Volt fell from a combined 71% in March to 51% in July. When the auto analysts turned to mainstream consumers—those not identified as EV Enthusiasts—the trends are even more troubling. The study concluded that only 3% of mainstream car buyers were likely to consider the Volt. (www.autobloggreen.com, Eric Loveday, 09/01/11; www.nlpc.org, Mark Modica, 09/02/11)

GM announces plans to sell a Cadillac EV in 2014

- GM is moving forward with its plans to produce a Cadillac EV—the ELR—to be built in 2013 as a 2014 model. The ELR will use the same version of the Voltec that powers the Volt, including the same four-cylinder 1.4L generator, making it “nothing more than a reskinned Volt instead of the tuned electric roadster worth of that sexy sheet metal,” wrote Matt Burns on *TechCrunch.com*. “Development of the ELR is just underway, so details on performance, price and timing will be announced later,” said G.M. (*TechCrunch.com*, Matt Burns, 08/17/11)



What are taxpayers getting for their money for GM's EVs?

- “It is time to ask what the taxpayers are getting in return for their money,” wrote NLPC’s Mark Modica. “ It is hard to justify the continued expenditures given the non-existent benefits of the Chevy Volt. One would also have to assume, given the fact that GM (i.e. the taxpayer) is losing money on the Volt, that the development of the Cadillac version is motivated by something other than expectations of profits from sales of the vehicle. Besides benefiting cronies at companies like GE that will gain from the taxpayer bilking by selling charging stations, there is little reason to pursue production of a cloned Volt in its current form. The only other reason would be to continue to receive taxpayer funds from a government that has a vested interest in presenting GM as a success story.” (www.nlpc.org, Mark Modica, 09/02/11)

Washington Post: “When will the Obama administration sell GM?”

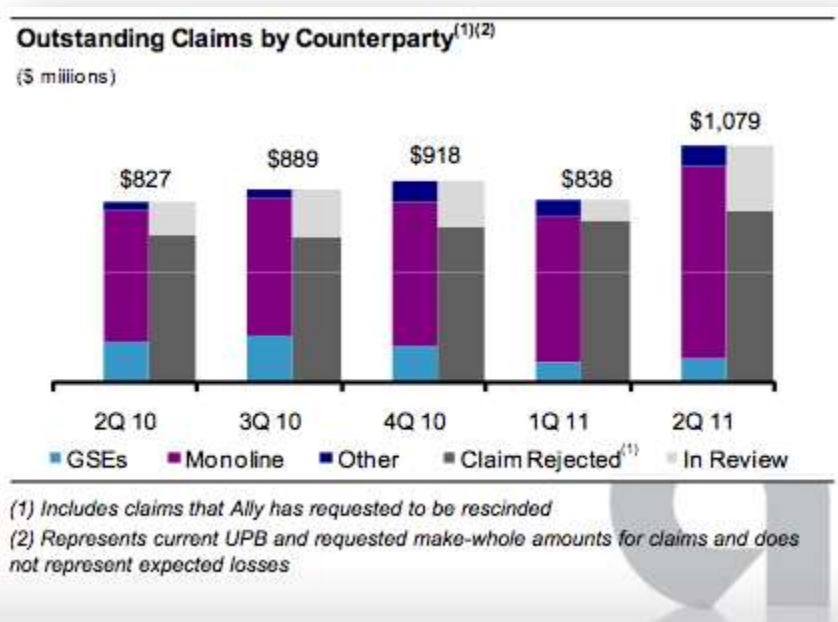
- “This is an editorial page, not a stock tip sheet,” wrote the *Washington Post*. “Still, maybe the Obama administration should have paid attention when we urged it to start selling off the Treasury Department’s stake in General Motors. That was on April 25, when GM’s stock sold at about \$30 per share. The administration didn’t sell then, and it’s still not selling — with GM down to about \$23.” [GM closed at \$22.07 on September 2.]



- “So much for all those reports that Treasury wanted to exit GM by summer’s end, just as it exited its much smaller stake in Chrysler this year amid much fanfare. The government continues to hold 500 million shares, about 26.2 percent of GM; its hesitation has cost the taxpayers \$3.5 billion in paper losses since our editorial.”
- “To be sure, market timing is a mug’s game. The goal of sinking \$51.3 billion into a restructured GM was not to make a profit for the Treasury; it was to rescue a major part of the U.S. manufacturing base. In fact, the likeliest outcome all along has been that the government — i.e., the taxpayers — would lose money. History will judge the GM rescue based on the totality of its results, which include not only the dollar cost to taxpayers but also the broader benefits of avoiding an industrial meltdown at the height of the 2009 recession.”
- “However, the administration’s policy creates the appearance of playing politics with its GM stake. Hanging on to the stock, even as it drops, protects President Obama from the hit he will take when the government’s loss changes from hypothetical to real. But a buy-and-hold strategy isn’t without cost to the Treasury — i.e., the taxpayers. Like any other investor who keeps his money tied up in an underperforming asset, the Treasury forfeits the benefits it might reap by cutting its losses and redeploying its funds, perhaps to reduce the deficit. And, of course, it runs the risk that the stock will go down even more.”
- “No one is saying the government should hold a fire sale. But it could announce a plan to sell its shares in GM at regular intervals over the coming months, regardless of price, so as to minimize market distortions. There will be losses. The benefits, though, would include reassuring the business community that this president really does have an exit strategy for federal ownership of industry — and relieving GM of the ‘Government Motors’ stigma, which still hampers its efforts to woo car buyers and prospective executives.”
- “As we said in April, selling GM creates financial risk for taxpayers and political risk for Mr. Obama no matter when the government does it. So Treasury might as well get on with the job. Maybe this time it’ll take our advice.” (*Washington Post*, 08/27/11)
- Treasury would have to sell its remaining shares in GM for \$54 a share to recoup its investment in the automaker, according to a GAO analysis released in May. GM’s stock priced closed at \$22.07 on September 2. (*Treasury’s Exit from GM and Chrysler Highlights Competing Goals, and Results of Support to Auto Communities Are Unclear*, GAO, May 2011; www.yahoofinance.com, 09/05/11)

Ally announces 80% decline in second quarter earnings due to mortgage buybacks

- Ally Financial’s net income fell 80% in the second quarter from the year ago period, as the company’s increased mortgage repurchases adversely impacted earnings. Ally reported net income of \$113 million for the three months ended June 30, which included a \$174 million loss from its legacy portfolio, related to its \$184 million of mortgage repurchases. The company’s losses in the mortgage unit, which were offset in part by lower loan loss provisions, totaled \$127 million for the quarter.
- Ally reported more than \$1 billion outstanding in mortgage repurchases on June 30, up 28% from the prior period.



(Source: Ally Financial Inc. 2Q Earnings Review, 08/02/11)

- “We continue to be vigilant in evaluating risks related to our mortgage business and addressing them appropriately,” said CEO Michael Carpenter. “As a result, we took some additional repurchase reserves during the second quarter. Reducing risk in our legacy portfolio has been among our top priorities. This is evidenced by our leading position in loss mitigation efforts and the repurchase settlements reached last year with Fannie Mae and Freddie Mac.”
- On September 2, the Federal Housing Financial Agency sued Ally Financial for the \$6 billion of toxic mortgages the originator sold to Fannie Mae and Freddie Mac.
- During the second quarter, Ally Financial spent \$200,000



lobbying members of Congress on financial reform and other issues, which is less than the company spent in the first quarter (\$340,000) but exceeds its lobbying expenses in the year-ago period (\$180,000). (*Washington Post's Political Economy Blog*, Sarah Halzack, 09/02/11; *HousingWire*, Jason Philyaw, 08/02/11; *Associated Press*, 08/16/11; *HousingWire*, Jon Prior, 08/03/11)

D.C. Court of Appeals' ruling will likely delay Dodd-Frank rules
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- On July 22, the U.S. Court of Appeals for D.C. District Court ruled that the SEC did not properly conduct a cost-benefit analysis before finalizing a proxy rule required under the Dodd Frank Act. In the ruling, Justice Douglas Ginsburg said that the SEC had acted “arbitrarily and capriciously” in failing to adequately assess the economic effect of the rule. Moreover, the SEC had “consistently and opportunistically framed the costs and the benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters.”
- “The entire Dodd-Frank implementation is at heavy risk because if any of these rules are challenged by the courts, they won’t survive,” said Hal Scott, Nomura Professor and Director of the Program on International Financial Systems at Harvard Law School. “[Rules issued under Dodd Frank by other agencies will be] completely attackable under this decision.”
- “Our regulatory agencies are not undertaking rigorous and deliberate analysis to understand the economic impact of their actions,” said Senator Richard Shelby (R-AL) after the court decision was announced. “The decision is an unequivocal validation of the concerns that Republicans have raised repeatedly over the past year.”
- “It is the shot across the bow saying the cost benefit analysis needs to be something done well and should be front and center in assessing the impact of regulations,” said Randall Kroszner, a former member of the Federal Reserve Board and currently a professor at the University of Chicago.
- “The immediate impact is that it puts the Dodd-Frank rulemaking under a sharper microscope,” said Tom Quaadman, VP of the Chamber of Commerce’s Center for Capital Markets Competitiveness. “There’s no question that there’s going to be much heightened scrutiny.” (*American Banker*, Donna Borak, 08/02/11)

A “mugging” in the U.S. Senate

- “Once upon a time, we could have expected the following sequence: After considerable debate, Congress would have passed a bill creating an agency. The president would then nominate someone to head that agency. That nomination would be considered on its merits by the Senate,” wrote Representative Barney Frank (D-MA) in a commentary in the *Washington Post*.
- “But this is now. The president has nominated Richard Cordray, an able, experienced and thoughtful former state attorney general who has a record of achievement in protecting individuals against financial abuse, to head the Consumer Financial Protection Bureau. And the Republican minority in the Senate has announced that it intends to deny any consideration of the individual whom the president has nominated pursuant to his constitutional prerogative. They will do that by blatantly distorting the Constitution, substituting a refusal to allow the constitutionally mandated nomination process for the legislative process in which they simply do not have the votes to accomplish what they want.”
- “Cordray is just the latest capable, dedicated public servant to fall victim to a Republican mugging. He joins Joseph Smith, the banking commissioner of North Carolina who recently drew unanimous bipartisan support from the North Carolina General Assembly for his renomination; Peter Diamond, a Nobel laureate in economics who was nominated to serve on the Federal Reserve System’s Board of Governors; and others as collateral damage of the Senate Republicans’ war on financial regulation in particular and the Obama presidency in general. Cordray’s record as attorney general of Ohio puts him in a small group of people able to act effectively to deal with the mortgage crisis. No one has raised any questions about his intelligence, integrity or dedication.”
- “Yet his nomination will not even be fairly considered by the full Senate. Forty-four Republicans have announced that in disregard of their constitutional duty to consider nominations on the merits. They will not confirm anyone until the Senate majority reverses itself to once again put bank regulators in a position to overrule virtually all of the policies that would be set by the consumer agency. The president is being told that the price of having a nominee confirmed is reversing himself on a major policy initiative that has already been enacted.”
- “It is, of course, entirely legitimate for Republicans to object to the independence of the consumer agency and to press for their solution, which is to allow bank regulators to overrule that agency. It should be remembered that the chairman of the House Financial Services Committee, Spencer Bachus, noted that ‘the regulators are there to serve the banks.’ While they are entitled to that opinion, Senate Republicans are not entitled to use the confirmation power as a bludgeon to get their way when they cannot do so through the normal legislative process.”

- “There is an interesting consequence of the Republican effort to undermine the most important consumer protection step the Congress has taken in a long time. Out of deference to the Senate confirmation power — before supporters of the bill realized how blatantly it would be misused — the legislation creating the agency specified that a number of the bureau’s powers would not take effect until the agency has a director.”
- “This is key because the economic crisis would not have been so bad had only deposit-taking institutions, which are insured and regulated by the federal government, made mortgage loans. A large number of non-banks continue to operate outside of federal regulation and, in many cases, without significant state regulation. A large majority of these other entities behave responsibly, but there are enough abuses among those that are under-regulated to make it important that full regulation be allowed. The Bush administration overrode consumer protection laws regarding national banks in those states where they existed. In some cases mortgage originators were allowed to have tenuous connections to national banks, which resulted in further insulation from state law. Community banks have to compete with many of these entities, and they will continue to suffer from unfair competition and pressure to do things they would rather not do if the new bureau is not able to assume its full powers.”
- “Cordray’s hearing is scheduled for Tuesday, and we’re going to see an extraordinarily qualified administrator of an important consumer protection agency be trashed by the Senate Republican minority because their primary goal is to ensure that financial institutions are not troubled by what they may see as an excessive concern for consumer fairness. They are now refusing to confirm any recess appointment, not because of flaws of the appointee but because of an unachievable legislative objective, followed by an objection to a presidential recess appointment. It is the legislative equivalent to an arsonist having set a fire and objecting to a building’s inhabitants using the fire exit.” (*Washington Post*, Representative Barney Frank, 09/01/11)

Fannie Mae and Freddie Mac

The GSEs completed 135,000 home retention and 32,000 home forfeiture actions during the second quarter

Treasury withholds HAMP funds for Bank of American and JPMorgan Chase

Federal Reserve identifies four stumbling blocks to HARP's effectiveness and the need for a conversion of single-family REO to rental units

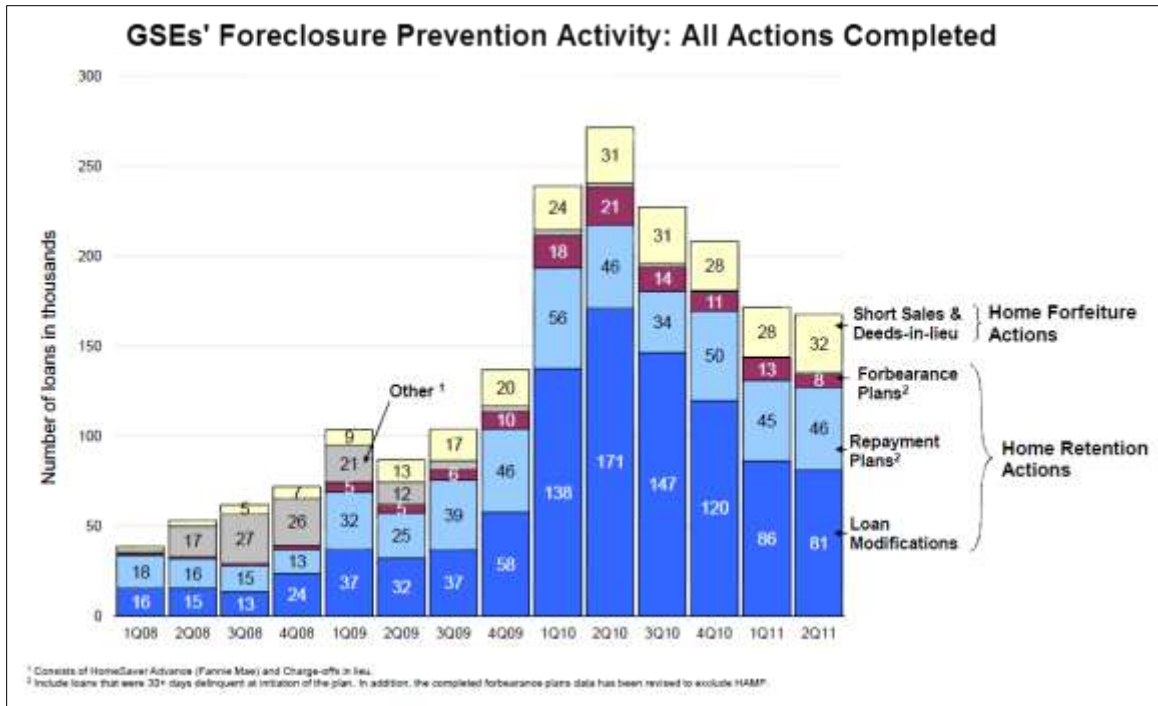
Ways to make HARP more effective in helping distressed homeowners

Refinancing "hype" overstates the administration's deliberations on massive refi program

Housing market remains in shambles

The GSEs completed 135,000 home retention and 32,000 home forfeiture actions during the second quarter

- Fannie Mae and Freddie Mac completed 81,000 loan modifications, 46,000 repayment plans and 8,000 forbearance plans during the second quarter, along with 32,000 home forfeiture actions. Home retention actions accounted for 80% of all actions completed during the quarter. The GSEs' completed foreclosure prevention actions declined for the fourth consecutive quarter, as a result of decreases in the number of completed loan modifications and forbearance plans.
- Fannie Mae and Freddie Mac have completed more than 1.8 million foreclosure prevention actions since the fourth quarter of 2008 with more than half of the actions taken consisting of loan modifications and 13.4% comprised of home forfeiture actions. (*Foreclosure Prevention and Refinance Report*, Federal Housing Finance Agency, Second Quarter 2011)



(Source: Foreclosure Prevention and Refinance Report, Federal Housing Finance Agency, Second Quarter 2011)

Treasury withholds HAMP funds for Bank of America and JPMorgan Chase

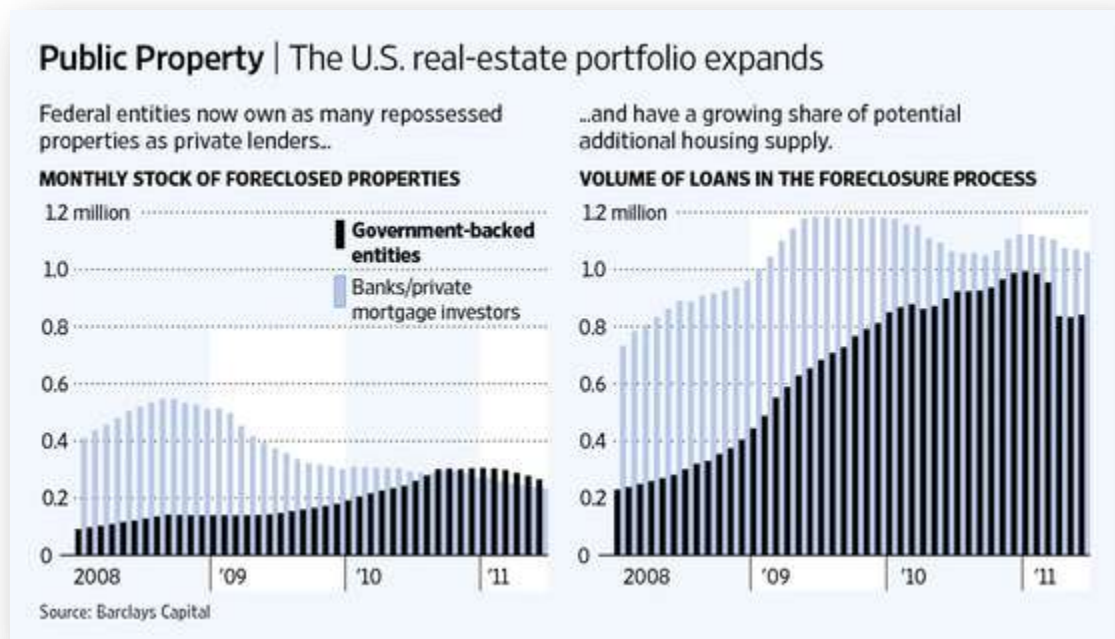
- The Treasury Department is withholding payments to Bank of America and JPMorgan Chase for their poor performance in modifying mortgages in the second quarter. Both banks need to make substantial improvement to their mortgage servicing operations for HAMP, according to the agency’s compliance review. In the first quarter, Treasury withheld HAMP payments to the two Banks and Wells Fargo due to poor performance. During the second quarter, Wells Fargo made the mandated improvements, triggering the release of withheld funds by Treasury. If BofA and JPMorgan Chase fail to make the mandated corrections, Treasury could permanently reduce its payments to the banks. (*HousingWire*, Jon Prior, 09/01/11)

Federal Reserve identifies four stumbling blocks to HARP’s effectiveness and the need for a conversion of single-family REO to rental units

- In a September 1 speech, Federal Reserve Board Governor Elizabeth Duke outlined four factors that the central bank has identified that have limited the effectiveness of the Home Affordable Program—(i) loan level pricing adjustments, which increases the cost of refinancing for an existing loan; (ii) limited lender competition due to concerns about “putback” risk from previous underwriting; (iii) junior lien holders, who in some cases are refusing to allow their loans to remain subordinate to the proposed refinanced mortgage; and (iv) mortgage insurers, some of whom will not agree to reunderwrite their new mortgage policies. “The common theme in all of

these frictions is that, in each case, the parties to the transaction are applying risk-management tools that would normally apply to low- or no-equity loans—but they are applying them to risk they already own,” said Duke. “The economics of the situation suggests that if the first mortgage becomes more affordable, the existing risk exposure of all credit risk actually decreases.” Moreover, the extent to which widespread refinancing reduces the overall volume of distressed mortgages, they likely will reduce the downward pressure on home prices, leading to lower losses on sales of REO properties, she added. Removal of these barriers to refinancing would boost the economic recovery provided by lower long-term interest rates, said Duke.

- Duke also addressed the need to convert residential REO—an estimated 1 million properties each year in 2011 through 2013—into rental properties. The Fed estimates that 500,000 to 600,000 of the 2 million vacant homes for sale in the second quarter of 2011 were REO properties, said Duke. The current inventory of homes for sale represents a nine months’ supply, resulting from very low demand in the market. Weak purchase demand coupled with growing demand for rental housing suggests the need to transition some REO properties into the rental market, she said.



- The Federal Housing Finance Agency, Treasury and HUD, issued a request for information to obtain suggestions for the disposition of large volumes of REO owned by Fannie Mae, Freddie Mac, and FHA. Together, these GSEs hold about half of the REO inventory, which may afford a bulk sale of properties to investors and financial institutions in given markets to facilitate a cost-effective rental program. Duke noted that converting REO properties to rentals will not work in all cases, particularly where the homes are too damaged or otherwise low-value. The Fed estimates that approximately 5% of the GSEs’ and FHA’s REO inventory is appraised at less than

\$20,000, and in some markets that share is significantly higher. In these cases, often the cost to demolish or repair the home exceeds its fair market value, and creates the need for a different type of solution, she added. In these cases, the use of a land bank, through which local communities gain control of low value properties and rehabilitate and dispose of the properties in a manner suitable to the local market, may be the key to resolving area blight and help local markets stabilize. (*Prepared Remarks*, Governor Elizabeth Duke, 09/01/11; *Bureau of National Affairs*, Thecla Fabian, 09/02/11; *Wall Street Journal*, Nick Timiraos, 08/10/11)

Obama administration is expected to unveil improved mortgage refi plan

- The Obama administration is considering unveiling new plans to revamp Home Affordable Refinance Program (HARP) that would allow certain borrowers to refinance their loans that are backed by Fannie Mae, Freddie Mac and FHA. However, a broad-based effort to automatically refinance millions of mortgages is not in the works, sources told *Reuters*. Instead, the administration is looking to make targeted changes to HARP, which could potentially allow borrowers to take advantage of low interest rates even if the borrowers owe more on their mortgage than their home is worth. (*Reuters*, Margaret Chadbourn, 08/31/11)
- In an August 31 report, Amherst Securities' Laurie Goodman outlined three changes that could be made to HARP to improve the program's ability to help distressed homeowners. The first proposed change is the elimination loan level pricing adjustments (LLPAs), which are currently capped at 2%. Since the GSEs already have the risk of the original loan, why charge the LLPAs? "We believe that this is the single most likely change," wrote Goodman. "...Removing LLPAs in and of itself will have a minimal impact."
- Secondly, Goodman recommends that loan documentation be streamlined, particularly with regard to appraisals. "Greater reliance (or complete) reliance on the automated valuation models of Fannie and Freddie would eliminate this issue," wrote Goodman. "...It is our view that eliminating appraisals entirely (relying exclusively on AVM and HVE) would help some borrowers who find it difficult to refinance; this would moderately increase speeds on higher coupon mortgages." The title search requirement—the second most costly refinancing expense after appraisal fees—for HARP refinances could be modified, said Goodman. "Perhaps instead of a full title search, a more limited 'refi' title search could be amended to the original title search. ... We believe that Treasury and FHFA will find that, since a title search and insurance provides significant legal protections for the new loan, it will be much more difficult to streamline the title requirement without taking on additional risk." One final and easy documentation fix would be the use of the date that the loan was sold to Fannie or Freddie as the cut-off date for HARP loans.
- Lastly, Goodman suggests that the 125% loan-to-value ceiling for agency refinances be eliminated. Goodman notes that the administration is likely looking at (i)

eliminating some of the rep and warrant risk on the new loan; (ii) dealing with second liens [which Amherst believes doesn't provide much of an impediment to HARP refinancing, given the "minimal" differences in voluntary prepayment speeds on first mortgages with and without a second mortgages]; and (iii) streamlining the mortgage insurance modification process.

- “While we believe a universal refinancing program is unlikely, it is clear the HARP program has reached far fewer people than hoped,” wrote Goodman. “We would expect to see measures to increase the effectiveness of HARP, within the confines of the present program. . . . In particular, we believe that eliminating LLPAs, streamlining the documentation (including greater use of automated valuation models), as well as removal of the 125% LTV ceiling, are the three most likely changes. Even if the changes are made relatively quickly, we would not see the impact until early 2012, given the lag between (program’s announced changes) and implementation, and the lag between implementation and increased prepayments.” (*Amherst Mortgage Insight*, Laurie Goodman, 08/31/11)

Refinancing “hype” overstates the administration’s deliberations on massive refi program

- During the Federal Reserve’s summer policy retreat in Jackson Hole, economists appeared eager to back a “trial balloon” that the administration was prepared to announce a massive mortgage refinance program, which would lower borrowers’ interest rate to 4% and create as much as \$85 billion (off-budget) stimulus for the economy. Glen Hubbard, a former economic advisor to President Bush and now dean of Columbia University’s business school, said he presented a massive refi program to the White House, which would allow borrowers that have loans guaranteed by Fannie Mae, Freddie Mac or FHA, to refinance even if the mortgage exceeded the home’s value. Hubbard argued that the plan could help up to 30 million borrowers and serve as a long-lasting “tax cut” that would add \$70 billion a year of possible savings in lower mortgage payments. Hubbard contended that while bondholders would be the loser under this plan, they would have certainty. While banks would lose “some,” they would gain a more stable economy, he added. The adverse impact to the federal government budget would be tempered by some degree by the lower tax deduction resulting from the borrowers’ lower interest payment.
- An executive summary of the streamline refinance plan proposed by Hubbard, Alan Boyce [CEO of Absalon Project], and Chris Mayer [professor of real estate, finance, and economics at Columbia Business School and visiting scholar at the Federal Reserve Bank of New York] can be downloaded at <http://absalonproject.com/wp-content/uploads/2011/09/BHM-V11-final.pdf>. Their simulation is also available at http://www4.gsb.columbia.edu/null/download?&exclusive=filemgr.download&file_id=739309.
- Bill Galston, a senior fellow at the Brookings Institute, urged the president to include a massive refi program in his new stimulus and job package to be announced during

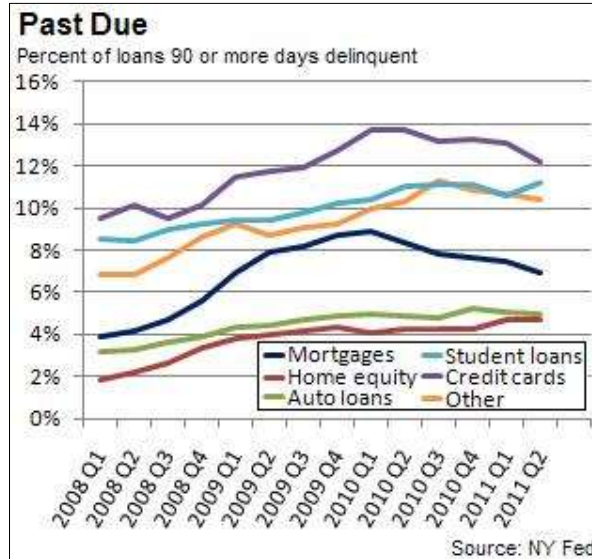
his September 8 address at a joint session of Congress. “Either we wait three or four years for households to reduce their debt burdens and regain their balance or government and business can find a way to work together to accelerate the process, which would boost growth,” wrote Galston in *The New Republic*.

- “[A massive mortgage refi is] a good idea, and, properly executed, the benefits would exceed any risks,” wrote the *New York Times* in an editorial. “The biggest question is President Obama’s willingness to battle the inevitable opposition.” (*New York Times*, 08/26/11)
- Regulatory onlookers view Edward DeMarco, the Federal Housing Finance Agency’s acting director, as an impediment to a massive refi program. DeMarco would likely view such a program as inconsistent with the FHFA’s duties as the GSEs’ conservator. DeMarco must determine if such a subsidy program would help preserve the assets of Fannie Mae and Freddie Mac and limit taxpayers’ losses. David Felt, former FHFA’s deputy general counsel, said agency officials have long worried about new administration policies and programs being used as a “backdoor way of hitting up taxpayers and the Treasury.” Relying on FHFA to finance stimulus is “a crazy way of allocating taxpayer dollars,” added Felt.
- Laurie Goodman, senior managing director at Amherst Securities, views a universal refinance program to be “unlikely” since it cannot be implemented without “subjecting the GSEs (and implicitly the taxpayer) to an increased level of risk.” Goodman adds, “Yes, it is possible to conceive a program in which Treasury waves a magic wand and every borrower obtains a new 4% mortgage—but Freddie and Fannie would lose their rep and warrant rights on the old loans and would probably need to assume all the rep and warrant risk on these new mortgages. (And no one who has proposed such a program has addressed the role of the mortgage insurers.) Such a program is inconsistent with the GSEs in a state of conservatorship. Conservatorship requires that the GSEs conserve assets, and a universal refinancing program that requires the GSEs to absorb any new risks would be blatantly in violation of that dictum. For that reason, we believe that the likelihood of any attempt to refinance loans in non-agency securitizations is very remote.”
- “The leading bondholders of the GSEs’ mortgage-backed securities include the Federal Reserve (\$884.9 billion on August 31); foreign institutions holdings (approximately \$732.3 billion); Fannie Mae (\$728 billion retained portfolio on July 31); Freddie Mac (\$683 billion retained portfolio on July 31) and Treasury (\$89 billion). Collectively, the federal government—through its central bank, agencies and conservatees—has \$2.4 trillion of GSE MBS on its balance sheet. *If* the yield on the GSEs’ mortgages were to fall by 150 to 175 basis points through a massive mortgage refinance initiative, the federal government would lose approximately \$36 billion to \$42 billion annually of revenues, making the U.S. taxpayers the *big* loser in such a program. Consumer spending might be boosted, ultimately at the cost of growing budget deficits.”

- “Refinancing makes little sense as stimulus, whose goal is to provide a temporary benefit that induces more spending today,” wrote Edward Glaeser, professor of economics at Harvard University. “Instead, state-supported refinancing is a benefit that pays off year after year for as long as three decades. As the loss to investors is experienced immediately, while the benefit to credit-constrained borrowers is spread over time, the net effect on the economy may well be negative. It’s also hard to see why housing markets would be significantly strengthened by lowering the interest payments for existing homeowners. My work suggests that the link between interest rates and housing market is relatively modest, and this refinancing effort won’t do anything to reduce borrowing costs for new buyers...Empirical work typically finds weak evidence that lower mortgage payments reduce the likelihood of defaults.”
- Speculation that the administration was moving forward with a massive mortgage refinance program is “getting way ahead of itself, because at this point, it’s all just research” said Ted Tozer, president of Ginnie Mae. “It’s really disconcerting to hear all this hype that something is imminent and that’s something the market is trading off,” said Tozer. During the last week of August, the \$5.4 trillion agency MBS market recorded one of its worst weeks in a year, as traders dumped their MBS out of concern that the administration would move forward with a massive mortgage refi program that would saddle them with losses.
- “People in the administration I’ve talked to understand the context of walking the fine line of trying to help the economy, without hurting the mortgage finance system,” said Tozer. “They know there’s no silver bullet, they know everything has repercussions, everything has a downside. The administration is really conscientious. They’re thoughtful people.”
- “It’s the political hail Mary,” said John Kerschner, head of Janus Capital’s securitized products. “It’s unclear why they want to throw a monkey wrench into a \$5 trillion market.” The net benefits to a massive refi program are negligible, adding \$20 billion to \$30 billion “at best,” Kerschner added. (*The New Republic*, Bill Galston, 08/25/11; *Marketwatch*, Greg Robb, 08/28/11; *Marketwatch*, Ronald D. Orol and Greg Robb, 08/31/11; *Amherst Mortgage Insight*, Laurie Goodman, 08/31/11; *Reuters*, Margaret Chadbourn, 08/31/11; *Bloomberg*, Edward Glaser, 08/29/11)

Housing market remains a shamble

- Mortgage delinquencies increased 12 basis points in the second quarter to 8.44%, while the level of foreclosure starts to outstanding loans fell 12 basis points to 0.95%, according to the Mortgage Bankers Association. (*HousingWire*, Kerri Panchuk, 08/22/11)



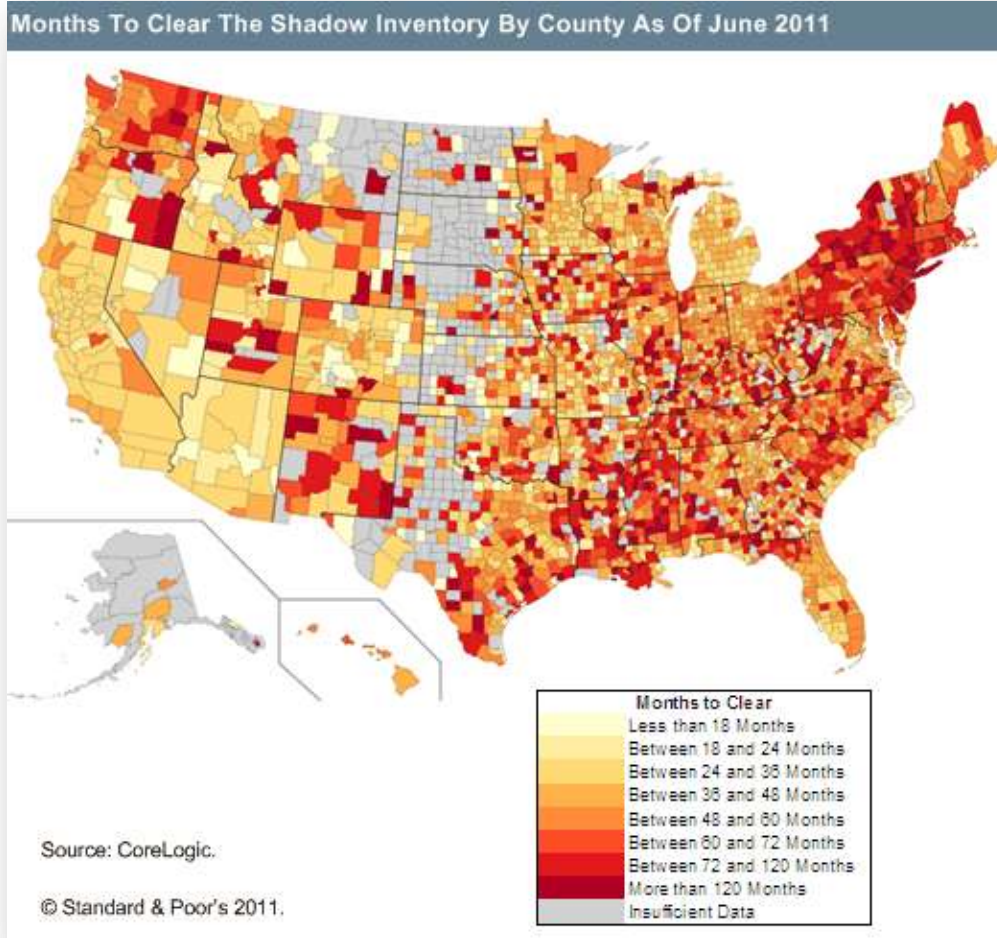
- The U.S. housing market remains depressed with depressed existing and new home sales and continued growth in homes for sale inventory. Home prices fell at a 2.5% annual rate in the second quarter according to FHFA’s House Price Index, marking the 17th consecutive decline. On a year-over-year basis, the FHFA Index reflects a 5.9% decline in prices to Quarter 4, 2003 levels. (*FHFA Press Release*, 08/24/11)
- The Case-Shiller Index reflected a similar price trend for the second quarter, falling 4.5% on a year-over-year (YoY) basis. Deflation was broad-based with all 20 cities tracked by Case-Shiller falling on a YoY basis with home prices are down some 32% from the peak. Excess supply remains a problem with 3.65 million homes and condominiums available for sale, representing a 9.4 months’ supply. However, the S&P/Case-Shiller Home Price Indices for June were “mostly” positive with the 10- and 20-City Composites each up 1.1% for the month and the National Composite up 3.6% for the second quarter. The seasonally adjusted annual rates of change is finally showing something marginally positive for the housing market, concluded S&P (*Standard and Poor’s Housing Views*, Maureen Maitland, 09/01/11)

S&P/Case-Shiller Home Prices Indices			
Region	Year-over-year percent change		
	May 2011	June 2011	Improvement?
Minneapolis	-11.4%	-10.8%	yes
Portland	-9.1%	-9.6%	no
Phoenix	-9.5%	-9.3%	yes
Chicago	-8.1%	-7.4%	yes
Tampa	-8.0%	-7.0%	yes
Detroit	-6.3%	-6.6%	no
Seattle	-7.0%	-6.4%	yes
Cleveland	-6.3%	-6.1%	yes
Las Vegas	-6.6%	-6.0%	yes
San Francisco	-5.4%	-5.4%	no
San Diego	-5.1%	-5.3%	no
Miami	-5.3%	-5.1%	yes
Atlanta	-4.7%	-4.9%	no
Composite-20	-4.6%	-4.5%	yes
Dallas	-4.7%	-4.3%	yes
Charlotte	-5.2%	-4.1%	yes
Composite-10	-3.9%	-3.8%	yes
New York	-3.1%	-3.6%	no
Los Angeles	-3.2%	-3.4%	no
Denver	-3.4%	-2.5%	yes
Boston	-3.2%	-2.1%	yes
Washington	-1.7%	-1.2%	yes

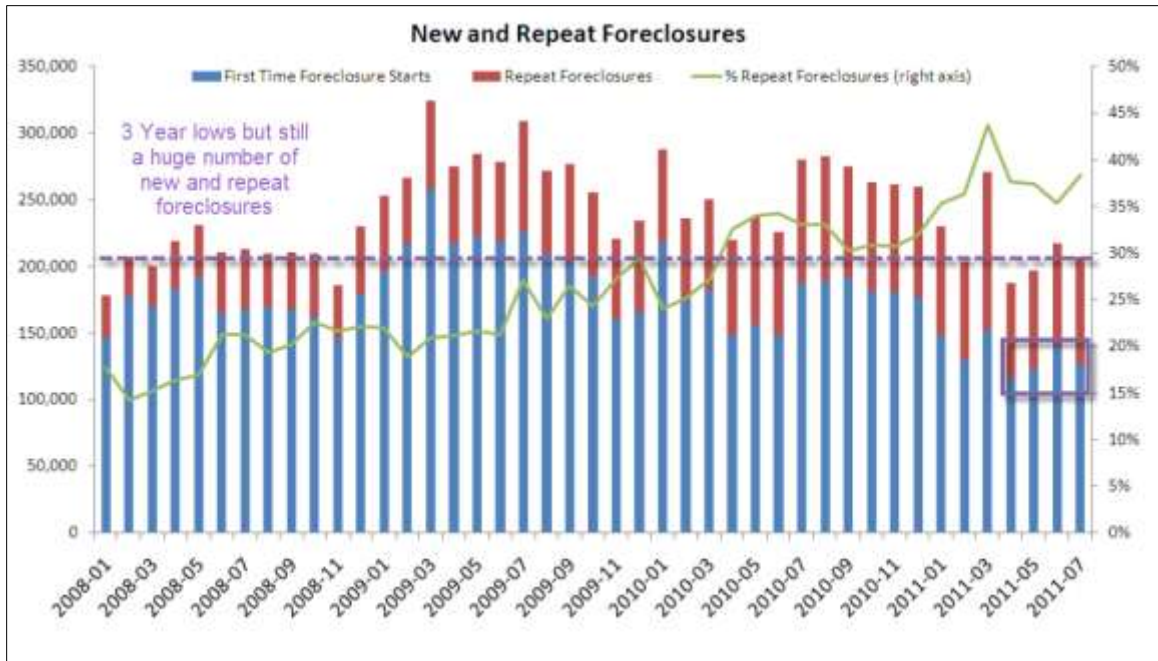
Sources: S&P Indices and FiServ

S&P/Case-Shiller Home Prices Indices. Sources: S&P Indices and FiServ

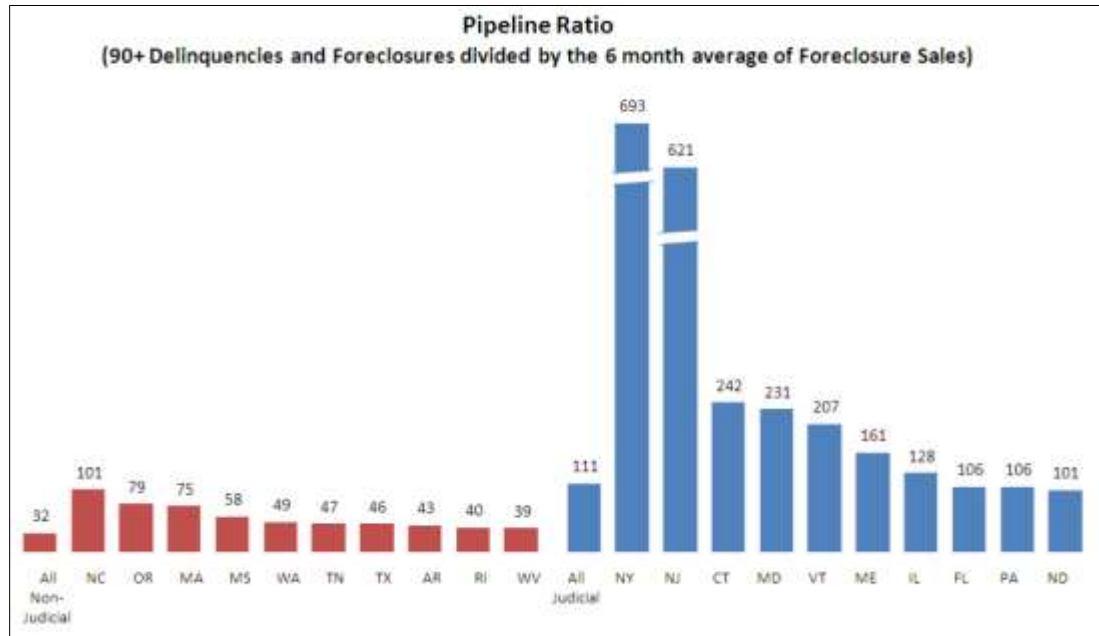
- The nation's \$407 billion shadow inventory (e.g., mortgages seriously delinquent 90 days or more) represents a 47-month supply of homes on June 30, according to Standard & Poor's. The rating agency's estimate of the months-to-clear grew throughout 2009 and 2010 to a peak of 52 months in March 2011, S&P's June estimate of 47 months fell by five months, making it the largest quarter-over-quarter decline since mid-2008. The decline was triggered primarily by liquidation rates (the speeds at which servicers close nonperforming loans) remaining relatively stable over the past several months. If liquidation and default rates continue their flat trends, S&P believes its months-to-clear estimates should continue to decline at a steady pace of approximately three months each quarter.
- On June 30, seriously delinquent borrowers, have missed on average 19 mortgage payments, have an average FICO score of 645 and typically are underwater, according to S&P. Home prices will continue to deflate, as the lingering glut of homes is cleared over the next four years, concluded S&P. (*Second-Quarter 2011 Shadow Inventory Update: Is The First Months-To-Clear Decline A Sign Of Good Things To Come?*, Diane Westerback and Jacques Alcabes, 08/17/11)



- First-time foreclosure starts are near three-year lows, according to the August LPS Mortgage Performance Report. That's the good news.



- However , the bad news in the mortgage space includes:
 - The average loan in foreclosure is delinquent for a record 599 days.
 - Of the nearly 1.9 million loans that are 90 or more days delinquent but not yet in foreclosure, 42% have not made a payment in more than a year with an average delinquency of 397 days—a new record.
 - As of the end of June, 4.1 million loans were either 90 or more days delinquent or in foreclosure. Delinquencies remain two times and foreclosures eight times pre-crisis levels.
 - On average, at the current rate of foreclosure sales, judicial foreclosure states would require 111 months to work through inventories of loans that are 90 or more days delinquent or in foreclosure as compared to non-judicial states, which would be able to clear the inventories in approximately 32 months.
 - Most of the foreclosure “outflow” is back into delinquency.
 - Loans deteriorating over 90 days still outnumber foreclosure starts 2:1.
 - Foreclosure starts outnumber sales by a factor of almost 3:1.
 - The foreclosure pipeline in New York is 693 months (over 57 years) and 621 Months (over 51 years) in New Jersey.



- The states with highest percentage of non-current loans include Florida, Mississippi, Nevada, New Jersey, and Illinois. The states with the lowest percentage of non-current loans include Montana, Wyoming, Alaska, South Dakota and North Dakota. (*LPS Mortgage Monitor*, August 2011)

Obama administration considers preserving a federal role in mortgage lending

- The Obama administration is developing a legislative proposal to preserve the federal government’s major role in the U.S. mortgage market by extending a federal loan subsidy for most home buyers, according to people familiar with the matter. The proposal might even preserve Fannie Mae and Freddie Mac—under different names and with “significant new constraints,” such as the elimination of their retained mortgage portfolios and higher capital requirements. Any government effort to restructure the GSEs would be phased in over a five- to ten-year period, said sources.
- However, White House officials insist that the three options for reforming the U.S. housing system, as outlined in Treasury’s white paper, remain under “active consideration” and “no recommendation has been made to the president by his economic advisors.” The administration has not decided whether to advance a final proposal before the 2012 presidential election, said officials. Under a best case scenario, GSE reform may be addressed by the 113th Congress after the next election. (*Washington Post*, Zachary A. Goldfarb, 0816/11)

Legislation to extend higher conforming loan limits faces uphill battle

- A bipartisan group of lawmakers, supported by banking and housing groups, are lobbying for passage of legislation that would extend the conforming limits for the housing GSEs through September 30, 2013. “If we don’t extend them, and they’re allowed to drop, you’ll take what is already a struggling housing market and depress it further, said Representative John Campbell (R-CA), a co-sponsor of the bill along with Representative Gary Ackerman (D-NY). “Housing prices will decline further.” Senators Robert Menendez (D-NJ), Johnny Isakson (R-GA) and Dianne Feinstein (D-CA) have introduced a bill in the Senate which would extend the higher loan limits through December 31, 2013.
- The legislation faces an uphill battle due to heavy opposition from the House Republican leadership and the Obama administration. “The White House wants to move away from that,” said Representative Scott Garrett (R-NJ), who chairs the subcommittee on capital markets and government-sponsored entities. “Republican leadership wants to move away from that. There’s enough room on the bank’s balance sheets to absorb this hit, so I think it’s a necessary next step.” (*American Banker*, Devin Wack, 08/08/11)

Pension funds sue FHFA over rule that limits their recoveries under securities laws

- The Ohio Public Employees Retirement System and the State Teachers Retirement System of Ohio have sued the Federal Housing Finance Agency over the agency’s rule that could limit their recovery for damages stemming from securities fraud. The pension funds have asked a federal judge to throw out FHFA’s rule establishing the priority for payment of unsecured claims against Fannie Mae and Freddie Mac. The groups argue that FHFA’s rule, which took effect July 20, violates the Appointment Clause of the Constitution and the Housing and Economic Recovery Act, because FHFA acting director Edward DeMarco has held his position for almost two years without Senate confirmation.
- In the rule, FHFA subordinated certain claims, including damages arising from shareholder lawsuits. Richard Cordray, then Ohio’s attorney general, objected to the rule, saying it “would have a devastating impact of millions of beneficiaries of public, union, and private pension plans and taxpayers in Ohio and other states who suffered substantial damages as a result of fraud at Fannie Mae and Freddie Mac.” When finalizing the rule in June, FHFA called the shareholder plaintiff concerns “unfounded.” (*Bloomberg News*, Tom Schoenberg and Lorraine Woellert, 08/27/11)

Fannie Mae and Freddie Mac suspend Republic Mortgage Insurance

PMI warns of shutdown

Fannie Mae and Freddie Mac suspend Republic Mortgage Insurance

- Fannie Mae and Freddie Mac will no longer purchase mortgages insured by Republic Mortgage Insurance and its affiliate RMIC of North Carolina. On September 30, the insurer breached its regulatory risk-to-capital limits, said Fannie Mae. While North Carolina regulators had temporarily allowed the company to continue selling insurance, the waivers were due to expire at the end of August and there was no sign that the regulators would renew them, added Fannie. RMIC was the fifth-largest U.S. mortgage insurer with \$18 billion of risk-in-force, according to Fitch. (*HousingWire*, Liz Enochs, 08/03/11)

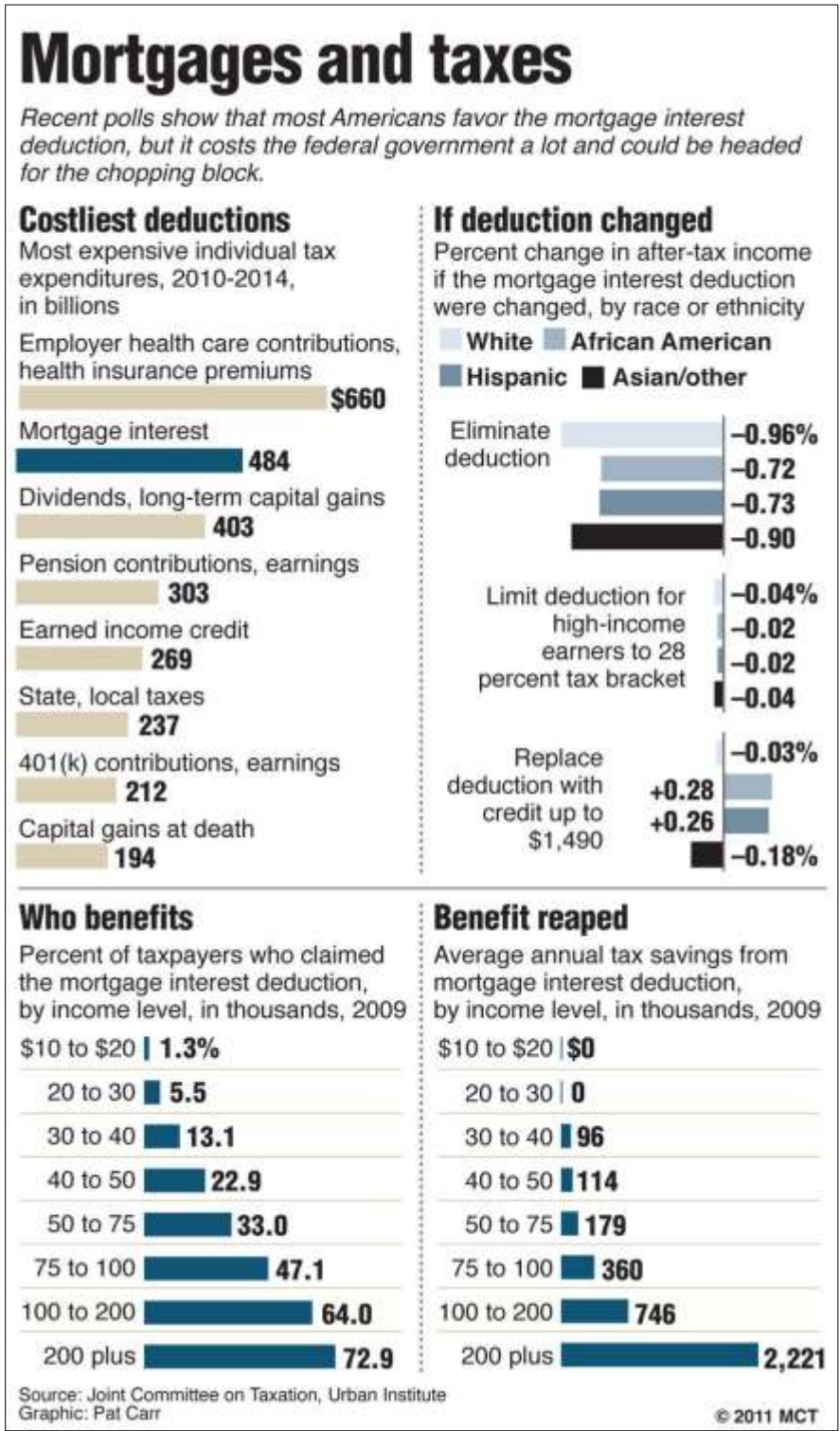
PMI warns of shutdown

- PMI Group warned that it could be forced to stop selling new insurance coverage after its primary subsidiary missed key capital targets. The Arizona insurance department, which serves as the subsidiary's primary regulator, could shut down their operations if it is unable to "obtain significant capital relief" or at least outline a credible plan to raise capital. PMI also warned that the ability of their second subsidiary—which operates with the approval of their two main customers, Fannie Mae and Freddie Mac—was also under threat. The GSEs could revoke their approval of the second subsidiary before it expires at year-end. "If this were to occur, the company would not be able to offer mortgage insurance through its combined insurance subsidiaries in all 50 states," said PMI. (*Wall Street Journal*, Erik Holm, 08/01/11)

Is the mortgage-interest deduction in play?

- The mortgage interest deduction, which allows 35 million homeowners to write off their mortgage interest payments, may be in for serious restructuring if Congress' ongoing efforts to reduce the bulging federal deficit are broadened. During the debt ceiling debate, the bipartisan "Gang of Six" senators proposed lowering the limit on mortgages eligible for the deduction from \$1 million to \$500,000 and providing the tax deduction only for primary residences.
- However, the mortgage deduction emerged unscathed in the debt-limit compromise that President Barack Obama signed into law. That reprieve may not last with lawmakers looking for \$1.2 trillion to \$1.5 trillion in additional budget cuts by the end of the year. The mortgage deduction, which will cost the federal treasury about

\$131 billion next year, makes for a juicy target. (McClatchy Newspapers, Tony Pugh, 08/02/11)



Fannie Mae

Fannie Mae's serious delinquency rate for single-family mortgages unchanged in July

- Fannie Mae reported a 4.08% seriously delinquent rate for single-family mortgages in July, unchanged from June. The GSE's serious delinquency rate for multifamily mortgages fell 1 basis point to 0.45% on July 31. Fannie Mae's mortgage securitization business declined in July with its gross mortgage portfolio falling at a 6.1% annualized rate in July. The GSE's retained mortgage portfolio also fell at an annualized 6.1% to \$728.0 billion in July, bringing the GSE's compound annual decline year-to-date to 12.9%. (*Monthly Summary*, Fannie Mae, July 2011)

Fannie Mae reaches settlement with three credit unions in fraudulent sale of loans

- Fannie Mae has agreed to settle a multi-million lawsuit brought by Suffolk Federal Credit Union (NY), Picatinny Federal Credit Union (NJ), and Treasury Employees Federal Credit Union (WA), which claimed more than \$62 million of their mortgages were sold by Fannie Mae as part of a \$140 million fraud perpetrated by Michael McGrath, president of U.S. Mortgage Corp. Sources knowledgeable of the settlement said that the combination of Fannie Mae's payments, coupled with insurance claims, will reimburse the credit unions for more than 90% of their original claims. Proponent Federal Credit Union (NJ) and Sperry Associates Federal Credit Union (NY), which have filed claims for \$21.6 million and \$9.2 million, respectfully, have yet to reach settlements with Fannie Mae. (*American Banker*, Ed Roberts, 08/30/11)

Fannie Mae increases its foreclosure fees paid to attorneys in Hawaii, New York and Delaware

- Fannie Mae will allow its servicers to pay its network of attorneys more for foreclosure work to cover the costs of each state's new foreclosure process. In Hawaii in which new laws have effectively shifted all foreclosures to the judicial system, all pending Fannie Mae foreclosures that have not proceeded to a resale must be dismissed and restarted in the new judicial process. Fannie has establish a new maximum foreclosure fee of \$2,200 for attorneys for the two firms in GSE's network—RCO Hawaii and Clay, Chapman, Iwamura, Pulice & Nervell.
- “Due to potential title insurance issues, Fannie Mae may be required to eliminate certain recent acquisitions that resulted from nonjudicial foreclosures,” Fannie said. “Upon being notified of any eliminations, servicers must immediately restart the matters as judicial foreclosures.”

- Fannie increased the maximum allowable attorney fee for lawyers working in the states of New York (up 28.6% to \$1,800) and Delaware.(up 21% to \$1,150). In New York City and Long Island, Fannie raised the fee 10% to \$2,200. (*HousingWire*, Jon Prior, 09/02/112)

Freddie Mac

Freddie Mac's mortgage delinquencies tick up slightly in July

- In July, Freddie Mac reported a slight increase its seriously delinquent mortgages with single-family delinquencies increasing 1 basis point to 3.51% and multi-family delinquencies up 4 basis points to 0.35%. Freddie Mac's retained mortgage portfolio fell at a 3.5% annualized in July to \$683.0 billion. (*Monthly Volume Summary*, Freddie Mac, July 2011)

Freddie Mac will accelerate its multi-family mortgage securitization in 2011
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- Freddie Mac plans to increase its purchase of loans secured by apartment buildings to help bolster the multi-family real estate market. The GSE's officials expect Freddie to fund more than \$16 billion of such loans this year, an increase of more than 8% over its 2010 originations. More than half of this year's originations will occur in the second half, said David Brickman, head of the GSE's multifamily lending. "It's been steady growth, and that's a very stark contrast to what's been going on in the [private] market," said Brickman. "We are getting very strong support from the market."
- Demand for Freddie Mac's CMBS was evident in July, when its eighth deal of the year was enmeshed in the midst of a ratings squeeze as Standard & Poor's refused to deliver a final ratings on CMB offerings by Goldman and Citigroup (\$1.5 billion, which had a final rating from Morningstar) and Freddie Mac (\$1.04 billion, which had a final rating from Fitch). Goldman and Citigroup pulled the offering, hired Moody's to provide a second rating, and rescheduled the CMBS issue for later this fall. Freddie Mac took their deal to market with the single rating. "Not a single one of more than 30 investors dropped from the deal," said Brickman.
- The CMBS market remains fragile two years into the recovery. With investors backing away from risky assets this summer, banks have been halting loans in the pipeline and renegotiating them with less favorable terms, said David Viklund, a real estate lawyer with the New York-based Paul Hastings. Yields on Freddie Mac CMBS average around 3.13%, 0.84 percentage point over a common bench mark, while top rated, private CMBS yields are at 4.84%. (*Wall Street Journal*, Al Yoon, 08/31/11)

Federal Home Loan Banks

The Federal Housing Finance Agency approves capital plans for 11 FHLBs

- The Federal Housing Finance Agency has approved plans for all but one of the 12 Federal Home Loan Banks to boost capital, now that the FHLBs have paid all interest owed on Resolution Funding Corp. bonds issued to bail out failed savings-and-loan institutions. FHFA has signed off on modified capital plans for all of the FHLBs, except for the Chicago Bank, which is not yet operating under an approved capital-structure plan. The FHLB-Chicago recently submitted a new capital plan to FHFA that is under review.
- The FHLBs' new capital plans "will increase the banks' retained earnings and capital," said the FHFA. Under the plans, each of the banks will begin allocating 20% of net income to a restricted account until the bank's account amounts to 1% of that bank's outstanding consolidated obligations, said FHFA. The FHLBs will be prohibited by FHFA from paying dividends out of these special accounts. The banks' capital plans should enhance their capital levels and the safety and soundness of the Federal Home Loan Bank System.
- "The banks' cooperative approach to establishing and building restricted retained earnings accounts will enhance the system's safety and soundness," said FHFA Acting Director Ed DeMarco. (*Dow Jones Newswire*, Maya Jackson Randall, 08/05/11; *FHFA Press Release*, 08/05/11)

Ginnie Mae

FHA reports seasonally adjusted nonperforming mortgages rate of 15.86% on June 30

- FHA delinquency rates increased 59 basis points to 12.62% on a seasonally-adjusted basis, driving total non-performing FHA mortgages, including foreclosures, up 48 basis points to 15.86%. Non-seasonally adjusted FHA delinquencies increased from 10.69% to 11.75% with the total FHA non-performing mortgages increasing 0.99% to 14.86%. Analyst argue that the trend in FHA delinquencies reflects the “normal seasoning” of the FHA portfolio. “[T]he moderation in FHA loan growth will likely result in further increases in delinquencies on this portfolio which will likely push up the national averages,” concluded Keefe, Bruyette & Woods analysts. The increase in FHA delinquencies mirrored the national trend, reflecting an increase in unemployment during the second quarter. (*Mortgage Servicing News*, Amilda Dymi, 08/26/11)

Ginnie Mae changes will reduce mortgage servicer costs

- Ginnie Mae now allows issuers to repurchase mortgages from its guaranteed securities, if the borrower completes a three-month trial modification. Previously, the agency had required that delinquent mortgages have three full missed payments before being eligible for a buyout.
- The changes that FHA and Ginnie Mae have made to their loan-modification rules demonstrate that compromises that take the interests of consumers and investors into consideration are possible, said Ted Tozer, president of Ginnie Mae. To help investors, Ginnie Mae wanted to limit the amount of delinquent borrowers with loans that were quickly defaulting after being taken out of its securities, modified and then placed into new bonds. Ginnie Mae officials approached FHA with the concept of requiring borrowers with reworked debt to go through three-month trials before the modifications became official, said Tozer. FHA, which was facing re-default rates of more than 50%, wanted to create more modifications for borrowers who weren't yet delinquent, he said.
- The result of the agencies efforts was the creation of new rules that allow more homeowners who haven't yet defaulted to get lower payments, including those who have “net surplus income of less than 20% of total net income.” The modification trials, which will leave loans within bonds until consumers complete them or fail and reach foreclosure, are also being required.
- Ginnie Mae won't tolerate servicers using the changes to lower rates for consumers who haven't experienced hardship and could use a typical refinance, said Tozer. “From our perspective it would be abusive to the spirit of the program,” he said.

- The initiative will alter the economics of buyouts for Ginnie Mae servicers, said Barclays Capital analyst Derek Chen. “[B]ecause FHA only reimburses the principal portion but not the interest part of the advances in cases where the loan eventually goes into foreclosure, the new rule should reduce the total costs associated with modifications for servicers,” wrote Chen in a note to clients. The impact to others, including investors, will be insignificant, he added.
- Chen dismissed arguments that this initiative would incentivize servicers to pursue modifications more strenuously and lead to higher Ginnie Mae pool prepayments. “Under the new rule, servicers have to commit themselves to the modification three to four months in advance—at the start of the trial period,” said Chen. “This significantly increases the probability that the modified loans will be sold below par, which implies a reduced incentive for loan modifications.” FHA will closely monitor the redefault rate of modified loans and compare the performance among servicers, reducing the likelihood of servicers using modifications as a blanket loss-modification tool, he added. (*Bloomberg News*, Jody Shenn, 09/01/11; *HousingWire*, Jacob Gaffney, 08/29/11)

SunTrust halts production of reverse mortgages
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- On August 31, SunTrust Bank stopped accepting applications for reverse mortgages, but will continue processing reverse mortgages already in its pipeline. “After careful consideration, we have determined that we will no longer offer reverse mortgages,” said SunTrust. “Production volume for these types of loans is extremely small compared to our overall mortgage volume, and from a strategic perspective focusing our full resources on more traditional mortgage origination and servicing is the most effective and efficient use of our resources.”
- SunTrust’s announcement follows similar decisions by Wells Fargo and Bank of America to exit reverse mortgages because of unpredictable home values and restrictions on those loans. (*HousingWire*, Kerri Panchuk, 09/02/11)

Farm Credit System / Farmer Mac

Farm Credit System reports second quarter profits of \$982 million

- “FCS net income was a near-record \$982 million for the second quarter of 2011, down from \$1.004 billion in the first quarter of 2011 due to a modest decline in loans outstanding,” wrote Bert Ely in Farm Credit Watch. “The lending drop was ‘primarily due to decreases in production and intermediate-term loans and agribusiness loans offset in part by an increase in real estate mortgage loans.’ Real estate lending ‘increased primarily due to strong demand for cropland and competitive interest rates on loan products.’ That is a euphemistic way of saying that the FCS continues to benefit from the relatively greater competitive advantage it has as a real estate lender because its profits on real estate lending are completely tax exempt while its profits on non-real estate lending are exempt only from state income taxes.”
- “Key to FCS profit growth in recent years has been its steadily wider net interest spread. From 1.99% in 2008 and 2.43% in 2009, this spread widened to 2.61% last year, to 2.64% in the first quarter of this year, and to 2.66% in the second quarter. The FCS press release announcing its second-quarter 2011 financial results stated that ‘the increases in the net interest spread were primarily attributable to the [FCS’s] ability to more quickly reprice [its] outstanding debt in the lower interest rate environment and to adjustments in loan pricing to better reflect credit risk and market conditions.’ More specifically, the FCS was able ‘to lower [its] cost of funds relative to [its] assets, which did not reprice as quickly.’”
- “During the twelve-month period ending June 30, 2011, the FCS called debt totaling \$52.8 billion (47% of its Systemwide Debt Securities on June 30, 2010 with more than a year to maturity), including \$20 billion called during the first half of 2011. While warning that ‘the positive impact on the net interest spread that the [FCS] has experienced over the last several years from calling Systemwide Debt Securities will likely diminish,’ the recent plunge in longer term Treasury yields to fifty-year lows will likely lead to the FCS calling additional debt for refunding at lower interest rates. Such actions will make it even harder for taxpaying lenders to compete against the taxpayer-subsidized FCS.”
- “FCS credit quality dropped somewhat during the first half of 2011, with non-performing loans rising from 1.93% of loans outstanding at the end of 2010 to 2.04% of outstanding loans on June 30, 2011. Despite that increase, the FCS held its allowance for loan losses constant while trimming its provision for loan losses to \$234 million for the first half of 2011 from \$351 million for the second half of 2010. That reduction accounted for 56% of the FCS’s increase in pre-tax profits from the second half of 2010 to the first half of 2011. Time will tell if the FCS has gotten

ahead of itself in reducing its loan-loss provision and failing to increase its allowance for loan losses.” (*Farm Credit Watch*, Bert Ely, August 2011)

HUD proposes rule to permit members of the Farm Credit System to become FHA-approved lenders

- On August 26, HUD proposed a rule that would enable the direct lending institutions of the Farm Credit System to seek approval to participate in the FHA mortgage insurance programs as approved mortgagees and lenders. Given the recent difficulties in mortgage finance markets that has reduced the availability of housing credit in rural areas, HUD proposes to extend FHA mortgagee and lender eligibility to the Farm Credit System to provide an additional avenue for mortgage financing in these areas. The public comment period for this proposal ends October 25, 2011. (*Federal Register*, 08/26/11)

Proposed Infrastructure Bank

The “fix is nearly in” for creation of an infrastructure bank

The creation of an infrastructure bank is *not* a salvation for the U.S. economy

The infrastructure bank: “A public private partnership like Fannie Mae”

The “fix is nearly in” for creation of an infrastructure bank

- “The fix is nearly in,” wrote *Barron’s* Jim Mctague. “There’s a ballooning consensus in the nation’s capital that America must begin serious spending on infrastructure. There’s no need to draw on our maxed-out national credit card to pay for it all, proponents argue. User fees and the creation of an infrastructure bank to leverage private investment will provide an estimated \$1 trillion in required upgrades.”
- The U.S. Chamber of Commerce and AFL-CIO have joined forces to promote the need for infrastructure spending and the creation of a federal infrastructure bank for this dedicated purpose. Tom Donohue, president and CEO of the Chamber, is urging Congress to pass fully funded highway, aviation and water-system legislation, along with a bill creating an adequately capitalized infrastructure bank. Taxpayers would capitalize the infrastructure bank with an infusion of \$10 billion. In turn the bank would attract private investment funds through the sale of construction bonds to fund infrastructure projects. “An estimated \$250 billion is sitting around in private global investment funds that would like to invest in our infrastructure because they have a sure way of being paid,” says Donahue.
- “We’re pretty much in agreement [with Donohue] that an infrastructure bank is a good thing, if properly funded,” said Richard Trumka, president of the AFL-CIO. The longer the U.S. postpones its infrastructure work, the less competitive our economy will become and higher the costs will be to fix the problem. “Right now, you have low interest rates and a lot of people who need work,” said Trumka. “It is insane not to be putting them together to fix a problem that needs fixing.” (*Barron’s*, Jim Mctague, 09/03/11)

The creation of an infrastructure bank is *not* a salvation for the U.S. economy

- “The President’s ongoing obsession with an infrastructure bank as a source of salvation from the economic crisis at hand is—to be polite about it—a dangerous distraction and a waste of his time,” wrote Heritage Foundation’s Ronald Utt. “It is also a proposal that has consistently been rejected by bipartisan majorities in the House and Senate transportation and appropriations committees, and for good reason. Based on the [American Revitalization and Investment Act—the 2009 stimulus bill’s]

dismal and remarkably untimely performance, Obama's infrastructure bank would likely yield only modest amounts of infrastructure spending by the end of 2017 while having no measurable impact on job growth or economic activity—a prospect woefully at odds with the economic challenges confronting the nation.” (*Heritage Foundation's WebMemo #3346*, Ronald Utt, 08/30/11)

The infrastructure bank: “A public private partnership like Fannie Mae”

- “Here’s a novel idea: Have Congress create a ‘bank’ that could borrow huge sums with only a small federal outlay and would be independent of any political interference,” wrote the *Wall Street Journal* in an August 31 editorial. “If you believe in this miracle, you probably thought Fannie Mae was a private company that wouldn’t cost taxpayers a dime.”
- “We’re referring to Washington’s latest marketing tool to sell spending to a skeptical public, a new federal ‘infrastructure bank.’ For the low, low price of \$30 billion or so, President Obama says Congress can conjure hundreds of billions in new ‘grants and loans’ to rebuild ‘roads, bridges, and ports and broadband lines and smart grids.’ He says the bank would put ‘all those construction workers’ back to work and ‘be good for the economy not just for next year or the year after that, but for the next 20 or 30 years.’ In a cats and dogs living together moment, the Chamber of Commerce and the AFL-CIO are both in favor. Since both unions and construction companies would be beneficiaries, this alone ought to give taxpayers pause.”
- “This is the Fannie Mae model applied to public works. The new bank would be a government-sponsored enterprise, or GSE, whether or not anyone admits it. The bank would have an implicit subsidy for its debt because it is backed by the government. And the debt it issued would be ‘off budget,’ which means it wouldn’t show up in annual outlays. When she first proposed the concept in 2008, Connecticut Democrat Rosa DeLauro explicitly described the bank as a ‘public private partnership like Fannie Mae.’”
- “Such an outfit will inevitably be politicized, as similar examples have been all over the world. Japan’s postal bank has been used for decades to finance public works. Japan’s roads and bridges are grand but its economy has grown little in 20 years. Agribanks, regional development banks, Brazil’s BNDES national bank have all become vehicles for the political allocation of credit.”
- “Ms. DeLauro’s bill admits as much, stating that the bank must take into account the ‘economic, environmental, social benefits and costs’ of the projects seeking financial assistance. Among the considerations: responsible employment practices, use of renewable energy, reduction in carbon emissions, poverty and inequality reduction, training for low-income workers and public health benefits.”

- “No one disputes that American public works need improving, and government has been spending huge sums to do so...Between 2001 and 2011 federal ‘public physical capital investment outlays’ more than doubled to \$330 billion from \$142 billion. Every major area of infrastructure—transportation, Army Corps of Engineers, energy—is up by at least 75% in a decade.”
- “The scandal is that we buy so little brick and mortar with all this money. Earmarking has wasted billions and is an inevitable byproduct of a system that collects federal taxes and allows Congressmen to send it back to their districts. The bank is supposed to eliminate earmarking, but the Members will surely find a way to influence the bank’s lending too.”
- “Taxpayers also get less for their money because federal projects must follow Davis-Bacon Act rules that require ‘prevailing wages.’ This law has come to mean de facto union wages on all public projects, inflating costs by 10% to 30%, depending on the project and location. Democrats and Republicans both refuse to relax Davis-Bacon rules, and the infrastructure bank would require them. The bank would also divert dollars to the mass transit lobby, which favors rail projects that serve a tiny fraction of commuters.”
- “Instead of a Washington-centric bank that picks winners and losers, Congress would be wise to move in the opposite direction: devolving most public-works decisions to the state and local levels so users decide whether they want to finance a new school, bridge or water system. The feds can focus on maintaining the interstate highway system and then let states and localities choose what to fund. Arizona Rep. Jeff Flake and others have bills that would let states opt out of the federal highway program in return for getting back the federal gas tax money that its residents send to Washington.”
- “GOP Congressman John Mica of Florida, Chairman of the House Transportation and Infrastructure Committee, is no fan of a federal infrastructure bank. He says he wants more state and local control of funds because ‘that way they won’t have to come to Washington to get approval.’ Mr. Mica is dealing with a reality that eludes many in both parties: With a \$1.28 trillion deficit, Uncle Sam can’t afford to keep serving as paymaster to states and localities. The infrastructure bank is merely a new gimmick to maintain the old system.” (*Wall Street Journal*, 08/31/11)
- “The track records of our country’s existing governmental ‘banks,’ like the Federal Reserve, Fannie Mae, and Freddie Mac, don’t bode well for a national infrastructure bank, wrote K.E. Campbell in the *American Thinker*. “Like most ‘public-private partnerships,’ the associated risks would be borne solely or disproportionately by the public. Further, granting decision-making authority to unelected bureaucrats rather than elected officials is a bad idea (though neither is perfect). A national infrastructure bank would be an embodiment of statism, central authority, deficit spending, and social engineering (think ‘green jobs’ and union favoritism) in the form

of a new, eternal and ever-expanding federal bureaucracy. It is exactly what we don't need." (*American Thinker*, K.E. Campbell, 09/03/11)

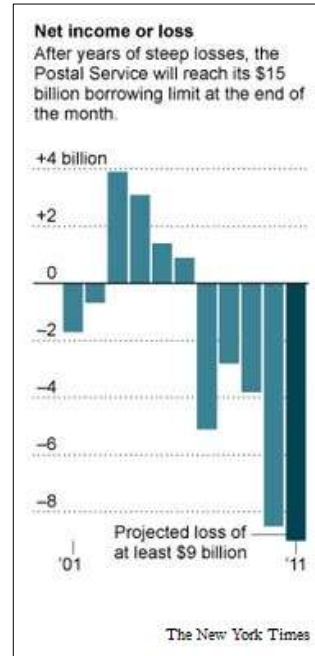
The high speed rail boondoggle

- In 2009, the Obama administration allocated \$8 billion of stimulus funds to create and fund the high speed rail (HSR) program and provided an additional \$1 billion in annual appropriations for the five following years for the project. Only two of the dozens of projects approved—in Florida and California—were true HSR with the vast majority of projects consisting of modest improvements and extensions of existing Amtrak service. Over time, state government officials and lawmakers on Capitol Hill realized that the HRS would require extraordinarily large expenditures, while yielding only modest transportation benefits. Congress defunded parts of the HSR program and several states turned down more than \$3 billion in federal grants.
- The Obama administration is turning to provisions in the Railroad Rehabilitation and Improvement Financing Act (RRIF) that provides \$35 billion in federal loans and loan guarantees at the discretion of the President to fund its HSR program in response to Congress' cuts to HSR funding and Amtrak's soaring subsidies. Specifically, the Department of Transportation is contemplating a \$6 billion RRIF loan for construction of the DesertXpress, a high speed rail system from Victorville, CA [a desert town 85 miles east of Los Angeles] to Las Vegas, NV. The administration recently issued a federal funded request for proposals to evaluate the DesertXpress proposal for DOT.
- Assuming DOT funds the DesertXpress proposal, the RRIF would still have more than \$27 billion to lend for future. "This must not happen," wrote Ronald D. Utt with the Heritage Foundation. "Because nearly all passenger rail systems in the world lose money, these loans are unlikely to be paid back, and taxpayers will be on the hook for multi-billion-dollar losses." (*Heritage Foundation's WebMemo #3349*, Ronald Utt, 09/01/11)

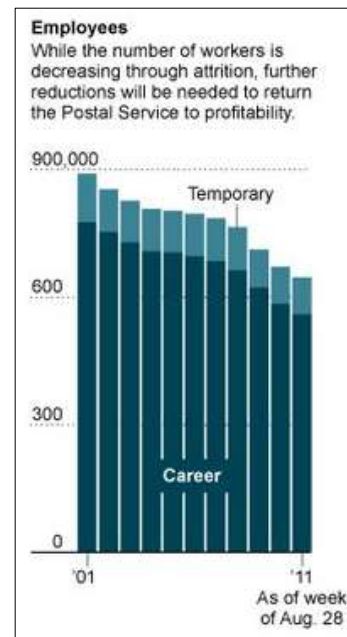
Postal Service

Postal Services proposes a 39% reduction in force and closure of 3,700 post offices

- The U.S. Postal Service has long lived on the financial edge, but has never been this close to the precipice of bankruptcy. Patrick R. Donahoe, the Postmaster General, has warned that his agency will run out of cash by the end of September and may have to shut down entirely this winter unless Congress takes emergency actions to stabilize the USPS. “Our situation is extremely serious,” said Donahoe. “If Congress doesn’t act, we will default.”
- The Postal Service’s problems stem from a hard reality—the agency is getting squeezed by falling revenue and rising costs. Over the last four years, the Postal Service has lost \$20 billion, including \$8.5 billion in FY2010. Decades of contractual promises to unionized workers, including no-layoff clauses, have driven the USPS’s labor costs up to 80% of the agency’s total expenses versus 53% for UPS and 32% for FedEx. Concurrently, mail volume has plummeted 22% over the past five years to 167 billion pieces for FY2010. Mail volume is projected to decline an additional 30% to 118 billion pieces in 2020.

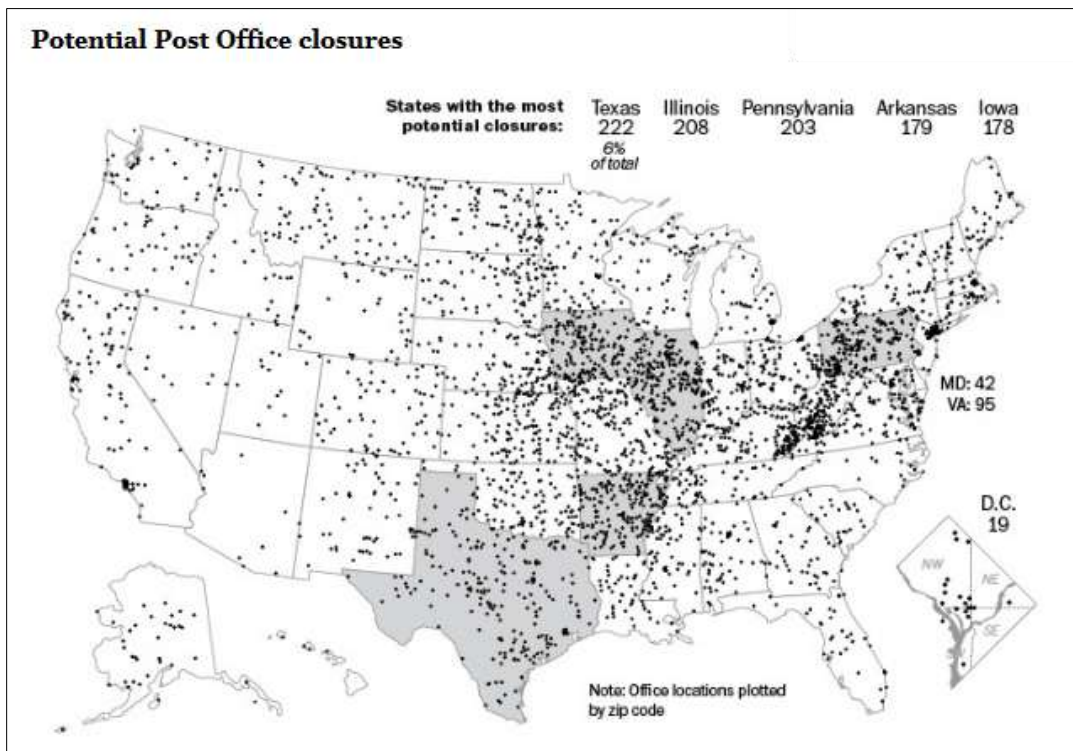


- To address the crisis, Donahue has proposed dramatic job cuts, office closures, and a curtailment of mail delivery, all steps requiring Congressional action .
- The USPS proposes to eliminate 220,000 jobs—120,000 career positions and 100,000 other positions through attrition, representing a 39% reduction of its 563,400 member workforce. Some of the 120,000 job losses could come through buyouts and other programs, but a significant number would probably result from layoffs if Congress allows the Postal Service to circumvent union contracts.
- In a white paper entitled Workforce Optimization, the USPS acknowledges that it is making an “extraordinary request” for Congress to allow the agency to break its labor contracts. “Unfortunately, the collective bargaining agreements between the Postal Service and our unionized employees contain layoff restrictions that



make it impossible to reduce the size of our workforce by the amount required by 2015,” wrote the USPS in the white paper. “Therefore, a legislative change is needed to eliminate the layoff protections in our collective bargaining agreements. ...[E]xceptional circumstances require exceptional remedies. The Postal Service is facing dire economic challenges that threaten its very existence. ...If the Postal Service was a private sector business, it would have filed for bankruptcy and utilized the reorganization process to restructure its labor agreements to reflect the new financial reality.”


- In a white paper on health and retirement benefits, the Postal Service said it is imperative to rein in health benefit and pension costs, which comprise a third of its labor expenses. To resolve this problem, the USPS proposes to withdraw its 480,000 pensioners and 600,000 active employees from the Federal Employees Health Benefits Program “and place them in a new, Postal Service administered” program. The USPS said the federal health care programs do not meet “the private sector comparability standard,” a statement that could be translated as meaning that government plans are too generous and too costly.
- The USPS also proposes to close more than 3,700 offices and close 300 of the agency’s 500 sorting facilities. The Postal Service’s proposals to dramatically reduce its workforce and retail network would trim \$20 billion of the agency’s \$75 billion annual costs by 2017.



(Source: *Washington Post*, 08/11/11)

- Postal union leaders quickly and sharply rejected the Postal Services' proposals. "The APWU will vehemently oppose any attempt to destroy the collective bargaining rights of postal employees or tamper with our recently negotiated contract — whether by postal management or members of Congress," said American Postal Workers Union President Cliff Guffey. "Our advisers are not encouraging us at all to even consider it," said National Rural Letter Carriers' Association President Don Cantriel. "We are absolutely opposed [to the layoff proposal]. We are opposed to pulling out of the Federal Employees Health Benefits Plan."
- "The issues of lay-off protection and health benefits are specifically covered by our contract," said National Association of Letter Carriers President Fredric V. Rolando. "The Congress of the United States does not engage in contract negotiations with unions, and we do not believe they are about to do so."
- "The situation is dire," said Senator Thomas R. Carper (D-DE), who is chairman of the Senate subcommittee that oversees the Postal Service. "If we do nothing, if we don't react in a smart, appropriate way, the Postal Service could literally close later this year. That's not the kind of development we need to inject into a weak, uneven economic recovery."
- Senator Susan Collins (R-ME), minority leader on the Senate subcommittee, vigorously opposes the Postal Service's proposal to end Saturday mail delivery, a move that would trim only 2% from the agency's budget. Collins contends that reduced mail delivery service would be particularly tough on people living in small towns, who receive prescriptions and newspapers by mail. "The postmaster general has focused on several approaches that I believe will be counterproductive," said Collins. "They risk producing a death spiral where the postal service reduces service and drives away more customers."
- Carper and Collins back the USPS's proposal to recover approximately \$60 billion of overpayments that actuaries claim the agency has made into two pension funds. While the Obama administration is working closely with Carper and Collins to find solutions to the Postal Service's problems, officials have signaled discomfort with the pension proposals, questioning if the agency has really overpaid its pension liabilities. Representative Darrell Issa (R-CA), chairman of the House Oversight Committee, argues that the pension proposals amount to an unjustifiable taxpayer bailout of the USPS. Instead, Issa has sponsored legislation that would create an emergency oversight board to oversee huge cost-cutting measures and void postal contracts—a proposal opposed by Carper, Collins, and the USPS unions.
- "This is about one of America's oldest institutions," said NALC's Rolando. "It survived the telegraph, it survived the telephone, and we have to do everything we can to preserve it and adapt." (*Washington Post*, Joe Davidson, 08/11/11; *New York Times*, Steven Greenhouse, 09/04/11)

A political fight is brewing over the USPS's broken business model

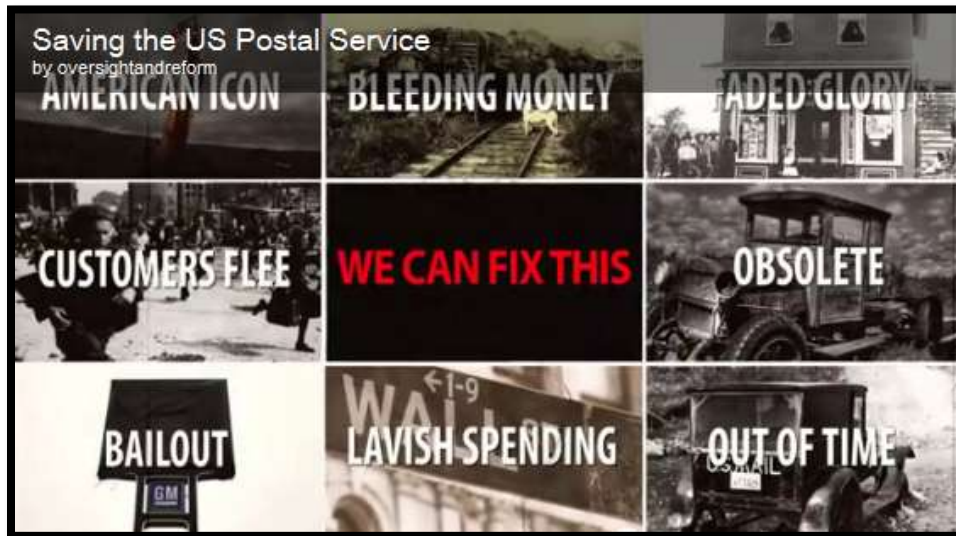
- "...The fiscal situation at the USPS is bad—really bad," wrote *Slate*'s Annie Lowrey. "According to its most recent quarterly report, the USPS lost \$3.1 billion between April 1 and June 30. Add that to billions of dollars in losses racked up since the recession hit—the USPS has been in the red for 18 of the last 20 fiscal quarters. It has also amassed tens of billions in unfunded liabilities, mostly in pension and retiree health-benefit obligations."
- 
- "The problem is not mismanagement. The problem is that the USPS has an enormous, expensive physical and human infrastructure. It operates more than twice as many U.S. outlets as McDonald's. It runs the largest vehicle fleet on Earth. It has a staff of nearly 600,000, despite considerable reductions in the last decade. To pay for all those people, trucks, and buildings, the USPS needs to handle a lot of mail."
 - "The recession accelerated the longtime trend of businesses and individuals shifting correspondence to the Internet. ...Mail volumes have plummeted more than 25 percent since 2006. Moreover, the mix has gotten cheaper—more bulk mail, fewer first-class letters. Unlike some of its other national counterparts, the USPS has no other revenue stream to speak of except for delivering mail, so less mail means a lot of red ink. The USPS plunged deep into the red in 2007. By 2020, with no big surge in first-class mail likely even if the economy recovers, cumulative losses will total an estimated \$238 billion. That's three times the size of the auto bailout."
 - "The postal service has tried valiantly to stanch the bleeding. It has told Congress it wants more room to charge higher prices, reduce the number of deliveries, invest in new technologies, and negotiate new terms with its workers. (The USPS is structured a bit like Fannie Mae and Freddie Mac—it is an independent organization with federal backing, and Congress has a check on it.) It has shuttered post offices. It has streamlined operations. In the last four years alone, it has reduced its staff by 110,000 and saved some \$12 billion."
 - "But it is not nearly enough, and the USPS says so itself. In its most recent quarterly statement, it writes: 'Postal Service efforts to positively impact cash flow will not be, either individually or in the aggregate, sufficient to avoid a cash shortfall in 2011.' The report continues: 'Absent significant changes ... the \$15 billion debt ceiling will be reached in September 2011, thereby exhausting the Postal Service's external funding ability. No assurance can be given that Postal Service efforts to secure legislative changes will be successful, or that Congress will enact legislation in time to favorably impact 2011, or at all.'
 - "The catastrophe is twofold. The USPS is going to need a higher debt limit or big changes pronto, or it is going to run out of cash. Then it needs significant—maybe

even radical—changes to return it to fiscal stability. Indeed, a congressionally ordered Government Accountability Office report from April 2010 starts with the blunt line: ‘USPS’s business model is not viable due to USPS’s inability to reduce costs sufficiently in response to continuing mail volume and revenue declines.’ The ‘business model’ is not “viable.” Changes are necessary. So what might those changes look like?”

- “The most radical option is simply to end the USPS, as suggested by former Republican presidential candidate Tim Pawlenty and the Cato Institute, among others. This is unnecessary and unlikely. But it is not nearly as crazy as it sounds. The shift to online communication is permanent, and letter volumes will continue to decline. It is hard to see how the USPS will ever make money given its legal strictures, even with its monopoly on letter delivery. Congress could break the monopoly and privatize USPS, opening the field up to the host of companies that already deliver packages and letters, cheaply and fast. FedEx could bring you your paycheck. DHL could get you your circular. The ‘USPS brought to you by Wal-Mart’ could get you your tax forms.”
- “But let’s say we want to leave the service, and its monopoly, in place. What changes might be necessary then? The USPS proposed two big ones this month, saying ‘exceptional circumstances require exceptional remedies.’ First, it wants to shed another 120,000 employees, breaking its labor agreements to do so. ...Second, it wants to withdraw from federal pension and retiree health care plans, administering those programs itself. ...Pulling out might help save the USPS. But it will be controversial, and it might even threaten the stability of the federal programs. To help ease the immediate cash-flow problem, the USPS wants Congress to drop a requirement that it prefund retiree health care benefits—staving off financial apocalypse for a year or two and giving time for other changes to take effect.”
- “Changes to service are coming down the pike, too. The USPS wants Congress to loosen restrictions on how and when it delivers mail, who it hires, and how much it charges for its services. That could mean more contract and part-time employees. It could mean reduced pick-ups and drop-offs. It will probably mean the end of Saturday delivery. There are more creative ideas out there as well. The USPS could add a cool service in which it accepts your physical mail but delivers it via email scan. It could let you pay to refuse junk mail, or turn a photograph into a postcard.”
- “One way or another, expect changes—and soon: A serious congressional fight over what to do with the USPS and how to do it is due when members come back from August recess, with advertisers, unions, and other delivery firms gearing up for a huge push. And expect a number of existential questions about—if not existential changes to—the mail service. (*Slate*, Annie Lowrey, 08/17/11)

An American icon is broke

- The House Committee on Oversight and Government Reform has launched a new website, www.SavingThePostalService.com, to educate the public about the Postal Service's financial troubles. In a video introducing the new website, the Committee points to the parallels between USPS's financial condition and that of banks and car makers which ultimately received government bailouts.



- “An American icon is broke,” says the video narrator. “Done in by decades of lavish spending. Defeated by new technology. Booming last century, it’s bleeding money today. Customers flee. It begs for a government bailout. The collapsing clunker: not a car make, not a bank. It’s the United States Postal Service: out of money, and almost out of time. But not out of options.”
- The website provides readers information about the proposed Postal Reform Act of 2011, which would restructure the Postal Service’s finances and business model to save it from bankruptcy, along with a countdown clock to the agency’s September 30 default deadline.
- “The USPS is fast-approaching default and without serious reforms it will collapse and be unable to meet payroll as early as next year,” said Chairman Darrell Issa (R-CA). “The American people will not accept the bailout of yet another failing institution which is why Congress must act to put the Postal Service on a sustainable course.” (*Daily Caller*, Alexis Levinson, 09/01/11)

USPS has dramatically reduced its employees' standby time"

- The Postal Service continues to paying thousands of its workers millions of dollars each year to do nothing, as required by long-standing labor agreements that prohibits the agency from laying off or reassigning workers because of broken equipment or periods of low mail volume. But the USPS is paying tens of millions of dollars *less* for so-called "standby time" than it did just two years ago, according to a new report by its inspector general. During the first six months of 2011, standby time totaled 170,666 hours at a cost of \$4.3 million for the Postal Service, according to IG. In 2009, the UPSP paid its employees \$30.9 million on 1.2 million of standby hours. (*Washington Post*, Ed O'Keef, 08/29/11)

TVA

TVA plans to structure a sale/leaseback of nuclear reactor to finance completion of a mothballed reactor

- TVA plans to temporarily sell ownership of a new nuclear reactor to avoid exceeding its federal debt limit and fund construction of a reactor in Alabama, said an agency spokesman. TVA plans to arrange the sale and leaseback of unit 2 reactor at the Watts Bar nuclear plant to fund the \$2.5 billion construction of a mothballed nuclear reactor at the Bellefonte plant. While a sale/leaseback would be more costly than issuing bonds, the transaction would allow TVA to finance construction without issuing additional debt. TVA has \$24 billion debt outstanding and a statutory debt limit of \$30 billion.
- TVA CFO John Thomas said structuring the financial arrangement, which is at least two years away, would be slightly more costly than issuing bonds, but its impact on ratepayers would be "minor." The lease term would likely range from 20 to 30 years with ownership of the reactor reverting back to TVA at the end of the term. Thomas said TVA's pursuit of the sale-leaseback strategy has "absolutely nothing to do with" any recent actions by credit rating agencies.
- TVA Group President Kim Greene said the leasebacks of plants will likely cost TVA more money than borrowing with its own money, but the utility is reluctant to ask Congress for additional borrowing authority at this time. "It just doesn't seem like a good time politically for this discussion in Washington, D.C.," said Greene.
- TVA President and CEO Tom Kilgore said TVA would still control everything about operations and safety in a nuclear sales-lease arrangement.

- National Regulatory Commission spokesman Roger Hannah said his agency examines an applicant’s “ability to be able to operate the plant safely.” In cases of investor ownership the NRC requires sufficient funds to restore the site and clean it up if a plant is shut down and places restrictions on how much of a nuclear plant can be owned by a foreign entity.
- Senator Lamar Alexander (R-TN) said TVA “should have financial flexibility to achieve its clean-energy goals, which requires building new nuclear power plants and putting pollution-control equipment on coal plants.” Alexander said he’ll be glad to consider any alternative financing “if it helps keep electric bills lower.” (*Associated Press*, Bill Poovey, 08/24/11; *Chattanooga Times Free Press*, Chris Carroll, 09/01/11)

Callous agenda—or goal of *creating* and *protecting* jobs?

- “On Dec. 22, 2008, about 5.4 million cubic yards of coal ash—a byproduct from the burning of coal to produce electricity— spilled out of a retention pond at a [TVA] generating plant in East Tennessee,” wrote *The Commercial Appeal* [Memphis] in a September 3 editorial. “About 3 million cubic yards of the sludge, which has been found to contain mercury, lead, arsenic and selenium, spilled into a river. Cleanup has cost about \$1 billion so far.”
- “Against that backdrop, the Republican leadership of the House of Representatives plans to make relaxing an Environmental Protection Agency plan to regulate coal ash as hazardous waste one of the party’s primary goals when Congress returns from its summer recess next week. ...Republicans also aim to undo an EPA regulation that requires Tennessee and 26 other states to cut power plant emissions that cause air quality problems downwind.”
- “Their contention that easing EPA rules will create jobs seems to be gaining traction. The Obama administration on Friday said it was overruling the EPA’s plan to adopt a stricter standard for ground-level ozone, which causes respiratory illness.”
- “It’s hard to imagine an agenda more transparently callous. That it is getting White House support now, too, leaves advocates for the protection of human lives and the environment wondering what’s next.” (*The Commercial Appeal*, 09/03/11)

“Above all, there is a moral hazard in central bank activism. It risks encouraging governments to sit back and let others do the work that they find too difficult themselves. That is both a dangerous abdication of responsibility and a missed opportunity.”

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