

The **GSE** REPORT

Fannie Mae & Freddie Mac

- *Columnist Calls No Explicit Federal Guarantee, "Splitting Hairs":*
 - In his regular Q&A column in the Monday Money Section of the *Boston Globe*, columnist Kenneth Hooper, was asked by an investor about the difference between Ginnie Mae and Fannie Mae/Freddie Mac funds. Mr. Hooper in his response said that Value Line describes Fannie Mae and Freddie Mac securities as the following: "Debt enjoys favorable 'government-agency' status, but no explicit federal guarantee." According to Kenneth Hooper, "this is splitting hairs; there is no reason to worry about the credit quality of these issues." (*The Boston Globe Online*, 2/23/98)
- *MBA Working with GSEs on New Technology:*
 - The Mortgage Bankers Association (MBA) is working with Fannie Mae to build an interface containing all the data needed by Fannie Mae's Desktop Underwriter and Freddie Mac's Loan Prospector. While the GSEs are working with the MBA to share data, they do not want to have one central underwriting system. (*Inside Mortgage Finance web site*, posted 2/20/98, as appeared in Feb. 23, 1998 issue of *Inside Mortgage Technology*)
- *Servicer Tracker Receives Approval to Be Original Mortgagee on Loans Sold to Fannie and Freddie:*
 - Mortgage Electronic Registration Systems Inc. (Mers) received final approval to be original mortgagee on loans that will be sold to Fannie and Freddie. Mers is an electronic system that tracks ownership of servicing rights, said the change should save lenders an average of \$22 per loan. Lenders that are members of Mers will no longer need to record assignments once servicing rights are sold or transferred. A consortium of mortgage

companies owns the Mortgage Electronic Registration Systems, including lenders, mortgage insurers, and Fannie Mae and Freddie Mac. (*American Banker*, 2/19/98)

- *Fannie Mae and Freddie Mac Provide Adoption Benefits to Employees:*
 - Companies are increasingly providing adoption benefits to employees including Fannie Mae and Freddie Mac. Fannie Mae provides up to one month of paid leave and another five months of unpaid leave to help encourage the parent-child bond. Fannie Mae's adoption benefits include financial reimbursement, paid leave, and resource and referral services. Fannie Mae first instituted its program in 1989 providing for adoption leaves, and it expanded it to include a \$5,000 cash benefit toward adoption expenses in 1994. Freddie Mac provides financial reimbursement and resource and referral services. (*Washington Post*, 2/27/98)

Fannie Mae

- *Fannie Objects to Fed Move to Assign Same Risk Weights to Fannie Mae MBS as AAA-rated home equity loan securities:*
 - Fannie Mae does not like a proposal by federal banking regulators to give AAA-rated home equity loan securities the same risk weighting as Fannie Mae MBS. "We recommend the agencies revise the proposal to place AAA-rated private securities in multi-class transactions between the 20% risk weight now assigned to GSEs and the 50% risk class," Fannie Mae stated in a comment letter. The capital markets acknowledge that debt and MBS issued by GSEs pose "distinctly less risk" than those of private issuers, Fannie Mae explained.
 - Furthering its argument, Fannie Mae commented that the rating organizations such as Moody's, Standard & Poor's, and Fitch typically do not give Fannie Mae's standard domestic obligations a rating on an issue-by-issue basis because investors and the rating agencies "view the implied government backing of Fannie Mae as a sufficient indication of the investment quality of Fannie Mae obligations." Private-label debt and asset-backed securities, on the other hand, are rated based on the specific credit characteristics of each asset pool and assumptions may prove inaccurate. Record levels of debt accompanied by record levels of foreclosure, credit card delinquencies, and consumer bankruptcies make the performance of asset-backed securities "far more volatile and difficult to predict than the performance of GSE debt or mortgage-backed securities, and renders ratings less reliable." Fannie Mae's comment letter details a few of the rating agencies comments on Fannie Mae, including Fitch, which assigned a blanket AAA rating to all of Fannie Mae's MBS and senior long-term and short-term debt. In assigning this rating, a Fitch analysis dated March 29, 1993 states: "The 'AAA' ratings are based primarily on the Federal government's compelling incentives to insure FNMA's continued viability. Although FNMA's obligations are not explicitly guaranteed by the U.S. government, Fitch believes that in the unlikely event of financial difficulties, the Federal government would support the company to the extent necessary

to provide for full and timely payment of FNMA mortgage-backed securities (MBS) and unsecured senior debt.”

- Fannie Mae stated that in all the rating agency examples they listed in their comment letter, the rating organizations “expressly emphasize[s] that its AAA rating directly reflects the ties and the continued strong involvement of the U.S. government with Fannie Mae. The close correlation between Fannie Mae obligations and Treasuries, as evidenced in these rating evaluations, allows the market to make a simple credit risk comparison between the two types of securities.” (*National Mortgage News* web site, 2/23/98; *Fannie Mae Comment Letter to OCC*, 2/3/98)
- *Fannie Opposes Higher FHA Limits:*
 - HUD Secretary Andrew Cuomo announced that President Clinton’s 1999 budget proposal to Congress will propose that FHA have the same loan ceiling as Fannie Mae and Freddie Mac. Sec. Cuomo, the Mortgage Bankers Association, the National Association of Realtors and the National Association of Home Builders held a joint press conference to announce their support for the Administration’s plans for FHA expansion. The new limit is controversial because it would mean that the FHA could go after the same loans as private mortgage insurers and Fannie Mae and Freddie Mac. Fannie and Freddie may invest in loans up to \$227,150 (their low-down-payment loans are backed by private insurers). Fannie Mae, the Mortgage Insurance Companies of America, community bankers, neighborhood activists, and the Heritage Foundation are opposed to the expansion, which would increase the ceiling for loans insured by the FHA by as much as \$140,833 from current levels. Fannie Mae says HUD should stick to its core mission and not take on new business – that incidentally might take business away from Fannie Mae. David Jeffers, vice president for corporate relations at Fannie Mae, said the proposal would put the government into a new market for larger mortgages with which it has little experience. “It’s a serious set of public policy questions,” Jeffers stated. Since the FHA’s core business is helping families most in need, he said, the agency’s move into a new market could have an adverse effect on poorer neighborhoods. (*Washington Post*, 2/17/98, 2/18/98; *Greensboro News & Record*, 2/18/98; *American Banker*, 2/19/98)
- *Should Fannie Mae be Taxed by the District of Columbia?:*
 - On behalf of the D.C. Tax Revision Commission, the Greater Washington Research Center has been studying the long-standing issue of whether the District and the states should be able to levy business taxes on Fannie Mae and similar organizations that are exempt because of their quasi-governmental status. At the Research Center’s recent annual meeting, luncheon guests were reminded that the venerable center “calls them like it sees them” even if the research isn’t popular. The guest speaker for the lunch was James Johnson, Chairman of Fannie Mae who told the luncheon guests that Fannie Mae’s D.C. address is “a choice, not a necessity.” Mr. Johnson further stated that the firm had stayed put during the District’s recent fiscal crisis while greatly increasing the financing of home purchases in some of the city’s most difficult neighborhoods. “We are committed to the District,” he said. “We are here to stay.” It is not clear how the Tax

Commission will ultimately decide the issue, although commission members recently received a briefing paper on what might happen if the District were able to tax Fannie Mae – including the possibility that the firm might move jobs out of the District of Columbia to escape a new tax. (*Washington Post Business*, 2/16/98)

- *Fannie Mae May Launch Third Benchmark Issue – Seven-Year Dollar Bond:*
 - Fannie Mae is expected to issue a seven-year benchmark dollar bond soon. The issue size is expected to be between \$3 and \$4 billion and would be Fannie Mae's third benchmark note issued this year. Fannie Mae began issuing benchmark notes (jumbo non-callable international bonds) in January and has said it plans to raise more than \$85 billion via the program in 1998. In January it issued a \$4 billion five-year bond and in February it followed with a \$4 billion 10-year. The highly liquid securities have been positively received by institutional investors, particularly in the U.S., because they are perceived as higher-yielding alternatives to U.S. Treasury notes.
 - Fannie Mae's issue is part of a recent trend towards larger bond issues. Bankers estimate that Fannie Mae has derived savings of three to five basis points from the massive size of its recent benchmark deals. Each basis point in yield costs the borrower \$1m over the life of a \$1bn issue of 10-year bonds. Jumbo issuers believe there are cost advantages to larger issues and they hope to build a complete yield curve believing investors will expect to receive lower yields in exchange for arbitrage opportunities along the yield curve. "Providing a liquid yield curve also gives you some kind of premium," according to Linda Knight, treasurer of Fannie Mae. However, Mooyaart, a company that analyzes bond prices relative to the performance of the most liquid benchmark issues, dismisses many of the arguments in favor of jumbo loans as "pure marketing." Brian Mooyaart, director of Mooyaart believes that maintaining a full and liquid yield curve could prove to be more of a headache than a benefit. For example, the borrower might need eight to 10-year funds but the market would demand a two-year bond to keep the yield-curve fully supplied. "Pledging to maintain a liquid yield curve is one way of tying your hands behind your back," he said. Analysts also say large issuers are taking advantage of cyclical factors in their favor, including the "flight to safety" prompted by the Asian crisis and the popularity of the dollar. Once these disappear, supranational borrowers could return to the "opportunistic" habit of issuing in high-yield currencies to exploit good arbitrage opportunities. Some underwriters believe that even large corporate deals might not provide the kind of liquidity investors crave. "The benchmark note structure will show its true worth when the market faces an external shock – if the U.S. bombs Iraq, for example. Regular spread product will widen in that situation, but Fannie Mae's bonds will be bid up because they're more in the realm of government debt than anything else," said a banker at a major European bank. (*Financial Times* web site, 2/23/98; *Reuters-London*, 2/18/98, 2/23/98)
- *Fannie Mae to Open Field Office in New Mexico:*

- Fannie Mae plans to open a field office in Albuquerque, New Mexico – the 29th office Fannie Mae has opened as part of its program to finance more than 10 million homes this decade. Fannie Mae plans on providing \$3 billion in financing for affordable housing over the next five years. Only nine other cities or states selected for the program have received equivalent or greater financing. Fannie Mae also hopes to increase its business with Native Americans, as 8.5% of New Mexico’s population is Native American. Fannie Mae will supply up to \$6 million of mortgage financing for the Pojoaque and Laguna Pueblos and the Navajo Nation. The agency has established loan initiatives for buying or refinancing, but its focus will be on the purchase of new-construction loans, according to Mark Vanderlin, a housing-impact specialist in Fannie Mae’s Dallas regional office. (*American Banker*, 2/23/98)

- *Fannie Mae Announces Initiative with AFL-CIO in Selected Cities (Features include: lower interest rates, lower mi premiums, lower down payments, more flexible underwriting, and forward interest rate locks/float downs):*
 - Fannie Mae and the AFL-CIO announced that thirteen cities have been selected to share \$250 million to boost homeownership among low- and moderate-income residents. The program, the Home Ownership Opportunity Initiative, allows city employees and members of AFL-CIO-affiliated unions to receive low-interest loans from a revolving fund with down payments of as little as 3%. The selected cities are Detroit, San Francisco, Oakland, Atlanta, Boston, Chicago, Las Vegas, Minneapolis, New Orleans, St. Paul, St. Louis, Seattle and Columbus. The AFL-CIO’s Housing Investment Trust Fund and Fannie Mae are setting the money aside and the trust fund and Fannie Mae will establish partnerships with private lenders and mayors in the selected cities. The Initiative will provide financing to purchase properties that are newly constructed or substantially rehabilitated single-family homes using 100% union labor.

 - Key features of the initiative include:
 - (1) Assisting individuals and families by reducing their mortgage payments during the initial year of homeownership by providing a *lower interest rate* up to one-half of a percentage point for the first five years;
 - (2) Lower Mortgage Insurance Premium Requirement- private mortgage insurance companies – the Commonwealth Mortgage Assurance Co. and PMI Mortgage Insurance Co. – have partnered in the initiative to *reduce premiums* for the required coverage;
 - (3) Lower Cash Outlay Required from Borrowers – the borrower’s minimum cash contribution would be only 3% of the cost of the home. The remaining fund needed to pay for closing costs and down payments can be provided by other acceptable sources;
 - (4) Flexible Underwriting – Eligible *family income has been increased to 115% of the area median income*, or greater in some cases. *Maximum debt-to-income ratios are 33% to 38%, or greater with compensating factors*. A nontraditional credit history will be allowed under this initiative;
 - (5) Forward Rate Lock/Float Down Provision: For homes to be built or rehabilitated, the *initiative will lock-in the current interest rate, with a float-down option up to nine*

months, protecting the borrower from rising interest rates. (Business Wire, 2/18/98; Detroit News, 2/19/98; Boston Herald, 2/19/98)

- *REIT Obtains Two Credit Facilities (One from Fannie Mae):*
 - Apartment Investment and Management Co. (Aimco), a real estate investment trust, received two credit facilities totaling \$100 million. Aimco said it received a \$50 million unsecured revolving credit line from Bank of America and BankBoston and a \$50 million master revolving credit facility from Fannie Mae and Washington Mortgage Financial Group Ltd. Under this master revolving credit facility, interest is charged at the rate of short-term discount mortgage backed securities which are credit enhanced by Fannie Mae, giving them AAA rating. Presently, the rate on these securities approximates LIBOR plus 50 basis points. The master revolving credit facility matures in five years. In the first four and ½ years, the master revolving credit facility can be converted into a term loan, subject to certain customary conditions. In addition, the master revolving credit facility allows for expansion up to \$250 million under terms agreed upon by both parties. \$36.9 million is currently outstanding under the new master revolving credit facility. Proceeds from the facilities will be used to fund acquisitions on an interim basis and for general corporate purposes. (*PR Newswire, 2/13/98; Wall Street Journal, 2/17/98*)
- *Mortgage Origination Software Allows Seamless Access to Fannie Mae's Desktop Underwriter and Desktop Originator:*
 - Byte Enterprises announced that their mortgage origination software, The Qualifier Series (TQS)™ now offers seamless access for lenders to Fannie Mae's Desktop Originator and Desktop Underwriter from point-of-sale software. The interface between TQS and Fannie Mae's Desktop Underwriter and Desktop Originator allows loan officer to use TQS and the Fannie Mae products simultaneously. Loan officers submit borrower information directly to lenders through Fannie Mae's Desktop Originator program and the lender then uses Desktop Underwriter to obtain underwriting directly to the loan officer. "We are pleased with the initiative that Byte has taken to seamlessly integrate their TQS product with our Desktop Originator and Underwriter systems," said David Coleman, Fannie Mae's director of consulting and integration services. "Byte's integration initiative furthers our mutual interests in bringing automation to the mortgage industry and offering lenders choices to suit their unique business needs through flexible connectivity options." (*Business Wire, 2/24/98*)
- *GMAC Commercial Mortgage Named Master Servicer for \$326 Million Fannie Mae Securitization – First FNMA Security Backed by Collateral from its Multifamily Aggregation Facility:*
 - GMAC Commercial Mortgage was selected by Fannie Mae as the master servicer for Fannie Mae's recently announced \$326.1 million multifamily Real Estate Mortgage Investment Conduit (REMIC). GMACCM also said it is contributing \$16 million in mortgages to the REMIC, Fannie Mae's first security backed by collateral from its

multifamily Aggregation facility. According to Denise Pagnucci, vice president and director of investor relations for GMACCM's Servicing Group, "one of the innovations we will be providing to investors for the first time is the ability to access loan-level information on a Fannie Mae transaction via the Internet. Previously, investors usually had to rely on periodic status reports to monitor their investments. Now, they will be able to get a snap shot in real time over the Internet through GMACCM's website." The new Fannie Mae security, a Wisconsin Avenue Securities (WAS) senior-subordinated structure, consists of multifamily and blanket cooperative mortgage loans. NCB and the originators of the Aggregation loans will subservice their respective loans. The REMIC consists of 133 recently originated, fixed-rate multifamily and residential cooperative mortgage loans. (*PR Newswire*, 2/19/98)

- *Fannie Mae Purchases City Bonds in Philadelphia to Assist Housing:*
 - The Philadelphia Redevelopment Authority completed two private placements totaling \$12.2 million with Fannie Mae, providing funding for the Authority's Home Improvement Loan and Single-Family Home Mortgage Revenue Bond Program. The Authority has sold \$4.6 billion of its home improvement loan bonds and another \$7.5 million of home mortgage bonds to Fannie Mae, to benefit low and moderate-income residents. The Philadelphia Home Improvement Loan Program offers FHA-insured Title I loans to city homeowners at significantly reduced interest rates: 3 percent for low-income borrowers and 6% for those with moderate incomes. A 9 percent rate is available without income restrictions. (*Philadelphia Daily News*, 2/20/98; *Philadelphia Business Journal*, 2/23/98)

- *Fannie Mae Assists Homebuyers in Herald Rock, SC:*
 - U.S. Rep. John Spratt (D-SC) announced that Fannie Mae would join Rock Hill Joint Venture for Affordable Housing to help more first-time homebuyers. With this announcement, more of Rock Hill's first-time homebuyers will get as much as \$5,000 for a down payment and closing costs through the new partnership. The program is for families that make less than 80% of the area's median income. A family of four has to make less than \$39,700 before taxes to qualify. Kathy Cornett, a planner with the city of Rock Hill, said families that live in the house they buy for at least five years do not have to repay the \$5,000. To qualify, families must complete Rock Hill Joint Venture's homebuyer education program. Fannie Mae also announced that they would bring their Flexible 97 program to the area. (As noted in previous *GSE Reports*, the Flexible 97 program allows eligible home shoppers with good credit to buy a house, with as little as 3% down. The downpayment can come from a family member, loan from a non-profit, or a credit card.) (*The Herald Rock Hill, SC*, 2/19/98)

- *Fannie Mae Credit Enhances \$57 Million Commitment to Refinance Tax-Exempt Debt:*
 - Walden Residential Properties, Inc. (a self-administered and self-managed real estate investment trust) obtained a \$57 million commitment of tax-exempt financing from Washington Mortgage, part of the WMF Group. Fannie Mae provided credit

enhancement. The new financing will provide Walden with 30-year credit enhancement for weekly variable rate demand bonds, with the option to convert at any time to fixed rate tax-exempt bond financing. The loan will replace prior weekly variable rate tax-exempt debt of the Company, most of which was scheduled to mature in June 1998. The facility will be collateralized by a pool of properties, with Walden having the ability to substitute properties throughout the term of the loan. (*Business Wire*, 2/19/98)

- *Fannie Mae Puts REMIC and SMBS Disclosure Documents On-Line:*
 - Fannie Mae is making Fannie Mae REMIC and stripped mortgage-backed securities (SMBS) disclosure documents available through the Fannie Mae web site. Internet users will be able to download these documents into a file or print them directly from the screen. Available documents include REMIC Prospectuses and REMIC Prospectus Supplements issued since January 1993: SMBS Prospectuses and SMBS Preliminary Data Statements. (*Business Wire*, 2/27/98)

Freddie Mac

- *Freddie Mac Chairman and CEO Tells Salomon Smith Barney that Freddie Mac Intends to Enter Into New Markets:*
 - Freddie Mac Chairman & CEO Leland Brendsel recently delivered a speech to Salomon Smith Barney giving an overview of Freddie Mac's business, their basic lines of business, new opportunities for increasing shareholder value, and his perspective on the outlook for 1998. Chairman Brendsel stated that since Freddie Mac went public in 1989, their shareholders have earned a compound annual return of 31% - compared to 18% for the S&P 500 over the same period. In 1997, Freddie Mac's earnings grew 15% and their return on common stock exceeded 20% for the sixteenth year in a row. At year-end 1997, Freddie Mac had \$579 billion of Freddie Mac MBS outstanding –earning an average guarantee fee or spread of about 23 basis points as compensation for bearing the default risk on the mortgages underlying these securities. At year-end 1997, Freddie Mac's retained portfolio totaled \$164 billion. Mr. Brendsel remarked that the average spread on their investment portfolio is higher than securitization, but they must hold more capital per dollar of mortgages financed.
 - According to Mr. Brendsel, “we are implementing a strategic plan to build the capabilities to expand our market reach beyond our traditional bounds.” He further stated, “Our initial focus will be on recapturing the business we have lost in recent years in the Alternative A and A- segments. Then we will begin entering new market segments in a controlled fashion. Overall, I expect to see our penetration of the market increase, and our growth exceed the market's, as we succeed in implementing our strategic direction.”
 - On the investment side, Mr. Brendsel felt that Freddie Mac's retained portfolio continued to offer strong asset growth at excellent returns on capital. Their investment strategy

includes several components: (1) continue to use a high proportion of callable debt in their funding mix, recognizing that the cost is lower near-term earnings; (2) with a large issuance volume, consistent market presence, and ability to tap global capital markets – they will continue to broaden their investor base and use preferred stock to reduce their overall cost of capital; and (3) purchase more non-generic mortgage assets (such as certain types of REMIC tranches). Mr. Brendsel expects that the “retained portfolio to be solid source of revenue growth for years to come.” Mr. Brendsel went on to say they must increase their purchasing by stating that “at the current level of mortgage rates, we expect one-quarter or more of our retained mortgage portfolio to run off this year. This means it will take a much higher level of gross purchases to replace runoff and produce the strong growth we have seen in recent years.” (*Remarks by Chairman Leland Brendsel to Salomon Smith Barney, 2/29/98*)

- *Freddie Mac Reports Retained Portfolio Growth for January, 1998:*
 - Freddie Mac announced record monthly retained portfolio purchase commitments of \$17.1 billion in January. During the month, the retained portfolio settled \$7.4 billion, less liquidations of \$2.7 billion, for net growth of \$4.7 billion. “There were many attractive investment opportunities last month,” said Greg Parseghian, Chief Investment Officer. “Mortgage spreads had widened and we experienced reduced funding costs.” However, Parseghian cautioned, “This level of growth is not likely to be sustained throughout 1998.” (*PR Newswire, 2/17/98*)
- *Freddie Mac Creates New Industry-Relations Position:*
 - Freddie Mac named Dwight Robinson to the newly created position of vice president, industry relations. In that role, Mr. Robinson will be responsible for coordinating the corporation’s relationships with trade associations and other key industry groups and for developing strategies on issues of importance to the housing finance industry. (*Freddie Mac press release, 2/18/98*)
- *Freddie Mac/MGIC Alliance Expand EarlyIndicator (Scoring Model):*
 - Freddie Mac and Mortgage Guaranty Insurance Corporation (MGIC) have released an expanded scoring model (Early Indicator(SM) – Version 3.0) to give services the option of using borrower credit scores to enhance loss mitigation and collection efforts. Early Indicator, first developed in 1997 through an alliance between Freddie Mac and MGIC, is a statistical modeling system that determines the probability of late paying borrowers becoming more delinquent and continuing through to foreclosure. The newest version of Early Indicator(SM) will allow servicers for the first time to combine the Early Indicator collection scores with borrower credit scores for new risk ranking of high-risk delinquent loans. In related news, Freddie Mac/MGIC have also created an interface for the Early Indicator (SM) that will allow servicers with loan files on the ALLTEL platform (used by mortgage servicers to manage databases) to have seamless access to Early Indicator (SM). (*Freddie Mac press releases, 2/9/98, 2/11/98*)

- *Freddie Mac Pilots Expense Reimbursement Request Status Reports for Servicers:*
 - Freddie Mac has started a pilot, Expense Manager (SM), on their Gold Works® network (Freddie Mac’s managed subscription network between Freddie Mac and business partners) that will enable servicers to obtain electronic daily status reports and other detailed information about their Freddie Mac default management reimbursement requests. The pilot involves seven servicers and is expected to lead to full deployment this summer. (*Freddie Mac press release, 2/17/98*)
- *Freddie Mac Recognizes Four Servicer Companies for Outstanding Performances:*
 - Freddie Mac announced that GMAC, Resource Bancshares Mortgage Group, Inc., WMC Mortgage Corp. and U.S. Bank, Home Loans were recognized as the first servicers to achieve Freddie Mac’s Tier One performance rankings for both performing and non-performing loans. As a result of Tier One status, the four servicers will receive financial benefits including increased workout incentive fees, complimentary GoldWorks® software, and waivers of several standard Freddie Mac fees including transfer of servicing fees and the Early Indicator (SM) annual renewal fee. To qualify for the Tier One program’s special recognition and benefits, servicers must achieve Tier One ratings for both performing and non-performing loan portfolios for at least two quarters during a calendar year. (*Freddie Mac press release, 2/19/98*)

International GSEs

- *“GSE-like” Institutions May Have Caused Asian Financial Crisis:*
 - Paul Krugman, a Ford International Professor of Economics at MIT presented a paper recently on the Asian financial crisis at a conference in Japan that attempted to sketch out a framework for understanding the nature of the Asian financial crisis. He felt it was necessary to approach the examination of the crisis from a perspective different from the traditional currency crisis theory. In his opinion, the Asian economies did, of course experience currency crises, but that is only part of what happened and in order to make sense of what went wrong, the role of “financial intermediaries” and of the moral hazard associated with such intermediaries when they are poorly regulated must be examined. (His descriptions of “financial intermediaries” appear to be very similar to the US definitions of GSEs.) According to Krugman, “what would a true account of the Asian crisis look like? Let me propose the following story: The problem began with financial intermediaries – institutions whose liabilities were perceived as having an implicit government guarantee, but were essentially unregulated and therefore subject to severe moral hazard problems. The excessive risky lending of these institutions created inflation – not of goods but of asset prices. The overpricing of assets was sustained in part by a sort of circular process, in which the proliferation of risky lending drove up the prices of risky assets, making the financial condition of the intermediaries seem sounder than it was. And then the bubble burst. The mechanism of crisis... involved that same circular

process in reverse: falling asset prices made the insolvency of intermediaries visible, forcing them to cease operations, leading to further asset deflation. This circularity, in turn, can explain both the remarkable severity of the crisis and the apparent vulnerability of the Asian economies to self-fulfilling crisis.”

- According to Krugman, “financial intermediaries” (whose liabilities are guaranteed by the government) pose a serious moral hazard but the problems in Asia were even murkier because there were implied guarantees of liabilities. He believes the US savings and loan crisis was a classic example of the government guarantee problem: “because depositors in thrifts were guaranteed by FSLIC, they had no incentive to police the lending of the institutions in which they place their money; since owners of thrifts did not need to put much of their own money at risk, they had every incentive to play a game of heads I win, tails the taxpayer loses.”
- The Asian financial crisis is “murkier” in his opinion than the US savings and loan crisis because in general, creditors of financial institutions in Asia did not receive explicit guarantees but only implied guarantees by the governments. “However, press reports do suggest most of those who provided Thai finance companies, South Korean banks, and so on with funds believed that they would be protected from risk – an impression reinforced by the strong political connections of the owners of most such institutions... It is a familiar point that such intermediaries then have an incentive not merely to undertake excessively risky investments, but to pursue investments with low expected returns as long as they have ‘fat right tails’ - that is, the owner of a guaranteed intermediary likes investments that could yield higher returns if he gets lucky, even if there is a strong possibility of heavy losses.” (*Paper by International Professor of Economics at MIT, Paul Krugman for a conference in Japan, Jan. 1998*)
- *Argentina Expected to Start Privatizing State Mortgage Bank in June:*
 - The Argentine government is expected to offer the first tranche of its initial public offering in Banco Hipotecario (BNH), the Argentine National Mortgage Bank, in June. The initial public offering is expected to raise between \$2.0 billion and \$3.0 billion, according to unofficial estimates published in the press. The Argentine trade group Aldea said the state mortgage bank Hipotecario is the country’s eighth largest bank in terms of assets as of August 31, 1997. (*AP, Dow Jones Newswires, 2/3/98, 2/4/98*)

Federal Home Loan Banks

- *FHLBank of NY Opposes FHLBank Expansion Provisions in the Financial Services Modernization Bill:*
 - Alfred DelliBovi, President of the FHLBank of NY, wrote a letter to House Members asking them to defeat the financial services modernization bill (H.R. 10) or delete the Home Loan Bank provisions contained in Subtitle H of H.R. 10. According to Mr. DelliBovi, the language as drafted would have a “significant negative impact on the Home Loan Bank, the communities we serve and our members who are the leading established housing lenders in New Jersey, New York, Puerto Rico and the United States Virgin Islands.” As we stated in an earlier *GSE Report* (11/14/97), the FHLBank provisions would expand the powers of the FHLBanks and allow system members to use advances for small-business, economic development and agricultural loans. Mr. DelliBovi’s problems with the provisions are the following: “First, Section 177 would hike the cost of membership through excessive capital requirements. Second, Section 178 mandates a reduction of our investments so that growth in our Affordable Housing Program would be halted. This section would also reduce our capacity to pay dividends to our members and thus cause capital to flee from the Home Loan Bank System. Third, Section 176 would appear to reduce our taxes, but the proposed REFCORP Tax change is drafted without an adequate guarantee that the American taxpayer will be held harmless from this shift. Finally, Section 179 would transform the Federal Housing Finance Board, our safety and soundness regulator from an independent agency to a politically controlled entity.” (*FHLBank of NY Letter to Capitol Hill, 2/26/98*)
- *Reports of “Strong-Arm Tactics” by Fannie Mae Against FHLBanks’ New \$1 Billion Global Bond:*
 - Comments by a bookrunner in the publication, *Euroweek*, indicate that a new liquid benchmark global transaction by the FHLBank is missing most of the heavy-weight U.S. banks. The \$1 billion FHLBank global bond was launched on January 15. The deal was put together because several of the FHLBank members had demands for five year money but was never motivated by a desire to copy the recent issues by Fannie Mae, nor was the deal positioned as such. Market appraisers have made the following comments: “there has been lots of talk about Fannie Mae using strong arm tactics on the US houses to prevent them from being involved in this issue. The only American to accept the deal was Lehman which actually was co-arranger of Home Loans global note programme. The deal is a completely different animal to the Fannie Mae which is a \$4bn benchmark deal. Consequently Home Loans are paying 25 cents in fees instead of 10 cents.” Further comments include “I am amazed that the US houses are kowtowing to Fannie Mae. We even heard that Goldman Sachs had accepted a joint books position initially but were persuaded to pull out yesterday.” Another comment was “...Fannie Mae is extremely annoyed by Home Loans jumping on to their coat tails once more. People will remember when they did this in the Deutschmark market in 1996 – with the result that both deals performed poorly. That is no doubt why so few US banks are involved in the syndicate for this transaction and why they are prepared to give up their relationship with FHLB. As this is a completely different trade to the Fannie Mae, it is hard to see why

they would be so upset. Fannie Mae is a hugely liquid US Treasury substitute, Home Loans a normal global bond.” (*Euroweek*, 1/16/98)

- *FHLBank of NY and FHA/HUD Enter Into Risk Sharing Agreement:*
 - The FHLBank of New York and HUD will share the risk of loss on mortgages for certain affordable multifamily housing projects equally under a new agreement. The public-private partnership is designed to lower the cost and increase the supply of mortgage credit for affordable housing. Loan originating local member lenders may be required to assume a portion of any potential loss with the FHLBank of New York. The FHLBank’s ability to share the risk on a mortgage loan with the member lender is a separate function from HUD’s risk-sharing obligation on the loan. (*National Mortgage News* web site, 2/23/98)
- *FHLBank of Cincinnati President appointed to Habitat for Humanity International Board of Directors:*
 - Charles Thiemann, president of the FHLBank of Cincinnati was appointed to the Habitat for Humanity International Board of Directors for a three-year term. The Board is comprised of 28 business and community leaders. Over \$3.2 million has been awarded to FHLBank of Cincinnati’s member financial institutions in partnership with Habitat for Humanity. (*PR Newswire*, 2/24/98)

Farm Credit System

- *Farm Credit System Substantially Increases Net Income for 1997:*
 - The Farm Credit System combined net income increased \$66 million to \$1.267 billion for the year-end of 1997, as compared with combined net income of \$1.201 billion for 1996. The fourth quarter net income for 1997 was \$332 million, as compared to \$250 million for fourth quarter 1996. Net interest income also increased \$26 million and \$29 million to \$561 million and \$2.190 billion for the fourth quarter and year ended December 31, 1997, respectively. This compares to net interest income of \$535 million and \$2.161 billion for the same periods of 1996. The increase in net interest income in 1997 was due principally to higher loan volumes, funded in part by an increase in interest-free funds. (*Business Wire*, 2/25/98)

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