

The *GSE* REPORT

Ralph Nader Conference on "Appraising Fannie & Freddie"

Ralph Nader's Comments:

Consumer Activist Ralph Nader and Essential Information hosted a conference on "Appraising Fannie Mae and Freddie Mac" on May 14th. Nader sponsored the conference to raise questions and stimulate dialogue about the GSEs, particularly Fannie Mae and Freddie Mac. Nader said he expects to take a later look at the other GSEs. Announcing the hearing, Nader said he wanted the conference "to explore numerous aspects of the GSEs' status and to discuss what the status means in carrying out secondary market operations, what liability it creates for taxpayers, and how it affects others in the housing finance markets." Nader refers to Fannie and Freddie as appearing "less like exemplars of a competitive free enterprise system than they do overgrown adolescents demanding generous allowances from a wealthy and indulgent uncle."

At the conclusion of the hearing, Nader recommended that the Legislative and Executive branches do more to encourage and define the missions of the GSEs. The missions of the GSEs may well be as golden as Fannie and Freddie claim. However, in Nader's opinion, their missions do not justify taking taxpayer money. In Nader's opinion, the taxpayer subsidy is "old-fashioned corporate welfare." Nader also believes that the media has been kind to the GSEs. Nader argued that the GSEs have an aggressive public relations program, claiming credit for risks that their industry partners actually take. The agencies do not want to engage in any in-depth discussion of their corporate activities. Nader would like to open the dialogue, and hopes that the Senate will "wake up" on this issue and engage in a full-scale examination of the GSEs. Nader called for "no-holds-barred hearings" to examine the GSEs.

Participants at the conference were reluctant to ask questions during the conference at the risk of being identified as criticizing the practices of Fannie and Freddie. None of the name badges of the participants listed company affiliations and some of the name badges only listed first names because according to conference organizers, some in attendance expressed concern ahead of time about being identified.

Fannie Mae and Freddie Mac's Comments:

Ann Shnare, Senior Vice President of Corporate Relations for Freddie Mac noted that studies have shown that if Fannie and Freddie's role were altered, homebuyers would suffer. Congress has given the agencies a "ringing endorsement." Fannie and Freddie help make funds available during good and bad times and across all regions. They estimate that Fannie and Freddie save homebuyers approximately \$10 billion every year. One of the agencies' most significant technological advancements has been automated underwriting. The agencies do not use a single cent from taxpayers and they operate without significant liability to taxpayers. The government does not guarantee them. They have much tougher regulations than the private sector and they are one of the nation's largest federal taxpayers, paying approximately \$2 billion in income taxes. During Q&A, Shnare stated that Fannie and Freddie are not undercapitalized and have the tightest capital standards in the world. Shnare also disagreed with a questioner that their work in automated underwriting overstepped their charter. She believes that their work in this area fits "the essence of their charter" because the technology improves the efficiency of the market and lowers the cost of credit to homebuyers. If there was no Fannie or Freddie, interest rates would rise, down payments would go up, fixed-rates would go up, regional disparities would occur, there would be an increase in government programs, and the homeownership rate would fall. The questions you need to ask yourself are: (1) Do we want to go back to the old system?; and (2) Is there a compelling reason to change?

Barry Zigas, Executive Director of Fannie Mae stated that Fannie and Freddie are not subsidized by the government, do not receive appropriations from the government, do not have the full faith and credit of the government, and they pass along benefits to taxpayers. Zigas estimates Fannie and Freddie reduce mortgage rates to homebuyers by 20-25 basis points. They believe the CBO study in 1996 was incorrect and its methodology was faulty. Fannie and Freddie are not duopolies. They compete in the mortgage market with Ginnie Mae, banks, thrifts, etc. Every dollar they borrowed in the capital markets, they pass along to consumers. Zigas believes that through automation, they have lowered the cost of home buying by \$700-\$800. Fannie allows lenders to use competing automated underwriting systems, but they encourage people to use their automated underwriting systems because they think they are efficient and Fannie Mae believes that their work in this area is within their charter. He believes it is inaccurate and irresponsible to say they are undercapitalized and he noted that the Treasury Secretary stated in 1992, that it was naïve to compare their capital standards with other companies.

Congressional Budget Office (CBO):

The Congressional Budget Office (CBO) refers to Fannie and Freddie as "Spongy Conduits" – CBO finds that Fannie and Freddie may be even Less effective vehicles for delivering federal subsidies to the mortgage market than CBO and Treasury first estimated in their 1996 reports:

June O'Neill, Director of the Congressional Budget Office, made the following points in her remarks:

1. "Government sponsorship reduces the operating costs of Fannie Mae and Freddie Mac by billions of dollars per year. Much of these savings arise from the perception of an implicit federal guarantee of the enterprises' obligations."
2. "Fannie Mae and Freddie Mac pass along about two-thirds of their federal subsidies to mortgage borrowers by lowering interest rates, and they retain about one-third for other purposes. The enterprises have broad discretion under the law to decide both the magnitude and the allocation of their subsidies. It is inherently difficult for the government, through regulation, to affect their decisions."

According to O’Neill, the “cost of subsidizing Fannie and Freddie is as real as the cost that would be incurred if the government gave away, free of charge, permits to harvest timber in national forests or licenses to broadcast on the radio spectrum.”

CBO calculates the explicit government subsidies by examining the GSEs’ pretax net income, the tax rates of the relevant governments, and the volume of securities they issue. In 1996, CBO estimated that the exemption from state and local income taxation cost federal taxpayers approximately \$260 million in 1995 and the GAO estimated that the exemption from SEC registration is worth more than \$100 million annually.

Measuring the government’s implicit guarantee is more difficult to estimate but the CBO used market data to compare the yields of debt and MBSs issued by Fannie and Freddie with the yields of similar obligations issued by private firms that pose comparable default risk to arrive at a figure. CBO estimated that the implicit federal guarantee conveyed \$6.5 billion in subsidies to Fannie and Freddie in 1995. O’Neill refers to Fannie and Freddie as “spongy conduits,” because they pass through about \$4.4 billion of their federal subsidies to home buyers, while keeping approximately \$2.1 billion, “or nearly \$1 for every \$2 they delivered to the intended beneficiaries.” And because the GSEs have broad discretion to determine the volume of mortgages they will finance, the prices they pay for loans, and the mix of debt and MBS they will issue, Fannie and Freddie have “substantial influence over the size of their federal subsidies.”

The CBO also found that the mortgage market today is more efficient in recent years, and that the Fannie and Freddie do not reduce the interest rates on conforming fixed-rates loans as much as they once did. By examining the spread between the yields on 30-year, fixed-rate jumbo and conforming mortgages, CBO found that the spread has averaged 25 basis points since 1991, down from an average of 45 basis points from 1986 to 1991. “Thus, the most recent data indicate that the enterprises are less effective vehicles for delivering federal subsidies to the mortgage market than CBO and the Treasury had previously estimated.”

The CBO believes that it is inherently difficult for the government to influence, by regulation, the magnitude or allocation of federal subsidies to Fannie and Freddie. Future research should focus on the range of regulatory mechanisms to address both the size of the federal subsidies and allocation of the subsidies (including the portion the agencies retain).

House Banking Committee Chairman James Leach:

House Banking Committee Chairman Jim Leach recommended a greater Treasury Department role in overseeing the GSEs’ investment practices. Leach believes that the Treasury Department should “be insisting that its cohorts in the Executive Branch watch the chicken coop more closely. Absent greater Executive Branch oversight as currently structured, Congress might want to require that a Treasury representative be placed on every GSE board.” During Q&A, Leach stated that he was “open” to the idea of a single regulator because he was astonished at how little attention has been given to mission regulation. Leach also mentioned that he was “open to the idea of privatization,” although it was unlikely to happen in the near future.

The principal risk the GSEs face is political risk, not credit risk or interest rate risks like other private financial institutions. Given their political lobbying muscle, Leach believes it is unlikely that any charter revisions to Fannie and Freddie will happen in the foreseeable future. Given that fact, Leach notes that an “issue that cries out for greater attention” from Treasury (which holds the latchkey to federal borrowing), HUD and the Agriculture Department (which regulate the missions of GSEs), is

making sure the GSEs are not taking advantage of the privilege of borrowing at government rates to make investments that advance their missions, not the interests of their shareholders. Of the GSEs, Farmer Mac had the greatest proportion of non-mortgage investments, leading Leach to comment that Farmer Mac “takes the prize for arrogance in arbitrage.” In particular Leach was concerned that one bank owns 31.2 percent of Farmer Mac’s stock. “Farmer Mac’s arbitrage activities thus amount to an insider game played solely for the benefit of insiders and to the detriment of competitors and free-market precepts, with the taxpayer on the line for any potential losses.”

Leach refers to Fannie and Freddie as “national savings banks.” Fannie and Freddie are two of the most profitable companies in the U.S., benefiting both investors and employees. Leach commented that in *Fortune Magazine*’s annual listing of per employee profits, Fannie Mae topped last year’s list with \$826,000 in profits per employee and Freddie Mac was second with \$388,000. (In comparison, Coca-Cola had \$134,000; Microsoft had \$107,000.) Leach believes one of the reasons GSEs have such astounding figures is because they are holding a greater share of mortgages for their own investment purposes. “Rather than simply bundling mortgages, as anticipated in their charters, to be sold to a tertiary market, Fannie and Freddie have increasingly become national savings and loans.” From 1993-1997, Fannie’s retained mortgage portfolio has increased steadily from \$189 billion to \$316 billion, while Freddie’s has tripled from \$56 billion to \$164 billion.

Leach noted that during the ten year transitional period of privatization, Sallie Mae and Connie Lee’s successors would make annual payments to the Treasury Department to cover the costs of government oversight for the liquidation of their activities generated while they were GSEs. Leach stated that HUD, with respect to Fannie and Freddie is currently exploring this concept of reimbursing the government for oversight costs. In Leach’s opinion, Fannie and Freddie should have no trouble with making such a reimbursement, since the two GSEs have such high net incomes relative to the cost of HUD’s GSE oversight expenses.

Leach believes “by and large,” the GSEs have advanced the public interest and have been prudently managed. He cautions, however, that in the past the GSEs’ “operations have not been without risk to the government and the tax-paying public.” For example, the Farm Credit System ran into problems in the mid-1980’s (requiring a \$1.26 billion bail-out), while Fannie and Freddie “also ran into trouble at that time and had to be helped out with tax relief and relaxed capital standards.”

NEWS SINCE THE CONFERENCE – Cong. Leach’s staff said a Fannie/Freddie reform bill might be introduced during the next session of Congress in January 1999. The reform package may include some of the proposals Leach discussed during the Nader conference, including placing a Treasury Department official on the boards of Fannie & Freddie and requiring the GSEs to pay for the cost of their regulation. Cong. Leach has said that a Treasury representative might help ensure that investments by Fannie and Freddie focus more on mortgages and less on “arbitrage profits.” Wall Street analysts said placing a Treasury representative on the boards of the agencies would have little impact on stock performance or debt issuance. (*American Banker*, 5/21/98)

Boston College Professor of Finance Edward Kane:

When it comes to subsidies, Boston College Professor of Finance Edward Kane, believes the GSEs have a “Bart Simpson” defense: “We don’t receive subsidies...nobody has seen us receive any subsidies...and nobody can prove we hold onto subsidies anyway.” Fannie, Freddie, and the

FHLBanks (Flubbie) receive explicit and implicit subsidies by the government. Kane believes there should be some concern over the recent efforts by Flubbie asking Congress to “expand its statutory mission so that Flubbie can reap subsidized profits in parallel ways.” Kane believes that the GSEs’ “positive returns are transferred to shareholders”, while the “deep downside of negative returns are transferred to taxpayers.” Kane also notes that “although Fannie and Freddie note that one cannot prove the markets do not fully shift the subsidy away from their stockholders...Flubbie, private competitors...industrial-organization theory, and the GSEs’ extraordinary profitability and market dominance...strongly suggest otherwise.”

Kane notes that Fannie and Freddie have managerial control of their subsidies, and their skillful lobbying has denied OFHEO officials “the authority and information they would need to measure and control in a timely fashion the activities by which the federal credit enhancement can be made more valuable to GSE shareholders.” The GSEs sometimes claim that they operate at no cost to the government because they receive no explicit subsidy, however, in a Feb. 3, 1998 comment letter to the OCC, Fannie’s general counsel wrote: “Fannie Mae standard domestic obligations, like Treasuries, typically receive no rating on an issue-by-issue basis, because investors and the rating agencies view the implied government backing of Fannie Mae as a sufficient indication of the investment quality of Fannie Mae obligations.”

Kane notes that Fannie and Freddie’s managerial compensation contributes to a lack of control over the GSE subsidies. He believes there is a brutal conflict of interest between the legal duties that GSE managers owe taxpayers and the duties they owe their own GSE shareholders. Kane writes that the “public-policy defect in this compensation scheme is that GSE stock price performance increases with increases in the size of the federal subsidy that their firm retains.” He recommends reforming the way incentive managerial compensation is paid and changing the role that Fannie and Freddie play in the political process. In his opinion, incentive rewards should be “reduced by a substantial multiple of estimate increases in the value of the imbedded taxpayer credit enhancement” and that “managers’ ability to orchestrate political donations and other benefits for elected officials should be subjected to special reporting restrictions and to other controls that recognize GSE managers’ quasi-civil-servant status.” He noted in his remarks that incentive compensation contracts of Fannie and Freddie resemble “illegal influence peddling” (because the agencies have control over their subsidies). He said if he were a public interest lawyer, he would “explore the possibility of filing a fraud or negligence suit to recover for taxpayers the portion of past incentive compensation that can be fairly allocated to the subsidy flow” of the GSEs. He recommends that Congress “require that all future contracts be written on stock prices net of subsidy increases.” In his opinion, “this would make willful misrepresentations of subsidy value prosecutable as fraud.”

Mark Kinsey, Acting Director of OFHEO:

Mark Kinsey, Acting Director of OFHEO, believes that the most important benefit Fannie and Freddie receive is their implicit government guarantee perceived by the market. The studies done by the CBO and Treasury were based on reasonable methodologies but they should not be considered “gospel.” Estimates of Fannie and Freddie’s implicit guarantees will change over time, because the agencies can alter their businesses to alter the benefits of GSE status. Kinsey believes that the government can provide more oversight and more clarity about the role of Fannie and Freddie in the market. Scott Calhoun, Director of Examination and Oversight at OFHEO, stated that they would issue a Notice of Proposed Rulemaking in early 1999 on Fannie and Freddie’s risk-based capital standard to be used to create a stress test model.

Nicholas Retsinas, former HUD Assistant Secretary:

Nicholas Retsinas, former Assistant Secretary of HUD, does not recommend combining the GSEs' safety and soundness regulation and mission regulation under one regulator. He believes that if the two were joined, there would always be a bias toward safety and soundness concerns. He stated that it is a fair question to examine the unprecedented economic returns of the GSEs to make sure the government as a charter investor is receiving an adequate return from its charter investment. He recommends that the best regulator is "more information" about the GSEs' practices and to make sure that information is more widely shared. Retsinas notes that Fannie and Freddie have done an "exemplary" job of meeting their affordable housing goals, but he noted that it may be time to reevaluate what the government is measuring and whether additional goals should be established.

Critics:

Susan Sweet, President, Capitol Financial Insights, Inc., believes that real estate mortgage lending today does not need government subsidies. Since Fannie Mae's introduction of the mortgage-backed security in the early '80s, there has been a tremendous growth in the private MBS market. Since 1985, private lender participation in the MBS/asset-backed market has increased from less than 1% to almost 25%. Private asset-backed securities represent the fastest growing segment of the securitization market. Asset-backed outstandings for private lenders are growing by more than 30% a year. Agency mortgage-backed securities balances are growing by less than 10% annually. In 1997, Fannie Mae and Freddie Mac issued \$263 billion in mortgage-backed securities. Private asset-backed securities totaled \$185 billion, giving private lenders a 41% market share. Current trends, as reported in Barrons on May 11, indicate that private mortgage securitizations could double in 1998. There is also evidence that the subsidies that are given to the GSEs are not lowering mortgage rates as much as they did in the past. The Congressional Budget Office 1996 Report states that consumers receive a 35 basis point benefit on mortgage interest rates. However, this same report states that the spread between jumbo loans and conforming loans was 25 basis points in 1993. In December 1997, First Union issued a \$407 subprime mortgage-backed security guaranteed by Freddie Mac; First Union representatives told American Banker that the Freddie Mac guarantee saved only 7 basis points. Sweet recommends giving competition a chance. She believes competition would lead to more local underwriting because local lenders have "the most thorough knowledge of area markets, community values and local circumstances that augment or mitigate credit risk, and are in the best situation to manage local risk."

Vernon McKinley, attorney and regular policy contributor to the CATO Institute, calls Fannie and Freddie "cafeteria capitalists." He believes that there is no reason for subsidies to the GSEs. The extent to which Fannie and Freddie fight to keep their status and benefits is the greatest proof that the subsidies are no longer needed. He believes the GSEs would not be active in politics, if Fannie and Freddie did not receive some kind of benefit from their GSE status. Market failure is not a valid justification for keeping the GSE model. He believes it is difficult for the private sector to compete against Fannie and Freddie. The GSEs should be fully privatized and their benefits should be placed "on-budget" because they are a contingent liability on the taxpayers. He believes that the Sallie Mae transition of privatization could serve as a useful example for Fannie and Freddie privatization.

Tom Stanton, attorney, believes that the GSEs may be more politically influential than their own regulators, while posing "concentrations of risk that are potentially greater than the risks of large money center banks." He recommends that the government impose capital standards and oversight that is comparable to the supervision of large financial institutions. He believes Fannie and Freddie are a duopoly in the mortgage market; investor shareholders and company profits are a greater priority for the directors and managers at the agencies than serving their public purposes; and that the agencies'

“overwhelming political power” means that the “government lacks the ability to make a serious change in the balance between service to shareholders and service to public purposes.” He recommends that Congress consider the Affordable Housing Fund of the FHLBank System as a model of reforming the GSEs. According to Stanton, “it would be much more effective to require Fannie Mae and Freddie Mac also to contribute a stated percent of their income to help fund low and moderate income housing opportunities.” Because the GSEs pose a state a risk for taxpayers, Stanton also recommends that OFHEO position itself to be able to regulate the GSEs for a possible GSE failure to “prevent a troubled GSE from gambling to recoup its losses.” He notes that the GSEs are currently using technology to move forward into new markets. Stanton concludes that it “may well be that an end to government sponsorship could benefit both taxpayers and GSE shareholders, with minimal perceptible consequences for consumers.”

Consumer Groups:

Nader stated that while HUD establishes the goals of affordable housing for the GSEs, the goals are so low that they are almost meaningless.

The CBO found in their 1996 report that depository institutions and the Federal Housing Administration “devote a larger proportion of their mortgage lending to targeted borrowers and areas than do the enterprises.”

James Follain, Professor of Economics at Syracuse University, recommended reducing the role of FHA and increasing the role of the GSEs and the private sector in multi-family housing because FHA’s role in multi-family has been “disastrous.”

Harold Bunce, Director, Housing Finance Office of Policy Development and Research at HUD, believes that there is room for the GSEs to improve their affordable housing goals. Studies of HMDA data show that Fannie and Freddie lag the conventional market but studies show Fannie is doing a better job at trying to close the gap than Freddie Mac. Also, Fannie, more than Freddie Mac, is purchasing more multi-family loans. The GSEs must meet three housing goals: (1) low- and moderate-income goal; (2) special affordable housing goal; and (3) geographically targeted goal (or underserved areas goal). A single mortgage loan can qualify as meeting or counting for all 3 of the goals. Multi-family loans are one of the easiest ways to qualify for these goals.

Allen Fishbein, General Counsel, Center for Community Change, believes that Fannie and Freddie are not competitive in the area of affordable housing. In his opinion, Freddie consistently lags and HUD should address this problem in a new rule-making. He believes that there is an inherent conflict when HUD regulates the mission of Fannie and Freddie, while Fannie and Freddie are competitors with FHA. He notes that Fannie and Freddie provide less data than the private sector counterparts provide with HMDA data.

Susan Wachter, Professor of Real Estate and Finance at the Wharton School believes that the private sector alone would not achieve the affordable housing and social goals better than the GSEs, nor would just one government entity be able to better achieve these goals. The GSEs lessen market imperfections. She recommends that instead of asking for financial information from the GSEs, regulators should ask if the GSEs could do more to effectively meet their mission.

Calvin Bradford, Community Reinvestment Associates, gave examples of Fannie and Freddie’s business practices that lead to discrimination. For example, the appraisal guidelines of

Fannie and Freddie have a discriminatory effect. The GSEs, however, have been unresponsive about reforming the appraisal process.

Christopher Garlin, Housing Director, the Domus Corporation, believes that Fannie and Freddie should set housing goals in the area of small multi-family units. He recommended that Fannie and Freddie use their lobbying power at the state-level to combine public and private funds more efficiently.

Debra Katz, Bernabei & Katz, questions Freddie Mac's ability to serve underserved communities and meet affordable housing goals when Freddie Mac is currently engaged in a lawsuit brought by former employees that Freddie Mac discriminates against minorities and maintains a racially hostile work environment. (Katz represents the former Freddie Mac employees.) According to Katz, "a culture of racial discrimination is flourishing at Freddie Mac and affects its workforce, from top to bottom, and, having pervaded the senior management, affects its lending practices." Fannie and Freddie have yet to demonstrate a "significant contribution" to the nation's affordable housing goals. In the first three years that HUD set affordable housing goals for the GSEs, Freddie Mac did not meet all of its affordable housing goals. Examining the data, she notes that the GSEs consistently give preferential treatment in home mortgage acquisition to white borrowers, across all income categories.

Patrick Woodall, ACORN, stated that Fannie and Freddie have a tremendous impact on fair lending, especially in the area of automated underwriting and credit scoring. He believes there is a problem with the automated underwriting and credit scoring systems that are being pushed by Fannie and Freddie because they try to take a "cookie-cutter" approach to home lending. Most of the borrowers that they counsel do not fit such an approach and are often left on the sidelines. He would like for the systems to be more open and consider different types of credit for different borrowers.

Political Influence by the GSEs:

Charles Lewis' organization, the Center for Public Integrity, has been working on gathering research on the political influence wielded by Fannie and Freddie. Lewis noted that his researchers had an extremely difficult time getting Congressional staffers to talk on record regarding Fannie and Freddie and he stated that he had never witnessed such an obvious intimidation process. Fannie and Freddie gave a combined \$764,959 to both parties and Members of Congress during the 1995-96 election cycle. Fannie and Freddie have a history of hiring very connected political operatives, former staffers, and spouses of staffers. Whenever the agencies are criticized, their response is unusually heavy-handed. The Foundations of the GSEs also contribute to their political success, because few want to criticize the efforts of the GSEs, when they do such good things for the community. Lewis also questions the need of the Foundation to set up offices around the country that seem reflective of the political districts for which they most need to curry favor. Lewis suggests that it might be interesting to study the amount of money given to the academic community by the GSEs (providing favorable reports on the GSEs from the academic community).

Fannie Mae & Freddie Mac

- ***Fannie and Freddie are Entering the Mortgage Insurance Business:***

- Fannie & Freddie Introduce New Low Down Payment Loans that Will Cause Damage to the MI Industry & Mortgage Lenders
- Fannie & Freddie are Requiring that New Low Down Payment Loans Must be Processed through their Automated Underwriting Systems
- Freddie Mac's MODERNS Program is a New Reinsurance Product

Fannie & Freddie's New Low Down Payment Loan Programs:

- Fannie & Freddie's new low down payment products are an attempt by the GSEs to enter the mortgage insurance business. Fannie's product (Flexible '97) and Freddie's product (Alt '97) offer a conventional (up to \$227,150) fixed-rate mortgage that can be bought with a 3% down payment. Fannie's Flexible 97 is 30-year fixed-rate mortgage, while Freddie's Alt 97 will be offered as 15-, 20-, or 30-year fixed rate mortgages. The 3% down payment can come from several sources – a gift, or unsecured loan from the family; a nonprofit agency or municipality; a loan secured by a marketable asset; or a grant from an employer, nonprofit, or government agency. Neither agency has an income limitation or counseling requirement for the loans. The Flexible 97 will be available by early June through the network of 500 lenders that use Fannie's Desktop Underwriting System. The product has been tested in pilots in a few states over the last 18 months. Mortgage insurance companies participating in Flexible 97 include Mortgage Guaranty Insurance (MGIC) and Commonwealth Mortgage Assurance Co. (CMAC), while United Guaranty and Commonwealth Mortgage Assurance Co. (CMAC) are participating with Freddie.

Fannie & Freddie Require That New Low Down Payment Loans Must be Processed through their Automated Underwriting Systems:

- All mortgage loan applications for Fannie & Freddie's low down payment program must be run through their respective automated underwriting systems. Some large lenders who have invested in other automated underwriting system have reportedly been complaining about this requirement, but Fannie & Freddie believe their automated underwriting systems are key to the development of the new 97% LTV programs. (*American Banker*, 4/29/98, 5/8/98; *Business Wire*, 4/27/98; *Dow Jones Newswire*, 4/27/98; *Fannie Mae Press Release*, 4/27/98; *Freddie Mac Press Release*, 5/6/98; *Inside Mortgage Finance*, 5/8/98; *Lexington Herald-Leader*, 5/1/98; *Reuters*, 4/27/98; *Washington Post*, 5/2/98)

Agencies' Low Down Payment Program Will Cause Damage to MI Industry & Mortg. Lenders:

- This marks the first time Fannie & Freddie have paid for mortgage insurance directly.
- Reports are that Fannie charges lenders a 150 basis point delivery fee and the borrower will pay a 50 basis point MI premium, similar to the current FHA pricing. Reportedly, Freddie Mac will collect a one-time fee of 135 basis points and a monthly fee of 50 basis points to cover mortgage insurance.
- Fannie will only require that a minimal up-front MI coverage be purchased by the borrower: (a) currently Fannie requires that 30% coverage be purchased on 97% LTV loans. Fannie's

Flex 97 program reportedly drops the coverage to 18%, which is the minimum amount. Freddie Mac's mortgage insurance coverage has also reportedly been dropped from 30% to 18%. Fannie believes this is within their charter; (b) the current rate for 18% coverage on a 97% LTV loan is roughly 59 basis points. Fannie has requested that the MIs lower that rate to 50 basis points (would match FHA's current renewal rate). At this time, some MI companies reportedly declined to lower their rate on this coverage, while others have agreed.

- To cover the "lost MI coverage," Fannie will purchase directly from the MI industry supplemental blocks of insurance on some portion of the Flex 97 business. This supplemental coverage will be paid out of the 150 basis point delivery fee. On good books of business, Fannie may choose not to purchase any of the supplemental coverage allowing them to profit from the full 150 basis point delivery fee.
- While this program (low initial coverage amounts with supplemental coverage purchased on the back-end of the transaction) is being targeted to the 97% LTV market for now, if it's successful, the program could be extended to the 95% LTV and 90% LTV.
- *The net effect of the lower coverage requirements, reduced premium rates and the negotiated purchase of supplemental blocks of coverage effectively eliminates the premium that has been shared with lenders in a captive reinsurance structure.*

Freddie's Mac's MODERNS Program is a New Reinsurance Product:

- Freddie's new MODERNS deal worries private mortgage insurers that Freddie may be trying to get into the mortgage insurance industry. Under its first MODERNS deal, Freddie is effectively reinsuring its residual risk on a \$140 million pool of mortgages. The MODERNS notes represent claims against an offshore special purpose reinsurance company (G3 Mortgage Reinsurance Limited) which issued the security and will make payments based on the losses experienced and absorbed by the pool of Freddie Mac mortgages. The MODERNS are a derivative vehicle that will be used to transfer the default risk of a portion of Freddie's mortgage portfolio to investors – effectively acting as a reinsurance policy. MODERNS will transfer to investors the risk of homeowners defaulting on mortgages owned by Freddie Mac. MODERNS aren't directly backed by a pool of loans like private-label mortgage-backed securities – their value depends on the performance of a sample, or reference portfolio, of Freddie Mac loans. Payments on MODERNS will be based on the performance of the \$15 billion proposed reference portfolio. The MODERNS act as interest-bearing bonds, with Freddie agreeing to pay reinsurance premiums that help pay interest to investors. Investors will lose money on the bonds if there are problems with the loans in the reference pool and will accept that default risk in the form of reduced principal they receive at maturity. MODERNS have no prepayment risks.
- According to Moody's the reference pool includes approximately 147,500 loans (representing about 17.4% of the 30-year, fixed-rate, one-to-four-family mortgage loans than Freddie purchased in 1996). The mortgage loans in the reference pool are geographically diverse, were originated over the span of one year, and exclude any loan that is 30 or more days delinquent when the pool was formed. The reference pool will also exclude all loans that Freddie purchased with credit enhancement other than standard primary mortgage insurance, Moody's said. The loans will be serviced by Freddie Mac-approved mortgage-loan servicers. The offering consists of four floating-rate tranches and one equity tranche. Moody's rated the deal's class A bonds Baa2, class B Baa3, class C Ba2 and class D B2. The loans are not

publicly registered with the SEC. Freddie Mac had no comments about the securities. (*American Banker*, 4/28/98; *Capital Markets Report – Dow Jones*, 5/5/98; *Inside Mortgage Finance*, 5/8/98, & article posted 5/19/98 on website (appeared in 5/15/98 issue of *Inside Mortg. Finance*)

- ***Congress Considered User Fees on Fannie & Freddie to Pay for Highway Transport. Bill:***

- Congress considered imposing user fees on Fannie & Freddie securities as a way to pay for a \$200 million highway transportation bill. However, the agencies were successful at removing the provisions. A Fannie spokesman said they were assured that this proposal has been rejected and is likely to be dead this year. The initial proposal was introduced when House & Senate conferees tentatively agreed last week to a list of “pay-for” items to raise \$23 billion in revenues. Among the items under consideration was a proposal to impose a user fee of 20 basis points on Fannie & Freddie’s debt offerings, and a proposal to raise the Ginnie Mae guaranty fee from 6 to 12 basis points. Estimates show that a Fannie & Freddie user fee could raise \$4.5 billion in revenues over six years. Fannie & Freddie argued that the user fees would have wrecked the international market for their debt securities and resulted in higher mortgage rates. A Fannie spokesman said that user fees “are widely understood to be a tax on homeownership, and that is not something most members of Congress would want to champion in an election year,” he said. “We have been told this is not in play.” Sources on Capitol Hill said the proposal is unlikely to be adopted but no final decisions have been made.

- According to one lobbyist, the idea for the user fees emerged during a speech by Speaker Newt Gingrich to former GOP Members and lobbyists. The Speaker asked how many of the participants were working for Fannie, which spent \$5.8 million in lobbying last year. After several of the participants raised their hand, the Speaker reportedly told the group that the GOP leadership planned to take the transportation money “from Fannie Mae’s hide.” According to the lobbyist, the implication was that the GOP leadership was unhappy with the political connections of Fannie. The leadership of Fannie, including the new Chairman-designate Franklin Raines, has political connections. Raines, who is the outgoing director of the OMB, will replace Jim Johnson, a former top aide to Vice President Mondale. Several Republican staffers from the Administration and Congress are also on Fannie’s payroll. Even though Fannie & Freddie were successful at keeping the user fees out of the transportation proposal, one lobbyist said the idea may resurface the next time Congress needs to look for large offsets – “It tends to strip the veneer,” he said. “People know where they can get \$6.5 billion pretty quickly.” “The real issue is, it is cued up,” a bank lobbyist said. “It is money that is out there that is vulnerable.” (*American Banker*, 5/21/98; *CQ Monitor*, 5/20/98; *National Mortgage News*, 5/18/98)

- ***Legal Opinion Written for Freddie Mac on the Constitutionality of User Fees on Freddie’s Outstanding Securities:***

- Gibson, Dunn, & Crutcher wrote a legal opinion on May 7th on user fees. The opinion notes that: “Although no court has addressed this issue, it is our opinion that any attempt by the Government to levy a retroactive assessment of this nature on outstanding Freddie Mac securities would violate the Takings Clause of the Fifth Amendment to the United States Constitution. First, the proposed retroactive ‘user fees’ would be unrelated to any reciprocal benefits to Freddie Mac or to the fulfillment of any legitimate regulatory purpose, and would instead constitute nothing more than the expropriation of private resources for the

Government's own use, the very abuse that the Takings Clause exists to prevent. Second, the proposed 'user fees' would upset Freddie Mac's reasonable investment-backed expectations, founded upon an express congressional guarantee, that no such fee or charge would be assessed on Freddie Mac's outstanding securities. Under the Takings Clause, the Government cannot frustrate such reasonable investment-backed expectations without providing reciprocal compensation." (*Copies of the legal opinion are available upon request.*)

- ***Controversial Agency Mortgage Pool Insurance May Become Extinct in 1998- Guarantee Fees Likely to Increase:***

- Agency mortgage pool insurance is a controversial product that may be cut back or even become extinct because the mortgage industry may be getting out of that market. Recently, Mortgage Guaranty Insurance (MGIC), the largest writer of agency pool coverage over the past year, informed lenders that it had "maxed out" on the amount of capital it wanted to dedicate to writing pool insurance and would not be offering new commitments in the forthcoming months. Freddie also recently informed analysts that it anticipated seeing less pool coverage during the rest of 1998. One mortgage insurance official noted that they had "heard reports before that agency pool insurance is drying up, but this time it really appears to be happening. MGIC and some of the other MIs are definitely backing way from offering the product."
- The mortgage insurance industry has been battling the issue of whether or not to offer the mortgage pool insurance to large lenders who use the coverage to negotiate lower guarantee fees with Fannie & Freddie. The MI industry typically writes pool insurance policies at a reduced rate, knowing that the coverage will guarantee them a sizable amount of primary insurance on the underlying loan. In return, the MIs hoped for more primary business and more market share, but some of the downsides have been more risk without a lot of compensation. Adolfo Marzol, senior vice president for single family business at Fannie noted that lenders have been asking Fannie for alternative ways to obtain lower guarantee fees in the absence of pool insurance coverage. "We have started a dialogue with some lenders, but the reality is that as pool insurance goes away, agency guaranty fees will go up," Marzol said. (*Inside Mortgage Finance*, 5/8/98)

- ***Consumer Group Recommends HUD Reform its Oversight & Setting of Goals for Fannie & Freddie:***

- The Chicago Fair Housing Alliance released a study called "The Two Faces of FHA" by Dr. Calvin Bradford charging that the FHA lending program is discriminatory. The study was released at a House Banking Subcommittee hearing. Bradford noted in his study and in his testimony that HUD has "failed to use its authority in the conventional markets to create a fair balance of lending," because HUD "has failed to monitor the fair lending practices of these GSEs" who drive the conventional mortgage market. His study indicates how HUD has failed to measure the performance of the GSEs in relation to the lack of conventional lending in areas impacted by FHA lending and foreclosures. Also, he finds that HUD has failed to provide the public with adequate data on the performance of the GSEs so that others can assess their performance in local minority markets. Among his recommendations, he includes a list of reforms for Fannie & Freddie: (1) recommends restructuring the setting of the GSE goals "to create a balance of conventional and government-insured loans in all markets"; (2) provide data to the public on the performance of the GSEs in a form that parallels the structure and accessibility of the Home Mortgage Disclosure (HMDA) data; and (3) make a special

assessment of GSE performance and set specific goals for the GSEs in at-risk communities and high FHA impacted areas.

Data Required by HUD from the GSEs Looks Less Like HUD is Regulating than “Courting” Fannie & Freddie:

- In Dr. Bradford’s study, he attacks the type of information and format for which HUD releases the data on Fannie & Freddie to the public. He also believes HUD’s affordable housing goals are too general. Fannie & Freddie must meet goals targeted towards specifically defined income groups and to geographic areas defined by combinations of minority concentrations and income. But community lending organizations note that “the metropolitan area family income levels used to define lower-income targets allow young single individuals with substantial incomes to be used to satisfy income goals.” And, the geographic targets “are structured so that concentrated lending to whites can be used to meet the overall goals for areas that are 30% or more minority.” According to Bradford, examining data for loans purchased by Fannie & Freddie in 1996, Fannie achieved its geographic goals with only 7% of its loans from African-Americans and only 11% from Hispanics, while Freddie had only 6% of its geographic target goal loans from African-Americans and 8% from Hispanics.
- Bradford notes that the data HUD releases to the public on Fannie & Freddie’s purchases is in such an unworkable format, that “only the most sophisticated local organizations with considerable technical and computer skills could even process the data... In deciding what to release to the public, HUD has acted more like someone courting Fannie Mae and Freddie Mac than someone holding them accountable.” He notes that HUD has “accepted almost all of the claims by Fannie Mae and Freddie Mac to suppress data because it allegedly discloses business secrets.” However, he comments that the data that is needed is not much different than the HMDA data that private lenders have disclosed for years. (Testimony Before the Housing Subcommittee of the House Banking Committee, 5/13/98 and “*The Two Faces of FHA*” by Dr. Calvin Bradford, March 1998)
- ***QuickenMortgage Talking to Fannie & Freddie About Using their AU Systems:***
 - QuickenMortgage (an on-line multi-lender mortgage site by Intuit, Inc.) is talking to Fannie Mae & Freddie Mac regarding the use of their respective automated underwriting systems, according to David Rosenblatt, a product manager for QuickenMortgage. While Intuit has said it’s not interested in becoming a lender, Rosenblatt told a group of mortgage technology professionals that the company is not sure what the future holds. “We’re still learning a lot.” (*Inside Mortgage Finance website*, posted 5/19/98, appeared in 5/18/98 issue of *Inside Mortgage Technology*)
- ***Analysts Recommend both Fannie & Freddie Stock, However, Many Favor Freddie’s Stock:***
 - Fannie & Freddie stock both appear to be good investments, but Freddie appears to be the company with the most potential. Freddie is expected to increase its portfolio at a faster rate than Fannie (Freddie’s portfolio increased 30% in the first quarter compared to Fannie’s 12% growth). Freddie is also ahead of Fannie in the earnings area – Freddie earned 23% in the first quarter compared to Fannie’s 12% growth). Longer term, Freddie’s earnings are also expected to continue expanding faster at 15% versus 13% for Fannie Mae. Freddie Mac plans to grow by using its automated underwriting system, Loan Prospector. Ken Posner, a Morgan Stanley Dean Witter analyst who recently upgraded Freddie’s stock to “attractive” from “neutral,” said

Freddie's system would enable the agency to have more control of the entire mortgage process and even extend its business online. Freddie also plans to purchase more subprime loans, which are riskier but more lucrative because of their greater credit risk. But the biggest risk to Freddie is Congress. Although Congress has been talking for years about stripping Fannie and Freddie from their federal charters - analysts think it is unlikely to ever come to fruition. (*Dow Jones Newswire*, 5/8/98)

- ***Barron's Article Refers to Fannie and Freddie As "Quasi-Governmental" with Fannie Enjoying Enormous Political Clout:***

- In an article published in *Barron's Online* recommending Fannie & Freddie stock, the agencies were referred to as having "quasi-governmental status that allows them to borrow money at rock-bottom rates." The article noted that these "two behemoths dominate the US mortgage market," and have shown double-digit earnings growth for years. The article also stated that the "biggest risk for Fannie and Freddie is political, but Fannie's awesome clout makes a successful congressional assault on its privileges unlikely." (*Barron's Online*, 5/11/98)

- ***Analysts Believe Fannie's Volume Records in April Reflect Dominance of Fannie & Freddie:***

- Mortgage-market analysts say that Fannie Mae's record breaking volume levels in April illustrate the "blistering pace of the mortgage business in 1998 and the increasing dominance of Fannie Mae and Freddie Mac." According to Michael Youngblood, managing director and mortgage analyst at Chase Securities, "Fannie Mae, like Freddie Mac, is a mainstay of demand for the mortgage market and between the two of them and agency REMICs that they guarantee, they've absorbed the lion's share of net new issuance in 1998 as they did in 1997." Fannie Mae committed to purchase \$17.6 billion in mortgages in April and issued \$31.4 billion of MBSs, setting new records. Commitments to purchase were up from \$14.7 billion in March, and MBS issuance rose from \$25.1 billion. Mortgage purchases also reached a high in April, rising to \$14.7 billion, from \$12.1 billion in March. Fannie's net mortgage portfolio grew at an annualized rate of 18.1% to \$741.9 billion, after growing 14.2% in March. (*American Banker*, 5/15/98; *Dow Jones Newswire*, 5/13/98)

- ***Private Sector Creates Secondary Market Purchaser of Luxury Mortgage Loans:***

- LuxMac is a new specialized mortgage money source run by Covino & Co and 400-plus local originators. LuxMac, like Fannie & Freddie, buys locally originated mortgages from a nationwide network of mortgage bankers, brokers and banks. It pays for the mortgages by turning them into securities via Wall Street, or it sells them in pieces or in whole loans. Unlike Fannie & Freddie, however, LuxMac is a private enterprise, with no "government backing." LuxMac home loans start at \$500,000, averaging \$1.4 million, and have no upper dollar limit. LuxMac financing packages also require no minimum down payment and no mortgage insurance. If you want a \$1.5 million zero-down payment mortgage and you qualify, it's available unlike Fannie & Freddie, who by contrast, generally require at least a 3% down payment and mortgage insurance. (*Washington Post*, 5/16/98)

Fannie Mae

- ***Fannie Mae in Battle With Congress and Administration on FHA Loan Limits:***

- Fannie may be in a tougher battle than usual with Congress over a proposal to raise the FHA loan limits, because the issue has now been framed around “money.” The outcome may not be decided on policy grounds but “How badly does Congress want money from the HUD-insured loans - \$1 billion in revenue from premiums over five years – to pay for pet projects?” The FHA issue centers around a HUD proposal to raise the FHA loan limit to the same loan ceiling as Fannie & Freddie (\$227,150). Fannie is opposed to raising the loan limit because it says HUD should stick to its core mission and not take on new business – which incidentally might take business away from Fannie Mae. David Jeffers, vice president for corporate relations at Fannie Mae, said the proposal would put the government into a new market for larger mortgages with which it has little experience. “It’s a serious set of public policy questions,” Jeffers stated. Since the FHA’s core business is helping families most in need, he said, the agency’s move into a new market could have an adverse effect on poorer neighborhoods. But raising the FHA loan limit is rated as a plus by budget officials. “Raising the loan limits leads to a revenue flow that is significant in terms of the problems that I have in my appropriations process,” says HUD/VA Appropriations Subcommittee Chairman Rep. Jerry Lewis (R-CA). The House and Senate Banking Committees oppose raising the loan limits, but Rep. Lewis may try to work around those committees and put the increase in his appropriations bill, which has prompted Chairman of the Banking Committee Jim Leach (R-IA) to write a letter to Speaker Gingrich asking the Speaker to stop Rep. Lewis’ intrusion.
- Opponents should not dismiss, however, the great lobbying power of Fannie Mae. Fannie’s staff is very politically-connected. Charles Lewis of the Center of Public Integrity said that “Fannie Mae is so wired on Capitol Hill that there is not much outrage up there because they are all petrified of Fannie Mae.” Fannie also uses its Partnership Offices to curry favor with lawmakers. “It isn’t coincidental that one of Fannie Mae’s first local partnership offices was in San Antonio, home to Rep. Henry Gonzalez, ranking Democrat on the House Banking Committee. Mr. Gonzalez took ill last year, essentially making Buffalo, NY, Rep. John LaFalce the panel’s top Democrat. Now, Fannie Mae will open a local office in Buffalo. Officially, the 31 offices target lending plans for localities, but critics seem them as political tools to build relationships.” (*American Banker*, 2/19/98; *Greensboro News & Record*, 2/18/98; *Washington Post*, 2/17/98, 2/18/98; *Wall Street Journal*, 5/11/98)

- ***Comparison of Fannie Mae and Other Large Corporations:***

- The *Wall Street Journal* on 5/11/98 printed the following table from *Fortune Magazine* to illustrate how Fannie has become one of the nation’s largest financial institutions. By using its implied government guarantee, Fannie is able to “borrow more cheaply than competitors, an arrangement that has allowed huge profits, shareholder gains, and lavish salaries and benefits for executives.”

	Fannie Mae	Compaq	GTE
1997 Revenue	\$27 billion	\$24 billion	\$23 billion
1997 profit	\$3 billion	\$1.8 billion	\$2.7 billion
Employees	3,500	37,000	114,000

Source: Fortune Magazine

- ***Fannie Mae Long-Term Global Debt Ratings Reflect GSE Status:***
 - Moody's Investors Service confirmed its Aaa ratings on the senior unsecured long-term global debt of Fannie Mae, including its US and global medium term-notes programs and its global debt program. According to Moody's, Fannie Mae's ratings reflect its GSE status – with its diverse financing and other benefits – as an important creditworthiness consideration. Moody's "aa3" rating for Fannie's non-cumulative preferred stock partly reflects its role in regulatory capital, as well as from the benefits it derives from its GSE status. (*Dow Jones Newswire, 5/15/98*)
- ***New York Times Runs Large Profile Piece on New Fannie Mae Chairman Franklin Raines:***
 - The *New York Times* ran a profile piece on Fannie Mae's new Chairman-designate Franklin Raines and his challenging role at Fannie Mae – "perhaps the most politically astute of big corporations." The article notes that "although it doesn't make mortgage loans, Fannie Mae is the dominant force in the nation's housing finance industry," bringing steadily profitable business for its shareholders and its top executives. The article notes that "because much of its success can be tied to financial advantages stemming from its roots as a Government agency, Fannie Mae has a huge interest in holding off political attacks." Fannie Mae "plays hardball politics with tremendous sophistication to defend its interests," and "Raines will have no choice but to continue the practice." Fannie Mae has "consolidated and exploited the advantages granted to it by Washington" by hiring some of the best lobbyists, contributing to political campaigns, and "relentlessly selling members of Congress on what Fannie Mae is doing to help homebuyers in their states and districts." (*New York Times, 5/17/98*)
- ***Fannie Mae Stock May be "Settling Down":***
 - Over the last decade, Fannie Mae's stock has been a stock market favorite with its earnings defying any clear link to interest rates, but recently, concerns have been expressed about rising interest rates, weaker earnings rates, and political uncertainty that have slowed the advance of its stock. (*New York Times, 5/17/98*)
- ***Fannie Mae Foundation Presented Awards in Congressional Caucus Room:***
 - The Fannie Mae Foundation presented awards on May 19th to 62 nonprofit US organizations for excellence in low-income housing revitalization projects in the Caucus Room of the Senate Russell Building.

Freddie Mac

- ***Will Freddie Mac Transform B & C Loans Using their Underwriting System?:***
 - Faith Arnold Swartz, director for alternative markets at Freddie Mac, told attendees at a Faulkner & Gray's B&C Lending Conference in Miami, that Freddie's automated underwriting system (Loan Prospector) would identify as many as 20% of the loans in the subprime market that should be classified as conforming. Swartz told subprime lenders, "We think we're talking about transforming the industry." She denied that Freddie's interest in the B&C loans violated

their charter and she stated that Freddie would move ahead “slowly and prudently” doing as many as 10 subprime deals this year. Freddie Mac has done two so far this year, and did five last year. (*National Mortgage News* website, posted 5/19/98)

- ***Freddie Mac, MGIC, and Homefree Unveil New Low Down-Payment Product in DC:***
 - Freddie Mac, Mortgage Guaranty Insurance Corporation (MGIC) and HomeFree USA announced a new product that allows the purchase of a home in the Washington, DC area with as little as \$500 from the homebuyer’s own funds. Chevy Chase FSB and Crestar Bank will originate the Freedom Fund Mortgages and MGIC will provide the private mortgage insurance for mortgages bought by Freddie Mac under the program. HomeFree USA will offer pre- and post-purchase homeownership counseling. Freedom Fund Mortgages will permit the use of cash from gifts, grants, or small second mortgage loans for downpayments. Closing costs and other non-downpayment expenses can be paid by a non-borrower. (*Freddie Mac press release, 5/15/98; National Mortgage News website, 5/19/98*)
- ***One Month After Fannie’s Record REMIC, Freddie Launches Even Larger REMIC – Investors Seem Unmoved:***
 - A month after Fannie issued a then-record \$4.02 billion REMIC deal, Freddie Mac announced an even larger REMIC. Freddie increased to \$5 billion its REMIC Series 2054 backed by \$225 million in 6.0 percent Gold PCs (participation certificates); \$190 million in 7-1/2s; \$1,865 million in 7s; and \$2.72 billion in 6-1/2s. A Freddie Mac spokesperson said it would be “disingenuous” to say the Fannie Mae record was not influential, but other factors also favored doing such a large offering. Market participants seem to be unmoved by the size of the offering. Richard Moogan, head of the MBS department at LaSalle National Bank said the record size “is for bragging rights at best.” (*Capital Markets Report-SmartMoney Interactive, 5/19/98; Reuters, 5/19/98*)
- ***Freddie Mac, CA Housing Finance Agency, & Major Mortgage Lenders Announce No Down-Payment Pilot:***
 - Freddie Mac, the CA Housing Finance Agency, Countrywide Home Loans, North American Mortgage Company, and Chase Manhattan Mortgage Corp. announced a \$100 million pilot initiative called “Affordable Gold 100”®. The pilot is eligible for borrowers with incomes up to 120% of the area median. Under the pilot, no down payment is required, but borrowers are responsible for paying the closing costs. The cash for the closing costs can come from a gift from a relative, unsecured loan or a grant from qualified institutions. (*PR Newswire, 5/19/98*)

Federal Home Loan Banks

- ***The Firing of FHFB Director, Costiglio, Triggers Senate Investigation and Legislation:***

Senate Investigation:

- The Senate Governmental Affairs Committee will investigate the firing of FHFB Director Lawrence Costiglio as part of a broader probe of the Federal Housing Finance Board. In a letter to FHFB Chairman Bruce Morrison, Chairman of the Senate Governmental Affairs Committee, Senator Fred Thompson (R-TN), requested “any information and documentation

regarding the removal, replacement or termination of...Lawrence Costiglio.” A staff member on the committee said they were “very concerned by some of the allegations raised by Mr. Costiglio and feel it’s our responsibility to make further inquiries.” Senator Thompson also requested additional background on the FHFB, including its responsibilities as a regulator of the FHLBank System, how FHLBank Board executives are selected and on the Chairman of the FHFB’s authority to compensate the executives. Senator Thompson further requested a list of all the FHFB personnel assigned to the other agencies since June 1, 1995 for any period greater than 10 days. According to the letter, Senator Thompson seeks to determine “whether the FHFB is fulfilling its statutory mandates and is using its resources properly.” The deadline for the FHFB to respond is May 20th. After evaluating the response from the FHFB, the Committee will decide whether or not to hold hearings, request further documentation, examine statutory or regulatory problems with the agency, or drop the inquiry altogether. In addition, as we noted in last week’s *GSE Report*, Senate Banking Committee Chairman Alfonse D’Amato (R-NY) who has also questioned the firing of Costiglio, introduced legislation to abolish the FHFB, transferring its functions to other agencies. (*American Banker*, 5/11/98; *Dow Jones Newswire*, 5/7/98; *National Mortgage News website*, posted 5/11/98)

Senate Legislation Would Abolish the FHFB – Chairman of FHFB Believes Abolishing the FHFB Would Cause “Corporate Welfare”:

- As we reported in the May 8th issue of the *GSE Report*, Senate Banking Committee Chairman Alfonse D’Amato (R-NY) proposed a bill that would abolish the FHFB and transfer its responsibilities to HUD and OFHEO. The bill, “Federal Home Loan Bank System Regulatory Restructuring Act of 1998” (S. 1986), is co-sponsored by Senator Richard Shelby (R-NC). Senator D’Amato believes that the FHFB is “outdated and needs to be reformed,” and he believes that the FHFB has an inherent conflict of interest because it oversees both the mission and the safety and soundness of the FHLBanks. His proposal would transfer regulation of all the GSEs under the same regulator.
- Sen. D’Amato’s bill would: (1) transfer safety and soundness regulation responsibilities to OFHEO (currently the safety and soundness regulator of Fannie and Freddie); (2) transfer mission compliance oversight to HUD (current mission regulator of Fannie and Freddie); (3) dissolve the FHFB; and (4) transfer all employees of the board to OFHEO. According to his statement, the GAO testified that one regulator should be responsible for overseeing the safety and soundness of the FHLB and Fannie Mae and Freddie Mac. Senator D’Amato did not specifically mention the recent controversial firing of FHFB Member, Lawrence Costiglio, as a factor in his decision to introduce FHFB reform legislation, however, he introduced the bill shortly after he said he wanted to investigate the operations of the FHFB after the dismissal of Costiglio.
- In a letter to Sen. D’Amato, FHFB Chairman Bruce Morrison stated that abolishing the FHFB would foster “corporate welfare” within the FHLBank System. Morrison noted that provisions in the bill would essentially require FHLBanks to use their ability to borrow funds at below market rates to ensure the payment of high dividends to member institutions. “By mandating that the federal subsidy for the FHLBanks be used in this manner, the bill creates a ‘corporate welfare’ program that not only is inconsistent with the historical purposes of the FHLBank System, but that also would effectively transform the System into one lacking any meaningful public purpose,” Morrison said. Morrison believes the proposal would also encourage the FHLBanks to focus only on profits at the expense of their mission of assisting housing, and splitting the regulation between OFHEO and HUD would create a “weak and ineffectual

regulatory scheme for the FHLBanks,” and “shift to the taxpayers regulatory costs that currently are paid by the FHLBanks.” Morrison also thought the D’Amato bill would create “a serious conflict of interest” in giving to OFHEO (who is the safety and soundness regulator of Fannie and Freddie) direct regulatory authority over its principal competitor by giving new responsibilities for issuing FHLBank debt obligations. “This would require OFHEO to compete directly in the capital markets with Fannie Mae and Freddie Mac,” Morrison said. (*American Banker*, 5/21/98; *BNA Daily Report for Executives*, 4/28/98, 5/21/98; *Congressional Record Statement by Senator D’Amato*, S3589; *Dow Jones Newswire*, 4/24/98, 5/20/98)

Meanwhile, Judge in the FHFBCase is Anxious to Decide the Case on Its Merits:

- US District Judge Thomas Penfield Jackson stated during a hearing that he was anxious to decide the merits of a lawsuit challenging President Clinton’s dismissal of Federal Housing Finance Board (FHFBC) Director Lawrence Costiglio. The hearing was on the motion by Costiglio for a preliminary injunction to put him back on the FHFBC until the case could be decided on its merits. Judge Jackson told the lawyers that he would like to skip over the preliminary injunction motion and decide the case on its merits, giving lawyers three weeks to file any further arguments on the merits that they deem appropriate. As we have reported in previous GSE Reports, Costiglio was dismissed in late March from the FHFBC, but he insisted he had a legal right to remain on the job until a successor is appointed and qualified. The Department of Justice argues that President Clinton had full authority to dismiss Costiglio, citing the Swan case, where a federal appeals court upheld the dismissal of a member of the National Credit Union Administration. During the hearing, however, Judge Jackson kept noting the fact that Costiglio was dismissed without a successor named and the Judge observed that the Swan case “there was somebody standing in the wings.” Judge Jackson also suggested that a logical extension of President Clinton’s action and the defense would be to say that the President could shut down the FHFBC by simply dismissing all its members and not appointing any successors. (*Dow Jones Newswire*, 5/11/98)

• ***FHLBank Reform/Expansion Language Advances in House and Senate:***

House-Passed Financial Services Modernization Bill Contains FHLBank Provisions:

- The House-passed financial services modernization bill (H.R. 10) contains provisions similar to Senator Hagel’s FHLBank bill (S. 1423). The bill lifts the requirement that 10% of total assets be in residential mortgages or mortgage-backed securities for federally insured institutions with less than \$500 million of assets that want to join the FHLBank System. The bill also allows FHLBank members to receive advances for funding small-business, agricultural, and community development loans.

Senator Hagel Plans to Offer FHLBank Bill As Amendment to Credit Union Bill:

- Senator Chuck Hagel (R-NE) stated at an Independent Bankers Association of America Conference that he may offer his FHLBank System reform bill (S. 1423) as an amendment to the Credit Union Membership Access Act (H.R. 1151). Hagel’s bill would make it easier for small banks to join and borrow from the FHLBank System. His bill would also make system membership voluntary for thrifts, and equalize stock purchase requirements for all member institutions. The bank and thrift industries support the bill because it would provide them with easier access to additional funds.

Financial Services Experts Oppose FHLBanks’ Expansion Provisions:

- As we stated in the May 8th issue of the *GSE Report*, the Shadow Financial Regulatory Committee, a group of industry experts and academics who meet periodically to offer recommendations on key issues in the financial services industry, said they strongly oppose efforts to expand the role of GSEs. According to Paul Horvitz of the University of Houston, it is “unwise and risky to the taxpayer to expand the role of the [Federal Home Loan Banks]...It is undesirable to see any expansion of GSEs.” The Shadow Committee is concerned that Senator Chuck Hagel (R-NE) and Cong. Richard Baker (R-LA)’s bills would result in the FHLBanks becoming “general purpose lenders to depository institutions.” The Committee recommended privatizing the FHLBanks to help alleviate any potential risk to taxpayers that could result as more loans are approved by the FHLBanks. “The FHLBanks are now profitable and expanding their lending within current constraints. There is no financial need for any expansion of their role,” Horvitz said. (*American Banker*, 5/15/98; 5/19/98; *BNA Daily Report for Executives*, 5/5/98, 5/19/98)
- ***FHFB Holds Hearing on FHLBanks’ Investment Practices:***

Overview

- The Federal Housing Finance Board (FHFB) held a hearing on May 11th to discuss the FHLBanks’ investment practices. Chairman of the FHFB Bruce Morrison and Finance Board Director J. Timothy O’Neill chaired the hearing. The hearing consisted of six panels, many of whom advocated a “flexible” regulation of the FHLBanks’ investments and objected to the strict regulations recommended in the FHFB staff report. Community groups, however, objected to allowing the FHLBanks too much freedom and flexibility in their investment practices, preferring that the FHLBanks make targeted investments to low and moderate-income communities. Cong. Paul Kanjorski (D-PA) also advocated, in written testimony, that the FHLBanks should “make a small amount of narrowly targeted investments in people and communities left behind.” Many of the FHLBanks and the trade groups objected to the FHLBanks receiving permission to make targeted investments. Generally, the hearing left the impression that there was not widespread support for regulation on the FHLBanks’ investment practices.
- Representatives from the FHLBanks and industry trade associations were in unanimous agreement that Congress should pass FHLBank legislation similar to the legislation sponsored by Senator Hagel, S.1423, that suggests reforms to the capital structure and REFCORP assessments. They did not agree that legislation must pass before the FHFB regulates the FHLBanks’ investments. The FHLBanks and the trade groups were not unanimous that legislation was necessary before implementation of any regulation of their investment practices. The FHLBank of San Francisco, the Independent Bankers Association, and the National Association of HomeBuilders did not believe that legislation was necessary before regulation. The National Association of HomeBuilders went so far as to say they would prefer regulations prior to Congressional legislation.

Expansion of Powers:

- A few who testified thought that the FHLBanks powers should be expanded. The National Association of HomeBuilders supported the FHLBanks involvement in pilots in residential land acquisition, land development, and construction financing, and multifamily financing. The NAHB believes that these innovative products and pilot programs should be encouraged because “pilots are the best way to increase the portion of FHLBank portfolios invested in mission-related assets.” The National Community Reinvestment Coalition (NCRC)

recommended that the FHFB consider developing a secondary market for community development loans and small business loans. The NCRC also recommended that the FHLBanks provide voluntary reporting of the characteristics of small business owners. Paul Pryde, President of Capital Access, LLC, a financial advisory firm, also supported the FHLBanks' entrance into the secondary market for community development securities. In his opinion, the FHLBanks could structure special advance programs specifically designed for members who wish to purchase community development securities or invest in securitization conduits that purchase community development loans and package them into securities.

Opening:

- Opening the hearing, Chairman Morrison reiterated that any regulations on investment-related changes by the FHFB would be done in a formal rulemaking process. Morrison noted that the recent FHFB staff report found many of the FHLBanks' investments were non-mission related. Morrison stated that the staff report does not necessarily reflect the views of the Board, however, the report's findings cannot be dismissed. Morrison assured everyone that any rule proposed by the FHFB would be done carefully and would be flexible enough to respond to unforeseen changes in the marketplace. In Morrison's opinion, Chairman of the House Banking Committee Chairman Jim Leach, captured the purpose of the hearing in his letter to Morrison when he said, "I have become increasingly concerned that the GSEs are using these benefits, specifically their ability to borrow at rates only slightly above Treasury borrowing rates, more to generate arbitrage profits through investments than to advance the achievement of their public mission. Thus, I believe it is crucial that the GSE regulators focus not only on whether GSE investment activities are safe and sound, but also on whether such activities are directly related to the GSE mission." Morrison seems to recognize the political implications of Chairman Leach's comments.
- O'Neill, on the other hand, wondered "whether there really is a problem here that needs fixing?" O'Neill said he is open on the issue, but it was obvious from his questioning of witnesses that he preferred that Congressional legislation pass before the FHFB regulates the investment practices of the FHLBanks.

FHLBank Views:

- The Council of FHLBanks, representing 10 of the 12 FHLBanks, testified that mission fulfillment should be measured by a FHLBanks' activities and that each FHLBank should be responsible for its own investment, liquidity plans, and mission fulfillment. Investment policies should also be flexible enough to accommodate specific market conditions and business cycles of each individual FHLBank. The Council supports comprehensive FHLBank reform, specifically supporting Senator Chuck Hagel's bill that would "...in addition to many other notable reforms, recognizes that our debt issuance, even our investment activities, are driven by this need to deploy capital. Therefore, legislation is needed to provide the Banks with a more permanent and flexible capital base with which to operate." The Council cautioned that this would not be the best time to cut back investments because they have a large number of new members who have not yet used the System. The FHLBanks are currently in the process of educating these new members on how they can best use the System. According to the Council, the short-term assets provide liquidity and allow the System to hold excess capital for those members who haven't yet tapped the System.

The following is a summary of the FHLBanks that submitted testimony:

Atlanta – Cautioned that since the FHLBanks are GSEs, “subject to a significantly greater degree of oversight than that imposed on the private sector, there is high sensitivity among FHLBank members regarding the possibility of arbitrary or abrupt Congressional or regulatory action.” The Bank noted that “any regulatory action which might adversely affect members’ legitimate expectations regarding their FHLBank’s reliability as a provider of liquidity and other credit services, or maintenance of a reasonable return on their investment in FHLBank stock, could seriously undermine the voluntary and cooperative nature of the FHLBanks.” They acknowledge that the GSEs have broader access to capital markets than most private sector institutions. “However, GSE status is no guarantee that the capital market will always be available, or accessible at a reasonable price, when the need for future funding arises.”

Boston – Stated that “the FHLBanks should be granted broader, not narrower, investment powers.” The Bank said the FHF’s staff paper on investments contains “a fundamental flaw in the assumption that the mission fulfillment of the FHLBanks can be captured by a simple balance sheet metric.” The balance sheet of a FHLBank is not its mission, but rather a means, to fulfill its mission.

Chicago – Believed that the “financial structure and practices of the FHLBanks should not be considered in isolation, but in the context of other housing GSEs, Fannie Mae and Freddie Mac.” The Bank recommended a new formula for balancing mission assets: housing finance should at all times equal at least 85 percent of COs outstanding.

Cincinnati – Noted that “in the absence of statutory changes to Bank capital requirements and REFCORP assessments, the current Finance Board proposal to reduce investments will significantly reduce the System’s ability to fulfill its public mission and hinder its efforts to serve as a credit reserve facility for community-based financial institutions.” During Q&A, the FHLBank of Cincinnati stated that if legislation passed this year, there would be a reduction in money market investments by the FHLBanks.

Des Moines – Wrote that “reducing investment income reduces a Bank’s ability to consistently provide attractively priced funding to its members. Investment income directly contributes to the mission of the Banks.”

Indianapolis – Noted that the FHLBanks were trading on their GSE status and making excessive profits on short-term investments. They believe that “reducing profitability is simply an unrealistic alternative.”

New York – Warned the FHF that “fabrication of regulatory limits on economically rewarding activity would likely spur development of methods or mechanisms to circumvent the limits and reap the economic rewards.” The Bank also noted that unless modifications were made to REFCORP and the capital structure, “asset restructuring would harm the FHLBanks’ ability to accomplish their mission.” They believe Senator Hagel’s bill “almost accomplishes this, and with modification it would be the preferred option to solve this REFCORP funding issue. The Banks use their GSE funding advantage to meet their housing mission provide support for community and economic development, and meet their FIRREA-imposed financial mission. “And yet, notwithstanding, this extensive use of their advantage, the Banks’ return on stockholder equity is well below that of the GSE community as a whole.” In comparison to the other GSEs, the FHLBank stockholders were receiving sub-par returns on their capital. “In this

context, actions by the Finance Board to further reduce Home Loan Bank stockholder returns would be ill considered.” Morrison felt that the FHLBank of New York had a good argument when they used the Fannie and Freddie comparisons, but he commented that maybe this simply indicates that the regulators of Fannie and Freddie have not looked at Fannie and Freddie’s debt adequately.

San Francisco – Said it voluntarily began to change the profile of its balance sheet to that of a “mission-consistent Bank” two years ago by decreasing the amount of non-housing investments supported by FHLBank Consolidated Obligations (COs) and replacing the runoff with shareholder credit. One of the reasons the Bank voluntarily changed their investment practices two years ago was because “arbitraging COs with money market investments was not consistent with the public policy purpose of the Bank System.” The Bank was able to make the transition to lower levels of non-mission related investments smoothly, and without a flight of capital or a decline in membership. They credit much of the success of their plan to the development of innovative products that “without the crutch of arbitrage investments, credit opportunities that previously had been considered non-viable were developed into robust new products.”

The FHLBank of San Francisco would support the FHFB’s efforts to develop reasonable guidelines for limiting investment activity at the FHLBanks. The FHLBank of San Francisco did not feel that Senator Hagel’s bill needed to be passed before establishing limits on the FHLBanks’ money market investments. The FHLBank of San Francisco also did not think that the FHLBanks should be permitted to make targeted investments in people and communities. The FHLBank of San Francisco wrote that “...absent express direction from the Congress, the role of the FHLBanks is to provide wholesale funds in support of mortgage finance lending. The San Francisco Bank believes that there are ample opportunities for FHLBanks to maintain a fully mission-consistent portfolio without the need to rely upon mission-weighted, higher-risk investments in “people or communities left behind.”

Seattle – Opposes restrictions on the current investment authority of the FHLBanks. “Further restrictions on the investments policies of the FHLBank, which are already conservative by GSE standards, pose a significant threat to the FHLBanks ability to effectively meet the needs of their stockholders and the communities they serve.

Topeka – Supports the FHFB’s investment review, but cautioned against imposing specific targets on individual banks, stating that “there is nothing inherently negative about a GSE investing in money market instruments or mortgage-backed securities.” They believe Congress should be the one to determine whether FHLBank investments should be limited.

Trade Associations:

- America’s Community Bankers (ACB), Independent Bankers Association of America (IBAA), and the National Association of Home Builders (NAHB) were split on whether comprehensive legislation should be passed before regulations were imposed on investment practices. ACB believes that no regulations on investments should be imposed until legislation or statutory reform is passed. The ACB believes that unless statutory revisions are made to the “perverse aspects” of the fixed REFCORP obligation and of the subscription capital base of the FHLBanks, “proceeding with any of the proposed limits on either money market or mortgage-backed securities holdings would not assist the mission fulfillment of the System and would be prejudicial to the health of the System and its constituent FHLBanks.” The IBAA strongly

supports Senator Hagel's bill and thinks the issues of investments would be less complicated if legislation is passed, but they are not sure they have a "strong feeling" about whether or not legislation should proceed or follow regulation on investments. The NAHB, on the other hand, prefers that investment regulations be imposed before legislation is enacted.

- All of the trade associations recommended that any prospective investment regulations on the FHLBanks should be flexible and acknowledge the specific needs of the individual FHLBanks. The ACB has not observed a "significant single incident at any of the 12 FHLBanks where an inappropriate "arbitrage" of agency funding status has been alleged." The NAHB believes that any limitations on investments should be expressed in ranges rather than specific limits and transition provisions. The transition provisions would allow a time period for legislation to pass that would change the System's REFCORP obligation from an absolute dollar amount to a percentage of earnings.

Community Groups:

- The National Low Income Housing Coalition, National Council of State Housing Agencies, the Coalition of Community Development Financial Institutions, National Congress for Community Economic Development and the National Community Reinvestment Coalition objected to allowing the FHLBanks too much flexibility, and advocated that the FHFB encourage the FHLBanks to invest in lower income communities. The consumer groups felt that the FHLBanks should make narrowly targeted investments in "people and communities left behind."
- Helen Dunlap, president of the National Low Income Housing Coalition, believes that the System is safe and sound and that Bank membership, advances, and income (over \$1.5 billion) are currently high, so it is time to reduce money market investments in accordance with FHLBank housing mission limits. In her opinion, the extent to which MBSs support the Banks' housing finance mission is questionable. She mentioned a *Wall Street Journal* article on April 3rd that said the System is issuing a "torrent of debt...[and] passed the Treasury in the first quarter as the bond market's most active issuer, selling \$593 billion in securities, compared with an estimated \$515 billion from the Treasury." According to Dunlap, "[T]his isn't you're grandfather's Federal Home Loan Bank." (Written & Oral Testimony at the FHFB Hearing, 5/11/98; *American Banker*, 5/18/98; *BNA Daily Report for Executives*, 5/12/98; *Dow Jones Newswire*, 5/11/98; *National Mortgage News website*, 5/18/98)
- ***FHFB Issues Proposed Rule on Defining the Types of Community Advancements for FHLBank Cash Advance Programs and Expanding the Letters of Credit:***
 - The FHFB issued proposed rules on May 8th to define the community investment cash advance programs that the FHLBanks may establish and to expand the use of letters of credit. The first proposed rule would allow the FHLBanks to make advances for economic development projects benefiting low- or moderate-income households. The proposal would establish general standards for Community Investment Cash Advance Programs, giving the FHLBanks guidelines on setting up programs oriented toward fostering economic development. According to the BNA, "The aim of the program is to encourage the banks to support these programs more, instead of concentrating community investment resources in housing-related programs." The letters of credit proposal would reclassify letters of credit as an incidental power, allowing the FHLBanks to issue letters of credit without many of the restrictions that apply to advances. The FHFB believes this proposal would provide more flexibility among the

FHLBank System and according to a FHFB statement, “It would provide the FHLBanks to issue assist their members in housing and targeted economic development finance, asset liability management, and liquidity and other funding.” The FHFB also said the proposal expands the type of collateral the FHLBanks can accept for letters of credit to include secured small business loans and investment-grade bonds, but the expanded collateral would be restricted to letters of credit that support the FHLBanks’ mission of economic development and housing. Comments on the proposed rules are due on August 6, 1998. (*BNA Daily Report for Executives*, 4/23/98; *Federal Register*, 12 CFR Parts 935, 938, and 970, pages 25718- 25733)

- ***FHFB Issues Proposed Rule on Changing the Elections of the FHLBank Directors:***

- The Federal Housing Finance Board (FHFB) issued a proposed rule on May 13th to amend its regulations on the election of FHLBank directors. The rule would transfer responsibility for determining the eligibility of elective directors and administering the FHLBank director process from the FHFB to the FHLBanks. According to the FHFB, the rule is part of Board’s efforts to transfer management and governance responsibilities to the FHLBanks. Comments on the proposed rule are due by June 29th, 1998. (*Federal Register*, 5/13/98, 12 CFR Parts, 922, 931, 932, 933, 934 & 941, pages 26532-26560)

Farmer Mac

- ***Farmer Mac CEO Doesn’t Believe Loan Delinquencies Will Turn Into Losses:***

- Loan delinquencies at Farmer Mac are up two-and-a-half times last year’s rate, but Farmer Mac’s CEO Henry Edelman said he doesn’t expect those delinquencies to turn into losses. In its first-quarter news release, Farmer Mac said that at March 31, loans 90 days or more past due, in bankruptcy or in foreclosure represented 0.92% of the principal amount of all loans underlying guaranteed securities, compared with 0.39% last year. Edelman calls the delinquencies a “cyclical thing...the loans are not really in trouble, they’re just delinquent,, and that is the nature of agricultural lending.” Edelman also noted that the loan-to-value ratios in agriculture are much lower than the residential market. (*Dow Jones Newswire*, 5/19/98)

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