

The **GSE** REPORT™

Contents of GSE Report™

“Combined Fannie, Freddie, and the FHLBanks have \$2.6 trillion – T as in trillion – of outstanding debt...I can’t explain why the amount of outstanding debt is so huge. I would think that \$2.6 trillion would be enough to provide every man, woman and child in the US who doesn’t own a home with the equivalent of a custom-designed palace on two acres in the Hamptons.” (*Dow Jones Newswire*, Jim Murphy, 4/12/00)

“Fannie Mae and Freddie Mac, the largest S&L’s the world has ever seen, want to have it all. They’re beyond the reach of Congress and the voters. As for further expansion, you ain’t seen nothing yet.” (*International Economy*, Peter Wallison, March/April 2000)

Major Events

- House Banking Capital Markets Subcommittee Chairman Cong. Richard Baker (R-LA) compares Fannie & Freddie to the failed hedge fund, Long Term Capital Management (*p. 5*)
 - Cong. Baker suggests that the President’s Working Group on Financial Markets analyze the potential systemic risk of the housing GSEs on the financial markets
 - “The bigger the GSEs become in the mortgage and capital markets and the larger the exposure of financial institutions to GSEs, the greater the concern we should have about systemic risk – in other words, the more potential for problems at a GSE causing instability in the financial markets and banking system.”
 - “...to ignore the potential impact of a misstep by a GSE on our housing market and financial system is to flirt with potential disaster”
- House Banking Capital Markets Subcommittee will hold second hearing on Cong. Baker’s GSE bill on May 16 (*p. 7*)
- Senate Banking Committee Chairman Phil Gramm (R-TX) takes pending reforms of the GSEs “very seriously” but does not believe legislation to overhaul regulation of Fannie & Freddie will pass this year (*p. 7*)
- American Enterprise Institute (AEI) will hold its third conference on GSEs on May 23 – “Thinking about the Future of Fannie Mae and Freddie Mac” (*p. 8*)

All GSEs

- Financial markets strategist Doug Noland says the US financial system is a “ticking time bomb” and “the leading culprits for this unfolding debacle are none other than the Washington-based Government Sponsored Enterprises (GSEs)” – Fannie, Freddie, and the FHLBanks (*p.9*)
 - The GSEs are leading the way to “unfathomable US credit excesses,” creating a financial “house of cards”
 - The GSEs have “embarked on a crusade with has resulted in a dangerous financial and economic bubble”
 - “Importantly, unprecedented lending growth and mortgage-backed security guarantees by the GSEs have distorted market-pricing throughout the real estate sector, leading to a dangerous misallocation of resources. This has meant significant over-investment in home-building as well as problematic inflation”
- AEI Resident Fellow Peter Wallison accuses the GSEs of leveraging Uncle Sam (*p. 11*)
 - The GSEs are part of a disturbing trend: “Congress establishes a GSE, and the GSE, once established, assembles constituencies that benefit from their subsidies and lobby to keep them growing and unimpaired. Depending on the size and wealth of its constituency, a GSE can acquire a kind of invulnerability to congressional scrutiny”

- *American Banker* estimates that 70% of banks would have to unload investments of Fannie, Freddie, and the FHLBanks if Treasury Undersecretary Gary Gensler's testimony on restricting the banks' holding of GSE debt were imposed (p. 12)
 - Banks hold more than \$210 billion in GSE debt – a third of total bank capital – as of mid-1999

Fannie Mae and Freddie Mac

- Citizens Against Government Waste (CAGW) praises Cong. Baker on his oversight of the GSEs (p. 13)
 - CAGW says Cong. Baker is doing a great service to homeowners and taxpayers around the nation
 - CAGW says “Congressman Baker has been getting a lot of flak from Fannie Mae since he started talking about GSE debt” but “America is well served when someone like Richard Baker is looking after taxpayers’ money.”
- National Community Reinvestment Coalition says Fannie & Freddie lag behind the nation’s banks in financing single-family and home mortgages for minorities and low- and moderate-income homebuyers (p. 13)
- Fannie & Freddie recommended massive changes to OFHEO’s risk-based capital proposal – a proposal that OFHEO has been working on for six years (p. 14)
 - The GSEs and the private mortgage insurers are at odds over the proposal
 - OFHEO intends to finalize the rule by the end of the year
- An *Economist* editorial likens Fannie & Freddie to “spoiled rich kids, at risk of getting out of control.” The editorial suggests that “Congress should force them to leave home before they do serious damage to themselves and the economy.” (p. 15)
 - Fannie & Freddie “distort the private market” and are a “perfect example of what people mean when they talk of moral hazard caused by government intervention”
 - “If the modern American dream is to privatise gains and socialise risks, then Fannie & Freddie are certainly living it.”
- The *Economist* argues that the GSEs may be the source of nasty economic problems ahead (p. 16)
 - “Fannie and Freddie may be doing more harm than good” and they “may have fueled an unsustainable credit bubble”
- *Insight Magazine* runs a cover story (Home \$weet Home”) examining the growing concerns about Fannie & Freddie (p. 17)
 - Fannie & Freddie were meant to help Americans buy homes, but now, “these two companies are making politically appointed executives rich while amassing debt that could cost taxpayers billions.”
 - “...a downturn in the economy could result in a huge bailout bill for US taxpayers...Much like the savings and loan crisis a decade ago that cost taxpayers \$500 billion.”
- *Business Week* article calls Fannie & Freddie’s ties to the government “under siege” (p. 19)
 - Top Administration officials and key Republican lawmakers are criticizing Fannie & Freddie
- A *Wall Street Journal* article by Michael Schroeder noted that “In the hot debate over predatory lending, a sticky question has arisen: Is Fannie Mae...a white hat or a black hat?” (p. 21)
 - Some banks are contending that Fannie’s entrance into the subprime market is a thinly veiled strategy by Fannie to capture a big share of the market under the guise of cleaning up abuses
 - In related news, HUD announces a new proposal that would bar Fannie & Freddie from purchasing loans originated through predatory lending practices
 - HUD says the government should determine the definition of a predatory loan and the terms and conditions - this is not a matter of GSE discretion
 - The consumer group, ACORN, calls Fannie & Freddie’s new guidelines vague and asserts that the policies do not go far enough
- *Wall Street Journal* article notes that as Fannie & Freddie mushroom in size, concerns about their risk also rises (p. 23)
 - Securities firms pick up the tab for lunch once a week for 70 of Freddie’s employees
 - Concerns are mounting that Fannie & Freddie “may be slipping.” “Critics complain that they are taking unnecessary risks to expand their business. And in Washington, their once vaulted political machine has failed to stop unaccustomed attacks from both Democrats and Republicans, in the administration, and Congress.”
- *Barron’s* article notes that “By so rapidly expanding their balance sheets, the GSEs have offset the Fed’s attempt to restrain the economy” (p. 25)
 - Efforts to restrain the amount of credit created by the GSEs, “could potentially do more to restrict credit” than could even the Fed
 - “Observers who fear that the US is in the midst of a 1920s-like credit-induced economic bubble think a move to curb GSEs would mark an important return to sobriety”
- *Virginian-Pilot* article reports on Cong. Baker’s GSE bill to strengthen the regulation of the GSEs (p. 25)

- As the national debt shrinks, GSE debt skyrockets (*p. 26*)
 - Fannie & Freddie want their debt securities to replace Treasuries as a benchmark security
 - “Efforts by Fannie Mae and Freddie Mac to become bigger players, however, raises concerns among some policy makers. The two firms are privately owned. Their securities are considered safe largely because the markets assume that the government, which created both agencies, will stand behind them. If this is true, it means taxpayers are assuming an ever larger risk as Fannie Mae and Freddie Mac expand, while the companies’ shareholders enjoy profits at taxpayers’ expense.” (*Wall Street Journal*, 2/3/00)
 - “Combined, Fannie Freddie, and the FHLBanks have \$2.6 trillion – T as in trillion – of outstanding debt...I can’t explain why the amount of outstanding debt is so huge. I would think that \$2.6 trillion would be enough to provide every man, woman and child in the US who doesn’t own a home with the equivalent of a custom-designed palace on two acres in the Hamptons.” (*Dow Jones Newswire*, Jim Murphy, 4/12/00)
- GSE debt news:
 - GSE debt has a significant impact on Treasury borrowing costs
 - The recent volatility of GSE debt harms Fannie & Freddie’s ability to make GSE debt the new benchmark to replace Treasuries – groups considering other bonds as potential benchmarks
 - *Wall Street Journal* takes first step in search for a new benchmark – it will replace its chart of the 30-year Treasury bond with a chart of the 10-year Treasury note
 - Fannie will list all new Benchmark notes on the Luxembourg stock exchange to attract more international investors
- Fannie & Freddie report record first quarter earnings (*p. 29*)
 - Fannie & Freddie are still aggressively purchasing their own mortgage-backed securities (MBS)
- Fannie & Freddie's safety and soundness regulator, OFHEO, makes new hire (*p. 29*)

Fannie Mae

- Fannie’s very size and influence have now put it in the middle of a firestorm – Fannie is facing assaults from the Treasury Department, a powerful member of Congress, and a coalition of trade groups (*p. 30*)
- Fannie tells investors it will charge more for purchasing subprime loans (*p. 30*)
- Fannie will sponsor a forum on the “Role of Automated Underwriting in Expanding Minority Ownership” (*p. 31*)
 - [Editorial Note: HUD is currently conducting a fair lending investigation of Fannie & Freddie’s automated underwriting systems (which control 95% of the automated underwriting market)]
- 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 (*p. 31*)
 - Fannie continues to make more political hires - Fannie hires former Senate Banking Committee Chairman Alfonse D’Amato as a consultant
 - Fannie opens a new partnership office in North Dakota
 - Charles Lewis, Executive Director of the Center for Public Integrity, stated that Fannie & Freddie’s hiring of high level government and political officials blurs the line between public service and private enterprise. In his opinion, the recent hirings by Fannie and Freddie are an example of how “incestuous these quasi-governmental entities are with the people that ostensibly regulate them or have oversight over them.”

Freddie Mac

- Expanding outside its mission, Freddie increased its holding of home equity loans in 1999 by 134% (*p. 34*)
 - [Editorial Note: The majority of home equity loans are made to middle- to higher-income, non-minority homeowners for debt consolidation. Home equity borrowers already own their own homes. Home equity loans are a consumer loan product, not a product that helps homebuyers purchase a home.]
- Freddie increases its use of derivatives in 1999, up from 35.4% from 1998 (*p. 34*)
- Freddie forms partnership with Rainbow Push Coalition/Wall Street Project (founded by the Rev. Jesse Jackson, Sr.) (*p. 34*)
 - Compaq Computer Corp. is providing over 200 computers to churches in the program to be used as a distribution channel for Freddie’s consumer credit initiative
 - In 1998, Jackson urged shareholders to withdraw investments from Freddie and for Congress to hold “oversight hearings amid a \$15 million race discrimination lawsuit filed by a former Freddie executive
- Freddie teams up with Citibank and the City of San Jose for a new affordable housing program in San Jose, CA (*p. 35*)
- Freddie teams up with Bank of America, Wells Fargo, SouthTrust Sun Trust and AmSouth Bank for affordable housing program in Jacksonville, FL (*p.36*)

- Freddie makes a number of new hires (*p. 36*)
 - Freddie names a new Vice President of Congressional Relations, a new Vice President of Industry, Trade Relations, a new Vice President of Multifamily Risk Management, and a new Vice President of Strategic Relationships

Federal Home Loan Banks

- FHLBank System's Mortgage Partnership Finance (MPF) Program continues to grow (*p. 37*)
 - FHFB proposes to lift the \$9 billion cap on the MPF program and make the program a permanent FHLBank program instead of a "pilot"
 - FHFB proposes a soft cap on FHA loan purchases under the MPF program
 - MPF program is a competitor to Fannie & Freddie in the secondary mortgage market
- FHFB issues rule on FHLBanks' acquired member assets and core mission activities (*p. 38*)
 - The proposal does not limit investments in non-mission assets such as mortgage-backed securities (MBS), however, MBS will not be considered "core mission assets"
 - America's Community Bankers is upset about the new FHFB proposal and believes that the FHFB has gone back on its word to Congress
- Mitchell Securities analyst Charlie Peabody is concerned about the FHLBank System's risk to the economy (*p. 40*)

Farm Credit Administration/Farm Credit Banks

- American Bankers Association (ABA) hires a new Senior Counsel who will lobby in opposition to proposals that would allow Farm Credit System banks to lend nationally instead of regionally (*p. 40*)
- The Farm Credit Administration (FCA) issued proposals to make it easier for commercial banks to borrow from the Farm Credit System (*p. 40*)

Ginnie Mae

- The Mortgage Bankers Association, the National Association of Realtors, the National Association of Home Builders, and the US Conference of Mayors send a letter to Capitol Hill to protest proposals that would privatize FHA and Ginnie Mae (*p. 41*)
- Ginnie Mae is moving forward on its proposal to purchase its own mortgage-backed securities (*p. 41*)

Major Events

House Banking Capital Markets Subcommittee Chairman Cong. Richard Baker (R-LA) compares Fannie & Freddie to the failed hedge fund, Long Term Capital Management

Cong. Baker suggests that the President's Working Group on Financial Markets analyze the potential systemic risk of the housing GSEs on the financial markets

“The bigger the GSEs become in the mortgage and capital markets and the larger the exposure of financial institutions to GSEs, the greater the concern we should have about systemic risk – in other words, the more potential for problems at a GSE causing instability in the financial markets and banking system.”

“...to ignore the potential impact of a misstep by a GSE on our housing market and financial system is to flirt with potential disaster”

- At an April 11 House Banking Committee hearing on hedge funds and derivatives, Cong. Richard Baker (R-LA) testified about the systemic risk of Fannie and Freddie. He compared the risks of the housing GSEs on the US financial system to the hedge fund, Long Term Capital Management (which nearly collapsed in 1998). He suggested that the President's Working Group on Financial Markets analyze the potential systemic risk of the housing GSEs on the financial markets. “I would like to have the working group analyze the relative degree of potential systemic risk that the GSEs might present to our economy if there would be a misstep,” he testified. (*National Mortgage News Daily*, 4/11/00) Cong. Baker was the first panelist at the hearing.
- Cong. Baker believes that the potential systemic risk of the housing GSEs is an area that should be explored and if warranted, Congress should take legislative action.

In Baker's opinion the implications of the following facts should be examined:

- (1) the GSEs continue to grow in size, holding a dominant position in the mortgage market and a significant share of the debt market;
- (2) insured depository institutions have enormous holdings of GSE debt;
- (3) despite the best efforts of the Administration, the markets still view GSE debt instruments as government backed; and
- (4) the GSEs are highly leveraged.

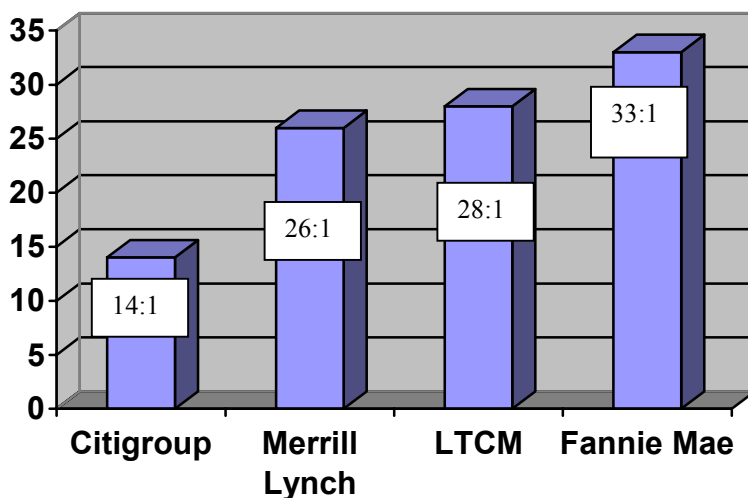
“The bigger the GSEs become in the mortgage and capital markets and the larger the exposure of financial institutions to GSEs, the greater the concern we should have about systemic risk – in other words, the more potential for problems at a GSE causing instability in the financial markets and banking system.”

- He compared the large concentration in one investment, mortgages, to the risk that brought down Long Term Capital Management (LTCM). “LTCM's investments were heavily concentrated as well. When those markets failed, LTCM was unable to raise capital to cover losses and defend its positions,” he testified. “Should the housing market encounter problems, investors may turn elsewhere than GSE debt as a safe haven, raising questions about the ability of the GSEs to raise capital to defend their positions should dramatic losses ever be incurred.”

- The fact that GSE debt has become a significant part of the assets of the banking system is another area that should be examined. Cong. Baker questioned whether US banks should be allowed to hold unlimited amounts of investments in GSE mortgage debt. He pointed out that banks held more than \$210 billion in housing GSE debt in mid-1999, comprising more than one-third of all bank capital. In addition, 41% of commercial banks and savings banks have invested 100% or more of their total capital in housing GSE and other GSE securities. This alone is not a cause of concern “but it is certainly reason to ask if such concentration of investments is prudent. Imagine what the repercussions might be if one of the GSEs happens to stumble in difficult market circumstances.”
- The markets’ “skewed” perception that the GSEs’ debt is government-backed is another area that should be examined. He pointed out that despite Treasury Undersecretary Gary Gensler’s recent testimony that the GSEs’ debt is not backed by the full faith and credit of the US government, the markets had still not adequately heeded “repeated admonition” that the agencies’ debt is not government-backed. “I am concerned that the market is not basing their valuation on the underlying financials alone, but essentially on the premise that these instruments are backed by the full faith and credit of the taxpayer,” he testified. “The GSEs’ reputation, skewed by investor belief they are government-backed, could mean investors are not exercising due diligence,” he said. “In this instance, market discipline has become warped.”

GSEs are more highly leveraged than the largest bank, the largest security firm, and Long Term Capital at its height

- Cong. Baker presented two charts to the Committee to compare the high ratio of assets-to-capital leverage of Fannie Mae compared to other financial institutions Cong. Baker noted that “Fannie Mae is more highly leveraged than not only the biggest bank [Citigroup] and biggest security firm [Merrill Lynch] in this country, but also than Long Term Capital was at its height. [One of the charts Cong. Baker presented at the hearing is recreated below.]



- Baker said, “We must begin to mitigate systemic risk by promoting market discipline, transparency and improved supervision and regulation of all three of our housing GSEs.” He added that, “**to ignore the potential impact of a misstep by a GSE on our housing market and financial system is to flirt with potential disaster.**”

- Speaking to reporters after the hearing, Assistant Treasury Secretary Lee Sachs said that the President Clinton’s Working Group on Financial Markets had no current plans to study the extent to which GSE debt poses a risk to the overall financial system. He said the Working Group will consider such risks if Congress formally asks them to do so. “We do not have plans to undertake that at this time,” Sachs said. “Anytime congress makes a request of the Working Group, we’ll respond to that in due course.” Sachs did not address the GSEs in his written testimony. (*Dow Jones Newswire*, Joseph Rebello and Dawn Kopecki, 4/11/00)

Fannie believes the comparison of Fannie to Long Term Capital is “unfounded”

- Fannie believes that Cong. Baker’s comparison between Long Term Capital and Fannie is “unfounded.” Fannie Spokesman David Jeffers said that “every reputable observer agrees” that Cong. Baker’s GSE bill “is going nowhere because it’s anti-housing.” Jeffers said, “We’re not going to comment every time someone tries to generate support for this bill by making unwarranted comments about our safety and soundness.” He added that OFHEO “has found that Fannie Mae exceeds safety and soundness standards in all areas.” Freddie Spokeswoman Sharon McHale said Cong. Baker’s comparison “couldn’t be further from the mark” and he “needs to get his facts straight.” She said Freddie has some of the best risk management systems in place and that the firm is one of the best hedged companies in the world. (*Dow Jones Newswire*, John Connor, 4/11/00; *Bloomberg*, Michael McKee and John Rega, 4/11/00) (*Statement of Cong. Richard Baker before the House Banking Committee*, 4/12/00)

House Banking Capital Markets Subcommittee will hold second hearing on Cong. Baker’s GSE bill on May 16

- The House Banking Capital Markets Subcommittee, chaired by Cong. Baker, will hold a hearing at 10:00 a.m. on May 16. The hearing will focus on H.R. 3703, “Housing Finance Regulatory Improvement Act,” that among other things, combines the regulators of the three housing GSEs – Fannie, Freddie, and the FHLBanks. Fannie Chairman Franklin Raines, Freddie Chairman Leland Brendsel, and Council of FHLBank Chairman Curtis Hage will testify at the hearing. [The Council of FHLBanks represents 10 of the 12 FHLBanks.]
- “I agree with Senator Phil Gramm’s desire to seek input from the GSE lenders concerning H.R. 3703. Hence, I believe the May 16 hearing will be of vital importance for both Congress and the GSEs to make progress in understanding these very complex issues,” said Cong. Baker. (*House Banking Capital Markets Subcommittee press release*, 4/27/00)

Senate Banking Committee Chairman Phil Gramm (R-TX) takes pending reforms of the GSEs “very seriously” but does not believe legislation to overhaul regulation of Fannie & Freddie will pass this year

- According to *Reuters*, Senator Gramm does not believe Congress will pass legislation this year that would overhaul regulation of Fannie and Freddie. Senator Gramm said he had spoken to Cong. Baker regarding his GSE bill and said he takes the pending reforms “very seriously” but doubted that the Senate Banking Committee would act this year. (*Reuters*, 5/2/00)

**American Enterprise Institute (AEI) will hold its third conference on GSEs on May 23 –
“Thinking about the Future of Fannie Mae and Freddie Mac”**

- AEI will hold its third conference on GSEs on Tuesday, May 23 from 9:00 a.m.- 4:00 p.m. at the AEI Wohlstetter Conference Room. In approaching the issue of the future of Fannie and Freddie, AEI believes there are four general approaches: (1) shedding the government’s risk through full privatization; (2) forcing pass-through of the GSEs’ subsidy by enhancing competition; (3) requiring greater use of the subsidy in support of housing policy; or (4) recapturing the subsidy through taxes, fees, and similar means. The AEI conference will focus on those four areas in detail.
- The following is the schedule for the AEI conference (subject to schedule change)

8:45-9:00 a.m. *Registration*

9:00-9:10 *Introduction: Peter J. Wallison, AEI*

9:10 - 10:50 *Privatization*

The Privatization of Sallie Mae

Speaker: Paul Carey, Sallie Mae

Strategies for Privatization of Fannie Mae and Freddie Mac

Speaker: Stephen Moore, Cato Institute

The Effect of Privatization on the Mortgage Markets

Speaker: Dwight Jaffee, University of California
at Berkeley

Discussants: Robert Van Order, Freddie Mac

Robert S. Seiler, Jr., Office of Federal Housing
Enterprise Oversight

11:00- 12:15 *Enhanced Competition*

A More Competitive GSE Sector

Speaker: Alex Pollock, Federal Home Loan
Bank of Chicago

Chartering Competitive GSEs

Speaker: Thomas H. Stanton, attorney at law

Discussant: Edward Golding, Freddie Mac

12:30 *Lunch*

Speaker: Richard H. Baker (R-LA), U.S. House of Representatives

1:45- 3:00

Mission and Charter

HUD Policies on Mission and Affordable Housing

Speaker: William Apgar, HUD

Setting Policy for GSEs by Charter and Regulation

Speaker: John Weicher, Hudson Institute

Increasing the Commitment to Affordable and Low-Income Housing

Speaker: John Brown, Essential Information

3:00- 4:00

Focusing on the Subsidy

The Case for Full Faith and Credit Backing for Fannie Mae and Freddie Mac

Speaker: Francis X. Cavanaugh

Improving Control over the GSE Subsidy: Options and Challenges

Speaker: Ron Feldman, Federal Reserve Bank of Minneapolis

Discussant: Marvin Phaup, Congressional Budget Office

All GSEs

Financial markets strategist Doug Noland says the US financial system is a “ticking time bomb” and “the leading culprits for this unfolding debacle are none other than the Washington-based Government Sponsored Enterprises (GSEs)” – Fannie, Freddie, and the FHLBanks

The GSEs are leading the way to “unfathomable US credit excesses,” creating a financial “house of cards”

The GSEs “have embarked on a crusade which has resulted in a dangerous financial and economic bubble”

“Importantly, unprecedented lending growth and mortgage-backed security guarantees by the GSEs have distorted market-pricing throughout the real estate sector, leading to a dangerous misallocation of resources. This has meant significant over-investment in home-building as well as problematic housing inflation.”

- Doug Noland, a financial markets strategist with David W. Tice & Associates wrote an article in the March/April issue of the *International Economy* in which he warns that **the GSEs -- Fannie, Freddie and the FHLBanks -- are the culprits for turning the American financial system into a “ticking time bomb.”** Noland stresses that **the GSEs have been at the forefront of creating “blatant” credit excesses in the financial sector, and warns, “during the past 18 months...they have embarked on a crusade which has resulted in a dangerous financial and economic bubble.”** Noland adds that the GSEs are powerful -- both on Wall Street and in the political arena. However, he notes, **“this power has not been wielded responsibly. Rather than exhibiting a modicum of restraint against a credit-induced frenzy of speculation, these GSEs have abused**

their powerful position by partaking of enormous lending excess, not to mention timely market interventions, creating momentous risk to the American taxpayer, financial system, and global economy as a whole. Nor has anyone else in the US had the courage to reign in these institutions and say, ‘Enough is enough.’”

- Noland noted that in October 1998, the US boom hung in the balance and globally, it was described by leading policymakers as the worst financial and economic crisis in “more than 50 years.” Noland credits Fannie and Freddie for helping the economy recover. On October 8, 1998, Noland reported that Fannie bought \$5 billion in loans -- more in one day than it had in the previous several months. Industry estimates put Freddie Mac’s purchases at about \$4 billion. **“Truly Wall Street was on the brink. Fannie and Freddie, armed with their implied government debt guarantees...responded forcefully to as buyers of last resort. . . It is not a stretch to credit these institutions with inciting an historic refinancing boom.”**
- **However, this boom in the economy was “unnecessary and undesirable” for a stock market and economy already headed towards “bubble excess,” noted Noland. When the GSEs aggressively infused a great deal of liquidity into the market, the market did not have a chance to self-correct and weed out those firms engaged in reckless behavior. Now, according to Noland, rampant credit excesses run unchecked.** Noland called 1998, the “Year of the GSE,” as Fannie, Freddie and the FHLBanks combined to expand their balance sheets (lending) by an astonishing \$305 billion, or 33%. During the fourth quarter of 1998, the three GSEs increased lending by \$138 billion and borrowed aggressively from the money markets to finance their ballooning balance sheets. “In short, previous heady credit growth gave way to truly foolhardy money and credit excess, and the GSEs were leading the charge.”
- **Noland writes, “A strong argument can be made that the financial tumult which unfolded during the fall of 1998 was the marketplace’s natural and inevitable reaction to previous credit and speculative abuses...However, the market mechanism was circumvented with the GSEs’ aggressive moves. Rather than to allow market processes to work towards self-correction by meting out punishment for reckless and undesirable behavior, unprecedented credit creation from the GSEs provided a quiet bailout for the speculators and both perpetuated and exacerbated the US financial and economic bubble.”**
- According to Noland, the GSEs began 1997 with assets of \$900 million and ended 1999 with asset sheets likely over *\$1.5 trillion*. And to support those assets, the GSEs claim about \$60 billion in equity. The GSEs began 1993 with assets of less than \$400 billion and expanded lending by about \$300 billion during each of the past two years. The GSEs have also become players in derivatives, adds Noland, with over \$800 billion of derivative contracts, partially used to mitigate reliance on their short-term borrowings.
- **Noland notes that “Importantly, unprecedented lending growth and mortgage-backed security guarantees by the GSEs have distorted market-pricing throughout the real estate sector, leading to a dangerous misallocation of resources. This has meant significant over-investment in home-building as well as problematic housing inflation.”**
- **“And with Fannie and Freddie ‘creaming’ the market of the most favorable mortgages, the banking industry has drifted into more risky lending . . . essentially poison[ing] the money and credit creation process.”** Noland concludes by strongly stressing that the US is purely a proverbial “house of cards” -- vulnerable to high interest rates and any decline in real estate prices

or equity. **“When confidence falters, the great American stock market bubble will be pierced and the foolishly over-leveraged credit system will be in peril. As for the world’s currency, it is both ironic and inexcusable that for all the talk within the beltway that ‘a strong dollar is in the best interest for the United States,’ the Washington-based Government-Sponsored Enterprises have done the most to effectuate the current financial and economic bubble that ensures a coming crisis of dollar confidence.”** (*International Economy*, March/April 2000, Doug Noland)

AEI Resident Fellow Peter Wallison accuses the GSEs of leveraging Uncle Sam

The GSEs are part of a disturbing trend: “Congress establishes a GSE, and the GSE, once established, assembles constituencies that benefit from their subsidies and lobby to keep them growing and unimpaired. Depending on the size and wealth of its constituency, a GSE can acquire a kind of invulnerability to congressional scrutiny.”

- Peter Wallison, Resident Fellow at the American Enterprise Institute, wrote an article in the March/April 2000 edition of the *International Economy* raising concerns about the GSEs. Wallison first draws attention to the FHLBanks. According to Wallison, Congress should have abolished the FHLB System several years ago, when it became clear that the housing market no longer needed liquidity from the FHLBanks. Instead of abolishing the FHLBanks, Congress expanded the FHLBanks’ mission under the Gramm-Leach-Bliley Act. Now the FHLBanks are authorized to finance small bank lending to local small business and agriculture. He believes that the FHLBanks will now be able to exploit their association with small business to justify their existence and expansion.
- This is part of a troubling trend in Wallison’s opinion: **“Congress establishes a GSE, and the GSE, once established, assembles constituencies that benefit from their subsidies and lobby to keep them growing and unimpaired. Depending on the size and wealth of its constituency, a GSE can acquire a kind of invulnerability to congressional scrutiny. Fannie Mae and Freddie Mac, for example, have made themselves virtually untouchable by parlaying their own enormous wealth and the political power of their housing communities.”**
- Wallison then outlined the political power of Fannie and Freddie. He noted that both contribute a great deal of money to both political parties (over \$1.3 million in the last election cycle) and both hire a vast cadre of lobbyists to promote their agendas. Both GSEs also open offices in congressional districts and make donations to community groups favored by powerful Members of Congress. According to Wallison, **“these activities enable Fannie and Freddie, which carry serious financial risks, to manage political risk...Hence the top officers of Fannie are not experts in housing or finance but are best known for their political networks.”**
- **Wallison also warned that the GSEs are “out of control”** because they have not been properly monitored by Congress or the executive branch and have subsequently put the taxpayers at risk for trillions of dollars, should the GSEs go under, because the US government implicitly backs the GSEs. Wallison noted that growth estimates show that the GSEs will likely undertake over \$3 trillion of mortgage risk by 2003.
- The GSEs are also expanding into new programs, added Wallison. He noted that Fannie and Freddie have used their “housing” mission to move into housing-related areas of consumer finance, offering programs for home improvement loans and for improving home fixtures such as heating

systems. **“Many believe that this is just the beginning of what will eventually become a full-fledged consumer finance business.”** However, with little government oversight, Wallison notes that the GSEs have not really needed to justify their programs. Since the GSEs are off-budget, Congress does not have the time or resources to effectively monitor the risks being taken by the GSEs. Combined with their extensive political power, the GSEs essentially have a free reign. **“As long as they [GSEs] are left without oversight or political restriction, their off-budget, market-based funding allows them to expand indefinitely without having to go back to Congress.”**

- Wallison concludes, **“that is why the new authority of the FHLBs is so troubling. It represents another step in a process which is gradually replacing more and more government activity outside the control of Congress, the executive branch, and ultimately the voters.”** (*The International Economy*, Peter Wallison March/April 2000)

***American Banker* estimates that 70% of banks would have to unload investments of Fannie, Freddie, and the FHLBs if Treasury Undersecretary Gary Gensler’s testimony on restricting banks’ holding of GSE debt were imposed**

Banks hold more than \$210 billion in GSE debt - a third of total bank capital - as of mid-1999

- Dean Anason with the *American Banker* reported that an estimated 70% of commercial banks would have to unload investments of Fannie, Freddie, or other GSEs if Treasury Undersecretary Gary Gensler’s testimony on restricting banks’ holding of GSE debt were imposed. In March 22 testimony before the House Banking Committee’s Capital Markets Subcommittee, Gensler suggested placing restrictions or limiting the amount of Fannie and Freddie debt commercial banks can hold.
- Gensler testified that at mid-year 1999, banks held \$21 billion in GSE securities – just under 4% of total bank assets and over one-third of total bank capital – constituting a “significant portion” of the assets of the US banking system. In addition, banks held more than \$355 billion in mortgage-backed securities guaranteed by the GSEs.
- Currently, Fannie and Freddie debt does not come under the same restrictions as other debt. Current law limits a bank’s credit exposure to any one entity. While national banks cannot hold more than 10% of their capital in the corporate bonds of any one issuer or lend unsecured more than 15% of their capital to any one borrower, there are no limits on the holdings of GSE debt. Gensler stated that “Congress should seriously consider the best way to repeal such exceptions, including a sufficient transition period to prevent any market disruption.” **“The bill highlights an important issue – the potential for problems at one financial institution to cause instability in the financial markets or at other institutions.”**
- According to Anason, Treasury has not calculated how many banks hold more than 10% of their capital in any GSE securities and it’s difficult to determine a precise figure because banks lump all their GSE holdings together in quarterly call reports. An American Bankers Association analysis of filings by 8,500 commercial banks shows that most would exceed the limit. As of December 31, 54 banks had an amount equal to more than 500% of their capital in GSEs and 4,003 banks held between 100% and 500%. Another 2,019 institutions (24%) held an amount equal to 50% to 100% of their capital in GSEs. (*American Banker*, Dean Anason, 4/14/00; *Dow Jones Newswire*,

Fannie Mae and Freddie Mac

Citizens Against Government Waste (CAGW) praises Cong. Baker on his oversight of the GSEs

CAGW says Cong. Baker is doing a great service to homeowners and taxpayers around the nation

CAGW says “Congressman Baker has been getting a lot of flak from Fannie Mae since he started talking about GSE debt” but “America is well served when someone like Richard Baker is looking after taxpayers’ money”

- CAGW praised Cong. Baker for his work in exploring the risk to taxpayers inherent in the mounting debt issued by Fannie and Freddie. “Congressman Baker is doing a great service to homeowners and taxpayers in Baton Rouge and around the nation by asking Fannie Mae and Freddie Mac some tough questions about their skyrocketing debt,” said CAGW President Thomas Schatz. “His work will help insure that these organizations stick to their mission of making home mortgages available for middle- and working-class families.”
- “Unfortunately, Fannie and Freddie are engaging in ‘mission creep,’” Schatz continued. “If they continue their quest to reach into sub-prime and jumbo mortgages, there is a potential danger of collapse on the scale of the savings and loan crisis of the 1980s.”
- “Congressman Baker has been getting a lot of flak from Fannie Mae since he started talking about GSE debt. Most federal bureaucracies, including quasi-government agencies like Fannie Mae, aren’t happy to be put in the spotlight of congressional oversight,” Schatz said. “But America is well served when someone like Richard Baker is looking after taxpayers’ money.” (*US Newswire*, 4/18/00)

National Community Reinvestment Coalition says Fannie & Freddie lag behind the nation’s banks in financing single-family and home mortgages for minorities and low- and moderate-income homebuyers

- According to the *Housing Affairs Letter*, the National Community Reinvestment Coalition says Fannie and Freddie lag behind the nation’s banks in financing single-family and home mortgages for minorities and low- and moderate-income homebuyers. A study, based on 1995 and 1996 data, finds that 41% of banks’ single-family loans went to low- and moderate income homebuyers during those years, while only 32% of Freddie’s and 33% of Fannie’s loan purchases involved such mortgagors. While 27% of bank loans went to lower-income and minority neighborhoods, only 20% of Fannie’s and 19% of Freddie’s went to those communities. The National Community Reinvestment Coalition concludes that Fannie and Freddie are more successful in financing loans made to underserved populations when they work with private-sector and non-profit entities. (*Housing Affairs Letter*, 3/31/00)

Fannie & Freddie recommend massive changes to OFHEO's risk-based capital proposal – a proposal that OFHEO has been working on for six years

The GSEs and the private mortgage insurers are at odds over the proposal

OFHEO intends to finalize the rule by the end of the year

- Fannie and Freddie reportedly raised a number of serious objections to OFHEO's proposed risk-based capital rule covering Fannie and Freddie, potentially delaying further implementation of the proposed rule. In their comments to OFHEO, Fannie and Freddie raised more than a dozen problems with the proposed rule and objected to everything from the rule's restrictions on their ability to develop new mortgage programs, to a lack of clarity on ways to tie the companies' risk to their capital base. (*Dow Jones Newswire*, Jerry Guidera, 3/10/00)
- Fannie said that "the assumptions and modeling methods fail to link the required capital to the true economic risks that the companies face." Fannie warns that this could have unintended consequences, such as making low down-payment mortgages more expensive and discouraging risk sharing with third parties. "In sum, failure to tie capital to risk will compromise the safety-and-soundness purpose of the rule while, at the same time, impeding the ability of the companies to fulfill their missions." (*National Mortgage News Daily*, 3/13/00)
- Fannie's comment could be summed up in one word – "unworkable." Fannie wrote, "Because of its excessive complexity and massive data and infrastructure requirements, the proposal is not operationally workable." Further, "Under the proposed regulation, Fannie Mae and Freddie Mac could not expect to know their capital requirements in either an accurate or timely manner." Fannie continued, "Nor would Fannie Mae and Freddie Mac be able to anticipate future capital requirements. Indeed, we believe that accurate, timely quarterly capital determinations by OFHEO itself would be impossible." (*Dow Jones Newswire*, John Connor, 3/29/00)

GSEs and MIs at odds

- *National Mortgage News* reports that the Mortgage Insurance Companies of America (MICA) and Fannie and Freddie are at odds over the proposal, specifically the capital "haircuts" for counterparty risks. MICA is concerned that narrowing the capital "haircuts" (as was suggested by the GSEs) will encourage the GSEs to use lower-rated or even unrated credit-enhancement counterparties, as opposed to mortgage insurance companies rated AAA or AA. OFHEO proposed haircuts ranging from 10% on AAA rated counterparties to 80% on BBB rated counterparties. The more severe the haircuts, the higher the amount of capital Fannie and Freddie have to hold against the risk that a counterparty could default. A Spokeswoman for OFHEO said the agency intends to finalize the proposal by the end of the year. (*National Mortgage News Daily*, 4/26/00)

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 six 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. The comment period on OFHEO's proposed risk-based capital proposal for Fannie and Freddie closed on March 10, 2000 after 11 months and two extensions. The comment periods were

extended at the request of Fannie and Freddie. OFHEO also sought reply comments in response to the comments that were submitted by the March 10 deadline. The deadline for the reply comments closed on April 14, 2000

An *Economist* editorial likens Fannie & Freddie to “spoiled rich kids, at risk of getting out of control.” The editorial suggests that “Congress should force them to leave home before they do serious damage to themselves and the economy.”

Fannie & Freddie “distort the private market” and are a “perfect example of what people mean when they talk of moral hazard caused by government intervention”

“If the modern American dream is to privatise gains and socialise risks, then Fannie and Freddie are certainly living it.”

- *The Economist* ran an editorial that **likened Fannie and Freddie to “spoiled rich kids, at risk of getting out of control.”** The GSEs were created with an “innocuous” task - to provide liquidity in the mortgage market. **However, now the market is more than able to deliver liquidity through fully private lenders, and “what the federal mortgage agencies do now is to distort the private market. This is a perfect example of what people mean when they talk of moral hazard caused by government intervention.”**
- *The Economist* notes that the GSEs’ “quasi-public” status has allowed them to become among the New York Stock Exchange’s most profitable companies. **But with this “quasi” status, the GSEs have “aggravated the moral hazard, for they now combine the incentives (and pay) of the private sector with the protection of the public sector, and impose none of the constraints associated with either. If the modern American dream is to privatise gains and socialise risks, then Fannie and Freddie are certainly living it.”**
- Fannie and Freddie are exempt from state and local taxes, have “less onerous capital-adequacy requirements” than private lenders, and Wall Street is urging them into riskier but more profitable activities. The editorial asks, **“What public enterprise can match Franklin Raines, boss of Fannie Mae, who is paid \$14m [million] a year, with share options on top?” “Fannie and Freddie have exploited fully the edge they get from the belief that they are government-guaranteed.”** Because the GSEs are assumed to be government-backed by those on Wall Street, they can borrow at almost the same rates as the Treasury, earning “a fortune” by investing in higher yield mortgages and mortgage-backed securities.
- The GSEs have also increased their borrowing and lending at spectacular rates in the past few years. Any doubts that Wall Street believes that the government stands behind the GSEs were dispelled when in March of this year, the market reacted strongly to a Treasury Department official’s claim that the government does not guarantee the GSEs’ debt. Spreads between Treasuries and GSE debt immediately widened and only a “soothing noises from the Treasury (but not a retraction) calmed the markets down.”
- Others have accused the GSEs of inflating a credit bubble. **“To meet their ambitious profit-growth targets, Fannie and Freddie will need to undertake ever riskier lending, and to retain ownership of a growing proportion of mortgages. They will find it ever harder to hedge away their risks. So any downturn in the housing market could easily cause one or both of them to**

stumble, with knock-on effects throughout the economy. Any bill would almost certainly go to the taxpayer.”

- The author concludes that there is an alternative -- to privatize the GSEs. However, with their extensive political connections, this will certainly be a difficult task. If the GSEs are fully privatized, they will be forced to borrow at interest rates that reflect their riskiness -- thereby forcing them to curb their lending. The editorial concludes with this warning, **“Fannie and Freddie...are like spoiled rich kids, at risk of getting out of control. Congress should force them to leave home before they do serious damage to themselves and the economy.”** (Editorial, *The Economist*, 4/15/00)

***The Economist* argues that the GSEs may be the source of nasty economic problems ahead “Fannie and Freddie may be doing more harm than good” and they “may have fueled an unsustainable credit bubble”**

- An article in *The Economist* warned that if the housing market enters into a down cycle, there may be serious implications for the housing GSEs (Fannie, Freddie, and the FHLBanks), which have fueled the current housing boom. The article notes that Congressman Baker has been worrying about the growing risk of Fannie and Freddie and has warned that the taxpayers may be left with a bill that “dwarfs the size of the savings and loan mess of a decade ago.”
- The GSEs have combined debt of over \$1.4 trillion and have been increasing their lending at an annual rate of 20% -- as has the FHLBanks, and if current trends continue, by 2003 they will be bearing some of the risk on half of America’s residential mortgages.
- Financial markets may be allowing this expansion to occur because they believe that the government backs the GSEs and if things go wrong, the government will come to the rescue. Fannie and Freddie have “moved into a twilight zone between the public and private sectors.” Fannie and Freddie’s shares are publicly traded stocks on the New York Stock Exchange and are among the fifty wealthiest American companies. The companies claim they are fully private, yet the GSEs receive many benefits not available to any truly private firm. Fannie and Freddie do not pay local and state income taxes and have lower capital standards than other fully private rivals. Fannie and Freddie have roughly \$32 of debt for each dollar of capital, while large banks have roughly around \$11.50 of debt per dollar. The GSEs borrow money at rates almost equal to those of the US Treasury due to their implicit government guarantee and also have an emergency line of credit at the Treasury. In 1996, government studies found that the GSEs receive roughly \$6 billion of subsidy from their quasi-public status -- of this amount only about \$4 billion is passed on to homebuyers, with stockholders and employees benefiting from the remainder.
- When the GSEs were created, they provided useful liquidity in the secondary market, and in the 1960s and 70s they led the development of asset-backed securities. **Now, however, “the financial markets are large and sophisticated enough to do without a federal helping hand.”** The article adds, **“so Fannie and Freddie may be doing more harm than good. They make mortgages slightly cheaper, while mostly stifling truly private competition . . . And they are expanding their range of activities. They are moving into ‘sub-prime’ lending to less creditworthy borrowers. Some of the firms in that market reckon that the agencies’ recent crusade against ‘predatory lending’ in these markets is merely a figleaf to cover up their own predatory swoop.”** In addition, others have predicted that the GSEs are on a course to “nationalize” the mortgage market. The article cites an American Enterprise Institute report by

Peter Wallison and Bert Ely that suggests the GSEs will expand into other arenas such as jumbo mortgages, commercial mortgages and small-business loans. Another area of concern is the level of GSE securities and debt that banks are currently holding - amounting to one-third of total bank capital – a highly concentrated risk.

- **“Fannie and Freddie may have fueled an unsustainable credit bubble.”** The article explains that the GSEs’ “continued expansion” since the financial crisis in autumn 1998 has “pumped liquidity into the system when the Federal Reserve was trying to reduce it.” And, while no one believes the GSEs to be in immediate danger, the article notes, **“since they expanded so fast, the quality of their risk management has not been tested by a market downturn. Ominously, during the last housing bust in the 1980s, Fannie became technically insolvent, though regulators allowed it to ‘grow out of its difficulties.’”**
- The markets may be waking up to the GSEs’ risks. Last month, after testimony by senior Treasury official Gary Gensler at a hearing chaired by Congressman Richard Baker on the GSEs, market spreads rose considerably between the GSEs and Treasuries simply because Gensler stated that GSE debt is not guaranteed by the federal government. Markets did not return to normal until the Treasury issued a “clarification” which basically said that nothing had changed with the Treasury’s position on the GSEs -- thereby confirming the implicit government guarantee.
- **The article suggests two options for dealing with the GSEs. The first option is to increase oversight of the GSEs by curbing their lending and forcing them to increase capital requirements. The second option, favored by *The Economist* article, is to privatize the GSEs, so that the markets are clear on the fact that the GSE debt carries no government guarantee.** However, “expect Fannie and Freddie to pull all their influential political strings to stop it happening to them.” (*The Economist*, 4/15/00)

***Insight Magazine* runs a cover story (“Home Sweet Home”) examining the growing concerns about Fannie & Freddie**

Fannie & Freddie were meant to help Americans buy homes, but now, “these two companies are making politically appointed executives rich while amassing debt that could cost taxpayers billions”

“...a downturn in the economy could result in a huge bailout bill for US taxpayers . . . Much like the savings and loan crisis a decade ago that cost taxpayers \$500 billion.”

- *Insight on the News* ran a cover story by Catherine Edwards that examined the growing concerns about Fannie and Freddie. **Fannie and Freddie were meant to help Americans buy homes, but now, “these two companies are making politically appointed executives rich while amassing debt that could cost taxpayers billions.”** Edwards noted that while the GSEs are among Wall Street’s most profitable companies (its net profits amount to \$900,000 for each of its 4,000 employees), they also racked up around \$1.89 trillion in debt last year. And while politicians promise to pay down the national debt, some are concerned about the amount of debt that the GSEs carry. Edwards notes, **“a downturn in the economy could result in a huge bailout bill for US taxpayers . . . Much like the savings and loan crisis a decade ago that cost taxpayers \$500 billion.”** Therefore, some Members of Congress and watchdog groups are calling for stricter oversight of the GSEs and for an overhaul of the quasi-government organizations.

- However, the GSEs are notoriously political -- Edwards notes that watchdog groups complain that **“what should be a business is so political that the president appoints five members to Fannie Mae and Freddie Mac’s boards. In fact, Fannie Mae CEO Franklin Raines has been touted as a possible running mate for Al Gore.”** Edwards further adds that Raines was director of the OMB prior to becoming CEO of Fannie and saw his salary rise from \$130,000 to \$4 million per year, with almost \$6 million in unexercised stock options. Other politically-connected Fannie executives include VP Jamie Gorelick, former Assistant Attorney General to Janet Reno, who now pulls down a \$2 million salary, and Jack Quinn, former White House Counsel (who was found in contempt of Congress for the Travelgate scandal), who now sits on Fannie Mae’s Board. When Quinn joined the board, adds Edwards, he immediately was offered an option to purchase 3000 shares of Fannie Mae. Jose Villareal, who currently serves as Vice President Gore’s campaign treasurer and in 1992 served as Deputy Campaign Management for President Clinton’s presidential campaign, also serves on Fannie Mae’s Board. **“This sort of thing makes a board appointment look like a huge political payment,”** added Edwards.
- Daniel Mitchell, Senior Fellow in Political Economy at the Heritage Foundation, supposes that in the Depression when Fannie was created, “there was a need for government sponsorship to help provide secondary-mortgage market liquidity. But with today’s economy that certainly isn’t the case... There are plenty of financial institutions that would jump at the chance to compete on a level playing-field in the secondary mortgage market.” Fannie Spokesman David Jeffers says it “would welcome competition from anyone who could do the job any better.”
- However, in addition to their political connections, the GSEs also receive numerous perks for their government-sponsored status that fully private companies do not enjoy, which the Congressional Budget Office estimated as a \$6 billion annual subsidy. Chief “perks” include the fact the GSEs do not have to register securities with the SEC and they do not have to pay state and local taxes – “a requirement that costs other giant corporations billions.” Fannie and Freddie also each have a \$2.25 billion line of credit to the US Treasury -- which Edwards calls the most visible reminder to Wall Street that the GSEs are implicitly backed by the U.S. Government. In addition, the CBO estimates that of their \$6 billion annual subsidy, the GSEs only pass on an estimated \$4 billion to homebuyers -- keeping the remaining two billion for shareholders, executives and lobbyists. The CBO also estimates that 40% of Fannie and Freddie’s earnings result from their government sponsorship. Fannie’s Spokesman Jeffers says the CBO study “has been widely denounced as flawed,” but when asked by whom, he replies, “Lots of people, but especially us.”
- In an attempt to more effectively regulate the GSEs, Congressman Baker introduced legislation (HR 3703) that would among other things, take away the GSEs’ line of credit with the Treasury. Edwards notes that if this bill were to pass, the GSEs could lose their AAA rating after their line of credit disappears. Fannie denounced Baker’s bill, calling it “bad and stifling to their product innovation as a private company.” However, Baker is not alone on Capitol Hill. Congressman Peter Hoekstra (R-MI), a member of the House Budget Committee, recently sent a letter to House Budget Committee Chair John Kasich (R-OH), asking Kasich to appoint a task force to review the potential government waste and taxpayer liability associated with the GSEs.
- Fannie Spokesman Jeffers claims that Fannie’s debt is backed by mortgages whose assets are houses – which he calls “the safest investment there is.” He says Fannie’s benchmarks are considered “reliable and liquid.” However, Edwards adds that **“continuing volatility on Wall Street may yet prove that Fannie Mae and Freddie Mac are not as safe as they like to appear.”** As evidence, Edwards notes that moments after Treasury Department official Gary Gensler testified at a hearing on Cong. Baker’s bill that the Treasury supported cutting the GSEs’

line of credit, the market reacted wildly -- causing spreads to climb between Treasurys and GSE debt.

- According to Edwards, many have called for more stringent regulation of the GSEs, including Peter Wallison of the American Enterprise Institute and financial advisor Bert Ely, who warn that American taxpayers will suffer immensely if the GSEs continue their “uncontrolled growth.” Wallison’s solution is either to privatize the GSEs or put them back on budget like other federal agencies. Edwards also notes that the GSEs may be falling short in their affordable housing mission, citing a 1998 GAO report that found that the GSEs lag the private market in providing loans to low-income borrowers. She also noted the GSEs’ recent public battle with HUD Secretary Andrew Cuomo who charged that the GSEs are not doing enough to help low-income borrowers.
- However, Edwards concludes with this warning, **“those who want to change the situation will have an uphill battle. Fannie Mae and Freddie Mac spend a fortune on advertising and lobbying...They place full-page ads almost weekly in the *Washington Post* at \$34,000 apiece. Meanwhile Fannie Mae spent \$6 million on lobbyists last year and political contributions from Fannie Mae staff totaled almost \$70,000 at the end of 1999, 75 percent of it going to Democrats.** The article ends with this quote from a Hill staffer. **“You have to watch out with those two if you challenge them...Even though they enjoy government benefits, they’ll come after you.”**(*Insight on the News*, Catherine Edwards, 5/1/00)

***Business Week* article calls Fannie & Freddie’s ties to the government “under siege”**

Top Administration officials and key Republican lawmakers are criticizing Fannie & Freddie

- A *Business Week* article by Howard Gleckman reported on the recent criticisms of the GSEs by members of the Administration, Congress and watchdog groups. **Gleckman noted that within just a few weeks of each other, “two top Clinton Administration officials fired shots across Fannie’s bow.” HUD Secretary Andrew Cuomo charged that Fannie and Freddie do too little to help low-income homebuyers. Within weeks of HUD’s comments, Treasury Under Secretary Gary Gensler “struck at the heart of the companies’ special relationship with the federal government” and testified that the US Treasury gives no explicit guarantee that it will back up the bonds of Fannie and Freddie should they fail.** Gleckman also noted that Gensler supported legislation proposed by Congressman Baker that would, among other things, cut the GSEs’ line of credit with the Treasury. After Gensler’s comments, the market reacted harshly -- causing GSE bonds to “tank” in the markets. While the Treasury Department did issue a statement the next day, insisting that Gensler was just echoing a long-held Treasury policy, Gleckman quoted a “gleeful” GSE critic as stating, “They’ve put the guarantee in play.”

Fannie & Freddie’s ties to the government are “under siege”

- Gleckman listed the many perks that Fannie and Freddie receive from their GSE status: the GSEs do not register their securities with the SEC; they do not pay state or local income taxes; they have a standing \$2.25 billion line of credit with the US Treasury; and banks may hold an unlimited amount of their bonds. “All of these things make a powerful implicit argument that the government would support the holders of those securities,” says Standard & Poor’s Corp. Managing Director Michael DeStefano. All the GSEs’ benefits add up to a AAA rating on Wall Street and allow the GSEs to reduce their borrowing costs, added Gleckman. GSE securities trade at a “bare” 0.72 percentage points above Treasuries, while similar non-GSE bonds trade at about 1.10 percentage points higher than Treasuries. However, after Gensler pointed out that the

government does not guarantee GSE securities, the spreads widened sharply for a while. **Gleckman believes Treasury went on the offense because Treasury officials do not want bond investors to price debt as if a federal guarantee exists, because “that would mean a government bailout in a market crisis is also assumed. They are especially worried because Fannie and Freddie could become the country’s largest issuers of bonds -- and replace Treasuries as the credit markets’ benchmark. Today, the companies have nearly \$1.5 trillion in outstanding bonds, while the Treasury is paying down the \$2.7 trillion national debt.” In addition, adds Gleckman, if the GSEs were to become the nation’s benchmark, then most of the country’s interest rates would be tied to two companies -- making it close to impossible for the federal government to allow them to default. Peter Wallison, senior fellow at the American Enterprise Institute, is quoted as stating, “It would make them immortal.”**

Not good news for Fannie

- Gleckman noted that the recent criticisms do not spell out good news for Fannie CEO Franklin Raines. **Until recently, Raines and other GSE executives have been able to use the argument that due to their GSE status, costs are lower for the GSEs, and these lower costs are passed down to consumers. As Gleckman noted, “until now, that argument has made the companies bulletproof in the Washington wars.” However, now that argument may be losing its muster.** Gleckman adds that in addition to pressure from the Clinton Administration Treasury Department, HUD and from key Congressional Republicans such as Congressman Baker, the GSEs also face extreme opposition from a well-connected group called FM Watch. FM Watch boasts a membership list of large banks, mortgage insurers, subprime lenders, and powerful Washington lobbyists such as former chair of the Republican National Committee, Haley Barbour, and Tony Podesta, brother of White House Chief of Staff John Podesta. Together, Gleckman notes, FM Watch is aiming to block the GSEs from expanding their business. And, according to Gleckman, “they [FM Watch] are making progress.
- However, according to Gleckman, “Fannie and Freddie aren’t taking the assault sitting down. Fannie’s top ranks are filled with well-connected pols, from Raines to John Buckley, spokesman for Bob Dole’s Presidential campaign. Fannie also spent \$6 million on lobbying last year. They’ll need the muscle. The bigger they grow, the bigger a target they’ll be. While critics know they can’t score many points against the companies in an election year, they insist that Congress will eventually mandate a level playing field. Perhaps -- but not without a battle.” (*Business Week*, Howard Gleckman, 4/10/00)

A *Wall Street Journal* article by Michael Schroeder noted that “In the hot debate over predatory lending, a sticky question has arisen: Is Fannie Mae...a white hat or a black hat?”

Some banks are contending that Fannie’s entrance into the subprime market is a thinly veiled strategy by Fannie to capture a big share of the market under the guise of cleaning up abuses

In related news, HUD announces a new proposal that would bar Fannie & Freddie from purchasing loans originated through predatory lending practices

HUD says the government should determine the definition of a predatory loan and the terms and conditions – this is not a matter of GSE discretion

Shortly after HUD’s announcement, Fannie announces new guidelines for combating predatory practices

The consumer group, ACORN, calls Fannie & Freddie’s new guidelines vague and asserts that the policies do not go far enough

- Fannie recently announced safeguards aimed at combating predatory lending in the subprime area. However, some banks are contending that Fannie’s entrance into the subprime market is a thinly veiled strategy by Fannie to capture a big share of the market under the guise of cleaning up abuses and a counterattack against the Fannie/Freddie watchdog group, FM Watch. **Schroeder notes that Fannie has expanded into the subprime market even though the market has little to do with the first-time homebuyer market. Of the four million subprime loans originated in 1999, nearly all were mortgage refinancings, second mortgages and home-equity loans.**
- In a recent speech, Fannie CEO Franklin Raines attacked banking and finance industries for inaction on sponsoring predatory lending reforms. “There’s no question many legitimate lenders are being tempted to get into the business because of its profits,” he said. “Many subprime lenders are owned by big banks.”
- Schroeder reported that the suggestion by Raines that predatory lending problems may be moving from shady home equity finance companies to mainstream brand-name financial institutions “galls” bankers. Raines says Fannie is interested in expanding into the subprime market in order to provide borrowers a better deal that they are currently receiving from traditional lenders. “I can’t believe their animosity is so strong,” he said. (*Wall Street Journal*, Michael Schroeder, 4/11/00)

HUD announces a new proposal that would bar Fannie & Freddie from purchasing loans originated through predatory lending practices

- HUD announced a “legislative proposal” on April 9 that would prohibit Fannie and Freddie from purchasing mortgages with points and fees in excess of 5% of the mortgage loan amount. HUD Assistant Secretary William Apgar said the proposal “will prevent predatory lenders from gaining a foothold in the nation’s secondary market.” The HUD proposal would also prohibit Fannie and Freddie from purchasing mortgages with single-premium credit life insurance policies and those mortgages with “unreasonable prepayment penalties, including penalties linked to prepayments due to borrower default.” Fannie and Freddie would also be banned from purchasing mortgages from subprime lenders that violate fair housing laws. “This proposal will protect consumers from being victimized by predatory lenders and ensure that these two government sponsored enterprises are

held to the highest standard of conduct in the marketplace,” said HUD Secretary Andrew Cuomo. “The cleanest, clearest most effective way to stop predatory lending is to make it illegal for Fannie and Freddie,” said Cuomo in a telephone interview with the *Washington Post*. (*BNA Daily Report for Executives*, Adam Wasch, 4/11/00; *Washington Post*, Caroline Mayer, 4/10/00; *Dow Jones Newswire*, 4/9/00) **Cuomo added that “We should define by legislation what is a predatory loan and the terms and conditions. This should not be a matter of GSE discretion.”** (*PR Newswire*, 4/12/00)

Shortly after HUD issued its predatory lending proposal, Fannie issues guidelines aimed at predatory lending practices

- Fannie announced anti-predatory lending policies on April 11. As part of their guidelines, Fannie said it will not purchase mortgages from lenders who “steer” consumers into high-cost mortgage products, attach single premium credit life insurance policies to mortgages, charge excessive fees, impose unfair prepayment penalties, don’t report a borrower’s full credit history to credit repositories and don’t maintain escrow deposit accounts for customers. (*Inman News Feature*, 4/11/00) Under the guidelines, for loans delivered to Fannie, the points and fees charged to a borrower should not exceed 5%, except where this would result in an unprofitable origination. In addition, Fannie will not purchase a mortgage that is subject to the requirements of the Home Ownership and Equity Protection Act of 1994 (HOEPA) that apply to “high-cost” mortgages. Although Fannie said it would not purchase mortgages with single premium credit life insurance tied to the mortgage, this does not apply to credit life insurance policies that require separately identified premium payments on a monthly or annual basis or to prepaid hazard, flood, or mortgage insurance policies. Fannie said it would also only consider allowing prepayment penalties under the terms of a negotiated contract, and where the lender adheres to the following criteria: a mortgage that has a prepayment penalty should provide some benefit to the borrower; the borrower should also be offered the choice of another mortgage product that does not require payment of such a premium; the terms of the prepayment penalty should be disclosed to the borrower; and the prepayment penalty should not be charged when the mortgage debt is accelerated as the result of the borrower’s default in making his or her mortgage payments. (*Fannie press release*, 4/11/00)

Groups not very impressed with Fannie’s new guidelines

- **The Association of Community Associations for Reform Now (ACORN) does not think Fannie and Freddie’s recent predatory lending guideline announcements go far enough. ACORN Spokesman Mike Shea said the companies’ guidelines are vague and don’t carry sufficient auditing and enforcement provisions.** (*Washington Post*, Kathleen Day, 4/12/00) [Freddie issued predatory lending guidelines in late March.] **Wright Andrews, a partner in law firm Butera & Andrews and the Washington counsel for the National Home Equity Mortgage Association (NHEMA) says “Fannie Mae guidelines are just PR fluff.” He added that “It looks like they’re doing a lot when they’re really not doing much. They do not want risky loans. They want to skim the cream off the top.”** (*Credit Risk Management Report*, 4/17/00) According to a *National Mortgage News* article, Fannie’s new guidelines failed to impress Freddie. **A Freddie Spokesman said there was nothing new in Fannie’s guidelines and many of their ideas are ones that have already been put into effect by Freddie.** (*National Mortgage News*, Dawn Bailey, 4/17/00)

***Wall Street Journal* article notes that as Fannie & Freddie mushroom in size, concerns about their risk also rises**

Securities firms pick up the tab for lunch once a week for 70 of Freddie's employees

Concerns are mounting that Fannie & Freddie “may be slipping.” “Critics complain that they are taking unnecessary risks to expand their business. And in Washington, their once-vaulted political machine has failed to stop unaccustomed attacks from both Democrats and Republicans, in the administration and Congress.”

- The *Wall St. Journal* reports that Fannie and Freddie have become the “600-pound gorilla of the debt markets” due to the volume of loans each handles. The authors, Patrick Barta, Gregory Zuckerman, and Michael Schroeder, note that the number of loans each company has undertaken in the past two decades has tripled. **Since the GSEs pay out about \$460 million in underwriting fees each year, Wall Street has plenty of reasons to want to please Fannie and Freddie, note the authors. The article notes that Freddie's employees had a long-standing tradition of calling their favorite Wall Street securities firms and asking them to pick up the lunch tab for its employees at the trading desk of Freddie's headquarters (a practice that has now been discontinued after the *Wall Street Journal* article). Usually about once a week -- confirmed Freddie Investment Officer, Greg Parseghian -- a Wall Street firm would pick up the tab for approximately 70 Freddie staffers.**
- **Fannie and Freddie have mushroomed in size over the past several years, and while the two “swell their portfolios to unprecedented levels, there's concern that the risk to taxpayers is swelling as well.”** With their special GSE status, investors assume the government backs Fannie and Freddie and taxpayers would pick up the tab if they failed. **Fannie and Freddie combined “are on the path to be the largest issuers of debt in the world, and could soon replace Treasury bonds as the market's benchmark – which would help lower their borrowing costs and enable them to grow even more.”**
- **“Right now, the companies' credit remains sterling, a testament to their perceived skill at managing risks - both financial and political. But concerns are mounting that the two ‘government-sponsored enterprises’ may be slipping. Critics complain that they are taking unnecessary risks to expand their business. And in Washington, their once-vaulted political machine has failed to stop unaccustomed attacks from both Democrats and Republicans, in the administration and Congress.”**
- The authors point out several examples of scrutiny the GSEs have faced in the past few months.
 - (1) Congressman Baker's proposed legislation to strengthen GSE regulation.
 - (2) A recent letter by Congressman Hoekstra which states, “Fannie Mae's and Freddie Mac's underlying practices... may be laying the foundation for another savings-and loan-style crisis.”
 - (3) Surprisingly harsh criticism from Treasury and HUD – surprising because Fannie CEO Franklin Raines was Director of the Office of Management and Budget for President Clinton and he is a former colleague of Treasury Secretary Lawrence Summers and HUD Secretary Andrew Cuomo. Treasury Secretary Summers and Treasury Undersecretary Gary Gensler have

raised questions about the risks of GSEs to taxpayers and HUD Secretary Cuomo has attacked the GSEs for failing to do as much for low-income homebuyers. Treasury Undersecretary Gary Gensler made a point of stating that the Treasury Department does not guarantee GSE debt, which caused an immediate reaction from Wall Street.

(4) Critics are also concerned about the GSEs' backing riskier lower-quality loans, including loans that require only 3% for a down payment, or loans which cost more than 50% of a borrower's monthly income. Fannie funded nearly \$4 billion of the 3% loans last year. Although Fannie's written standard for lenders says the usual standard is for borrowers to spend no more than 36% on housing and other credit related expenses, Fannie has begun funding loans in which monthly payments exceed 50% of the borrower's monthly income.

(5) **Critics are also concerned that the GSEs are buying millions of mortgage-backed securities that were sold to investors, which boosts profits, but "if interest rates suddenly shift, the GSEs could see huge losses."** Fannie now holds close to \$300 billion of mortgage-backed securities, more than half its portfolio. The authors concede that the GSEs are in sound financial shape right now, with losses from poor loans at all time lows. However, it would not take much to put them into real financial trouble. In fact, during the 1980s, Fannie went through a period during which it lost about \$1 million a day.

- Fannie is fighting hard to counterattack criticisms of the GSEs. The authors note that after Treasury Undersecretary Gensler's remarks about the GSEs', Fannie Vice Chair and former US Attorney General under Janet Reno, Jamie Gorelick, called the White House to complain, while Fannie CEO Frank Raines called Treasury Secretary Summers to voice his displeasure. The administration and Fannie declined to comment on the calls to the authors. Fannie also attempted to get the Mortgage Bankers Association, America's Community Banker's and the American Bankers Association to sign a letter of complaint to the White House on Gensler's remarks. The trade associations declined to sign the letter, note the authors.
- According to the authors, Fannie places the blame on the current scrutiny on one source -- a new coalition of large mortgage lenders and mortgage insurers called FM Watch -- which has come out against the rapid expansion of the GSEs.
- The authors conclude by noting that while GSE security prices may have plunged immediately after Treasury's remarks, they are back at their average levels. **"the debt has largely retraced its losses, and the love affair with GSE debt continues -- exactly what many in Washington are worried about."** Taxpayers still may not realize the risks associated with GSE debt, note the authors. They note that Seattle holds 53% of its portfolio in GSE bonds, up from 49% in 1997. The city's director of investments, Rodney Rich, is quoted as stating, **"I know they don't have a guarantee and aren't as safe as Treasury's -- but they're close. If the Fed put together a group of banks to bail out Long-Term Capital, [Fannie Mae and Freddie Mac] would also have to get a line of credit."** (*Wall St. Journal*, Patrick Barta, Gregory Zuckerman, Michael Schroeder, 4/25/00)

***Barron's* article notes that “By so rapidly expanding their balance sheets, the GSEs have offset the Fed’s attempt to restrain the economy”**

Efforts to restrain the amount of credit created by the GSEs, “could potentially do more to restrict credit” than could even the Fed

“Observers who fear that the US is in the midst of a 1920s-like credit-induced economic bubble think a move to curb GSEs would mark an important return to sobriety”

- A *Barron's* article by William Pesek, Jr. notes that after nine months, the Fed has been trying to reign in the booming US economy, while Fannie, Freddie, and the FHLBanks “have been pumping hundreds of billions of dollars of credit into the economy at a furious pace.” Pesek writes, “Observers who fear that the US is in the midst of a 1920s-like credit-induced economic bubble think a move to curb GSEs would mark an important return to sobriety.”
- Thanks to federal subsidies, the GSEs are able to expand credit more than they would be able to do on their own. The GSEs can also leverage their own balance sheets because they’re required to hold only 2% capital against their assets. Medley Global Advisors recently recommended that percentage should be increased by half, to 3%.
- Pesek further notes that efforts on Capitol Hill to restrict the amount of credit created by the GSEs, “could potentially do more to restrict credit than could even the putatively all-powerful central bank.” There is interest growing in eliminating the GSEs’ line of credit to the Treasury – which is “the clearest manifestation” of the government implied backing of the GSEs’ securities. Pesek believes that the exponential growth in GSE debt is what’s really raising eyebrows in Washington. Treasury wants Congress to limit the amount of agency debt commercial banks can purchase. According to Tom Gallagher, Washington analyst for the ISI Group, banks hold GSE debt equal to one-third of their capital. Were any of the GSEs to face a failure, the government would face the ‘untenable choice’ of bailing out the agency or seeing a contraction in bank lending. Lessening the bank’s exposure to GSE debt would be a ‘sensible policy response,’ he writes. (*Barron's*, William Pesek, Jr., 4/10/00)

***Virginian-Pilot* article reports on Cong. Baker’s GSE bill to strengthen the regulation of the GSEs**

- Tom Shean of the *Virginian-Pilot*, wrote an article on Congress’ consideration of Congressman Baker’s GSE bill which aims to curb GSE expansion and tighten regulation. According to Shean, the GSEs are facing increased criticism from Members of Congress, the Treasury Department, and members of a new coalition - FM Watch.
- Shean notes that many mortgage bankers are already wary of what will happen to their business should Baker’s legislation pass. Pat Hilliard, of CENIT Mortgage Co., is quoted as stating that among mortgage bankers, the bill has already provoked a cry of **“Oh my God, what’s going to happen if Fannie Mae and Freddie Mac lose their guarantees of government support?”** However, many in the business are not as sure the bill will pass, or if it does, if it will have much of an effect on consumers, added Hilliard. “If it were enacted, there could be a slight, and I mean slight, increase in the price of a mortgage.” Edward Cunningham, retired chairman of the old Life Savings Bank in Norfolk, VA, and a director of the Federal Home Loan Bank of Atlanta since

1998, feels the bill will not do anything in this Congress. **“The bill isn’t likely to make headway in Congress this year, but its proponents have a basis for their concerns.”** Cunningham explains, **“the fear is that with the growth of Fannie Mae and Freddie Mac, where does their expansion end? They already rule the market.”**

- Shean adds that it is difficult to miss the influence the GSEs have on the mortgage market -- purchasing over \$642 billion mortgages last year alone, and by some estimates purchasing almost half of all mortgages nationwide. In order to finance their massive purchases, the GSEs issue billions of dollars in debt every week in the nation’s debt market.
- The GSEs have many advantages that come with their government status -- including the fact that the GSEs do not register their securities with the SEC, and that the GSEs are not required to maintain levels of capital required to be maintained by banks and securities firms. With these special subsidies, both the GSEs have provided their shareholders with phenomenal returns, and have both risen to the near top of Fortune Magazines ranking of corporations by assets -- Fannie Mae is No. 3 and Freddie Mac falls in at No. 6.
- While the GSEs face resistance from some in government, they still yield enormous power on Capitol Hill and in the industry by forging alliances with influential community development groups, notes Shean. He states, however, that **“even with these ties, the challenges to Fannie’s and Freddie’s reliance on implied government backing aren’t likely to fade away.”** He notes that the residential mortgage market can provide only so much additional growth for Fannie and Freddie. As the two companies try to satisfy their shareholders by expanding into new markets, retired Life Savings Bank Chairman Cunningham said, other players in the mortgage market have been asking: **“Where are they going next? Multifamily housing? Commercial mortgages?”** (*The Virginian-Pilot*, Tom Shean, 4/23/00)

As the national debt shrinks, GSE debt skyrockets

Fannie & Freddie want their debt securities to replace Treasuries as a benchmark security

“Efforts by Fannie Mae and Freddie Mac to become bigger players, however, raise concerns among some policy makers. The two firms are privately owned. Their securities are considered safe largely because the markets assume that the government, which created both agencies, will stand behind them. If this is true, it means taxpayers are assuming an ever larger risk as Fannie Mae and Freddie Mac expand, while the companies’ shareholders enjoy profits at taxpayers’ expense.” (*Wall Street Journal*, 2/3/00)

“Combined Fannie, Freddie, and the FHLBanks have \$2.6 trillion – T as in trillion – of outstanding debt...I can’t explain why the amount of outstanding debt is so huge. I would think that \$2.6 trillion would be enough to provide every man, women and child in the US who doesn’t own a home with the equivalent of a custom-designed palace on two acres in the Hamptons.”
(*Dow Jones Newswire*, Jim Murphy, 4/12/00)

GSE debt news:

GSE debt has a significant impact on Treasury borrowing costs

The recent volatility of GSE debt harms Fannie & Freddie's ability to make GSE debt the new benchmark to replace Treasurys – groups considering other bonds as potential benchmarks

***Wall Street Journal* takes first step in search for a new benchmark – it will replace its chart of the 30-year Treasury bond with a chart of the 10-year Treasury note**

Fannie will list all of its new Benchmark notes on the Luxembourg stock exchange to attract more international investors

Background:

- As the national debt is shrinking, GSE debt is skyrocketing. As the national debt is paid down, the supply of Treasury securities shrinks – a phenomenon likely to accelerate on the heels of President Clinton's proposal to pay off the national debt by 2013 and the Treasury Department's announcement on February 2 that it is reducing the number of Treasury debt auctions it will hold. Now for the first time in 70 years, the Treasury is purchasing its own debt, further decreasing the supply. President Clinton has suggested the entire pool of Treasurys could be eliminated by 2013 as the national debt is paid off.
- Investors, traders, borrowers, and even the US Federal Reserve are being forced to find new benchmark securities to invest in, hedge with, and with which to compare themselves to replace the shrinking number of Treasurys. Among possible alternatives as a benchmark are the debt securities of Fannie and Freddie, which issue huge numbers of bonds on a regular schedule, just as Treasury has done. Investors are attracted to similar types of assets and risk-free investments -- because of the implicit government guarantee on Fannie and Freddie's securities, investors view them as "almost" as good as US Treasurys.
- Fannie and Freddie would like to replace Treasurys as a benchmark security. Fannie and Freddie both have bond issuance programs (Fannie – Benchmark bond program; Freddie- Reference bond program) that mirror traditional Treasury operations in size and regularity.

GSE Debt news:

GSE debt has a significant impact on Treasury borrowing costs

- **In a speech last year, Ex-Treasury debt manager Francis X. Cavanaugh made a point that more recent Treasury debt managers have been loath to tackle head on: "GSE borrowing clearly does have a significant impact on Treasury borrowing costs."** (*Dow Jones Newswire*, John Connor, 4/14/00)

The recent volatility of GSE debt harms Fannie & Freddie's ability to make GSE debt the new benchmark to replace Treasurys – groups considering other bonds as potential benchmarks

- Economist Henry Kaufman, speaking in the wake of Treasury Undersecretary Gary Gensler's testimony favoring eliminating the GSEs' line of credit to the Treasury, said, "The extent to which the US government has said that maybe the line of credit that the two agencies (Fannie and Freddie) have with the US Treasury ought to be removed, that disturbs the extent to which these agencies will ultimately serve as benchmarks." Kaufman, who is President of Henry Kaufman & Co. and a member of Freddie's Board of Directors, looked hypothetically down the road and speculated that Japan's bonds could one day replace US Treasurys as the main debt pricing benchmark in financial markets. "In the longer-term, and I put this in the hypothetical form, there

is a government out there that could eventually perform that role – and that is Japan.” (*Dow Jones Newswire*, John Connor, 4/14/00; *Dow Jones Capital Markets Report*, Henry Pulizzi, 4/5/00)

- Peter Wallison, Resident Fellow at the American Enterprise Institute said Undersecretary Gensler’s comments exposed a real vulnerability of GSE securities. “Any charge that [Fannie and Freddie] are going to establish their securities as immortal has gone by the board for a long time,” he said. “The people who buy these types of securities are not looking for volatility. They don’t want rapid rises and falls. And what [Gensler’s comments] showed is that any kind of comments can cause the market to fluctuate.” (*Real Estate Finance Today*, Mike Sorohan, 4/3/00)
- GSE debt, corporate bonds, and swaps are all candidates to replace the 30-year Treasury bond as the new benchmark in the market. Greg Kitter with *Dow Jones Newswire* speculates that different people will use different benchmark pricing mechanisms until the marketplace settles on some form of standardized benchmark. He writes that, “Fannie Mae and Freddie Mac would seem on the surface to be the leading contenders [as the new benchmark], given their gallant attempts to increase liquidity in the GSE markets. There is a problem with these issuers, however: the concerns recently raised in Washington about long-term creditworthiness. Thanks to Representative [Richard] Baker, the two most prolific funding mechanisms have taken it on the chin. While it remains highly unlikely anything materially will actually befall either Freddie or Fannie, the fact remains that some investors may have been dissuaded by the ‘Baker sanctions.’” (*Dow Jones Newswire*, Greg Kitter, 5/3/00) Stephen Cecchetti with *Financial Times* notes that there is a somewhat misguided quest going on for a new benchmark to replace Treasuries. He believes that no single instrument is likely to take over the role of US Treasuries and questions whether there is really even a need for a new supreme benchmark; people will invent instruments that will suit their purposes. (*Financial Times*, Stephen Cecchetti, 5/3/00)

Wall Street Journal takes first step in search for a new benchmark – it will replace its chart of the 30-year Treasury bond with a chart of the 10-year Treasury note

- The financial community agrees that 30-year Treasuries are no longer the benchmark for the \$14.7 trillion bond market. No one, however, can agree on what should replace it and it may take years before any one security will replace the long bond. The *Wall Street Journal*, however, is taking its first step in the search for a new benchmark. Starting May 3, the *Wall Street Journal* will replace its 30-year Treasury bond with a chart of the 10-year Treasury note in the “Markets Diary” column, which appears daily in the “Money & Investing” section. Although the 10-year Treasury has been given greater prominence, neither the *Wall Street Journal* nor *Dow Jones Newswire* will anoint any particular security, for the moment, as a bond market bellweather. However, Paul Steiger, Managing Editor of the *Wall Street Journal* stated, “The Journal’s decision to emphasize the 10-year note in our coverage reflects a trend that has been building in the bond market: The 10-year note is quickly replacing the 30-year bond as a benchmark.” Thomas Sowanick, Chief Fixed Income Strategist at Merrill Lynch, predicts the benchmark role will be shared among a number of securities, including Treasuries, GSEs, swaps, and bonds issued by blue-chip companies. (*Dow Jones Newswire*, 5/2/00; *Wall Street Journal*, 5/3/00)

Fannie will list all new Benchmark notes on the Luxembourg stock exchange to attract more international investors

- Fannie said it will list all new Benchmark notes on the Luxembourg stock exchange. (*Reuters*, 4/5/00)

Fannie & Freddie report record first quarter earnings

Fannie & Freddie are still aggressively purchasing their own mortgage-backed securities (MBS)

Fannie's earnings rose 16%

- Fannie reported first quarter earnings of \$1.062 billion, or \$1.02 per common share, diluted, compared to earnings of \$1.038 billion, or \$0.99 per common share, for the fourth quarter of 1999. Fannie said its first quarter earnings were a 16% increase over 1999's first quarter earnings of \$924.9 million, or \$0.88 per common share. Fannie said its increase in net income between the fourth quarter of 1999 and the first quarter of 2000 was driven by a 17.3% annualized increase in net interest income. This increase, which totaled \$56.5 million, resulted from a \$16.3 billion rise in the average net mortgage portfolio and a one basis point increase in the quarterly average net interest margin. The company's guaranty fees grew by \$6.8 million, or at an 8.4% annual rate, during the first quarter, stemming from a \$7.5 billion increase in average net MBS outstanding and a rise in the average effective guaranty fee rate from 19.3 basis points to 19.4 basis points. The company's portfolio expanded to \$537 billion at the end of the first quarter, compared with \$523 billion at the end of the fourth quarter of 1999 and \$441 billion a year earlier. Fannie's net interest income was \$1.362 billion in the first quarter of 2000, compared with \$1.306 billion in the fourth quarter of 1999 and \$1.160 billion in the first quarter of 1999. (*Fannie press release, 4/12/00*)

Freddie's earnings rose 19%

- Freddie reported diluted earnings per common share of \$0.81 for first quarter 2000, a 19% increase over first quarter 1999 diluted earnings per common share of \$0.68. Net income for the first quarter was \$608 million, compared to \$513 million for the same period a year ago and \$594 million for fourth quarter 1999. The company said its earnings were driven by a combination of retained portfolio growth, stable margins and outstanding credit performance. The company added \$12 billion to its retained portfolio in the quarter, putting them on track for growth of \$40 billion to \$50 billion. Freddie's total revenues reached \$1.066 billion in first quarter 2000, an increase of 7% over first quarter 1999, and up from \$1.049 billion in fourth quarter 1999. Net interest income on earnings assets totaled \$667 million in first quarter 2000, compared to \$626 million in first quarter 1999 and \$664 million in fourth quarter 1999. The average balance of the retained portfolio grew by \$5.5 billion, or 2% during first quarter 2000. (*Freddie press release, 4/18/00*)

Fannie & Freddie still aggressively purchasing their own MBS

- According to Michael Youngblood, Director of Real Estate Research at Banc of America Securities, Fannie and Freddie were steady buyers of their own paper in the first quarter. Freddie purchased approximately \$4.9 billion of its own MBS and about \$4.3 billion of non-Freddie securities in March. "There is no other sector of the market, apart from Treasuries, where you have such aggressive purchasing of securities," Youngblood said. (*Dow Jones Newswire, 4/29/00*)

Fannie & Freddie's safety and soundness regulator, OFHEO, makes new hire

- OFHEO hired David Roderer, a lawyer with Goodwin, Procter & Hoar as Deputy Counsel. Roderer spent the last 14 years in private practice after working for Fannie and the OCC. He said he was attracted to OFHEO's mission to strengthen its oversight of Fannie and Freddie. OFHEO also promoted Dorothy Acosta from Associate General Counsel to Deputy Counsel. Both Roderer and Acosta will report to OFHEO's new General Counsel, Alfred Pollard. (*American Banker, 4/17/00*)

Fannie Mae

Fannie's very size and influence have now put it in the middle of a firestorm – Fannie is facing assaults from the Treasury Department, a powerful member of Congress, and a coalition of business rivals

- The Saturday, April 22, 2000 *New York Times* ran an article by Richard W. Stevenson on the many different battles Fannie is facing this year. As Stevenson notes, Fannie Mae **“is no stranger to hardball politics or highstakes finance, having established itself as a power to be reckoned with both in Washington and on Wall Street.”** However, the GSEs are finding themselves wrapped up in battles with the Treasury Department, a powerful member of Congress, and with a lobbying group of powerful mortgage lenders and business rivals.
- “There has been a strong political consensus that the success Fannie Mae and Freddie Mac have had in making mortgages available at the lowest possible cost to millions of home buyers has far outweighed any potential risks. Now, though, both the administration and Congress seem intent on at least taking another look at the question.” Recent battles include:
 - Treasury Department – Treasury Undersecretary Gary Gensler’s testimony that financial markets considered “a coded suggestion that the government wanted to sever its ties to Fannie Mae and Freddie Mac.” In an interview with the *New York Times*, Fannie CEO Frank Raines suggested that the Treasury Department’s interest in reconsidering the benefits and potential risks of GSEs was motivated by ideological opposition to government support for a company operating in the capital markets and a reluctance to give up the influence it exerts in the markets as the issuer of the benchmark security. Raines called back a day later to say that he had no objection to “the legitimate role they must play in systemic risk.”
 - Cong. Baker – Congressman Baker, Chairman of the House Banking Subcommittee that oversees Fannie and Freddie, has been raising questions in hearings about the GSEs and has a proposal to tighten regulation of the GSEs. Congressman Baker said he was concerned about the risks GSEs pose to the financial system in an economic downturn and he compared the companies to Long-Term Capital Management. He warned the “potential impact of a misstep” of one or both of the companies “is to flirt with potential disaster.”
 - FM Watch – A coalition of banks, mortgage companies and trade groups have organized an aggressive offensive to limit the ability of Fannie and Freddie to use their advantages to expand outside their mission. “Our goal is to ensure that that GSEs perform their original mission, which is to provide liquidity in the secondary market, and that they do not compete unfairly in markets that private enterprise is already adequately serving,” said W. Mike House, Executive Director of FM Watch. (*New York Times*, Richard W. Stevenson, 4/22/00)

Fannie tells investors it will charge more for purchasing subprime loans

- Fannie CEO Frank Raines told investors that Fannie intends to be compensated for the additional risk of buying mortgages from “subprime” borrowers. According to *Bloomberg*, in a conference call for clients of Prudential Securities, Raines said Fannie will “only do those products that we think we can be adequately compensated for the risk.” (*Bloomberg*, 4/20/00)

- Morgan Stanley Dean Witter analysts reported that Fannie’s increasing volume of alt-A, A-, and other niche products should help Fannie’s margin, because they apparently carry higher guarantee fees (charged by Fannie). (*Morgan Stanley Dean Witter, “Fannie Mae: Investor Luncheon: New Products Could Help the Margin”*, Kenneth Posner, Michael Courtian, 10/20/99)

Fannie will sponsor a forum on the “Role of Automated Underwriting in Expanding Minority Ownership”

[Editorial Note: HUD is currently conducting a fair lending investigation of Fannie & Freddie’s automated underwriting systems (which control 95% of the automated underwriting market)]

- On June 8-9 in Warrenton, VA, Fannie is sponsoring “The Role of Automated Underwriting in Expanding Minority Homeownership.” (*National Low Income Housing Coalition, Memo to Members 4/28/00*)

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

Fannie continues to make more political hires – Fannie hires former Senate Banking Committee Chairman Alfonse D’Amato as a consultant

Fannie opens a new partnership office in North Dakota

Charles Lewis, Executive Director of the Center for Public Integrity, stated that Fannie & Freddie’s hiring of high level government and political officials blurs the line between public service and private enterprise. In his opinion, the hirings by Fannie & Freddie are an example of how “incestuous these quasi-governmental entities are with the people that ostensibly regulate them or have oversight over them.”

Hiring of political officials blurs the line between public service and private enterprise

- **A spokeswoman for the Fannie/Freddie watchdog group, FM WATCH, stated that “many of those hired by Fannie Mae and Freddie Mac are specifically assigned to oppose any legitimate debate on Capitol Hill, in the administration, in the White House and the industry, about Fannie Mae’s and Freddie Mac’s role.”** (*American Banker*, Joshua Brockman, 7/16/99)

Fannie hires former Senator Alfonse D’Amato as a consultant

- Fannie added former Senate Banking Committee Chairman Alfonse D’Amato as a consultant. Fannie Spokesman David Jeffers said Fannie hired New York-based Park Strategies - where Senator D’Amato is a partner – about two months ago. He gave few details for the arrangement with Park Strategies or about former Senator D’Amato’s specific role. (*Bloomberg News*, Rob Wells, 4/14/00)

Senator Kent Conrad (D-ND) – Opens New Partnership Office

- Fannie held a press conference with Senator Conrad to announce the opening of Fannie’s new North Dakota partnership office in Bismarck. (*Fannie press release*, 4/20/00)

Senator John Ashcroft (R-MO)

- Fannie joined Sen. Ashcroft, Metropolitan Kansas City Board of Realtors, Home Builders Association of Greater Kansas City, North American Savings Bank, and the MBA of Greater Kansas City for a free affordable homebuying seminar. (*Fannie press release*, 4/19/00)

Congressman John Conyers, Jr. (D-MI), Congresswoman Carolyn Kilpatrick (D-MI) and Detroit Mayor Dennis Archer

- Fannie held a press conference with the above officials to announce that the company completed its five-year “House Detroit” commitment two years early and to announce a new \$1 billion investment over the next seven years to increase homeownership in Detroit. (*Business Wire*, 4/24/00; *Associated Press*, 4/24/00)

Congresswoman Nancy Pelosi (D-CA) and San Francisco Mayor William Brown

- Fannie joined the above officials to announce a New Immigrants Initiative pilot in eight targeted “gateway” regions across the nation. Fannie has committed \$150 million nationwide to the pilot. Available in the nine-county Bay Area, the Initiative enables employment-authorized immigrants whose applications for permanent resident status is in process to apply for mortgage loans or to refinance existing home loans. (*Fannie press release*, 4/20/00)

Congressman Ed Pastor (D-AZ) and Phoenix Mayor Skip Rimsza

- Fannie held a press conference with the above officials to celebrate a new housing effort called the “Downtown Phoenix Homeownership Program” that would help 135 families become homeowners. The initiative is in partnership with various employers – The Arizona Republic, Bank of America, the Downtown Phoenix Partnership’s Retail Council, and Wells Fargo Bank. (*Fannie press release*, 4/25/00)

Congressman David Wu (D-OR) and Portland Mayor Vera Katz

- Fannie held a press conference with the above officials to place the final piece of roofing on a six-story Cornerstone Condominiums construction site – a \$5.4 million mixed-income, mixed-use development. (*Fannie press release*, 4/17/00)

Congressman Ed Bryant (R-TX)

- Fannie joined Cong. Bryant in a housing forum with Maury County housing leaders. (*Fannie press release*, 4/24/00)

Congressman Saxby Chambliss (R-GA)

- Fannie joined Cong. Chambliss in a housing forum with Southeast Georgia housing leaders. (*Fannie press release*, 4/25/00)

Congressman Dan Miller (R-FL)

- Fannie joined Cong. Miller in a housing forum with Manatee and Sarasota Counties housing leaders. (*Fannie press release*, 4/25/00)

Congressman Leonard Boswell (D-IA)

- Fannie joined Cong. Boswell in a housing forum with Clarinda community leaders. (*Fannie press release*, 4/28/00)

Congresswoman Karen Thurman (D-FL)

- Fannie held a press conference with Congresswoman Thurman, Jennings Development Group, and HKW Enterprises to announce the opening of a 112-unit apartment development in Florida - Lewis Place. (*Fannie press release, 4/20/00*)

Congressman Lee Terry (R-NE)

- Fannie held a press conference with Cong. Terry and representatives from First National Bank to showcase Fannie's automated underwriting system - Desktop Underwriter [a system Fannie developed several years ago]. The highlight of the press conference was a borrower who was approved for her first mortgage using the system. (*Fannie press release, 4/20/00*)

Governor of Nevada Kenny Guinn and Reno Mayor Jeff Griffin

- Fannie held a press conference with the above named officials and The Diamon Creek Partners, Manage, Inc., ARCS Commercial Mortgage, Washoe County, City of Reno, Sate of Nevada Housing Division, Edison Capital Housing Investments, and Candle Development to celebrate the opening of \$36 million, 288-apartment development. The development features two- and three-story garden-style buildings. (*Fannie press release, 4/19/00*)

Pittsburgh Mayor Tom Murphy

- Fannie held a press conference with the Mayor of Pittsburgh, the Pennsylvania Housing Finance Agency, the Housing Authority of the City of Pittsburgh, Beacon/Corcoran Jenison, and the Allequippa Terrace Residents Council to celebrate the opening of Oak Hill Apartments – a mixed-use property which will include an exercise facility and an outdoor pool. (*Fannie press release, 4/10/00*)

Baltimore Mayor Martin O'Malley

- Fannie held a press conference with the Mayor of Baltimore and the Baltimore Housing Commissioner to announce a revitalization initiative in Northeast Baltimore. Fannie has made a \$750,000 debt investment in St. Ambrose Housing Aid Center to support the acquisition and renovation of vacant, single-family homes. (*Fannie press release, 4/28/00*)

Columbus Mayor Michael Coleman

- Fannie held a press conference with the Mayor of Columbus and the Concorde Capital Corporation and Key Bank to celebrate the grand opening of Fair Oaks Apartments. (*Fannie press release, 4/14/00*)

Toledo Mayor Carleton Finkbeiner

- Fannie held a press conference with the Mayor of Toledo and the Northern Ohio Investment Company to announce the availability of the Working Mortgage in Northern Ohio. (*Fannie press release, 4/12/00*)

Macon, GA Mayor Jack Ellis

- Fannie held a press conference with the Mayor of Macon at City Hall to announce a new \$18.2 million bond finance agreement between the Macon Housing Authority and Fannie. (*Fannie press release, 5/2/00*)

Laredo, TX Mayor Betty Flores

- Fannie held a press conference with the Mayor of Laredo to announce a low down-payment mortgage product and celebrate new homeowners. (*Fannie press release, 5/2/00*)

Grand Forks North Dakota Mayor Pat Owens

- April 19 was declared “Fannie Mae Day” by Grand Forks Mayor Owens because of the help the community received from Fannie after the flood of 1997. (*Grand Forks Herald*, 4/20/00)

Freddie Mac

Expanding outside its mission, Freddie increased its holding of home equity loans in 1999 by 134%

[Editorial Note: The majority of home equity loans are made to middle- to higher-income, non-minority homeowners for debt consolidation. Home equity borrowers already own their own homes. Home equity loans are a consumer loan product, not a product that helps homebuyers purchase a home.]

- According to Freddie’s 1999 annual report, Freddie increased its presence in the non-traditional loan market as Freddie’s holdings of home equity loans increased to \$13.8 billion in 1999, from \$5.9 billion in 1998. (*Dow Jones Newswire*, Joe Niedzielski, 4/6/00)

Freddie increases its use of derivatives in 1999, up 35.4% from 1998

- Freddie’s use of derivatives increased last year. In its 1999 annual report, the company said it entered into derivatives transactions worth a notional, or contractual, \$424.2 billion in 1999, up 35.4% from \$313.2 billion in 1998. Freddie reported that the net fair value of its derivatives was \$5.2 billion, based on its year-end \$424.2 billion notional balance, up from a net fair value of \$427 million in 1998. The increase was attributed to the overall increase in the company’s derivatives position, as well as to changes in interest rates, which increased the net gain position on contracts with several of Freddie’s counterparties. Freddie said its use of derivatives has become increasingly important in its strategy for managing interest-rate risk. A *Dow Jones Newswire* article reported that derivatives can be risky at times, and some view their usage as speculative, although the Federal Reserve and others consider them to be legitimate tools in managing risk. (*Dow Jones Newswire*, Joe Niedzielski, 4/6/00)

Freddie forms partnership with Rainbow Push Coalition/Wall Street Project (founded by the Rev. Jesse Jackson, Sr.)

Compaq Computer Corp. is providing over 200 computers to churches in the program to be used as a distribution channel for Freddie’s consumer credit initiative

In 1998, Jackson urged shareholders to withdraw investments from Freddie and for Congress to hold “oversight hearings” amid a \$15 million race discrimination lawsuit filed by a former Freddie executive

- Freddie and the Rainbow PUSH Coalition/Wall Street Project announced a joint \$1 billion campaign aimed at increasing homeownership among minority families. Under the partnership, Freddie agreed to purchase up to \$1 billion in mortgage loans made to minority families through Bank of America and minority-owned lenders in selected locations over the next five years.

Freddie also pledged \$1 million to support the Minority Homeownership Initiative to help the Wall Street Project's "One Thousand Churches Connected" economic literacy effort to educate minority families about the benefits of homeownership and about mortgage loan products available to them. Compaq Computer Corp. is providing over 200 computers to the churches in the program to be used as a distribution channel for Freddie's consumer credit initiative. The Rainbow/PUSH Coalition was founded by Reverend Jesse Jackson, Sr. in January 1997 to urge corporations to hire and promote more minorities in corporations. (*BNA Daily Report for Executives*, Eileen Canning, 4/17/00; *Freddie press release*, 4/14/00)

In 1998, Jackson urged shareholders to withdraw their investments in Freddie amid a \$15 million discrimination lawsuit filed by a former Freddie executive

- In 1998, Jackson urged shareholders to withdraw investments from Freddie amid a \$15 million race discrimination lawsuit filed by a former executive. (*Associated Press*, 4/14/00) As reported in the June 5, 1998 *GSE Report*, Jackson held a press conference in 1998 with a former Freddie employee, Tony Morgan (former Director of Executive Corporate Relations), who accused Freddie of discrimination. Morgan charged that his job was down-sized and he was terminated two years ago because he raised concerns about Freddie's "poor performance" in purchasing mortgages from low-income and minority homebuyers. Morgan's attorney, Debra Katz, said "Freddie Mac's employment practices with respect to African-American employees are disgraceful and worthy of public condemnation." Katz alleges that top managers at Freddie Mac were aware of extensive racial misconduct, as well as efforts to curb investment in low income and minority mortgages. Katz said the suit will allege "that there is a racist work environment that Freddie Mac is aware of, and that it condones and ratifies this environment." According to Katz, "People who raise questions about affordable housing and other minority-related issues are also being retaliated against." Morgan filed a \$15 million civil lawsuit in US district court on June 3, 1998 alleging Freddie had a "racially hostile" work environment that discriminated against him and others. Named as defendants were Freddie's CEO Leland Brendsel, then CFO John Gibbons, and Mitchell Delk, Vice President of Government and Industry Relations. Morgan is also seeking class-action status on behalf of 500 current and former Freddie African-American employees.

Jesse Jackson's 1998 Comments

- Reverend Jesse Jackson urged Freddie's major shareholders to withdraw their investments because of Freddie's "hostile" work environment for blacks. This was reportedly the first time Jackson urged shareholders to withdraw their investments from a company that he says displays "antiworker or anticivil rights" policies. Jackson said he believed that Freddie has a duty to be accountable to the public because of the benefits it receives from its GSE status and that Freddie does a poor job serving minority homebuyers. Jackson also urged Congress to "conduct appropriate oversight hearings" of Freddie in light of the allegations of racial discrimination. (*American Banker*, 6/5/98; *Associated Press*, 6/4/98; *Chicago Tribune*, 6/4/98; *Dow Jones Newswire*, 6/3/98, 6/4/98; *National Mortgage News website*, posted 6/3/98; *Reuters*, 6/2/98; *Wall Street Journal*, 6/2/98; *Washington Post*, 6/4/98)

Freddie teams up with Citibank and the City of San Jose for a new affordable housing program in San Jose, CA

- The City of San Jose joined forces with Citibank and Freddie to launch an affordable housing program called the Mayfair Improvement Initiative. The program, headquartered, at the new San Jose/Mayfair Housing Counseling and Assistance Center, will offer one-stop access and homebuyer education, financial counseling, and several flexible, low down-payment mortgage

products. Citibank, Freddie, and the Hewlett Foundation provided financial support. Citibank's CPAP mortgage will help families with non-traditional credit references or less than perfect credit histories buy homes with down-payments of two percent of the purchase price. CPAP mortgage also feature flexible underwriting criteria that will allow borrowers to use non-traditional credit references. Citibank will originate the loans and Freddie will purchase mortgages under the initiative. (*National Mortgage News Daily*, 4/27/00; *Freddie press release*, 4/26/00)

Freddie teams up with Bank of America, Wells Fargo, SouthTrust, Sun Trust, and AmSouth Bank for affordable housing program in Jacksonville, FL

- Bank of America, Wells Fargo, SouthTrust, Sun Trust Banks and AmSouth Bank agreed to make \$250 million of low down-payment mortgage loans in Jacksonville, FL. The lenders worked with Freddie, the city of Jacksonville, and community groups to form the Jacksonville Homeownership Alliance, which promises down-payments as low as \$500. Freddie will purchase the loans. (*American Banker*, 4/28/00)

Freddie makes a number of new hires

Freddie names a new Vice President of Congressional Relations, a new Vice President of Industry, Trade Relations, a new Vice President of Multifamily Risk Management, and a new Vice President of Strategic Relationships

- Freddie announced that Clarke Camper has been named Vice President of Congressional Affairs. He will report to Mitchell Delk, Freddie's Senior Vice President of Government Relations. Camper joins the company from the law firm of Morrison & Foerster. From 1991 to 1992, he was Manager of Congressional Relations at Freddie. (*Freddie press release*, 4/6/00)
- Freddie announced that Kirk Willison has been named Vice President of Industry and Trade Relations. He will be responsible for fostering relationships with key industry and trade association and other important housing and financial organizations. He will report to Dwight Robinson, Freddie Senior Vice President of Corporate Relations. Willison comes to Freddie from Countrywide Home Loans, where he most recently served as Senior Vice President and Director of Government and Public Affairs. (*Freddie press release*, 5/1/00)
- Freddie named Robert Tsien as Vice President of Multifamily Risk Management. Tsien came from Titanium Investment Company, a diversified real estate finance company where he was Director of Risk Management. Prior to Titanium, he held positions of increasing importance with New England Life Insurance Company and John Corcoran & Company. (*Freddie press release*, 4/13/00)
- Freddie announced that Ed Albrigo has been named Vice President of Strategic Relations. He will be responsible for leading and managing Freddie's strategic relationship with HomeAdvisor Technologies and future relationships with new mortgage market entrants. He will report to Jim Taylor, Vice President, Business Development. He most recently was Director of Business Development at Freddie. (*Freddie press release*, 4/26/00)

Federal Home Loan Banks

FHLBank System's Mortgage Partnership Finance (MPF) Program continues to grow

FHFB proposes to lift the \$9 billion cap on the MPF program and make the program a permanent FHLBank program instead of a "pilot"

FHFB proposes a soft cap on FHA loan purchases under the MPF program

MPF program is a competitor to Fannie & Freddie in the secondary mortgage market

- The Federal Housing Finance Board (FHFB) agreed to issue a proposed rule on April 12 to lift the \$9 billion on the MPF program and change the status of the program from a "pilot" to a permanent FHLBank program. "We are very pleased with the idea of removing the cap," said Alex Pollock, President and CEO of the FHLBank of Chicago. "We are moving onward and upward." The proposed rule was published in the May 3 *Federal Register*. Comments are due on or before June 2, 2000. A final rule is expected to be published in the fall.
- The MPF program, originally designed and sponsored by the FHLBank of Chicago, gives banks and thrift members an alternative secondary market execution for fixed-rate mortgages (an alternative to selling loans to Fannie, Freddie). The FHLBank of Chicago claims that institutions can also boost their profits under the MPF program by not having to pay loan guarantee fees to Fannie and Freddie. Under the MPF program, the FHLBank purchases the mortgage from the lender and assumes the interest rate risk, while the lender retains some credit risk not covered by mortgage insurance and servicing.
- Currently six of the 12 FHLBanks now offer the program. (The board of directors of the FHLBank of San Francisco approved a plan to allow its members to participate in the MPF program and the FHLBank of Topeka is close to being approved. The FHLBank of Boston has received approval to participate.) Morrison expects that all 12 FHLBanks will be participating in the MPF program, or a program similar to MPF, by the end of the year. At last count, outstanding loans in the MPF program increased 146% during the first quarter of 2000 to more than \$4.4 billion, up from \$1.8 billion at year-end. MPF master commitments (indicator for future volume) also rose sharply to \$24.2 billion from \$6.6 billion three months ago, an increase of 267%. Currently 126 members are approved to fund MPF loans, and an additional 78 are in the process of joining the program. Over 150 more members are in discussions to join.
- Under the FHFB proposed rule, loans acquired under the MPF program and certain other specified assets would be considered "acquired member assets." These assets would mainly consist of whole mortgage loans originated by or held by a FHLBank member institution, provided that the credit risk is shared between the FHLBank and the member institution.

FHFB proposes soft cap on FHA loan purchases under MPF

- To address concerns that have been raised that current MPF production has become predominantly FHA-insured loans, the FHFB proposed a soft cap on FHA loans. MPF loans will be considered "core mission assets." However, if FHA-insured loans exceed one-third of MPF production in any given year, the excess FHA loans will be excluded from core mission assets. Current FHA commitments will be grandfathered under the proposal. Excess FHA loans – above the one-third limit – could be singled out for higher capital requirements when new risk-based capital rules are

implemented during the next 12 to 18 months. FHFB Chairman Bruce Morrison said the purpose of its provision is to avoid a market division where the FHLBanks focus solely on FHA loans and leave the conventional mortgage market to Fannie and Freddie. He said that “the whole idea here is competition across the board,” and added that “the one-third ratio is based on marketplace numbers.” “Our initial reaction is that we are disturbed that there is going to be a limit on participating in the MPF for FHA loans,” said Ed Hill of the Financial Services Roundtable. The Council of Federal Home Loan Banks does not like the direction the FHFB is taking, according to Malin Jennings, Vice President for Public Affairs. “If they set a 33% cap, they are essentially determining how much we will have in our portfolio,” she said. (*National Mortgage News*, 4/17/00, 4/24/00; *National Mortgage News Daily*, 4/10/00, 4/12/00; *Dow Jones Newswire*, John Connor, 4/12/00; *American Banker*, Erick Bergquist, 4/17/00; *FHLBank of Chicago press release*, 4/3/00; *Federal Register*, pages 25676-25692, 5/3/00)

Advantages of MPF over Fannie & Freddie

- Member institutions using the MPF program do not pay guarantee fees. According to a source at one of the FHLBanks, in 1999, Fannie and Freddie’s guarantee fees averaged close to 20 basis points per year of the outstanding principal balance of each loan. The FHLBanks pay participating institutions 7 to 13 basis points per year for managing credit risk. So, rather than paying a fee to Fannie and Freddie, MPF participants would receive a fee for managing the credit risk. Fannie and Freddie complain that MPF program should be subject to the same oversight as Fannie and Freddie. A spokesman for one of the FHLBanks said “We would love to play by their rules.” According to the spokesman, the FHLBanks operate under a stricter regime than Fannie and Freddie and that the FHLBanks hold more capital as a percentage of assets than Fannie and Freddie. (*American Banker*, Erick Bergquist, 4/17/00)

FHFB issues rule on FHLBanks’ acquired member assets and core mission activities

The proposal does not limit investments in non-mission assets such as mortgage-backed securities (MBS), however, MBS will not be considered “core mission assets”

America’s Community Bankers is upset about the new FHFB proposal and believes that the FHFB has gone back on its word to Congress.

- On April 12, the FHFB approved a proposed rule that would authorize the FHLBanks to acquire assets of their members through risk-sharing arrangements (like the MPF program) and define which activities are “core mission activities.” The rule also ends the pilot status of the MPF program (see previous story). The proposed rule was published in the May 3 *Federal Register*. Comments are due on or before June 2, 2000. A final rule is expected to be published in the fall.
- Specifically, acquired member assets (AMA) will mainly consist of whole mortgage loans originated by or held by a FHLBank member institution, provided that the credit risk is shared between the FHLBank and the member. The rule also specifies which FHLBank activities qualify as core mission activities, including: advances to members, standby letters of credit, targeted investments that support affordable housing and economic development activities, and small business investment corporations.

Proposal does not limit investments in non-mission assets such as MBS – Proposal says they just won’t be considered “core mission assets”

- The proposed rule would not restrict beyond current law the FHLBanks' investment in non-mission-related assets such as mortgage-backed securities. The rule specifies that any limit on MBS that might be imposed by the FHFB in the future would allow the FHLBanks to hold to maturity any MBS that they held as of April 12, 2000. (*FHFB press release, 4/12/00; Federal Register, pages 25676-25692, 5/3/00*)
- America's Community Bankers (ACB) is upset about the new FHFB proposal and believes that the FHFB has gone back on its word to Congress. The group warned House and Senate Banking Committee leaders that the FHFB was breaking an agreement with Congress by proceeding with the FHFB's new proposal that defines "core mission assets." In 1999, when the FHLBank expansion provisions were being debated in the Gramm-Leach-Bliley Act, FHFB Chairman Morrison agreed to postpone action on a FHFB proposal that would have phased out FHLBank investments in non-mission related assets, including mortgage-backed securities over five years. Morrison contends that he has not violated his promise to Congress because the new proposal only says that MBS are not preferred ("core mission asset") investments and does not restrict any investments. A spokesman for the FHFB said "It is very much what we did last year except there is no limitation on MBS. You can do it, but it will not count as a core-mission asset." America's Community Bankers Lobbyist Eric Mondres says it wants Congress to intervene and stop the FHFB from going forward with the proposal. (*National Mortgage News Daily, 5/2/00*) The Council of FHLBanks took strong exception to the FHFB's new proposed treatment of mortgage-backed securities, likening the FHFB's proposal to "banning the use of bricks by home-builders." (*Dow Jones Newswire, John Connor, 4/12/00; American Banker, Kevin Guerrero, 4/11/00*)
- Even prior to the FHFB meeting on April 12, four trade associations sent a letter to the FHFB requesting that the FHFB delay its proposed rule on the FHLBanks' mission and mission-related assets until a new capital structure for the FHLBank System was in place. The letter, signed by the America's Community Bankers, American Bankers Association, Independent Bankers of America, and the Council of the FHLBanks, said the System's mission was adequately addressed by Congress and that any further mission work should be undertaken only in conjunction with a development of a new capital structure. Over their objection, the FHFB proceeded as scheduled and issued its proposed rule on April 12. Morrison said that the FHFB would consider a capital proposal at the end of May and that it makes sense to begin with defining core mission assets. (*Dow Jones Newswire, John Connor, 4/10/00*)

Mitchell Securities Analyst Charlie Peabody is concerned about the FHLBank System's risk to the economy

- According to a *Barron's Online* article, Mitchell Securities analyst Charlie Peabody is especially worried about the FHLBank System. Rhonda Brammer recently talked to Peabody about his concerns, and attempted to summarize his thoughts for the *Barron's* article. Peabody is concerned that unlike Fannie and Freddie, the FHLBank System flies under the radar screen and its financial reports are issued only after a sizable lag of time (the '99 annual financial data, for example, is due in May). This is not the kind of disclosure that Peabody would like to see in a system that's huge, highly leveraged, growing rapidly, operates on razor-thin margins and owns a number of derivatives. Peabody estimates that the FHLBank System was leveraged 21-to-1 at year-end and has assets of \$531 billion and derivatives of \$410 billion (the notional value of "interest-rate exchange agreements").

- Peabody is troubled that like the S&Ls in the 1980s, the FHLBank System borrows short and lends long. Its 1999 borrowings encompassed over \$3 trillion in consolidated obligations (mostly overnight funds). Margins must be getting squeezed because despite the 45% increase in advances in the first nine months of 1999, spread income only increased 17%. He is also concerned about the FHLBanks derivative positions. In the 1998 annual financial records, the FHLBank System had a \$1.7 billion unrealized loss on \$382 billion in derivatives. In Peabody's opinion, the System has the potential to cause much greater disturbances affecting the entire economy. (*Barron's Online*, "Up and Down Wall Street," Alan Abelson, 4/3/00)

FHLBank responds to Peabody's concerns

- In a letter to the editor of *Barron's*, John Von Seggern, Executive Vice President of the Council of FHLBanks (represents 10 of the 12 FHLBanks) responded to Peabody's concerns. Seggern noted that the \$410 billion in derivatives that Peabody was concerned about were interest-rate risk hedges, not speculative investments. In response that the System had a 21-to-1 leverage, Seggern states that the System is over-collateralized and holds twice the capital of Fannie and Freddie, in addition to having a AAA credit rating. He agrees that the System's margins are thin and "they're going to stay that way." The System is happy with a 7% or 8% return on equity. Seggern did not think Peabody should worry about the System borrowing short and selling long in the form of COs, since the FHLBanks are heavily regulated entities that must conform to strict interest-rate risk requirements set by the Federal Housing Finance Board. Finally, Seggern states that the lag time between annual financial reports would have been valid 12 months ago, since the System just released its 1999 report on March 28 before the column came out. (*Barron's Online*, 5/1/00)

Farm Credit System/Farm Credit Banks

American Bankers Association (ABA) hires a new Senior Counsel who will lobby in opposition to proposals that would allow Farm Credit System banks to lend nationally instead of regionally

- According to the *American Banker*, the ABA has hired Robert Fouberg as Senior Counsel for Agricultural and Rural Banking. Fouberg was previously Manager of Agricultural and Conservation policy at Ducks Unlimited. Among his priorities are lobbying House and Senate lawmakers on opposing proposals by regulators to let Farm Credit System banks lend nationally instead of regionally. (*American Banker*, 4/24/00)

The Farm Credit Administration (FCA) issued proposals to make it easier for commercial banks to borrow from the Farm Credit System

- According to Alan Kline with the *American Banker*, the FCA issued proposals to make it easier for commercial banks to borrow from the Farm Credit System. According to the FCA, only about a dozen commercial banks borrow from the system. The FCA is requesting comments on ways to improve access to Farm Credit System funds for "Other Financial Institutions" (banks, credit unions, and other lenders not part of the System). One proposal would allow financial institutions to borrow from Farm Credit banks outside their geographic district. Another proposal would adjust the risk-weighting of Farm Credit System loans to non-system borrowers. (*American Banker*, Alan Kline, 4/14/00) Comments on the proposals are due June 19, 2000. (*Federal Register*, pages 21151-21154, 4/20/00)

- The FCA also adopted a final rule that eliminates territorial restrictions for loan participations but does not authorize direct lender associations to make loans outside their chartered territory without consent and does not change the chartered territory of any system institution. The regulation becomes effective 30 days after publication in the *Federal Register*. (*Federal Register*, pages 24101-24102, 4/25/00) According to the *American Banker*, the FCA's decision to drop rules that regulators said hampered participation loans involving banks and system lenders, has made many bankers skeptical at teaming up with the farm credit lenders, who they have long feared as competitors. "Farm Credit is a major competitor," said John Evans, Jr., CEO of D.L. Evans Bank in Burley, ID. "It'd make me nervous to participate with them on a loan. I'd be leery of working with any Farm Credit lender, wherever they're located." (*American Banker*, Craig Woker, 5/1/00)

Ginnie Mae

<p>The Mortgage Bankers Association, the National Association of Realtors, the National Association of Home Builders, and the US Conference of Mayors send a letter to Capitol Hill to protest proposals that would privatize FHA and Ginnie Mae</p>

- The MBA, NAR, NAHB, and the US Conference of Mayors sent a letter to Capitol Hill "asking Congress to oppose a congressional proposal to privatize FHA and Ginnie Mae." According to HUD, the joint Capitol Hill letter says that "Under the leadership of [HUD] Secretary Andrew Cuomo, FHA and Ginnie Mae are the strongest they have ever been," and the groups "urge you to pledge your support for keeping FHA and Ginnie Mae within HUD, and oppose any [c]ongressional proposal to privatize these agencies."
- Assistant Secretary William Apgar said Cong. Rick Lazio (R-NY) was involved in an effort to privatize FHA and Ginnie Mae. However, in a March 7 statement, Cong. Lazio disputed that he initiated the proposal, and charged HUD with misattributing the proposal to him. "I have never proposed privatizing either HFA or Ginnie Mae," he said. "I did begin work on an initiative to combine FHA with Ginnie Mae, separate from a dysfunctional HUD, at a time when...[the Clinton Administration] contemplat[ed] dismantling HUD." He argued that the Clinton Administration in 1995 originated the proposal to separate FHA from HUD, and in 1999 discussed privatization.
- A staffer for Cong. Lazio told *BNA* that the Congressman thinks privatization should be explored because of the potential benefits, one of which would be the ability to pay for more qualified staff. The staffer noted that Cong. Lazio did not have any problem with the way the industry groups worded their opposition, but took issue with HUD's characterization of the origin of the proposal (*BNA Daily Report for Executives*, Kenneth Talley, 3/8/00)

<p>Ginnie Mae is moving forward on its proposal to purchase its own mortgage-backed securities</p>

- In an interview with *Reuters*, Ginnie Mae Executive Vice President George Anderson said the agency is moving forward with its proposal that would allow Ginnie Mae to purchase its own mortgage-backed securities to increase revenues and the total return on its securities. According to Anderson, originally Ginnie Mae had proposed creating a \$60 billion MBS portfolio, but now Ginnie Mae believes that the size of the portfolio will be smaller due to an unexpected drop in mortgage demand in a climate of rising interest rates. The portfolio plan "has a viable chance (to be approved by Congress) this year," said Anderson.

- Although Fannie and Freddie purchase their own MBS for their portfolios (without any limits on the portfolio), senior Fannie and Freddie officials have criticized Ginnie Mae's plans as a cost burden for the Treasury, saying Ginnie Mae does not have the expertise to manage such a portfolio. According to Anderson, the Treasury Department will play a key role in the Ginnie Mae plan by providing the funding for Ginnie Mae to buy the securities, and by lending its market expertise to manage the portfolio. Further he noted that Ginnie Mae would also hire investment experts to manage the portfolio as a backup to Treasury support. Anderson noted that the agency has been working with the Clinton Administration and the OMB on the proposal. (*Reuters*, Richard Leong, 3/31/00)

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