

The **GSE** REPORT™

Contents of GSE Report™

Major Events

“The bombs are once again raining down on Fannie Mae and Freddie Mac” – Jim McTague, *Barron’s Online*

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 - “Tens of thousands of black Americans pay higher mortgage rates or may not be able to get a mortgage at all because of lending policies at Fannie Mae and Freddie Mac,” according to HUD officials
 - Fannie & Freddie lag the private industry in loans to blacks says HUD
 - In exchange for the benefits that Fannie & Freddie receive from their close ties to the government – estimated to be approximately \$6 billion a year – Congress said that Fannie & Freddie are supposed to *lead* the housing industry in lending to underserved communities. However, the share of Fannie & Freddie mortgages going to minorities *trails* the national average.
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- Coalition of prominent taxpayer groups forms watchdog group – called HomeEc- to examine growing concerns with Fannie & Freddie and advocate major reform of the GSEs (p. 12)
 - Coalition says the GSEs may be putting taxpayers in danger
 - The group is comprised of Citizens Against Government Waste, Citizens for a Sound Economy, the National Taxpayers Union, the Competitive Enterprise Institute, Capitol Watch, the 60+ Association, and the Small Business Survival Committee
 - Fannie says HomeEc’s position is another misguided attempt to “defend the interests of those who would charge consumers higher costs” [Editorial Note: Fannie Mae’s standard response to anyone who expresses concerns about the GSEs.]

- HUD releases its proposed affordable housing rules for Fannie & Freddie (*p. 13*)
 - *Dow Jones Newswire* reports that the HUD proposal says that Fannie & Freddie share some of the blame for the racial gap in America
 - HUD proposal increases the percentage of mortgage loans for low- and moderate-income families that Fannie & Freddie must purchase
 - Final rule is expected later this year
- Senate Banking Committee Chairman Phil Gramm (R-TX) wants:
 - large-scale review of the GSEs
 - further GSE privatization
 - calls Cong. Baker's GSE bill a "good start" (*p. 15*)
- American Enterprise Institute (AEI) releases study warning that the growth of Fannie & Freddie poses the threat of an expensive taxpayer-financed bailout (*p. 16*)
 - By 2003, Fannie & Freddie will have assumed the risk for almost *half* of all residential mortgages in the US - in effect, nationalizing the mortgage market
 - "That means that the taxpayers, who ultimately stand behind the obligations of these two companies, will have unwittingly become responsible for almost *\$3 trillion* of residential mortgage risk that should be on the books of private-sector firms."
 - Fannie & Freddie will have to expand into new sectors (e.g., subprime and consumer finance lending) to meet Wall Street's growth expectations
 - Based on CBO's 1996 study which estimated that Fannie & Freddie's implicit government subsidy was worth \$6.5 billion, their 1999 subsidy is now worth \$10 billion
 - What does Fannie & Freddie's \$10 billion subsidy buy? Not much.
 - GSEs' government subsidies increase home prices, benefiting sellers and developers, not home buyers
 - GSE trends are similar to those seen in the S&Ls in the 1980s
 - The more the GSEs try to replace Treasuries as a benchmark security, the more the GSEs reinforce the notion that they are explicitly backed by the government and even more so as the GSEs continue to grow. If someone tied to privatize them, it would make it that much more difficult to privatize if they replace Treasuries as benchmarks.
- National Taxpayers Union holds Capitol Hill conference examining Fannie & Freddie's risk to taxpayers (*p. 19*)
 - Speakers include National Taxpayers Union President John Berthoud, Resident Fellow Peter Wallison of American Enterprise Institute, Bert Ely, financial institutions consultant, Tom Miller of Competitive Enterprise Institute, and Steve Moore from the Cato Institute
- The Congressional Budget Office (CBO) lists the following as options for increasing federal revenues: (1) imposing an annual fee on the investment portfolios of the GSEs; (2) requiring the GSEs to register their securities with the SEC; (3) increasing the Ginnie Mae guarantee fee (*p. 21*)
 - When the CBO provided these options last year, Fannie & Freddie were opposed
- In response to HUD's fair lending investigation of the GSEs' automated underwriting systems, Fannie finally provides information to HUD (*p. 23*)
 - HUD requested the information a year ago
 - HUD has been conducting an investigation into Fannie & Freddie's automated underwriting systems to determine if their systems disproportionately affect minorities and low-income borrowers
 - With this last submission, HUD Secretary Andrew Cuomo announces that Fannie is "cooperating fully" with the review, demonstrating that HUD can be an effective regulator of Fannie & Freddie
 - Prior to Fannie's last submission, HUD accused Fannie of dragging its feet on the investigation and providing "grossly incomplete" data
 - Freddie is expected to provide information on its automated underwriting system shortly
 - HUD says the review will go beyond a fair lending investigation, noting that HUD wants to learn how the GSEs' systems are affecting the entire mortgage market. OFHEO will also have access to the information
 - HUD estimates it will take six months to complete a review and testing – HUD plans to release its findings and recommendations by the end of the year
- Federal regulators issue proposed rule for public comment that gives all AAA-rated and AA-rated asset-backed securities (ABS) the same capital treatment as Fannie & Freddie's MBS (*p. 25*)
 - Fannie was originally opposed to this idea when first proposed in 1997
 - A joint financial services trade group letter was sent to the Fed in May 1999 requesting that all investment-grade MBS be given a 20% risk-weighting (same as Fannie & Freddie) to ensure that Fannie & Freddie MBS would not be treated more favorably under bank risk-based capital guidelines than private-label MBS with AAA and AA ratings. The letter notes that currently Fannie & Freddie's MBS have "support from an array of government-granted benefits" which provides preferential treatment to GSE-supported MBS over other private sector MBS

Fannie Mae and Freddie Mac

- After 11 months and two extensions, the comment period on OFHEO's risk-based capital proposal for Fannie & Freddie closed on March 10, 2000 (p. 26)
 - *Dow Jones Newswire* reports that Fannie & Freddie raised a number of serious objections to the proposal, which could delay further implementation of the rule
 - OFHEO is giving interested parties 30 days to react to the comments that were submitted
- 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, 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 even larger risk as Fannie Mae and Freddie Mac expand, while the companies' shareholders enjoy profits at taxpayers' expense." (*Wall Street Journal*, 2/3/00)

Recent news indicating that the amount of GSE debt will only increase this year:

 - Fannie & Freddie's regulator OFHEO plans to examine Fannie & Freddie's skyrocketing debt
 - "In just a few years, Fannie Mae and Freddie Mac could be issuing more long-term debt than the entire US government" – a "role reversal of seismic proportions," says OFHEO
 - OFHEO says that Fannie & Freddie's plan to achieve benchmark status implies new responsibilities
 - "As the debt of Fannie Mae and Freddie Mac assume a more central role in international debt markets, disruption caused by failure of these enterprises could extend well beyond housing finance," says OFHEO
 - Despite increased market reliance on GSE debt, the Treasury Department says there is no change in US policy towards the securities
 - Although there is no change in policy, Treasury has been discussing the implications for financial markets and possible risk to the government from the growth of GSE debt
 - New York Federal Reserve Bank is holding \$82 billion of GSE securities on behalf of foreign central banks
 - There is a belief that by purchasing GSE debt securities in the open-market, the Fed would be supporting the perception that the securities are government guaranteed
 - Amount of Treasuries continues to decrease – for the first time in 70 years, the US Treasury buys back its own debt
 - GSE debt being used more often in bond "repos" (repurchase agreements) instead of Treasuries
 - Chicago Mercantile Exchange sets March 14 date to launch futures on Fannie & Freddie's debt securities; Chicago Board of Trade sets March 15 launch date – Investors believe Fannie & Freddie's debt will increasingly battle for benchmark status once futures contracts are developed
 - Fannie says it will use its own GSE debt instead of Treasuries as a benchmark for its 7-year note sale
 - Freddie makes changes to its Reference Note program
- Fannie & Freddie are accused of blocking cost-saving automated appraisals (p. 31)
 - Mark Sennott, President of Chicago Title Market Intelligence claims there are lots of good automated valuation models (AVMs) in the market now but the Fannie & Freddie "are standing in their way" because the GSEs only want to use their own proprietary automated systems
 - "Freddie Mac accepts only its own system – Home Value Estimator – but tests show that others are just as good," Sennott charged
- Fannie/Freddie watchdog group, FM Watch, launches "Truth Watch" on its homepage in an effort to point out inconsistencies in what Fannie & Freddie say to the public (p. 32)
 - "One thing FM Watch has learned is that Fannie and Freddie say one thing to Congress and the public and another to customers and Wall Street," said Mike House, Executive Director of FM Watch
- OFHEO hires Alfred Pollard (formerly chief lobbyist with the Financial Services Roundtable) as its new General Counsel (p. 32)
- AEI-Brookings hold a joint event on incentives for anti-competitive behavior by public enterprises (such as Fannie & Freddie) (p. 32)
 - The report presented an analysis of the incentives available to public enterprises to undertake activities that disadvantage competitors
 - There are examples of anti-competitive practices by public enterprises that can be applied to Fannie & Freddie

Fannie Mae

- Fannie hires Daniel Mudd (President and CEO of GE Capital, Japan) as Vice Chairman and Chief Operating Officer (p. 35)
 - Mudd replaces Lawrence Small who made over \$4 million in salary plus bonuses in 1998
- Will Fannie Chairman Franklin Raines be Al Gore's Presidential running mate? (p. 35)
 - *American Banker* reports that Raines would "seem a strong candidate" but "would have to overcome the bad press" recently prompted by HUD's report that "Fannie Mae's policies have raised the costs and decreased the availability of mortgages for blacks"
- 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 opens three new Partnership Offices) (p. 35)
 - Fannie continues to make more political hires
 - 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

- Freddie continues to expand into the subprime (A-) market (p. 38)
 - Freddie works on a new pilot – the "Step Down" mortgage product – that is similar to Fannie's "Timely Payments Rewards" product
 - [Editorial Note: Will investors and traders be concerned with Freddie's pilot as they were with Fannie's similar pilot?]
 - [Editorial Note: Will Freddie, like Fannie, require that lenders use Freddie's automated underwriting system if they want to provide the product to consumers?]
- Freddie says it has a "moral objection" to subprime loans in which credit life insurance is financed out of the loan proceeds (p. 40)
- Freddie forms a technology alliance with the credit unions (p. 41)
 - Alliance will allow credit unions online access to Freddie's automated underwriting system at the point-of-sale through the credit union's website
- Freddie's CFO, John Gibbons, leaves the company (p. 41)

Federal Home Loan Banks

- FHLBank's Mortgage Partnership Finance (MPF) program continues to grow (p. 42)
 - MPF program is a competitor to Fannie & Freddie in the secondary mortgage market
 - MPF program allows the FHLBanks to purchase mortgage loans from its member institutions
 - Banks and thrift commitments to sell loans to FHLBanks under the MPF program soared 696% last year, to \$6.6 billion
 - More than 100 institutions are approved to participate in the MPF program, more than double the number in 1998
 - MPF program soared by over 200% in January to \$21.7 billion in loan commitments
 - Half of the FHLBanks offer the program and two more FHLBanks will soon offer the program

Major Events

**“The bombs are once again raining down on Fannie Mae and Freddie Mac.”
(Jim McTague, *Barron’s Online*, 3/6/00)**

HUD says that Fannie & Freddie’s mortgage policies hurt blacks (*Washington Post* runs front-page story)

“Tens of thousands of black Americans pay higher mortgage rates or may not be able to get a mortgage at all because of lending policies at Fannie Mae and Freddie Mac,” according to HUD officials.

Fannie & Freddie lag the private industry in loans to blacks says HUD

In exchange for the benefits that Fannie & Freddie receive from their close ties to the government – estimated to be approximately \$6 billion a year – Congress said that Fannie & Freddie are supposed to *lead* the housing industry in lending to underserved communities. However, the share of Fannie & Freddie mortgages going to minorities *trails* the national average.

William Michael Cunningham, Chief Executive of Creative Investment Research in Washington, DC estimates that Fannie & Freddie have turned down as much as \$2 billion of loans sought by black applicants

***Washington Post* follows-up with an editorial that says Fannie & Freddie have improved but “could do more” to help poorer Americans and minorities – “not just for those who would be able to buy a house anyway.” Fannie & Freddie “appear to lag behind banks and other lenders in the share of financing that goes to African American home buyers”**

Fannie Chairman Franklin Raines says the “*Washington Post* committed journalistic malpractice by mixing inadequate data with unsubstantiated analysis to arrive at a provocative conclusion.” Raines says he is “outraged” at the *Washington Post* article calling it “wrong” to imitate that Fannie does not support African American home buyers

HUD stands by its numbers and its assessment that HUD’s policies hurt blacks

Cong. Maxine Waters (D-CA) commends HUD’s inquiry into lending practices of Fannie & Freddie

Washington Post front-page article – HUD says Fannie & Freddie’s mortgage policies hurt blacks

- In a front page article by Kathleen Day, the *Washington Post* reported that HUD officials say that lending policies by Fannie and Freddie may cause tens of thousands of black Americans to pay higher mortgage rates or prevent them from buying a home. HUD Assistant Secretary William Apgar is quoted as stating, **“The absence of active involvement by Fannie Mae and Freddie Mac in these markets limits the opportunities for African American families to get conventional mortgages.”** (*Washington Post*, 3/2/00)

- According to Apgar, if Fannie and Freddie fail to buy mortgages made to particular groups, in this case blacks, and to a lesser extent, Hispanic borrowers, then credit costs for these groups go up. Currently HUD is conducting an inquiry of the GSEs to determine if their automated underwriting systems are discriminatory towards minority groups. Apgar said that HUD is releasing proposed affordable housing rules for the GSEs, which require the GSEs to do more business with underserved consumers. (*Washington Post*, 3/2/00) [HUD's proposed affordable housing rule was released on March 2 – see story in this *GSE Report*.]
- HUD's proposed affordable housing rule states that the percentage of loans to blacks that Fannie and Freddie purchase lags behind the percentage of loans that are made to blacks nationally. **Spokesman for Fannie and Freddie agree that their companies' record on purchasing mortgages to blacks has lagged behind national averages.** They, however, believe that the numbers HUD used overstates the difference and doesn't reflect their efforts to expand the loan market for blacks. (*Washington Post*, 3/2/00)
- **Day reported that “Freddie Mac and Fannie Mae point out that their overall lending patterns show that they have a good record on lending to minorities as a group, including blacks, Hispanics and Asian Americans. But that overall number is boosted by the companies' higher-than-average rate of lending to Asians, which masks a slightly lower-than-average rate of lending to Hispanics and a bigger gap in the lending rate to blacks.”** (*Washington Post*, 3/2/00)
- **In exchange for the benefits that Fannie and Freddie receive from their close ties to the government – estimated to be approximately \$6 billion a year – Congress has said that Fannie and Freddie are supposed to lead the housing industry in lending to underserved communities. However, the share of Fannie and Freddie mortgages going to minorities trails the national average.** According to 1998 housing data provided by HUD, banks and lenders made an estimated 8 million new mortgages under the GSEs' \$227,150 conforming loan limit. Out of that amount (which does not include FHA or VA loans), 5 percent went to African Americans. However, noted Day, only 3.2 percent of the loans purchased by Fannie and 3 percent by Freddie Mac in 1998 were from black borrowers. Overall, 15 percent of the mortgage market in 1998 included loans made to minority borrowers, including blacks, Hispanics and Asians. Fannie's 1998 portfolio included 14 percent of minority loans while Freddie purchased 12.2 percent. However, Day noted that these numbers are “substantially boosted by the fact that 5.9 percent of the loans Fannie Mae and 4.8 percent of those that Freddie Mac bought were to Asian Americans -- numbers well above the 3.6 percent of loans nationally that banks and other lenders sold to that group.” (*Washington Post*, 3/2/00)
- **“We believe that there are a lot of loans to black Americans that are good loans that could be safely purchased by Fannie Mae and Freddie Mac if these companies were more flexible.”** (*The Washington Post*, 3/2/00) **Apgar and others said that Fannie and Freddie's policies have had the effect of leaving blacks out at a rate that is disproportionate to other minorities, whether intended or not, and that the practice has been a pattern for years.** (*Washington Post*, 3/3/00)

William Michael Cunningham from Creative Investment Research responds

- **William Michael Cunningham, a consultant on banking in minority communities and Chief Executive of Creative Investment Research Inc. in Washington, DC estimates that Fannie**

and Freddie have turned down as much as \$2 billion of loans sought by black applicants.

(Austin American Statesman, 3/4/00; Bloomberg News, 3/2/00)

Fannie's response to *Washington Post* article

- In a letter-to-the-editor published in the *Washington Post*, Fannie Chairman Franklin Raines said that “the Post committed journalistic malpractice by mixing inadequate data with unsubstantiated analysis to arrive at a provocative conclusion.” (*Washington Post letter-to-the editor, Fannie Chairman Franklin Raines, 3/10/00*)
- Raines also held a last-minute press conference on the day of the *Washington Post* article (March 3) to announce that Fannie has played a critical role in the expansion of minority homeownership over the past decade. Raines pledged that Fannie will lead the market in mortgage credit for blacks in this decade. Raines stated that “The Post story imitates that Fannie Mae does not support African American homebuyers. That story is simply wrong, and I am outraged by it. Fannie Mae’s ‘policies’ are to expand homeownership, as aggressively as possible. The Post’s implication that Fannie Mae has ‘policies’ that exclude borrowing by blacks is neither supported by the article nor correct. During the 1990s, Fannie Mae grew to become the nation’s single largest source of home financing for minority families.” (*Fannie press release, 3/2/00*)
- Raines claimed that African Americans are being steered to the subprime market and are given loans with no mortgage insurance – both of which Fannie says it can’t purchase. Raines attacked the Post article but did not attack HUD’s numbers. Despite HUD’s numbers, Raines says that “We [Fannie Mae] basically match the market on loans to African Americans now.” (*Fannie press release, 3/2/00*)
- Raines said Fannie is going to increase its subprime lending activities to improve its record of lending to African-Americans and meet new affordable housing goals recently proposed by HUD. “We have not been a major presence in the subprime market, but you can bet that under these goals we will be,” he stated. (*Washington Post, 3/3/00*)

HUD stands by its assessment that Fannie & Freddie’s policies hurt blacks

- In his press release expressing his outrage at the *Washington Post* article, Raines noted that he was joined in the press conference by HUD Secretary Andrew Cuomo and Assistant Secretary William Apgar. According to the *Washington Post*, Cuomo and Apgar participated in the press conference by telephone and the HUD officials defended their assessment of Fannie’s lending practices. **“We stand by the [HUD] numbers and believe they represent a comprehensive assessment of mortgage lending patters to African Americans,”** said Apgar. **Although Congress has mandated that Fannie and Freddie should lead the market in lending to underserved customers, Apgar said Fannie is not “leading the market” today in lending to blacks. “They need to be more aggressive and more flexible in the types of loan products they buy,”** he said. **“Their business practices produce certain results, and we’re saying their business practices come up short. And that’s why we’re expanding their [affordable housing] goals for reaching underserved communities.”** (*Washington Post, 3/3/00*)
- Apgar stated in the press conference that **“There is significantly more that both companies [Fannie and Freddie] can do in order to expand lending, and to African-Americans, in particular.** (*National Mortgage News, 3/6/00*)

Washington Post runs an editorial on Fannie & Freddie saying Fannie & Freddie could do more for poorer Americans and minorities

- **The *Washington Post* ran an editorial on March 6 noting that the justification for Fannie and Freddie receiving approximately \$6 billion a year in direct and indirect subsidies “is that Fannie and Freddie must demonstrate they are financing mortgages for poorer Americans and minorities – not just for those who would be able to buy a house anyway. The companies have improved but could do more. More than half the mortgages they finance go to families above the median income in their area. And though the statistics are variously interpreted, the two companies appear to lag behind banks and other lenders in the share of financing that goes to African American home buyers.” (*Washington Post* editorial, 3/6/00)**

Fannie/Freddie watchdog group, FM Watch, responds

- **FM Watch spokesperson Beneva Schulte stated that Fannie and Freddie should be concentrating on serving the underserved rather than on making profits by buying other loans. “They’re not fulfilling their congressional mandate,” she said. The companies should pay more attention to leading the market for the underserved and less attention to making enormous profits, she added. (*United Press International*, 3/3/00)**

Cong. Maxine Waters (D-CA) responds

- **Cong. Maxine Waters issued a press release commending HUD for its inquiry into lending practices of Fannie and Freddie. “Fannie Mae and Freddie Mac are special, congressionally chartered corporations granted certain legal privileges and exemptions not generally available to other corporations. Because of this public support, Fannie Mae and Freddie Mac’s responsibility must include servicing markets that have traditionally been excluded from conventional home lending,” she stated. “A problem arises when Fannie Mae and Freddie Mac fail to buy loans of a specific group – namely, African Americans and Latinos. This forces these groups to obtain loans at a much higher rate.” Waters stated, “I am surprised at the information regarding the overall loans to minorities, particularly to African Americans.” (*Press release by Cong. Maxine Waters*, 3/2/00)**

Chairman of the House Banking Capital Markets Subcommittee Cong. Richard Baker (R-LA) introduces a bill to improve regulatory oversight of the three housing GSEs (Fannie, Freddie, and the FHLBank System)

House Banking Committee Chairman Jim Leach (R-IA) co-sponsors the bill

Fannie says the bill could “harm consumers by interfering with the functioning of the secondary market and stifling product innovation.”

Fannie/Freddie watchdog group, FM Watch, lauds Cong. Baker’s bill to “curb reckless GSE expansion,” calling the bill “a good first step”

America’s Community Bankers says the bill deals with issues that are priorities of ACB

- Cong. Richard Baker (R-LA) introduced a bill on February 29 called the “Housing Finance Regulatory Improvement Act of 2000” (H.R. 3703) to improve regulatory oversight of the housing GSEs (Fannie Mae, Freddie Mac, and the FHLBank System). House Banking Committee Chairman Jim Leach (R-IA) is a co-sponsor of the bill.
- Cong. Baker says he hopes to move his bill through the full House Banking Committee this year and possibly bring the bill to the floor of the House for a vote before the end of the year. Otherwise, he will push for a House vote early next year. (*National Mortgage News Daily website*, 3/10/00)
- **Cong. Baker believes that now is the time to act since the “housing GSEs are large and growing larger.” He noted that the total obligations of the three housing GSEs is about half of the federal government’s \$5.6 trillion national debt. His bill aims to improve their supervision “[t]o assure they remain healthy throughout economic downturns and that taxpayers are never called upon to bail out GSEs.” Baker added, “The last thing we need today is a repeat of the Savings and Loan crisis of the 1980s, in which taxpayers and the economy were jolted by a massive bailout.” (Cong. Baker press release, 2/29/00; (“Dear Colleague Letter from Cong. Baker,” 2/17/00)**
- The bill will among other things, create a single regulator for the housing GSEs. Currently, there are several regulators for the housing GSEs. For Fannie and Freddie, HUD is the mission regulator and the Office of Federal Housing Enterprise Oversight (OFHEO) is the safety and soundness regulator. The Federal Housing Finance Board (FHFB) regulates the FHLBank System. Under Cong. Baker’s proposal, OFHEO and the FHFB would be merged into a single regulator with a five-member board. The President would appoint three of the five seats. HUD and Treasury would each have a single seat. “I believe that an independent board consisting of five persons, including representatives from HUD and Treasury, is a more effective oversight agency for the three housing GSEs than the current regulatory system,” Cong. Baker stated. (*“Dear Colleague Letter from Cong. Baker,” 2/17/00)*
- Other provisions in the bill include:
 - Reforming the approval process for new GSE initiatives;
 - Limiting GSEs’ non-mission related investments;
 - Removing each GSE’s line of credit with the Treasury;

- Imposing uniform risk-based capital requirements on the GSEs;
- Requiring annual credit ratings of each GSE;
- Putting into statute the current GSE practice of maintaining the conforming loan limit to reflect downward movement in average home prices;
- Equalizing the capital treatment of GSE and private-label mortgage-backed securities;
- Studying the exposure of the deposit insurance funds to GSE failure. (*“Dear Colleague Letter from Cong. Baker,”* 2/17/00)

Fannie’s response

- A Fannie spokesman declined to comment on the specific provisions of the bill but said that the company is concerned that the bill could “harm consumers by interfering with the functioning of the secondary market and stifling product innovation.” (*National Mortgage News website*, 3/2/00) Fannie Chairman Franklin Raines said it is in Fannie’s interest to have an effective regulator, however, he raised concerns about the five-member board that Cong. Baker is proposing. He doubted it represents “progress to have a multi-headed board.” (*National Mortgage News*, 2/28/00)

HUD opposes the bill

- HUD Secretary Andrew Cuomo opposes the bill and insisted that HUD is an effective regulator. “If it ain’t broke, don’t fix it,” Cuomo stated at a press conference in which he announced that Fannie had submitted information to HUD in its ongoing fair lending investigation of the GSEs. “I believe the fact that HUD is an effective regulator gives people more confidence in the whole GSE system,” he stated. (*National Mortgage News*, 2/28/00)

OFHEO’s response

- In an interview with *BNA*, OFHEO Director Armando Falcon stated that if the best way to regulate the GSEs and get OFHEO out of the appropriations process is to merge OFHEO and the FHFB, then “that’s fine.” “I gather that whatever entity would result from the merger in his [Cong. Baker’s] bill would be out of the appropriations process,” Falcon stated, adding that merging the two regulators would leave “one or the other.” Removing OFHEO from the budget process is equally as important as having financial independence for the regulator of the GSEs and learning what is the most effective means of regulating the GSEs for both safety and soundness and mission. “I will take a look at his [Cong. Baker] bill...and assess it when it is introduced,” Falcon said. “But, if the best way of regulating the GSEs means that I’m out of a job, well, that’s fine. I’ll go raise cattle in Texas or something. For me, this isn’t about preserving my job, it’s about what’s the best way of regulating the GSEs.” OFHEO is the only financial regulator subject to the appropriations process. Although OFHEO is subject to the appropriations process, its funding does not come from taxpayers but from assessments on Fannie and Freddie. (*BNA Daily Report for Executives*, Eileen Canning, 2/18/00)

FHFB’s response

- FHFB Chairman Bruce Morrison (regulator of the FHLBanks) said that he could support consolidation of the housing GSEs’ regulators. “I think there is value to an independent agency,” Morrison stated. “I think it is absolutely essential for GSE regulation that mission and safety and soundness be in the same institution, not divided up as it is currently between OFHEO and other parts of HUD.” (*National Mortgage News Daily*, 2/25/00)

FM Watch’s response

- FM Watch applauded Cong. Baker’s leadership and leadership in enhancing federal oversight of the GSEs. FM Watch Chairman Gerald Friedman said that he is enthusiastic about the bill and its

attempts to control mission creep. “Rep. Baker sets up a procedure where new activities would be brought under a telescope and reviewed to see if they are mission consistent...That is something that is badly needed as Fannie Mae very quickly expands to other market activities like home equity lending,” he stated. **FM Watch called the bill an “important first step” and noted that there is more to do especially in the following three areas:**

- (1) **“Fannie Mae and Freddie Mac are failing to lead the market when it comes to their affordable housing mission. Congress needs to make sure their substantial taxpayer subsidies are for helping underserved Americans – not to pad their stockholders’ wallets.”**
- (2) **“To increase their profits and satisfy their investors, Fannie Mae and Freddie Mac are intruding on, and upsetting, open and competitive markets for many financial products and services, to the ultimate detriment of the consumer.”**
- (3) **“While their debt is skyrocketing and the taxpayer risk is increasing, the GSEs continue to provide record-shattering profits for their stockholders.”** (*FM Watch press release, 2/29/00; National Mortgage News, 3/6/00*)

America’s Community Bankers’ response

- Eric Mondres, a lobbyist with the ACB, said that the Baker bill deals with issues that are priorities of ACB. “We strongly oppose the development or expansion of activities by Fannie and Freddie that discourage or subsume the roles of other mortgage market participants,” he said. (*National Mortgage News, 3/6/00*)
- Some observers say that Cong. Baker’s proposed legislation isn’t likely to become law this year as the legislation faces a skeptical Congress, no record of hearings on the proposal, no companion legislation in the Senate, and strong opposition from the GSEs. Even if the legislative efforts fails this year, financial services experts and industry officials say Cong. Baker’s proposal is part of a broader trend to explore new regulatory approaches to the GSE system. (*Dow Jones Newswire, Jerry Guidera, 3/1/00*)

Coalition of prominent taxpayer groups forms watchdog group – called HomeEc – to examine growing concerns with Fannie & Freddie and advocate major reform of the GSEs

Coalition says the GSEs may be putting taxpayers in danger

The group is comprised of Citizens Against Government Waste, Citizens for a Sound Economy, the National Taxpayers Union, the Competitive Enterprise Institute, Capitol Watch, the 60+ Association, and the Small Business Survival Committee

Fannie says HomeEc’s position is another misguided attempt to “defend the interests of those who would charge consumers higher costs” [Editorial note: Fannie Mae’s standard response to anyone who expresses concerns about the GSEs.]

- A new coalition of taxpayer groups is pushing for stronger oversight of Fannie and Freddie, saying the GSE may be putting taxpayers in danger. The coalition, called HomeEc (short for Homeowners’ Education Coalition) - held a press conference on Capitol Hill on March 9 with Cong. Richard Baker (R-LA) who recently introduced a bill to strengthen oversight of the GSEs. [See earlier story on Cong. Baker’s bill in this *GSE Report*.]

Citizens Against Government Waste

- **“If Freddie and Fannie continue their attempts to expand their reach into subprime and jumbo mortgages, there is a real danger of collapse,”** said Thomas Schatz, President of the Council for Citizens Against Government Waste. Schatz said the **“GSEs could become the savings and loans of the coming decade.”** Expressing fear that the GSEs’ debt could outstrip the Treasury, he said the public image of a potential bailout would make the S&L crisis **“look like chump change.”** (*American Banker*, 3/13/00) Schatz said that Cong. Baker’s bill “would institute important steps toward making GSE regulation and oversight more effective.” (*Citizens Against Government Waste press conference*, 3/9/00)

Citizens for a Sound Economy

- CSE supports Cong. Baker’s bill, arguing that the GSEs have exposed taxpayers to a high level of risk. **“We are greatly concerned about the staggering \$1 trillion worth of debt these organizations now bear, especially when the federal government is actually paying down the publicly held debt,”** said Scott Hodge, CSE’s Director of Tax and Budget Policy. **“If this trend continues, in just a few years, these two GSEs could be issuing more debt than the entire federal government. This is a fact that should trouble every American taxpayer”** Hodge applauded a provision in Cong. Baker’s bill that would remove Fannie and Freddie’s line of credit with the Treasury Department **“The irony of this effort is that it is taking a coalition of taxpayer organizations to bring overdue oversight to Fannie Mae and Freddie Mac, who were given their market power and near-monopolistic status by the federal government. Meanwhile, the Justice Department’s Antitrust lawyers are busily waging war on the Microsoft Corporation who earned its success in a highly competitive marketplace.”** (*BNA Daily Report for Executives*, Kenneth Talley, 3/10/00; *CSE press release*, 3/9/00)

National Taxpayers Union

- **“Fannie Mae and Freddie Mac have spent millions to advertise the benefits of their services to Americans, but taxpayers need more information about these programs to weigh their future value,”** said NTU President John Berthoud. **“With the debt holdings of these government-**

sponsored enterprises about to skyrocket, there is no time to lose in getting this public dialogue up and running.” NTU noted that its organization held a Capitol Hill conference for policymakers on the need to discuss reforms of Fannie and Freddie. [See story on NTU conference in this *GSE Report*.] (*NTU press release, 3/9/00*)

Capitol Watch

- **A press release by Capitol Watch noted that for almost sixty years, the GSEs “have operated with lax government oversight while receiving the benefits of their governmental ties. But now with skyrocketing debt, there is a fear that the current investment practices of these two institutions are exposing the US taxpayer to great financial risk.”**
- “As quasi-governmental organizations, Freddie Mac and Fannie Mae are able to use their governmental perks to turn a profit on a smaller margin making it unfair for others competing with them in the same market. Up until now, they have been able to use their special governmental ties and political power to avoid being accountable and transparent. But in the age where we are brining the national debt down, how can we sit by and watch the GSEs issue unlimited taxpayer backed debt without fully exploring the potential liabilities,” said Capitol Watch Executive Director Andrew Quinlan. (*Capitol Watch press release, 3/9/00*)

Small Business Survival Committee

- Small Business Survival Committee President Christopher Wysocki noted that **“It is important for small businesses across America to have a competitive lending market where GSEs are not able to use a congressional charter and a statutory relationship with the government to achieve an unfair economic advantage over private companies.”** (*BNA Daily Report for Executives, Kenneth Talley, 3/10/00*) **“In bad economic times, Government Sponsored Enterprises (GSEs) like Fannie Mae and Freddie Mac have the potential of costing taxpayers billions of dollars...While both of these GSEs are doing well now, we believe that an implicit guarantee that the United States government will bail these companies out in times of crisis should be explicitly removed.”** (*Small Business Survival Committee press release, 3/9/00*)

Fannie Mae responds

- Fannie Spokesman David Jeffers says HomEc’s position is another misguided attempt to “defend the interests of those who would charge consumers higher costs.” (*American Banker, 3/13/00*)

HUD releases its proposed affordable housing rules for Fannie & Freddie

***Dow Jones Newswire* reports that the HUD proposal says that Fannie & Freddie share some of the blame for the racial gap in America**

HUD proposal increases the percentage of mortgage loans for low- and moderate-income families that Fannie & Freddie must purchase

Final rule is expected later this year

- On March 2, HUD released its proposed affordable housing rule for Fannie and Freddie. HUD Secretary Cuomo said the proposal raises the required percentage of mortgage loans for low- and moderate-income families that Fannie and Freddie must purchase from the current 42% of their total purchases to a new high of 50% - a 19% increase in the year 2001. HUD also proposed an increase in the affordable housing goals for families with very low incomes (an increase from the

current 14% to 20%) and an increase in the underserved areas, such as central cities and rural areas (an increase from the current 24% to 31%). The proposed rule was published in the *Federal Register* on March 9, 2000. The deadline for comments is May 8, 2000. HUD is expected to issue a final rule by the fall of this year. (*HUD press release, 3/2/00; Federal Register, pages 12632-12816, 3/9/00*)

Special multi-family adjustments were given to Freddie

- Adjustments were made to HUD's affordable housing proposal in response to complaints by Freddie that it would be difficult for Freddie to meet the higher affordable housing goals because it has a much smaller multi-family program than Fannie. Last September, Freddie was successful at having language included in the HUD-VA Appropriations bill that instructed HUD to consider this factor. Under the affordable housing proposal, Freddie's purchases of multi-family loans will count more towards meeting its affordable housing goals than Fannie's. There is a "temporary adjustment fact" that awards Freddie 1.2 points for every multi-family unit financed, compared with only one point for Fannie. The bonus applies to multi-family properties with 50 or more rental units. It would be in effect until December 31, 2003. (*National Mortgage News Daily website, 2/14/00; BNA Daily Report for Executives, Adam Wasch, 2/29/00*)
- The affordable housing proposal also encourages Fannie and Freddie to finance more A- loans and it awards bonus points if they increase their purchases of loans on single-family rental properties and small multi-family properties with less than 50 units. (*National Mortgage News Daily website, 2/14/00*) The proposal also seeks comments on whether HUD should deny affordable housing points for purchases of multi-family loans if the GSEs require originators to bear all future risk of default. (*National Mortgage News Daily website, 3/3/00*)

The GSEs share blame for racial gap

- **According to Jerry Guidera with *Dow Jones Newswire*, HUD says that Fannie and Freddie share some of the blame for the racial gap in America. "Certain segments of the population have not benefited to the same degree as have others from the advantages and efficiencies provided by Fannie Mae and Freddie Mac," HUD said in its affordable housing proposal. "The GSEs have been much less active in markets where there is a need for additional financing sources to address persistent housing needs including small multifamily rental properties, manufactured housing, single family owner-occupied rental properties, seasoned affordable housing mortgages and older housing in need of rehabilitation...America's unmet housing needs, identified credit gaps, and its consideration of all the statutory factors causes HUD to propose increased goals so that as the GSEs grow their businesses they will address new markets and persistent housing-finance needs," HUD said. (*Dow Jones Newswire, Jerry Guidera, 3/2/00*)**

Senate Banking Committee Chairman Phil Gramm (R-TX) wants:

- **a large-scale review of the GSEs;**
- **further GSE privatization;**
- **calls Cong. Baker's GSE bill a "good start"**

- Speaking at a meeting of the America's Community Bankers on March 7, Senator Gramm said Fannie and Freddie need to be reined in. Stopping just short of advocating the complete privatization of Fannie and Freddie, he stated that "guaranteed lending...[is] out of control." The current financial health of the GSEs is to be commended, but "to what degree the taxpayer is at risk, we should do what we can do to sever" the GSEs' ties to the federal government. (*BNA Daily Report for Executives*, Adam Wasch, 3/8/00) "I'm not in any way hostile to them. But I think going back and looking at the degree to which the taxpayer is on the hook in guaranteeing these loans, I think that time has come to do that." Specifically, he noted the wide-ranging debate over whether the federal government is obligated to stand behind the GSEs' debts. "Well, if we're not, there's a lot of people who think we are. Maybe we ought to make it clear that we're not." (*Dow Jones Newswire*, Jonathan Nicholson, 3/7/00)
- Senator Gramm said that he would like the next administration to examine further privatization of Fannie and Freddie. "In some ways, severing this umbilical cord with Freddie Mac and Fannie Mae liberates them, as well, to engage in more business practices rather than having the government telling them how to run their businesses." (*National Mortgage News Daily website*, 3/7/00)
- Senator Gramm is also interested in reviewing what effect the GSEs have on mortgage rates and how Fannie's recently announced entry into the subprime market might affect the mortgage default rate. (*BNA Daily Report for Executives*, Adam Wasch, 3/8/00)
- Senator Gramm called Cong. Baker's GSE bill a "good start" in examining the GSEs but he didn't think it was an "endpoint." (*Dow Jones Newswire*, Jonathan Nicholson, 3/7/00)

American Enterprise Institute (AEI) releases study warning that the growth of Fannie & Freddie poses the threat of an expensive taxpayer-financed bailout

By 2003, Fannie & Freddie will have assumed the risk for almost *half* of all residential mortgages in the US – in effect, nationalizing the mortgage market

“That means that the taxpayers, who ultimately stand behind the obligations of these two companies, will have unwittingly become responsible for almost *\$3 trillion* of residential mortgage risk that should be on the books of private-sector firms.”

Fannie & Freddie will have to expand into new sectors (e.g., subprime and consumer finance lending) to meet Wall Street’s growth expectations

Based on CBO’s 1996 study which estimated that Fannie & Freddie’s implicit government subsidy was worth \$6.5 billion, their 1999 subsidy is now worth \$10 billion

What does Fannie & Freddie’s \$10 billion subsidy buy? Not much.

GSEs’ government subsidies increase home prices, benefiting sellers and developers, not home buyers

GSE trends are similar to those seen in the S&Ls in the 1980s

The more the GSEs try to replace Treasuries as a benchmark security, the more the GSEs reinforce the notion that they are explicitly backed by the government and even more so as the GSEs continue to grow. If someone tried to privatize them, it would make it that much more difficult to privatize if they replace Treasuries as benchmarks.

- AEI released a new study on March 6, “*Nationalizing Mortgage Risk: The Growth of Fannie Mae and Freddie Mac*,” by Peter Wallison and Bert Ely. Wallison is a former General Counsel for the Treasury Department and current Resident Fellow at the American Enterprise Institute. Ely, Principal at Ely & Company, Inc. is a financial institutions and monetary policy consultant. **Relying on the GSEs’ own earnings projections, their study shows that by 2003, Fannie and Freddie will have assumed the risk for almost *half* of all residential mortgages in the United States, in effect partially nationalizing the residential market. “That means that the taxpayers, who ultimately stand behind the obligations of these two companies, will have unwittingly become responsible for almost *\$3 trillion* of residential mortgage risk that should be on the books of private-sector firms,” the authors note. “Anyone who recalls the thrift industry’s collapse in the 1980s will recognize that this is a prescription for another expensive taxpayer-financed bailout,” warns Wallison. In conjunction with the release of the report, Wallison and Ely held a press briefing on March 6 to explain the findings of their report.**
- Last year, Fannie Chairman Franklin Raines told Wall Street that his company planned to double its earnings per share in five years, promising 15% annual growth in earnings over the next five years. Raines predicted that by the end of 2003, Fannie will have 28% of the US residential mortgage market on its books (either guaranteed or in its portfolio), a risk of \$1.8 trillion. (Freddie has also made similar projections to Wall Street on its growth rate. Ely and Wallison estimate Freddie will have \$1.2 trillion of risk on its books by 2003.) Using the GSEs’ promises to Wall

Street, Wallison and Ely projected just what that would mean to the mortgage market. Together, they estimate that the two GSEs will be bearing the risk associated with more than \$3 trillion in residential mortgages, or almost half (48%) of all residential mortgages in the United States and by 2003, to reach that total, Fannie and Freddie will need to control 92% of the conventional/conforming market. Further, Fannie and Freddie's outstanding debt, which capital markets assume to be backed by the federal government, was \$908 billion in 1999 and is projected to double in just a few years (2003) to \$1.8 trillion – 14 times the amount of Long Term Capital Management's on-balance-sheet debt before it crashed. **In effect, the mortgage market is on its way to being nationalized.**

GSEs must grow to meet Wall Street earnings

- **“These two gorillas are growing faster than their cage.”** Since the total residential mortgage market is only growing at about 6% a year, there is not a sufficient amount of the higher quality, conventional/conforming mortgages to meet Wall Street's expectations. “So in addition to assuming a great degree of risk simply through their growth over the next four years, the GSEs will also be increasing their overall risk by going more deeply into the lower-quality sectors of the market that until now have been served satisfactorily by nonsubsidized lenders.” **Wallison and Ely note that because Fannie and Freddie receive subsidies from their GSE status, it allows them to overwhelm nonsubsidized firms in any market the GSEs choose to enter.** Potential areas for which Fannie and Freddie might seek to expand their market include the jumbo mortgage market, non-residential commercial mortgages, consumer credit, acquiring home equity loans in addition to first mortgages, and direct mortgage origination, starting with refinances.
- **Wallison and Ely note that perhaps the “greatest competitive threat” from the GSEs' growth is in the mortgage origination business.** “Although Fannie and Freddie vigorously deny that they have any intention to originate mortgages, pointing out that they lack the statutory authority to do so, what exactly constitutes origination of a mortgage is a matter of interpretation. If Fannie and Freddie were to open their automated underwriting facilities to direct borrower access over the Internet, it might be possible for them to provide the prospective homebuyer with a certification that his or her mortgage would qualify for purchase by Fannie or Freddie. At that point, the actual lender would have little to do except to perform the ministerial acts necessary to fund the loan and deliver it to one of another of the GSEs. The compensation for that role would, of course, be small.”

What does Fannie & Freddie's \$10 billion implicit government subsidy buy? Not much.

- Fannie and Freddie's securities are not explicitly guaranteed by the government, however, there are a number of extraordinary privileges and subsidies granted to Fannie and Freddie from its GSE status, which have convinced the capital markets that the federal government will never allow Fannie and Freddie to fail. Thus, the nation's taxpayers will ultimately bear the risks associated with Fannie and Freddie's debt obligations. **Based on the Congressional Budget Office's 1996 study, Wallison and Ely estimate that Fannie and Freddie's 1999 subsidy from its GSE status was approximately \$10 billion. What does the \$10 billion implicit government subsidy buy? Wallison says “not much.”** The market no longer needs the liquidity assistance provided by Fannie and Freddie. And of the estimated \$10 billion subsidy, 1/3 of that amount (approx. \$3.5 billion) benefited Fannie and Freddie's management and stockholders (not homebuyers), accounting for over 40% of Fannie and Freddie's 1999 pre-tax earnings. CBO found that “they [Fannie and Freddie] are not an efficient [subsidy] delivery vehicle because they retain nearly \$1 for every \$2 they pass through.”

GSEs' government subsidies increase home prices, benefiting sellers and developers, not home buyers

- **The GSEs claim that their subsidy from their GSE status lowers the interest rates for home buyers, but the authors contradicted the claims by the GSEs that their activity results in mortgage rates being up to 30 basis points lower than they would be without their involvement. They state that many economists have noted that this saving for homebuyers is an illusion since the lower interest rate is immediately capitalized into the cost of the home, so that the real benefit of the implicit subsidy goes to developers and home sellers rather than to the homebuyers whom Congress presumably intended to assist. The GSEs also claim that they have superior underwriting skills but the authors note that their systems have not been tested in a recession.**

GSE trends similar to those seen in the S&Ls in the 1980s

- There are a number of trends that were responsible for the S&L problems in the 1980s that are similar to the GSEs:
 - Large number of long-term mortgages
 - Lack of diversification (only asset holding is real estate)
 - Low capital ratios
 - Short-term debt
 - Risk-taking for profitability
 - No market discipline

There are accountability and oversight problems with Fannie and Freddie:

- Fannie and Freddie are not subject or debt market discipline because of their GSE status
- Fannie and Freddie have no real marketplace competitors, except potentially the FHLBanks
- Fannie and Freddie's political clout enables them to easily trump OFHEO and HUD oversight
- GSE bailouts can happen – remember the Farm Credit System and FICO

Recommendations

- Wallison and Ely propose a number of options for policymakers to consider in order to protect taxpayers from another bailout crisis and to keep private businesses from being driven out of the market for an entire sector of the financial industry:
 - Contain their growth/no new powers – They noted, however, that it was a futile strategy to try and contain them because of the GSEs' promises to Wall Street to grow their earnings 15% every year over next five years.
 - Refederalize the GSEs. Return Fannie and Freddie to their former status as on-budget federal agencies. "If they're so important to our financial system, then we should make their guarantee explicit and be willing to assume those risks head on," Wallison stated.
 - Sell competing GSE franchises to the private sector so the government can receive some compensation. The government should recapture its implicit subsidy to Fannie and Freddie from the free sale of identical government-sponsored enterprise franchise. Comparing this approach to the current scenario facing Microsoft, Wallison said breaking up the GSEs would eliminate the market's "too big to fail" perception.

- Levy a GSE user fee on Fannie and Freddie. Allow a “targeted housing finance tax credit” to replace the mission now served by Fannie and Freddie so that homebuyers receiving the subsidy are the ones that most need the subsidy.
- Limit Fannie and Freddie’s use of lobbyists and political contributions, and their efforts to manipulate the legislative process.
- Truly privatize Fannie and Freddie by cutting their links to the federal government and stripping them of their special privileges. (Perhaps, along the lines of the Sallie Mae privatization.)
- During the question and answer period, **Wallison and Ely noted that the more the GSEs try to replace Treasurys with their own securities as benchmark securities, the more the GSEs reinforce the notion that they are explicitly backed by the government and even more so as the GSEs continue to grow. It would make it that much more difficult to privatize if they replace Treasurys as benchmarks.** (*BNA Daily Report for Executives*, Adam Wasch, 3/7/00; *Dow Jones Newswire*, Jerry Guidera, 3/6/00; *AEI press release*, 3/6/00; “*Nationalizing Mortgage Risk: The Growth of Fannie Mae and Freddie Mac*,” Peter Wallison and Bert Ely, 2000)

National Taxpayers Union holds conference examining Fannie & Freddie’s risk to taxpayers

Speakers include National Taxpayers Union President John Berthoud, Resident Fellow Peter Wallison of American Enterprise Institute, Bert Ely, financial institutions consultant, Tom Miller of Competitive Enterprise Institute, and Steve Moore from the Cato Institute

- A day after AEI released its paper on Fannie & Freddie by Peter Wallison and Bert Ely, the National Taxpayers Union held a Capitol Hill conference on March 7 to examine Fannie and Freddie’s risk to taxpayers.

National Taxpayers Union – John Berthoud

- **“Although Congress has loosened the antiquated straitjacket on America’s banking industry, it left untouched a pair of programs that continue to shackle taxpayers and lenders alike: Fannie Mae and Freddie Mac,”** observed Berthoud. **“Experts may not agree on the exact future of Fannie and Freddie, but most seem to agree that these tax-subsidized twins reflect the thinking of the past.”** Concluding the conference, Berthoud stated **“The dialogue we’ve begun has not yet settled on the best way to clean house at Fannie Mae and Freddie Mac, but the brooms are finally being reading for sweeping.”**(*US Newswire*, 3/8/00)

AEI - Peter Wallison and Bert Ely

- Wallison and Ely presented the findings of their recently released study, “*Nationalizing Mortgage Risk: The Growth of Fannie Mae and Freddie Mac.*” The findings they presented at the NTU conference were similar to those they provided at AEI’s press briefing on March 6 [see earlier story in this *GSE Report*].

Cato Institute – Steve Moore

- **Fannie and Freddie have the dual status of being public and private. Congress needs to decide if Fannie and Freddie are one or the other – either refederalize or privatize. He notes that for the first time in 70 years, the Treasury Department is going to buy back its own securities, but no one is paying attention to the growing amount of GSE debt - so we are not**

making any progress in cutting the public debt, since Fannie and Freddie are trying to replace Treasuries. GSE debt will soon exceed the amount of publicly held debt. (A chart distributed by Moore showed that GSE debt was projected to soon overtake publicly held US Treasury debt.) Moore notes that Fannie and Freddie's subsidy is a form of corporate welfare for the rich and that it exacerbates the income gap between the rich and the poor. Most of the benefits from the GSEs' subsidies are going to white, middle- to upper-income class. The GSEs are keeping 1/3 of their federal subsidies for their employees who are some of the highest paid employees in the nation. The real danger of the GSEs becoming more profitable is that they will continually expand their empire by taking over the mortgage banking business. This is unhealthy for our credit markets.

Cato's five suggestions for reform:

- (1) Take away the GSEs' line of credit and other privileges to reduce the "aura" of the federal government. The 30-50 basis point advantage the GSEs receive over the private industry could be narrowed if their subsidies are taken away.
- (2) Impose a reasonable fee on GSE debt. A 20 basis-point fee might be a suggestion. During the question and answer period, Moore noted that currently Congress has to vote on whether or not to increase the federal debt cap each year. One suggestion might be to put GSE debt under a debt cap so that Congress has to decide whether or not to increase the cap each year.
- (3) Shut down their political activities.
- (4) Lower the conforming loan limit from \$252,000 to something like the median house price
- (5) Put a reasonable cap on Fannie and Freddie's salaries – perhaps putting them under civil service salaries

Competitive Enterprise Institute- Tom Miller

- **"If you want the GSEs privatized, we're half-way there – the risks and losses are public, while the profits are privatized." Miller noted that CEI will be participating in a new taxpayer coalition group, called HomeEc that will examine the taxpayer risk from Fannie and Freddie [see story in *this GSE Report* on HomeEc]. A key concern is the GSE benefits are not worth the risks. The role for which Fannie and Freddie were first created is no longer uniquely necessary for a liquid market. Private players can step up the role. Fannie and Freddie are "spongy conduits" that are soaking up 1/3 of their subsidies for their shareholders and management. Even waiters he notes only get 20% tips. Taxpayer risk is important. There is a concentration of risk in two companies with undiversified portfolios. Fannie and Freddie should be considered as part of the further corruption of our political culture. Fannie and Freddie's hiring of former officeholders and officials is like "Who Wants to be a Millionaire."**

CEI's suggestions for reform:

- Lower cap on mortgages the GSEs can purchase
- Eliminate their \$2.5 billion line to Treasury
- Not crazy about imposing a fee because it keeps the whole franchise going
- Privatize the GSEs entirely, along the lines of the Sallie Mae privatization.

(National Taxpayers Union Capitol Hill Conference on Fannie Mae and Freddie Mac, 3/7/00)

The Congressional Budget Office (CBO) lists the following as options for increasing federal revenues:

- (1) Imposing an annual fee on the investment portfolios of the GSEs;**
- (2) Repealing the GSEs' SEC registration exemption**
- (3) Increasing the Ginnie Mae guaranty fee**

When the CBO provided these options last year, Fannie & Freddie were opposed

- The Congressional Budget Office (CBO) in its annual report to Congress lists the following as revenue raising options:
 - (1) Imposing an annual fee on the investment portfolios of GSEs; (raises \$7 billion over a 10-year period)
 - (2) Requiring the GSEs to register their securities with the SEC (raises \$2.1 billion over a 10-year period)
 - (3) Imposing an Increase in the Ginnie Mae Guaranty Fee.
- The CBO made these same proposals in last year's annual report to Congress. ("*Maintaining Budgetary Discipline: Spending and Revenue Options*", Congressional Budget Office, April 1999)

Imposing an annual fee on the investment portfolios of GSEs – would address concerns about the arbitrage activities of the GSEs

- The CBO estimates that imposing the user fee on the investment portfolios of the GSEs could raise \$700 million per year over a 10-year period and could address concerns about the arbitrage activities of the GSEs. The CBO notes that "Imposing an annual fee on the four GSEs that earn arbitrage profits enterprises [Fannie, Freddie, FHLBank System, Farmer Mac] that would equal 10 cents for every \$100 (10 basis points) of each GSE's holdings of debt securities that the enterprise finances with debt would raise \$700 million in 2001, \$3.5 billion over five years, and \$7 billion by 2010." (*Budget Options*, Congressional Budget Office, March 2000, page 281) (*Dow Jones Newswire*, John Connor, 3/10/00)
- The CBO notes that the implied government guarantee allows the GSEs to borrow at lower rates and then use the borrowed money to invest in higher yielding obligations. "The four enterprises [Fannie, Freddie, FHLBank System, Farmer Mac] conduct an arbitrage between the market for GSE debt and that for private debt, profiting from the difference between the yields on their investments and their own subsidized cost of funds," the report stated. The CBO further noted that before the 1990s, the GSEs generally used the money they borrowed to make loans or buy loans made by other lenders. "More recently, the three largest GSEs – Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System – have used borrowed funds to acquire enormous portfolios of debt securities." The report noted that "At the end of 1999, the investment portfolios of those three enterprises totaled \$745 billion [up from 1999's \$586 billion], or 51 percent of their combined assets." (*Budget Options*, Congressional Budget Office, March 2000, page 281) ("*Maintaining Budgetary Discipline: Spending and Revenue Options*," Congressional Budget Office, April 1999, page 219)

Repealing the GSEs' securities exemption – require all GSEs to register with the SEC

- Another revenue raising option provided by CBO, would require that all GSEs register their securities with the SEC. The CBO notes that currently the federal government explicitly subsidizes

five GSEs – Fannie, Freddie, the FHLBank System, the Farm Credit System, and Sallie Mae – by exempting them from the registration requirements of the Securities Act of 1933. (Farmer Mac is not exempt from SEC registration.) In 1992, the Department of Treasury, the Federal Reserve, and the SEC advocated requiring the five GSEs that are now exempt to register their securities with the SEC. (*Budget Options*, Congressional Budget Office, March 2000, page 161) (*Dow Jones Newswire*, John Connor, 3/10/00)

- The CBO notes that originally the GSEs were exempted from registering their securities with the SEC in part to relieve them of the cost of registering until they became accepted names in the market. “That rationale no longer applies: the five exempt GSEs are well known in financial markets.” Repealing the exemption would not impose significant regulatory burdens on the GSEs because they currently disclose most of the required information voluntarily. CBO also said that requiring the GSEs to register their securities would enhance competition between GSEs and their wholly-private competitors. “It would reduce the competitive advantage that the enterprises have over other firms that finance loans by issuing debt or mortgage-backed securities.” Further, the CBO notes that requiring issuers to register their securities with the SEC protects investors. The CBO estimated the requirement for the GSEs to register their securities with the SEC would raise \$300 million in 2001, \$1.5 billion over five years, and \$2.1 billion by 2010. According to CBO, “To register with the SEC, each of the five GSEs would pay about 25 cents for every \$1,000 (about 2.5 basis points) in securities it issued in 2001. (*Budget Options*, Congressional Budget Office, March 2000, page 161)

Increasing the Ginnie Mae Guarantee Fee

- The CBO also proposed increasing the Ginnie Mae guaranty fee to 9 basis points from the current 6 basis points. The increase would be effective in the year 2001. Under current law, a fee increase to 9 basis points is scheduled to take effect in 2005. According to CBO, moving the fee increase up to the year 2001 would raise \$40 million in 2001 and \$160 million over five years. (*Budget Options*, Congressional Budget Office, March 2000, page 160)

GSEs opposed the CBO options last year

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

In response to HUD's fair lending investigation of the GSEs' automated underwriting systems, Fannie finally provides information to HUD

HUD requested the information a year ago

HUD has been conducting an investigation into Fannie & Freddie's automated underwriting systems to determine if their systems disproportionately affect minorities and low-income borrowers

With this last submission, HUD Secretary Andrew Cuomo announces that Fannie is "cooperating fully" with the review, demonstrating that HUD can be an effective regulator of Fannie & Freddie

Prior to Fannie's last submission, HUD accused Fannie of dragging its feet on the investigation and providing "grossly incomplete" data.

Freddie is expected to provide information on its automated underwriting system shortly

HUD says the review will go beyond a fair lending investigation, noting that HUD wants to learn how the GSEs' systems are affecting the entire mortgage market. OFHEO will also have access to the information.

HUD estimates it will take six months to complete a review and testing – HUD plans to release its findings and recommendations by the end of the year

- On January 31, Fannie turned over information to HUD on its automated underwriting system, Desktop Underwriter. HUD is requiring Fannie and Freddie to turn over the information to determine if the GSEs are in compliance with fair lending standards, which are designed to prevent mortgage lending discrimination against minorities and others. Fannie reportedly provided four boxes of data tapes and documents and data on more than 10 million loans it has purchased using its automated underwriting system as well as loans it declined to purchase. HUD threatened enforcement action against Fannie including civil fines if Fannie did not provide the necessary information to HUD by January 31, 2000. (*Dow Jones Newswire*, Jerry Guidera, 2/1/00; *HUD press release*, 2/2/00; *National Mortgage News*, Brian Collins, 2/28/00)
- HUD Secretary Andrew Cuomo held a press conference with Fannie Chairman Franklin Raines on February 23 to announce that Fannie was "cooperating fully" with the review. [Prior to Fannie's last submission of data on January 31, HUD had accused Fannie of dragging its feet in the investigation and providing "grossly incomplete" data.] HUD says it will review the data and estimates that it will take six months (September) to complete a review and testing. HUD plans to release its findings and recommendations by the end of the year. **HUD Senior Counsel Mercedes Marquez said the review will go beyond fair lending, noting that HUD wants to learn how the GSEs' systems are affecting the entire mortgage market. Marquez further notes that OFHEO (Fannie and Freddie's safety and soundness regulator) will also have access to the information.** Fannie Spokesman David Jeffers stated that the company had not considered the possibility of OFHEO using the data. Sec. Cuomo said it demonstrates that HUD can be an effective regulator of Fannie and Freddie. (*National Mortgage News*, Brian Collins, 2/28/00; *Dow Jones Newswire*, Jerry Guidera, 2/23/00; *BNA Daily Report for Executives*, Adam Wasch, 2/24/00)

- Freddie is expected to make its submission to HUD within the next 30 days. Freddie was reportedly waiting to see what type of safeguards HUD developed with Fannie to keep the GSEs' proprietary information confidential. (*National Mortgage News*, Brian Collins, 2/28/00)

Background:

- HUD has been investigating Fannie and Freddie's automated underwriting systems (which control 95% of the automated underwriting market share) for almost a year. In February 1999, HUD sent letters to Fannie and Freddie requesting information to ensure that the GSEs' systems comply with fair-lending standards. **An independent study commissioned for HUD by the Urban Institute in March 1999 found that Fannie and Freddie's underwriting guidelines may inadvertently have a disparate impact on minority borrowers. The report also noted that Fannie and Freddie "do not appear to have gone as far as some primary lenders to serve low-income and moderate-income borrowers and to minimize disproportionate effects on minorities."** The report noted that "Primary lenders are making more aggressive efforts" to serve the lower income and minority homebuyers "by offering loan products with underwriting guidelines that are more flexible than the GSEs' guidelines." Further, the report noted that "depository lenders are serving low- and moderate-income borrowers better than the GSEs and so the percentage of loans purchased by the GSEs that are originated to low- and moderate-income borrowers is less than the percentage of loans originated in the primary market." The report also noted that "there is some evidence that the GSEs' purchase of loans made to black and Hispanic homebuyers have actually declined (in share and absolute number) over the last two years." (*HUD/Urban Institute Study, "A Study of the GSEs' Single Family Underwriting Guidelines,"* April 1999)
- HUD sent a separate letter to Fannie on December 21, 1999 as a follow-up to its fair lending investigation, accusing Fannie of dragging its feet in the investigation. In HUD's December 21, 1999 letter to Fannie Chairman Franklin Raines, HUD's General Counsel Gail Laster criticized Fannie for providing information that "was grossly incomplete and did not provide the information necessary for HUD to even begin to perform its legal responsibilities." Laster also noted that Fannie included documents falsely labeled as confidential and proprietary and that the company ignored HUD's request that its Chief Executive Officer certify the information as truthful and correct. Laster returned the documents to Fannie and asked that Fannie provide more detailed and accurate information to HUD by January 31, 2000. (*HUD General Counsel Gail Laster letter to Fannie Chairman and CEO Franklin Raines, 12/21/99; Wall Street Journal, Michael Schroeder, 1/4/00; Dow Jones Newswire, Jerry Guidera, 1/4/00*)

Federal regulators issue proposed rule for public comment that gives all AAA-rated and AA-rated asset-backed securities (ABS) the same capital treatment as Fannie & Freddie's MBS

Fannie was originally opposed to this idea when first proposed in 1997

A joint financial services trade group letter was sent to the Fed in May 1999 requesting that all investment-grade MBS be given a 20% risk-weighting (same as Fannie & Freddie) to ensure that Fannie & Freddie MBS would not be treated more favorably under bank risk-based capital guidelines than private-label MBS with AAA and AA ratings. The letter noted that currently Fannie & Freddie's MBS have "support from an array of government-granted benefits" which provides preferential treatment to GSE-supported MBS over other private sector MBS.

- Federal regulators (the Federal Reserve System, FDIC, OCC, and OTS) re-proposed rules to reform the treatment of recourse obligations and direct credit substitutes. The new proposal reflects the views expressed in comments received in response to a proposal issued in 1997. The proposed rule was published in the *Federal Register* March 8, 2000. Comments on the proposal are due June 7, 2000. (*Federal Register*, pages 12320-12352, 3/8/00)
- Under the proposed rule, banks and thrifts would only have to hold 20% risk-based capital against purchases of triple-A and double-A rated ABS. Currently, only Fannie and Freddie mortgage-backed securities enjoy this low capital requirement. This would make private label mortgage-backed securities a more attractive investment for banks.
- Fannie objected to having private-label securities treated the same as its MBS when the proposal was first floated in August 1997. (*National Mortgage News Daily*, 2/10/00) The recourse rule has been in the works for nine years, and regulators had a falling out when the last proposal was issued in August 1997. (*National Mortgage News website*, 1/27/00)

Background:

- **As reported in previous *GSE Reports*, a joint financial services trade letter was sent to the Federal Reserve Board on May 11, 1999 requesting that the Federal Reserve and other bank regulators revise the risk-weightings so that all investment grade MBS be given a 20% risk-weighting to ensure that Fannie and Freddie MBS would not be treated more favorably under bank risk-based capital guidelines than private-label MBS with AAA and AA ratings. The letter noted that currently Fannie and Freddie's MBS have "support from an array of government-granted benefits" which provides preferential treatment to GSE-supported MBS over other private sector MBS.**
- The letter further noted that, **"Since banks and thrifts need to hold less capital against government sponsored enterprise (GSE) securities than other comparable investments, their required hurdle is lower, thereby making investments in Fannie Mae or Freddie Mac MBS preferred over other investment alternatives, even when they have identical investment ratings."** The letter was signed by the Financial Services Roundtable, America's Community Bankers, American Bankers Association, Consumer Mortgage Coalition, Mortgage Insurance Companies of America, and the National Home Equity Mortgage Association. (*Joint Bank Trade Letter to Federal Reserve Board*, 5/11/99) The Mortgage Bankers Association also sent a letter to the Fed on the issue.

Fannie Mae and Freddie Mac

After 11 months and two extensions, the comment period on OFHEO's risk-based capital proposal for Fannie & Freddie closed on March 10, 2000

***Dow Jones Newswire* reports that Fannie & Freddie raised a number of serious objections to the proposal, which could delay further implementation of the rule**

OFHEO is giving interested parties 30 days to react to the comments that were submitted

- 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 Director Armando Falcon said he would like to review the comments "with an open mind" and "won't hesitate to incorporate suggestions that improve the rule." (*National Mortgage News Daily website*, 3/10/00; *Dow Jones Newswire*, Jerry Guidera, 3/10/00)
- Fannie and Freddie raised a number of serious objections to the proposed rule, potentially delaying further implementation of the proposed rule. In their comments to OFHEO, Fannie and Freddie noted more than a dozen problems with the proposed rule and raised objections 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)
- OFHEO is seeking reply comments in response to the comments that were submitted by the March 10 deadline. The deadline for reply comments is April 14, 2000. (*Federal Register*, 3/13/00, page 13251)

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)

Recent news indicating that the amount of GSE debt will only increase this year:

Fannie & Freddie's regulator OFHEO plans to examine Fannie & Freddie's skyrocketing debt

"In just a few years, Fannie Mae and Freddie Mac could be issuing more long-term debt than the entire US Government" - a "role reversal of seismic proportions" says OFHEO

OFHEO says that Fannie & Freddie's plan to achieve benchmark status implies new responsibilities

“As the debt of Fannie Mae and Freddie Mac assume a more central role in international debt markets, disruption caused by failure of these enterprises could extend well beyond housing finance,” says OFHEO

Despite increased market reliance on GSE debt, the Treasury Department says there is no change in US policy towards the securities

Although there is no change in policy, Treasury has been discussing the implications for financial markets and possible risk to the government from the growth of GSE debt

New York Federal Reserve Bank is holding \$82 billion of GSE securities on behalf of foreign central banks

There is a belief that by purchasing GSE debt securities in the open-market, the Fed would be supporting the perception that the securities are government guaranteed

Amount of Treasurys continues to decrease – for the first time in 70 years, the US Treasury buys back its own debt

GSE debt being used more often in bond “repos” (repurchase agreements) instead of Treasurys

Chicago Mercantile Exchange sets March 14 date to launch futures on Fannie & Freddie's debt securities; Chicago Board of Trade sets March 15 launch date - Investors believe Fannie & Freddie's debt will increasingly battle for benchmark status once futures contracts are developed

Fannie says it will use its own GSE debt instead of Treasurys as a benchmark for its 7-year note sale

Freddie makes changes to its Reference Note program

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 will purchase its own debt, further decreasing the supply [see story in this *GSE Report*]. 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 Treasuries as a benchmark security. Fannie and Freddie both have bond issuance programs (Fannie - Benchmark Notes program; Freddie- Reference Notes program) that mirror traditional Treasury operations in size and regularity.

Recent GSE Debt news:

OFHEO plans to examine Fannie & Freddie's skyrocketing debt

- OFHEO Director Armando Falcon told *BNA* that OFHEO must keep an eye on the possibility of GSE debt replacing Treasury debt in the capital markets. Within a year or two, Falcon notes, the total GSE debt will surpass the Treasury debt. Increasingly, the markets are looking at GSE debt (particularly long-term debt) as the new benchmark, he said. **“We have to follow this closely and make sure we understand all the implications of [GSE debt becoming the benchmark], both from the standpoint of doing our part and ensuring a smooth functioning capital market, and also that we understand what are the safety and soundness implications,”** he said. (*BNA Daily Report for Executives*, Eileen Canning, 2/18/00)

OFHEO says that Fannie & Freddie's benchmark status implies new responsibilities

- Falcon citing discussions that Fannie and Freddie could achieve benchmark implies new responsibilities. Benchmark status would add to be the special benefits that Fannie and Freddie receive from their GSE status. “But those additional benefits imply additional responsibilities,” Falcon said. **“If the enterprises’ debt should become the new benchmark, then the pricing and distribution of those securities should be subject to safeguards and standards of transparency comparable to those of Treasury debt.”** Falcon elaborated that there is a need to assure that the pricing and distribution of GSE securities **“can’t be gamed by anyone.”** According to *Dow Jones Newswire*, Falcon recalled the 1992 Salomon Brothers scandal when the SEC and bank regulators took enforcement action against nearly 100 firms for allegedly inflating customer orders for GSE securities. (*Dow Jones Newswire*, John Connor, 3/10/00)
- Falcon warned that **“as the debt of Fannie Mae and Freddie Mac assume a more central role in international debt markets, disruption caused by failure of one of these enterprises could extend well beyond housing finance.”** (*Dow Jones Newswire*, John Connor, 3/7/00)
- **“Consider this: In just a few years, Fannie Mae and Freddie Mac could be issuing more long-term debt than the entire US Government,”** he said. Falcon calls this a **“role reversal of seismic proportions.”** When the Treasury Department held an auction of 30-year bonds on February 10, it was described as a “disaster” and “disappointing,” in part because of Fannie Mae. “Wall Street analysts pointed to supply pressures resulting from a Fannie Mae bond announcement the day before, and confusion about Treasury’s long-term borrowing plans,” he stated. **On the same day as the “ill-fated” Treasury auction, the New York Federal Reserve Bank reported that it now holds \$82 billion of GSE securities on behalf of foreign central banks. “These developments constitute a role reversal of seismic proportions,”** he stated. **“Only eight years ago, long-term Treasury debt issues were 13 times as large as those of the two enterprises.”** (*Dow Jones Newswire*, John Connor, 3/7/00, 3/10/00)

Despite increased market reliance on GSE debt, the Treasury Department says there is no change in US policy towards the securities

- Although there is increased market reliance on debt issued by GSEs, Treasury Secretary Lawrence Summers said there was no change in US policy towards the securities. “The change in the financial environment occasioned by the reductions in federal debt are likely, over time, to have a significant impact on the financial markets...I suspect it will influence the behavior and the judgements that are pursued by a wide range of issuers, but it does not in any way suggest any change in current policies with respect to government sponsored enterprises.” Asked to clarify the government’s policy on GSE debt further, Summers smiled and said, “I think the current policy is stated in the prospectuses with respect to their securities.” [Prospectuses state that GSE debt is not backed by the federal government.] (*Dow Jones Newswire*, Jonathan Nicholson, 2/7/00)

Although there is no change in policy, Treasury has been discussing the implication for financial markets and possible risk to the government from the growth of GSE debt

- The Treasury Department released minutes of a pre-funding meeting between Treasury debt managers and members of the Treasury Borrowing Advisory Committee of the Bond Market Association, known as the borrowing committee. The meeting discussed “the implications for financial markets and the possible risks to the government as Treasury debt declines.” **The report said one of the items that its members discussed “at the Treasury’s request...was the implication for financial markets and possible risk to the government” from among other things, “the growth of government sponsored enterprises.”** The minutes note that increased agency debt has helped provide hedging and pricing vehicles for market participants. “This, however, has been in a benign and untested credit environment,” the minutes said. “There was no consensus on how to assess the nature and severity of the potential risk to the (Federal) Government of Government-Sponsored Enterprises.” (*Dow Jones Newswire*, John Connor, 2/2/00)

New York Federal Reserve Bank is holding \$82 billion of GSE securities on behalf of foreign central banks

- Foreign central banks – not just private investors – are increasingly flocking to GSE securities. As of February 9, the New York Federal Reserve Bank held \$82.892 billion in agency securities for foreign governments – 12% of its total custody holdings of \$694.750 billion, which consists of US agency and government securities. The NY Federal Reserve Bank decided to report the amount of these holdings because they have “grown so large” – nearly doubling in percentage terms in the last two years. In 1997, foreign governments had an aggregate \$42.19 billion in agency securities in the Fed’s custody holdings – only 6.% of the total holdings of \$645.57 billion at the end of 1997. Sonoko Setaishi with *Dow Jones Newswire* reports that “The shrinking supply of Treasuries could accelerate the foreign investors’ shift towards agency securities, which offer just as much safety and as US government bonds and better returns.” Lou Crandall, Chief Economist at R.H. Wrightson & Associates in New York says that the agencies “are working very hard marketing their securities to foreign official institutions.” Christopher Rupkey, Senior Financial Economist at Bank of Tokyo-Mitsubishi in New York predicts the portion of agency securities in custody holdings at the New York Federal Reserve Bank will rise to about 15% in a year, and expects it to increase faster in the future. (*Dow Jones Newswire*, Sonoko Setaishi, 2/14/00)

There is a belief that by purchasing GSE debt securities in the open-market, the Fed would be supporting the perception that the securities are government guaranteed

- Market watchers note that GSE debt securities are not playing a more prominent role in the Federal Reserve’s purchases in open-market operations because there is a belief that the Fed doesn’t want to support the perception of being a government guarantee for agency debt. “For the

Fed to single out the government-sponsored enterprises from other corporations would reinforce that impression,” said Lou Crandall, Chief Economist for Wrightson Associates, a fixed-income research firm in New York City.

- The GSE debt securities are eligible for open-market purchases by the Fed. One possible concern on the part of the Fed is that officials feel the agency market now absorbs too much capital. Another possible concern is the Fed’s need to avoid playing favorites. If the Fed were to be actively purchasing debt from one agency but not the others, it could cause some friction among the agencies. Another reason is that “The Fed is a slower-moving entity than a private firm because it has to evaluate the potential market impact of its actions,” said Robert Lunder, Senior Managing Director of Bear, Stearns & Co. Becoming a more active purchaser of agencies would be “a pretty big step,” he said. “We expect that, as it [Fed] watches the liquidity and prominence of (agency) issues grow, the Fed will become more comfortable with the use of agency debt for open market operations,” said Jerome Lienhard, Senior Vice President of Investment Funding at Freddie. “Naturally, we would be pleased by that development.” A spokesman for Fannie referred comment to the Fed.
- The Fed’s portfolio of agency securities included \$181 million on average in the bank statement for the week ended January 19, 2000. That’s a 46.5% decrease from \$338 million a year earlier and a fall of 73.6% from \$685 million two years ago. (*Dow Jones Newswire*, Tyler Lifton, 1/25/00)

Amount of Treasuries continues to decrease – for the first time in 70 years, the US Treasury buys back its own debt

- The amount of Treasuries continues to decrease. In the first buyback of federal debt in 70 years, the US Treasury bought \$1 billion in outstanding 30-year bonds. The last time the US repurchased debt was during the Hoover administration in 1930. The offer is small but is likely to be the first of many over this decade. The Treasury is buying back bonds to reduce overall federal debt and save money on interest payments. The next \$1 billion buyback is planned for sometime later in March. (*BNA Daily Report for Executives*, Diana Gregg and Marc Selinger, 3/8/00; *Wall Street Journal*, Gregory Zuckerman, 3/9/00; *Washington Post*, John Berry, 3/8/00)

GSE debt being used more often in bond “repos” (repurchase agreements) instead of Treasuries

- As the amount of Treasuries decrease and as government agency debt (particularly Fannie and Freddie) seek to replace Treasuries for benchmark status, government agency debt is being used more often as collateral in place of Treasuries in “repos” (repurchase agreements). Repos involve lending securities in exchange for loans. Dealers often use this market to raise funds for trading or to borrow securities to cover short positions. “We are seeing them on the screens everyday,” said a repo trader of the agency debt. (*Dow Jones Newswire*, Marianne Sullivan, 2/16/00)

Chicago Mercantile Exchange sets March 14 date to launch futures on Fannie & Freddie’s debt securities; Chicago Board of Trade sets March 15 launch date - Investors believe Fannie and Freddie’s debt will increasingly battle for benchmark status once futures contracts are developed

- The Chicago Mercantile Exchange chose March 14 as its launch date for its proposed agency note futures contracts. Trading in agency notes will begin via open outcry, pending approval from the Commodities Futures Trading Commission. The CME will offer block trading of the contracts. The new 5- and 10-year agency note futures contracts will be sized at \$100,000 and listed with quarterly expirations. Contracts will be settled through physical delivery of eligible non-callable Fannie Benchmark and Freddie Reference notes with differential. (*Dow Jones Newswire*, Daniel Rosenberg, 2/28/00)

- The Chicago Board of Trade will begin trading agency note futures and options contracts on March 15. The new futures contracts will trade in the five-year Treasury note futures pit, and new options contracts will trade in the 10-year Treasury note options pit. The agency futures and options will trade on the CBOT's electronic Project A system starting March 19. The contracts will be certified by the Commodity Futures Trading Commission. (*Dow Jones Newswire*, Daniel Rosenberg, 3/6/00)
- As reported in previous *GSE Reports*, Cantor Fitzgerald, the leading Treasury securities interdealer-broker, says it will also start trading agency-note futures contracts.
- **According to Lynn Adler with *Reuters*, Fannie and Freddie's debt will increasingly "wrangle benchmark status once futures contracts are developed, and after it has a longer track record of long bond sales."** (*Reuters*, Lynn Adler, 2/10/00)
- Freddie voiced support for the opening of trading in five and ten-year note GSE futures and options Contracts. "Freddie Mac welcomes the GSE futures and options contracts that will trade on the Chicago Mercantile Exchange, Chicago Board of Trade, and the Cantor Exchange beginning in March 2000," said Senior Vice President of Investment Funding Jerome Lienhard. (*Freddie press release*, 3/13/00)

Fannie says it will use its own GSE debt instead of Treasuries as a benchmark for its 7-year note sale

- Fannie will use five-year Treasuries and an existing Fannie note issue maturing in 2005 as pricing benchmarks for its March 8 sale of \$3.0 billion or more of seven-year benchmark notes. In doing so, Fannie is ignoring the US Treasuries maturing in 2007 as a benchmark. Fannie said it intends to use its existing 7.125% note due Feb. 2005 as a pricing benchmark. Nadine Bates, Fannie's Director of Long-Term Funding said Fannie's decision to ignore Treasuries maturing in 2007 results in part from traders practices of using five-year Treasuries as a base for pricing Fannie's only existing seven-year benchmark notes, which it sold in June 1998. (*Reuters*, 3/1/00)

Freddie makes changes to its Reference Note program

- Freddie added a new settlement date option, a longer when-issued period and public disclosure of the weekly bid-to-cover ratios in its Reference Note program. Participants in the Internet-based auction will have the ability to specify either cash or regular settlement for the one- and two-month bills, and cash, regular or skip day settlement for the three-, six- and 12-month bills. In addition, Freddie is moving up its bill schedule announcement date to Thursday from Friday for the following week's auctions. (*Dow Jones Newswire*, Tyler Lifton, 3/8/00)

Fannie & Freddie are accused of blocking cost-saving automated appraisals

Mark Sennott, President of Chicago Title Market Intelligence claims there are lots of good automated valuation models (AVMs) in the market now but that Fannie & Freddie "are standing in their way" because the GSEs only want to use their own proprietary automated systems

"Freddie Mac accepts only its own system – Home Value Estimator – but tests show that others are just as good," Sennott charged

- Attempts by private enterprise to bring cost-saving automated appraisal programs into the mainstream of housing finance are being blocked by Fannie and Freddie. Mark Sennott, President of Chicago Title Market Intelligence has "been hammering away" at the GSEs in an effort to

persuade them to accept his firm's automated valuation model (AVM), but with little success. **Sennott claims there are lots of good AVMs in the market now but that the issue is nothing more than a "turf battle" about which software to use – the GSEs own AVMs or one or more of the half-dozen systems being offered.**

- Freddie says it doesn't exclude systems, yet claims that "as far as we're concerned, for our purposes, ours is the best system going," a spokesman stated. **"Freddie Mac accepts only its own system – Home Value Estimator – but tests show that others are just as good," Sennott charged. "There are lots of AVMs. There isn't just one that works: six or seven of them are equally as good," he told *National Mortgage News*. "But Fannie Mae and Freddie Mac are standing in their way. It's definitely a free-market issue." (*National Mortgage News*, Lew Sichelman, 2/21/00)**

Fannie/Freddie watchdog group, FM Watch, launches "Truth Watch" on its homepage in an effort to point out inconsistencies in what Fannie & Freddie say to the public

"One thing FM Watch has learned is that Fannie and Freddie say one thing to Congress and the public and another to customers and Wall Street," said Mike House, Executive Director of FM Watch

- FM Watch launched "Truth Watch" on its homepage (www.fmwatch.org) to provide analysis of Fannie and Freddie public statements ranging from advertising to speeches. "One thing FM Watch has learned is that Fannie and Freddie say one thing to Congress and the public and another to customers and Wall Street," said Mike House, Executive Director of FM Watch. **"They talk out of both sides of their mouths and their messages change with the audience," he added. "Truth Watch has been established to point out their inaccuracies and contradictory messages in their public statements." The campaign is targeted primarily at policymakers on Capitol Hill.** (*National Mortgage News Daily website*, 2/29/00; *American Banker*, 3/3/00)

OFHEO hires Alfred Pollard (formerly chief lobbyist with the Financial Services Roundtable) as its new General Counsel

- OFHEO hired Alfred Pollard to be General Counsel. He was formerly the chief lobbyist with the Financial Services Roundtable. (*American Banker*, 3/6/00)

AEI-Brookings hold a joint event on incentives for anti-competitive behavior by public enterprises (such as Fannie & Freddie)

The report presented an analysis of the incentives available to public enterprises to undertake activities that disadvantage competitors.

There are examples of anti-competitive practices by public enterprises that can be applied to Fannie & Freddie

- On February 28, the American Enterprise Institute sponsored a conference to introduce "*Incentives for Anticompetitive Behavior by Public Enterprises*," a study published by the AEI-Brookings Joint Center for Regulatory Studies and authored by David E.M. Sappington and J. Gregory Sidak. The paper has relevance to such public enterprises as the US Postal Service, the Tennessee Valley Authority, Fannie Mae, Freddie Mac, and Amtrak. The report presented an analysis of the

incentives available to public enterprises that permit them to undertake activities that disadvantage competitors. Although the paper only addressed public enterprises in general, and did not apply the theories to specific public enterprises, there are examples of anti-competitive practices by public enterprises that can be applied to Fannie Mae and Freddie Mac.

- The public enterprises sponsored by the federal government serve a variety of missions with differing emphasis on producing a profit. One characteristic that fits all public enterprises is the maxim that “bigger is better.” The larger they are, the more broadly they are fulfilling their public mission. Unlike private enterprises, the desire for growth outweighs the desire to maximize profit, and public enterprises will cut price or move into unprofitable markets in order to extend their reach. Lofty growth goals are further encouraged by the fact that public enterprises can tap into the immense resources of the federal government. They do not have to maximize profit in order to attract capital. On the contrary, the larger the market they serve, the more they justify their continued public support.
- Gregory and Sidak identify three factors that influence public enterprise price-setting strategy:
 - (1) Price is set further above cost if demand is insensitive to price (inelastic). The more a public enterprise grows, the more it enters increasingly price sensitive (elastic) markets, and so it develops a growing dependence on price cutting or raising its rivals costs.
 - (2) There is an inverse relationship between a public enterprise’s profit orientation and the prices it sets; the lower the importance of profit, the more it is willing to cut price to expand its market.
 - (3) At the point where the marginal cost of adding new revenue is rising, profit-centered companies stop growing. However, since public enterprises value revenue growth over profitability, they continue to seek new and increasingly less profitable markets, actually decreasing operating efficiency by moving up marginal costs up for every new dollar of business.
- When the public enterprise finds that rising marginal costs or a need to maintain profitability inhibit its ability to cut price, it will look for ways to increase costs for its rivals. If successful, its rivals will be forced to raise prices while the public enterprise holds its prices constant. One avenue of cost raising is to use its political influence to urge more regulation on its rivals. Gregory and Sidak note that public enterprises often face less regulation than private rivals. If the public enterprise can increase the size of the regulatory cost differential, it has a competitive advantage. Another means of manipulating costs is to restrict rivals’ access to essential productive inputs. [Editorial Note: For example, mandating the use of “closed” GSE automated underwriting systems which force mortgage lenders to run both their models and the GSE models before they understand the underwriting risks of a loan request.] Finally, the public enterprise can attempt to raise the price of essential productive inputs for its rivals by buying and holding excessive amounts. [Editorial Note: Or, as the GSEs have begun to do with debt, issuing so much debt in the public markets that rivals find the cost of their public debt going up in reaction to the increased supply.] This behavior of seeking to raise costs for rivals is not solely directed at competitor private enterprises. In a duopoly, the public enterprises that share the market will undertake activities that raise costs for their public rivals, giving the competitor public enterprise the opportunity to take duopoly market share.

- The paper makes many points that are appropriate to less profit-centered public enterprises, such as the Post Office, Amtrak, and the Tennessee Valley Authority. For example, when profitability is not a key factor in strategic decision-making, public enterprises will invest more in new technologies than projected return justifies, and they do not make timely decisions to discontinue a line of business that is no longer generating positive returns. The loss of revenue can be considered a negative outcome that is not offset by higher profitability.
- The paper ends with important arguments about the impact that public enterprises have on competition: Since revenue flow is the highest measure of success, the fewer competitors, the better. As a public enterprise grows and takes a dominant position in a market, it will actively work to exclude competitors that prevent it from continuing its expansion plans. It will lobby for impenetrable barriers to entry. It will engage in predatory pricing. The incentives and signs of success for public enterprises lead to anticompetitive behavior, and antitrust law should recognize the potential for public enterprise abuse. Sappington and Sidak conclude:

“The optimal design of antitrust law as applied to public enterprises also merits extensive study. We have shown that a public enterprise may have greater incentive to engage in anticompetitive practices and circumvent antitrust laws than its private counterpart. Therefore, more stringent antitrust laws and harsher penalties for violating these laws may be appropriate for public enterprises. Such legislation or enforcement policy would necessarily raise the question of the proper scope of sovereign immunity for the proprietary, as opposed to political, actions of governments.” (*“Incentives for Anticompetitive Behavior by Public Enterprises,” David E. M. Sappington and J. Gregory Sidak, November 1999*)

Fannie Mae

Fannie hires Daniel Mudd (President and CEO of GE Capital, Japan) as Vice Chairman and Chief Operating Officer

Mudd replaces Lawrence Small who made over \$4 million in salary plus bonuses in 1998

- Fannie announced the appointment of Daniel Mudd as the company's Vice Chairman, Chief Operating Officer, and Member of the Board of Directors, effective immediately. The position of COO has been open since January when Lawrence Small retired from Fannie to become Secretary of the Smithsonian Institutions. Mudd was most recently President and Chief Executive Officer of GE Capital, Japan. (*Fannie press release, 2/23/00*)
- According to the *New York Times*, Small was paid \$4.2 million in 1998. The *American Banker*, reported that Small was paid approximately \$4.25 million plus bonuses in 1998. (*American Banker, Hala Habal, 9/21/99; New York Times, 9/20/99*)

Will Fannie Chairman Franklin Raines be Al Gore's Presidential running mate?

***American Banker* reports that Raines would "seem a strong candidate" but "would have to overcome the bad press" recently prompted by HUD's report that "Fannie Mae's policies have raised the costs and decreased the availability of mortgages for blacks."**

- According to the *Wall Street Journal*, as Vice President Al Gore's backers began compiling a list of potential running mates, Fannie Chairman Franklin Raines' name pops up. (*Wall Street Journal, 3/3/00*) Before his chairmanship at Fannie, Raines was the former Office of Management and Budget Director under President Clinton. The *American Banker* reported that he would "seem a strong candidate" but "would have to overcome the bad press" recently prompted by HUD's report that "Fannie Mae's policies have raised the costs and decreased the availability of mortgages for blacks." A Fannie spokesman said "I am confident that Franklin Raines is fully committed to being chairman of Fannie Mae for a long time." (*American Banker, 3/6/00*)

**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 opens three new Partnership Offices)**

Fannie continues to make more political hires

Fannie hires former state director for Senator Dianne Feinstein (D-CA) as Director of its Bay Area Partnership Office and hires former staffer to retired Cong. Ronald Coleman (D-TX) and Cong. Esteben Torres (D-CA) as Senior Deputy Director of its Border Region Partnership Office

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."

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’s Partnership Offices:

- According to a listing on Fannie’s website, the company currently has 34 Partnership Offices “officially” operating (contact information is available on these 34 locations on Fannie’s website). Fannie’s press releases, however, claim that they have opened 44 partnership offices. Other Partnership Offices that Fannie has announced plans to open or commitments to open (but are not listed on Fannie’s website) include: Newark, NJ (just opened); Bismarck, ND; Pittsburgh, PA; Columbia, SC; South Dakota (just opened); Nashville, TN; Salt Lake City, UT; Milwaukee, WI; and Cheyenne, WY (just opened).

Fannie holds press conference with Senators Craig Thomas (R-WY) and Mike Enzi (R-WY) to announce the opening of Fannie’s Wyoming Partnership Office

- Fannie held a press conference with the above mentioned officials to announce the opening of a new Wyoming Partnership Office. Statements of support by the officials were included in Fannie’s press release. (*Fannie press release*, 2/29/00)

Fannie holds press conference with Senator Tim Johnson (D-SD) to announce opening of Fannie’s South Dakota Partnership Office

- Fannie held a press conference with Senator Johnson to announce the opening of Fannie’s South Dakota Partnership Office in downtown Sioux Falls. (*Fannie press release*, 2/18/00)

Fannie holds press conference with Cong. Bill Pascrell, Jr. (D-NJ) and Passaic, NJ Mayor Margie Semler to announce the opening of Fannie’s Partnership Office in Newark

- Fannie held a press conference in the Passaic City Hall’s Council Chambers with the above officials to announce the recent opening of Fannie’s new Partnership Office in Newark, NJ. (*Fannie press release*, 2/28/00)

Fannie hires Senator Feinstein’s state director

- Fannie has appointed Bill Chandler as Director of its Bay Area Partnership Office. Chandler was formerly state director for Senator Feinstein. (*Inman News Features*, 2/22/00)

Fannie hires former aide to retired Congressmen

- Fannie hired Sandra Sanchez Almanzan as Senior Deputy Director for its Border Partnership Office. Almanzan previously worked at the Greater El Paso Chamber of Commerce, where she served as the Director of Public Policy. Almanzan also has worked for Cong. Ronald Coleman (D-TX, retired) and Cong. Esteban Torres, (D-CA, retired). (*Fannie press release*, 3/1/00)

Cong. John LaFalce (D-NY), Cong. Jack Quinn (R-NY) and Buffalo, NY Mayor Anthony Masiello

- Fannie held the inaugural meeting of Fannie’s Western and Central New York Partnership Office Advisory Council. The above mentioned officials were on hand to kick-off the meeting. (*Fannie press release*, 2/18/00)

Cong. Doug Bereuter (R-NE)

- Cong. Bereuter joined Fannie, the Southeast Nebraska Community Action Council, the Nebraska Investment Finance Authority (NIFA), and Perry Associates for a ceremony to dedicate the 24-unit

Timber Ridge apartments. The \$1.58 million development was financed in part, through a \$780,000 bond purchase agreement among the NIFA, Greystone Servicing Corp. and Fannie. The Otoe County Bank and Trust and Fannie provided land acquisition, infrastructure improvements, and construction financing. (*Fannie press release, 3/6/00*)

Cong. Sam Johnson (R-TX) and Cong. Ralph Hall (D-TX)

- Fannie and the Collin County Housing Finance Corp. announced a \$16.9 million mortgage revenue bond agreement. Fannie purchased the tax-exempt municipal revenue bond, the proceeds of which will be made available through participating lenders to qualifying home buyers and will finance 7.8%, 30-year fixed-rate mortgage loans and down payment and closing cost assistance grants equal to 3% of the loan amount. Statements of support by the above mentioned officials were included in Fannie's press release. (*Fannie press release, 3/6/00*)

Cong. Steve Largent (R-OK) and Tulsa, OK Mayor Susan Savage

- Fannie held a press conference with the above mentioned officials to announce a \$2 million lease-purchase pilot. The pilot will provide \$2 million in mortgage financing for the Community Action Project of Tulsa County (CAPTC) to purchase and renovate distressed housing for lease to eligible low-income Tulsa families. Bank One will originate the loan to CAPTC, Self Help will provide a credit enhancement to the loans and Fannie will purchase the loans. (*Fannie press release, 2/22/00*)

Cong. Bob Barr (R-GA)

- Fannie held a press conference with Cong. Barr to convene a housing forum with Rome Housing Leaders on February 28. (*Fannie press release, 2/28/00*)

Cong. Earl Pomeroy (D-ND)

- Cong. Pomeroy joined Fannie and area housing leaders for a community and housing roundtable meeting on March 7. (*Fannie press release, 3/6/00*)

Cong. John Spratt (D-SC)

- Cong.. Spratt joined Fannie to convene a housing forum with housing leaders on February 22. (*Fannie press release, 2/22/00*)

Utah Lieutenant Governor Olene Walker

- Fannie held a press conference with the above official to announce an initiative called "Home at Last" that allows qualified home buyers to obtain a conventional mortgage with a down payment as low as \$1,000. Borrowers receive a second mortgage from the Neighborhood Housing Services of up to 20 percent of the purchase price at an interest rate of 4%. (*Fannie press release, 3/6/00*)

Fort Worth, TX Mayor Kenneth Barr

- Fannie held a press conference with the above official and representatives from the United Cerebral Palsy of Tarrant County and the Texas Home of your Own Coalition to announce the Tarrant County Home of Your Own Coalition to help individuals with disabilities and their families overcome obstacles to homeownership. (*Fannie press release, 3/9/00*)

Selma Alabama Mayor Joe Smitherman, City Council President Pro Tempe Yusuf Salaam

- Fannie announced the first Selma Conference on Housing and Community Development sponsored by Fannie Mae, the Enterprise Foundation, and the Jonathan Daniels Community Development Corporation. The above mentioned officials participated in the conference. Statements in support by the above officials were included in Fannie's press release. Fannie also announced a \$3,500

grant to the Jonathan Daniels Community Development Corporation for the purchase of computer equipment. In addition, Fannie provided its Desktop Home Counselor software and training to the organization. (*Fannie press release, 2/28/00*)

Allegheny County, PA Chief Executive Jim Roddey

- Fannie held a press conference with the above mentioned official to announce the availability of Fannie’s “Working Mortgage” product in western Pennsylvania. National City Bank of Pennsylvania was selected as one of the four lenders nationally to pilot the initiative. (*Fannie press release, 2/28/00*)

Freddie Mac

Freddie continues to expand into the subprime (A-) market

Freddie works on a new pilot – the “Step Down” mortgage product – that is similar to Fannie’s “Timely Payments Rewards” product

[Editorial Note: Will investors and traders be concerned with Freddie’s pilot as they were with Fannie’s similar pilot?]

[Editorial Note: Will Freddie, like Fannie, require that lenders use Freddie’s automated underwriting system if they want to provide the product to consumers?]

- Freddie is working on a new interest-rate-reduction pilot for credit-impaired borrowers called a “Step Down” mortgage. The product will allow borrowers to move to a lower rate after 24 consecutive months of good payment history without having to refinance. Freddie’s Chief Credit Officer David Andrukonis announced the product during a recent conference on predatory lending in Atlanta. Andrukonis further stated that Freddie has not purchased any subprime mortgages where credit life insurance is financed out of the loan proceeds. “In addition to our moral objection to the predatory use of this product, we don’t like it from a financial perspective as the mortgage investor,” he said. “Anything that strips equity out of the home and increases the likelihood of default is bad news for us as well as homeowners.” Freddie has a portfolio of 120,000 subprime loans. (*National Mortgage News Daily website, 3/1/00*)
- In related news, Freddie introduced a \$100 million “CreditWorks” pilot for borrowers with impaired credit or heavy debt loans to obtain a market-rate mortgage. The program was launched in conjunction with the National Foundation for Credit Counseling. Potential borrowers are required to participate in a debt management plan for at least 18 months, making timely payments on existing debt and receiving homebuying counseling. Participating lenders include Bank of America Mortgage, Chase Manhattan Mortgage, and Norwest Mortgage. The three lenders will originate Credit Works mortgages, which Freddie will purchase. Credit Works mortgages are 30-year, fixed rate loans on single family properties with 97% loan-to-value ratios and flexible underwriting requirements. (*National Mortgage News Daily website, 2/10/00; Freddie press release, 2/9/00*)

Fannie has “Timely Payments Rewards” mortgage product

- As reported in the October 29, 1999 *GSE Report*, Fannie has a similar pilot to Freddie’s “Step Down” mortgage product, called the “Timely Payments Rewards” mortgage. Announced in

September 1999, Fannie's pilot allows borrowers with slightly impaired credit who do not qualify for a lower conventional mortgage to borrow under the program. Borrowers who qualify for the product will be able to obtain a mortgage rate as low as 2 percentage points lower than what credit-impaired borrowers typically pay, and will be guaranteed a mortgage rate reduction of 1% after 24 monthly payments without a delinquency. Twenty-six banks in 15 markets are participating in the project.

NHEMA criticized a similar Fannie pilot

- **NHEMA is concerned that Fannie's program, by narrowing the margins on A- paper, will drive up the costs for B&C borrowers. "The decades of experience and intense competition within the [home equity] industry have led to interest rates and costs that carefully balance the additional risks that accompany this market," Zeltzer said. "Our industry is committed to holding down the cost of loans for all borrowers." "Fannie Mae is expanding its mission into areas where it has virtually no experience," said Jeffrey Zeltzer. "Many borrowers will pay more, not less, for their mortgages. And taxpayers should be prepared for a bailout that could rival our savings and loan experience."**
- NHEMA believes that Fannie's program would have the following consequences:
 - Borrowers who need the most assistance will suffer immediately;
 - Taxpayers will be taking a huge risk; and
 - An effective marketplace could be destroyed by government intervention.
- **"Fundamentally, we don't believe Fannie Mae's new program will work," said Zeltzer. "It will suffer losses that Fannie Mae has never experienced before, especially when our economic growth slows down. And then you will see Fannie Mae back out of the entire program. But at that point, the entire industry serving consumers with less than perfect credit ratings may have been decimated. Then they will be back where they were 25 years ago – no access to mortgages or loans at all, other than loan sharks."** (*National Mortgage News website, 10/1/99; NHEMA press release, 9/30/99*)

Will investors and traders be concerned with Freddie's pilot like they were with Fannie's similar pilot?

- According to *Bloomberg*, Fannie's Timely Payments Rewards program was unsettling to investors because if these risky loans start showing up as collateral in the mortgage pools backing Fannie's securities, that could increase the risk of loan defaults and prepayments, making it more difficult to predict the rate of interest and principal payments used to establish the securities' values. "It does represent a threat to the continued integrity of the market," said George Miller, Deputy General Counsel at the Bond Market Association. (*Bloomberg, 10/4/99*)
- Alt-A and subprime loans have different credit profiles than traditional conforming product and can skew the weighted average coupon of a pool because they carry higher rates, said Amitabh Arora, Vice President of Mortgage Research at Lehman Brothers. Arora notes that "Initially, Alt-A and subprime loans will be slower to refinance." Michael Hoeh, Senior Portfolio Manager at Dreyfus Corp. warned that "should the credit environment turn and residential defaults rise, the Alt-A and subprime loans will be the first to default." (*Dow Jones Newswire, Sara Landis, 10/6/99*)
- "I think this is a terrible thing," said one Wall Street observer. "The wide acceptance of the passthrough market, its liquidity, its huge number of committed and occasional players alike are all owed fundamentally at bottom that we are able to understand, model and somewhat control the risk

regarding prepayments. The comfort level with prepayments is threatened when they start changing the collateral.” [Editorial note: Fannie’s core mission of providing liquidity to the secondary market seems to be jeopardized by this program.]

- “Though on a passthrough it won’t make a big difference,” said another mortgage-backed securities Wall Street source, “when you leverage it into IO’s [interest only], PO’s [principle only], super PO’s and inverse-IO’s, it begins to increase the level of uncertainty, and from our perspective, that is not a good thing.”
- Talks took place between the Bond Market Association and Fannie to limit the amount of Timely Payment Reward loans to no more than 10% of TBA (to-be-announced) pools. However, some observers didn’t buy it. “This is just disingenuous to say this 10% doesn’t change the prepayment characteristics of collateral,” said a Wall Street source that chose to remain anonymous. “But given the politics of this market and the weight of those entities, their power is lobbying, they have organizations in Congress and so forth. That housing capital is already available for these borrowers, and we don’t need Fannie Mae or Freddie Mac to do it, especially since, over time, they crowd out truly private players...Perhaps it makes that A-minus loan a little cheaper, but it doesn’t make it that much cheaper, because they charge for it.” (*Mortgage-Backed Securities letter*, Adam Tempkin/Frank Musero, 10/11/99)

Will Freddie, like Fannie, require that lenders use Fannie’s automated underwriting system if they want to provide the product to consumers?

- According to the *American Banker*, Fannie’s new Timely Payment Rewards mortgage product is available only through lenders that use Fannie’s automated underwriting system, Desktop Underwriter, for originating loans. (*American Banker*, Joshua Brockman, 10/11/99)
- [Editorial note: This goes against the Mortgage Bankers Association policy statement on the GSEs stating that the GSEs should not tie their technology to products. The MBA’s policy statement on the GSEs states that the GSEs should not develop, distribute, or use technology in a way that: (1) bypasses their seller/servicers by going direct to the customers, or vendors of those partners, including, but not limited to consumers, owners/developers of housing, mortgage brokers, and other real estate professionals; (2) displaces or discourages innovation and development of competing systems by private enterprises; and (3) limits access or is a pre-condition for waivers of representatives and warranties or waivers of program and documentation requirements. (*MBA press release*, 8/10/99; *MBA GSE Policy Statement*, 8/10/99)
- [Editorial note: There is a question as to whether Fannie’s automated underwriting system is the best system available for subprime or credit-impaired borrowers since a study by the Urban Institute in April 1999 found that Fannie and Freddie’s automated underwriting systems and use of credit scoring may have an unintended but adverse impact on borrowers with low incomes, limited wealth and poor credit histories.]

Freddie says it has a “moral objection” to subprime loans in which credit life insurance is financed out of the loan proceeds

- Freddie’s Chief Credit Officer David Andrukonis announced during a recent conference on predatory lending in Atlanta that Freddie has not purchased any subprime mortgages where credit life insurance is financed out of the loan proceeds. “In addition to our moral objection to the predatory use of this product, we don’t like it from a financial perspective as the mortgage

investor,” he said. “Anything that strips equity out of the home and increases the likelihood of default is bad news for us as well as homeowners.” (*National Mortgage News Daily website*, 3/1/00)

Freddie forms a technology alliance with the credit unions

Alliance will allow credit unions online access to Freddie’s automated underwriting system at the point-of-sale through the credit union’s website

- Freddie and CUNA Mutual Mortgage Corp. formed an alliance to provide credit unions with online access to Freddie’s automated underwriting system, Loan Prospector (LP). CUNA Mutual Corp., a unit of CUNA Mutual Group, is a midsize mortgage bank that specializes in buying loans from credit unions. Under the alliance, credit unions will be able to use LP at the point-of-sale through their credit union’s website or CUNA Mutual’s site and fill out a loan application. In return Freddie gets a fee, and it intends to buy a substantial portion of CUNA Mutual’s conforming loans. Of the 10,628 credit unions in the US, only 316 currently use LP. James Taylor, Vice President of Business Development at Freddie, said the alliance gives CUNA Mutual an incentive to sell loans to Freddie. “I think we will see a substantial portion of that business,” he said. (*National Mortgage News Daily website*, 2/29/00; *American Banker*, Marc Hochstein, 3/7/00)
- The version of LP that CUNA will be using reportedly contains several features that the widely used version of LP does not. The CUNA version can assess the value of properties in most metropolitan areas, based on information that Freddie has collected from Internet multiple listing services and other sources. The new version can also give a risk-based, or customized, price minutes after the borrower submits an application over the Internet. (*American Banker*, Marc Hochstein, 3/7/00)

Freddie’s CFO, John Gibbons, leaves the company

- Freddie announced that Executive Vice President and Chief Financial Officer John Gibbons resigned from Freddie, effective March 31, 2000 to explore opportunities in the technology and other industries. Vaughn Clarke, Senior Vice President of Finance, was named CFO while the search for a permanent successor is conducted. (*Freddie press release*, 3/1/00)

Federal Home Loan Banks

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

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

MPF program allows the FHLBanks to purchase mortgage loans from its member institutions

Banks and thrift commitments to sell loans to FHLBanks under the MPF program soared 696% last year, to \$6.6 billion

More than 100 institutions are approved to participate in the MPF program, more than double the number in 1998.

MPF program soared by over 200% in January to \$21.7 billion in loan commitments

Half of the FHLBanks offer the program and two more FHLBanks will soon offer the program

- The FHLBank System's MPF program is designed to offer banks and thrift members an alternative secondary market execution for fixed-rate mortgages (an alternative to selling loans to Fannie, Freddie, and now Ginnie Mae). The volume of loans bought under the MPF program grew 87.4% last year, to \$1.8 billion. Loan commitments by the MPF program soared by over 200% in January. Loan commitments jumped from \$6.8 billion as of December 31, to \$21.7 billion as of January 31. MPF loans outstanding grew by \$700 million in January to \$2.5 billion. Banks and thrift commitments to sell loans to FHLBanks under the MPF program soared 696% last year, to \$6.6 billion, the FHLBank of Chicago said.
- Alex Pollock, President of the FHLBank of Chicago said the MPF program will continue to grow despite the reduction in fixed-rate mortgage lending. "If we were in a down interest rate scenario where you had significant refinance activity, MPF would be growing even faster," he said. More than 100 institutions are approved to participate in the MPF program, more than double the number in 1998. The MPF program is currently offered by half of the FHLBanks (six FHLBanks – Atlanta, Chicago, Dallas, Des Moines, New York, and Pittsburgh) and two more FHLBanks are expected to offer the program shortly (FHLBanks of Boston and Topeka). FHLBanks in Seattle, Cincinnati and Indianapolis may also create their own secondary market program. (*National Mortgage News*, Brian Collins, 2/7/00; *American Banker*, Joshua Brockman, 2/11/00)

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