

# The **GSE** REPORT

---

---

## ***Fannie Mae & Freddie Mac***

- ***The Financial Incentives Fannie & Freddie Provide Lenders to Use their Automated Underwriting Systems Creates Duopoly:***
  - A Milwaukee *Business Journal* article reported that lenders are increasing their usage of Fannie & Freddie's automated underwriting systems to compete and find quicker loan approvals. St. Francis Capital Corp. and several other local banks have signed contracts to use Fannie's automated underwriting system, Desktop Underwriter, which lets the bank know whether the agency will buy the loan. According to the *Business Journal* article, "In effect, that tells the bank whether to approve the loan."
  - St. Francis Capital had looked at other automated underwriting packages, but a price reduction convinced the company to sign a contract with Fannie Mae. The article noted that until recently, banks paid \$60 to \$70 for every loan processed through Fannie's Desktop Underwriter, whether or not it was approved. The processing fee applied even if the bank didn't want to sell the loan to Fannie Mae but intended to keep the loan on the books. James Eckel, senior vice president of lending for St. Francis said "Those were costs we could not justify." So, Fannie made two changes to convince the bank to use their system. The first change was a reduced fee, which Eckel wouldn't disclose. Fannie also lowered the cost to process loans the bank doesn't want to sell to Fannie Mae, allowing St. Francis to run the loan through their system to see if it should be approved without being charged the same as if it were selling the loan. "And if Desktop Underwriter gives the loan an 'accept' rating, Fannie Mae will buy the loan and never require the bank to buy it back if the borrower defaults. Two other ratings mean the bank could be required to repurchase the loan if it goes bad." M&I Mortgage Corp. decided to use Freddie Mac's automated underwriting system, Loan Prospector, it says because it is a better match with their bank's existing software. "We have investors who buy our loans, then sell them on the secondary market to Fannie or Freddie," said Scott Happ, president of M&I Mortgage. "As long as we have one of the services checking our loans, they are acceptable for sale." (Milwaukee *Business Journal*, 7/6/98)

- ***Analysts Predict Double-Digit Earnings Growth in 2<sup>nd</sup> Quarter for Fannie & Freddie:***
  - Analysts predict that Fannie Mae is expected to post earnings of 79 cents a share, up 14% from 69 cents last year and Freddie Mac's earnings to increase 56 cents a share, up 22% from 46 cents last year. Salomon Smith Barney analyst Thomas O'Donnell believes that the earnings growth of Fannie & Freddie should alleviate market fears that profits at Fannie and Freddie had topped out due to the immensity of their portfolios. According to O'Donnell, Fannie & Freddie had increased their fixed-rate portfolios in the quarter: Freddie Mac's grew about 22% and Fannie Mae's increased about 27%. PaineWebber analyst Gary Gordon estimated that Fannie & Freddie purchase approximately \$175 billion in mortgages for their loan portfolios and mortgage-backed securities business in the second quarter, which is about 47% of all loans originated in the period. This compares with about \$63 billion, or about 32% of total loan originations, a year ago. (*Dow Jones Newswire, 7/7/98*)
- ***HUD Makes it Easier for Fannie & Freddie to Meet Affordable Housing Goals – HUD Announces New “Utility Allowances” to Determine Whether Rental Units Financed by GSE Mortgage Purchases are Considered “Affordable Housing”:***
  - HUD announced new utility allowances to determine whether rental units financed by GSE mortgage purchases are affordable and may count toward the income-based affordable housing goals of the GSEs. These utility allowances shall be added to the contract rent for rental units in which: (1) tenant income is not available; (2) contract rent does not include the cost of utilities; and (3) the GSE does not use the HUD Section 8 utility allowances. The utility allowances for 1998 and 1999 are: Multifamily - (efficiency-\$51; 1 bedroom-\$61; 2 bedrooms-\$79; 3 bedrooms or more-\$105); Single-Family – (efficiency-\$61; 1-bedroom-\$81; 2 bedrooms-\$111; 3 bedrooms or more-\$145). (*Federal Register, 7/8/98, pages 36931-36932*)
- ***Private Sector Creates New CRA Securitization Program:***
  - As we noted in the June 26<sup>th</sup> *GSE Report*, in the last eight months Fannie Mae and Freddie Mac have started to securitize more CRA loans to meet their housing goals. The private sector, however, seems to be more creative and resourceful in this area. For example, Access Capital Strategies LLC just launched a mutual fund that is designed to act as a national secondary market for CRA loans, with an initial \$25 million investment from BankBoston Corp. According to the *American Banker*, “the fund will buy securities structured for direct sales to the fund, or it will purchase private placements – a custom-crafted security where the price of the guarantee and the price of the sale of asset can be negotiated simultaneously and locked in – to create a secondary market presence.” The fund will then purchase securities from CRA loans. Sources on Wall Street note that other firms such as Salomon Smith Barney, Lehman Brothers, and Credit Suisse First Boston, are also interested in getting into the securitization business. Ronald Home, chief executive officer of Access Capital Strategies, noted that Fannie Mae and Freddie Mac are both overlooking or “constantly evolving” some of their criteria for purchasing such

loans and “this could be pioneering for their ongoing CRA initiatives.” (*American Banker*, 7/7/98)

- ***Wrong Bet on Mortgage Strips Costs Investors Dearly:***

- “A wrong bet on interest rates has cost hedge funds and other mortgage portfolio managers hundreds of millions of dollars. The investors bought interest-only strips in the mortgage-backed securities market – but their purchases turned sour when borrowing costs stayed lower than expected during May and June. Those sustained cheap mortgage rates prompted a flood of refinancing by homeowners, creating high prepayments and pounding the value of interest-only strips over the last few weeks. The losses were so bad that some were forced to sell, market participants said. And the problems may not be over.” “As an example of price behavior, a trade said that a 6.5% IO strip from Freddie Mac trust 192 declined to 31  $\frac{3}{4}$  on May 12 from a price of 32  $\frac{1}{8}$  on April 27, according to figures in a recent Bear Stearns & Co. research report.” Reportedly, the selling started with Capstead (selling IOs) about six to eight weeks ago. “Capstead’s house cleaning may have affected other areas of the MBS market beyond IOs. In addition to liquidating its IOs, it sold portions of its other MBS holdings, including \$659 million of its Fannie Mae and Freddie Mac adjustable-rate mortgages (ARMs) securities and \$656 million of its Ginnie Mae ARM securities.” (*Dow Jones Newswire*, 6/26/98)

## ***Fannie Mae***

- ***DC Mayoral Candidate Suggests Taxing Fannie Mae:***

- During a recent forum of DC mayoral candidates, DC council member and mayoral candidate Carol Schwartz (R-At Large) spoke in favor of taxing Fannie Mae and perhaps nonprofit agencies. Democratic candidates said they oppose trying to change the law. (*Washington Post*, 7/1/98)

- ***Fannie Mae Increases REMIC Fees:***

- Fannie Mae announced a fee increase for some of its real estate mortgage investment conduits (REMICs). Market participants believe that in the short-term this fee increase may bolster near-term issuance of Freddie Mac REMICs but it won’t have a meaningful impact on long-term Fannie Mae REMIC issuance. According to market sources, the fee increase affects REMICs which pay on the 18<sup>th</sup> day of the calendar month and is being levied on deals which are structured in July. Fannie Mae did not comment on the fee increase and Fannie Mae spokesman Gene Eisman told Reuters that “Fannie Mae does not discuss its REMIC fees.” A Freddie Mac spokesperson said they change their fees based on market forces and would not comment about Fannie’s new fee increase.
- A participant estimated that in a deal pooling Fannie Mae 6  $\frac{1}{2}$ % collateral, the fee increase translates into a 1/32 increase. “The fair value of the seven day float on Fannie

Mae 6 ½ percents is 4/32 and, until recently, Fannie Mae was charging 3/32,” the market participant said. So, for a \$1 billion REMIC this 1/32 adds up to \$312,500, according to the market participant. Sources did not believe that the higher fee increase was tied to the increasing deal sizes recently but suggested that Fannie Mae may have introduced the fees as away to regulate the massive flow of REMICs in July. One participant reasoned that Fannie is seeing a large book of business in July and the fees may be a way of managing the volume. Also, the market player noted that this sort of tack has been taken before by the GSE. A market participant warned that “what would slow REMIC issuance, though, is if Fannie Mae and Freddie Mac appetite to buy REMIC tranches for their own investment portfolio diminished. If that would diminish that would slow REMIC issuance considerably.” (*Reuters*, 7/10/98)

- ***Fannie Mae Streamlines Co-Op Appraisals:***

- Fannie Mae announced that it has streamlined appraisals on its automated underwriting system, Desktop Underwriter, for cooperative share loans. Appraisers of co-op units will now have the option to base their appraisals solely on inspections of the buildings’ exteriors so long as they can certify that they have adequate data from reliable sources. Previously, appraisers were required to inspect both the exterior and interior of a co-op. (*American Banker*, 7/1/98)

- ***Fannie Mae and FHLBank of Pittsburgh Hold Press Conference with Rep. Kanjorski:***

- Fannie Mae, the FHLBank of Pittsburgh, and Banking Committee Member Paul Kanjorski (D-PA) announced that Fannie’s Mae low-down payment program, Flexible 97, and the FHLBank’s Home Buyer Equity Fund can now be used together. James Chaney, Senior Vice President at the FHLBank of Pittsburgh noted that “Paul Kanjorski’s leadership has been pivotal in bringing two Government Sponsored Enterprises together in northeastern Pennsylvania today; perhaps this will set an example for other creative partnerships in the future.” The FHLBank of Pittsburgh’s Home Buyer Equity Fund provides up to \$5000 in grant assistance for down payment and/or closing costs to qualified buyers who complete pre-homeownership counseling. Loans made under the Home Buyer Equity Fund can be used in conjunction with several Fannie Mae affordable mortgage products, including Flexible 97, a low down-payment product that allows borrowers to make only a 3% down-payment on a 30-year fixed rate mortgage. The 3% down payment may be a gift, or unsecured loan from the family; a non-profit agency or municipality; a loan secured by a marketable asset; or a grant from an employer, non-profit, or government agency. (*PR Newswire*, 7/8/98)

- ***Fannie Mae Pilots Experimental Multi-Family Program:***

- Fannie Mae announced a \$25 million “mini-loan” initiative to finance apartments in the Bronx. Funds will be provided for the acquisition, rehabilitation or refinancing of apartment buildings with 5 to 25 units, particularly focusing on financing affordable rental properties in the Northwest Bronx. Owners or potential owners of such properties will be able to get 30-year, fixed-rate loans through three lender partners. Fannie Mae

will package the loans into mortgage-backed securities and a New York City pension fund will buy the securities. (*American Banker*, 7/1/98; *Business Wire*, 6/26/98)

- ***Fannie Mae Shuffles Executives and Creates New Post:***

- Fannie Mae announced that Robert Levin, who had been executive vice president for marketing since 1990, was named executive vice president for housing and community development (a new position). Ann Logan, who had been executive vice president and chief credit officer since 1993, was recently appointed executive vice president for single-family mortgage business. Adolfo Marzol (who was senior vice president for single-family marketing) will take over Logan's former position of executive vice president and chief credit officer. All changes are subject to board approval. Fannie Mae said the creation of a new community development position "reflects a commitment by the company to significantly enhance its community lending initiatives." (*Dow Jones Newswire*, 6/25/98; *National Mortgage News website*, posted 6/26/98; *PR Newswire*, 6/25/98)

Other Fannie Mae Staff Hires:

- Fannie Mae also announced the appointment of Patricia Ann Milon as vice president and deputy general counsel in its legal department and John Powell, Jr. as vice president for multifamily activities in its Midwest Region. Milon will be responsible for advising senior management on legislation and major regulatory initiatives affecting Fannie Mae and its customers. Prior to joining Fannie Mae, Milon was with the US Treasury Department in its Office of General Counsel. Prior to her work at the US Treasury Dept., Milon worked at Shaw, Pittman, Potts and Trowbridge in Washington, DC. Powell will be responsible for Fannie Mae's multifamily marketing and lender relationships, and the implementation of its policies and procedures in the Midwest region. (*PR Newswire*, 6/29/98)
- ***Fannie Mae Delays Benchmark Note Announcement and Reopens Old Issue:***
  - Fannie Mae decided to delay issuing its newest Benchmark Note until mid-July, and instead launched a \$2 billion reopening of its \$3 billion 6% Benchmark note due May 15, 2008. The combined total of \$5 billion makes it the largest non-sovereign dollar bond in the 10-year sector. The issue being reopened is Fannie Mae's fifth Benchmark, priced May 6<sup>th</sup>. The \$3 billion offering yielded 6.006% at that point, a spread of 33.5 basis points over the 10-year Treasury. The spread is now 37.5 basis points over the Treasury. According to a Fannie Mae spokesman, Gene Eisman, Fannie Mae had a "sense that the market's pretty crowded," and they've "been told that investors want a chance to hold back and evaluate where they stand" after June 30<sup>th</sup>. The news of the delay and reopened Benchmark came on the heels of a highly successful Freddie Mac issue of \$4 billion of 5-year Reference Notes. (*Dow Jones Newswire*, 6/26/98, 7/7/98; *Financial Times*, 7/10/98)

- ***Fannie Mae Coordinates End-Loan Financing for Elderly Deaf Community:***
  - Fannie Mae is providing end-loan financing for an elderly housing complex, Wyndholme Village in Southwest Baltimore, exclusively dedicated to deaf and hearing-impaired seniors. The facility will include 928 residential condominiums, along with a 90-room hotel with a conference center. Wyndholme expects to invest about \$150 million for the project. A one-bedroom condominium at Wyndholme costs about \$105,000 while larger units sell for about \$230,000. (*Baltimore Business Journal*, 7/6/98)

## ***Freddie Mac***

- ***Freddie Mac's Captive Reinsurance Program (MODERNs) May Be Used for Subprime Mortgages:***
  - As we noted in the May 22<sup>nd</sup> *GSE Report*, Freddie Mac's MODERNs program is a new reinsurance arrangement that is sounding alarm bells with private mortgage insurers who fear that Freddie Mac may be trying to get into the mortgage insurance business. This captive reinsurance program involves very little capital and virtually no MI involvement. *Inside Mortgage Finance* has uncovered even more details about the program. MODERNs are Mortgage Default Recourse Notes that are issued by a special purpose reinsurance company (G3 Mortgage Reinsurance Limited) effectively created by Freddie Mac and Morgan Stanley in the Channel Islands for tax and insurance reasons and started with a net worth of only \$10. The offshore reinsurance company will effectively assume all the default risk on a huge pool of \$20 billion in mortgages purchased by Freddie Mac in 1996. Freddie Mac will then pay out monthly "reinsurance premiums" consisting of generous interest rate payments to MODERNs bond holders, running as high as LIBOR plus 20%.
  - According to *Inside Mortgage Finance*, "One of the most interesting – and perhaps most telling - aspects of the recent MODERNs transaction is the huge insurance benefits afforded to Freddie Mac." Under the reinsurance agreement, Freddie Mac will be paid 27% of the outstanding balance for any loan that defaults – regardless of the actual claim amount that may be incurred. In addition, the reinsurance payments are expected to be paid on top of existing PMI claims payments. Approximately 40% of the \$20 billion in Freddie Mac-purchased mortgages are loans with LTVs above 80% and already carry private mortgage insurance. The mortgage industry is particularly upset about the appearance of this double mortgage insurance coverage on Freddie Mac's mortgages, since most insurance contracts reportedly prohibit multiple payments on the same loan default. MI companies are not expected to challenge Freddie Mac on the double coverage. Technically, however, Freddie Mac's reliance on reinsurance claim payments could result in some MIs refusing to pay separate claims on the same loan, resulting in problems for lenders and Freddie Mac, since mortgage borrowers would be paying for MI coverage that was never provided.

- According to *Inside Mortgage Finance*, “With \$243 million in MODERNS proceeds held by the reinsurance company, Freddie Mac could theoretically suffer a foreclosure/default rate of nearly 5 percent on the 197,457 loans in the reference pool without experiencing a loss.” It is unlikely that Freddie Mac will also have many problems in the loans they selected for the program, since Freddie Mac “went out of its way to select mortgages with extremely low risk characteristics.” However, “there appears to be little question that Freddie Mac is testing the waters for future deals involving riskier loans.” Some speculate that Freddie Mac might use MODERNS to reduce or eliminate the risk associated with purchasing large amounts of subprime mortgages. (*Inside Mortgage Finance website*, posted 6/26/98, as appeared in 6/26/98 issue of *Inside Mortgage Finance*)
- ***Freddie Mac Investigating Loan Fraud in South Florida:***
  - In a letter sent on June 4<sup>th</sup>, Freddie Mac announced that it has been investigating loan fraud in South Florida, citing “unusually high” mortgage default rates in South Florida. The letter, written by David Andrukonis, general manager of Freddie Mac’s seller division, targets mortgage brokers and correspondent lenders for providing false information on loan applications, from fabricated income to artificially inflated property values. “You should be circumspect with borrowers, brokers, appraisers and other parties involved in the loan origination process,” the letter stated. “We recommend that you review your processes for evaluating, approving and monitoring third-party originators.” Freddie Mac is targeting lenders in Miami-Dade and Broward counties. According to Freddie Mac spokesperson Brad German, Freddie Mac has never “sent an industry letter like this out before.” Florida’s Mortgage Bankers Association said it would also set up a group to research how to prevent and report mortgage fraud. Douglas Pollack, vice president of Information Data Services, Inc., which tracks mortgage fraud in Florida for title insurers, said approximately \$10 billion in fraudulent loans originated in Florida in 1996. (*Dow Jones Newswire*, 7/2/98)
- ***Freddie Mac’s Five-Year Note Outshines Five-Year Treasury Auction:***
  - A recent five-year Treasury note auction was disappointing in comparison with the \$4 billion sale of five-year notes from Freddie Mac. Underwriters noted that investors saw the securities as an opportunity to pick up extra yield while still having the implied guarantee of the US government. Market participants reported thin trading during the Treasury five-year note session, due in large part, to the Freddie Mac issue. Analysts said the new five-year Treasury note came under pressure earlier in the day as participants sold it and bought Freddie Mac bonds with the proceeds. The Freddie Mac deal was priced to yield 0.27% points more than the new five-year Treasury note, which closed just below 5.5% on June 25<sup>th</sup>. According to the *Wall Street Journal*: “But while the yield was more, Freddie Mac’s bonds carry little additional risk, thanks to the implied backing of the US government.” (*Wall Street Journal*, 6/26/98)

- ***Freddie Mac Announces Two Affordable Housing Initiatives:***

- New Orleans

- Freddie Mac formed a partnership with the city of New Orleans and the AFL-CIO Housing Investment Trust to launch a \$20 million revitalization program in several historic districts by offering various low down-payment mortgage products. The program, called “At Home in New Orleans,” will initially target 50 homes for rehabilitation, with the hopes of rehabilitating 500 homes in the future. Freddie Mac will purchase up to \$20 million in mortgages originated by local lenders, repackage them into securities, which will be purchased by the AFL-CIO Housing Investment Trust.

- Los Angeles

- Freddie Mac has teamed up with Broadway Federal Bank and Family Savings Bank to offer \$15 million of low down-payment loans under flexible underwriting criteria in an effort to increase minority homeownership in south central Los Angeles. Borrowers can use Freddie’s Community Gold program or Affordable Gold 97 Plus ® to purchase a home. Under Community Gold, a borrower who has completed a homeownership education program, will only have to provide 3% of the home price as the down-payment, of which only 2% of the purchase price has to come from the borrower’s own funds. Under Affordable Gold, borrowers can buy a home with 3% down, but none of the money has to come from the borrower’s own funds. Money can be obtained from secured secondary financing from a government agency, non-profit or employer, or an unsecured loan from a relative, employer or non-profit. Further if secondary financing is employed, the total amount borrowed can reach 105% of the home’s appraised value. (*Freddie Mac press releases, 7/8/98; National Mortgage News website, 7/9/98*)

- ***Freddie Mac will try to attract Asian Investors:***

- Freddie Mac officials stated that they are interested in creating a market for the agency’s securities in Asia, but have not started a program yet. Freddie Mac’s vice president of investor/dealer services, William Stephens, said Freddie Mac officials are planning to visit Asia later this year to educate Asian investors in agency mortgage-backed securities and Freddie Mac is seeking associations with Asian fund managers to help the agency market its products. Stephens noted that Japanese investors are more leery of mortgage-backed securities. “At this point, it is a little bit of a leap for Japanese investors’ to jump into the MBS market, because they’re not familiar with the issue of mortgage prepayments,” he said. Stephens said Asian investors are a little more comfortable with investing in agency debt than mortgage securities, at this point. Freddie Mac may try to create a Libor-based fund in Asia like the one created last year for European investors. “We found that people were not ready to invest in mortgages directly in Europe because they don’t have the structure to handle prepay risk, but they’re more willing to buy a fund that (returns) Libor and some spread.” (*Dow Jones Newswire, 6/30/98*)

- ***National Center for Adoption Recognizes Freddie’s Employee Adoption Assistance:***

- The National Center for Adoption recognized Freddie Mac with its National Champion of Adoption Award at the Center's annual meeting. Currently, \$7,000 is provided to employees to cover adoption costs. (*Freddie Mac press release, 7/8/98*)

## **Federal Home Loan Banks**

- ***FHFB Wins Court Case Challenging Controversial Chicago FHLBank Mortgage Partnership Finance Program:***

### US District Court Ruling:

- The US District Court for the Western District of Texas ruled on June 25<sup>th</sup> that the Chicago FHLBanks' controversial Mortgage Partnership Finance Program (MPF) was permissible under the FHLBank Act. Judge Sam Sparks dismissed the case brought by the Texas Savings and Community Bankers Association, Western League of Savings Institutions, World Savings Bank, Austin, World Savings and Loan Association, Oakland, CA, and Charter One Bank, a Cleveland-based thrift in May 1997. Sparks said the FHLBanks may hold mortgages as investments because holding mortgages does not make the FHLBank of Chicago a retail mortgage lender because the member institutions create and service the loans. The FHLBank "still functions as a wholesale credit provider under this arrangement," Judge Sparks said. The only significant difference given by the court between advances and the pilot program was that under a traditional advance, the member institution is the mortgagee, and under the pilot program, the Chicago FHLBank is the mortgagee. The court found that this difference, however, doesn't violate the FHLBank Act because the Chicago FHLBank is permitted to hold mortgages as investments, and the Chicago FHLBank is given incidental powers to carry out its duties under the FHLBank Act. FHFB Chairman Bruce Morrison called the decision a "landmark decision" because this is the "first time that a court has found that the FHLBank Act, on its face, permits a Federal Home Loan Bank to invest in mortgages as a security."

### Bankers' Arguments Against FHFB:

- The banking groups argued that the Federal Housing Finance Board (FHFB) overstepped its regulatory authority by permitting the Chicago FHLBank to fund and hold mortgages made by member banks and thrifts and because the pilot allows the Chicago FHLBank to engage in direct mortgage lending. The banking groups asserted that Congress prohibited direct mortgage lending by the FHLBanks. The banks noted that the FHLBanks' function was clearly to provide wholesale credit to mortgage lenders, while Fannie Mae, Freddie Mac, and Ginnie Mae's function was to purchase residential mortgages and making the mortgages available as securities. The banking groups have not yet decided whether to appeal the decision. One banker who was displeased with the court's decision noted "We already have Fannie Mae and Freddie Mac, and now they want to create another monster," said Manuel Mehos, president of Coastal Banc SSB, Houston.

### FHFB Arguments:

- The FHFB argued that the FHLBank Chicago Pilot Program gave member institutions an alternative to selling loans to the secondary market or holding fixed rate loans in portfolio. The FHFB felt that the Chicago FHLBanks' purchase of residential mortgage loans was justified as a permissible investment of FHLBank funds because that activity was functionally indistinguishable from advances, which the FHLBanks are already explicitly able to make. The FHFB also felt that the MPF was permissible under the incidental powers of the FHLBanks because the policies enable the FHLBanks to carry out their housing finance mission.

Controversial Pilot Will Now Be More Popular with Other FHLBanks:

- After the court decision, it is expected that the other FHLBanks will create similar programs like the Chicago MPF program. Alfred Dellibovi, Chairman of the FHLBank of New York, believes that the court decision will pave the way to make the MPF program "a standard product" of the FHLBanks. He said the decision "removes something that was a drawback to participation" and will facilitate involvement in the program by his bank and others.
- The *Dow Jones Newswire*, noted that the FHLBanks of New York and Pittsburgh are both interested in MPF initiatives, but the New York and Pittsburgh Banks are interested in tapping into the Chicago program rather than launching their own programs, and any such expansion likely would entail consideration of raising or eliminating the \$750 million cap on the Chicago MPF program.
- As we noted in the June 5<sup>th</sup> *GSE Report*, the FHLBank of Indianapolis is also interested in a similar MPF program. According to *National Mortgage News*, the FHLBank of Indianapolis is preparing to apply to the Federal Housing Finance Board (FHFB) for approval to purchase residential mortgages from its member financial institutions like the Chicago FHLBank. The FHLBank of Indianapolis calls their new program, the "Mortgage Purchase Program." According to an announcement by the FHLBank of Indianapolis, the new program will require no additional paperwork or processing and will "merely be another bidder on any mortgages its members want to sell." The FHLBank of Indianapolis will purchase home mortgages from its members, who will retain servicing rights. The FHLBank of Indianapolis believes they will be better able than Fannie & Freddie to tailor their programs for the specific needs of their regions. According to their announcement: "The close working relationship between the FHLBI and its members will also enable the Bank to tailor its loan requirements to the needs of lenders in Indiana and Michigan instead of relying on the one-size fits all criteria of the national secondary market." A Freddie Mac spokesman said, "We don't think it's going to have that big an impact on our business. We are only talking a couple of hundred million dollars here. If it grew to \$10 billion – that's another story."
- If the MPF program is expanded in one way or another (and plans are underway to do that) – it could compete more directly with Fannie and Freddie. Fannie Mae said it is monitoring the developments of the MPF pilot program. (*American Banker*, 7/2/98; *BNA Daily Report for Executives*, 7/2/98; *Dow Jones Newswire*, 6/30/98, 7/1/98; *FHLBank of*

*Indianapolis website- news announcement, 5/26/98; National Mortgage News website, posted 5/26/98, 6/1/98, and 7/7/98; PR Newswire, 7/1/98)*

- ***Senator Hagel's FHLBank Expansion Bill May Expand FHLBanks Even More:***

- Senator Chuck Hagel's (R-NE) FHLBank expansion bill has been debated in the back rooms of Congress this week. Senator Hagel initially wanted to attach the bill to the credit union legislation that the Senate is expected to vote on this month. However, an agreement was worked out between the supporters of Senator Chuck Hagel's bill, including FHFB Chairman Bruce Morrison and opponents of the bill, including Senate Banking Committee Chairman Alfonse D'Amato, FHFB Chairman Bruce Morrison, and FHLBank President Al DelliBovi. The *American Banker* reported that sources involved in the agreement indicate that the compromise contains a provision requiring the FHLBank to set aside extra risk-based capital for nontraditional investments such as mortgage-backed securities. Also, a provision would be added letting banks and thrifts buy nonredeemable stock in the FHLBanks. Senator Hagel is expected to add his FHLBank bill either to a Regulatory Burden Relief bill sponsored by Senators Connie Mack (R-FL) and Richard Shelby (R-AL) or move the bill separately. (*American Banker*, 7/9/98; *Dow Jones Newswire*, 7/8/98)

- ***Large FHLBank Shareholders Advocate Investment Limits on the FHLBanks:***

World Savings

- World Savings and Loan Association, a major shareholder in the FHLBank System, sent a letter to Senate Banking Committee Chairman Alfonse D'Amato urging him to block Senator Hagel's FHLBank Expansion bill from being included in regulatory relief legislation. World Savings stated that any legislation to reform the FHLBank System must include strict limits on non-mission investments. World Savings stated that the investment limits in Senator Hagel's bill "are not meaningful, and would, in fact, constitute congressional authorization for non-housing related Federal Home Loan Bank investment activities even above and beyond those in which the banks currently engage." The letter went on to say that "One simple fact conveys just how far afield of its traditional mission of support for retail mortgage finance the Federal Home Loan Bank System has already gone." World Savings added that "In the first quarter of 1998, the System issued more debt than the Treasury itself, investing the proceeds of this massive fund raising not in housing-related assets but in money market instruments. "This inappropriate private arbitrage of a public guarantee puts taxpayers at risk for the sole purpose of increasing dividends to system shareholders." World Savings also noted that the FHLBank System's shift to the "money market arbitrage business" has benefited financially from a benign interest rate environment. However, "Congress can safely assume neither that the current benign environment will long continue nor that the System has the experience or expertise needed to manage its arbitrage business safely under more volatile circumstances." According to the FHLBank System's 1997 Financial Report, World Savings and Loan is the third largest holder of FHLBank capital stock in the FHLBank System, holding \$424 million in stock, and the fourth largest advance

holding member of the FHLBank System, holding \$5,793 million in advances (at December 31, 1997).

#### Bankers Roundtable

- The Association for the largest commercial banks in the US, the Bankers Roundtable, also wrote a letter to Senator D'Amato opposing Senator Hagel's FHLBank proposals, complaining that the measure would inappropriately expand the System's mission. The letter states that "As a GSE, the FHLBSystem enjoys advantages over private sector lenders, and any expansion of its mission should be undertaken only in cases of extreme need as its participation in the market distorts market place dynamics." The Bankers Roundtable does not believe that Senator Hagel's provision allowing insured institutions with less than \$500 million in assets to now use advances for small business, agriculture, rural development, and low-income community development loans is justified, since no case has been made that the private sector is not meeting these needs. "Even if such evidence exists, one should question the value of a housing GSE providing funding to support small business and agricultural lending." The Bankers Roundtable also fears that the terms "small business, agriculture, rural development, and low-income community development" are too broad and that the FHLB will define the terms without limitations. "Thus the expanded mission would be open-ended under this language, not tied to any particular need."

#### Golden West Financial

- Golden West Financial also wrote a letter to Senator D'Amato urging him to block Senator Hagel's FHLBank bill from being added to the Senate Regulatory Relief bill. Golden West Financial argued that Senator Hagel's FHLBank bill would let the FHLBanks further expand their non-housing investments, stating that investments in money market and other non-housing investments create a "significant risk" for taxpayers and Golden West – one of the largest shareholders in the System. "The system lacks the expertise to manage or regulate such large-scale activity competently and prudently," especially if the economy takes a down-turn, wrote Golden West Financial Chairman Herbert Sandler. According to the *American Banker*, an aide to Senator Hagel called Golden West's comments "completely false" and "disingenuous," arguing that their bill contains sufficient investment limits. The aide accused Golden West of opposing the plan because it fears new competition if community banks gain broader access to FHLBank advances. (*American Banker*, 7/8/98; *Bankers Roundtable Letter to Senator D'Amato*, 7/7/98; *Dow Jones Newswire*, 7/7/98; *Federal Home Loan Bank System 1997 Financial Report*)
- ***FHFB Issues Final Rule on Expanding Eligibility for Membership and Advances:***
  - The FHFB issued a final rule on June 29<sup>th</sup> amending its membership and advances regulation to make it easier for small rural banks to qualify for membership in the FHLBank System, and to provide the collateral necessary to obtain FHLBank advances. The amended rules allow any loan secured by farm or business property to qualify for system advances as long as there is a residence on the property. These amended rules, however, only apply to financial institutions with total assets less than \$500 million.

Currently, FHLBank System members must have at least 10% of their loans in home mortgage loans. The 10% minimum was hard for small rural banks to meet because home mortgage loans for certain properties that include large tracts of land were defined as a home mortgage loan where the appraised value of the residence on the property equals at least 50% of the entire property. The FHFBS thought the 50% test was difficult for small rural banks to meet. The 50% test for combination properties would now be eliminated for those institutions with less than \$500 million in assets. The 50% test still applies to those institutions with more than \$500 million in assets. The combination property loans would be considered as residential property loans in determining eligibility for membership or collateral for advances as long as there is a permanent residence that is an "integral" part of the property. The rule took effect on June 29<sup>th</sup>, 1998. (*Federal Register*, 6/29/98, page 35117)

- ***FHLBank System Increases Investments and Advances:***
  - According to a recently released FHLBank System 1997 Financial Report, the FHLBank System advances were \$202.2 billion at the end of last year, up \$41 billion, or 25.3%, from the 1996 level of \$161.4 billion. System investments increased 11.9% during 1997, to \$140.1 billion from \$125.2 billion at year-end 1996. Mortgage-backed securities were \$50.5 billion at the end of 1997, up 10.5% from \$45.7 at year-end 1996. Because of the increase in both advances and investments, total assets reached \$348.5 billion at year-end 1997, \$56.5 billion or 19.3% higher than year-end 1996. The report also noted that the System had \$304.5 billion of consolidated obligations outstanding, \$53.2 billion, or 21.2% above the level outstanding in 1996. The report also noted that the System sold more than \$1.9 trillion in short-term discount notes during 1997. Responding to recent criticism about the FHLBanks non-mortgage investments, the Finance Board said it "may propose regulations later in 1998 that would place limits on the aggregate amount of money-market investments of an FHLBank." The membership of the FHLBank System rose to an all-time high of 6,504 at the end of 1997 surpassing the System's 1996 year-end high of 6,146. The number of commercial bank members reached 4,514 at the end of 1997 (69.4% of the System's membership). Voluntary membership is 84.6% of the total membership. (*Dow Jones Newswire*, 7/8/98; *Federal Home Loan Bank System 1997 Financial Report*, 7/2/98)
- ***Community Banker Believes FHLBank System Helps their Company Stay Competitive:***
  - Michael Middleton, President of Community Bank of Tri-County (Waldorf, MD), wrote a letter to the *American Banker* describing how the FHLBank of Atlanta has helped their community bank compete and survive. Shrinking deposits and the growth of mutual funds have hurt community banks because the capital levels of banks and thrifts are growing faster than deposits, leading to declining returns on equity and lower stock values for shareholders. Community banks like his need to leverage their capital with FHLBank advances to bring their net worth to an optimal level. The FHLBank advances "act as platform to leverage capital to fund both residential and nonresidential community development loans." He also believes that the FHLBank System makes liquidity

management easier and helps community banks attain a strong community reinvestment grade. (*American Banker*, 7/8/98)

## Farm Credit Administration

- ***Farm Credit Administration Issues Final Rule to Expand Access to Farm Credit System Funding:***
  - After two years of rule-making, the Farm Credit Administration issued a final rule on July 7<sup>th</sup> revising their regulations “so that farmers, ranchers, and other eligible rural residents have greater access to credit through OFIs [non-System other financing institutions] that are financed by FCBs [Farm Credit Banks] and ACBs [agricultural credit bank].” Sixteen comment letters were sent to the Farm Credit Administration on the proposed rule. All System direct lender association commenters, except one, opposed any revision to the existing OFI regulation because of their concerns over competition. Three commercial bank trade associations recognized the FCA’s efforts to improve OFI access to System funding, but they recommended modifications to the rule. One commercial bank supported the proposed rule and urged the FCA to adopt it as a final rule without revision. Commercial bank trade associations believe the FCA’s regulatory proposal made progress toward granting OFIs more access to System funding, but believe that several provisions of the statute discourage many commercial banks from becoming OFIs. The most commonly cited impediments for commercial banks to become OFIs were: (1) No authority for OFIs to obtain System bank funding for long-term mortgages; (2) lack of OFI representation on the boards of FCS funding banks; and (3) the need to offer borrower rights. Therefore the commenters wanted the FCA to support legislative proposals that would remodel the FCS so that is similar to the FHLBank System.
  - The Farm Credit Administration’s final rule allows financial institutions to become an OFI, if the company maintains at least 15% of its loan volume in loans and leases to farmers, ranchers, aquatic producers and harvesters (doesn’t include the loans assets of the OFI’s parent, affiliates, or subsidiaries), and if the company signs a 2-year general financing relationship agreement with the Farm Credit Bank or agricultural credit bank. The requirements for OFI funding relationships include (1) signing a general financing agreement; (2) purchasing non-voting stock in its Farm Credit Bank or agricultural credit bank. Each Farm Credit Bank and agricultural credit bank must also apply comparable and objective loan underwriting standards and pricing requirements to both OFIs and Farm Credit System direct lender associations. (*Federal Register*, 7/7/98, pages 36541-36549)

July 10, 1998

---

**Canfield & Associates, Inc.**  
801 Pennsylvania Ave., NW, Suite 625  
Washington, DC 20004  
Phone: (202) 661-2100  
Fax: (202) 661-2101  
[www.canfieldassoc.com](http://www.canfieldassoc.com)