

# The **GSE** REPORT

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

- *Consumer Advocate Ralph Nader Announces Conference on Fannie and Freddie:*
  - Consumer Advocate Ralph Nader officially announced that he would be holding a conference on May 14<sup>th</sup> at the Grand Hyatt Hotel in Washington, DC to examine the policies and operations of Fannie and Freddie. Essential Information and Ralph Nader will sponsor the conference. Chairman of the House Banking Committee Jim Leach (R-IA) will be the keynote speaker for the conference. The CEOs of Fannie and Freddie – Jim Johnson and Leland Brendsel – have also been invited to speak at the conference.

### Ralph Nader's Comments Regarding GSEs:

- “Fannie Mae and Freddie Mac have evolved from their original status as agencies of the federal government into powerful shareholder-owned corporations that dominate the nation’s housing finance markets,” said Nader. “A full-scale top to bottom public examination is long overdue of corporations which have so much influence on the economy and the well-being of all segments of the industries involved in providing shelter for the nation.” Commenting about his conference, Nader said, “We want this conference to explore numerous aspects of the GSE status and to discuss what this status means in carrying out secondary market operations, what liability it creates for taxpayers, and how it affects others in the housing and the housing finance markets.” Nader said an important part of the conference will consider the adequacy of regulation and what changes might be needed to protect the government’s and the taxpayers’ interest. He said the conference would also place emphasis on low-income housing goals assigned to Fannie and Freddie and what is needed to properly monitor and enforce the goals. (*US Newswire*, 3/31/98)
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- *HUD Receives Comments on Oversight of GSE Non-Mortgage Investments:*

- Late last year, HUD issued an advance notice of proposed rulemaking requesting comments on whether HUD should regulate Fannie and Freddie's non-mortgage investments. According to a recent GAO Report, as of June 30, 1997, non-mortgage investments accounted for 15% of the on-balance-sheet assets at Fannie Mae and 10% at Freddie Mac. The comment period for HUD's advance notice closed on March 30<sup>th</sup>. As of April 3, 1998, HUD received 20 comment letters.

Fannie Mae Says HUD Lacks Investment Authority:

- Fannie Mae stated in their comment letter that the notice presumes that HUD has discretion to adopt "broad prescriptions," but argued that prospective HUD regulation of its investments "is inconsistent with congressional intent and beyond the scope of HUD's authority." HUD's regulation of their non-mortgage investments is unnecessary and is a "serious, counterproductive and risky intrusion into the financial and capital management of the enterprises." Fannie argued that regulatory power over its portfolio holdings lies exclusively with OFHEO. Fannie Mae believes that its liquid investment portfolio "raises no safety and soundness concerns, comports with our Charter Act obligations, and promotes fulfillment of our statutory mission." To back up its arguments, Fannie Mae attached a 26-page legal opinion written by the law firm of Arnold & Porter.

Freddie Mac Opposes New Regulation:

- Freddie Mac's comment letter stated that they opposed any new regulation of non-mortgage investments, calling additional regulation "neither necessary nor appropriate." However, Freddie seemed more open to the concept, stating that HUD already has ample authority to require it to submit reports on its non-mortgage investments as long as such reports don't create a regulatory burden. Requiring Freddie Mac to report information to HUD in a form that minimizes regulatory burdens "would permit HUD to carry out any additional oversight that the Secretary concludes may be desirable in connection with Freddie Mac's investments." Freddie Mac believes that restrictive regulations, on the other hand, "could impede Freddie Mac's ability to fulfill our statutory purposes and would entail the type of micromangement of normal business operations that is inconsistent with HUD's statutory authority."

FHFB Supports HUD Regulation of Fannie/Freddie Non-Mortgage Investments:

- The Federal Housing Finance Board supports HUD's issuance of a regulation governing Fannie and Freddie's non-mortgage investments and would even support "a broader initiative to review the consistency of all of Fannie Mae and Freddie Mac's investment activities with their statutory mission." The FHFB is in the process of considering establishing limits on certain FHLBank investment activities. While the FHLBanks, and Fannie and Freddie are different, they would like the rules concerning the investment activities of the housing GSEs to be consistent (not consistent currently). Chairman of the FHFB Bruce Morrison stated that the extent to which the GSEs "are using their GSE status to generate additional earnings by investing in assets unrelated to their public purpose is a significant policy issue." One of the federal benefits of a GSE is the ability to issue debt at rates only slightly above Treasury borrowing rates. Since the GSEs have this funding advantage, their balance sheets (particularly their assets funded with GSE debt) "should be reflective of their missions to enhance the availability of residential mortgage credit."

### Wall Street Firms Oppose HUD's Regulation of Non-Mortgage Investments:

- In their comment letter to HUD, Salomon Smith Barney argued that imposing qualitative restrictions on the non-mortgage investments of Fannie and Freddie “would be counterproductive at best and dangerous at worst.” The “GSEs’ non-mortgage investment of about \$75 billion helps maintain investor confidence in the GSEs’ \$1.5 trillion investment in mortgages and mortgage securities.” By “imposing an arbitrary constraint on this critical but small element of the business could have a negative impact on the market’s perception of the entire business at the most inappropriate time, potentially impairing the ability of the GSEs’ to support the mortgage market when it is most needed.” The non-mortgage investments provide liquidity and allow the GSEs to invest funds temporarily in anticipation of investment opportunities in the mortgage business and will vary as market conditions vary. “Penalizing the GSEs for holding liquidity in the most efficient manner would send a negative and incorrect message to the markets – that the GSEs own program regulator is of the view that liquidity is harmful to the GSEs’ ability to meet their housing goals.” Further, “over the long term the market could question whether additional and unnecessary regulation of the non-mortgage portfolios is the first step to further regulation of the overall business of the GSEs.” HUD and OFHEO currently have authority to monitor the activities of Fannie and Freddie, including their non-mortgage investments, so no additional regulation is needed. The GSEs could be required, however, to provide an annual description of their investment philosophies and methodologies used in managing their non-mortgage investments.
- Lehman Brothers was also critical of HUD’s notice, stating that “other regulators strongly advocate liquidity portfolios as a means of reducing risk” and that having non-mortgage investments is important for liquidity purposes. “Our belief is that holding a portfolio of investments that are non-mortgage related is important.”
- Merrill Lynch had “reservations about the application of regulations affecting these portfolios [non-mortgage] which could detract from the considerable advantages they provide for GSE financing activities.” The GSEs’ current non-mortgage investments are adequate but not excessively large. Regulating the GSEs’ non-mortgage investments is neither “necessary or beneficial at this time” and any regulation “should be limited in scope, covering only the avoidance of illiquid holdings and investments which could be deemed to have a potential negative impact on the financial strength and safety of the GSEs.”
- Goldman, Sachs & Co. did not feel that there was a need for HUD to issue non-mortgage investment regulations on the GSEs. The non-mortgage investments of the GSEs are “essential to the GSEs’ achievement of their statutory missions.” Any non-mortgage investment regulation should be limited to safety and soundness concerns, but no further restrictions, general or numerical, appear warranted.
- Morgan Stanley believes that HUD’s proposed rulemaking, by limiting non-mortgage investment by the GSEs, discourages the GSEs from raising money “at opportune times.” Further imposing regulatory restrictions on the GSEs’ non-mortgage investments would limit the ability of the GSEs to maintain a risk-appropriate level of diversification with

respect to the GSEs' non-mortgage investment portfolio. "This would result in risks to the Government Sponsored Enterprises and thus to the U.S. mortgage market, that we do not view as worth any benefit that might be achieved by the proposed rulemaking."

- JP Morgan's letter stated that the prohibition of Fannie and Freddie's non-mortgage investment is "quite troubling." "Effectively forcing Fannie Mae or Freddie Mac to pass up attractive funding opportunities by requiring that proceeds be only invested in mortgage assets would severely diminish their ability to capture additional value that can be passed on to shareholders and homeowners." The "need for regulatory limits on the type or amount of non-mortgage investments is not apparent, and we believe such restrictions are not advisable."

#### Financial Services Industry Supports Regulation of GSE Non-Mortgage Investments:

- The American Financial Services Association (AFSA) - association representing diversified financial services companies, automotive finance companies, consumer finance companies, and credit card issuers - believe that the GSEs "have used their access to 'cheap money' for investment purposes that do not conform to their public missions. They have used their 'favored borrower' status to 'arbitrage,' locking in investment returns by using 'cheap money' to buy investments that yield higher returns, and pocketing the difference." AFSA believes that this "arbitrage is a misuse of a special privilege and creates competitive inequities in the marketplace. Cash balances should be invested in only the most liquid short-term securities." HUD and the Treasury Department should work together to determine the economic values of the GSEs' various benefits, and "use these values as part of a 'Net Public Benefits' test that is applied to the GSEs' non-mortgage investments." The "Net Public Benefits" test "should quantify the revenue from a non-mortgage investment and weigh it against the public cost of federal subsidies and lost tax revenue. If this benefits test finds that the housing enterprises are earning arbitrage profits from their existing portfolios, these profits should be specifically earmarked and channeled into affordable housing."
- The Association of Financial Guaranty Insurers (AFGI) - association representing the insurers and reinsurers of municipal bonds and asset-backed securities - wrote that HUD should carefully review the GSEs' investment practices "to ensure that the GSEs are fulfilling their public mission of making mortgage financing affordable and available, and not maximizing return from non-mortgage investments unrelated to their public mission." The GSEs have grown their investment portfolios and concentrated them into longer-term assets. "AFGI agrees with both the General Accounting Office and the U.S. Department of Treasury's statements that these GSEs' long-term non-mortgage investments generate arbitrage profits without furthering the GSEs' missions."
- The Bankers Roundtable - association representing 125 largest banking companies - "does not support policies that would permit the GSEs to use their implied government guarantee to access "cheap money" to buy non-mortgage investments that yield high returns. The GSEs should pass the profits onto homeowners in the form of low mortgage rates. Cash reserves should be invested in only the most liquid short-term securities. They would support efforts by HUD to regulate the GSEs' non-mortgage investments including limits on

the investments and routine reporting. HUD should focus on making sure that the GSEs stay within their charter of making mortgage financing affordable and available. “Maximizing return from non-mortgage investments is unrelated to this public mission.”

Executive Director Anthony Cluff stated the following:

1. “Regulations governing GSE non-mortgage investments are appropriate, as such investments may detract from the mission of providing low-cost funds to the public and focus GSE attention on managing a higher risk portfolio.
2. The purposes for which non-mortgage investments would be made should be limited by regulation and should include time limits as well as risk-avoidance measures in GSE portfolios.
3. The timing and use for non-mortgage investments should focus on short term, liquid investments tied to targeted needs, as established by regulation.
4. The best method for determining standards for GSE investments in non-mortgage products should be tied to the GSE charter and the impact of such investments on the public. In line with the GSE charter, a given investment should be ‘essential’ for the GSE to meet its charter purposes and not have any ‘adverse impact’ on credit markets or GSE stability.
- 5 & 6. HUD should monitor its rules through GSE reports and audits.”

- The Independent Bankers Association of America (IBAA) - the association representing community bankers - believes that HUD and OFHEO should work together to establish a rule on the GSEs’ non-mortgage investments. There should be some regulatory guidelines to ensure that the investments are appropriate for a GSE and that they are not made for speculation. The “GSEs must balance its investment activities so that it earns sufficient income to meet its obligations without abusing the advantages of GSE status.” Any rule, however, should not micromanage the GSEs’ investments, nor place specific numerical or percentage of assets of limitations, but should allow maximum flexibility for the GSEs to meet fluctuating needs. Reporting requirements should be made on a quarterly basis.
- The Mortgage Bankers Association (MBA) believes it would be appropriate for HUD to develop explicit rules on the GSEs’ non-mortgage investments “if it elects to do so.” The GSEs are driven by two forces: public mission and attracting capital from private shareholders. The MBA stated that they would provide specific comments should HUD decide to move forward with their rulemaking.

#### Consumer Group Supports HUD Regulation of Non-Mortgage Investments:

- The National Community Reinvestment Coalition (NCRC) urged HUD to regulate the GSEs’ non-mortgage investments. The regulations should explicitly include, and be focused on, investments in small business, small farm and community development loans. HUD should also establish restrictions and prohibitions on the types of non-mortgage investments by the GSEs (e.g., tobacco-related investments).

#### Misc. Comments:

- Brown & Wood, a law firm that provides legal advice to Merrill Lynch and Fannie Mae, does not believe that HUD has the statutory authority to prospectively regulate the GSEs investment and liquidity portfolio.

- The law firm Sullivan & Cromwell does not believe that regulations concerning the GSE' non-mortgage investments are necessary or appropriate. The GSEs' liquid non-mortgage investments are not "clearly inconsistent" but are essential to the GSEs' statutory purposes. If any regulations should be adopted, OFHEO is the proper regulator for this area. HUD should not establish restrictions on the GSEs' non-mortgage investments, either generally or numerically.
- Frank Fabozzi, Ph.D., CFA, wrote (at request of Freddie Mac) that in order for Freddie Mac to fulfill its mission it needs the flexibility to invest in non-mortgage investments. Those who criticize Freddie's non-mortgage investments as efforts to "arbitrage" their GSE position are only looking at their investments as a "stand-alone" investment strategy. Freddie Mac's non-mortgage investments are an integral part of a strategy to manage risk in a crisis scenario.
- Tom LaMalfa, a mortgage researcher, believes that HUD should tightly regulate Fannie and Freddie's activities in all areas, including their non-mortgage investments. There is no reason for the GSEs to maintain \$62 billion (Fannie Mae) and \$15 billion (Freddie Mac) in non-mortgage investments. "These so-called 'liquidity portfolios' are unprecedented in size and scope. They really are massive slush funds that generate huge financial rewards – combined totaling in the hundreds of millions of dollars – for the GSEs' managements and shareholders." HUD should reduce the size of the GSEs' non-mortgage investment portfolios to "make-sense levels," and return the principal balances to the US Treasury. Alternately, HUD should also expropriate any and all funds generated from the NMPs [non-mortgage portfolios] and return them to Treasury. [Please see March 27<sup>th</sup> *GSE Report* for more information about Fannie and Freddie's non-mortgage investments and GAO's recent report on the GSEs investments.] (*Dow Jones Newswire*, 3/31/98; *Mortgage Marketplace*, 4/6/98; *Written Comment Letters Received at HUD*, Docket No. FR-4297-A-01)
- *National Home Mortgage Association (NHEMA)'s Washington Counsel Gives Perspective on Fannie and Freddie:*
  - NHEMA's Washington Counsel Wright Andrews wrote an article about Fannie and Freddie in a recent NHEMA publication. Andrews writes that Fannie and Freddie's expansion efforts are a challenge to home equity and subprime lenders. At a minimum, the industry should give this expansion serious and immediate consideration. NHEMA's leadership is taking the GSE challenge very seriously and is setting up a task force to address these issues.

#### Fannie and Freddie's Special Benefits Ensure Competitive Success

- In a recent report issued by the Association of Financial Guarantee Insurers (AFGI), Fannie and Freddie averaged over 20 percent return on equity – far higher than that of the top 20 banks – as well as significant growth in their assets during the period of 1990-1996. Fannie and Freddie's charter allows them tremendous benefits accounting for a significant portion of their high earnings. Andrews asks "What private subprime/home equity lender wouldn't be more competitive, and probably dominant, if it had such a supplement? And, conversely and more to the point, what lender can compete effectively against GSEs with such

significant federal advantages?” The GSEs also have lower funding costs than their private competitors because of their implied federal guarantee. “The financial markets’ perception of this government support reportedly translates into approximately a 70 basis point advantage on debt and a 40 basis point benefit on mortgage-backed securities.” Fannie and Freddie are also using technology as a means of exploiting their current and future markets.

#### Fannie and Freddie’s Growth is Limited:

- Fannie and Freddie have demonstrated tremendous growth in total assets and in their mortgage-backed securities business from 1990-1996. Ironically, this growth is now presenting problems for them. “The Fannie/Freddie growth rate of 15 percent yearly in the loan/MBS markets simply is hitting natural limits in this conventional market, which is growing at only about 8 percent annually. By 2004, Fannie and Freddie would have to have acquired a 93 percent share of their market to maintain this growth rate. Thus, it is clear that the inherent size limitations of this market are forcing the GSEs to push into new areas to ensure continued growth and high shareholder returns.”

#### Possible Avenues of Fannie and Freddie Expansion – Short-Term and Long-Term:

- In the immediate term, Fannie and Freddie are “seeking to generate more fee income and to further exploit their traditional conventional market segments while also pushing the limits of their charters to move into other markets.” Fannie and Freddie have been pushing technology (automated underwriting and credit scoring) as a means of “producing new products, growing their markets by making conventional mortgage credit available to a higher percentage of the public and establishing their proprietary software as the industry standards.” Fannie and Freddie have also increased their returns by holding more mortgages in their portfolios (which also increases risk). Fannie and Freddie have also recently moved closer to linking directly to consumers over the Internet and “positioning themselves to eliminate the traditional middleman (a/k/a the mortgage lender) in many transactions.” Fannie and Freddie have also targeted the buying and packaging of subprime and home equity loans as an area of rapid expansion. Many believe that in the long-term, Fannie and Freddie are working “to be in a position to accept privatization on terms that are highly favorable to them.” (*National Home Equity News*)
- *China is Big Investor in Fannie and Freddie Bonds:*
  - China has been purchasing a number of US government securities, especially Treasury bonds and bonds issued by Fannie and Freddie. China currently has a large capital surplus, but most of the money has been going into US Treasury bonds – estimates running as high as 40%. Usually, developing countries like China invest their capital in their own growing economies. One former Chinese bank official called it “scandalous” that a country of poor peasants is financing investment of an industrialized power such as the US. China’s central bank, like 50 others around the world, lends money to Fannie and Freddie, which use the funds to buy mortgage loans that banks and others extend to Americans. Neither Fannie Mae nor China will say how much of China’s reserves Fannie Mae has borrowed. But Treasury data suggests that China bought well over \$1 billion of Fannie Mae bonds last year, enough to finance more than 9,000 homes. Portfolio managers at the bureau that

manages China's reserves say that they plan to start investing in mortgage-backed securities. (*Wall Street Journal Interactive*, 3/30/98)

- *Analysts Expect Fannie and Freddie to Post Earnings Increase in First Quarter:*

- Analysts expect Fannie Mac to post earnings of 77 cents a share in the first quarter, up 15% from last year's 67 cents a share. According to Jonathan Gray of Sanford C. Bernstein & Co., Fannie Mae's loan portfolio grew 12% from a year earlier. Freddie Mac's first quarter earnings are expected to be up 53 cents a share, up 20% from last year's 44 cents. Gray said Freddie Mac's loan portfolio ended the quarter 20 to 25% larger than it had been 12 months ago. Analyst Thomas O'Donnell from Salomon Smith Barney said the earnings growth proves that the sluggish mortgage environment that made investors nervous a year ago was "cyclical, not structural." He said fears that growth at Fannie Mae and Freddie Mac had "topped out" were unfounded. "It was the dog that didn't bark," he stated. (*Dow Jones Newswire*, 4/6/98)

- *Fannie and Freddie in Top 100 of Fortune 500 Ranking:*

- Fannie Mae and Freddie Mac were ranked again in this year's Fortune 500 ranking of the nation's largest companies. The list is compiled by *Fortune* magazine on the basis of 1997 sales figures. Fannie Mae was ranked #33 with \$27.777 billion in sales earnings and Freddie Mac was ranked #95 with \$14.399 billion in sales earnings. Last year, Fannie Mae was ranked #29 and Freddie Mac was ranked #110. Fannie Mae was also listed #28 in the category of "highest profits" with \$3.055 billion in profits (a 12.1% increase from 1996), #9 in the category of "highest return to investors over 10 years" with the 1987-97 annual rate of 39.2%, #33 in "greatest growth in earnings per share over 10 years" with a 1987-97 annual rate of 22.0%, #26 in "highest market value" with 67.593 billion and #1 in "most assets" with \$391.673 billion. *Fortune* also divided the list within industries – in the category "Diversified Financials," Fannie Mae was ranked #2 and Freddie Mac was ranked #4. The following are the results of the "Diversified Financials" category:

***Diversified Financials:***

Rank	Company	1,000 Revenues Rank	Revenues		Profits	
			\$ Millions	% Change from 1996	\$ Millions	% Change from 1996
1	Travelers Group	17	37,609.0	76.2	3104.0	33.2
<b>2</b>	<b>Fannie Mae</b>	<b>33</b>	<b>27,776.9</b>	<b>10.9</b>	<b>3055.8</b>	<b>12.1</b>
3	American Express	73	17,760.0	2.8	1991.0	4.7
<b>4</b>	<b>Freddie Mac</b>	<b>95</b>	<b>14,399.0</b>	<b>18.8</b>	<b>1395.0</b>	<b>12.2</b>
5	Marsh & McLennan	269	6,008.6	44.8	399.4	-13.0
6	Aon	275	5,750.6	37.2	298.8	-10.9
7	Household International	287	5,503.1	8.8	686.6	27.5
8	SLM Holding Corp.	385	3,784.7	5.4	507.9	24.3
9	Beneficial	475	2,955.7	6.6	253.7	-9.7
10	Franklin Resources	589	2,163.3	42.1	434.1	37.9
11	First American Financial	648	1,887.5	18.1	64.7	20.8

12	Capital One Financial	678	1,787.1	25.5	189.4	22.0
13	Countrywide Credit Industries	800	1,429.2	25.1	257.4	31.5
14	Green Tree Financial	973	1,091.5	18.1	301.4	-2.5
Total			129,906.1		12,939.1	

Rank	Company	Profits as % of			Earnings Per Share	Total Return to Investors	1997 (%)	Employees	
		Revenues %	Assets %	Stockholders' Equity %				1987-97 annual rate (%)	1987-97 annual rate (%)
1	Travelers Group	8.2	0.8	14.9	41.3	32.7	79.8	67,250	16.9
<b>2</b>	<b>Fannie Mae</b>	<b>11.0</b>	<b>.08</b>	<b>22.1</b>	<b>22.0</b>	<b>39.2</b>	<b>54.5</b>	<b>3,500</b>	<b>6.1</b>
3	American Express	11.2	1.7	20.8	13.2	19.5	59.9	74,000	2.4
<b>4</b>	<b>Freddie Mac</b>	<b>9.7</b>	<b>0.7</b>	<b>18.6</b>	<b>0.0</b>	<b>0.0</b>	<b>53.4</b>	<b>3,200</b>	<b>0.0</b>
5	Marsh & McLennan	6.7	5.0	12.5	1.6	15.6	47.5	36,400	34.8
6	Aon	5.2	1.6	10.6	4.8	23.6	44.5	40,000	42.9
7	Household International	12.5	2.3	14.7	8.8	26.9	40.6	14,883	1.4
8	SLM Holding Corp.	13.4	1.3	75.3	19.4	19.6	51.4	4,608	-3.8
9	Beneficial	8.6	1.4	14.3	2.5	21.7	34.2	10,200	5.2
10	Franklin Resources	20.1	14.0	23.4	21.4	36.4	91.7	6,400	29.0
11	First American Financial	3.4	5.5	15.7	0.0	0.0	82.7	12,930	11.4
12	Capital One Financial	10.6	2.7	21.2	0.0	0.0	51.8	5,906	2.9
13	Countrywide Credit Industries	18.0	3.2	16.0	17.6	36.4	51.3	6,134	27.1
14	Green Tree Financial	27.6	6.2	22.6	23.1	33.1	-31.8	5,500	40.1
Total								290,911	

(Fortune magazine, 4/20/98 issue)

- *Salomon Smith Barney Recommends "Buy" Position for Fannie and Freddie:*
  - For the first time last year, Salomon Smith Barney used an Economic Value Added (EVA) analysis in evaluating the GSEs (Fannie Mae, Freddie Mac, and Sallie Mae). Using the EVA analysis again this year, Salomon is reiterating its "Buy" ratings for the GSEs. Salmon's EVA analysis in valuing GSEs differs from how they use EVA when analyzing industrial and manufacturing companies in several of the following ways:
    1. Funding for the GSEs comes from capital and from borrowing at low cost through use of the GSE charter. Funding is used to support both the guaranteed (MBS) business and the mortgage investment portfolio at Fannie and Freddie. "As a result, we do not believe that 'debt' can be adequately defined for GSEs. Therefore, the book value of debt is excluded from invested capital, and interest expense on debt is excluded from NOPAT [Net Operating Profit After Tax]."
    2. Salomon assumes that depreciation expense is equal to the capital expenditures in a given period. "Capital expenditures for GSEs are often different and shorter-

lived – some are expensed immediately or depreciated quickly and replaced often.” Salomon assumes that depreciation expenses are equal to the amount of capital expenditures made that year – an assumption that negates the need for a depreciation adjustment to net operating profits after tax or invested capital.

3. Credit costs are more important for Fannie and Freddie than for manufacturing or industrial companies. Therefore, adjustments for the loan loss provision, net charge-offs and the loan loss reserve are appropriately made to the net operating profits after tax and invested capital in their model.
4. Salomon’s model does not consider net deferred tax liabilities. “While theoretically, deferred tax liabilities (DLTs) represent an interest-free loan from the government or a postponement of a cash payment to the government (thereby increasing cash today), shareholders do not receive a direct benefit from this account.” (*Salomon Smith Barney Equity Research Industry Report, “Applying EVA to the GSEs in 1998”, 3/26/98, by Thomas O’Donnell*)

- *Fannie and Freddie are Top 2 Corporate Philanthropists in the Washington, DC Area:*

- The Fannie Mae Foundation and the Freddie Mac Foundation were ranked as the top corporate philanthropists for the DC area. Fannie Mae was ranked #1 (contributing \$8.59 million) and Freddie Mac was ranked #2 (contributing \$7.54 million). The list of top corporate givers was published in the *Washington Business Journal*. The list reflects total giving and does not weigh generosity as a ratio of net profits. (*Washington Post, 4/8/98*)

## ***Fannie Mae***

- *HomeCapital’s Business Plummet after Fannie Terminates Mortgage Selling and Servicing Contract- Company Significantly Cuts Work Force and Shares Lose Half their Value:*

- On March 24, Fannie Mae notified its termination of its mortgage selling and servicing contract and its loan repurchase arrangements with Austin-based HomeCapital Investment Corp. HomeCapital is the holding company for HomeOwners Mortgage & Equity, a consumer finance company that originates, purchases, and sells home-improvement loans and second mortgages.
- As a direct result of Fannie’s termination, HCAP has reduced its work force “significantly” (firing already 30 of its 150 employees) and is pursuing other cost-cutting measures, and seeking additional capital and outside financing as it tries to stay in business. Shares of HCAP dropped after Fannie Mae’s termination. On March 27, shares dropped 28.12 ½ cents per share to 59.37 ½ cents per share, just above its 52-week low of 37.50 cents per share. Its stock had been as high as \$11.50 a year ago. HCAP is trying to work out of the problems triggered by Fannie Mae’s action. HCAP sold about \$32.4 in MBSs to discharge its obligation to Fannie Mae associated with those securities and help its cash flow. The company is also trying to sell about \$10 million in FHA Title I loans currently held by warehouse lenders to discharge those obligations and generate some cash flow.

- The announcement has also led to several firings and resignations at the senior management level at HCAP. HCAP recently replaced their Chairman and CEO with a former managing director at Citicorp Mortgage who resigned after only two days when he also failed to restore the seller/servicer contract with Fannie Mae. The Company will be seeking to replace the CEO as well as other executive positions vacated in the wake of the unexpected termination of the Fannie Mae relationship. The Company will now be run by a three-member executive committee of the Board of Directors. HCAP has suspended new loan origination. A spokesman for Fannie Mae declined to discuss why it quit doing business with HCAP. (*Austin American-Statesman*, 3/28/98, 4/2/98; *Dow Jones Newswire*, 3/25/98, 4/1/98, 4/6/98; *Reuters*, 4/8/98)
- *Investment Planner Files Antitrust Lawsuit Against Reverse Mortgage Industry Leaders, Including Fannie Mae:*
  - A financial planner that was accused a year ago of charging senior citizens high fees for advice on reverse mortgages has filed an antitrust lawsuit against industry leaders, including Fannie Mae, alleging they fixed prices and conspired to put the company out of business. The company, Patriot Inc. and its owners, Jeffrey and Peggy Butler believe that the nation's top two reverse-mortgage lenders, a national referral service, the American Association of Retired Persons and Fannie Mae have been illegally boycotting them.
  - The antitrust lawsuit was filed in federal court in Washington seeking unspecified damages. The Butlers believe that there was a "concerted refusal to deal" with Patriot, thus eliminating 76% of their business. According to the suit, Patriot, which once had operations in 38 states, was charging customers fees amounting to 8.5% of their loans. But, it asserts, the defendants agreed among themselves to limit all such fees to a flat \$500 and to refuse to do business with any company that didn't abide by their rules. Besides Fannie Mae and AARP, other defendants are Transamerica HomeFirst Inc. in San Francisco, Wendover Funding Inc. in Greensboro, NC, and Ken Scholen and his referral business, National Center for Home Equity Conversion in Apple Valley, MN. The suit alleges that the referral company and AARP act as public clearinghouses, explaining reverse mortgage loans, and referring the elderly to various lenders. For this service, the suit alleges they receive fees from lenders, insurers and others that get referrals. The Butlers allege that AARP and the referral company defamed their company calling their operation "a scam."
  - Patriot was one of several companies last year that were targeted by HUD in a crackdown on estate and financial planners that "prey on the elderly" by charging excessive fees for reverse mortgages. HUD accused the companies of charging as much as 10% of the loan amount simply for information that the government provides for free. HUD said it would disqualify lenders from FHA programs if they knowingly make loans to people who have to pay such companies. Fannie Mae also issued rules prohibiting lenders from selling it reverse mortgages that came from financial planners and other third parties. Patriot went to court last year and won a preliminary injunction halting HUD from enforcing its rules. A similar effort against Fannie Mae was dismissed. (*Los Angeles Times*, 4/9/98)
- *Fannie Mae Launches \$4 Billion – Five-Year Benchmark Note:*

- Fannie Mae offered \$4 billion in five-year Benchmark notes on April 1st. The bond is part of a \$40 billion annual financing program initiated this year. The bonds were priced at 18 basis points over the US Treasury's on-the-run five-year note. It will be the fourth issue from Fannie's benchmark note programme. Bankers said this would be more of a domestic transaction than Fannie Mae's \$4.0 billion five-year issue in January. "I don't see much demand from an international audience, it offers nothing new," a banker said. Officials at Fannie Mae said the offering was oversubscribed by more than \$1 billion and served their financing needs as well. Top officials at Fannie Mae said that at least three five-year issues would hit the market this year. Each issue is expected to be in the \$3 billion to \$5 billion ranges. (*Dow Jones Newswire*, 3/27/98, 4/1/98; *The Guarantor*, 3/23/98; *Reuters*, 3/31/98)
- *Fannie Mae Enhances Automated Underwriting System – Extends Exterior-Only Property Inspections to Refinances, Adds New Credit Vendor:*
  - Fannie Mae enhanced its automated underwriting system, Desktop Underwriter, by applying its proprietary valuation model and exterior-only inspection report to mortgage refinances, and by adding Trans Union Real Estate Service to its selection of credit vendors. (*Business Wire*, 4/1/98)
- *Fannie Mae Reports Record Earnings for First Quarter 1998 – Earnings Per Common Share Up 15% Over First Quarter 1997:*
  - Fannie Mae reported earnings for the first quarter of 1998 of \$824.2 million, or \$0.77 per common share. This compares with earnings of \$794.0 million, or \$0.74 per common share, for the fourth quarter of 1997 and \$734.1 million, or \$0.67 per common share for the first quarter of 1997. (*Business Wire*, 4/9/98)
- *Fannie Mae Holds Press Conference with Senator Chris Dodd (D-CT):*
  - Fannie Mae held a press conference with Senator Chris Dodd (D-CT) and other housing partners to celebrate the success of "Connecticut Homebuyer Education Initiative." The initiative provided more than 200 families homebuyer education through their local school district's adult education program. (*Business Wire*, 4/6/98)
- *Fannie Mae Holds Press Conference with Cong. John Bereuter (R-NE):*
  - Congressman Doug Bereuter (R-NE), a member of the House Banking Committee, joined Fannie Mae in a press conference to celebrate the first year results of House Nebraska. - Fannie Mae's five-year, \$2 billion affordable housing program in Nebraska. (*Business Wire*, 4/6/98, 4/9/98)
- *Fannie Mae Foundation Supports "America's Promise" Youth Program:*

- The Fannie Mae Foundation helped kick off “Housin’ 2000” to launch the Foundation’s commitment to America’s Promise. The Foundation provided \$5 million in resources and hopes to engage 50,000 youths in community service activities to help reduce homelessness in the Washington area. As part of the program, the Foundation also assisted student volunteers in the 14<sup>th</sup>-annul Hunger Clean Up, sponsored by the National Student Campaign against Hunger and Homelessness. (*PR Newswire*, 4/3/98; *USA Today*, 4/6/98)
- *Fannie Mae Vice Chairman Ranked as one of the 50 Top Women Lawyers:*
  - The *National Law Journal* listed Jamie Gorelick, Fannie Mae’s Vice Chair, as one of the top 50 women lawyers, referring to her as on one of the most powerful lawyers in Washington, DC by Beltway insiders. Ms. Gorelick is responsible for the legal department, credit policy, corporate development, government relations, human resources and regulatory policy at Fannie Mae. Before her employment at Fannie Mae, she was deputy attorney general of the US, which made her the chief operating officer and the second-highest ranking official at the Department of Justice. (*National Law Journal*, 3/30/98)
- *Fannie Mae Receives 1998 Vanguard Award:*
  - Fannie Mae received a first place 1998 Vanguard Award. The award honors corporations or organizations that have taken action and instituted programs to help women and people of difference advance to positions of equality and leadership at work. The award is given by the Vanguard Foundation, part of Women in Communications (WIC) Foundation, and is co-sponsored by *Working Woman* magazine. (*Business Wire*, 3/26/98)

## **Freddie Mac**

- *Freddie Mac CEO Foresees Risk-Based Pricing:*
  - Leland Brendsel, Chairman and CEO of Freddie Mac, announced that Freddie Mac’s automated underwriting system, Loan Prospector ® will ultimately be used to deliver risk-based pricing to the market. Speaking at an Annual Regional Conference of Mortgage Banking Associations, Mr. Brendsel said “by (the year) 2000, we will price 100% of mortgage purchases according to their individual characteristics,” he said. “It depends on the lenders, though, (and) their ability to adapt to this method of doing business. It may take quite a bit of time for loan-level pricing to get into the market and be adopted by lenders.” Mr. Brendsel stated that they are “developing their implementation plans and we’ve been working with a handful of lenders to develop how best to proceed.” (*National Mortgage News website*, 3/31/98)
- *Freddie Mac Launches \$5 Billion 10-Year Reference Notes – Biggest Corporate Bond Ever:*

- Freddie Mac recently issued a \$5.0 billion 10-year bond – the largest fixed-rate international bond and the first of Freddie Mac’s Reference Note Issuance Programme (similar to Fannie Mae’s Benchmark issue). Aside from asset-backed deals, Freddie Mac’s is the biggest corporate bond offering ever. Freddie Mac plans to offer large, liquid issues with a minimum size of \$4.0 billion of non-callable debt on a quarterly basis. Dealers believe this issuance will put pressure on secondary market spreads. “The market is a bit soft, and \$5.0 billion is a lot to absorb at the best of times,” a syndicate manager at a US bank said. The Freddie Mac deal was fully subscribed, however, it hit the market with “little splash” according to some syndicate managers. Traders attributed the lack of excitement over Freddie Mac’s deal to the fact that it came at the end of a long line of outsized global bond deals from agencies including Fannie Mae, the World Bank, and the FHLBank System. Nonetheless, its successful completion was seen as a big accomplishment for the same reason. Freddie Mac’s new reference note program is working the same market as Fannie Mae’s benchmark securities program in that it seeks to provide an alternative to US Treasury notes. (*Dow Jones Newswire*, 4/7/98; *The Guarantor*, 3/23/98; *Reuters*, 4/6/98)
- *Freddie Mac Helps Launch House Auction Program:*
  - Freddie Mac’s HomeSteps (real estate unit), Asset Property Disposition (APD), and Countrywide Home Loans have teamed up on an affordable housing program that will make 50 properties in South Los Angeles available for purchase at an auction on May 16. On April 6<sup>th</sup>, APD will open a local office in a shopping mall to provide prospective homebuyers with information on Freddie Mac’s HomeSteps homes being auctioned and to arrange visits to the homes. Homebuyers also have the opportunity to receive counseling and become pre-qualified to bid at the auction. Auction lender, Countrywide Home Loans, will originate the loans and Freddie Mac will purchase them. The homes to be auctioned have an average price of \$120,000. (*PR Newswire*, 4/2/98)
- *Washington Post Publishes Interview with Freddie Mac Chairman:*
  - Just weeks after their story on Fannie Mae’s Chairman Jim Johnson, the *Washington Post* published an interview with Freddie Mac Chairman Leland Brendsel. Brendsel reiterated to the interviewers that Freddie Mac and their securities were not guaranteed by the government. “However, I would also say that investors in Freddie Mac and in our securities have immense confidence in the quality of those securities, in part because we are chartered by the United States government,” said Brendsel. He also acknowledged that it was important that Freddie Mac be exempt from SEC registration on their securities. “That’s very important. If we had to register our securities before we went to market, like Coca-Cola for example, we would have to go to the SEC 40,000 times a year because of the volume of securities that we issue. That just becomes impractical, and would inhibit our ability to raise money in large volumes.” Brendsel also noted that Freddie Mac is not exempt from all local taxes – just state and local income taxes, not property taxes. He believes that the reason for the tax exemption is that the exemption promotes the efficient gathering of mortgages in various states and jurisdictions across the country. Brendsel believes that Freddie Mac’s profits will grow, but acknowledges that growth may slow some

when interest rates rise. Brendsel also wanted to point out that Freddie Mac's non-mortgage investments are "a small but essential part of our primary mission of financing mortgages in this nation." According to Brendsel, "They're used for cash management purposes... We don't have a government charter that allows us to borrow money at lower rates."  
(*Washington Post*, 4/6/98)

- *Freddie Mac Purchased \$1.1 Billion Mortgage Bonds in 1997:*
  - Freddie Mac purchased \$1.1 billion in newly issued mortgage revenue bonds on 1997, according to Freddie's annual housing activities report to HUD. (*Dow Jones Newswire*, 4/3/98)
- *Freddie Mac Adds More Brokers Access to HomeSteps™ Listings:*
  - HomeSteps™, Freddie Mac's real estate sales unit, added 32 affiliated and independent brokers to its existing network of brokers who list properties from its \$2 billion inventory of approximately 20,000 homes. Twenty of the firms are ERA brokers who are being added under HomeSteps' Franchise Select program. Announced last November, Franchise Select gives ERA sales associates access to HomeSteps' listings and sales incentive programs. (*Freddie Mac press release*, 3/26/98)
- *Freddie Mac Adds First American CREDCO to Approved Credit Reporting Cos.:*
  - Freddie Mac added First American CREDCO to its group of approved credit reporting companies available to lenders using Loan Prospector® - Freddie Mac's underwriting system. (*Freddie Mac press release*, 4/1/98)
- *Freddie Mac's Senior Debt AAA/A-1+ Ratings Affirmed by S&P- Cites GSE Status:*
  - Standard & Poor's affirmed its triple-'A'/'A-1'-plus ratings on Freddie Mac's senior global debt facility in light of Freddie Mac expanding their debt issuance beyond the \$15 billion ceiling on the program and the elimination of the ceiling on the global debt facility. In addition, S&P also affirmed its double-'A'-minus rating on Freddie Mac's \$400 million preferred stock issue. S&P stated that the rating on the global senior debt program of Freddie Mac reflects the company's status as a GSE. "While there is no U.S. government guarantee on Freddie Mac's obligations, GSEs including Freddie Mac benefit from the ability to issue debt obligations pursuant to its GSE charter."
- *Freddie Mac Foundation Hosts World's Largest Baby Shower" for Child Abuse Prevention:*
  - The Freddie Mac Foundation hosted a baby shower honoring 700-plus local babies and their families as a kick-off to Child Abuse Prevention Month. The babies and families are part of the eight Foundation-funded local Healthy Families America programs (program for first-time parents). During the shower, the Foundation presented a check for \$450,000 to Healthy Families Fairfax to help fund Healthy Family sites across the Washington, DC area (currently 8 sites). (*Freddie Mac press release*, 3/30/98, 4/1/98)

## Federal Home Loan Banks

- *Federal Housing Finance Board Makes it Easier for Small Rural Banks to Join FHLBank System:*
  - The FHFB approved an amended final rule on April 9<sup>th</sup> that would make it easier for small rural banks to qualify for membership in the FHLBank System. The rule was amended despite objections from the Farm Credit System (FCS) institutions. The easing of criteria necessary to qualify a rural loan as a home mortgage loan will only apply to financial institutions with 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 is 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 FHFB thought the 50% test was difficult for small rural banks to meet.
  - The FHFB first proposed a rule eliminating the 50% test on combination properties last October, however, the FCS and the Treasury Department, among others opposed the proposal. The FHFB received 280 comment letters that were “fairly evenly divided” on the proposed rule. Treasury Under Secretary John Hawke, Jr. in opposition to the proposed rule said it “would further erode the system’s focus on housing finance by allowing agricultural and commercial mortgage loans on properties containing a residence to count towards system membership and collateral requirements.”
  - FHFB Chairman Bruce Morrison then proposed an amendment to the board’s October proposal that would eliminate the 50% test for combination properties for only those institutions with less 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. “Integral” is defined as “the residence must be occupied as a residence not as a temporary or seasonal residency...and secondly “that it be targeted so that the residential aspect is not an afterthought and that the nonresidential activities is in keeping with the community investment mission that is included in our housing finance mission,” Morrison said. (*BNA Daily Report for Executives*, 4/10/98)
- *Ousted Federal Housing Finance Board (FHFB) Member Files Lawsuit:*
  - Lawrence Costiglio, who was ousted recently by President Clinton from his FHFB seat, filed a lawsuit in federal Court on March 30 to regain his Board seat. The lawsuit names President Clinton and Finance Board Chairman Bruce Morrison among the defendants. Costiglio claims he has a statutory right to remain on the Board until a successor is in place. As stated in Costiglio’s lawsuit, “The enabling statute for the FHFB clearly states that a Board member may remain on the Board in a holdover capacity until a successor has been appointed and qualified and that the discretion is his and his alone.” He said the President’s action threatens the “independence and continuity of the FHFB.”

- The Finance Board is supposed to have five members, but currently only has three: (1) Chairman Bruce Morrison; (2) Republican J. Timothy O’Neill and; (3) Art Agnos, a former San Francisco mayor who is now with HUD and is filling the Board seat reserved for the Secretary of HUD or his designee. O’Neill’s term expired last year and he is serving in a holdover capacity. According to Costiglio’s lawsuit, however, “Mr. O’Neill has been told that if he is not supportive of Administration positions, he too will be removed from his directorship.” Costiglio’s lawsuit alleges that “the President now controls and dominates the Board through Board Chairman Morrison and (HUD) Secretary (Andrew) Cuomo as a result of the President’s failure to appoint successor directors.”
- Sources familiar with the FHFB’s operations, have said that at the heart of this controversy is a fight between Chairman Morrison on one side and Costiglio and several FHLBank Presidents on the other side over the banks’ securities investments. Chairman Morrison argues that the FHLBanks (which have invested more than a quarter of their assets in non-mortgage investments) should be forced to put the funds they raise with low government debt in more “mission-related” assets. Morrison stated that “there are people in the system who do not want to see their investment arbitrage curtailed... With them I disagree.” Costiglio thinks Chairman Morrison sought his dismissal because he didn’t support the appointment of Nicolas Retsinas (former HUD Assistant Secretary) to a panel that oversees the issuance of the Home Loan Bank debt. Costiglio said he didn’t want Retsinas appointed because he would be another member that would be considered closely tied to Chairman Morrison. Costiglio and Board Member J. Timothy O’Neill have worked together in the past to block Chairman Morrison from reducing the FHLBanks’ securities investments, arguing that changes to the banks’ lending practices should be left to Congress. Chairman Morrison denies that he engineered Costiglio’s firing, but said he made no secret of his differences with him. Morrison insisted that the firing was entirely President Clinton’s idea. [Please see March 13<sup>th</sup> and March 27<sup>th</sup> *GSE Reports* for past details about the FHFB controversy surrounding Board Member Costiglio’s firing.] (*American Banker*, 3/30/98; *Dow Jones Newswire*, 3/30/98)
- *FHFB Will Hold Public Hearing on May 11 to Discuss FHLBanks’ Investments:*
  - The Federal Housing Finance Board (FHFB) will meet on May 11 to discuss the FHLBank System’s controversial non-housing related investments. The FHFB announced its new public hearing in the *Federal Register* where it also published several possible approaches to limiting money market investments and posed a series of specific questions on investments. The option favored by the FHFB would cut the FHLBanks’ holdings of money market investments by 50% or \$49 billion. The FHFB has requested comments from outside groups on the subject including other government agencies, elected officials, and community and trade groups. The deadline for comments is April 13. Groups will also be able to testify at the May 11<sup>th</sup> hearing. A staff report prepared for the FHFB most recently stated that many of the assets in the FHLBanks’ investment portfolios “bear little if any relationship to the Banks’ mission of enhancing the provision of credit through members for housing and community development.” [Please see March 27<sup>th</sup> issue of *GSE Report* for more information

regarding the FHFB's efforts to address investment practices.] (*Dow Jones Newswire*, 4/3/98)

## **Farm Credit System**

- *ABA Finances Newsletter on Farm Credit System:*
  - The American Bankers Association (ABA) is financing a newsletter designed to fight what it calls "unfair competition" from the Farm Credit System (FCS). The newsletter, "Farm Credit Watch" is written by financial consultant, Bert Ely – a noted critic of the FCS. Ely hopes the newsletter stirs a policy debate and better informs rural bankers about their primary competitors. Future issues will include discussions about how the FCS prices its loans, how it is structured, and who borrows from it, and anecdotal information from bankers who compete with the FCS. The executive vice president of the Nebraska Bankers Association, George Beattie, said he expects a lot of anecdotal information will be sent to Ely – particularly from Nebraska bankers who have been complaining about FCS competition for years. "Now the bankers will know they're not alone in this," Beattie said.
  - A lawsuit was initiated by the ABA and the IBAA that claimed that the FCS's expansion into agribusiness, processing, and marketing loans as well as rural home loans, would let the government-backed lenders compete more directly with commercial banks. In the first newsletter, Ely states that the FCS is poised to use its \$11.6 billion of capital to make nonfarm loans – taking business away from bankers. "We think that the Farm Credit System is, quite frankly, out of control," said John Blanchfield, manager of the ABA's agricultural bankers division. "No one's been minding the store." Ely said he fears that the system will lend recklessly as it did in the 1970s, causing another 1980s-like farm credit crisis.
  - Ken Auer, executive vice president of government affairs for the FCS, called the newsletter "a propaganda sheet for the ABA," and thought that Ely was not qualified to make evaluations on the FCS's expansion of off-farm lending. "Mr. Ely has not been a student of the system," Mr. Auer said. "Every bit of information is slanted." (*American Banker*, 3/30/98)

## **Farmer Mac**

- *Five Mortgage Banking Companies Approved as Farmer Mac Loan Sellers:*
  - Five mortgage banking companies were approved as "sellers" in the Farmer Mac I secondary market program for agricultural and rural housing mortgage loans. The five companies are Alliance Mortgage Company, Jacksonville, FL; Cendant Mortgage Services Corporation (formerly known as PHH Mortgage Services Corporation), Mt. Laurel, NJ; GMAC Commercial Mortgage Corporation (GMAC), Horsham, PA; Headlands Mortgage Company, Larkspur, CA; and Zions Mortgage Company, Salt Lake

City, UT. "Seller" approval in the Farmer Mac program permits the lender to sell qualified loans directly to Farmer Mac through its "Cash Window" program. According to Farmer Mac, the approval of these mortgage lenders as Farmer Mac sellers also signals their recognition of the opportunity Farmer Mac participation affords them to expand their traditional mortgage business to include agricultural mortgage lending. (*PR Newswire*, 4/2/98)

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**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)