

The **GSE** REPORT™

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Major Events

HUD Report Finds that the Lending Guidelines of Fannie & Freddie May be Discriminatory and that Fannie & Freddie Do Not Appear to Have Gone as far as Private Sector Lenders in Serving Low- and Moderate-Income Homebuyers

HUD Notes that it will Examine Fannie & Freddie's Lending Practices

- An independent study commissioned for HUD by the Urban Institute found the following:
 - Fannie and Freddie's underwriting guidelines may inadvertently have a disparate impact on minority borrowers. While Fannie and Freddie's guidelines and lending practices do not "explicitly" discriminate against borrowers based on their race or ethnicity, "they do disqualify borrowers with low incomes, limited wealth, and poor credit histories," noting that borrowers with these characteristics are "disproportionately minority." "Therefore, the guidelines have the potential for a disparate impact on protected classes of borrowers." Although the report noted that even if the GSEs' lending practices are not unlawful the end result may be: "A guideline that has a disproportionate effect on a prohibited basis, such as race, and does not serve a business necessity meets the legal definition of disparate impact and is illegal." "Even if a guideline serves a business necessity," the authors argued, "it is still illegal if a less discriminatory alternative to that guideline exists."
 - The report also noted that Fannie and Freddie "do not appear to have gone as far as some primary lenders to serve low-income and moderate-income borrowers and to minimize disproportionate effects on minorities." The report noted that "Primary lenders are making more aggressive efforts" to serve the lower income and minority homebuyers "by offering loan products with underwriting guidelines that are more flexible than the GSEs' guidelines." Further noting that "depository lenders are serving low- and moderate-income borrowers better than the GSEs and so the percentage of loans purchased by the GSEs that are originated to low- and moderate-income borrowers is less than the percentage of loans originated to these borrowers in the primary market." The report went on to note that "While the GSEs are not serving low- and moderate-income borrowers to the same extent as primary lenders, Fannie Mae is doing a better job than Freddie Mac."
 - The report also noted that the use of automated underwriting systems and credit scores may place lower-income borrowers at a disadvantage when applying for a loan, even when they are acceptable credit risks. Further, automated systems make it more difficult for "marginal applicants" to receive personalized attention from an underwriter, and some "informants" believe credit scores might not be accurate predictors of loan performance, despite contrary claims by the GSEs. (As reported in previous *GSE Reports*, Fannie and Freddie control 95% of the market share for automated underwriting.)
 - The report also noted that "there is some evidence that the GSEs' purchase of loans made to black and Hispanic homebuyers have actually declined (in share and absolute number) over the last two years."
 - The report recommended that HUD enhance its monitoring of Fannie and Freddie to determine if the GSEs' underwriting guidelines can be changed to serve more low- and moderate-income

and minority borrowers without affecting safety and soundness. The report's recommendations for enhancing HUD's monitoring include the following four components:

- (1) "enhanced loan-level data base on mortgages purchased by the GSEs and supplemented, to the extent possible, with loan-level performance information on other mortgages within the conforming limit,
 - (2) an analysis of automated underwriting outcomes that uses hypothetical mortgage applications that contain information on different types of borrowers,
 - (3) a data set to conduct simulation analyses of GSE guideline changes, and
 - (4) an improved direct communication mechanism to provide a forum for lenders and advocates to raise issues with HUD on an ongoing basis."
- Fannie and Freddie disputed the report's findings criticizing the report as unscientific and riddled with errors. According to *BNA*, Fannie Spokesman David Jeffers stated that "It's a report that can't be taken seriously." Jeffers further stated that "All of its conclusions are based on absolutely no statistical evidence, no examinations of loans, no examinations of underwriting systems, and no data other than a few anecdotal conversations with a handful of lenders. An issue this serious requires serious study." A spokeswoman for Freddie called the report "irresponsible" and "riddled with inaccurate statements and allegations that are not supportable." According to the spokeswoman, "Automated underwriting has enabled us to make more loans to low-income and minority homebuyers," and help Freddie qualify borrowers that could not have qualified in the past. Further, she contended that Freddie's automated underwriting system, Loan Prospector, is "not tougher on one racial group over another." According to *BNA*, Freddie Spokeswoman Sharon McHale stated that the researchers for the report seem to have based their findings on talks with lenders in only four cities, and the researchers failed to validate the lender's perceptions. "We think that the report is speculative, inaccurate, and riddled with unsupported allegations," she stated. "Fair lending issues are something we take very seriously," McHale stated.
 - According to the *Wall Street Journal*, HUD Assistant Secretary William Apgar stated that the report raises serious questions about [the GSEs'] lending practices and the department will look into these immediately." According to *BNA*, an industry source stated that HUD might be planning to factor the report into revised affordable housing goals for Fannie and Freddie. HUD is expected to release new affordable housing goals later this year. (*American Banker*, Joshua Brockman, 5/6/99; *BNA Daily Report for Executives*, Marc Selinger, 5/14/99; *Dow Jones Newswire*, Jerry Guidera, 4/29/99; *Wall Street Journal*, 4/30/99; HUD Study, "A Study of the GSEs' Single Family Underwriting Guidelines", April 1999)

House Banking Subcommittee on Capital Markets, Securities and GSEs Holds Hearing on OFHEO's Proposed Risk-Based Capital Rule for Fannie & Freddie

OFHEO's Acting Director Mark Kinsey Testifies

Kinsey Notes that Risk-Based Capital Rule Would Not Cause Interest Rates to Rise, Guarantee Fees to Increase, or Hinder Fannie & Freddie in their Affordable Housing Mission

OFHEO May Extend the Comment Period on the Proposed Rule

- The House Banking Subcommittee on Capital Markets, Securities and GSEs, chaired by Congressman Richard Baker (R-LA) held a May 12 hearing on OFHEO's proposed risk-based capital rule on Fannie and Freddie. Acting Director of OFHEO Mark Kinsey was the only witness. Pat Lawler, the Chief Economist for OFHEO, was also in attendance at the hearing to answer technical questions.
- In his opening remarks, Kinsey noted that the housing enterprises currently enjoy strong financial health. However, he continued with the observation that GSEs have had problems in the past. In the early 1980's, when Fannie's mark-to-market liabilities far exceeded equity, the company was losing \$1 million a day. Later in the hearing, Kinsey remarked that Fannie would have been placed into conservatorship if it had been subject to the same oversight in the 1980's that it will have under risk-based capital rules.

Kinsey Explains Why a Risk-Based Capital Rule was Needed for Fannie and Freddie

- Kinsey began his remarks by explaining that regulating the capital of Fannie and Freddie was extremely important since the failure of Fannie or Freddie could have "serious consequences." Kinsey commented that "The sheer size of the Enterprises to the housing markets together with the distortion of market forces that their GSE status creates makes it critical that a strong risk-based capital standard be put in place." The risk-based capital rule would help ensure that Fannie and Freddie "remain financially strong even under severe economic stresses." Kinsey reported that in a little over six years, the obligations of Fannie and Freddie (debt and MBS guarantees) have doubled to nearly \$2 trillion. He noted that the fastest growing part of Fannie and Freddie's business is their retained portfolio. **"At over \$725 billion, the combined retained portfolio of mortgage assets at Freddie Mac and Fannie Mae now exceeds, by well over \$100 billion, the combined holdings of mortgage assets by the entire thrift industry,"** Kinsey remarked.
- Kinsey explained that "market forces" alone cannot be relied on to regulate the capital of Fannie and Freddie because the Enterprises are "not subject to the normal market discipline that fully private firms face." Kinsey noted that the Fannie and Freddie are able to borrow money from the credit markets more cheaply than fully private triple A rated firms, and at times, nearly as cheaply as the US Treasury. Investor's willingness to lend Fannie and Freddie money is not based on an evaluation of Fannie and Freddie's capital adequacy but rather on the perception that Fannie and Freddie enjoy an implicit government guarantee. "Therefore, the Enterprises have the ability to increase their risk-taking, possibly significantly, without much effect on their cost of funds."

OFHEO May Extend the Deadline for Comments

- Kinsey stated in the next couple of weeks, OFHEO would decide whether to extend the comment period on the proposed risk-based capital rule. The comment period currently ends August 11, 1999.

Kinsey Explains OFHEO's Proposed Risk-Based Capital Rule

- As directed by Congress, OFHEO's proposed risk-based capital rule is based on a stress test allowing OFHEO to capture the "bottom line" exposure to Fannie and Freddie from both credit and interest rate risk simultaneously. The stress test also acts as an "early warning indicator of financial distress" which allows Fannie and Freddie to fix otherwise hidden financial weaknesses today before the companies become too weak financially to do so. OFHEO's proposal is based on a single stress test model for both Fannie and Freddie. It also meets the statutory requirements for transparency and replicability, provides both the Enterprises and OFHEO with flexibility, and recognizes and rewards appropriate management of risk.

Results of the Proposed Risk-Based Capital Rule

- Using specific test dates – September 30, 1996 and June 30, 1997, if the risk-based capital proposal was in effect on these specific test dates, Fannie would have had sizable capital shortfalls (around \$3 ½ billion on both dates), while Freddie would have met its risk-based capital requirement on both dates with a surplus of about \$1 ½ billion. Kinsey explained that the reason Freddie met its capital requirement and Fannie did not was that Fannie had more interest rate risk than its capital base could support. Freddie chose to hedge its interest rate risk more extensively than Fannie did on those selected test dates. He cautioned that these results should be “interpreted with caution” since the “results do not necessarily reflect what an Enterprise’s current or future risk-based capital requirement might be” and a capital shortfall “does not imply that an Enterprise actually has to raise that amount of capital.” In addition, Kinsey noted that Fannie’s Chief Financial Officer suggested that Fannie could have met its capital requirement by reducing its interest rate risk in a variety of ways at an annual cost of about \$70 million. Fannie’s CFO also stated that “investors would see no perceptible change in the company’s future financial performance as a result of this proposed capital standard.”

Impact of the Proposed Risk-Based Capital Rule

- Kinsey noted the following in his concluding remarks:
 - (1) The proposed risk-based capital rule “is unlikely to cause any change in mortgage rates nor will it curtail” Fannie and Freddie’s “ability to finance affordable housing.”
 - (2) There would be no incentive under the risk-based capital proposal for either Fannie or Freddie to increase the guarantee fees that it charges lenders for accepting credit risk.
 - (3) The credit risk on affordable housing loans was not the reason Fannie did not pass its risk-based capital requirement. Affordable housing loans have been quite profitable for both Fannie and Freddie and the credit risk associated with these loans remains relatively low. “The far more important variable is the way an Enterprise chooses to fund all of the mortgages it holds in portfolio. It is these funding choices that comprise the interest rate risk that caused Fannie Mae to fall short of its capital requirement.”

The following Members of the House Banking Committee’s Capital Markets, Securities, and GSE Subcommittee attended the hearing:

Cong. Richard Baker (R-LA), Chair
Cong. Paul Ryan (R-WI)
Cong. John Sweeney (R-NY)
Cong. Judy Biggert (R-IL)
Cong. Lee Terry (R-NE)
Cong. Edward Royce (R-CA)

Cong. Paul Kanjorski (D-PA), Ranking Member
Cong. Ken Bentsen (D-TX)
Cong. Carolyn Maloney (D-NY)
Cong. James Maloney (D-CT)
Cong. Darlene Hooley (D-OR)
Cong. Stephanie Tubbs Jones (D-OH)

Congressman Bruce Vento (D-MN), Ranking Member of the House Banking Committee’s Financial Institutions and Consumer Credit Subcommittee also participated in the hearing.

Highlights of the Hearing:

- Chairman Baker and Kinsey agreed that there some private rating agency firms, such as S&P and Moody’s, that take into account more stringent and severe economic scenarios in testing private corporations before giving them a AAA rating than OFHEO used in developing its stress test.

Chairman Baker noted that Moody's stress scenario assumes a 27% price drop over a 10-year period, while OFHEO's test assumes an 11% price drop. Kinsey noted, however, that OFHEO was constrained by the requirements of the 1992 law requiring the creation of the risk-based capital regulation in the development of their stress test. Though constrained by the law, Kinsey feels at this time that the stress test is sufficient. According to Scott Barancik with the *American Banker*, Kinsey stated that "Once we put this in place and we have an opportunity to explore alternative scenarios, I might have a different opinion," he stated. "But right now I think it's sufficient." According to Marc Selinger with *BNA*, a Baker aide stated that Cong. Baker "suspects" the stress test is not rigorous enough but has not solidified his position. Reportedly, Baker would like to hear the views of other affected parties, including Fannie and Freddie and may hold a hearing this summer, possibly in June or July. Baker was concerned that the proposed rule might give a false sense of security about Fannie and Freddie.

- A number of Members were concerned that Fannie and Freddie would not be able to create innovative products since it was necessary for them to get prior approval from OFHEO under the proposed risk-based capital rule and that proprietary information would be leaked to their competitor in the approval process (i.e., Fannie's proprietary information being shared with Freddie and vice versa). Kinsey repeatedly stated that the rule did not require OFHEO to approve any products or activity emphasizing that OFHEO had no approval authority. Kinsey reiterated that no products or activities proposed by Fannie and Freddie had to be pre-approved by OFHEO. OFHEO's job was making sure that for whatever product or activity that Fannie and Freddie decide to do, there is adequate capital for the amount of risk. Kinsey noted that OFHEO expects to have conversations with Fannie and Freddie at the earliest possible date when the Enterprises have a good idea of their proposed activity so OFHEO can understand the risk. OFHEO would not release the information until the activity is public. Once the activity is on the balance sheets than OFHEO is required to evaluate the risk-based capital. Kinsey stated that no activity or programs would be held up by OFHEO in determining risk-based capital. OFHEO would keep proprietary information from their competitor as they have done over the past five years. Kinsey noted that OFHEO has been privy to the secrets of Fannie and Freddie for five years now and as far as he knows there have been no leaks. He further noted that all regulators have to deal with this same set of issues. OFHEO's risk-based capital rule would not stifle innovation. The bottom line is that Fannie and Freddie have to meet a capital standard that is set by OFHEO and there are dozens of ways Fannie and Freddie can choose to meet that capital standard.
- In response to a question by Ranking Member Paul Kanjorski (D-PA), Kinsey noted that if HUD decided to increase Fannie and Freddie's affordable housing goals, it would pose no problem for Fannie and Freddie and have no adverse impact on Fannie and Freddie's safety and soundness. Kinsey stated that there would be no incentives for affordable housing to decrease or mortgage rates to increase
- Kinsey noted the following as reasons why the capital requirements for Fannie and Freddie were lower than banks and thrifts: (1) Unlike fully private firms, GSEs can control their own balance sheets to a greater degree because the GSEs can issue debt at any time or amount and they can issue callable debt in any amount and at any time, so the GSEs have a better way of managing interest rate risk; (2) Fannie and Freddie purchase A mortgages that are the best assets to hold.
- Kinsey was questioned as to whether OFHEO created its risk-based model based on Freddie's model, since Freddie was in compliance with the proposed risk-based capital rule while Fannie had a capital shortfall. Kinsey stated that OFHEO created its model based on extensive study of what

Fannie and Freddie do and that its model was based on data from Fannie and Freddie. In defense, he noted that when OFHEO had discussions with academics last year on the risk-based model, Fannie was upset and complained that OFHEO was giving away their proprietary information because the model looked very much like Fannie's.

- Kinsey noted that Fannie and Freddie perform very important public missions. He just wanted to make sure they are doing it at times when they are needed the most (during times of economic stress).
- During an exchange of more technical questions and answers during the end of the hearing, Chairman Baker and Cong. Bentsen asked questions about OFHEO's decision to use across-the-board percentage calculations to account for broad risk factors, focusing on "haircuts" for counterparty risk, and OFHEO's determination that a 30% capital adjustment was needed to account for general risk factors. The risk-based rule calculates capital requirements using the various formulas to adjust for specific interest rate risk, credit risk, and counterparty risk. Counterparty risk measures the possibility that an entity that has entered into a contractual relationship with the housing enterprise may not perform as contracted; for example, the counterparty in a derivative transaction may not be able to cover the underlying option in a highly volatile market, or a seller/servicer may not be able to pay its portion of a loss sharing agreement when unfavorable market conditions impair its financial condition. OFHEO accounts for counterparty risk by applying "haircuts" that increase as the counterparty's credit ranking falls:

Rating Classification	Derivative Counterparties	Other Counterparties/Instruments
AAA	2%	10%
AA	4%	20%
A	8%	40%
BBB or below; unrated	16%	80%

- These "haircuts" are applied to specific transactions, reducing cash flow or affecting asset/liability value. The "haircuts" noted above are reduced by formula as transactions season. After these specific stress test adjustments are used to calculate a baseline risk-based capital amount, this requirement is increased by 30% to derive the final risk-based capital amount.
- Questions focused on the harshness of the 80% "haircut" for counterparties having credit rankings of BBB and below. This would include many privately owned seller/servicers. Some members thought that adding the 30% adjustment to the 80% "haircut" would reduce the transaction's value or cash flow by 104%. Kinsey and Lawler pointed out that this calculation was a mathematical error (it would be a 30% adjustment after the 80% "haircut" is taken, not the two added together), and that this "haircut" reduced quickly with seasoning. Chairman Baker expressed some concern that the 80% haircut applied to DUS lenders may be higher than the actual performance of these programs justifies.
- Others noted that mortgage insurers, as other counterparties, got a higher "haircut" than derivative counterparties, and questioned whether this discrepancy would encourage risk management through derivatives instead of insurance. Kinsey pointed out that the housing enterprise charters do not currently allow the GSEs to eliminate mortgage insurance for high margin loans.

- Kinsey also reported that Fannie and Freddie are increasingly holding their own MBSs on their portfolios, which is the fastest growing part of their business. Kinsey noted that 62% of Fannie’s portfolio was their own MBS and Freddie’s percentage was 77%. Kinsey estimated that Fannie and Freddie hold approximately ¼ of their original issues. Kinsey noted that MBS really does not “put anybody in a house.” The act of holding more of their MBS in portfolio does not change the GSEs’ credit risk exposure but it does make the GSEs take on more interest rate risk. Kinsey stated that Fannie and Freddie would argue that holding more of their MBS in portfolio would help the market for their securities, which in his opinion is a very indirect way of supporting housing. OFHEO, however, is not in a position to say whether holding more MBS in portfolio is okay or not.
- OFHEO would be making a decision within the next two weeks whether to seek an extension on their current comment deadline of August 11. Kinsey noted, however, that it would be at least two years before the risk-based capital rule was enforceable. OFHEO will either finalize the rule or propose a revised rule “as early as next year,” and the standards will not take effect for one year after the final rule is published. Chairman Baker requested that OFHEO stick as close to their deadlines as possible and that extensions be minimal.
- According to Marc Selinger with *BNA*, a spokeswoman with OFHEO noted that the agency plans to start posting on its website (<http://www.ofheo.gov>) beginning May 14 answers to questions that have arisen in briefings in order to help outside groups understand the proposed risk-based capital rule.
- (*OFHEO Acting Director Mark Kinsey testimony before House Capital Markets Subcommittee, 5/12/99; BNA Daily Report for Executives, Marc Selinger, 5/13/99; American Banker, Scott Barancik, 5/13/99*)

Congressional Budget Office (CBO) Recommended a 10-Basis Point User Fee on the GSEs’ Investment Portfolios (to address concerns about GSEs’ arbitrage activities), a Repeal of the GSEs’ SEC Exemption, and an Increase in the Ginnie Mae Guaranty Fee

Fannie, Freddie, Council of FHLBanks, and Six Trade Groups Oppose CBO’s Recommendations calling the CBO Proposals “Taxes on Homeownership”

- As we noted in the April 30 *GSE Report*, the Congressional Budget Office (CBO) in its annual report to Congress recommended the following:
 - (1) Imposing an annual fee on the investment portfolios of GSEs;
 - (2) Repealing the GSEs’ SEC exemption;
 - (3) Imposing an Increase in the Ginnie Mae Guaranty Fee.

Imposing an Annual Fee on the Investment Portfolios of GSEs – Recommended to Address Concerns about the Arbitrage Activities of the GSEs

- The CBO estimates that imposing the user fee on the investment portfolios of the GSEs could raise \$550 million per year over a 10-year period and could address concerns about the arbitrage activities of the GSEs. The CBO notes that “Imposing an annual fee on the four GSEs that earn arbitrage profits enterprises [Fannie, Freddie, FHLBank System, Farmer Mac] that would equal 10 cents for every \$100 (10 basis points) of each GSE’s holdings of debt securities that the enterprise

finances with debt would raise \$550 million in 2000, \$2.8 billion over five years, and \$5.5 billion by 2009.”

- The CBO notes that the implied government guarantee allows the GSEs to borrow at lower rates and then using borrowed money to invest in higher yielding obligations. “The four enterprises [Fannie, Freddie, FHLBank System, Farmer Mac] conduct an arbitrage between the market for GSE debt and that for private debt, profiting from the difference between the yields on their investments and their own subsidized cost of funds,” the report stated. The CBO further noted that before the 1990s, the GSEs generally used the money they borrowed to make loans or buy loans made by other lenders. “More recently, the three largest GSEs – Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System – have used borrowed funds to acquire enormous portfolios of debt securities.” The report noted that “At the end of 1998, the investment portfolios of those three enterprises totaled \$586 billion, or 52 percent of their combined assets.” (*“Maintaining Budgetary Discipline: Spending and Revenue Options”*, Congressional Budget Office, April 1999, page 219; *Dow Jones Newswire*, John Connor, 5/3/99; *Wall Street Journal*, John Connor, 5/4/99)

Repealing the GSEs’ Securities Exemption – Require all GSEs to Register with the SEC

- The CBO recommended the requirement that all GSEs register their securities with the SEC. The CBO noted that currently the federal government explicitly subsidizes five GSEs – Fannie, Freddie, the FHLBank System, the Farm Credit System, and Sallie Mae – by exempting them from the registration requirements of the Securities Act of 1933. (Farmer Mac is not exempt from SEC registration.) The CBO notes that originally the GSEs were exempted from registering their securities with the SEC in part to relieve them of the cost of registering until they became accepted names in the market. “That rationale no longer applies: the five exempt GSEs are well known in financial markets.” Repealing the exemption would not impose significant regulatory burdens on the GSEs because they currently disclose most of the required information voluntarily and “it would reduce the competitive advantage that the enterprises have over other firms that finance loans by issuing debt or mortgage-backed securities.” Further, the CBO notes that requiring issuers to register their securities with the SEC protects investors. The CBO estimated the requirement for the GSEs to register their securities with the SEC would raise \$259 million in 2000, \$1.3 billion over five years, and \$2.1 billion by 2009. According to CBO, “To register with the SEC, each of the five GSEs would pay about 26 cents for every \$1,000 (about 3 basis points) in securities it issued in 2000.” (*“Maintaining Budgetary Discipline: Spending and Revenue Options”*, Congressional Budget Office, April 1999, page 101)

Increasing the Ginnie Mae Guarantee Fee

- The CBO also recommended increasing the Ginnie Mae guaranty fee to 9 basis points from the current 6 basis points. The increase would be effective in the year 2000. Under current law, a fee increase to 9 basis points is scheduled to take effect in 2005. According to CBO, moving the fee increase up to the year 2000 would raise \$40 million in 2000 and \$200 million over five years. (*“Maintaining Budgetary Discipline: Spending and Revenue Options”*, Congressional Budget Office, April 1999, page 100)

Fannie, Freddie, Council of FHLBanks, and Six Trade Groups Oppose CBO’s Recommendations calling the CBO Proposals “Taxes on Homeownership”

- In letters to Congress, Fannie, Freddie and the Council of FHLBanks joined with other housing trade groups (Mortgage Bankers Association, National Association of Realtors, National Association of Home Builders, America’s Community Bankers, the Independent Community Bankers of America, and the National Association of Mortgage Brokers) warning that the CBO

suggestions “would make homeownership more costly for the American homebuyers that we serve.” The coalition wrote that the CBO proposed fees are “taxes that jeopardize the individual and the broader benefits that homeownership delivers.” The coalition said such fees would constitute “a tax on homeownership” and would raise mortgage rates for millions of Americans. (*Dow Jones Newswire*, 5/10/99; *Reuters*, 5/6/99)

- According to a *Dow Jones Newswire* article by John Connor, Freddie Spokeswoman Sharon McHale believed that the CBO proposals would be harmful and stated that Freddie’s non-mortgage investments are limited and that the cost of SEC registration would be felt by homebuyers. Fannie’s Spokesman John Buckley likened the emergence of a “home ownership tax” plan in the spring to the swallows returning to Capistrano, and stated that such proposals vanish when their “harmful” impact on homeownership is revealed. The article also noted that FHLBank Spokesman Bill Glavin said the FHLBank System also opposes the CBO options for GSEs, as it “would oppose any fee that would be passed on to the consumer.” (*Dow Jones Newswire*, John Connor, 5/3/99, 5/4/99)

Following in the Footsteps of the Freddie/Norwest Automated Underwriting Agreement, Freddie Reaches Agreement with Bank of America to Purchase the “Vast Majority” of Bank of America’s Loans

Fannie May Lose Market Share to Freddie from these New Deals

- According to an *American Banker* article by Marc Hochstein and Joshua Brockman, Freddie has agreed to purchase the “vast majority” of Bank of America’s production. According to the article, Bank of America is the fourth-largest originator. As reported in previous *GSE Reports*, Freddie recently reached an historical agreement with Norwest. Under the Norwest/Freddie partnership, Norwest agreed to sell almost 100% of its conforming conventional loans exclusively to Freddie (instead of selling to both Fannie & Freddie). In return, Freddie will accept Norwest Mortgage’s automated underwriting decisions. The article noted, however, that unlike the Norwest agreement, the Bank of America agreement with Freddie is not exclusive and Bank of America will use their own automated underwriting systems and Freddie’s. (*American Banker*, Marc Hochstein and Joshua Brockman, 5/14/99)
- According to an article in *National Mortgage News*, some are calling Norwest’s recent deal with Freddie the “shot heard round the world” – a “major coup” for Freddie and a “great deal” for Norwest. The article notes that the Freddie-Norwest agreement “is a positive development for lenders and consumers because for the first time a GSE is giving its seal of approval to a private credit scoring system” – Norwest Mortgage Co.’s “Enhanced Credit Scoring” or ECS model. Industry key players are stating that the Norwest-Freddie arrangement will cause Fannie to lose at least five points of market share to Freddie. “This is huge,” said one mortgage industry official. “If the top lenders were smart, and they are, you have to ask yourself: why aren’t they on their way to McLean (Freddie’s headquarters) to ask for the same deal.” The article notes that “if other lenders jump ship for Freddie Mac, the results could be disastrous for Fannie Mae.” The article further noted that increasingly seller/servicers are complaining about being charged a \$45 fee per loan (the fees can vary) by both Fannie and Freddie to use their automated underwriting systems. The article further notes that using Fannie and Freddie’s automated underwriting system is required for delivery of product to either agency. (Note: The 5 point market share *National Mortgage News* estimated that Fannie may lose to Freddie from the Norwest deal does not take into account the

potential market share loss from the just announced Bank of America agreement.) (*National Mortgage News*, Paul Muolo and Brad Finkelstein, 3/29/99)

Financial Services Trade Groups Send Joint Letter to the Fed Requesting that the Fed Lower the Risk Weighting Assigned to All Investment Grade Private Institution Mortgage-Backed Securities (MBS) to 20% (Same as for Fannie & Freddie's MBS)

- A joint financial services trade letter was sent to the Federal Reserve Board on May 11 requesting that the Federal Reserve and other bank regulators revise the risk-weightings so that all investment grade MBS be given a 20% risk-weighting to ensure that Fannie and Freddie MBS would not be treated more favorably under bank risk-based capital guidelines than private-label MBS with AAA and AA ratings. The letter notes that currently Fannie and Freddie's MBS have "support from an array of government-granted benefits" which provides preferential treatment to GSE-supported MBS over other private sector MBS. "In addition to being among the limited class of securities insured depositories may hold, the risk based capital regulations afford their MBS [Fannie and Freddie's] a favorable 20 percent risk weight, resulting in a 1.6 percent capital charge." On the other hand, "MBS guaranteed by private institutions are assigned a risk weight of either 50 percent (equal to a 4 percent capital charge) or 100 percent, depending on the 'prudential' nature of the underlying mortgages."
- The letter further notes that "Since banks and thrifts need to hold less capital against government sponsored enterprise (GSE) securities than other comparable investments, their required hurdle is lower, thereby making investments in Fannie Mae or Freddie Mac MBS preferred over other investment alternatives, even when they have identical investment ratings." The letter concluded by stating that "We urge the Federal Reserve and other bank regulators to revise the risk-weightings so that all investment grade mortgage backed securities should be given a 20 percent risk weighting. This would further the process of reform of the risk-based capital system to more closely align ratings with real risk." The letter was signed by the Financial Services Roundtable, America's Community Bankers, American Bankers Association, Consumer Mortgage Coalition, Mortgage Insurance Companies of America, and the National Home Equity Mortgage Association. (*Joint Bank Trade Letter to Federal Reserve Board*, 5/11/99)

Fannie Mae and Freddie Mac

Home Equity Lenders Concerned about Fannie & Freddie's Expansion into the Subprime Market

- According to an *American Banker* article by Joshua Brockman, home equity lenders are "watching warily" as Fannie and Freddie expand into the subprime market. Laura Borrelli, President of the National Home Equity Mortgage Association, worried that Fannie and Freddie's presence in the subprime home equity market could split the market. "The last thing that the home equity industry needs is [for Fannie and Freddie] to simply take the cream off the top," leaving other borrowers to rely on a costlier secondary market, Borrelli noted. There are others, however, who appear to welcome Fannie and Freddie entrance into the subprime market. Their participation "ought to bring some direct benefit to borrowers," stated Brian Smith, Director of Policy and Economic Research at America's Community Bankers.

- The article noted that both Fannie and Freddie are increasingly using their proprietary automated technology systems to reach further into the subprime market and reportedly that lenders are able to use their systems to underwrite more subprime loans. However, Borrelli remains skeptical. She said she would “hate to see a large segment of the A-minus and B customers” kept out of the automated underwriting system. Ken Posner, an analyst with Morgan Stanley Dean Witter, also noted in a recent report that the A-minus, Alternative-A and high LTV loan segment of the subprime market, “could roughly double the size of the market that Fannie Mae can go after.” Posner noted that “niche product lenders,” including thrifts and subprime lenders “will need to rethink their business models” as Fannie and Freddie “arm their lender and broker partners to go after these niche segments.” (*American Banker*, Joshua Brockman, 5/12/99)

Chase Mortgage CEO States that Lenders are Concerned about Fannie & Freddie’s Encroachment into their Markets

- According to the *National Mortgage News website* and the *Mortgage-Backed Securities Letter*, Tom Jacob, CEO of Chase Manhattan Mortgage Corp., stated that lenders are concerned that Fannie and Freddie may be encroaching on their markets. Their expansion efforts, he observed, were causing “great anguish” among lenders. He noted, however, that Fannie and Freddie were working closely with lenders and mortgage insurance companies to resolve their differences. Jacob reportedly made his statements during a recent Real Estate Services Providers Council conference. According to the articles, Jacob commented that lenders were concerned about Freddie’s desire to self-insure mortgages, increasing insistence by Fannie and Freddie to use and pay for their automated underwriting systems, and a fear that both GSEs will start “table funding” loans through brokers on the Internet. He stated that after “constructive engagement” with the chief executive officers of Fannie and Freddie, he perceived movement toward addressing lenders’ concerns, noting that Fannie and Freddie have become “more open to accepting the technology of the private sector.” At the same time, Jacob stated that Fannie and Freddie must recognize “that we are their customers,” he stated “and nobody has ever prospered by tangling with their customers.” (*Mortgage-Backed Securities Letter-American Banker*, 5/10/99; *National Mortgage News website*, posted 4/30/99)

Fannie & Freddie’s Market Share Grow Even As Originations Slow

- According to an article in the *National Mortgage News* by Paul Muolo, residential originations are slowing in the primary market yet Fannie and Freddie are “gobbling up loan product like there’s no tomorrow.” According to March figures, Freddie’s March mortgage acquisitions jumped 55% while Fannie’s rose 32%. The article noted that numbers collected by *National Mortgage News* and the Database Products Group shows that lenders are originating less and that refinancings are off by as much by 50% yet Fannie and Freddie had “robust” first quarters in terms of purchases and earnings.
- The article noted that even when production and GSEs purchases slow, Fannie and Freddie can still make a great deal of money off the yield on their retained mortgage portfolios. The article noted that at the end of March, Fannie had a net portfolio of \$440 billion while Freddie had \$277 billion. (*National Mortgage News*, Paul Muolo, 4/19/99)
- (As OFHEO’s Acting Director Mark Kinsey testified during a House Subcommittee Hearing on May 12, holding MBS in portfolio really does not “put anybody in a house.” Kinsey noted that the

act of holding more of their MBS in portfolio does not change the GSEs' credit risk exposure but it does make the GSEs take on more interest rate risk.)

Consultant Tom LaMalfa States that Fannie & Freddie Should be Stripped of the Privileges they Receive from their GSE-Status and be Fully Privatized – LaMalfa further Warns that the Appraisal, Title, and Survey Businesses Could be Fannie & Freddie's "Next Targets"

- According to *National Mortgage News' website*, Tom LaMalfa, a consultant and partner in Wholesale Access, a publishing and research firm, warned that the appraisal, title, and survey businesses could be Fannie and Freddie's "next targets." LaMalfa stated that "What they've done to mortgage lenders and are now doing to private mortgage insurers could be done to you." LaMalfa made his remarks during the annual meeting of the Real Estate Services Providers Council. He noted that Fannie and Freddie co-existed with lenders "in perfect harmony" for years, but lately have been "having a detrimental effect" on the private sector. According to the website, LaMalfa recommended that Fannie and Freddie should be "stripped of the privileges they receive from their charters and fully privatized." He believes that "the industry would be better served if they were not as large or as dominant" as they are now. It is Fannie and Freddie's growth during the 1990s and their potential for even greater expansion over the next few years "that really disturbs me," he noted. (*National Mortgage News website*, posted 5/6/99, and 5/10/99)

Congressional Quarterly Runs a Profile Piece on the Private Sector Mortgage Industry Efforts to Address Concerns about Fannie & Freddie's Expansion into their Markets

- A recent article in the *CQ Daily Monitor* reported on the Competitive Consumer Lending Coalition – a new coalition formed to address concerns about the GSEs. According to the author, Emily Pierce, the new coalition is aimed for a fight of Biblical proportions. "A new coalition of private mortgage lenders and insurers is spending millions of dollars on a small army of Washington lobbyists who are throwing stones at Fannie Mae and Freddie Mac, the two housing giants who are known for a take-no-prisoners style of lobbying."
- The new coalition is gearing up to fight what it sees as inevitable expansion by the GSEs. "Recent maneuvers . . . have increased the housing industry's wariness that they [the GSEs] are ready to move into mortgage origination, equities and corporate bonds." Pierce also noted that the coalition is primarily concerned with Fannie Mae, especially Fannie's insistence that lenders pay to use its automated underwriting systems. While Fannie recently began allowing lenders to use other automated underwriting systems, after using Fannie's system first, Pierce notes that this was not enough for the new coalition. "There are huge fair-lending problems if you don't have competing underwriting systems' that rate the credit worthiness of the borrowers, said an industry lobbyist."
- According to Bert Ely, a financial services industry consultant, Fannie and Freddie are aiming to expand because of stockholder pressure to increase earnings. Ely is cited as saying that Fannie and Freddie will have to increase earnings by nearly \$5 billion by 2003 to simply maintain their growth rate. "But increased earnings will require expansive initiatives," he said.
- Taken together, the new coalition along with the GSEs intent to expand may result in a big, expensive fight, according to Pierce. Coalition members told her that Fannie and Freddie have attempted to "lock up or intimidate lobbying firms that might be enlisted by a mortgage industry insurgency. In some cases . . . lobbyists not actively involved in the dispute are being paid **not to**

work for Fannie Mae and Freddie Mac's opponents." Fannie Mae allegedly hired the firm of Williams & Jensen, after they were approached by the coalition, by tripling the coalition's offer. The coalition has not been left empty-handed, however. Pierce notes that an impressive roster of lobbyists have been hired from Barbour, Griffith & Rogers; Akin, Gump, Strauss, Hauer & Feld; and Hogan & Hartson.

- Fannie Mae spent \$2.6 million on lobbying in the first 6 months of 1998 alone, while Freddie Mac spent \$2.2 million for all of 1998. As for the coalition, "some mortgage industry experts estimate that the coalition will spend \$10 million this year to keep Fannie Mae and Freddie Mac at bay." (*CQ Daily Monitor*, Emily Pierce, 5/10/99)

***Credit Risk Management Report* Runs a Profile Piece on the Private Sector Mortgage Industry Efforts to Address Concerns about Fannie and Freddie's Expansion into their Markets**

- The *Credit Risk Management Report* reported on the new Competitive Consumer Lending Coalition in a May 3, 1999 article. The coalition has yet to disclose its membership, according to the author, but claims to represent the entire mortgage industry. The article also notes that the coalition has gained the support of consumer-advocate Ralph Nader.
- The article notes that the coalition is particularly concerned with Fannie and Freddie's domination of automated underwriting, thereby undercutting competition. A key issue voiced by coalition members is their concern that Fannie and Freddie's almost total domination of the automated underwriting market undercuts competition. Further, it was noted that Fannie and Freddie are increasingly forcing or requiring mortgage lenders to use their underwriting systems. The president of the coalition, Gerald L. Friedman, is quoted as stating "we're seeking a proper balance between Freddie and Fannie and the private mortgage industry. It's the role of the private sector to create competition. We feel that (Freddie Mac and Fannie Mae) are encroaching on private enterprise." Friedman acknowledged that Fannie's recent openness in offering other automated systems to consumers, was "a good step," but advocates a congressional review of the agencies. He noted that Fannie and Freddie should stick to providing liquidity to the industry, but instead they are competing with private sector products.
- The Mortgage Bankers Association has a neutral position at this time, according to Suzanne Samson, vice president of the association. However, the MBA has written letters of complaint about the GSEs in the past, and Samson noted that some of the association's members have joined the coalition, and also said that the coalition's issues will be discussed at the MBA's next board meeting in June. (*Credit Risk Management Report*, 5/3/99)

Another Example of "Charter Creep" – Fannie & Freddie are Entering the Commercial Multifamily Apartment Sector – Private Sector Companies are Having Difficulty Competing against Fannie & Freddie

- According to an article by Lew Sichelman with *National Mortgage News*, private sector companies have raised some concerns related to the entrance of Fannie and Freddie into the multifamily apartment sector. Joseph Peterson, a Dallas builder of market-rate apartments stated that "Life [insurance] companies are telling me that Fannie Mae and Freddie Mac are eating their lunch." "They're finally starting to pay attention," Peterson added. John Landon of Holiday Fenoglio Fowler, a Dallas-based mortgage banker with 25 offices nationally agreed. "They're kickin' our

rears right now,” he told participants at a Multi-Housing World Info. Expo 90 conference, noting that traditional sources of financing for apartments are “losing ground” to the GSEs. (*National Mortgage News*, Lew Sichelman, 4/26/99)

- According to a *Barron's Online* article by John Levy, the market is avidly seeking apartment mortgages and investment banks are eager to make multifamily mortgage loans because buyers of commercial mortgage-backed securities (CMBS) like to see apartments make up a large percentage of securitization pools. However, Fannie and Freddie “seem to be gobbling up every multifamily loan they can find at prices that Wall Street simply can’t duplicate.” (*Barron's Online*, John Levy, 4/5/99)

Fannie & Freddie Added their 1998 Annual Reports to their Websites – Fannie & Freddie’s Annual Reports are Not Filed with SEC Because of their GSE Status

- Fannie and Freddie have both added their 1998 annual reports to their website. Fannie’s 1998 annual report is located at http://www.fanniemae.com/markets/stock/annual_reports.html and Freddie’s annual report is located at <http://www.freddiemac.com/shareholders/>. Jerry Guidera with *Dow Jones Newswire* noted that unlike most shareholder-owned companies, Fannie and Freddie do not file their annual reports with the SEC, because of their special status as government-sponsored enterprises. (*Dow Jones Newswire*, Jerry Guidera, 5/7/99)

Fannie & Freddie Said they expect to Spend up to \$215 Million Collectively on Year 2000 Compliance

- According to Jerry Guidera at *Dow Jones Newswire*, Fannie and Freddie are expected to spend up to \$215 million collectively on Year 2000 compliance efforts. Guidera notes that in their most recent annual reports, Fannie and Freddie said they have spent \$38 million and \$93 million respectively on Year 2000 compliance efforts to date. Fannie estimated its total cost of Year 2000 compliance to be between \$60-65 million and Freddie estimated the total cost at between \$125 million and \$150 million. (*Dow Jones Newswire*, Jerry Guidera, 5/7/99)

Fannie Mae

Fannie Chairman Raines Says Fannie will Continue its 12-Years Record of Annual Double-Digit Operating Earnings Per Share (EPS) for at least the next Five Years, and Expects EPS to Double in Five Years

While Raines Noted that the Size of the Total US Housing Market will Continue to Expand only by 6 to 8% Annually, Fannie’s Share of the Market will Continue to Grow much Faster. Fannie Chairman Expects its Share of the Single-Family Mortgage Market to Increase up to 28% in Next Five Years

Raines Expects Fannie will Increase its Market Share by Expanding into Subprime and Home Equity Market

Raines Addressed Freddie’s Recent Open Architecture Partnership with Norwest - Raines Stated that any Attempt by Freddie to Steal Fannie’s Market Share Would Fail

- At its 10th Biennial Investor/Analyst Conference in Washington on May 6, Fannie Chairman Franklin Raines stated that Fannie “will continue its 12-year record of annual double-digit operating earnings per share (EPS) growth for at least the next five years.” Raines also stated that “I expect that Fannie Mae’s EPS growth over next five years will match or exceed the average 13.6% EPS growth of the past five years,” adding that “the future’s so bright that I’m willing to set as a goal that our EPS growth will double over the next five years.”
- Raines also reflected on the tremendous EPS performance of Fannie over the last year and previous years. “Nineteen ninety-eight was an extraordinary year for Fannie Mae,” Raines said. “We broke every business record on the book, including a 129 percent increase in business volume and produced another EPS record. Double-digit growth for more than a dozen years straight is unheard of among financial institutions. And there are only seven companies in the S&P 500 who can match our record of growth.”
- Raines cited the following as reasons for his expectations: Fannie has excellent growth prospects in the strong and growing US housing market; the margins that Fannie earns on its business should remain relatively stable; Fannie has stellar risk management strategies; Fannie has a competitive edge in the secondary mortgage market which will enable it to extend its leadership; and Fannie has a 12-year record of successfully delivering on its pledge to provide investors with double-digit EPS growth.
- While Raines noted that the size of the total US housing market will continue to expand only by 6 to 8% annually, Fannie’s share of the market will continue to grow much faster. Raines stated that its share of the single-family mortgage market has grown to 23% from 14% at the start of 1990, and the company expects continued growth up to 28% in the next five years. Raines further added that the company expects that its mortgage portfolio will grow at a “mid-teens pace.” Fannie said the portfolio growth will come through market expansion, lower industry costs and more comprehensive risk analysis including the use of technology.
- According to Raines, growth in Fannie’s market share will be achieved through expanding Fannie’s service to the subprime and home equity market. “There is a lot of growth potential” in the subprime market, according to Raines.
- As noted in *National Mortgage News’ website*, Raines made his first public comments about Freddie’s historic partnership with Norwest Mortgage during the biennial investor conference. As we reported in previous *GSE Reports*, under the Norwest/Freddie partnership, Norwest agreed to sell almost 100% of its conforming conventional loans exclusively to Freddie (instead of selling to both Fannie & Freddie) In return, Freddie agreed to accept Norwest Mortgage’s automated underwriting decisions. Raines noted in the conference that any attempts by Freddie to steal market share away from Fannie were destined to fail. “If such attempts to shift market share are based on price, they will fail because we will, of course, respond.” He further noted that “If these attempts are based on product expansion, we are well positioned to compete and win on that basis.” (*Bloomberg News*, 5/6/99; *Business Wire*, 5/6/99; *Dow Jones Newswire*, 5/6/99; *Fannie press release*, 5/6/99; *Franklin Raines Speech at the Fannie Biennial Investor/Analyst Conference*, 5/6/99; *National Mortgage News website*, posted 5/7/99)

Morgan Stanley Dean Witter Analyst Notes that Fannie's Growth is Expected to come from Technology, New Products, and Market Expansion – Especially into the Subprime Market

- Morgan Stanley Dean Witter Analyst Ken Posner noted in a recent report that during Fannie's recent biennial investor's conference, Fannie noted that the factors driving their projected acceleration in its portfolio growth were technology, new products, and market expansion. Posner writes that the "most important new product niches appear to be the A- component of the sub-prime market, alternative-A, and high loan-to-value loans. Together, we believe these niches could roughly double the size of the market that Fannie Mae can go after... Over the next couple of years, niche product lenders (such as thrifts and sub-prime lenders) will need to rethink their business models as Fannie (and Freddie) arm their lender and broker partners to go after these niche markets."
- Posner also notes that Fannie's 1999 plan is to further increase their market share for their automated underwriting system, Desktop Underwriter (DU). Fannie expects to increase the number of lenders and brokers signed up to use their automated underwriting systems and the number of transactions processed through their systems by 50%. Posner writes that "This is critically important, from a strategic perspective. The goal is to get models to the point of sale, so that lenders and brokers can capture both prime and niche products for Fannie Mae execution."
- According to Posner, CIO of Fannie Bill Kelvie gave the following as goals for Fannie's technology usage in 1999: 2.7 million loans to be processed through DU, up from 1.9 million in 1998; 1000 lenders and 3700 brokers to be signed up, up from 784 and 2600 at 1998 year-end. (Ken Posner, Morgan Stanley, Dean Witter, "Fannie Mae: Fannie Targets 15% EPS Growth at Biennial Conference", 5/7/99)

Fannie Downplays Political Risk to their Business, Despite the Considerable Amount of Political Risks Fannie & Freddie are Currently Facing

(Current Political Risks include the Following: OFHEO introduced a risk-based capital proposal that would impose higher capital standards on Fannie and Freddie, CBO suggested new fees on Fannie and Freddie's investment portfolio and requiring that Fannie and Freddie register their securities with the SEC, HUD is considering raising Fannie and Freddie's affordable housing goals, and HUD is evaluating the fair lending impact of their automated underwriting systems and lending guidelines. Further, there has been increasing competition from the FHLBank System and increasing concerns raised by the private sector on Fannie and Freddie's expansion into their business.)

- According to the *Wall Street Journal*, during the recent biennial investor conference, "Fannie Mae executives played down the significance of political risk to their operations, predicted that creeping political pressure to increase regulatory oversight of the company's lending practices won't materialize." Reportedly, Fannie "vowed to continue its lobbying efforts to maintain the regulatory status quo." According to a *Bloomberg* article, Fannie Vice Chairman Jamie Gorelick stated that "Political risk is something we manage and we manage it quite well." "Those who doubt it will miss out on a truly remarkable performance," she added. "There is more on the plate this year than any typical year," in terms of political risk, stated Jonathan Adams, an analyst with Prudential

Securities Inc. at the conference. (*Dow Jones Newswire*, Jerry Guidera, 5/6/99; *Wall Street Journal*, 5/7/99; *Bloomberg News*, 5/6/99; *American Banker*, Joshua Brockman, 5/7/99)

- According to a report by Morgan Stanley Analyst Ken Posner, during the investor conference, Fannie Vice Chair Jamie Gorelick noted at the conference that Fannie believes it could achieve compliance with OFHEO's proposed risk-based capital rule without any perceptible impact on earnings per share. However, Fannie believes that the rule is "flawed and will require substantial reworking." Gorelick also noted that Fannie is working with HUD to address Fannie's affordable housing goals and proposals by HUD to regulate Fannie's non-mortgage investments. Gorelick also stated that Fannie was working with the MBA and the National Association of Realtors to persuade Congress not to implement CBO's recent suggestions imposing user fees on Fannie and Freddie. Gorelick also reportedly noted that the FHLBank's Mortgage Partnership Finance (MPF) program, which is designed to compete directly with Fannie and Freddie, "faces legal challenges, Congressional scrutiny, and the question as to the capital adequacy of the FHLB system for this type of mission." (Ken Posner, Morgan Stanley, Dean Witter, "*Fannie Mae: Fannie Targets 15% EPS Growth at Biennial Conference*", 5/7/99)

<p style="text-align: center;">Fannie Chairman Raines Writes Open Letter in the Press to Mortgage Lenders Stating that Fannie is "Listening" in Response to Lenders' Concerns</p>

- Fannie Mae CEO Franklin Raines recently wrote an open letter to mortgage lenders, pledging Fannie's Mae's support and service. Referring to Fannie's only customer as "you, the mortgage lender," Raines noted that in response to lenders' concerns, "Fannie Mae is listening."
- Raines' letter summarized his April 19th speech at the MBA Secondary Market Conference, where he unveiled plans to reduce fees on Fannie's automated underwriting system. Raines' announcement included a waiver of fees on the Desktop Underwriter if lenders underwrite using Fannie's market products -- Flexible 97, High LTV ARM, and Alt A -- and then sell to Fannie. Raines also noted that Fannie is committed to the "open system architecture," advocated by former MBA President Ron McCord, where lenders pay a flat fee (to Fannie) for access to all underwriting systems (those chosen by Fannie). In addition, Raines mentioned in his announcement that Fannie would offer access to other automated underwriting systems, including Freddie Mac's, if Freddie agrees, for one fee (again to Fannie).
- Raines also included these assurances, "we are also aware that some lenders are concerned about brokers using our technology to obtain underwriting decisions. So let me reiterate our position with a three-part commitment: 1) Fannie Mae technology will be lender-focused and lender-controlled. 2) A DU decision is only for lenders, and it is up to lenders to decide with whom they want to share those decisions. 3) Waivers of reps and warrants can be transferred by lenders only."
- He concluded by adding, "Fannie Mae developed our technology to help you be more efficient, effective and profitable, and many of you are telling us this is what our technology has done for you. We will continue to harness technology to serve your needs and your profitability. At the same time, the future success of our industry lies in market expansion. That is, our future lies in reaching out to all the families in America who are not yet homeowners." (*American Banker*, 5/3/99; *National Mortgage News*, 5/3/99)

Responding to Criticism, Fannie Revises Controversial Website for Brokers (openclose.com) to Prevent Brokers from Having Direct Access to Fannie's Automated Underwriting System and Auctioning Loans to Lenders

- According to an *American Banker* article by Marc Hochstein, in response to criticisms, the controversial website for brokers, openclose.com, is being revised. The openclose.com website was criticized for bypassing lenders and allowing brokers to get a loan approved by Fannie's automated underwriting system (Desktop Underwriter) and then shop it around to lenders. The company who owns openclose.com – mortgage.com – said it will now require brokers to choose a "premier lender" every time they use the site to get a loan approved by Fannie's automated underwriting system. For a 24-hour period, the lender would have exclusive rights to negotiate with the broker to buy the loan. The "premier lender" scheme was reportedly developed "to ensure that openclose.com stays true to the intent not to have an auction system," said David Larson, President of Broker Services at mortgage.com. In a recent press conference, Fannie CEO Franklin Raines stated that Fannie would "constantly monitor" openclose.com to ensure that there was no "auctioning" of Desktop Underwriter-approved loans by brokers. The site will reportedly be up and running by the end of May. (*American Banker*, Marc Hochstein, 4/30/99)

On One Hand, Fannie Responds to Criticism and Revises its Controversial Website for Brokers (openclose.com) to Prevent Brokers from Having Direct Access to Fannie's Automated Underwriting System and then Auctioning Loans to Lenders (see above story) – While, on the other Hand, Fannie's Partner Finet Holdings Launches a Mortgage Auction site that Allows Consumers Direct Access to Fannie's Automated Underwriting System and Gives Consumers the Ability to Auction their Loan to Lenders

- Finet Holdings Corp., owner and operator of FiNet.com, is launching a mortgage auction site that allows consumers to have their application reviewed and approved on-line before it is put out to bid for multiple lenders, allowing consumers to auction Desktop Underwriter-approved loans to lenders. Desktop Underwriter is Fannie's automated underwriting system. The new service will anchor Homeseekers.com Finance Center and will utilize and expand Finet's iQualify.com automated loan analysis functionality, providing consumers with a choice of lenders through the auction process. Users can also select a mortgage program from one of the dozens of lenders available through Finet's main retail site, Interloan.com. As reported in previous *GSE Reports*, Fannie's first experiment with the Internet was to make its automated underwriting technology available to Finet's iQualify.com website (permitting consumers for the first time direct access to Fannie's automated underwriting technology). (*National Mortgage News website*, posted 4/26/99; *Inman News Feature*, 4/28/99)

As reported in the March 5 *GSE Report*, Morgan Stanley Dean Witter Analyst Kenneth Posner wrote that "Fannie Mae and Freddie Mac will use the Internet to accelerate the use of their automated underwriting systems. In so doing, they will create a growing class of originators who are dependent on agency technology and thus less likely to negotiate pricing or hold back from selling loans." (Morgan Stanley Dean Witter- US and the Americas Investment Research, US Savings & Loans/GSEs & Mortgage Finance, The Internet Mortgage Report: New Models, New Opportunities, Kenneth Posner, 2/4/99)

Court Finds no Retaliation by Fannie Mae Against Former Manager who had Sued

- The U.S. Court of Appeals for the District of Columbia Circuit recently ruled that Fannie Mae did not give a female employee a lower performance rating and reject her for a promotion after she appealed an adverse ruling in an earlier sex discrimination case she filed against the company. In the case, *Carpenter v. Federal National Mortgage Association*, (DC Cir., No. 98-7170, 4/27/99), Carpenter, a vice president and deputy general counsel, asserted that Fannie Mae had downgraded her performance reports after she began efforts to prevent sexual harassment at the company. The first case, filed in March 1998, resulted in summary judgement for Fannie. Her appeal resulted in the same ruling. The Court found that Carpenter had failed to show Fannie's intent to retaliate. (*BNA Daily Report for Executives*, 5/3/99)

Fannie Chairman to be Keynote Speaker at the New York Financial Writer's Dinner

- Fannie's Chairman Franklin Raines will be the keynote speaker at the June 17, 1999 Annual Awards Dinner of the New York Financial Writers' Association. The Association, founded in 1938, is made up of 285 current business and financial writers, editors and freelancers working for print, broadcast, cablecast and webcast news organizations, as well as 75 former reporters and editors who are now practicing corporate communications and other positions. (*PR Newswire*, 5/4/99)

Fannie Provides Mortgage Payment Relief for Tornado Victims in Oklahoma and Kansas - Fannie Foundation Grants \$50,000 to the American Red Cross to Assist Tornado Disaster Relief in Oklahoma and Kansas

- Fannie announced payment relief for tornado victims which includes suspending mortgage payments for up to three months, reducing the payments for up to 18 months, or in special cases, creating loan payback plans. All changes will be made on a case-by-case basis. (Reuters, 5/10/99)
- The Fannie Mae Foundation announced a grant of \$50,000 to the American Red Cross to support its emergency relief efforts resulting from recent tornadoes in Oklahoma and Kansas. The Kansas and Oklahoma Red Cross will receive \$25,000 each. Statements in support of the Foundation's grant were issued by Governor Frank Keating, Senator Don Nickles (R-OK), Senator Jim Inhofe (R-OK) and Cong. Todd Tiahrt (R-KS). (*PR Newswire*, 5/5/99)

Fannie Further Expands its Political Reach by Including Federal and State Officeholders in its Press Conferences and Press Releases and Increasingly Using its Partnership Offices in Press Events (currently 38 offices are either opened or in the process of being formed- another reportedly will be added in Pittsburgh, PA)

The April 30th GSE Report noted that Fannie was reportedly Opening a Newark, NJ Partnership Office and that Senators Thomas and Enzi were Urging Fannie to Open a Partnership Office in Wyoming

- According to a *Pittsburgh Post-Gazette* article, Fannie will be opening another Fannie Mae partnership office in Pittsburgh. According to the article, Fannie already has a regional office in Philadelphia. The article further noted that Fannie officials were not sure when or in what neighborhood the Pittsburgh office will open. (*Pittsburgh Post-Gazette*, 5/8/99)

- As reported in the April 30th *GSE Report*, it appears that Fannie might be opening local offices at the rate of practically one a month. Recently Fannie opened its 35th Fannie Mae Partnership Office in the Bay Area of San Francisco. According to *Bloomberg News*, the *Star Ledger of Newark* reported that Fannie is planning to open another Partnership Office in downtown Newark, NJ- making it the 36th Partnership Office. The *Associated Press* is reporting that Senators Craig Thomas (R-WY) and Michael Enzi (R-WY) are urging Fannie to open a Partnership Office in Wyoming. (*Associated Press*, 4/28/99; *Bloomberg News*, 4/20/99)

Congresswoman Sheila Jackson Lee (D-TX) and Mayor of Houston Lee Brown

- Fannie issued a press release to announce the results of its “new immigrants initiative” with participating lenders. Congresswoman Sheila Jackson Lee and the Mayor of Houston Lee Brown attended the Fannie press conference. (*Fannie press release*, 5/3/99)

Fannie announces New Director for its Indiana Partnership Office

- Fannie announced that Curtis Wiley would join the company as Director of the Indiana Partnership Office. Prior to joining Fannie, Wiley worked as the commissioner of the Indiana Department of Transportation and was previously the executive director of the Indiana Department of Commerce. A statement praising Wiley by Governor Frank O’Bannon was included in the press release. (*Business Wire*, 5/12/99)

Fannie Foundation Will Hold a Press Conference/Awards Ceremony on Capitol Hill

- The Fannie Mae Foundation will be honoring six Maxwell awardees at a Capitol Hill awards ceremony and reception on May 25. The Foundation introduced the Maxwell Awards in 1988. (*PR Newswire*, 5/11/99)

Freddie Mac

Freddie is Purchasing Prepayment Protection Mortgages (PPM) on a Flow Basis

- According to the *National Mortgage News*, Freddie is now purchasing PPMs on a flow basis. The article reported that PPMs offer borrowers either a slightly lower interest rate or lower closing costs in exchange for a promise not to repay their mortgages in the initial three year to five years the loans are on the book. According to a Fannie official, Fannie began purchasing PPMs on a negotiated transaction basis in August 1997. According to a Freddie spokesperson, Fannie securitized more than \$2 billion worth of prepayment protection loans during the first 10 months of 1998. (*National Mortgage News website*, posted 4/29/99; *National Mortgage News*, Lew Sichelman, 5/3/99)

Federal Home Loan Banks

Fannie Reportedly Welcomes Competition from FHLBank System

The FHLBank System’s MPF Program is Becoming a Real Competitor to Fannie & Freddie – Four FHLBanks are Now Offering the Program

- According to *Reuters*, Fannie reportedly stated during their biennial investor/analyst conference on May 6 that it would welcome competition from the FHLBank Systems if they become a “player” in

the secondary mortgage market. “We don’t shy away from competition,” stated Fannie Vice Chair Jamie Gorelick. Gorelick further stated that “We believe we have tremendous advantages in competing and if the Federal Home Loan Banks want to look like us and have all the attributes that Freddie and we have, we will meet their competition.” Gorelick notes that the FHLBanks will have to make a choice if they want to be in the secondary market. “The real question for them is whether they like their current structure, which is appropriate for making advances to members or whether they want to be in the secondary market,” she stated. (*Reuters*, 5/6/99)

- The competition from the FHLBank System that Gorelick is referring to is the FHLBank’s Mortgage Partnership Finance (MPF) program which gives savings institutions and commercial bank lenders a new alternative to holding home loans in portfolio or selling them to Fannie and Freddie. The program allows FHLBanks to purchase mortgage loans originated by member financial institutions. There are now four FHLBanks offering the program – the FHLBanks of Chicago (began the program), Dallas, Atlanta, and New York. According to a recent joint press release by the FHLBanks of Chicago and New York, there are currently 55 savings institutions and commercial banks approved as participating customers and over 100 additional institutions are in various stages of joining the program. The program has over \$1.2 billion in outstanding loans, with master commitments for another billion dollars. (*FHLBanks of NY and Chicago press release*, 4/20/99)

FHFB Issues an Interim Final Rule Making Technical Revisions to its Affordable Housing Program (AHP) Regulation

- The Federal Housing Finance Board (FHFB) issued an interim final rule making technical revisions to its Affordable Housing Program regulation. The interim final rule was published in the *Federal Register* on May 5 and is effective on June 4, 1999. (*Federal Register*, 5/5/99, pages 24025-24028)

FHLBank of Atlanta Hires a New President

- According to the *National Mortgage News website*, the FHLBank of Atlanta has hired Raymond Christman, a Pittsburgh businessman, as its new President. Christman has served as Chairman of the FHLBank of Pittsburgh since 1994. (*National Mortgage News website*, posted 5/10/99)

Status Report of Legislation Containing FHLBank Expansion Provisions

Senate Passes Financial Services Modernization Bill Containing Five FHLBank Expansion Provisions

Administration Continues to Oppose FHLBank Expansion Provisions

- According to the *Bank Investment Services Report*, the Clinton Administration issued a “Statement of Administration Policy” on the financial services modernization bills currently under consideration by Congress. According to the article, “Flaws in the [Senate] bill...include not only the op sub provision, but also provisions that would weaken the Community Reinvestment Act; inadequately protect and inform consumers; provide ‘piecemeal’ modification of the Federal Home

Loan Bank System; and grant the Federal Housing Finance Board independent litigation authority.” (*Bank Investment Services Report – American Banker*, 5/10/99)

- Prior to his resignation as Treasury Secretary on May 12, Robert Rubin testified on May 5 before the House Commerce Subcommittee on Finance and Hazardous Materials on financial services modernization. During his testimony, Rubin protested a provision in the House financial services bill that he stated would allow the Federal Housing Finance Board (FHFB) to reduce the FHLBank System’s capital in half. Rubin noted that a considerable amount of debt raised by the FHLBank System did not help homeowners but instead funds “arbitrage activities and short-term lending that benefit the system and its bank and thrift members.” Rubin reportedly called the system’s practices an “abuse of its government subsidy” that also introduces risk into a system that wasn’t designed to handle risk. He urged Congress to at least keep the current capital requirements in place and revise the bill to reform the FHLBank System to ensure that it’s used to stimulate housing. (*Dow Jones Newswire*, David Kopecki, 5/5/99)
- The Senate passed its version of financial services modernization (S. 900) on May 6 by a mostly party-line vote of 55-44. The bill contained five FHLBank provisions: (1) makes thrift membership voluntary; (2) makes access to FHLBanks easier for small banks with less than \$500 million in assets; (3) converts the annual \$300 million Resolution Funding Corp. obligation to a percentage of FHLBank earnings; (4) reduces FHFB control of day-to-day operations; and (5) instructs the General Accounting Office (GAO) to conduct a study of the FHLBank System capital structure. The Senate Banking Committee passed its version of financial services modernization (S. 900) on a party-line vote of 11-9 on March 4.
- The House Banking Committee passed its version of financial services modernization (H.R. 10) on March 11 by a 51-8 bipartisan vote. The House version must now pass the Commerce Committee. The House Commerce Subcommittee on Finance and Hazardous Materials held hearings on H.R. 10 on April 28 and May 5. As reported in previous *GSE Reports*, H.R. 10 contains the following FHLBank expansion provisions: (1) makes thrift membership voluntary; (2) makes access to FHLBanks easier for small banks with less than \$500 million in assets; (3) changes financing from fee-based system to flat rate by converting the annual \$300 million REFCorp. obligation to 20.75% of earnings; (4) reduces FHFB control of day-to-day FHLBank operations; and (5) establishes new capital structure based on two classes of stock. The House leadership had previously given the Commerce Committee a May 14 deadline to vote on H.R. 10 but the Committee has been granted an extension until June 11.
- Separate FHLBank bills have also been introduced in the House and Senate (H.R. 822 and S. 458). The bills were introduced in the Senate (S. 458) by Senator Chuck Hagel (R-NE) and Senator Evan Bayh (D-IN) and in the House (H.R. 822) by Congressman Richard Baker (R-LA) and Congressman Paul Kanjorski (D-PA). The bills would do the following: (1) ease small bank access to FHLBank advances; (2) make thrift membership voluntary; (3) convert the \$300 million REFCorp. obligation to 20.75% of FHLBank earnings; (4) reduce federal intrusion in day-to-day FHLBank operations; (5) and provide for permanent capital and a risk-based capital standard. (*National Mortgage News website*, posted 2/25/99)

Private Sector Items to Note

Cendant Mortgage and Philadelphia NAACP Form a Partnership to Assist NAACP Members in Becoming Homeowners

- Cendant Mortgage has formed a three-year partnership with the Philadelphia NAACP and its affiliate, Next Generation Community Development Corp. to form an affordable housing program for first-time homebuyers. The program, called the Next Generation Mortgage Program, will offer mortgage financing and homeownership counseling to help NAACP members become homeowners. According to J. Whyart Mondesire, President of the Philadelphia NAACP, "Through our partnership with Cendant Mortgage, we will provide information and assistance to borrowers on a wide range of affordable mortgage products, financial counseling services and underwriting flexibility to help put homeownership within their reach." Terry Edwards, President and CEO of Cendant Mortgage, stated "We're excited to have the opportunity to work with Next Generation members and help them realize their dream of homeownership. As mortgage experts, we believe we have much to offer prospective homebuyers." Edwards said the company hopes to provide \$6 million in mortgage loans annually over the course of the program. (*Cendant Mortgage press release, 5/12/99*)

Ginnie Mae

Ginnie Mae will Give Geographical Breakdown of Mortgage Bonds

- According to *Bloomberg News*, Ginnie Mae said it will start issuing geographical breakdowns on the bundles of mortgages backing its bonds to facilitate research for investors. Starting in July, Ginnie Mae will issue detailed information identifying the state in which the mortgages backing the securities were originated, average loan balance and a breakdown of whether the mortgages were made under the FHA or VA programs. Reportedly the information will be vital to investors and traders because homeowners in different parts of the country refinance their mortgages at different paces. According to the article, Fannie and Freddie already provide this information. "People have been telling them to do it for a while; it will improve" trading of their securities, said Arthur Frank, head of mortgage research at Nomura Securities International Inc. Average loan balance and geographic distribution are important, he said. (*Bloomberg News, 5/4/99*)

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