

The **GSE** REPORT TM

Contents of GSE Report TM

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 - Despite Fannie’s claims to consumer groups and financial service institutions that it will be a “stretch” for Fannie to meet HUD’s new proposed affordable housing goals applicable to Fannie & Freddie, Prudential analysts say HUD is adjusting its affordable housing definitions in such as way that Fannie will not have to “stretch” at all. According to Prudential analysts, the definitions have been adjusted enough by HUD that Fannie is already likely to be in the 46% to 48% range (HUD recently proposed increasing the GSEs’ affordable housing goals from 42% to 50% over the next four years.)
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 - Ten of the twelve FHLBanks reacted negatively to a provision that changes how the FHLBanks pay off a portion of the REFCORP bonds used to finance the S&L cleanup
 - FHFB Chairman Bruce Morrison says that if financial services modernization bill is enacted, he will withdraw the FHFB’s controversial proposal that phases out the FHLBank System’s arbitrage investments and implements a new risk-based capital standard for the FHLBanks
 - Both the proposal and S.900 would change the FHLBanks’ capital structure (although in different forms)
 - Opponents of FHFB’s controversial proposal were not successful in including language in the final HUD-VA Appropriations bill mandating a one-year GAO study of FHLBank capital that would have effectively delayed the FHLBanks’ capital proposal
 - Debate by the Conference Committee on financial services modernization related to the FHLBank provisions sparked a commitment by House Banking Committee Chairman Jim Leach (R-IA) and Capital Markets, GSE Subcommittee Chairman Richard Baker (R-LA) to review the GSEs in general next year
- Congress approves 22% budget increase for Fannie & Freddie’s safety and soundness regulator (OFHEO) for FY 2000 (*p. 14*)
 - Senate Banking Chairman Phil Gramm (R-TX), the Clinton Administration, Chairman of the House Banking Capital Markets Subcommittee Cong. Richard Baker (R-LA), consumer advocate Ralph Nader, and Fannie/Freddie watchdog group, FM Watch, all supported the 22% increase

Fannie Mae and Freddie Mac

- OFHEO (Fannie & Freddie's safety and soundness regulator) extends comment period on its risk-based capital proposal for Fannie & Freddie until March 10, 2000 (*p. 15*)
 - This is the second extension of the comment period
 - The original deadline for implementing the risk-based capital proposal on Fannie & Freddie was December 1994. With the new comment period extension, the timetable for implementation will likely be 2002 (8 years later).
 - Fannie, Freddie, the Mortgage Bankers Association (MBA) and the Mortgage Insurance Companies of America (MICA) all requested comment period extensions
- MBA's new President Kit Sumner says GSEs are one of his primary worries and thinks HUD should intervene and referee the conflict between the mortgage industry and the GSEs (*p. 16*)
 - MBA's outgoing President Donald Lange says one of the most exciting aspects of his tenure at the MBA was working to "push back" Fannie & Freddie
- *National Mortgage News* column by Paul Muolo raises interesting points on Fannie & Freddie – "Who Would You Rather Trust: GSE or Wall Street?" (*p. 17*)
 - Muolo states, "Fannie Mae spokespeople like to argue that Fannie Mae is pro consumer and is only trying to reduce housing costs for consumers... But Fannie Mae also forgets that for every dollar it saves the consumer... not all of that savings is being passed on to the consumer. Fannie Mae runs a business and when it supposedly saves the consumer money it is putting some of that 'saved money' into its own pocket as well. After all, if it really wanted to save the consumer money it would donate all of its profits to homebuyers so they can use the cash for a much-needed downpayment."
- Despite record profits by Fannie & Freddie, their stock has fallen because of investor concerns over: (1) rising mortgage interest rates; (2) increased political risk; (3) fears that portfolio growth [primary way Fannie & Freddie make money] have topped out; and (4) worries about possible price wars between the two GSEs (*p. 17*)
 - Fannie & Freddie announce record third quarter earnings yet, Fannie's stock has fallen 15% & Freddie's 19% for the year
 - Fannie & Freddie's double digit-earnings are due in large part to an aggressive move into non-traditional areas, such as home equity and manufactured housing loans, analysts said
 - Falling stock prices have led Fannie & Freddie to resort to unconventional methods – like Fannie's Timely Payments Reward product for subprime market – in order to appease investors
 - The formation of Fannie/Freddie watchdog group, FM Watch, and a new Congress with a perceived different attitude has created political uncertainty for the GSEs. "This has kept investors away from purchasing Fannie Mae and Freddie Mac stocks. All are more aware of political risk to the agency's expansion plans that didn't exist a year ago," said one Wall Street analyst who wished to remain anonymous.
 - Rising interest rates caused Fannie's loan purchases and commitments to plummet in September – Fannie's purchases fell to the lowest level in 19 months
- Fannie & Freddie dramatically increase their purchase of adjustable-rate mortgages (*p. 19*)
- The GSEs and MBA have difficulty smoothing out differences (*p. 20*)
 - Fannie & Freddie's comments at the MBA conference do not alleviate lenders' concerns
- Foreign investors are selling their US Treasury holdings and shifting into riskier corporate and agency bonds (e.g., Fannie, Freddie, Ginnie Mae) (*p. 21*)
 - However, the recent weakness of the dollar may be more dangerous to the struggling markets for these riskier bonds than to the Treasury market or even the US stock market because corporate and GSE bonds are more dependent than Treasury on foreign investors
 - For Japanese banks, US agency securities offer an accounting advantage over Treasuries
 - In related news, more than half of Freddie's recent \$5 billion reference note was placed overseas
 - Fannie said it plans to offer another \$50 billion of benchmark securities next year – Fannie sells more notes and bonds than anyone except the Treasury
- Fannie & Freddie add new products that expand their technology beyond their core mission area of conforming mortgages (*p. 22*)
 - Fannie and PMI Mortgage Insurance announce approval of automated underwriting for veterans' loans using Fannie's automated underwriting technology system
 - Fannie releases new version of its automated underwriting technology system that will enable lenders to underwrite construction loans, home improvement loans, and other products
 - Fannie announces its automated underwriting technology system will be available over the Internet – Fannie says MORNETPlus.com will make Fannie's website "the leading web portal for the mortgage finance industry's business-to-business transactions and services" [Editorial note: With announcements such as these, how can Fannie deny that it is using its technology to control the origination process?]

- Fannie adds appraisal and flood information from Chicago Title to its automated underwriting technology system
- Freddie announces that users of its automated underwriting technology system will now have more credit reporting companies from which to choose

Fannie Mae

- Critics blast Fannie's new Timely Payment Rewards mortgage product that allows Fannie to expand into subprime (A-) market (*p. 24*)
 - The National Home Equity Mortgage Association (NHEMA) says the product is beyond Fannie's mission, will drive up costs for consumers (particularly the B&C market), and increase the potential for a taxpayer bailout
 - Investors and traders are concerned with Fannie's new program because it could increase the risk of loan defaults and prepayments, making it more difficult to predict the rate of interest and principal payments used to establish the securities' values – the Bond Market Association says it “does represent a threat to the continued integrity of the market”
 - Paine Webber notes that Fannie's new product will mean less business for companies that are primarily subprime lenders
 - Paine Webber analysts also note that an economic downturn might lead to greater credit worry about the inclusion of poorer credit loans in Fannie's pools
 - At the same time Fannie enters subprime market, the FDIC recommends tighter capital rules for FDIC insured institutions that engage in subprime lending because it is a high-risk activity [Editorial note: Fannie & Freddie hold less capital than fully private financial institutions. Risk to the taxpayers increases as the GSEs engage in riskier activities, but are not required to set aside more capital.]
 - Lenders must use Fannie's automated underwriting technology system, Desktop Underwriter, if they want to provide the product to consumers [Editorial note: It is likely that Fannie will charge technology delivery fees when they offer this product – the GSEs' equivalent of a “tax on homeownership.”]
 - [Editorial note: This product goes against the Mortgage Bankers Association GSE policy statement that says the GSEs should not tie their technology to products]
 - [Editorial note: There is a question as to whether Fannie's automated underwriting system is the best system available for subprime or credit-impaired borrowers since a study commissioned by HUD found that Fannie & Freddie's automated underwriting systems and use of credit scoring may have an unintended but adverse impact on borrowers with low incomes, limited wealth and poor credit histories.]
- A firm with Fannie stake (HomeStore.com) is buying 2 consumer websites (*p. 28*)
 - This despite Fannie's assurances that they are not trying to circumvent lenders by going direct to brokers and consumers
- Analyst says Fannie is “out of control both economically and politically” (*p. 28*)
- Fannie moves outside its core mission of providing liquidity to the secondary market and expands into construction loans and home improvement loans (*p. 28*)
 - [Home improvement loans do not put consumers into homes – these consumers already own their own homes]
- Fannie Chairman Franklin Raines says Fannie will double its earnings per share in five years in a recent CNBC interview and denies that the company is affected by interest rates (*p. 29*)
 - Raines says the company makes its money on the expansion of mortgage debt outstanding
- Although law prohibits Fannie & Freddie from purchasing mortgages greater than \$240,000 (jumbos) – In a speech recently before the Merrill Lynch Investor Conference, Fannie Chairman Franklin Raines notes how Fannie has found a back door way into jumbos (*p. 30*)
 - One New York investment banker who attended the Merrill Lynch speech described it as, “Frank's speech about how Fannie Mae was going to take over the world”
 - While Fannie's Chairman tells analysts that Fannie has entered the jumbo market (mortgages over \$240,000) through the back door, Fannie's Vice Chair, Jamie Gorelick tells the press that Fannie has no intention of entering the market for jumbo mortgages, but will continue to buy and securitize mortgages under \$240,000, “for the middle class and underserved”
 - [Editorial note: Congress never intended to have Fannie & Freddie's government subsidies passed along to wealthy homebuyers seeking loans above the conforming loan limit (currently over \$240,000).]
- Fannie acquires \$155 million of seasoned multi-family mortgages from Prudential Insurance (*p. 31*)
 - Fannie said it is actively looking at several pools of loans
 - Fannie plans to hold the assets until maturity
- Fannie is ranked as the 58th largest public company in the world (*p. 31*)
- 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 34 offices are officially open and operating and nine more are in the process of being organized) (*p. 31*)

- Fannie says it plans to have 45 partnership offices opened by the end of the year

Freddie Mac

- Controversy continues to swirl around Freddie's study finding that African Americans are twice as likely as whites to have bad credit (p. 33)
 - House Banking Committee Member Maxine Waters (D-CA) writes *Washington Post* op-ed criticizing Freddie's study
 - National Community Reinvestment Coalition Vice President Joshua Silver says that Freddie's survey "smacks of politics" and that perhaps, Freddie may be using the study to say it is not possible to meet HUD's increased affordable housing goals [Editorial note: Attempts by Freddie to include language in the HUD-VA Appropriations bill on the increased affordable housing goals (see earlier story) bolster's Silver's argument.]
 - Expert credit scoring company – Fair, Isaac – rejects Freddie's controversial study linking race with credit
- Freddie begins a servicer certification program to employees of lenders so that the employees can teach others in the company how Freddie would like things done (p. 34)
 - Freddie offers waivers and financial incentives to companies with employees under the servicer certification program

Federal Home Loan Banks

- FHFB grants approval to the FHLBanks of Cincinnati, Indianapolis, and Seattle to begin development of single-family Member Mortgage Asset (MMA) programs that will be another competitor to Fannie & Freddie (p. 34)
 - MMA allows for risk-splitting between the FHLBanks and the member bank originating the loan
 - FHFB announces that the FHLBank of Des Moines has received approval to offer the FHLBanks' Mortgage Partnership Finance (MPF) program [another program that is a direct competitor to Fannie & Freddie]
 - Half of the 12 FHLBanks are now offering the MPF program – the MPF program is becoming a real competitor to Fannie & Freddie in the secondary mortgage market
- FHFB approves a FHLBank of New York program called Sequential Participation for lenders who may want an alternative to selling their mortgages into the secondary market, but still want to hold portions of the loan (p. 35)
 - Sequential Participation is part of a pilot program – the Community Mortgage Asset Activities Program – that will split the credit and interest rate risk between private-sector mortgage lenders and the FHLBank of New York
 - The Sequential Participation Program offers lenders an alternative to selling their loans into the secondary market to Fannie & Freddie but is not a direct competitor with Fannie & Freddie
- FHFB approves a final rule providing joint liability of FHLBank debt (p. 36)
- Federal Housing Finance Board: "*Not Well Known, But Very Well Sued*" – Though not well known, the FHFB is no stranger to controversy and is currently involved in a number of lawsuits (p. 37)
- US Appeals Court affirms President Clinton's dismissal last year of FHFB Member Lawrence Costiglio (p. 38)

Farm Credit Administration/Farm Credit Banks

- Amendment in the Agriculture Appropriations bill that would have broadened the authority of the Farm Credit System, at the expense of private sector banks was not included in the final Agriculture Appropriations bill (p. 38)
 - American Bankers Association and Community Bankers Association were opposed to the amendment

Ginnie Mae

- HUD says a proposal to allow Ginnie Mae to purchase its own mortgage-backed securities (MBS) could raise millions
 - Ginnie Mae proposal would allow Ginnie Mae to act like Fannie & Freddie (p. 39)
 - Fannie & Freddie scoff at Ginnie Mae proposal because they say it would be too risky [Editorial note: If Fannie & Freddie consider MBS purchases by Ginnie Mae as risky – then why don't they view their purchasing of MBS as risky? Fannie & Freddie hold a much greater concentration of their own MBS in their portfolio than would be allowed under the Ginnie Mae proposal.]
- Prudential analysts say Fannie & Freddie should still be "investment friendly" despite Ginnie Mae proposals being discussed. A public review of Ginnie Mae brings further analysis of the political risks faced by Fannie & Freddie. (p. 40)

Major Events

Language approved by the Conference Committee on the financial services modernization bill (S. 900) broadly exempts the GSEs from privacy requirements imposed on other fully private financial institutions

Language was inserted, however, into the Statement of Managers that narrowed the intent of the privacy exemption

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FM Watch says its another “midnight raid by the government subsidized enterprises”

- The Conference Committee on the financial services modernization bill (S. 900) approved by voice vote late in the evening on October 18 an amendment sponsored by Congressman Spencer Bachus (R-AL) that would exempt the GSEs from certain privacy provisions. The Bachus amendment broadened the GSEs’ exemption from the privacy requirements in the broader financial services modernization bill. Originally, the GSEs had received a secondary market exemption, as did all institutions engaging in secondary market activities. The Bachus amendment, however, exempts the GSEs from the requirements of the underlying legislation as long as they do not sell or transfer non-public, personal information to non-affiliated third parties. (The word “transfer” was added by Congressman Edward Markey (D-MA).) The Bachus amendment became part of an agreement reached by the Conference Committee on October 22.
- The Bachus amendment was then included in the statutory language of the financial services modernization legislation that was released on November 1. Language was included in the Statement of Managers that narrowed the intent of the Bachus amendment. The Conference Report is currently being circulated to each conferee for signature. Once a majority of both the Senate and House conferees sign the document, the bill will move to the House and Senate floors for a final vote.
 - The following language was included in the Statement of the Managers to narrow the intent of the Bachus Amendment:

“The Conferees also excluded from this subtitle institutions chartered by Congress specifically to engage in securitization or secondary market transactions, so long as such institutions do not sell or transfer nonpublic personal information to nonaffiliated third parties. The Conferees granted the exemption based on the understanding that the covered entities do not market products directly to consumers” (Statement of Managers, Summary of Major Provisions, November 1, 1999)
- **According to an article by Kathleen Day with the *Washington Post*, Fannie and Freddie have what the companies themselves describe as the largest bank of information on consumers’ home-buying habits. House Banking Committee Chairman Jim Leach (R-IA) said he did not believe the amendment was needed. The amendment, however, passed by voice vote, and several Congressional aides expressed concern that the exemption might permit the two companies to sell information from their database with little knowledge by consumers. (*Washington Post*, Kathleen Day, 10/19/99)**

FM Watch says GSE privacy exemption is “anti-consumer”

- Fannie/Freddie watchdog group calls the GSEs’ privacy exemption “anti-consumer.” FM Watch stated in a recent bulletin:

- **“Fannie Mae and Freddie Mac struck a blow to consumers this week. They skirted federal privacy disclosure requirements in an amendment agreed to by the Conference Committee on S. 900, The Financial Services Modernization Act of 1999. It was yet another midnight raid by the government subsidized enterprises.**

Their amendment is anti-consumer. It exempts the largest database on homebuying habits in the financial services industry from provisions protecting consumer privacy....

In vintage fashion, Fannie and Freddie deployed smoke and mirrors and misled lawmakers. They did not fully explain their hidden agenda to Members who questioned the amendment’s purpose. There is no reason Fannie and Freddie should be advantaged over the rest of the financial services industry at consumers’ expense. Their amendment means that 20 million America families are vulnerable to privacy invasions because Fannie and Freddie hold their mortgages. Once again, Fannie and Freddie are choosing higher investor profits over consumers’ rights and interests.” (*FM Watch Bulletin*, 10/22/99)

[Editorial Comment: The GSEs’ effort to get an exemption from the privacy requirements in this legislation is significant. This exemption is likely to be a first step in what will be a methodical program to exempt the GSEs from the consumer protection laws that affect all other financial institutions as the agencies. Over time, their exemption will be more valuable to them as they more fully deploy their business strategies of moving closer to the consumer. The long-term impact of this amendment and the precedent it sets is far greater than any benefit that may accrue to them on date of enactment. Furthermore, as the states or Congress, in the future, impose greater privacy protections than those provided for in this legislation, the benefit of an exemption will increase substantially because the GSEs have federal charters that preempt state law. Therefore, the GSEs will not be impacted by any action taken by the states.]

Treasury Secretary Lawrence Summers says the President’s Working Group on Financial Markets should focus on GSE systemic risk

- In a speech to Women in Housing and Finance, Treasury Secretary Lawrence Summers said that **GSEs may pose “system risks” to the financial markets and that the President’s Working Group on Financial Markets should consider the GSEs’ capital requirements and oversight. Summers stated, “Debates about systemic risk should also now include government-sponsored enterprises, which are large and growing rapidly.”** The five GSEs, including Fannie and Freddie, are expected to issue more debt this year than the US Treasury. **“It also goes to questions of the scope of their activities - to the extent to which their activities are related to their central missions or are further afield into activities that might traditionally be treated as being of the more speculative sort,”** Mr. Summers stated. (*National Mortgage News website*, posted 10/6/99; *National Mortgage News*, 10/11/99)

Fannie & Freddie are trying to get around their affordable housing requirements

Fannie & Freddie were able to get language inserted in the HUD-VA Appropriations Conference Report asking HUD Secretary Andrew Cuomo to consider certain factors in establishing new affordable housing goals for Fannie & Freddie [Reports are that the language came from Freddie]

***National Mortgage News* columnist Brian Collins notes that Freddie’s “self-serving” language instructs HUD “to go easy on Freddie Mac when it comes to increasing its affordable housing goals”**

Fannie/Freddie watchdog group, FM Watch, questions the report language – noting that Fannie & Freddie should “not be given any opening to shirk their mission to promote affordable housing” and that the language “is further proof that Fannie Mae and Freddie Mac are looking to avoid fulfilling their public mission”

Despite Fannie’s claims to consumer groups and financial service institutions that it will be a “stretch” for Fannie to meet HUD’s new proposed affordable housing goals applicable to Fannie & Freddie, Prudential analysts say HUD is adjusting its affordable housing definitions in such a way that Fannie will not have to “stretch” at all. According to Prudential analysts, the definitions have been adjusted enough by HUD that Fannie is already likely to be in the 46% to 48% range (HUD recently proposed increasing the GSEs’ affordable housing goals from 42% to 50% over the next four years.)

- Language was inserted into the HUD-VA Conference Report (H.R 2684) that asks HUD Secretary Andrew Cuomo to consider certain factors in establishing new affordable housing goals for Fannie and Freddie. The HUD-VA Appropriations Conference passed the House on October 14, the Senate on October 15, and was signed into law by President Clinton on October 20. (HUD recently proposed increasing the GSEs’ affordable housing goals from 42% to 50% over the next four years.)
- The language asks Secretary Cuomo to consider the following: “First, the stretch affordable housing efforts required of each of Freddie Mac and Fannie Mae should be equal, so that both enterprises are similarly challenged in attaining the goals. This will require the Secretary to recognize the present composition of each enterprise’s overall portfolio in order to ensure regulatory parity in the application of regulatory guidelines measuring goal compliance. Second, any new affordable housing goal regulations must recognize that attainment of materially higher goals will be largely dependent on the continuation of the current economic conditions that are very favorable for housing affordability. Deterioration in these conditions likely would render stretch affordable goals infeasible within the intent of the 1992 legislation.” (*H.R. 2684 Conference Report Language*)
- The language appears to be favorable to Freddie, which has a smaller mortgage portfolio and smaller multifamily lending program than Fannie. (*National Mortgage News website*, posted 10/19/99) According to Freddie, multifamily loans have a much larger impact on meeting affordable housing goals because they include more low- and moderate-income borrowers. Further, the multifamily loan market is, for the most part, a refinancing market and is fueled by existing relationships, Freddie said. “The fact that [Fannie Mae’s] portfolio of existing loans is four times the size of ours puts us at a disadvantage in meeting the goals,” a Freddie spokeswoman told *BNA* in June of this year. Neither Fannie nor Freddie had returned phone calls to *BNA* for comment on the HUD-VA Appropriations language. (*BNA Daily Report for Executives*, Eileen Canning, 10/29/99)

- **Brian Collins writes in a recent *National Mortgage News* column entitled “*Freddie Strikes Again,*” that similar to last year’s middle-of-the-night inclusion of a provision in the 1998 HUD-VA Appropriations bill that would have allowed the GSEs to self-insure mortgages, language was included in this year’s HUD-VA Appropriations bills “that instructs the Department of Housing and Urban Development to go easy on Freddie Mac when it comes to increasing its affordable housing goals.” Collins notes that “Last year’s legislative power play by Freddie turned out to be a defining moment for the mortgage industry. It led to the realization that Fannie Mae and Freddie Mac had not only become too big and too powerful, but they are prepared to turn against their partners to expand their businesses.” While the new “self-serving” affordable housing language “is not as far-reaching or as dastardly as last year’s attack. Nevertheless, the GSE easily caught its opponents napping and showed once again that it has powerful allies on Capitol Hill.”**
- Collins believes that the affordable housing language essentially tells HUD that it should consider setting different affordable housing goals for Fannie and Freddie. “While report language is not binding on HUD like legislative language, it does send a message.” **Collins also noted that the report language “does signal that lawmakers may make it difficult for HUD to finalize the higher affordable housing goals if the department ignores the instructions.”**
- Freddie has complained to HUD that the size of Fannie’s multifamily portfolio places Freddie at a disadvantage over Fannie in complying with the new proposed affordable housing goals. As Collins notes, Freddie was completely out of the multifamily market earlier in the decade while Fannie continued to build its multifamily business. “Now Freddie Mac believes that HUD should consider the fact that Fannie Mae has a larger multifamily portfolio, because multifamily financing reaches more lower-income persons and underserved neighborhoods, which are important components of the AH [affordable housing] goals. Needless to say, Freddie Mac officials have been talking to HUD about their concerns, but now they have report language to back them up.” (*National Mortgage News website, “Freddie Strikes Again,”* Brian Collins, posted 10/22/99; *National Mortgage News*, Brian Collins, 10/18/99)

FM Watch is disappointed with the language and the efforts by GSEs to avoid fulfilling their public missions

- FM Watch Executive Director Mike House stated, **“I’m disappointed that this report language was included. Fannie Mae and Freddie Mac should not be given any opening to shirk their mission to promote affordable housing. Since HUD began the discussion about increasing Fannie Mae and Freddie Mac’s affordable housing goals, these two government-subsidized enterprises have been fighting the increases. In the end, Fannie Mae was dragged kicking and screaming to the table, while Freddie Mac has not agreed to the goals. The report language is further proof that Fannie Mae and Freddie Mac are looking to avoid fulfilling their public mission.”**
- House further stated, **“The real shame is that this language asks HUD to consider when setting the goals ‘the continuation of current economic conditions that are very favorable for housing affordability.’ FM Watch believes that it is precisely when economic times deteriorate that the low-income and underserved Americans Fannie Mae and Freddie Mac are charged with serving need the most help. And that’s precisely when Fannie and Freddie want to be excused from the table. Once again, their focus is clearly on their investors, not homebuyers.”**
- **Rather, FM Watch believes Secretary Cuomo should consider the following factors when setting Fannie and Freddie’s affordable housing goals:**

- **“Fannie Mae and Freddie Mac lag behind the private market in promoting affordable lending to low-income and minority borrowers;**
- **As the Congressional Budget Office stated, Fannie and Freddie are spongy conduits that soak up nearly \$1 in federal subsidies for their investors for every \$2 delivered to homebuyers; and**
- **If Fannie and Freddie are allowed to circumvent the increased affordable housing goals, they will be permitted to continue to place the interests of their investors over American homebuyers.”** (*FM Watch press release, 10/15/99*)

Prudential analysts say HUD is adjusting its affordable housing definitions in such a way that Fannie will not have to “stretch” to meet its new affordable housing goals

- According to a Prudential securities analyst report by Jonathan Adams, Chuck Gabriel and Bose George, recent inquiries made by the analysts “confirm that HUD is adjusting the definition of low and moderate income housing in such a way that Fannie Mae is already likely to be in the 46% to 48% range.” [HUD’s new goal for Fannie & Freddie was proposed at 50%.] “In our view, this provides Fannie Mae with a greater degree of flexibility in its acquisition strategies without compromising its commitment to attain HUD’s goals of 50% by 2001.” (*“To Investors Fretting Over Fannie Mae’s Outlook: Watch What They Do,”* Jonathan Adams, Chuck Gabriel, and Bose George, 10/1/99)
- This seems contrary to Fannie Chairman Raines’ statement before the MBA Conference on October 12, 1999: “On the new HUD goals, we have indicated to Secretary Cuomo that we will stretch to achieve the new affordable lending goal levels. The new goals will see a full one-half of all of Fannie Mae’s business will be done with low- and moderate-income borrowers. There should be no doubt about it – it will be a stretch for us and for you. But we have agreed to this because we believe it is in the best interest of lenders, Fannie Mae and the home buyers we serve.” (*Franklin Raines speech before the MBA Annual Conference, 10/22/99*)

IRS seeks \$76.7 million in back taxes from Freddie

- As was reported in the April 2, 1999 *GSE Report*, the IRS is seeking \$76.7 million in back taxes from Freddie Mac for 1987-90, the years following Freddie Mac’s switch to a private company. According to a recent *Washington Business Journal* article by Jerry Moskal, Freddie Mac denies owing any taxes, and claims the IRS owes them over \$138.3 million in refunds. The details of the initial IRS claim are as follows:
 - Freddie declared taxable income of \$20,862,143 in 1985 – the IRS claims the figure should be \$104,134,544. Freddie declared taxable income of \$26,938,082 in 1986 – the IRS claims the figure should be \$114,181,184.
 - Before 1985, Freddie was a tax-exempt company. In 1985 and 1986 returns, Freddie sought to amortize the value of some assets and deduct those amounts in calculating what it owed. The amortizations (\$58.1 million for 1985, \$56.6 million for 1986) are what the IRS questions. Without the amortizations, the IRS calculates that Freddie income taxes increased from \$9,592,936 to \$46,216,631 in 1985 and for 1986, the taxes increased from \$12,413,021 to \$52,524,148.

- The tax deductions sought by Freddie were made on customer service assets, valued at \$600 million and amortized at \$60 million per year over 10 years. The intangible asset included debts; software information systems; rental contracts; information on the institutions that regularly sold mortgages to Freddie; and the roster of Freddie’s “specialized professionals” with unique skills. The IRS denied the deductions on the grounds that Freddie had no “basis” in the asset.
- The deductions are the grounds for Freddie’s argument that it overpaid taxes – Freddie claims it merits a refund of the \$9.6 million and \$12.4 million in taxes it already paid in 1985 and 1986.
- Moskal noted that the IRS issued a decision in July that found that Freddie Mac could not take \$432.6 million in depreciation deductions, and also denied them a \$67.6 million write-off of the prior year’s loss. Further, the IRS found that Freddie had “millions of dollars in additional taxable income from various activities than reported,” noted Moskal. However, Freddie Mac disagrees with the IRS’ findings. The GSE filed a petition on September 29 to dispute the findings. Both the IRS and Freddie Mac denied to comment on the dispute, stating that it was their policy not to comment on pending cases.
- But, Moskal noted, “Freddie Mac’s 56-page petition speaks volumes.” In their petition, Freddie Mac asserted that the IRS had made many errors in determining that the company owes more taxes. Among Freddie’s claims were that the IRS erroneously:
 - Found that Freddie had an additional \$21.5 million in taxable 1990 income verses the \$103,325 Freddie reported for the sale of “yield maintenance contracts”
 - Ruled that Freddie had more than \$22.2 million in additional taxable income over the four-year period from mortgage commitment fees
 - Denied Freddie credit for \$28 million investments in mortgages lost in the sale of participation certificates.
 - Refused to allow Freddie to take a \$67.6 million net operating loss deduction in 1987 for a loss it incurred in a prior tax year
 - Refused Freddie’s \$1.67 deduction for investment credits; refused a \$3.36 million tax write-off for research expenses; and refused a \$49,688 deduction for the depreciation of trademarks and tradenames for 1987-88.
 - Finally, Freddie accused the IRS of adding an “undetermined amount of interest for alleged underpayment of tax as a large corporation.”
- Moskal stated that the IRS had 60 days to respond to Freddie Mac’s petition. If no agreement is reached, the case may be appealed to the tax court. (*Washington Business Journal*, Jerry Moskal, 10/15/99; *Washington Business Journal*, William Ringle, 3/12/99)

The Conference Committee approved language on the financial services modernization bill (S. 900) that changes the capital requirements for the FHLBanks, among other things

Ten of the twelve FHLBanks reacted negatively to a provision that changes how the FHLBanks pay off a portion of the REFCORP bonds used to finance the S&L cleanup.

FHFB Chairman Bruce Morrison says that if the financial services modernization bill is enacted, he will withdraw the FHFB's controversial proposal that phases out the FHLBank System's arbitrage investments and implements a new risk-based capital standard for the FHLBanks.

Both the proposal and S. 900 would change the FHLBanks' capital structure (although in different forms)

Opponents of FHFB's controversial proposal were not successful in including language in the final HUD-VA Appropriations bill mandating a one-year GAO study of FHLBank capital that would have effectively delayed the FHLBanks' capital proposal

Debate by the Conference Committee on the financial services modernization related to the FHLBank provisions sparked a commitment by House Banking Committee Chairman Jim Leach (R-IA) and Capital Markets, GSE Subcommittee Chairman Richard Baker (R-LA) to review the GSEs in general next year

- The financial services modernization Conference Report (S. 900), currently being circulated for signature by the conferees, changes the capital requirements for the FHLBanks, among other things.
- The Conference Report to S. 900 has the following provisions affecting the FHLBanks:
 - (1) The bill would change collateral requirements for the FHLBanks, allowing small business and agriculture loans to back financing. The bill would make it easier for institutions with less than \$500 million of assets to obtain FHLBank advances. Banks with less than \$500 million in assets may use long-term advances for loans to small businesses, small farms and small agri-businesses.
 - (2) The bill would establish a new, permanent capital structure of the FHLBanks. Two classes of stock are authorized, redeemable on 6-months and 5-years notice. FHLBanks must meet a 5% leverage minimum tied to total capital and a risk-based requirement tied to permanent capital. (The Conference Report thus included the House version of the financial services modernization (H.R. 10) which established a new capital structure for the FHLBanks. The Senate version (S. 900) called only for a General Accounting Office (GAO) study of possible revisions to the capital structure.)
 - (3) The bill would equalize the stock purchase requirements for banks and thrifts.
 - (4) Savings institutions would no longer be required to join the FHLBank system. Membership would be voluntary, freeing roughly 1,100 thrifts that have been required to purchase stock in the FHLBanks. Any member would be allowed to withdraw from the FHLBank System if the Federal Housing Finance Board (FHFB) decided that an institution's exit would not negatively affect the FHLBank System. Voluntary membership for Federal savings associations takes effect six months after enactment.
 - (5) The bill would change the way the FHLBanks pay off a portion of the REFCORP bonds used to finance the S&L cleanup. Instead of a set dollar figure, the FHLBanks would contribute a

flat percentage of income. The current annual \$300 million funding formula for the REFCORP obligations of the FHLBanks is changed to 20% of annual net earnings.

- (6) Governance of the FHLBanks would be decentralized from the FHFBS to the individual FHLBanks. Changes include the election of chairperson and vice chairperson of each FHLBank by its directors rather than the FHFBS, and a statutory limit on FHLBank directors' compensation. (*Gramm-Leach-Bliley Summary of Provisions of Financial Services Modernization Act; Wall Street Journal Interactive*, Dawn Kopecki, 10/12/99; *American Banker*, Barbara Rehm, 10/20/99)

- The following FHLBank amendments, however, were rejected by the Conference Committee on October 19:

- (1) An amendment offered by Congressman Paul Kanjorski (D-PA) providing for an economic development program in the FHLBank System. The Congressional Budget Office said the amendment would have required the Treasury Department to make direct loans to the FHLBanks to finance an economic development program. CBO estimated the Treasury would make loans of \$3.4 billion over the projected life of the program and that the federal government would incur subsidy costs of \$142 million over the 2000-2004 period. The CBO also estimated that there would be an additional cost to the federal government beyond the subsidy cost of the direct loans by the Treasury. "Government sponsorship of the FHLBs transfers a portion of their risk of insolvency to the federal government. The government would bear a portion of the increase in the risk of the system resulting from the decline in its capital and return on equity and the resulting greater uncertainty in its ability to attract and retain members."
- (2) An amendment offered by Congressman Kanjorski providing for the continued appointment of FHLBank Board chairperson and vice chairperson.
- (3) An amendment by Congressman Kanjorski that would reduce the FHLBank System's REFCORP contribution from 20% to 18.4%. This amendment was defeated 15 to 12.
- (4) An amendment offered by Congresswoman Maxine Waters (D-CA) to provide Community Development Financial Institutions (CDFIs) access to the FHLBank System. The amendment was defeated 14 to 12. (*House Banking Committee press release*, 10/19/99; *Dow Jones Newswire*, John Connor, 10/19/99; *Congressional Budget Office letter to Congressman Richard Baker (R-LA)*, 10/15/99)

- **John von Seggern, Executive Vice President of the Council of FHLBanks (represents 10 of the 12 FHLBanks) said the legislation represents an improvement over current law. "This is not what we would consider ideal, but it is an improvement," he said. "This is considerably more capital than Fannie and Freddie have to hold. Our members have to compete against Fannie and Freddie, and this puts them at a disadvantage."** (*American Banker*, Scott Barancik, Katharine Fraser, 10/19/99)

Debate on FHLBank provisions sparked a commitment by Members to review the GSEs next year

- During Conference Committee deliberations on S. 900, a commitment was made by House Banking Committee Chairman Leach and Congressman Richard Baker to begin a sweeping review of the GSEs next year. (At a recent AEI Conference on Fannie and Freddie, Congressman Baker indicated that he was considering introducing legislation on the GSEs next year.)

Ten of the twelve FHLBanks reacted negatively to the provision that changes how the FHLBanks pay off a portion of the REFCORP bonds used to finance the S&L cleanup.

- According to John L. von Seggern, Executive Director of the Council of Federal Home Loan Banks, directors of 10 of the 12 FHLBanks reacted negatively to the provision in the financial services modernization that changes the FHLBanks' REFCORP obligation from a flat \$300 million payment to a 20% of annual earnings. The council represents 10 of the 12 FHLBanks (does not include the FHLBanks of Chicago and New York). The Council of FHLBanks had reportedly sought 18.4% as the payment ratio. "We're talking a huge increase," stated von Seggern. "We're just disappointed," he stated. Brian Smith, Director of Policy and Economic Research at America's Community Bankers said the good news was that the REFCORP obligation would be paid off sooner, laying the groundwork for increased dividends to member banks and thrifts in the future. President of the FHLBank of New York Alfred DelliBovi stated the benefit was similar to homeowners paying off their mortgages earlier. "It's good news in the short term and better news overall," he said. "Get the burden off our backs earlier." (*American Banker*, Katharine Fraser, 10/28/99)

FHFB says if financial services modernization bill is enacted – FHFB will withdraw its capital structure and investment management proposal (currently out for public comment)

- FHFB Chairman Bruce Morrison sent a letter to Senate Banking Committee Chairman Phil Gramm (R-TX) and House Banking Committee Chairman Jim Leach (R-IA) on October 18 saying that if the financial services modernization bill was enacted, the FHFB would withdraw its proposal out for public comment that would overhaul the capital structure and investment management of the 12 FHLBanks. (Proposal is known as the Financial Management and Mission Achievement regulation – FMMA.) Either the financial services modernization bill or the FMMA proposal would change the FHLBanks' capital structure, though the two differ in detail. However, the FHFB would need to issue rules governing the new collateral provisions, Morrison stated. A bank borrowing from the FHLBank System would probably have to put up more small-business and farm loans than if it pledged real-estate backed loans as collateral. (*American Banker*, Scott Barancik, Katharine Fraser, 10/19/99; *National Mortgage News website*, posted 10/19/99)
- In his letter, Morrison acknowledged that there was "substantial concern" over the FMMA proposal and wrote, "Unfortunately, this legitimate concern regarding a far-reaching regulatory initiative has resulted in a proposal for a statutory moratorium on our regulatory authority. Despite the best efforts of well-meaning advocates, such statutory language can only lead to serious ambiguity and potential litigation over the independent regulatory authority of the Finance Board." In his letter, Morrison said the FHFB would "take no action to promulgate proposed or final regulations limiting assets or advances beyond those currently in effect," except as is necessary to protect the safety and soundness of the FHLBank System, until capital rules have become final. (*Capital Markets Report*, John Connor, 10/18/99; *FHFB Chairman Bruce Morrison letter to Senator Gramm and Cong. Leach*, 10/18/99)
- America's Community Bankers, which urged the FHFB to delay the proposal, welcomed Morrison's decision to withdraw the FHFB's controversial proposal. "It is our feeling that there is no need to address this now in the legislation," said ACB's Robert Davis. (*American Banker*, Scott Barancik, Katharine Fraser, 10/19/99; *National Mortgage News website*, posted 10/19/99)

Background on FHLBanks' controversial proposal

- The FHFB published its controversial proposal in the *Federal Register* on September 27. The proposal would phase out the arbitrage investments of the FHLBank System and establish a new risk-based capital requirement for the FHLBank System. Comments on the proposal are due on or before December 27, 1999. The FHFB's proposal phases out and eventually eliminates the FHLBanks' arbitrage activities. The proposal was likely made in response to criticisms from the Treasury and

Congress for the FHLBanks' arbitrage activities and investments - specifically, using its implied government guarantee from its GSE status to borrow heavily at preferential rates and then investing the proceeds in higher yielding instruments that are often unrelated to the system's mission of assisting housing and community development. After a five-year transition period, the proposal requires that 100% of what the FHLBank System borrows in the capital markets must be used to finance core mission activities in support of broadly defined housing and community development missions. Under the proposal, the 100% standard would be effective January 1, 2005.

- The FHFB proposal would also change the FHLBanks' capital requirements with plans to create a risk-based capital requirement for the FHLBanks based on credit risk, market risk, and operations risk. The FHFB stated that the proposed requirements would be created from historical credit loss experience, stress tests using interest-rate scenarios over a 20-year period, and the stress test scenarios developed by OFHEO recently for Fannie and Freddie. The FHFB stated that the proposed minimum capital to assets requirement of 3 percent is greater than required by statute for Fannie and Freddie (2.5%) and equals the minimum tier 1 capital required by primary bank regulators for banks without supervisory concerns. (*Federal Register*, 9/27/99, pages 52148-52210; *BNA Daily Report for Executives*, Eileen Canning, 7/29/99, 9/29/99; *Dow Jones Newswire*, John Connor, , 7/28/99, 9/22/99, 9/27/99, 9/28/99; *FHFB Fact Sheet, Proposed Financial Management and Mission Achievement Regulation*, 7/28/99; *National Mortgage News website*, posted 7/28/99)

Opponents of FHFB's controversial proposal were not successful in including language in the final HUD-VA Appropriations bill mandating a GAO study of FHLBank capital that would effectively delay the FHLBanks' capital proposal

- Opponents of the FHFB risk-based capital proposal were not successful in getting an amendment added to the final HUD-VA Appropriations bill that mandates a one-year GAO study of possible revisions to the FHLBank capital structure. The FHLBank study amendment was reportedly offered by Senator Chris "Kit" Bond (R-MO) and was considered a placeholder for a possible moratorium amendment. (*National Mortgage News website*, posted 9/27/99)
- Senator Bond, however, agreed to delete the language on the one-year GAO study of the FHLBanks' capital and the language was not included in the final HUD-VA Appropriations bill that was signed by the President on October 20.

Congress approves 22% budget increase for Fannie & Freddie's safety and soundness regulator (OFHEO) for FY 2000

Senate Banking Committee Chairman Phil Gramm (R-TX), the Clinton Administration, Chairman of the House Banking Capital Markets Subcommittee Cong. Richard Baker (R-LA), consumer advocate Ralph Nader, and Fannie/Freddie watchdog group, FM Watch, all supported the 22% increase

- Congress approved a 22% budget increase for Fannie and Freddie's safety and soundness regulator – the Office of Federal Housing and Enterprise Oversight (OFHEO). OFHEO's budget was increased from \$16 million to \$19.5 million for FY 2000. The budget increase was included in the HUD-VA Appropriations Conference Report (H.R. 2684) that passed the House on October 14, the Senate on October 15, and was signed into law by President Clinton on October 20.

- As reported in previous *GSE Reports*, Senate Banking Committee Chairman Phil Gramm (R-TX), the Clinton Administration, Chairman of the House Banking Capital Markets Subcommittee Cong. Richard Baker (R-LA), and consumer advocate Ralph Nader all supported the 22% increase.
- The Fannie/Freddie watchdog group, FM Watch issued a press release applauding the House for fully funding OFHEO at \$19.5 million. “OFHEO plays a critical role in regulating Fannie Mae and Freddie Mac, the two biggest and fastest growing government subsidized enterprises around,” said Mike House, Executive Director for FM Watch. “Increasing OFHEO’s funding was a wise decision and it was in the best interest of the taxpayer.” (*FM Watch press release, 10/14/99*)

Fannie Mae and Freddie Mac

OFHEO (Fannie & Freddie’s safety and soundness regulator) extends comment period on its risk-based capital proposal for Fannie & Freddie until March 10, 2000

This is the second extension of the comment period

The original deadline for implementing the risk-based capital proposal on Fannie & Freddie was December 1994. With the new comment period extension, the timetable for implementation will likely be 2002 (8 years later).

Fannie, Freddie, the Mortgage Bankers Association (MBA) and the Mortgage Insurance Companies of America (MICA) all requested comment period extensions

- The Office of Federal Housing Enterprise Oversight (OFHEO) announced that it was extending its public comment period for its risk-based capital proposal for Fannie and Freddie until March 10, 2000. This is the second extension of the comment period and brings the total comment period for the proposal to 11 months. OFHEO first issued a copy of the proposal on April 13, 1999 with a comment period ending on August 11, 1999. OFHEO then extended the deadline until November 10, 1999. The March 10, 2000 deadline is the second extension. OFHEO said it received extension requests from Fannie, Freddie, the MBA, and MICA. Fannie and Freddie both asked OFHEO to push back the November 10 deadline by 120 days to March 9, 2000 and MICA asked for a three-month extension to February 11, 2000. The deadline could result in moving the timetable for implementing the risk-based capital standard on Fannie and Freddie back to 2002. (*OFHEO press release, 10/14/99; Federal Register, pages 56274-56275, 10/19/99; BNA Daily Report for Executives, 10/5/99*)

Background

- OFHEO was created by Congress in 1992 and was tasked by Congress to create a risk-based capital rule for Fannie and Freddie to be completed by December 1994. OFHEO has been working five years on the proposal. At issue, the risk-based capital proposal would determine the amount of capital Fannie and Freddie would be required to set aside to remain solvent during a 10-year period of severe credit and interest rate stresses. The risk-based capital proposal would not go into effect until OFHEO hears public comments and gives Fannie and Freddie a year to comply with the new standards.

MBA's new President Kit Sumner says GSEs are one of his primary worries and thinks HUD should intervene and referee the conflict between the mortgage industry and the GSEs

MBA's outgoing President Donald Lange says one of the most exciting aspects of his tenure at the MBA was working to "push back" Fannie & Freddie

Incoming President says GSEs are one of his primary worries

- According to a *National Mortgage News* article by Lew Sichelman, the Mortgage Bankers Association's new President Christopher "Kit" Sumner listed the economy, technology, the government-sponsored enterprises, consolidation and government regulation as his primary worries. Sumner notes that Fannie and Freddie are "locking horns" with the mortgage banking industry on "the fungibility of the automated underwriting certificate." **He believes that Fannie and Freddie are "pushing the frontier" of electronic loan approvals by "auctioning" loans which brings into question "the sovereignty of the seller-servicer."** "They are saying that their underwriting expertise is at such a high level that their assessment of risk is better. If you follow that logic, than the next step would be to lower their requirements so brokers could become seller-servicers, and I have difficulty reconciling that."
- Sumner thinks that at some point, HUD will have to intervene and referee the conflict with the GSEs and wonders why HUD has not already exerted its influence. "HUD is the court of last resort for housing," he stated. "It has tremendous authority, but there's this huge controversy going on and where are they? At some point, HUD has got to deal with the issue. Either that, or assign all of its regulatory oversight to the Office of Federal Housing Enterprise Oversight or another regulator."(*National Mortgage News*, Lew Sichelman, 10/11/99)

Outgoing President says GSE issue was one of the two most exciting aspects of his tenure at the MBA

- According to a *National Mortgage News* article by Lew Sichelman, outgoing MBA President Donald Lange says that the two "most exciting aspects" of his year at the MBA were instituting the MBA's new strategic plan and working to "push back" Fannie and Freddie. Lange said the issue "came to a head" earlier this year when Fannie and Freddie began engaging each other in a game of "competitive one-upmanship." "We had been working very, very hard with Fannie Mae – and making some progress – about preserving the role of the mortgage banker when Freddie Mac began taking steps we saw as moving towards creating direct ties to mortgage brokers," Lange stated. "To use a bridge term, we had to jump-shift. We had to change our strategy, and the whole thing boiled over. The bidding got hot and heavy." Lange said Fannie is "pretty good at listening to the concepts we talk about. It's far more open and available to the MBA." Freddie is "still trying to catch up" to Fannie, he said and therefore "doesn't want to be fettered in any way."
- Lange does not see the issue of reigning in the GSEs going away, but says that if the various factions can't come to an agreement then he believes Congress will decide for them. Lange said the MBA doesn't have the backing it needs on Capitol Hill to control Fannie and Freddie, however, support for their position is building. "These are two very formidable groups," he stated. "But several members of Congress are quite concerned." (*National Mortgage News*, Lew Sichelman, 10/1/99)

***National Mortgage News* column by Paul Muolo raises interesting points on Fannie & Freddie –
“Who Would You Rather Trust: GSEs or Wall Street?”**

Muolo states, “Fannie Mae spokespeople like to argue that Fannie Mae is pro consumer and is only trying to reduce housing costs for consumers...But Fannie Mae also forgets that for every dollar it saves the consumer...not all of that savings is being passed on to the consumer. Fannie Mae runs a business and when it supposedly saves the consumer money it is putting some of that ‘saved money’ into its own pocket as well. After all, if it really wanted to save the consumer money it would donate all of its profits to homebuyers so they can use the cash for a much-needed downpayment.”

- *National Mortgage News* columnist Paul Muolo made a number of interesting points in his new column:
- He noted that “When it comes to a credit crisis the mortgage industry is better off doing “The Twist” with the GSEs than tangoing with Wall Street...That’s not to discount the recent complaints against Fannie and Freddie. There are indeed real issues here: mortgage insurance and risk, open architecture, wet funding, AU [automated underwriting] systems, guarantee fees, subprime purchases and so on. **Fannie Mae spokespeople like to argue that Fannie Mae is pro consumer and is only trying to reduce housing costs for consumers...But Fannie Mae also forgets that for every dollar it saves the consumer – in MI [mortgage insurance] for example – not all of that savings is being passed on to the consumer. Fannie Mae runs a business and when it supposedly saves the consumer money it is putting some of that ‘saved money’ into its own pocket as well. After all, if it really wanted to save the consumer money it would donate all of its profits to homebuyers so they can use the cash for a much-needed downpayment.”**
- Muolo suggests that “**The best way for Fannie and Freddie to end the current squabble is...split their firms in two. Have one side of the business with a government-charter that sticks to providing liquidity to the conventional market.**” (*National Mortgage News*, Paul Muolo, 10/11/99)

Despite record profits by Fannie & Freddie, their stock has fallen because of investor concerns over: (1) rising mortgage interest rates; (2) increased political risk; (3) fears that portfolio growth [primary way Fannie & Freddie make money] have topped out; and (4) worries about possible price wars between the two GSEs

**Fannie & Freddie announce record third quarter earnings, yet
Fannie’s stock has fallen 15% & Freddie’s 19% for the year**

Fannie & Freddie’s double-digit earnings are due, in large part, to an aggressive move into non-traditional areas, such as home equity and manufactured housing loans, analysts said.

Falling stock prices have led Fannie & Freddie to resort to unconventional methods – like Fannie’s Timely Payments Reward product for subprime market – in order to appease investors

The formation of Fannie/Freddie watchdog group FM Watch and a new Congress with a perceived different attitude has created political uncertainty for the GSEs. “This has kept investors away from purchasing Fannie Mae and Freddie Mac stocks. All are more aware of political risk to the agency’s expansion plans that didn’t exist a year ago,” said one Wall Street analyst who wished to remain anonymous.

**Rising interest rates caused Fannie's loan purchases and commitments to plummet in September –
Fannie's purchases fell to the lowest level in 19 months**

- According to an article by Frank Musero in the *Mortgage-Backed Securities Letter*, both Fannie and Freddie have had record strong profits during the first three quarters of 1999, however their stocks have plummeted, resulting from rising mortgage interest rates and increased political risk.
- According to an article by Janet Morrissey with *Dow Jones Newswire*, “Rising interest rates, fears that portfolio growth at Fannie and Freddie had topped out, worries about possible price wars breaking out between the two government-sponsored agencies, and political issues made investors jittery in the quarter.” Morrissey and Musero both point out, however, that analysts believe many of those concerns are overblown.

Record earnings by Fannie & Freddie for third quarter – Earnings driven by aggressive move into non-traditional areas and growth in retained portfolio

- Fannie has posted increased earnings every quarter for the past 12 years, including a third-quarter increase of 94 cents per share, up 16% over third quarter 1998. Freddie announced increased earnings of per common share of 75 cents per share for the third quarter, up 29% over third quarter 1998.
- **Fannie and Freddie's double-digit earnings are due, in large part, to an aggressive move into non-traditional areas, such as home equity and manufactured housing loans, analysts said. Credit Suisse First Boston analyst David Dusenbury estimates that 25% to 30% of all purchases made by Fannie and Freddie in the third quarter were comprised of non-traditional higher margin assets, such as home equity, manufactured housing, certain subprime, and multifamily housing loans, rather than their traditional AAA credit, tight-margin mortgages.** Salomon Smith Barney analyst Tom O'Donnell dismisses concerns that Fannie and Freddie are dangerously increasing their risk profiles. “Mortgage pricing and risk is their business,” he said. All mortgages are priced for risk and this would simply expand their product mix into underserved areas, he said. **O'Donnell estimates that Fannie's retained portfolio grew by about 26% on an annualized basis in the third quarter while Freddie's increased about 16%.**

Record earnings yet stock has fallen

- Fannie and Freddie's stock, however, has fallen 12% and 19%, respectively while other financial stocks are soaring. Standard & Poor's Ratings Group's Financial Miscellaneous index is up 11% for the year. According to an article by Joshua Brockman at the *American Banker*, so far as of September 30, Fannie's stock has fallen 15% and Freddie's stock is down 19% for the year.
- Musero notes that rising interest rates has led to a perception that homebuyers have stopped refinancing mortgages, leaving fewer loans for the companies to purchase – causing the GSEs' stocks to tumble. Analysts, however, indicate this downturn in stock value will be short-lived and there is little concern that rising interest rates will have a devastating impact on Fannie and Freddie's earnings. In a separate article by Joshua Brockman with the *American Banker*, however, he reported that Freddie's shares fell 4.5% on October 19 after the company's earnings report that raised concerns about Freddie's net interest margin and fell shy of the First Call Corp. analyst consensus. Although Freddie announced a 29% gain in earnings per share of 75 cents, First Call's calculations on Freddie found that Freddie's results were actually 74 cents per share (a penny short of consensus estimates). Freddie attributed its decline in net interest margin – the difference between the yield on its assets and

the cost of its liabilities – to rising interest rates and a move to restructure its short-term financing. The net interest margin of 0.76% was off from 0.83% in the second quarter and 0.90% last year.

- Musero further writes that rising interest rates and the total production of mortgages decreasing has led Fannie and Freddie to resort to unconventional methods – like Fannie’s new Timely Payment Rewards product (subprime) – to ensure that they will keep purchasing loans and expanding business ventures.

Political risk to GSEs greater

- **Musero points out that the formation of Fannie/Freddie watchdog group FM Watch and a new Congress with a perceived different attitude has created political uncertainty for the GSEs. “This has kept investors away from purchasing Fannie Mae and Freddie Mac stocks. All are more aware of political risk to the agency’s expansion plans that didn’t exist a year ago,” said one Wall Street analyst who wished to remain anonymous. (Mortgage-Backed Securities Letter, Frank Musero, 10/18/99; American Banker, Joshua Brockman, 10/1/99, 10/20/99; Dow Jones Newswire, Janet Morrissey, 9/30/99; Fannie press release, 10/13/99; Freddie press release, 10/19/99)**

Rising interest rates caused Fannie’s loan purchases and commitments to plummet – Fannie’s new business fell to the lowest level in 19 months

- Rising interest rates took a bite out of Fannie’s loan purchases in September. Fannie’s loan purchases fell to a 19-month low last month, the *National Mortgage News* reported. The GSE reported only \$35.46 billion of new loans purchased in September 1999, down 17% from August, 1999 and down 23% from September 1998. In addition to low loan purchases, Fannie only had \$7.4 billion net commitments to purchase mortgages, down 58% from August 1999. Fannie’s purchases include \$15.2 billion in loans purchased for its portfolio, and \$20.26 billion in product that was securitized. The *National Mortgage News* cited rising interest rates as the cause for Fannie’s low purchases and commitments, and said they “come as no surprise to lenders that are seeing refinance activity virtually dry up.”
- Fannie released these numbers along with their third-quarter earnings. The article noted that although Fannie’s earnings were strong, its stock was only trading at just four points above its 52-week low of \$58.56. Analysts predict that Fannie will continue to do well because it has a large portfolio of mortgages and securities that are less apt to run-off in a rising interest rate environment. However, declining loan purchases will result in weaker guarantee fee income. At the end of the quarter, Fannie’s portfolio was \$504.3 billion. (*National Mortgage News*, 10/18/99)

Fannie & Freddie dramatically increase their purchases of adjustable-rate mortgages

- According to an *American Banker* article by Joshua Brockman, both Fannie and Freddie dramatically increased their purchases of adjustable-rate mortgages in September. Freddie bought \$3.5 billion of ARMs in September, up from \$1.9 billion in August and \$910 million in September of last year. Freddie’s Deputy Chief Economist Frank Northaft said Freddie has changed its portfolio mix to reflect an increase in ARMs’ share of the conventional single-family market, to 30% in August, from 8% in October. Fannie purchased \$1.6 billion of ARMs in September, up from \$454 million in September of 1998. (*American Banker*, Joshua Brockman, 10/22/99)

The GSEs and MBA have difficulty smoothing out differences

Fannie & Freddie's comments at the MBA conference do not alleviate lenders' concerns

- In the October 18, 1999 edition of *National Mortgage News*, Lew Sichelman reported on the feud between the Mortgage Bankers Association (MBA) and Fannie and Freddie over the GSEs' possible entry into the mortgage origination business. According to Sichelman, the rift escalated during the MBA's recent conference in Boston, despite assurances from both Fannie CEO Franklin Raines and Freddie CEO Leland Brendsel that the GSEs have no plans to usurp the lenders' business.
- At the MBA conference, Brendsel and Raines both went on the record as saying the GSEs do not plan on originating mortgages. However, noted Sichelman, both also touted advancements in their expanding automated underwriting programs. Brendsel said that Freddie has made its automated underwriting system available to more than 4,000 "small lenders and brokers." Raines boasted that Fannie is placing its network on the Internet so that they "can be everywhere you are." However, Raines also said that "we know what your role is and we know what our role is," adding that Fannie will meet its earnings targets not by eating lenders' lunches, but by helping them expand their market shares "so you can sell more loans to us."
- MBA members do not agree with the GSEs' assertions and believe that the GSEs are moving too close to the point-of-sale, noted Sichelman. He quoted new MBA President Kit Sumner as asking "**Are we seeing the first step by Fannie and Freddie by taking the underwriting decision out of our hands by going direct to the broker? . . . Will underwriting become fungible?**" MBA officials are also concerned that the GSEs' practices will place the "sovereignty of the seller-servicer at risk" and will "perpetuate the predominance of the GSEs' proprietary technology systems. Inhibiting competition and stifling innovation." Executive Vice President of the MBA, Paul Reid, stressed that the MBA is not opposed to technological advancements, but is concerned that seller-servicers will be without protections from fraudulent loans even when they do not have a say in the loan approval process. "**Our greatest concern is that loan approvals don't become an auction process. . . That puts all the emphasis on price and speed, and quality checks go out the window.**"
- The MBA is not ready to wage full war on the GSEs, noted Sichelman. He quoted Reid as saying that some members of the MBA were ready to take their concerns to Congress, but that the MBA hopes its recent GSE policy statement will bring some order to a discussion with the GSEs. Reid asserted that the MBA's statement is more than "just a bunch of words," and he noted the MBA plans on developing "action steps" in order to meet their objectives. Sichelman noted that one step is to bring federal regulators into the GSE debate. MBA president Sumner is quoted as stating, "**where is HUD in this boundary issue of what the GSEs can or can't do?**" Another step would be to open up the GSEs' automated underwriting systems to a third party. Paul Reid noted, "**we're really blind about what's in their black boxes, and that's not a good defense with regulators... We don't think the 30,000-foot view is enough. We need a safe harbor. And maybe when we get down into them, we can make some improvements.**" (Lew Sichelman, *National Mortgage News*; 10/18/99)

Foreign investors are selling their US Treasury holdings and shifting into riskier corporate and agency bonds (e.g., Fannie, Freddie, Ginnie Mae)

However, the recent weakness of the dollar may be more dangerous to the struggling markets for these riskier bonds than to the Treasury market or even the US stock market because corporate and GSE bonds are more dependent than Treasury on foreign investors

For Japanese banks, US agency securities offer an accounting advantage over Treasuries

In related news, more than half of Freddie's recent \$5 billion reference note was placed overseas

Fannie said it plans to offer over \$50 billion of benchmark securities next year – Fannie sells more notes and bonds than anyone except the Treasury

- Foreign investors are selling their US Treasury holdings and shifting into corporate and agency bonds with higher yields, though the dollar's recent weakness may increase the risk of these securities. In the 12 months ending July 31, foreign investors were net sellers of \$8.9 billion of Treasuries. "Foreigners are still very important for the US markets, but there's been a big, big change – they don't want anything to do with Treasuries," said James Bianco, President of Bianco Research LLC. According to a *Wall Street Journal* article by Gregory Zuckerman, "the good news is that rather than taking their money home, the foreign investors are flocking to riskier corporate or agency bonds. The bad news is that the recent weakness of the dollar may now be more dangerous to the struggling markets for these bonds than to the Treasury or even the US stock market." Zuckerman notes that new data suggests that the market for corporate, high-yield (or junk), mortgage-backed and agency bonds may have more to lose than the US Treasury market if the dollar continues to falter, because purchasing by foreign parties of these types of bonds has become more important. Because markets for these riskier bonds have been weak in recent months – any shift in foreign buying could cause real damage. (*Wall Street Journal*, Gregory Zuckerman, 10/7/99; *Bloomberg*, 10/7/99)

US agency securities offer Japanese banks an accounting advantage

- According to a *Wall Street Journal* article, US agency securities offer Japanese banks an accounting advantage over Treasuries. Japanese banks are required to mark holdings of US Treasuries to market, or adjust the stated value of the securities for fluctuations in prices – which is not the case for non-Treasury securities. Shunichiro Totsuka, Portfolio Manager at Bank of Tokyo-Mitsubishi in New York said that the accounting advantage is a key reason major Japanese banks have cut US Treasuries holdings to around 10% to 20% of US bond holdings from more than 50% three years ago. (*Wall Street Journal*, Sonoko Setaishi and Shella Calamba, 10/4/99)

More than half of Freddie's recent reference note issue was placed overseas

- Freddie's recent \$5 billion reference note offering was more than \$1 billion more than Freddie had earlier announced due to a recent surge in demand by overseas buyers for agency debt. According to Freddie, more than half of the note was placed overseas, and about 85% of all sales were done in cash. (*Dow Jones Newswire*, Shella Calamba, 10/13/99)

Fannie plans to offer over \$50 billion of benchmark securities next year

- According to an *American Banker* story (attributed to *Bloomberg*), Fannie said it plans to sell more than \$50 billion of its benchmark notes and bonds next year. The article noted that Fannie sells more notes and bonds than anyone except the Treasury. Fannie reportedly also announced a schedule for

next year's sale to make its borrowing as predictable as the Treasury. Fannie said it may sell bonds through Dutch auctions (sellers gradually reduce their prices until a responsive bid is made). Fannie has sold approximately \$98 billion of benchmark notes and bonds since the program's inception in January 1998. (*American Banker*, 10/22/99 (attributed to *Bloomberg News*))

Fannie & Freddie add new products that expand their technology beyond their core mission area of conforming mortgages

Fannie and PMI Mortgage Insurance announce approval of automated underwriting for veterans' loans using Fannie's automated underwriting technology system

Fannie releases new version of its automated underwriting system technology that will enable lenders to underwrite construction loans, home improvement loans, and other products

Fannie announces its automated underwriting system will be available over the Internet – Fannie says MORNETPlus.com will make Fannie's website “the leading web portal for the mortgage finance industry's business-to-business transactions and services” [Editorial note: With announcements such as these, how can Fannie deny that it is using its technology to control the origination process?]

Fannie adds appraisal and flood information from Chicago Title to its automated underwriting technology system

Freddie announces that users of its automated underwriting technology system will now have more credit reporting companies from which to choose

Fannie and PMI Mortgage Insurance announce approval of automated underwriting for veterans' loans using Fannie's automated underwriting technology system, Desktop Underwriter

- Once Fannie receives a final Statement of Understanding from the US Department of Veteran's Affairs, Fannie's automated underwriting system, Desktop Underwriter for VA loans, will be available for commercial use by lenders. The system, made available to pmiAURA licensees, will be available to lenders in mid-November. Ten lenders participated in the pilot, including: Centant Mortgage, Corinthian Mortgage, Crossland Mortgage, GMAC, Guaranty Bank/Shelter Mortgage, HomeSide Lending, Irwin, Navy Federal Credit Union, NatCity, and Prism Mortgage. (*Business Wire*, 10/12/99)

Fannie releases new version of its automated underwriting system technology that will enable lenders to underwrite, construction, home improvement and other products

- Fannie announced that it had enhanced its automated underwriting technology system to allow lenders to underwrite HomeStyle home improvement mortgages, construction mortgages with one-time closing, and other “market expansion” products. The newest version – Desktop Underwriter 4.5 – enables lenders to take advantage to modifications to mortgage insurance requirements, enhanced bankruptcy and foreclosure policies, and additional credit providers.

- (1) HomeStyle home improvement loans – Lenders can use Fannie's system to underwrite HomeStyle mortgages for one- to four-unit owner-occupied, and one-unit second-home and investment properties for both purchase and refinance transactions.

- (2) One-time closing construction mortgages – Lenders can offer borrowers a one-time construction transaction, which enables the borrower to finance the construction phase of the loan with a modification to permanent financing when the construction is complete
- (3) Modified mortgage insurance requirements – The newest version of Desktop Underwriter no longer requires mortgage insurance for any mortgages with loan-to-value ratios of 80% or less, including mortgages secured by two- to four-unit properties, second homes, or investment properties. (*Fannie press release, 9/27/99*)

Fannie announces its automated underwriting system will be available over the Internet – Fannie says MORNETPlus.com will make Fannie’s website “the leading web portal for the mortgage finance industry’s business-to-business transactions and services” [Editorial note: With announcements such as these, how can Fannie deny that it is using its technology to control the origination process?]

- Fannie announced MORNETPlus.com, a multi-phase project designed to provide lenders Internet access to automated underwriting systems and other single-family mortgage transaction services. During the pilot 30 lenders and their originators can log onto Fannie’s website (www.FannieMae.com) click on MORNETPlus.com and access Fannie’s Desktop Originator for instant, point-of-sale underwriting recommendations over the Internet. In future phases, lenders will also be able to access Desktop Underwriter and other services. (*National Mortgage News website, posted 10/12/99*)
- [Editorial note: Fannie calls its MORNETPlus an “Open System” because it allows for unlimited access to any automated underwriting system on Fannie’s MORNETPlus system not just Fannie’s automated underwriting system. However, Fannie controls the final decision as to which of the competing automated underwriting systems are on their system, and on what terms. Fannie calls this system “OpenAccess,” however, Fannie is in charge of access and fees to the pipeline and still requires products like Flex 97 to be run through its automated underwriting system only. This is contrary to the MBA’s recent policy statement on the GSEs that states that the GSEs should not tie their technology to products. (*MBA GSE Policy Statement, 8/10/99*)]

Fannie adds appraisal and flood information from Chicago Title to its automated underwriting technology system

- Fannie and Chicago Title Corp. have entered into a partnership in which both companies will enable lenders to obtain appraisal and flood information, and credit transactions electronically through Fannie’s MORNETPlus and Chicago Title’s Electronic Spine. By accessing Fannie’s MORNETPlus network, lenders will be able to receive appraisal and flood certificates, as well as other services from Chicago Title. Chicago Title’s single source, nationwide mortgage settlement service called CastleLink is designed for customers that require multiple services on a national scale. CastleLink provides credit, flood, appraisal, property valuation, title, document preparation, escrow and closing services through Chicago Title’s Electronic Spine. The Electronic Spine allows customers to order, track, and receive all products with a single connection. (*National Mortgage News, 10/11/99; Fannie press release, 9/22/99*)

Freddie announces that users of its automated underwriting technology system, Loan Prospector, will now have more credit reporting companies from which to choose

- Users of Freddie’s automated underwriting technology system, Loan Prospector, that select the “merged credit report” option during the automated underwriting process will now have more credit reporting companies from which to choose. Under a new program, the five companies directly supplying the credit reports (CBC Cos, Chicago Title Credit Services, Equifax Mortgage Services,

Factual Data Corp., and First American Credco) can now contract with any credit reporting company willing to sign a technical affiliate agreement. The new options are also available on Loan Prospector on the Internet, which Freddie says is the only automated underwriting technology system that has been approved by all three national credit repositories for online transmission of credit reports. (*National Mortgage News website*, posted 10/4/99)

Fannie Mae

Critics blast Fannie's new Timely Payment Rewards mortgage product that allows Fannie to expand into the subprime (A-) market

The National Home Equity Mortgage Association (NHEMA) says the product is beyond Fannie's mission, will drive up costs for consumers (particularly the B&C market), and increase the potential for a taxpayer bailout

Investors and traders are concerned with Fannie's new program because it could increase the risk of loan defaults and prepayments, making it more difficult to predict the rate of interest and principal payments used to establish the securities' values – The Bond Market Association says it “does represent a threat to the continued integrity of the market”

Paine Webber notes that Fannie's new product will mean less business for companies that are primarily subprime lenders

Paine Webber analysts also notes that an economic downturn might lead to greater credit worry about the inclusion of poorer credit loans in Fannie's pools

At the same time Fannie enters subprime market, the FDIC Chief recommends tighter capital rules for FDIC insured institutions that engage in subprime lending because it is a high-risk activity. [Editorial note: Fannie & Freddie hold less capital than fully private financial institutions. Risk to the taxpayers increases as the GSEs engage in riskier activities, but are not required to set aside more capital.]

Lenders must use Fannie's automated underwriting technology system, Desktop Underwriter, if they want to provide the product to consumers. [Editorial note: It is likely that Fannie will charge technology delivery fees when they offer this product – the GSEs' equivalent of a “tax on homeownership”.]

[Editorial note: This product is contrary to the Mortgage Bankers Association GSE policy statement that states that the GSEs should not tie their technology to products]

[Editorial note: There is a question as to whether Fannie's automated underwriting system is the best system available for subprime or credit-impaired borrowers since a study commissioned by HUD found that Fannie & Freddie's automated underwriting systems and use of credit scoring may have an unintended but adverse impact on borrowers with low incomes, limited wealth and poor credit histories]

Background on Timely Payment Rewards mortgage

- The product will allow Fannie to enter the subprime market by allowing borrowers with slightly impaired credit who do not qualify for a lower conventional mortgage to borrow under the program. Borrowers who qualify for the product will be able to obtain a mortgage rate as low as 2% lower than what credit-impaired borrowers typically pay, and will be guaranteed a mortgage rate reduction of 1% after 24 monthly payments without a delinquency. The product is currently a pilot program involving 26 banks in 15 markets.

NHEMA blasts the product

- “Fannie Mae is expanding its mission into areas where it has virtually no experience,” said NHEMA Executive Director Jeffrey Zeltzer. “Many borrowers will pay more, not less, for their mortgages. And taxpayers should be prepared for a bailout that could rival our savings and loan experience,” stated Zeltzer. He further stated that the program will cost Fannie its biggest losses ever and that the outcome will be that consumers with credit problems will “be back where they were 25 years ago – no access to mortgages or loans at all, other than loan sharks.” Fannie’s “intrusion” into the market would “freeze competitors out,” effectively eliminating the competition that keeps prices down.
- NHEMA’s outside counsel, Wright Andrews, argues that most of the subprime business involves refinancing consumer debt into a first or second mortgages, not financing purchase money mortgages. “Home equity subprime lending is not the GSEs’ mission,” he stated. “Congress never intended the government sponsored enterprises to get into it,” he added. “We view this entry as an attempt [by Fannie] to maintain their high profitability and high shareholder returns at the ultimate expense of the consumer and the taxpayer,” he stated. He further argues that Fannie is overstating the earnings it can bring to this market, and that its automated underwriting technology systems will not work well. “We think those systems will prove to be discriminatory against minorities and others,” he stated. (*National Mortgage News*, Karen Thomas, 10/11/99; *American Banker*, Hala Habal, 10/6/99)
- **Bear, Stearns & Co. analyst David Hochstim said criticisms of Fannie’s program stems from a general industry fear of expansion of Fannie and Freddie. “The reality is that Fannie and Freddie have a lower cost of funds and can survive with a lower yield,” he stated. “It’s difficult for most mortgage investors to compete with them for most products.”**

Investors and traders are concerned with Fannie’s new program

- According to *Bloomberg*, **Fannie’s new program is unsettling to investors because if these risky loans start showing up as collateral in the mortgage pools backing Fannie’s securities, that could increase the risk of loan defaults and prepayments, making it more difficult to predict the rate of interest and principal payments used to establish the securities’ values. “It does represent a threat to the continued integrity of the market,” said George Miller, Deputy General Counsel at the Bond Market Association.**
- According to a *Bloomberg* article, about \$150 billion in loans were made to borrowers with spotty or bad credit last year, and Fannie estimates that about \$35 billion of that would have been available for it to purchase under its new program. Fannie guaranteed \$722 billion in mortgage securities last year. If those loans were included, they would have made up 4% of the loans backing Fannie mortgage securities issued last year. Freddie is already buying riskier home loans and including them in its regular mortgage securities. Freddie has estimated that it will purchase \$10 billion of such mortgage loans this year. (*Bloomberg*, 10/4/99)

- Alt-A and subprime loans have different credit profiles than traditional conforming product and can skew the weighted average coupon of a pool because they carry higher rates, said Amitabh Arora, Vice President of Mortgage Research at Lehman Brothers. Arora notes that “Initially, Alt-A and subprime loans will be slower to refinance,” and adds that he would like information on the guarantee fee that the agencies charge on each loan because those fees will have higher prepayment implications. Michael Hoeh, Senior Portfolio Manager at Dreyfus Corp. warned that “should the credit environment turn and residential defaults rise, the Alt-A and subprime loans will be the first to default.” (*Dow Jones Newswire*, Sara Landis, 10/6/99)
- **“I think this is a terrible thing,” said one Wall Street observer. “The wide acceptance of the passthrough market, its liquidity, its huge number of committed and occasional players alike are all owed fundamentally at bottom that we are able to understand, model and somewhat control the risk regarding prepayments. The comfort level with prepayments is threatened when they start changing the collateral.” [Editorial note: Fannie core mission of providing liquidity to the secondary market seems to be jeopardized by this program.]**
- “Though on a passthrough it won’t make a big difference,” said another mortgage-backed securities Wall Street source, “when you leverage it into IO’s [interest only], PO’s [principle only], super PO’s and inverse-IO’s, it begins to increase the level of uncertainty, and from our perspective, that is not a good thing.”
- Talks have reportedly taken place between the Bond Market Association and Fannie to limit the amount of Timely Payment Reward loans to no more than 10% of TBA (to-be-announced) pools. However, some observers don’t buy it. “This is just disingenuous to say this 10% doesn’t change the prepayment characteristics of collateral,” said a Wall Street source that chose to remain anonymous. “But given the politics of this market and the weight of those entities, their power is lobbying, they have organizations in Congress and so forth. That housing capital is already available for these borrowers, and we don’t need Fannie Mae or Freddie Mac to do it, especially since, over time, they crowd out truly private players...Perhaps it makes that A-minus loan a little cheaper, but it doesn’t make it that much cheaper, because they charge for it.” (*Mortgage-Backed Securities letter*, Adam Tempkin/Frank Musero, 10/11/99)

Paine Webber comments about Fannie’s program

- A *National Mortgage News* article by Bonnie Sinnock reported that Paine Webber researchers believe that Fannie’s new subprime program - the Timely Payment Rewards mortgage – **“will mean less business for companies that are primarily subprime lenders (and are not approved as Fannie Mae seller-servicers).”** The researchers further noted that the program would also create a narrowing of the credit grade spectrum involved in subprime originations. Although, as Paine Webber points out, the percentage of the lowest credit grade “Timely Reward” loans will be restricted to 10% of the loans in Fannie’s pools, however, the top two credit grades in the agency’s A-minus category will have no such restrictions. **The researchers noted that some of the credit quality concerns is mitigated by the fact that Fannie has its valuable implied government guarantee, however, the researchers added that there is a possibility of an economic downturn that might eventually lead to greater worry about the inclusion of poorer credit loans in these pools.** (*National Mortgage News*, Bonnie Sinnock, 10/11/99)

While Fannie enters the subprime market, the FDIC warns FDIC insured institutions about the risk of subprime lending

- Federal Deposit Insurance Corp. Chairman Donna Tanoue said that the FDIC will recommend changing the risk-based capital system to reflect the hazards associated with subprime lending. She said the FDIC has already asked several subprime lenders to raise capital. Speaking before a session at the American Bankers Association Conference, Tanoue said that “When not expertly managed...subprime lending has shown itself to be a high-risk activity that poses increased risk to the deposit insurance funds.” In an April Bulletin, the Office of the Comptroller of the Currency also acknowledged the unique risks associated with subprime lending and urged lenders to increase capital where appropriate. Tanoue, however, was the first regulator to recommend permanent revisions to the risk-based capital rules. (*American Banker*, Scott Barancik, 10/12/99)

Lenders must use Fannie’s automated underwriting technology if want to provide product to consumers

- According to an *American Banker* article by Joshua Brockman, Fannie’s new Timely Payment Rewards mortgage product for subprime credit-impaired borrowers is available only through lenders that use Fannie’s automated underwriting system, Desktop Underwriter, for originating loans. (*American Banker*, Joshua Brockman, 10/11/99)
- [Editorial note: This goes against the Mortgage Bankers Association policy statement on the GSEs that says the GSEs should not tie their technology to products. The MBA’s policy statement on the GSEs stated that the GSEs should not develop, distribute, or use technology in a way that: (1) bypasses their seller/servicers by going direct to the customers, or vendors of those partners, including, but not limited to consumers, owners/developers of housing, mortgage brokers, and other real estate professionals; (2) displaces or discourages innovation and development of competing systems by private enterprises; and (3) limits access or is a pre-condition for waivers of representatives and warranties or waivers of program and documentation requirements. (*MBA press release*, 8/10/99; *MBA GSE Policy Statement*, 8/10/99)]
- [Editorial note: There is a question as to whether Fannie’s automated underwriting system is the best system available for subprime or credit-impaired borrowers since a study commissioned by HUD found that Fannie and Freddie’s automated underwriting systems and use of credit scoring may have an unintended but adverse impact on borrowers with low incomes, limited wealth and poor credit histories.]

Fannie’s automated underwriting technology may be discriminatory

- **As reported in a previous *GSE Report*, an independent study commissioned for HUD by the Urban Institute found that that Fannie and Freddie’s underwriting guidelines may have an unintentional but adverse impact on borrowers with low incomes, limited wealth and poor credit histories which are “disproportionately minority.” 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 home buyers “by offering loan products with underwriting guidelines that are more flexible than the GSEs’ guidelines.”** 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. (*Wall Street Journal*, 4/30/99; HUD Study, “*A Study of the GSEs’ Single Family Underwriting Guidelines*,” April 1999)

A firm with Fannie stake (HomeStore.com) is buying 2 consumer websites

This despite Fannie’s assurances that they are not trying to circumvent lenders by going direct to brokers and consumers

- The *National Mortgage News* reported that Fannie may be moving closer to the loan origination process now that Homestore.com (in which Fannie owns a 4.5% stake) has purchased Homebuyer’s Fair, Inc of Scottsdale, Arizona, an Internet-based homeownership website. While the purchase of Homebuyer’s Fair by Homestore.com did not generate much press, “**it could fuel fears anew that Fannie Mae may one day try an end-run around mortgage bankers,**” noted author Paul Muolo.
- Muolo noted that some mortgage bankers believe Fannie has no desire to open retail offices but others fear that the company will use loan brokers as intermediaries, cutting out the wholesaler and the warehouse lender.
- According to Muolo, Homebuyer’s Fair “operates two websites that provide housing, mortgage, and other information geared towards employees that are relocating to another geographic area.” One of the websites, Homefair.com, has a “preferred lender” page where consumers can check mortgage rates with several Internet lenders including Mortgage.com and I-Own.com. Consumers can also apply for a mortgage from Mortgage.com, noted Muolo.
- Homestore has lost over \$95 million in the past two years, added Muolo, despite major seed capital from Fannie and GE Capital Corporation. Homestore’s websites currently include HomeStore.com, Realtor.com, CommercialSource.com and HomeBuilder.com. The firm recently went public, with its trades selling for \$44. The company’s stock had a 52-week high of \$60, and a low of \$19.75. The firm has 67 million shares outstanding with a total market cap of \$2.9 billion. (*National Mortgage News*, Paul Muolo, 10/18/99)

Analyst says Fannie is “out of control both economically and politically”

- Wholesale industry analyst Tom LaMalfa, speaking at a recent Illinois Mortgage Bankers Association of America conference, said Fannie is “out of control both economically and politically.” LaMalfa encouraged mortgage brokers to consider the Fannie/Freddie watchdog group, FM Watch, and to familiarize themselves with the group’s goals. In the long-run, he stated, “FM Watch’s efforts will further your business interests.” (*National Mortgage News website*, posted 10/4/99)

Fannie moves outside its core mission of providing liquidity to the secondary market and expands into construction loans and home improvement loans

[Home improvement loans do not put consumers into homes – these consumers already own their own homes]

- According to a press release by Fannie, as part of its HouseConnecticut program, Fannie is working on a home improvement pilot in partnership with Mechanics Savings Bank and the city of Hartford. The following were the only details of the program: “The program will offer below-market interest

rates to families in need of home renovations by blending 0% [?]city financing with Fannie Mae's funds." (*Fannie press release, 10/19/99*)

- According to a *National League of Cities – Nation's Cities Weekly*, Mayor Richard Daley announced at a news conference that the city of Chicago was starting a number of new initiatives to enhance home ownership. One of the new initiatives is the City of Chicago/Allstate Home Preservation Program, a \$5 million pilot program to help eligible residents of Pilsen, Little Village and Auburn-Gresham improve their homes and finance the improvements under one loan product. Allstate Insurance will provide the financing at below market rates to ensure affordability. To create the program, Allstate purchased a \$5 million city bond paying interest below the market rate, which will be combined with the city's initial investment of \$100,000. Other partners in the program are Countrywide Home Loans, which will monitor the rehabilitation process, and Fannie, which will buy and secure the loans. The securities will be pledged as collateral for the bond issue. (*National League of Cities – Nation's Cities Weekly, 8/30/99*)
- According to a press release by Fannie, as part of its HouseIowa program, Fannie invested \$100,000 in a one-year certificate of deposit in Manufacturers Bank and Trust in Forest City to help promote new construction in Forest City. The bank offers borrowers a construction loan that, with a modification, becomes a mortgage sold to Fannie. They provide part of an operating line of credit for a modular housing developer, and as part of a community program, waive origination fees for new construction in Forest City. Forest City is the home of Winnebago Industries. This partnership is part of Fannie's CDFI initiative. (*Fannie press release, 10/20/99*)

Fannie Chairman Franklin Raines says Fannie will double its earnings per share in five years in a recent CNBC interview and denies that the company is affected by interest rates.

Raines says the company makes its money on the expansion of mortgage debt outstanding

- Fannie Chairman Franklin Raines gave a CNBC interview on November 13 where he stated that the company's earnings per share would double over the next five years. Raines stated that the company's earnings were insulated from the Federal Reserve Board's interest-rate changes. "If you look over the last decade, you can see there's absolutely no correlation between our earnings and interest rates because we buy based on the difference between our debt cost and interest rates," he stated. "It's a margin business; it's not absolute interest rates."
- Raines did not see any potential softening in the housing market, particularly the recent drop in mortgage refinancings as a threat to its profits. "We don't make our money on volume," he stated. Raines said that it was more important for the company to maintain a portfolio of either mortgage-backed securities outstanding or loans on its books. In his opinion, a strong purchase housing market and "quality" in home prices were key to Fannie's success. Raines stated that mortgage refinancing was down as interest rates have edged to 8%, but home purchases and housing stats were still strong, thus mortgage debt outstanding will continue to rise. Raines believes that the mortgage lending industry will see its fourth strongest year on record in 2000. "Even with the higher interest rates going into next year, we think next year will be the fourth best year in history for mortgage origination," he stated.
- The interviewer asked Raines the following question: "The stock market has been signaling at least in financial stocks that the best news are behind in terms of interest rates and so stocks related to housing

are beginning to soften. Given that, perhaps the best levels of originations may have already been seen, and if so, how do you expect to maintain profitability?”

- Raines responded that “We’re upbeat because we’ve insulated ourselves from any particular level of interest rates and projected doubling our EPS over the next five years because we earn our money on the interest rates that we get from mortgages on our books and the credit risk that we take. We see mortgage debt outstanding continuing to rise over this period. And that is the difference between us and ordinary financials. We don’t make bets on interest rates. We make our money from the expansion of mortgage debt outstanding, which has never contracted since the Fed has kept figures. We think our performance will distinguish us from other financials.” (*Dow Jones Newswire*, Riva Richmond, 10/13/99; *Reuters*, 10/13/99; *CNBC Interview with Fannie Chairman Franklin Raines on the Housing Industry*, 10/13/99)

Although law prohibits Fannie & Freddie from purchasing mortgages greater than \$240,000 (jumbos) – In a speech recently before the Merrill Lynch Investor Conference, Fannie Chairman Franklin Raines notes how Fannie has found a back door way into jumbos

One New York investment banker who attended the Merrill Lynch speech described it as, “Frank’s speech about how Fannie Mae was going to take over the world”

While Fannie’s Chairman tells analysts that Fannie has entered the jumbo market (mortgages over \$240,000) through the back door, Fannie’s Vice Chair, Jamie Gorelick, tells the press that Fannie has no intention of entering the market for jumbo mortgages, but will continue to buy and securitize mortgages under \$240,000, “for the middle class and underserved”

[Editorial note: Congress never intended to have Fannie & Freddie’s government subsidies passed along to wealthy homebuyers seeking loans above the conforming loan limit (currently over \$240,000).]

- *National Mortgage News* ran an article on Fannie Chairman Franklin Raines’ speech before the Merrill Lynch Investor Conference. (A detailed description of Raines’ speech was included in the October 1, 1999 *GSE Report*.) The article noted that Fannie and Freddie are expanding into jumbo loans (\$240,000 or more which, by law, cannot be bought by Fannie and Freddie).
- Here’s how Fannie is using a “back door” into jumbos: Raines noted that “clever” lenders are breaking jumbo loans into two components and are structuring the jumbo debt amount into a first lien that is below the \$240,000 GSE cap, and a second mortgage. (*National Mortgage News*, 10/4/99)

While Fannie’s Chairman tells analysts that Fannie has found a back door into the jumbo market, Fannie’s Vice Chair tells the press that Fannie has no intention of entering the market for jumbo mortgages

- According to a *Mortgage Servicing News* article by Karen Thomas, Fannie’s Vice Chair Jamie Gorelick said that Fannie has no intention of entering the market for jumbo mortgages, but will continue to buy and securitize mortgages under \$240,000, “for the middle class and underserved.” (*Mortgage Servicing News*, November 1999)
- **One New York investment banker who attended Raines’ Merrill Lynch speech described it as, “Frank’s speech about how Fannie Mae was going to take over the world.”** (*National Mortgage News*, 10/4/99)

- **FM Watch’s Chairman Gerald Friedman cited the speech as an example of how Fannie is creeping into markets that are already being adequately served by the private sector. Friedman noted that Raines compared Fannie’s cost structure to that of banks and said the comparison shows that Fannie is beginning to view itself more as a financial services company instead of a provider of liquidity to the secondary market. (National Mortgage News, 10/4/99)**

Background on Raines’ speech

- During the speech, Raines said the company intends to double its Earnings per Share (EPS) by the end of 2003 by – (1) expanding its mortgage portfolio; (2) expanding further into the mortgage market (“non-traditional” products such as subprime, FHA/VA, multifamily, home equity, manufactured housing, and reverse mortgages); and (3) expanding the mortgage debt market. To broaden its reach into new markets and lines of business, Fannie is redefining the mortgage market from a \$4 trillion mortgage market (prime conforming conventional) to a \$12 trillion mortgage market to include: prime conforming conventional (the segment the GSEs originally served), home equity (including home improvement loans), subprime, multifamily, government (FHA/VA mortgages), manufactured housing, jumbo, and seller financed.

Fannie acquires \$155 million of seasoned multi-family mortgages from Prudential Insurance

Fannie said it is actively looking at several pools of loans

Fannie plans to hold the assets until maturity

- According to a *Commercial Mortgage Alert* article, Fannie has acquired about \$155 million of seasoned multi-family mortgages from Prudential Insurance. Fannie is eager to make similar purchases, said Grace Huebscher, a Vice President in Fannie’s multi-family capital markets area. “We are actively looking at several pools of loans,” she said. “We have plenty of capacity to purchase” other portfolios. Huebscher declined to disclose the price Fannie paid for the Prudential assets but said Fannie could bid competitively because its massive balance sheet gives it the flexibility to purchase loans with varying maturities and rate types. Fannie plans to hold the Prudential assets, which were acquired on a nonrecourse basis, until maturity. (*Commercial Mortgage Alert*, 9/27/99)

Fannie is ranked as the 58th largest public company in the world

- Fannie is ranked as the 58th largest public company in the world in 1999 as determined by Dow Jones Indexes. Fannie was ranked as the 57th largest public company in 1998. (*Dow Jones Newswire*, 9/27/99)

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 34 offices are officially open and operating and nine more are in the process of being organized)

Fannie says it plans to have 45 partnership offices opened by the end of the year

- According to a listing on Fannie’s website, the company currently has 34 partnership offices “officially” operating. Fannie has announced plans to open or commitments to open partnership offices in the following areas: Columbia, SC; South Dakota; Milwaukee, WI; Bismarck, ND; Pittsburgh, PA; Newark, NJ; Nashville, TN; Salt Lake City, UT and Cheyenne, WY. In a speech

before the Long Island Housing Partnership's Annual Meeting, Fannie Chairman Franklin Raines stated that Fannie hopes to expand to 45 partnership offices around the country by the end of the year. (*Fannie Chairman Franklin Raines speech before the Long Island Housing Partnership Annual Meeting, 6/18/99*)

- Fannie issued a press release to announce that it has named Drucilla Pasley as Director of its Wisconsin Partnership Office. A statement of praise by Congressman Tom Barrett (D-WI) was included in Fannie's press release. Prior to joining Fannie, Pasley worked as President and CEO of Firststar Community Investment Corp. [Fannie announced earlier this year that it was opening an office in Milwaukee – the contact information for the office is still not listed on Fannie's website] (*Fannie press release, 10/18/99*)

Senator Chris Dodd (D-CT), Cong. John Larson (D-CT) and Hartford Mayor Michael Peters

- Fannie held a press conference with the above officials to announce a \$6.5 billion "HouseConnecticut" investment plan. (*Fannie press release, 10/19/99*)

New York Lieutenant Governor Mary Donohue, Cong. Edolphus Towns, Cong. Nydia Velazquez, Cong. Carolyn Maloney, and Cong. Gregory Meeks

- Fannie held a press conference with the above officials to announce a \$21 billion investment plan for New York City and the counties of Nassau, Suffolk, Westchester and Rockland. (*Fannie press release, 10/18/99*)

Cong. John Conyers (D-MI) and Cong. Carolyn Filpatrick (D-MI) and Reverend Floyd Flake (former Congressman)

- Fannie held a press conference with the above officials to announce "Operation Community Redemption" – the largest-ever Detroit faith-based community development conference. Fannie pledged \$40,000 grant to the Congress of National Black Churches for housing development activities and homeownership counseling/training in city churches. Fannie also committed \$5 million in rehabilitation and home improvement mortgage financing through its HomeStyle product line. (*Fannie press release, 10/4/99*)

Cong. Scott McInnis (R-CO) with the Colorado Association of Home Builders

- Fannie announced a new environmental mortgage pilot with the Colorado Association of Home Builders to provide incentives to builders and buyers of energy, water and resource-efficient homes in Colorado. The announcement was made during the Colorado Association of Home Builders Annual Conference. A statement of support by Cong. Scott McInnis was included in the press release. Under the "Built Green" program, builders and buyers will be able to qualify for additional funds for green homes with the estimated energy and water savings factored into the qualifying equation. Fannie said it had committed to investing \$100 million in environmental initiatives in Atlanta, Columbus, Colorado, Albuquerque, Los Angeles, and Seattle. Of the \$100 million, \$20 million has been earmarked for Colorado. Fannie hopes to finish a total of 3,5000 Built Green homes by the end of 1999 in Colorado. (*Fannie press release, 10/8/99*)

Iowa Governor Tom Vilsack and Newton Mayor David Aldridge

- Fannie held a press conference with the above officials to announce the opening of Forest View Apartments. Fannie purchased \$7.7 million in tax-exempt bonds from the Iowa Finance Authority (IFA) to finance five multifamily complexes for 192 apartments. (*Fannie press release, 10/20/99*)

Freddie Mac

Controversy continues to swirl around Freddie's study finding that African Americans are twice as likely as whites to have bad credit

House Banking Committee Member Maxine Waters (D-CA) writes *Washington Post* op-ed criticizing Freddie's study

National Community Reinvestment Coalition Vice President Joshua Silver says that Freddie's survey "smacks of politics" and that perhaps, Freddie may be using the study to say it is not possible to meet HUD's increased affordable housing goals [Editorial note: Attempts by Freddie to include language in the HUD-VA Appropriations bill on the increased affordable housing goals (see earlier story) bolsters Silver's argument.]

Expert credit scoring company - Fair, Isaac - rejects Freddie's controversial study linking race with credit

Washington Post op-ed by Congresswoman Maxine Waters

- Congresswoman Maxine Waters wrote an op-ed to the *Washington Post* on October 9 criticizing Freddie's controversial study. She strongly rejected Freddie's assertion that the reason African Americans own fewer homes than whites is that they have "bad credit." She believes that the timing of Freddie's release raises questions on whether Freddie was attempting to counter the release of an ACORN and Urban Institute study on minority homebuying discrimination. She was also concerned about what was implied by Freddie's statement that income alone could not account for disparity and even in the \$65,000 to \$75,000 bracket – 34% of African American borrowers have bad credit compared with 20% of white borrowers. "In other words, we are a credit risk because no matter how much money we make, we are too stupid and undisciplined to know how to spend, plan and save." Congresswoman Waters noted a number of factors – including the lower hourly wages earned by African American men – that clearly demonstrate that African Americans are not similarly situated with whites in this society. (*Washington Post op-ed*, 10/9/99)

National Community Reinvestment Coalition Vice President Joshua Silver says that the survey "smacks of politics" and that perhaps, Freddie "was trying to avoid more demanding affordable housing goals set by HUD."

- Michelle Singletary also held a live discussion on the Freddie survey with Joshua Silver, Vice President of Research and Policy at the National Community Reinvestment Coalition. Silver thought Freddie should have released the entire study before announcing results to the public. Singletary asked Silver whether she was "too harsh in criticizing Freddie Mac for releasing a study that did nothing more than really label half of the black population as deadbeats?" Silver did not think Singletary was too harsh and he argued that Freddie published a major finding that was not well documented with several holes in the study which have not been answered by Freddie. **Silver stated, "One could argue that Freddie has not acted responsibly here. Maybe, they are trying to avoid more demanding affordable housing goals set by HUD, by saying we are now already stretching to reach all creditworthy minorities...Let's say, that this study smacks of politics."** Expanding upon his remark Silver noted that HUD wants to raise the affordable housing goals for Fannie and Freddie and that "Freddie may be using this study to say it is not possible to raise the percentages...when it may be possible." ("*Color of Money Live with Michelle Singletary*," *Washington Post*, 9/27/99)

Fair, Issac disputes Freddie's study

- According to *National Mortgage News*, the leading provider of scores to rate consumers' creditworthiness – Fair, Isaac & Co. - disagrees with Freddie's controversial study that said African Americans are twice as likely as whites to have bad credit. "Our research shows race and national origin are not predicative of future credit behavior." Fair Isaac's Consumer Affairs Manager Craig Watts told *Electronic Banker* (a *National Mortgage News* affiliate) that in a benchmark study of credit scoring among less wealthy and minority populations in 1997, "We found the best predictors of risk to be, in descending order: payment history, total outstanding debt, length of credit history, and kinds of credit in use." Freddie's study found a history of late payments, bankruptcy, and other indicators of bad credit to be among the most common among African Americans, then Hispanics, then whites. Watts was unable to explain the racial link found by Freddie but was "heartened by the effort to educate consumers." (*National Mortgage News website*, posted 10/4/99)

Freddie begins a servicer certification program to employees of lenders so that the employees can teach others in the company how Freddie would like things done

Freddie offers waivers and financial incentives to companies with employees under the servicer certification program

- According to a *Mortgage Servicing News* article by Ted Cornwell, Freddie is providing a servicer certification program for employees of lenders so that the employees can teach their colleagues about Freddie's servicing requirements. In addition to flexible training, companies with certified servicing experts will be eligible for certain waivers and financial incentives from Freddie. So far, 14 companies are participating in the certification program, including 11 servicing professionals who are seeking certification in investor reporting and custodial accounting and 20 who are doing loss mitigation and default management. (*Mortgage Servicing News*, Ted Cornwell, 10/99)

Federal Home Loan Banks

FHFB grants approval to the FHLBanks of Cincinnati, Indianapolis, and Seattle to begin development of single-family Member Mortgage Asset (MMA) programs that will be another competitor to Fannie & Freddie in the secondary market

MMA allows for risk-splitting between the FHLBanks and the member bank originating the loan

FHFB announces that the FHLBank of Des Moines has received approval to offer the FHLBanks' Mortgage Partnership Finance (MPF) program [another program that is a direct competitor to Fannie & Freddie in the secondary market]

Half of the 12 FHLBanks are now offering the MPF program - the MPF program is becoming a real competitor to Fannie & Freddie in the secondary mortgage market

MPP program

- According to a *National Mortgage News* article by Brian Collins, the Federal Housing Finance Board (FHFB) granted approval to the FHLBanks of Cincinnati, Indianapolis, and Seattle to begin development of a single-family mortgage purchase program (MPP). The three FHLBanks are sharing in the development costs of the MPP, however, each FHLBank intends to operate the program

independently. The MPP resembles a traditional secondary market transaction (with Fannie and Freddie) except the member originates, closes, and sells the loan to the FHLBank. Under the FHLBanks' Mortgage Partnership Finance (MPF) program, the loan is closed in the name of the FHLBank of Chicago. The FHLBanks expect to have the MPP program up and running in the second half of 2000.

- The FHFB first published a request for comments on the proposal in the *Federal Register* on August 12, 1999. On September 10 – when the comment period for that request expired – the FHFB announced that details for the plan were available on its website and did not extend the comment period to reflect any additional views. However, the FHFB staff indicated that they would continue to consider comments despite the comment period expiration.
- The new FHFB resolution allows private mortgage insurance to be used a credit enhancement and allows the FHLBanks to establish reserves when they purchase single-family loan pools with less than AA investment ratings. Under the MMA program, the lender (member) is expected to ensure that there is primary mortgage insurance if the loan-to-value ratio is higher than 80% and the lender is required to establish a risk-sharing account with the FHLBank that is equal to 50 basis points of the loan amount and is paid back over the life of the loan. The lender must also provide supplemental mortgage insurance in case losses burn through the primary mortgage insurance coverage and the risk-sharing account. The supplemental mortgage insurance ends at the 60% loan-to-value ratio with lenders having the option of getting supplemental mortgage insurance or pool insurance. The FHLBanks believe that the new program will be more beneficial to members than using Fannie and Freddie for their secondary market transaction. The FHLBanks expect the member institutions will get more favorable risk-based capital treatment from regulators and more flexible underwriting than with Fannie and Freddie. “Our members expressed a desire for more secondary market alternatives, and then we worked closely with them to design a product and a process that meets their requirements,” said Cynthia Chariot, Executive Vice President of the FHLBank of Seattle. (*National Mortgage News*, Brian Collins, 10/11/99; *National Mortgage News website*, posted 10/4/99)

MPF program

- The FHFB also announced that the FHLBank of Des Moines was granted authority to become the sixth participating FHLBank in the Chicago MPF program. (*National Mortgage News*, Brian Collins, 10/11/99; *National Mortgage News website*, posted 10/4/99)

FHFB approves a FHLBank of New York program called Sequential Participation for lenders who may want an alternative to selling their mortgages into the secondary market, but still want to hold portions of the loan

Sequential Participation is part of a pilot program – the Community Mortgage Asset Activities Program – that will split the credit and interest rate risk between private-sector mortgage lenders and the FHLBank of New York

The Sequential Participation Program offers lenders an alternative to selling their loans into the secondary market to Fannie & Freddie but is not a direct competitor with Fannie & Freddie

- According to an article by Karen Thomas for *Mortgage Servicing News*, the FHLBank of New York received regulatory approval from the FHFB to offer a new single-family financing program – called Sequential Participation – that helps portfolio lenders manage interest rate risk. According to the President of the FHLBank of New York Alfred DelliBovi, the program is designed to relieve

community banks of “onerous capital requirements” and is “custom-designed for people who don’t want to deal with the secondary market, but still want to hold portions of the loan,” he stated. Sequential Participation is different from the MPF program developed by the FHLBank of Chicago. Under MPF, members are offered an alternative to selling to Fannie and Freddie in the secondary market, while Sequential mitigates risks for portfolio lenders. DelliBovi noted that the FHLBank of New York did not have to fight Fannie and Freddie over the new program as it did over the MPF program, noting that the program does not directly compete with Fannie and Freddie. (*National Service News*, 10/99)

- Under the program, pools of one-to-four family conforming fixed-rate mortgage loans are divided into three tranches. The lender retains Tranche A-1, which is the first and shorter cashflow position in the mortgage pool, and Tranche B, which is the credit support representing a 3% first-loss position. Tranche 2 represents a 48.5% interest in the pool, which has a longer cashflow position. By keeping Tranche A-1 and selling Tranche A-2, the members passes on the interest rate risk inherent in the longer cashflow to the FHLBank, according to the FHLBank of New York. In this example, the lenders collect their share of interest and principal for the first seven years of the loan pool and the FHLBank collects all principal and interest (except servicing fees) during the remaining life of the 30-year mortgage. FHFBC Chairman Bruce Morrison said that the program is another example “of how to use the FHLBank system cooperative structure to create risk-sharing arrangements that bring competition to mortgage finance.” (*National Mortgage News*, 8/30/99; *National Mortgage News website*, posted 8/20/99)
- The FHFBC provided notice in the *Federal Register* that although the FHFBC had authorized modifications to the FHLBank of New York’s Community Mortgage Assets pilot Program which would authorize the FHLBank of New York to operate its Sequential Participation program, it was allowing individuals to submit comments on the proposal on or before October 12, 1999. The FHFBC noted that it was not obligated to publish notice for these modifications of the previously approved Community Mortgage Asset pilot program, but in the spirit of full disclosure, provided notice of the modifications. The FHFBC further noted that the FHLBank of New York will not implement modifications to the program until the staff of the Office of Supervision conducts a preliminary examination of the modified program policies, procedures, and controls have been established. (*Federal Register*, 9/10/99, pages 49186-49187)

FHFBC approves a final rule providing joint liability of FHLBank debt

- The FHFBC approved a final rule providing joint liability of FHLBank debt (consolidated obligations) if one FHLBank defaults. As of July 31, 1999, about \$445 billion of consolidated obligations were outstanding. The rule clarifies that each of the 12 FHLBanks is ultimately liable for the repayment of any and all consolidated obligations. The final rule was published October 12 in the *Federal Register* and is effective on November 12, 1999.
- According to the FHFBC, the final rule safeguards holders of bonds, notes, or other consolidated obligations issued by the FHLBank System by ensuring the continued payment of all principal and interest on those consolidated obligations in a timely manner if a FHLBank were unable to meet its debt service payment obligations. The final rule requires quarterly certification by the FHLBanks on the consolidated obligations that the FHLBank is participating in. The rule requires certification that it will not undergo a net loss and will remain in compliance with statutory and regulatory liquidity requirements and will be able to make full and timely payment on all its current obligations. It specifies that a FHLBank must notify the FHFBC immediately if it learns it cannot make the

certification when due, or projects that it won't meet its reserve and liquidity requirements or current obligations. If a FHLBank were unable to service a consolidated obligation, the FHFB would step in and assign one or several other FHLBanks to make the payments. The FHLBank in question would then be responsible for reimbursing the other FHLBanks for the payments.

- “In the history of the FHLBank System, there has never been a delinquency or a default of a consolidated obligation – the likelihood of it is extremely remote,” stated FHFB Chairman Bruce Morrison. (*National Mortgage News*, Brian Collins, 10/11/99; *Dow Jones Newswire*, John Connor, 10/4/99; *BNA Daily Report for Executives*, Eileen Canning, 10/5/99; *Federal Register*, 10/12/99, pages 55125-55131)

Federal Housing Finance Board: “Not Well Known, But Very Well Sued” – Though not well known, the FHFB is no stranger to controversy and is currently involved in a number of lawsuits

- According to an article by John Connor with *Dow Jones Newswire*, the FHFB isn't a household name but it is not stranger to controversy. Connor notes that the FHFB is involved in at least three lawsuits. (Since publication of the article, one of those lawsuits has been decided – see next article.)

The following are court cases in which the FHFB is involved:

- (1) A case pending before the US Court of Federal Claims which involves a consulting firm, Furash & Co. Furash was hired by the FHFB to conduct a study of the FHLBank System. Furash was fired by the FHFB for allegedly not complying with its contract. Furash sued the FHFB claiming that the FHFB was not happy with the firm's study because it “contradicted what the FHFB staff wanted the study to show,” and is seeking to retain nearly \$400,000 in payments for its work from the FHFB. Furash argues that the FHFB terminated its contract because “it was dissatisfied with the draft final report from a political and policy standpoint, not for any substantive reason related to Furash's performance.” The FHFB asked the Claims Court to dismiss Furash's claims on jurisdictional grounds. The Justice Department reportedly is urging the US Claims Court to dismiss the complaint. The Justice Department stated that the Claims Court “should conclude that it lacks jurisdiction to entertain this case and, consequently, that Furash's complaint should be dismissed.”
- (2) A case pending before the federal appeals court in New Orleans. A coalition of thrift groups are alleging that the FHFB exceeded its statutory authority when it authorized the FHLBank System's Mortgage Partnership Finance (MPF) program, started by the FHLBank of Chicago. Connor reported that a lower court sided with the FHFB and the appeals court is scheduled to hear oral testimony in the case in October.
- (3) A case involved the firing of former FHFB Member Lawrence Costiglio (Case now settled - See next story in this *GSE Report* for more details).
- (4) A case (now settled) in which Orange County, CA sued the FHFB's Office of Finance and each of the 12 FHLBanks in connection with the county's bankruptcy. The county later executed a release against those defendants as part of a settlement with Merrill Lynch. (*Dow Jones Newswire*, John Connor, 7/22/99, 9/29/99)

US Appeals Court affirms President Clinton's dismissal last year of FHFB Member Lawrence Costiglio

- According to John Connor with *Dow Jones Newswire*, a US Federal Appeals Court affirmed President Clinton's dismissal last year of FHFB Lawrence Costiglio. In a judgement handed down October 8, a three-judge panel of the appeals court affirmed a lower court's decision that upheld President Clinton's March 1998 dismissal of Costiglio. Reportedly, Costiglio was many times at odds with the views of FHFB Chairman Bruce Morrison. Costiglio filed a lawsuit challenging his firing, arguing that he legally should remain in office until a successor was appointed and confirmed. (*Dow Jones Newswire*, John Connor, 4/15/99, 10/14/99) Costiglio's firing left two vacancies on the five-member FHFB. Costiglio's term as director expired in Feb. 1995, but he had been serving the agency in a holdover capacity until his March 1998 firing.

Farm Credit System/Farm Credit Banks

Amendment in the Agricultural Appropriations bill that would have broadened the authority of the Farm Credit System, at the expense of private sector banks was not included in the final Agriculture Appropriations bill

American Bankers Association and Community Bankers Association were opposed to the amendment

- As reported in the October 1 *GSE Report*, an amendment was offered during the Agriculture Appropriations conference that would have broadened the authority of the Farm Credit System, at the expense of private sector banks. The amendment was not included in the final Agricultural Appropriations bill that was signed by the President on October 22.
- The American Bankers Association and the Community Banker's Association were opposed to the amendment because they believe it would "unfairly broaden the authority" of the Farm Credit System at the expense of banks. The amendment, introduced by Senator Tom Harkin (D-IA) would transfer lending and investment powers of a government-funded company – Alternative Agricultural Research and Commercialization Corp. – to a Farm Credit System Lender, Denver-based CoBank.
- The Alternative Agricultural Research Corp. invests equity capital and lends money to ventures. Woker contends that banking associations believe that giving authority over the Corp. to the quasi-governmental CoBank would give CoBank an advantage over private sector agricultural banks in competing for loans.
- **"This deal really smells," said John Blanchfield, Manager of Agricultural Banking and Rural Development at the American Bankers Association. "CoBank wants this authority really bad, and that disturbs me because this appears to be a major expansion of the Farm Credit System." "The issue needs more scrutiny," said Mark Scanlan, Agricultural Affairs Director at the Independent Community Bankers of America. "There are two many potential implications that need to be dealt with in a short time." (*American Banker*, Craig Woker, 10/1/99)**

Ginnie Mae

HUD says a proposal to allow Ginnie Mae to purchase its own mortgage-backed securities (MBS) could raise millions

Ginnie Mae proposal would allow Ginnie Mae to act like Fannie & Freddie

Fannie & Freddie scoff at Ginnie Mae proposal because they say it would be too risky [Editorial note: If Fannie & Freddie consider MBS purchases by Ginnie Mae as risky – then why don't they view their purchasing of MBS as risky? Fannie & Freddie hold a much greater concentration of their own MBS in their portfolio than would be allowed under the Ginnie Mae proposal]

- HUD is considering a proposal – known as the Community Housing Investment Fund (CHIF) - that would allow Ginnie Mae to purchase its own securities and build a \$60 billion investment portfolio. The proposal would allow Ginnie Mae to support the market for its own guaranteed securities – like Fannie and Freddie. Ginnie Mae would like to be able to repurchase about 11% of its outstanding MBS in the open market in order to help increase demand for its own debt and generate revenue for HUD.

HUD and MBA support the proposal

- According to sources, HUD Secretary Andrew Cuomo believes that Ginnie Mae already has the authority to “support the market” and purchase its own MBS. However, HUD needs Treasury Department approval, which is a “major stumbling block.” Treasury officials could not be reached for comment.
- MBA is also supportive of the proposal. “We are supportive of the concept,” said MBA Senior Staff Vice President Robert O’Toole. “The concern is now whether the Treasury Department will (sign off on it),” he said. O’Toole explained that the proposal has lots of positives. “It lowers the cost of homeownership for FHA-VA borrowers. It enriches the value of the Ginnie Mae security in the market and it gives an outlet for special types of loan products that are difficult to place in the secondary market.” However, the MBA would like restrictions on whole loan purchases by Ginnie Mae where mortgage lenders have created an active market.

Proposal would make Ginnie more like Fannie and Freddie

- Fannie and Freddie are aggressive purchasers for their own securities and Fannie and Freddie MBS trade at higher prices than Ginnie Mae MBS even though Ginnie Mae securities carry the full faith and credit of the US government, while Fannie and Freddie’s carry an implicit government guarantee. “We examined pricing of our mortgage-backed securities and it has become clear that we’re not pricing as well as the GSEs’ securities,” said George Anderson, Acting Chief of Ginnie Mae. “We believe the reason is that we lack the ability to support our securities. The GSEs have the ability and we don’t.”
- Fannie and Freddie MBS outstanding totaled \$1.48 trillion. The GSEs currently hold roughly 25% of their own MBS as investments and their mortgage loan/MBS investment portfolios generate 75% of their profits. HUD Assistant Secretary William Apgar acknowledged that HUD is considering proposals for Ginnie Mae, but he would not comment on purchase plan. “Our main concern is that there are still persistent rumors that Ginnie Mae is on the block to be sold and we are foursquare against that,” Mr. Apgar said. “As a revenue gimmick, Ginnie Mae is too valuable.” (*National*

Mortgage News, Brian Collins, 8/23/99) (*National Mortgage News website*, *Shake Your Money-Maker*,” Brian Collins, posted 9/10/99; *Dow Jones Newswire*, Jerry Guidera, 10/6/99)

- According to *Dow Jones Newswire* reporter Jerry Guidera, Ginnie Mae pulls in about \$400 million annually for HUD – a pale sum compared with Ginnie Mae’s own estimates for returns on the CHIF plan. The estimates are not enough to entice lawmakers to sign off on the proposal. Guidera notes that although the Congressional Budget Office has not done a full study of CHIF, lawmakers have been told that the benefit of return from the program could be as little as \$500 million or as much as \$3 billion. According to Guidera, the Office of Management and Budget, which oversees debt collection and is responsible for ensuring the quality of the government’s accounting practices, has said that the Ginnie Mae estimates are flawed and urged lawmakers to hold off supporting the program. (*Dow Jones Newswire*, Jerry Guidera, 10/6/99)

Fannie & Freddie scoff at Ginnie’s proposal – say the program would be risky

- According to a *Reuters* article by Richard Leong, Fannie and Freddie underscored the risks of Ginnie Mae’s proposal. Freddie’s President and COO said the proposal would be time-consuming and a risky venture for Ginnie Mae. “It would be very careful about that,” Glenn stated recently at the annual MBA conference. Fannie’s Chairman Franklin Raines warned that Ginnie Mae would burden the US Treasury Department with the MBS purchase cost. “It is an outlay in the (U.S.) budget, not a saving,” Raines stated. Raines and Glenn both stated that Ginnie Mae does not have the capability to manage the risks of a MBS portfolio. Ginnie Mae Executive Vice President George Anderson stated that Ginnie Mae would simply hire the proper staff if the MBS portfolio plan were adopted. “We would need to augment our staff. We’d need money managers. There would be internal and external advisors,” Anderson said. “We would work closely with Treasury to match interest rate risks.” (*Reuters*, Richard Leong, 10/13/99)

Others say Ginnie Mae program could raise risk

- According to a *National Mortgage News* column by Terry Peters, Salomon Smith Barney analyst, Sharad Chaudhary, wrote that allowing Ginnie Mae to accumulate a mortgage investment portfolio could help fund the federal housing budget, but the proposal is likely to raise question about Ginnie Mae’s risk management capabilities. According to Chaudhary, the proposal would serve at least three purposes: supporting the price of Ginnie Mae MBS, generating net interest income for HUD and stimulating loans from lenders in those areas. The revenues that are generated by the fund he noted could also reduce political pressure to privatize Ginnie Mae. “However, concerns will likely be raising about Ginnie Mae’s ability to manage the interest-rate and credit risk on a portfolio of this size,” he concluded. “In addition, given recent trends, there may be a considerable amount of focus on defining the appropriate risk-based capital guidelines for Ginnie Mae, and determining whether it has the risk-management expertise to manage the portfolio by these guidelines.” (*National Mortgage News website*, “*Ginnie Portfolio May Raise Risk Questions*,” Terry Peters, posted 9/7/99)

Prudential analysts say Fannie & Freddie should still be “investment friendly” despite Ginnie Mae proposals being discussed. A public review of Ginnie Mae brings further analysis of the political risks faced by Fannie & Freddie

- Prudential Securities analysts Charles A. Gabriel, Jr., Jonathan Adams, and Bose T. George wrote an equity research report on the possible effects of Ginnie Mae proposals on Fannie and Freddie. The analysts noted that there are three Ginnie Mae proposals that have been discussed.

- One proposal calls for acceleration of the increase on the 3 basis points increase (6 to 9 points) of Ginnie Mae loans that is scheduled to take place in 2004. The other calls for privatization of Ginnie Mae, which the authors note is very similar to the proposals advocated last summer, and has **“consistently been whispered as a potential threat to Fannie and Freddie on Wall Street (despite explicit language in such proposals confining the newly-created entity to securitizing only FHA, VA and other government-guaranteed loans).”** However, Gabriel, Adams and Bose note that **there appears to be one exception in the newer privatization proposal -- a previous provision denying Fannie and Freddie the ability to purchase Ginnie Mae loans has “apparently been dropped” from consideration.** The analysts reported that HUD Secretary Cuomo, Fannie Mae, Freddie Mac, MBA, and NAR are all against these proposals.
- The other proposal calls for Ginnie Mae to invest in and maintain a portfolio up to \$60 billion of their own securities. Known as the Community Housing and Investment Fund or “CHIF,” this proposal has a projected savings of near \$1 billion a year. The analysts note that HUD and House Appropriators will be pushing this plan, without the consent of the Treasury Department.
- Gabriel, Adams and Bose noted that the public review of Ginnie Mae may be imminent, bringing with it further analysis of the political risk of Fannie and Freddie. Additional public scrutiny may cause a “psychological impact” on the GSEs stock prices. However, the authors predict that **“adoption of the accelerated GNMA fee increase might actually boost Fannie and Freddie, by making FHA loans comparatively less attractive than conventional loans -- to borrowers and lenders alike.”** The most important effect of the GNMA proposals on the GSEs will be to extend opportunities for buying GSE stocks, according to the authors. They urged investors to ignore doubts raised by talk of privatizing or securitizing Ginnie Mae. (*Prudential Securities Equity Research*, Charles A Gabriel, Jr., Jonathan Adams, Bose T. George, 9/23/99)

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