

The **GSE** REPORT™

Contents of GSE Report™

Major Events

“Fannie, Freddie pose ‘next big’ financial issue for Congress.” (*Bloomberg News, 3/24/00*)

“Sounding link an annoyed parent whose 25-year-old kid won’t move out of the basement, the Treasury Department had a message for Fannie Mae and Freddie Mac last week. It’s time to cut you off.” (*Barrons, 3/27/00*)

- House Banking Comm. Capital Markets Subcom. Chairman Richard Baker (R-LA) holds hearing on his GSE bill (*p. 6*)
 - “To those who say, ‘It ain’t broke so don’t fix it,’” Baker asks, “What kind of shape were the housing GSEs in between 1979 and 1984?” – a period when the solvency of Fannie & Freddie were in question
 - Treasury Undersecretary Gary Gensler supports removing the GSEs’ line of credit with the US Treasury and suggests limiting the amount of GSE debt that commercial banks can hold – Gensler notes that Fannie & Freddie’s debt is not guaranteed by the US government
 - Treasury supports elements of Cong. Baker’s bill and believes now is an ideal time to examine regulation of the GSEs when the economy is strong
 - Treasury estimates GSE debt will surpass Treasury debt in next three years
 - Treasury notes that GSEs enjoy special benefits not available to other financial institutions, which allow the GSEs to dominate markets
 - Treasury notes the mortgage market’s increasing use of the GSEs’ automated underwriting systems may result in fewer options for consumers
 - HUD Assistant Secretary William Apgar was firm in saying that Fannie & Freddie currently and historically lag private financial institutions in serving low-income homebuyers, particularly African-Americans and Hispanics
 - Cong. Baker plans to hold more hearings this year
 - Treasury Undersecretary Gary Gensler’s testimony during Cong. Baker’s GSE hearing sent shock waves through the market over concerns that the government was taking away its backing of Fannie & Freddie (*p. 12*)
 - “The extremity of the backlash shows that the nervousness of both the GSEs and Wall Street any time the notion comes up that Fannie and Freddie no longer need the backing of the federal government”
 - Gensler’s comments cast doubt on whether GSE debt would replace Treasury bonds as benchmark securities
 - Fannie claims that they are a private institution, yet Fannie officials were “fuming” over Treasury’s support of removing the GSEs’ line of credit from the Treasury
 - Fannie called Gensler’s comments “unprofessional and irresponsible,” adding that the bond market’s reaction raised costs to consumers [Editorial Note: Fannie Mae’s standard response to anyone who expresses concerns about the GSEs.]
 - In a statement to reassure the market. Gensler stated that his testimony was “consistent with longstanding administration principles in this area...It does not represent a change in the government’s relationship with the GSEs.” US Treasury Secretary Lawrence Summers said he had “nothing to add” to Gensler’s comments
 - Fannie apologized for its comments about Treasury and then six days later lashed out again at Treasury saying saying Gensler’s testimony caused a destabilization in the agency debt market and raised costs to consumers, claiming that 206,000 families will be disqualified for homes
 - The next day Fannie apologized again for its comments about Treasury - Fannie Spokesman David Jeffers said “Our analysis of the impact of Treasury’s statement on consumers was neither accurate nor appropriate”
 - Although the market turmoil was short-lived after Gensler’s testimony, “the question remained in investors’ minds: Without the government’s implicit backing, are Fannie and Freddie ready for prime time?”
- [Editorial Note: Fannie & Freddie’s implied government guarantee is the main reason for its AAA ratings] - Standard & Poor’s suggested that if Congress lessened the implied government support, it would re-examine the AAA ratings of the GSEs

[Editorial Note: It's an unstable system if a couple of sentences can have such an impact on the market. In the eyes of the market, there's a huge gap between the GSEs' actual financial condition and the value of agency securities with government backing. It's especially disturbing that this turmoil came during prosperous times; one could only imagine the trouble that would exist at times of crisis when Treasury or other government officials need to speak more extensively about the GSEs. Treasury officials have been very responsible in alerting both policymakers and investors to their view of the GSEs.]

- Cong. Baker accuses Fannie of using intimidation tactics and “verbal attacks” to keep lawmakers and administration officials from supporting his GSE bill (p. 17)
 - Fannie's contention that “the mere mention of GSE reform means turbulence for national mortgage rates, and to a lesser extent by presuming it can intimidate the very government that sponsors its activities, Fannie Mae is itself providing the strongest justification for concern over its size.”
- Budget Committee Member Cong. Peter Hoekstra (R-MI) calls for a Congressional review of the “disturbing” increase in GSE debt (p. 18)
 - Cong. Hoekstra asks House Budget Committee Chairman John Kasich (R-OH) for permission to have a budget committee task force examine the issue
 - He contends that Congress did not understand that reducing the federal debt would lead to the emergence of GSE debt as a substitute for Treasury. He says the issue needs to be examined because the taxpayer is on the hook if the GSEs default
- Senate Banking Committee Chairman Phil Gramm (R-TX) may hold hearings on the GSEs (p. 18)
 - “The debate is over how much we guarantee Fannie Mae and Freddie Mac,” he said. “That's something we need to be clear about.”

Fannie Mae and Freddie Mac

- Citizens Against Government Waste (CAGW) calls Fannie & Freddie “a looming threat to taxpayers that is similar to the savings and loan crisis of the 1980s, but on a much larger scale” (p. 19)
 - “While the national debt has been decreasing over the past few years, housing GSE debt is skyrocketing”
 - Fannie & Freddie “portray themselves as private institutions when it suits their needs while implying that they are government-backed to investors”
 - Fannie called Treasury Undersecretary Gary Gensler's support for removing the GSEs' line of credit to the Treasury “irresponsible”
 - “Far from being irresponsible, the members of the Homeowners Education Coalition (HomeEc), CAGW, National Taxpayers Union, the Competitive Enterprise Institute, Citizens for a Sound Economy, Capitol Watch, and the Small Business Survival Committee, find Mr. Gensler's comments greatly encouraging”
- National Taxpayers Union (NTU) writes editorial for *The Hill* newspaper – “Fannie and Freddie: Still gnawing on the taxpayers” (p. 20)
 - There is a consensus that Fannie & Freddie have enriched themselves and their shareholders at taxpayers' expense
 - Congress should “clean house” and make Fannie & Freddie compete openly and fairly in the marketplace
- The “tough” new proposed affordable housing goals for Fannie & Freddie may not be that “tough” after all (p. 20)
- Fannie & Freddie use the excuse of cleaning up predatory lending practices in the subprime market as a reason to expand into new markets – Rather than cleaning up predatory lending practices in the subprime market, the GSEs' entry into the subprime market would exacerbate the problems (p. 21)
 - Consumer groups argue that Fannie & Freddie should be barred from buying subprime loans because their purchases could worsen the problems of predatory lending
 - The GSEs claim they will combat predatory lending, yet Freddie has 70 high-cost mortgage loans in its portfolio
 - Consumer groups say Freddie's purchases prove that Fannie & Freddie should be kept out of the subprime market, because their purchases would inevitably spur abusive lending
 - [Editorial Note: Subprime lending is not predatory lending. There are instances of predatory lending in all segments of the mortgage market – prime and subprime alike. Until now, Fannie Mae has not participated in industry efforts, such as the Mortgage Reform Working Group (MRWG) process. The MRWG was formed to develop proposals to streamline the mortgage process and curb predatory lending practices. Most of the proposals developed in the MRWG process were incorporated in the joint HUD-Fed report to Congress, and those proposals included recommendations to curb predatory lending practices.]
- Chairman of the House Banking Committee's Housing Subcommittee Cong. Rick Lazio (R-NY) says he was concerned over the turbulence in the “federally sponsored” bond market caused by Treasury Undersecretary Gary Gensler's testimony (p. 23)
- Senate Minority Leader Tom Daschle (D-SD) says he has not made a decision regarding whether Fannie needs to be overhauled and whether the Treasury Department should be implicitly backing the GSEs' debt securities (p. 23)

- Fannie & Freddie continue to increase their purchasing of jumbo loans (loans above the conforming loan limit of \$252,700) (p. 24)
 - “By financing a large chunk of a \$350,000 mortgage, which might be used to buy a \$400,000 home, the agencies are extending their preferential lending rates to somewhat affluent consumers. That could be evidence that they [GSEs] are expanding beyond their charters.”
- Analysts are starting to consider whether Fannie & Freddie’s political risk is increasing (p. 25)
 - International Strategy and Investment (ISI) analysts report that Fannie & Freddie’s political risks “could be more serious this time” and believe that “GSE reform is the next major financial services issue in Washington”
 - International investment advisor Richard Medley said that the White House, congressional forces and the Treasury strongly support efforts to reform and downsize the rapidly growing GSEs
 - Medley noted that a “very senior Washington official” said that there is at least a reason to be worried about a failure to address the GSEs’ rapid growth
 - Medley stated that Treasury is committed to reducing its ties to the GSEs
 - Salomon Smith Barney analyst says political risk for the GSEs is far off, however, the analyst raises his political risk assessment for Fannie & Freddie
- As the national debt shrinks, GSE debt skyrockets (p. 27)
 - 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)

GSE debt news:

- Although Fannie & Freddie are issuing bonds to take advantage of the shrinking amount of Treasuries, Federal Reserve Chairman Alan Greenspan says that obligations of entirely private firms could serve as the alternative benchmark to Treasuries
- Agency debt issuance increases 11% in 1999 to over \$7 trillion
- Chicago Board of Trade, Chicago Mercantile Exchange, and Cantor Exchange start trading GSE debt futures - Some market participants expressed concerns that Fannie & Freddie are allowed to trade the contracts, giving them the ability to manipulate trading of these contracts
- Fannie plans changes to its Benchmark bills
- Moody’s Investors Service says Fannie & Freddie’s purchases of subprime loans are “clouding the credit outlook for mortgage-backed securities” (p. 29)
- Increased use of Fannie & Freddie’s automated underwriting technology limits consumer choice (p. 30)
- Despite higher interest rates, Fannie & Freddie brought in double-digit earnings in the first quarter (p. 30)
 - [Editorial Note: Fannie & Freddie claim that any reform of the GSEs would cost consumers money, yet the GSEs only pass along a fraction of their subsidies to consumers. Consumers, rather than shareholders, could benefit from additional cost savings if the GSEs were to pass along more of the benefit of their subsidies.]
- Fannie & Freddie make a series of technology announcements (p. 31)
 - Microsoft joins forces with Freddie, Chase Manhattan, GMAC-RFC, Norwest Mortgage, and Bank of America to form a new company – HomeAdvisor Technologies Inc.
 - Fannie makes its MORNETPlus technology network Internet-accessible – Allows lenders to access Fannie’s controversial automated underwriting system through Fannie’s website
 - Fannie & Freddie enhance their servicing tools
 - Freddie approves OnePipeline.com (the web-based system of Real Estate Brokers Lending Service) as a seller of its products

Fannie Mae

- Fannie announces a pledge to fund \$2 trillion in new mortgages over the next 10 years (p. 32)
 - Mike House, Executive Director of Fannie/Freddie watchdog group FM Watch, said “it’s not a stretch” for Fannie to make \$2 trillion in loans to disadvantaged families as part of its ordinary business. “If it’s nothing but their normal course of business, [the announcement] is nothing but a PR gimmick.”
- Fannie appoints Economist Dr. Barbara Ryan as Vice President of Industry Analysis (p. 33)
- Fannie names 27 new members to its 45-member National Advisory Council (p. 33)
 - The new Chair of the Council is the past President of the National Association of Realtors, Sharon Millet

- Fannie further expands its political reach by including Federal and State officeholders in its press conferences and press releases and increasingly using its partnership offices in press events (*p. 35*)
 - Fannie holds press conference with the Federal Reserve Bank of Cleveland and the OTS. As part of its new initiative with Fannie in the Pittsburgh area, the Federal Reserve Bank of Cleveland will track the initiative, and the OTS will provide education and outreach to OTS-regulated savings institutions and other banks in the target counties about Fannie's initiatives
 - 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."
 - Fannie says it plans to expand the number of its partnership offices to 60

Freddie Mac

- Freddie invests in a luxury high-rise apartment building on the shore of Lake Michigan in Chicago (*p. 38*)
 - Apartment rents range in price from \$885 to \$3419 per month
 - Amenities include: (1) panoramic views of the Chicago skyline, Lake Michigan and Grant Park from each of the 600 apartments; (2) indoor swimming pool covered by a skylight and an outdoor deck; (3) a full-service fitness center; (4) grocery store with free delivery; (5) dry cleaners; (6) video rental machine; (7) cash station; (8) 24-hour doorman; (9) reserved or valet parking; (1) and central air conditioning included in rent
- Expanding beyond its mission, Freddie increases its purchasing of subprime loans (*p. 38*)
 - Freddie's purchasing of B and C loans increased 370%
- Freddie approves direct wholesale lender OnLoan.com to issue loans without the customary use of a third-party lender (*p. 38*)
- Consumer complains about Freddie's controversial HomeSteps program (*p. 39*)
 - HUD is currently investigating Freddie's HomeSteps retail mortgage center as a program that potentially expands beyond Freddie's charters
- Freddie increases its dividend to shareholders (*p. 39*)

Federal Home Loan Banks

- FHLBank System's Mortgage Partnership Finance (MPF) program continues to grow – the program is likely to grow nationwide (*p. 39*)
 - MPF program loans increased 146% in the first quarter and master commitments rose 267%
 - MPF program is a competitor to Fannie & Freddie in the secondary mortgage market
 - ACB's Director of Policy and Economic Research Brian Smith says competition between the MPF program and Fannie & Freddie will help the mortgage lending market
- Treasury Department recommends higher deposit insurance premiums on banks and thrifts with secured borrowings (e.g., advances) from FHLBanks (*p. 40*)
- FHLBank membership rules eased (*p. 41*)
 - Small banks will be able to pledge small business loans and small farm loans as collateral
 - FHFB left it to the 12 FHLBanks to decide how much small business and farm loans will be discounted
- FHFB extends the FHLBank System's Office of Finance's authority to issue debt through the end of the year (*p. 41*)
 - This is part of a proposed rule to reorganize the Office of Finance so that FHLBanks, instead of the FHFB, have direct responsibility for the issuance of all FHLBank debt, starting January 2, 2001
 - Part of the reason for the change is to limit the potential liability of the US to lawsuits from irate investors - the FHFB cited the Orange County bankruptcy suit in which the FHFB was sued
 - Some are concerned that the change could increase borrowing costs and that an investor-suitability provision could leave the System vulnerable to investor lawsuits
- FHLBank of Atlanta hires former staffer to Senator Chuck Hagel (R-NE) as its top lobbyist (*p. 43*)

Farm Credit Administration/Farm Credit Banks

- Supreme Court declines consideration on whether or not Farm Credit Associations are exempt from states sales and income taxes (*p. 43*)
 - American Bankers Association (ABA) Working Group has noted that the relatively favorable tax treatment given to Farm Credit System institutions gives these institutions a competitive advantage over community bankers
 - [Editorial Note: Fannie & Freddie are also exempt from paying state and local income taxes, thereby giving them an unfair advantage over community banks and other financial institutions.]
 - Fannie Chairman Franklin Raines says if the company had to pay taxes, the cost would have to be passed on to

consumers [Editorial Note: If Raines' theory is correct, then all financial institutions should enjoy a "tax holiday" so that consumers could save more money.]

- The new Chairman and CEO of the Farm Credit System is examining alternatives to its controversial (Customer Choice) proposal that would remove geographic boundaries and allow farm credit banks to compete (*p. 44*)
 - Farm credit lenders inside and outside the Farm Credit System are concerned about the proposal and bank groups worry that the Farm Credit System would have a bigger advantage over commercial banks in lending to farm customers
- Farm Credit Administration extends the comment period on its proposed risk-based capital rule (*p. 45*)

Major Events

House Banking Committee Capital Markets Subcommittee Chairman Richard Baker (R-LA) holds hearing on his GSE bill

“To those who say, ‘It ain’t broke so don’t fix it,’” Baker asks, “What kind of shape were the housing GSEs in between 1979 and 1984?” - a period when the solvency of Fannie & Freddie were in question

Treasury Undersecretary Gary Gensler supports removing the GSEs’ line of credit with the US Treasury and suggests limiting the amount of GSE debt that commercial banks can hold – Gensler notes that Fannie & Freddie’s debt is not guaranteed by the US government

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Cong. Baker plans to hold more hearings this year

- Cong. Baker held a hearing on March 22 on his new bill - H.R. 3703 - that would, among other things, consolidate the three housing GSE regulators (OFHEO, HUD, and the FHFB) into one regulatory agency. The standing-room-only hearing was well attended by Congressional Members, staff, and press. The debate among Members was very heated at times.
- Witnesses at the hearing were: (1) Undersecretary for Domestic Finance, Department of Treasury, Gary Gensler; (2) Assistant Secretary for HUD William Apgar; (3) OFHEO Director Armando Falcon; and (4) FHFB Chairman Bruce Morrison.
- The highlight of the hearing was Treasury Undersecretary Gensler’s support of a provision in the bill that would remove the GSEs’ line of credit with the US Treasury. He also suggested placing restrictions on or limiting the amount of Fannie and Freddie debt commercial banks can hold. **Speaking to reporters after appearing at the hearing, Gensler said that debt issued by Fannie and Freddie is not guaranteed by the US government.** (*Reuters*, 3/22/00)
- Cong. Baker said the overall aim of his bill was not to attack the GSEs but to make sure there is competent regulation of these enormous institutions to “reduce future risk to the taxpayer and financial system” posed by the GSEs. In an interview with *Bloomberg*, Cong. Baker said that Congress isn’t rushing to enact the bill and the full Banking Committee consideration isn’t

expected until after the November election. (*Bloomberg*, Michael McKee and John Rega, 3/22/00) **“To those who say, ‘It ain’t broke so don’t fix it,’ Baker asked, “What kind of shape were the housing GSEs in between 1979 and 1984” - a period when the solvency of Fannie Mae and Freddie Mac were in question.** (*BNA Daily Report for Executives*, Adam Wasch, 3/23/00) Cong. Baker said he plans to hold more hearings on the issue this year.

- Speaking on Cong. Baker’s bill, **Fannie Spokesman David Jeffers said, “No one yet has detected any support for a bill that is incoherent, unwieldy, and creates no value to consumers.”** (*Dow Jones Newswire*, John Connor, 3/24/00)

Undersecretary for Domestic Finance, Department of Treasury Gary Gensler

- **Gensler supports elements of Cong. Baker’s bill and believes that now is an ideal time to examine the regulation of the GSEs when the economy is strong.** Gensler noted that the GSEs have significantly increased their size and their market share and “have now become the dominant institutions in the secondary mortgage market,” and are “an increasing percentage of the overall credit markets.” **The GSEs currently own or guarantee 63% of all outstanding conforming, conventional mortgages, and their retained mortgage portfolios represent 26% of outstanding conforming, conventional mortgages.** **“To the extent that the GSEs now finance a significant portion of the their sector of the mortgage market, the willingness of a GSE to purchase a mortgage has become a far more significant factor in deciding whether to originate that mortgage.”**
- Coupled with less Treasury debt in the market, the GSEs have “a more central role in the capital markets than ever before.” **“Each of the GSEs has gone from being a small, relatively unknown borrower in the capital markets to being among the largest debt issuers in the world.”** (*Reuters*, Andrew Priest, 3/22/00) Any reform of the GSEs should enforce market discipline, increase financial transparency, and encourage competition in the financial markets. **“The potential benefits that GSEs bring to a particular market must be balanced, therefore, against potential risks to the financial system and potential effects on market competition,” Gensler said.** Any regulatory consolidation, however, should not interfere with OFHEO’s effort to finalize its risk-based capital proposal and HUD’s effort to finalize its affordable housing goals for Fannie and Freddie.
- **Gensler supports the removal of the GSEs’ line of credit to the Treasury.** (Current law authorizes the Treasury to purchase up to \$4 billion of loan obligations from the FHLBank System, and up to \$2.25 billion from both Fannie and Freddie. (*BNA Daily Report for Executives*, Adam Wasch, 3/23/00) **“Any function the lines perform at this point is purely symbolic,” he stated. “Repeal of the line of credit would be consistent with the congressional requirement that all GSE securities carry a disclaimer that they are not obligations of the US government. Thus, as part of a package of reforms, we would support repeal of the line of credit.”** Analysts noted that although the removal of the line of credit is seemingly technical, the existence of the line has helped Fannie and Freddie secure lower borrowing rates on Wall Street. (*Dow Jones Newswire*, Jerry Guidera, 3/22/00)
- **Gensler suggested placing restrictions or limiting the amount of Fannie and Freddie debt commercial banks can hold.** At midyear 1999, banks held \$21 billion in GSE securities - just under 4% of total bank assets and over one-third of total bank capital – constituting a “significant portion” of the assets of the US banking system. In addition, banks held more than \$355 billion in mortgage-backed securities guaranteed by the GSEs. Currently, Fannie and Freddie debt does not

come under the same restrictions as other debt. Current law limits the bank's amount of credit exposure to any one entity. While national banks cannot hold more than 10% of their capital in the corporate bonds of any one issuer or lend unsecured more than 15% of their capital to any one borrower, there are no limits on the holdings of GSE debt. Gensler stated that "Congress should seriously consider the best way to repeal such exceptions, including a sufficient transition period to prevent any market disruption." **"The bill highlights an important issue – the potential for problems at one financial institution to cause instability in the financial markets or at other institutions."** (*Dow Jones Newswire*, 3/22/00)

- **A considerable amount of time during the hearing was spent discussing the GSEs' \$1.4 trillion worth of outstanding debt, which Treasury estimates will surpass privately held marketable Treasury debt by 2003 and double to \$3 trillion by 2005. "The \$1.4 trillion of GSE debt is large on any relative scale" and is "roughly the size of the entire municipal bond market – the outstanding debt of the fifty states and localities that issue publicly traded debt," and "more than one-half of the \$2.7 trillion of outstanding privately held marketable Treasury debt." "Adding the \$1.2 trillion in GSE-guaranteed mortgage-backed securities to the mix, GSE involvement in the credit market is approaching the size of the Treasury market."**
- **Treasury supports a provision in the bill calling for the GSEs to obtain an annual credit rating from a ratings organization, such as Moody's Investors Service or Standard & Poor's.** "In determining such ratings, the bill specifically requires the ratings agencies to consider that the United States government does not guarantee the GSEs' obligations." "We believe this proposal is an improvement over current law, as it requires annual ratings and specifically sets a standard for such ratings." (*Dow Jones Newswire*, 3/22/00)
- **Treasury supports repealing the FHLBanks' "superlien," which allows each FHLBank to make secured advances to its members of up to 30% of a member bank's capital.** "Repealing the superlien would restore market discipline by increasing the Banks' incentives to distinguish among their members with regard to credit risk." FHLB Chairman Bruce Morrison opposed the elimination of the "superlien" because its elimination would force FHLBanks to perfect their security interests on an asset-by-asset basis and therefore would provoke higher lending costs. (*BNA Daily Report for Executives*, Adam Wasch, 3/23/00)
- **Gensler notes the GSEs receive statutory benefits that are not available to other financial institutions. The benefits provide the GSEs with three advantages over other financial institutions: (1) lower funding costs; (2) the ability to operate with less capital; and (3) lower direct costs.** Over the last six months, the GSEs borrowed at approximately 40 basis points less than AA-rated banking and financial firms on one- and five-year debt, and almost 30 basis points less than AAA-rated banking and financial firms. Fannie and Freddie have approximately \$32 of debt for each dollar of capital, FHLBanks have approximately \$19 of debt, while large banks have about \$11.50 of debt, thrifts have \$12.50 in debt, and the five largest securities firms have approximately \$25 of debt. **"These funding, leverage, and cost advantages are particularly significant to the GSEs because the markets in which they operate. The US capital markets are the most competitive and efficient in the world. Relatively small advantages...can allow firms to dominate the market."**
- **Gensler noted the mortgage market's increasing use of the GSEs' automated underwriting systems may result in less options for consumers. "The GSEs' automated underwriting**

systems are increasingly become the means by which originators decide to lend. This technology will make the process more efficient. In the long run, however, this trend may result in less diversity in credit decisions and less price competition.”

- **Gensler noted that as the GSEs continue to grow, systemic risk and market competition become greater concerns.** “Promoting competition in financial markets lessens systemic risk. The task of public policy must be to ensure the stability and integrity of the market system. In any sector of the financial market, the dominance of one or two firms can lessen competition and the efficiency of the market pricing mechanism. In addition, the entry of a subsidized financial institution into a market may motivate other firms to take on greater risks and weaken their operating results.”

HUD Assistant Secretary William Apgar

- The existing regulatory structure of the GSEs works well, but could be improved upon. “The current regulatory system is working well and is having a valuable impact on affordable housing markets,” he stated. (*Dow Jones Newswire*, Jerry Guidera, 3/22/00) HUD is proposing an increase in Fannie and Freddie’s affordable housing goals, conducting a fair-lending investigation of the GSEs’ automated underwriting systems, and increasing its oversight of their non-mortgage investments. (*American Banker*, Dean Anason, 3/23/00) Apgar supports the provision in the bill that would give regulators the authority to review new programs undertaken by the GSEs to determine whether they are consistent with their missions, however, he believes the proposal may be too limited because it is restricted to new activities associated with housing. (*BNA Daily Report for Executives*, Adam Wasch, 3/23/00) He stated that there were “instances where the GSEs pursue new diverse [non-mortgage] activities that are asserted by the GSEs to fall within their existing charters.” (*National Mortgage News*, Brian Collins, 3/27/00) Apgar stated that removing the GSEs’ line of credit to the Treasury would have no affect on Fannie and Freddie fulfilling HUD’s proposed affordable housing rules.
- Cong. Baker told Apgar he would like to know more about Fannie’s pilot with Home Depot, which would allow consumers to finance a home-improvement loan for such things as Jacuzzis and sunrooms. **“It [Fannie’s Home Depot pilot] is on the boundary of consumer lending – not necessarily secured by the home,” said Baker.** (*National Mortgage News*, Brian Collins, 3/27/00) Apgar stated that HUD is examining this program and that the pilot raises safety and soundness and mission concerns.
- **Apgar stood by the numbers that Fannie and Freddie lag the primary market in serving low-income homebuyers, particularly when it comes to serving African-Americans and Hispanics. “We stand by these facts,” he stated. Apgar stated that Cong. Baker was correct in saying that the GSEs’ lagging commercial banks and thrifts in these underserved areas was an historical problem and not just a recent phenomenon. Cong. Baker stated, “Making a \$4 billion profit last year [GSEs] hasn’t translated into lending to low-income Americans.”**

OFHEO Director Armando Falcon

- “Consolidation of the safety and soundness regulation of the housing GSEs could lead to even stronger oversight, if done right,” Falcon testified. “However, the consolidation of mission regulation with safety and soundness regulation is not essential for OFHEO or its successor to properly fulfill its safety and soundness responsibility.” (*Mortgage-Backed Securities Letter*, Frank Musero, 3/27/00)

- Responding to the bill’s requirement for an annual credit rating of the GSEs, Falcon stated, “With adequate funding, regular updates of this type would provide more information to investors about the enterprises’ financial condition and would provide an additional source of information about the enterprises’ financial condition to the regulator.” (*Mortgage-Backed Securities Letter*, Frank Musero, 3/27/00)
- Falcon believes that the risk-based capital proposal on Fannie and Freddie should be completed by the end of the year. (*Dow Jones Newswire*, Jerry Guidera, 3/22/00) He believes that OFHEO should be removed from the appropriations process, stating that it was bad public policy. He recommended that any new regulator be governed by one chair rather than a board in order to ensure its efficiency and that there should be a longer transition period between the old regulators and the new regulator than what was proposed in the bill.

FHFB Chairman Bruce Morrison

- Morrison said he broadly backed much of Cong. Baker’s proposed bill. **“A single independent agency regulating safety and soundness and mission for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks is preferable to the current structure,”** he said. “A combined safety and soundness and mission regulator can weigh the trade-offs between profit and mission suitability to determine the proper policy much more safely and efficiently than can two separate regulators where the responsibilities for safety and soundness and mission are housed in different agencies.” (*Dow Jones Newswire*, Jerry Guidera, 3/22/00) **“The stronger the regulation, the more respected by Congress and by the regulated entities, the better we will do at that hard job.”** (*American Banker*, Dean Anason, 3/23/00)
- He recommending enlarging the size of the supervisory board from five members to seven members to make more room for a greater presence drawn from the private sector. (*BNA Daily Report for Executives*, Adam Wasch, 3/23/00)
- Morrison stated that there were some who propose raising the cost of the operations of the GSEs to level the playing field, but this doesn’t solve the problem of the safety and soundness and “too big to fail” issues surrounding the GSEs. If there are concerns about the GSEs being “too big to fail,” then “perhaps it’s time to scale down the GSEs,” he said. (*BNA Daily Report for Executives*, 3/23/00)

Congressional Member comments

- The Subcommittee’s Ranking Democrat Paul Kanjorski (D-PA) stated that there was “no pressing need for reform at this time” and hopes that the bill is not on a “fast track.” Many Members were concerned that efforts to consolidate the regulators would interfere with OFHEO’s risk-based capital proposal and HUD’s affordable housing rule for Fannie and Freddie. “The creation of a single regulator at this time could delay all of these important activities.” Cong. Kanjorski also noted that he favored expansion of the GSEs into economic development in distressed communities. Congresswoman Marge Roukema (R-NJ) said consolidation should be considered but that it should be done “slowly and carefully” to avoid any “unintended consequences.” (*American Banker*, Dean Anason, 3/23/00)
- Cong. Ken Bentsen (D-TX) expressed concerns that new regulation of the GSEs could increase mortgage interest rates and that comparing GSE debt to Treasury debt was like comparing “apples to oranges.” He was also concerned that taking away the GSEs’ line of credit to the Treasury would effect the GSEs’ AAA credit ratings. He wondered if the consolidation of the regulators

shouldn't wait until OFHEO implemented its risk-based capital proposal and HUD implemented its affordable housing rule. FHFB Chairman Morrison said that consolidating the regulators did not necessarily have to wait until after these rules were finalized, nor did it have to be done before the rules were finalized – it was important to just ensure that consolidation did not affect the regulator's current work going forward.

- Congresswoman Carolyn Maloney (D-NY) believes that HUD's proposed affordable housing goals for Fannie and Freddie was a good step forward to helping minorities. She supports streamlining reform of the GSEs but she cautioned against unintended consequences of sweeping reform especially in light of OFHEO's proposed risk-based capital proposal and the FHLBank reforms in the Gramm-Leach-Bliley Act – the effects of which have not yet been seen. She also questioned whether the provision requiring the GSEs to seek approval from their regulator for new programs would make the government guarantee even more explicit because the regulator would be more involved in the day-to-day activities. Gensler responded that it was important that the GSEs be able to innovate but it was an appropriate role for the regulators to keep the GSEs focused on their missions. Maloney stated that she was not aware of any programs in which Fannie and Freddie were stepping outside their missions.
- Congresswoman Maxine Waters (D-CA) expressed concern that changing the regulatory structure of the GSEs would hinder the ability of African-American homebuyers to qualify for mortgages. "I want [Freddie Mac and Fannie Mae] to expand and provide more mortgages to poor people," Waters stated. (*BNA Daily Report for Executives*, Adam Wasch, 3/23/00)

(Sources: *Written and oral testimony for the House Banking Committee Capital Markets Subcommittee hearing on H.R. 3703*, 3/22/00)

Treasury Undersecretary Gary Gensler's testimony during Cong. Baker's GSE hearing sent shock waves through the market over concerns that the government was taking away its backing of Fannie & Freddie

"The extremity of the backlash shows the nervousness of both the GSEs and Wall Street any time the notion comes up that Fannie and Freddie no longer need the backing of the federal government"

Gensler's comments cast doubt on whether GSE debt would replace Treasury bonds as benchmark securities

Fannie claims they are a private institution, yet Fannie officials were "fuming" over Treasury's support of removing the GSEs' line of credit from the Treasury

Fannie called Gensler's comments "unprofessional and irresponsible," adding that the bond market's reaction raised costs to consumers [Editorial Note: Fannie Mae's standard response to anyone who expresses concerns about the GSEs.]

In a statement to reassure the market, Gensler stated that his testimony was "consistent with longstanding administration principles in this area...It does not represent a change in the government's relationship with the GSEs." US Treasury Secretary Lawrence Summers said he had "nothing to add" to Gensler's comments.

Fannie apologized for its comments about Treasury and then six days later lashed out again at Treasury saying Gensler's testimony caused a destabilization in the agency debt market and raised costs to consumers, claiming that 206,000 families will be disqualified for homes

The next day Fannie apologized again for its comments about Treasury – Fannie Spokesman David Jeffers said "Our analysis of the impact of Treasury's statement on consumers was neither accurate nor appropriate"

Although the market turmoil was short-lived after Gensler's testimony, "the question remained in investors' minds: Without the government's implicit backing, are Fannie and Freddie ready for prime time?"

[Editorial Note: Fannie & Freddie's implied government guarantee is the main reason for its AAA ratings] - Standard & Poor's suggested that if Congress lessened the implied government support, it would re-examine the AAA ratings of the GSEs

[Editorial Note: It's an unstable system if a couple of sentences can have such an impact on the market. In the eyes of the market, there's a huge gap between the GSEs' actual financial condition and the value of agency securities with government backing. It's especially disturbing that this turmoil came during prosperous times; one could only imagine the trouble that would exist at times of crisis when Treasury or other government officials need to speak more extensively about the GSEs. Treasury officials have been very responsible in alerting both policymakers and investors to their view of the GSEs.]

- During a March 22 House Banking Capital Markets Subcommittee hearing, Treasury Undersecretary Gary Gensler said he supported Congress removing the GSEs' line of credit to Treasury and possibly limiting the amount of GSE debt that commercial banks can hold. **“Sounding like an annoyed parent whose 25-year-old kid won’t move out of the basement, the Treasury Department had a message for Fannie Mae and Freddie Mac...it’s time to cut you off.”** (*Barron’s*, Brian Blackstone, 3/27/00) [See earlier story in this *GSE Report* for more details on the hearing and Gensler’s remarks.]
- Gensler’s statements sent shock waves through the stock market, triggering a sell-off of Fannie and Freddie agency bonds. “There was an immediate negative reaction,” said Dan Markaity, a Senior Agency Trader and Global Syndicate Manager at Merrill Lynch & Co. (*Bloomberg*, Jonas Bergman and Kathleen Spillane, 3/22/00) “The Treasury’s implicit guarantee of agency debt has been called into question,” sparking heavy buying of Treasuries, said Richard Bodkin, head of government trading at Banc One Capital Markets in Chicago. (*Wall Street Journal*, Gregory Zuckerman, 3/24/00) “The extremity of the backlash shows the nervousness of both the GSEs and Wall Street any time the notion comes up that Fannie and Freddie no longer need the backing of the federal government.” (*Realty Times*, 3/28/00)

Gensler’s statements cast doubt on whether GSE debt would replace Treasuries as alternative benchmarks

- The debt of Fannie and Freddie carry warnings that they are not guaranteed by the US government but many investors interpret the companies’ line of credit and other ties to the government as an implicit backing by US taxpayers. (*Washington Post*, Kathleen Day, 3/24/00) **Gensler’s statement cast doubt on whether GSE debt would replace Treasury bonds as benchmark debt securities.** (*Dow Jones Newswire*, 3/24/00) “There is some uncertainty” in the market about the status of GSE debt as an alternative benchmark to Treasuries, noted Dave Connors, Managing Director and head government bond trader at Credit Suisse First Boston. (*Dow Jones Newswire*, Sonoko Setaishi and Tyler Lifton, 3/24/00)
- According to the *Wall Street Journal*, Gensler’s comments “shook up the bond market and challenged Fannie’s ambitions to replace US Treasury bonds as a haven for risk-averse investors.” Investors reportedly reacted to Gensler’s comments by dumping agency bonds in the worst day for the market in months. (*Wall Street Journal*, Michael Schroeder and Gregory Zuckerman, 3/23/00)
- **“Heightened political risk poses a major obstacle” to Fannie and Freddie’s plans to have their debt replace Treasuries as benchmarks in the bond market. “Naturally, investors prefer a benchmark to be as risk-free as possible. If federal policy toward the GSEs continues to be a live policy issue – which we believe it will – that makes it less likely investors will adopt agency debt as the benchmark.”** (*International Strategy and Investment (ISI) Mortgage Political Report*, Tom Gallagher and Andy Laperriere, 3/24/00)
- **The market volatility exposes a weakness in using agency debt as a hedge against other spread products like corporates. “Thursday (day after the hearing) was a pretty good lesson why it’s difficult to hedge spread product with a spread product,” says William Hornbarger, Fixed-Income Strategist at A.G. Edwards.** (*Barron’s*, Brian Blackstone, 3/27/00)
- **“Some credit market participants were lulled into thinking that agency papers and Treasury debt were virtually indistinguishable. We’ve warned investors about it for the longest time,”**

said John Lonski, Chief Economist at Moody's Investor Services. "If the market is overreacting, then it may have more to do with its own nervous state than with Mr. Gensler's remarks." (*Financial Times*, 3/24/00)

- Now might be the best time to clarify the relationship between the GSEs and the government while the economy is good and before the GSEs' debt becomes benchmarks based on faulty assumptions. **If creditors assume these GSE securities are backed by the government, it could lead to reckless behavior.** "It addresses the moral hazard question," says Anthony Crescenzi, Chief Bond Strategist at Miller Tabak & Co. (*Barron's*, Brian Blackstone, 3/27/00)
- Morgan Stanley Dean Witter strategist Alec Crawford recommended that investors consider shifting into Ginnie Mae MBS and reduce their Fannie and Freddie holdings. **"While the proposals may not be adopted by Congress, we believe this talk will continue to be a short-term negative for agencies and conventional MBS," he wrote the afternoon of the hearing.** (*Dow Jones Newswire*, 3/22/00)

S&P may re-examine the AAA ratings of the GSEs

- In a related development, Standard & Poor's and Moody's affirmed their AAA ratings of Fannie & Freddie and the FHLBanks' debt. S&P said the AAA ratings reflect the GSEs' implied government guarantee. (*Dow Jones Newswire*, 3/23/00) However, Standard & Poor's suggested that if Congress acted on Gensler's remarks, they would re-examine the AAA ratings of the GSEs. "If Congress was to accept some of the things being proposed, and moves away from the implied support, we would reassess the credit" of the GSEs, said S&P Managing Director Mike DeStefano. (*Wall Street Journal*, Michael Schroeder and Gregory Zuckerman, 3/23/00) "If the intent is to distance the government...that could be significant," he said. However, if the proposed changes are merely technical, that wouldn't bear any meaning, he said. (*Dow Jones Newswire*, Tyler Lifton, 3/22/00) However, he believes that "any material change would appear unlikely over the short to intermediate term, and that in any case, existing rated securities would likely be grandfathered into their current GSE status." Moody's said it was too early to conclude whether Cong. Baker's bill "has sufficient support to be enacted, or to predict its ultimate content if adopted." (*Dow Jones Newswire*, Sonoko Setaishi and Tyler Lifton, 3/24/00)

Treasury reassures the market after testimony

- **In a statement to reassure the market, Gensler stated that his testimony was "consistent with longstanding administration principles in this area." He added that "It does not represent a change in the government's relationship with the GSEs."** "As I emphasized in my testimony, given the importance of these institutions to the housing market and the government's long-standing relationship with them it is appropriate for Congress to review the relevant issues from time to time." (*Dow Jones Newswire*, 3/24/00) **US Treasury Secretary Lawrence Summers said he had "nothing to add" to Gensler's comments. "Under Secretary Gensler made clear the department's policy in that area."** (*Dow Jones Newswire*, 3/24/00)
- **Although the market turmoil was short-lived after Gensler's testimony, "the question remained in investors' minds: Without the government's implicit backing, are Fannie and Freddie ready for prime time?"** (*Barron's*, Brian Blackstone, 3/27/00)

Fannie was furious with Treasury's comments and lashed out at Treasury, saying Treasury's comments raised costs to consumers

- *National Mortgage News Daily* reported that Fannie officials were “fuming” over Treasury’s comments. **Fannie Spokesman David Jeffers called Gensler’s comments “unprofessional and irresponsible,” adding that the bond market’s reaction raised costs to consumers.** (*National Mortgage News Daily*, 2/23/00) Fannie CFO Timothy Howard also referred to Gensler’s comments as “unprofessional and irresponsible.” (*Dow Jones Newswire*, Michael Schroeder, 3/27/00) Howard noted that Gensler’s testimony was “either inept or irresponsible.” He stated that Fannie has “very strong” support from both political parties in Congress and that the Treasury Department was stating a minority position. “This will cause the people (in Congress) who matter to declare which side they’re on,” he said. He said Gensler’s testimony was “anti-housing,” since it could drive up mortgage rates. (*Bloomberg*, Jonas Bergman, 3/23/00) Fannie also opposed the creation of a single regulator under the Baker bill. “We think it’s an unwieldy, incoherent structure that stifles innovation, adds regulatory burdens on Fannie Mae, and doesn’t add anything on safety and soundness,” said Jeffers. (*Bloomberg*, Michael McKee and John Rega, 3/22/00)
- Jeffers said that the market understands the relationship that Fannie and Freddie have with the government and that the loss of the credit line would not affect Fannie’s ability to issue debt in order to securitize the bundled loans it purchases in the secondary market. “Frankly, we see no reason why Treasury would want to give up a tool that supplies emergency credit at a time of crises,” he said. (*Dow Jones Newswire*, Jerry Guidera, 3/22/00) Though Fannie doesn’t foresee using the line of credit, it provides an important measure of security, similar to the Federal Reserve’s authority to provide extra liquidity to banks, said Jeffers. (*Bloomberg*, Michael McKee and John Rega, 3/22/00)
- Fannie also does not support Treasury’s proposal to limit or restrict the amount of GSE debt that commercial banks can hold. “It makes sense that banks should be able to hold more of Fannie Mae debt because it’s less volatile and less risky than other types of private issuance,” stated Fannie Spokesman David Jeffers. “There are elements inside of Treasury that have historically objected to the existence of Fannie Mae, purely on philosophical basis and the markets have always known that,” he added. “More importantly, Congress has always known that,” said Jeffers. (*Dow Jones Newswire*, Jerry Guidera, 3/22/00)

Independent Community Bankers write letter to Congress saying they were concerned that Gensler’s remarks about Fannie & Freddie raised costs to consumers

- In a letter to House Banking Committee Chairman Jim Leach (R-IA), the Independent Community Bankers of America stated that they were concerned about Gensler’s comments and noted that “the most damaging aspect of the proposed legislation is the immediately raised costs to consumers.” The letter stated that the costs of taking away the GSEs’ special benefits “would have to be recovered in higher consumer costs for housing.” “The world envies the US housing market and the high level of homeownership. This would not be the case, but for the housing GSEs.” The letter further added the Fannie and Freddie are trying to be the new alternative benchmark to Treasury’s and that the proposed legislation “would force the market to settle for less suitable benchmarks.” (*ICBA Letter to Cong. Leach*, 3/24/00)

Fannie apologizes for comments about Treasury

- **After Treasury released its statement to calm the market, Fannie CFO Howard stated that “this should be reassuring to market participants” and expressed “regret” for “any inappropriate statements regarding Treasury’s testimony made in the course of events during the last two days.”** (*Dow Jones Newswire*, 3/24/00)

Fannie lashes out again at Treasury

- **Only six days after Howard apologized for Fannie's remarks about Treasury, Fannie complained that Gensler's comments destabilized the GSE debt market and raised costs to consumers.** "It's unfortunate and regrettable when statements made by the Treasury have such an immediate and pronounced effect on American consumers," said Fannie Spokesman David Jeffers. He noted that spreads between Fannie's debt and Treasury bonds have now reached their widest point since Gensler's remarks. "Consumers attempting to purchase homes today will pay about ¼ point more in mortgage rates as a result of the Under Secretary's comments, and that means they will pay an extra \$5,800 over the life of an average Fannie Mae 30-year loan," he said. "The rise in mortgage costs caused by Treasury's remarks means that about 206,000 families will be disqualified for home loans," he added. (*Dow Jones Newswire*, Dena Albin, 3/30/00)

Fannie apologizes a second time

- A day after Fannie lashed out again at Treasury, Fannie Spokesman David Jeffers apologized for Fannie's comments about Treasury. **"I regret the comments I made regarding the impact of Treasury's testimony last week,"** who earlier said that **"the rise in mortgage costs caused by Treasury's remarks means about 206,000 families will be disqualified for home loans."** Jeffers added in his apology, **"There are, of course, many factors that affect both the pricing of bonds and mortgage rates. Our analysis of the impact of Treasury's statement on consumers was neither accurate nor appropriate."** (*Dow Jones Newswire*, 3/30/00)

Freddie and the FHFB would like to keep the line of credit to Treasury

- Freddie Spokeswoman Sharon McHale said that Gensler's comments show "an utter contempt for the nation's housing and mortgage markets." They had "an immediate and demonstrable effect" on Freddie's borrowing costs. (*Bloomberg*, 3/23/00) McHale said that the market volatility caused by Gensler's comments cost the company an extra \$65 million in borrowing costs the day after the hearing for a \$5 billion sale of the company's Reference Notes. (*Dow Jones Newswire*, Tyler Lifton, 3/24/00) She believes that the line of credit, though unused, was important to her company. "Perceptions can affect the value of what we do," she said. (*Bloomberg*, Michael McKee and John Rega, 3/22/00) "Freddie Mac's role in the mortgage system works well," she said. "We've never used the line of credit. We never intend to use it. Why risk fiddling with something when it works well?" (*Dow Jones Newswire*, Tyler Lifton, 3/22/00) FHFB Chairman Bruce Morrison said that removal of the GSEs' line of credit would send "the wrong message to purchasers of GSE debt." "The line of credit exists and it contributes to the lower funding costs supplied by capital market pricing of FHLBank System consolidated obligations," he said. "Removal of the line of credit could adversely affect these costs with no reciprocal reduction in government exposure." (*Mortgage-Backed Securities Letter*, Frank Musero, 3/27/00)

Even if Congress removed the GSEs' line of credit from Treasury, the GSEs are still "too big to fail" and may have to be bailed out by Congress

- If the GSEs' line of credit to the Treasury was removed, there still are plenty of ties that bind the GSEs to the government. The sheer size of the GSE market could make it "too big to fail." The GSEs also own or guarantee over 60% of the conventional mortgage market. "If a GSE failed, it would take the banking system with it," says Michael DeStefano, Managing Director at Standard & Poor's. (*Barron's*, Brian Blackstone, 3/27/00)
- **"What probably shouldn't be overlooked in all this is that the Treasury in general and Gensler in particular are arguably on exactly the right track with respect to both the debt**

management game plan and Fannie and Freddie.” (*Dow Jones Newswire*, John Connor, 3/27/00)

Cong. Baker accuses Fannie of using intimidation tactics and “verbal attacks” to keep lawmakers and administration officials from supporting his GSE bill

Fannie’s contention that “the mere mention of GSE reform means turbulence for national mortgage rates, and to a lesser extent by presuming it can intimidate the very government that sponsors its activities, Fannie Mae is itself providing the strongest justification for concern over its size.”

- Cong. Baker issued a statement on April 6 chastising Fannie for its recent “verbal attacks” and intimidation tactics against the Treasury Department, HUD and lawmakers. **“I am asking Fannie Mae to exercise caution before fully committing itself to a course of action and rhetoric that is neither productive nor constructive,”** Cong. Baker stated. **“In attacking” the administration for supporting many of the provisions in his GSE bill, “Fannie Mae chose to risk an implicit attack on the bill’s authors and co-sponsors...all for the sake, I believe, of intimidating others from considering the bill,”** he said.
- Baker noted that in response to Treasury’s testimony in support of certain aspects of his GSE bill, Fannie’s spokesman called the testimony “inept,” “irresponsible,” and “unprofessional.” And weeks earlier, Fannie’s President called HUD’s critical assessment of Fannie’s minority and low-income lending practices “wrong,” and expressed “outrage” at the *Washington Post*, which he accused of “journalistic malpractice” for reporting HUD’s finding.
- **In response to Fannie’s claims that the Treasury Under Secretary’s comments caused mortgage rates to rise and hurt 206,000 families.** “That the spokesman later disavowed this analysis does not diminish a dangerous conclusion implied in the remark, and it is this: What’s good for Fannie Mae’s profits is good for the American people, and vice versa.” **As a point in fact, “Fannie Mae’s profits may have stumbled, but all evidence clearly shows that mortgage rates indeed have not risen since Treasury’s testimony on March 22.”** He further adds that **from the time of his subcommittee hearing on his GSE bill, both 15- and 30-year mortgage rates have actually fallen ...And yet perhaps the episode should spur us to consider just how comfortable we’d feel if the entire housing industry truly did balance on the fate of Fannie’s profits.”**
- **Fannie’s contention that “the mere mention of GSE reform means turbulence for national mortgage rates, and to a lesser extent by presuming it can intimidate the very government that sponsors its activities, Fannie Mae is itself providing the strongest justification for concern over its size.”**
- “It should go without saying that I, along with each of my Republican and Democratic colleagues on the House Banking Committee, will oppose any measure that results in the passing of unnecessary costs on the average American homebuyer.” (*Dow Jones Newswire*, Henry Pulizzi, 4/6/00; *Reuters*, 4/6/00)

Budget Committee Member Cong. Peter Hoekstra (R-MI) calls for a Congressional review of the “disturbing” increase in GSE debt

Cong. Hoekstra asks House Budget Committee Chairman John Kasich (R-OH) for permission to have a budget committee task force examine the issue

He contends that Congress did not understand that reducing the federal debt would lead to the emergence of GSE debt as a substitute for Treasuries. He says the issue needs to be examined because the taxpayer is on the hook if the GSEs default

- In a letter to House Budget Committee Chairman John Kasich (R-OH), Cong. Peter Hoekstra (R-MI) suggested the creation of a budget committee task force to examine the “disturbing” increase in GSE debt. He contends that Congress did not understand that reducing the federal debt would lead to the emergence of GSE debt as a substitute for Treasuries. He says the issue needs to be examined because the taxpayer is on the hook if the GSEs default, and he has asked Cong. Kasich for permission to have a budget committee task force examine the issue. (*National Mortgage News Daily*, 3/29/00)
- In a March 27 “Dear Colleague” letter to Congressional Members entitled “*Government Sponsored Enterprise Debt: A Looming Crisis?*”, Cong. Hoekstra called for a Congressional review of the GSEs’ debt. He noted that the amount of GSE debt outstanding was growing at a “disturbing” rate. “I believe a Congressional review of the burgeoning GSE debt should be an essential part of the next stage of our debt reduction effort,” he said. “Unlike Treasury securities and despite a \$2.25 billion line of credit with the Treasury, the GSEs over-all debt is not explicitly guaranteed by the full faith of the federal government. Regardless of this, the capital markets behave as if it were.” At a minimum, he added that “Congress should examine how and why these so-called private companies, which nonetheless market their securities as ‘agency’ debt, manage their finances, how they issue, what they buy with their debt, and whether their debt securities should be used to replace Treasury debt as the ‘benchmark’ for all interest rates.” Referring to the market volatility caused by Treasury Undersecretary Gary Gensler’s testimony [see earlier story in this *GSE Report*], Cong. Hoekstra said, “Clearly, the GSEs have the ability to affect the market dramatically. And as they are ‘too big to fail,’ the federal government is unlikely to let them go under without stepping in to avert the crisis which could well arise should the GSEs be confronted with a sudden downturn in the economy.” **Cong. Hoekstra said that the GSEs’ “financial practices are not unlike those of the savings and loan industry in the 1980s.”** (*Dow Jones Newswire*, John Connor, 3/27/00; “*Dear Colleague*” Letter by Cong. Hoekstra, 3/27/00)

Senate Banking Committee Chairman Phil Gramm (R-TX) may hold hearings on the GSEs

“The debate is over how much we guarantee Fannie Mae and Freddie Mac,” he said. “That’s something we need to be clear about.”

- Referring to Cong. Richard Baker’s (R-LA) GSE bill, Senator Gramm said it would require more study and will be difficult to accomplish in an election year. He said he wasn’t convinced the bill is the right approach. “We’ve got to know what we’re doing before we go charging off,” said Gramm. **“The debate is over how much we guarantee Fannie Mae and Freddie Mac,” he said. “That’s something we need to be clear about.”** He left open the possibility the Senate Banking Committee may hold hearings this summer after he investigates the issue. “I’m going to sit down

with Federal Home Loan Bank, Fannie Mae, Freddie Mac, talk to them and then basically decide what we want to do,” he said. “I don’t know whether we’ll have a hearing on it or not. We’ve got an awful lot going on.” (*Bloomberg*, 3/28/00)

- *Dow Jones Newswire* reported that Senator Gramm may hold hearings this summer on the GSEs. (*Dow Jones Newswire*, 3/28/00) *Reuters* reported that Senator Gramm said he would hold hearings in mid-year. “There is a lot of evidence that investors think that there is a government guarantee and Chairman Gramm wants to make sure that investors aren’t getting the wrong impression,” a Senate Banking Committee aide said, adding that hearings are in “extraordinarily early planning stages.” (*Reuters*, 3/28/00)

Fannie Mae and Freddie Mac

Citizens Against Government Waste (CAGW) calls Fannie & Freddie “a looming threat to taxpayers that is similar to the savings and loan crisis of the 1980s, but on a much larger scale”

“While the national debt has been decreasing over the past few years, housing GSE debt is skyrocketing”

Fannie & Freddie “portray themselves as private institutions when it suits their needs while implying that they are government-backed to investors.”

Fannie called Treasury Undersecretary Gary Gensler’s support for removing the GSEs’ line of credit to Treasury “irresponsible”

“Far from being irresponsible, the members of the Homeowners Education Coalition (HomeEc), CAGW, National Taxpayers Union, the Competitive Enterprise Institute, Citizens for a Sound Economy, Capitol Watch, and the Small Business Survival Committee, find Mr. Gensler’s comments greatly encouraging”

- In a March 24 letter to Capitol Hill, Thomas Schatz, President of the Citizens Against Government Waste (CAGW) warned that Fannie and Freddie are a “looming threat to taxpayers that is similar to the savings and loan crisis of the 1980s, but on a much larger scale.” Fannie and Freddie “place the American taxpayer at enormous risk... While they are not technically backed by the full faith and credit of the United States, they do enjoy an ‘implied government guarantee,’ much in the same way the savings and loans did when they were bailed out in great excess of the legal obligation of the U.S.”
- Congress has committed to paying down the national debt. “While the national debt has been decreasing over the past few years, housing GSE debt is skyrocketing.” Schatz added that “As housing GSEs flood the debt market, they compete directly with US government-backed securities – driving up the interest rates Treasury must pay to service its guaranteed debt.”
- Schatz noted that Fannie and Freddie “portray themselves as private institutions when it suits their needs while implying that they are government-backed to investors.” In testimony before the House Banking Capital Markets Subcommittee on March 22, Treasury Undersecretary Gary Gensler supported removing the GSEs’ line of credit to the Treasury, noting that it “would be consistent with the congressional requirement that all GSE securities carry a disclaimer that they

are not an obligation of the US government.” Fannie called these comments “irresponsible.” Schatz writes, “Far from being irresponsible, the members of the Homeowners Education Coalition (HomeEc), CAGW, National Taxpayers Union, the Competitive Enterprise Institute, Citizens for a Sound Economy, Capitol Watch, and the Small Business Survival Committee, find Mr. Gensler’s comments greatly encouraging.” (*CAGW Letter to Congress*, 3/24/00)

- CAGW provided similar remarks in a *Washington Post* article. “Revoking this line of credit will help delineate whether Fannie Mae and other GSE debt is a public or private responsibility, said a spokesman for Citizens Against Government Waste. “Fannie is very happy to have this sort of vagueness as to whether they are private or public.” (*Washington Post*, Kathleen Day, 3/24/00)

National Taxpayers Union (NTU) writes editorial for *The Hill* newspaper – “*Fannie and Freddie: Still gnawing on the taxpayers*”

There is a consensus that Fannie & Freddie have enriched themselves and their shareholders at taxpayers’ expense

Congress should “clean house” and make Fannie & Freddie compete openly and fairly in the marketplace

- In a March 29 op-ed in the Capitol Hill newspaper, *The Hill*, Director of Congressional Analysis for the NTU Jeff Dickerson said that Fannie Mae and Freddie Mac are a “nest of subsidies that gnaw on taxpayers and financial services providers alike.”
- Dickerson notes that although Fannie and Freddie are quasi-private firms, they still receive substantial subsidies and benefits from their relationship to the government that allows them to borrow at rates below other private firms because the capital markets believe the federal government will stand behind the companies’ obligations. **“While most observers agree that Fannie and Freddie have been successful in establishing a secondary market for mortgages and mortgage-backed securities, there is also a consensus that the companies have enriched themselves and their shareholders at taxpayers’ expense.”** Fannie and Freddie’s taxpayer subsidy was estimated by the CBO as nearly \$6.5 billion yet **“Despite their mission to assist low-income home buyers, Fannie and Freddie only pass \$1 out of every \$2 in these subsidies to homeowners; the rest goes directly to their bottom line.”** Today, Fannie and Freddie can use their subsidies to undercut private lenders.
- **The secret of Fannie and Freddie’s success – subsidies – “could also prove to be Fannie and Freddie’s undoing. Given their market dominance, Fannie and Freddie may need to pursue increasingly risky loans to maintain a portfolio that has grown at 18 percent per year over the past decade. As governments get set to clean house, Congress should do the same, and let Fannie Mae and Freddie Mac compete openly and fairly in the marketplace.”** (NTU Op-ed, *The Hill*, 3/29/00)

The “tough” new proposed affordable housing goals for Fannie & Freddie may not be that “tough” after all

- Fannie and Freddie like to claim that HUD’s new proposed affordable housing goals will be a “stretch” for the companies to meet. Fannie Chairman Frank Raines has even been quoted as stating that the goals are “like CRA on steroids.” **However, the proposed goals are not nearly as**

tough as they may have seemed when they were announced in March. Critics of Fannie and Freddie say the proposal is favorably crafted for the GSEs and illustrates the undue clout the GSEs have been able to wield when regulators set their social goals. “What you’re seeing is Fannie and Freddie flexing their muscle. They have extraordinary political clout. They have more money than God and they use it,” said affordable housing advocate, Bruce Marks, CEO of the Neighborhood Assistance Corporation.

- Since data from Fannie and Freddie does not become available until a year after the affordable housing rules are finalized, no one outside the regulators knows how close the GSEs are already to the new target goals HUD has proposed. It appears that the GSEs are already well on their way to already meeting the “tough” new goals. An item working in the GSEs favor, is that under the new proposal, the GSEs are able to double count loans for small multifamily properties (5-50 units) toward all three goals and they are able to double count loans for small rental properties (2-4 units) when their purchases in this area pass 60% of their average for the past five year. (*American Banker*, Erick Bergquist, 3/24/00)

Background on HUD’s proposed affordable housing rule

- On March 2, HUD released its proposed affordable housing rule for Fannie and Freddie. 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)

Fannie & Freddie use the excuse of cleaning up predatory lending practices in the subprime market as a reason to expand into new markets – Rather than cleaning up predatory lending practices in the subprime market, the GSEs’ entry into the subprime market would exacerbate the problems

Consumer groups argue that Fannie & Freddie should be barred from buying subprime loans because their purchases could worsen the problems of predatory lending

The GSEs claim they will combat predatory lending, yet Freddie has 70 high-cost mortgage loans in its portfolio

Consumer groups say Freddie’s purchases prove that Fannie & Freddie should be kept out of the subprime market, because their purchases would inevitably spur abusive lending

[Editorial Note: Subprime lending is not predatory lending. There are instances of predatory lending in all segments of the mortgage market – prime and subprime alike. Until now, Fannie Mae has not participated in industry efforts, such as the Mortgage Reform Working Group (MRWG) process. The MRWG was formed to develop proposals to streamline the mortgage process and curb predatory lending practices. Most of the proposals developed in the MRWG process were incorporated in the joint HUD-Fed report to Congress, and those proposals included recommendations to curb predatory lending practices.]

Consumer advocates fear the GSEs will only exacerbate predatory lending problems

- According to an *American Banker* article by Robert Julavits, **consumer activists fear the entry of Fannie and Freddie into the subprime mortgage business and worry that it will worsen the predatory lending problems, rather than cleaning up the industry.** (*American Banker*, 3/27/00)
- Freddie has 70 high-cost, very-high-rate mortgage loans in its portfolio. Freddie claims that it purchased the loans inadvertently when it began to experiment in the subprime mortgage market. Freddie Spokesperson Sharon McHale claims that Freddie didn't want to purchase the loans, they just "slipped through." **The loans Freddie purchased are considered high-cost loans, and therefore subject to restriction under HOEPA. They are "the worst kind of subprime loans," said William Brennan, Director of the Home Defense Program of the Atlanta Legal Aid Society.**
- **Some affordable housing advocates said the purchases prove that Fannie and Freddie should be kept out of the market, because their purchases would inevitably spur abusive lending. "Fannie and Freddie will be giving billions of dollars to companies that abuse and exploit lower-income and minority neighborhoods," warned Brennan. "We are concerned that with GSEs in the subprime market, they will serve to strip wealth, not build it," said Peter Sillern, Executive Director of the Community Reinvestment Association of North Carolina.** David O'Bean, a Professor at Columbia Business School, said that Bear Stearn's responsibilities in a recent Baron case were clear but that Fannie and Freddie preventing predatory lending were more ambiguous. Bear Stearns came under fire for its role as clearing broker for the now bankrupt A.R. Baron & Co. (*American Banker*, Erick Bergquist and Marc Hochstein, 4/3/00)

As an excuse to enter the subprime market, Fannie & Freddie claim they can clean up predatory lending in the subprime market

- Freddie claims that purchasing subprime loans and making the "mortgage market safer" for "borrowers vulnerable to the abusive lending practices that are often linked to the subprime market" is part of its mission. Freddie is advising consumer and industry groups that it will no longer purchase high-fee/high interest-rate loans that are subject to the Home Owners and Equity Protection Act (HOEPA). Freddie Spokeswoman Sharon McHale says that Freddie is trying to address abusive lending practices. Freddie intends to send a letter to seller/servicers telling them they are responsible for fully and accurately reporting credit data on subprime borrowers. Freddie says it will impose penalties on those that don't comply. Freddie also announced a ban on the purchase of mortgages with single-premium credit insurance (life, disability, or unemployment) policies. Freddie believes that this product "has clear predatory potential." (*Freddie Letter to the Editor, American Banker*, 4/6/00; *Freddie press release*, 3/24/00; (*National Mortgage News Daily*, 2/22/00)

Financial regulators are already examining predatory lending practices

- As evidenced by recent developments, federal financial regulators are addressing predatory lending practices. Federal Reserve Board Chairman Alan Greenspan announced on March 22 that an interagency task force has been meeting to address predatory lending. The interagency task force, which consists of the Fed, the FDIC, the OCC, the OTS, the Department of Justice, the Federal Trade Commission, the National Credit Union Administration, and HUD, has been meeting since October 1, 1999. The group hopes to issue a joint statement by year-end that identifies predatory or abusive lending practices.

- When the Fed’s Consumer Advisory Council met on March 30 there was a discussion on the need to define the difference between subprime and predatory lending. FDIC Chairman Donna Tanoue is planning to hold two forums to examine the impact of predatory lenders on communities and financial institutions. On March 30, HUD Secretary Andrew Cuomo announced the formation of a national task force to address predatory lending practices. The task force plans to conduct public hearings on predatory lending in at least four cities, beginning with Baltimore. Community groups, activists, lender and homebuilder trade executives, and big city mayors are all included in the task force. On April 5, the OTS issued an advanced notice of proposed rulemaking asking for comments on regulatory approaches to address predatory lending. The Federal Trade Commission, the Department of Justice and HUD announced a settlement with Delta Funding over predatory lending practices.
- The industry has also been working on proposals to combat predatory lending. The Consumer Mortgage Coalition, a trade association comprised of leading national mortgage lenders and servicers, has been at the forefront of efforts since 1996 for overall mortgage reform that would eliminate abusive lending practices. In a letter to Capitol Hill on March 29, the CMC noted that it participated in the Mortgage Reform Working Group, to develop and advance a comprehensive series of reforms. The proposals advanced by CMC to combat predatory lending practices included provisions to address loan flipping, advance payments, force-placed insurance, collection practices, prepayment penalties, foreclosure reform, repeated abusive practices, counseling, and an advertising and awareness program. The CMC also made these recommendations in formal testimony before the House Banking Committee in October 1998. (*CMC Letter to Capitol Hill, 3/29/00*), In addition, the National Home Equity Mortgage Association adopted fair lending and consumer best practices guidelines aimed at combating predatory lending at their annual meeting in March 2000. NHEMA has also increased its consumer education efforts, proposed additional targeted legislative reforms to address specific abuses where it believes current laws may be inadequate, and called for greater enforcement of the many existing consumer protection laws. (*NHEMA letter to Capitol Hill, 3/29/00*)

Chairman of the House Banking Committee’s Housing Subcommittee Chairman Rick Lazio (R-NY) says he was concerned over the turbulence in the “federally-sponsored” bond market caused by Treasury Undersecretary Gary Gensler’s testimony

- Cong. Rick Lazio said he was “quite concerned about the turbulence in federally-sponsored agency markets that was caused by last week’s testimony of Treasury Undersecretary Gary Gensler before the House Banking Committee.” Cong. Lazio said he would oppose any legislation that would increase costs to homebuyers. He added that Cong. Richard Baker’s (R-LA) GSE bill was “at the beginning” of the legislative process. “It would be premature to pass judgement on a bill that has not yet even passed the most preliminary steps in the legislative process,” he said. He added that he would “oppose any legislation that will result in the passing of unnecessary costs on to the average American home buyer.” (*Dow Jones Newswire, John Connor, 4/3/00; Cong. Lazio press release, 3/31/00*)

Senate Minority Leader Tom Daschle (D-SD) says he has not made a decision regarding whether Fannie needs to be overhauled and whether the Treasury Department should be implicitly backing the GSEs’ debt securities

- According to CSPAN-2, Senate Majority Leader Daschle gave the following response when asked whether Fannie should be overhauled and whether the Treasury Department should be implicitly backing the GSEs' debt:

“...I am not prepared to give you an answer because I---I think that Fannie Mae has done a phenomenal job in this country providing the kind of housing support and the---and the infrastructure that---that this country has relied upon now for almost seventy years. And, you know, the old adage about not---if it ain't broke, don't fix it, makes a lot of sense to me. I do understand Treasury has some---some concerns that---that ought to be addressed and at this point, I don't think, at least many of us, are prepared to come to any conclusion about how we ought to proceed on public policy.” (CSPAN-2, 3/30/00)

Fannie & Freddie continue to increase their purchasing of jumbo loans (loans above the conforming loan limit of \$252,700)

“By financing a large chunk of a \$350,000 mortgage, which might be used to buy a \$400,000 home, the agencies are extending their preferential lending rates to somewhat affluent consumers. That could be evidence that they [GSEs] are expanding beyond their charters”

- Sarah Landis with *Dow Jones Newswire* reported that consumers are increasingly using piggy-back loans for the financing of their homes. The increasing use of piggy-backs raises questions of whether Fannie and Freddie are expanding beyond their chartered missions when they purchase portions of these loans. For example, if a borrower wanted to borrow 90% of the purchase price of a \$300,000 home, the borrower could take a mortgage (first lien) up to the agency conforming loan of \$252,700 and a second mortgage (second lien) for the remainder. Since the first mortgage is under the conforming loan limit, Fannie and Freddie are allowed to purchase the first mortgage. In contrast, a loan for the full amount of \$300,000 could not be purchased by the GSEs.
- Landis writes, “By financing a large chunk of a \$350,000 mortgage, which might be used to buy a \$400,000 home, the agencies are extending their preferential lending rates to somewhat affluent consumers. That could be evidence that they are expanding beyond their charters to help low, moderate and middle income families afford to buy homes.” Fannie and Freddie note that they have been purchasing first mortgages of piggy-back packages for years. “It's always been a part of the market,” said Fannie Vice President of Product Development Frank Demaris. **The GSEs could even invest in million-dollar homes. Landis adds that “there's nothing stopping affluent consumers buying million-dollar homes from making a 75% downpayment and obtaining a \$350,000 agency-guaranteed mortgage.”** (*Dow Jones Newswire*, Sarah Landis, 2/10/00)
- As reported in previous *GSE Reports*, in a speech before the Merrill Lynch Investor Conference in 1999, Fannie's Chairman Franklin Raines stated that Fannie and Freddie are expanding into jumbo loans, since “clever” lenders are breaking jumbo loans into two components and are structuring the jumbo debt amount into a first lien that is below the GSE cap, with the remainder of the loan amount secured by a second mortgage. (*National Mortgage News*, 10/4/99). While Fannie's Chairman told analysts that Fannie found a back door into the jumbo market, Fannie's Vice Chair told the press that Fannie has no intention of entering the market for jumbo mortgages. According to a *Mortgage Servicing News* article by Karen Thomas, Fannie's Vice Chair Jamie Gorelick said that Fannie has no intention of entering the market for jumbo mortgages, but will continue to buy

and securitize mortgages under \$240,000 (the 1999 conforming loan limit), “for the middle class and underserved.” (*Mortgage Servicing News*, November 1999)

Analysts are starting to consider whether Fannie & Freddie’s political risk is increasing

International Strategy and Investment (ISI) analysts report that Fannie & Freddie’s political risks “could be more serious this time” and believe that “GSE reform is the next major financial services issue in Washington”

International investment advisor Richard Medley said that the White House, congressional forces and the Treasury strongly support efforts to reform and downsize the rapidly growing GSEs

Medley noted that a “very senior Washington official” said there is at least a reason to be worried about a failure to address the GSEs’ rapid growth

Medley stated that Treasury is committed to reducing its ties to the GSEs

Salomon Smith Barney analyst says political risk for the GSEs is far off, however, the analyst raises his political risk assessment for Fannie & Freddie

ISI Report

- An International Strategy and Investment (ISI) report by Tom Gallagher and Andy Laperriere, said the political risks for Fannie and Freddie could be more serious this time because: (1) the debt issuance by the GSEs is enormous and growing; and (2) the GSEs now have organized opposition. **“While new legislation has almost no chance of becoming law this year, this issue is not going away. The concerns expressed...by the Treasury Department [Gensler’s March 22 testimony] are shared by an increasing number of policy makers in Washington. Now that Congress has passed the repeal of Glass-Steagall, GSE reform is the next major financial services issue in Washington.”**
- The report, entitled *“Fannie and Freddie Political Risk: This Time It’s Different,”* said that while Cong. Baker’s bill “won’t become law this year, we think some legislation is likely in the next few years – and it could very well include provisions that weaken the implied guarantee.”
- “Heightened political risk poses a major obstacle to Fannie and Freddie’s plans to have agency debt replace dwindling Treasury securities as the benchmark for the bond market...If federal policy toward the GSEs continues to be a live issue – which we believe it will – that makes it less likely investors will adopt agency debt as the benchmark.”
- “Many investors have the view that the politics of reforming the GSEs is heavily weighted on the side of Fannie and Freddie and that they enjoy public support because they have helped lower interest rates for homebuyers. We disagree. GSE policy has never been a retail political issue and few voters even know what Fannie and Freddie do. The politics of restructuring the GSEs has never been tested, but we doubt the politics are one-sided.”
- “It is true that the GSEs will argue that major reforms will have the effect of raising borrowing costs for homebuyers – and that argument might work. On the other hand, critics will argue that taxpayers face the potential of footing the bill for another S&L-sized bailout in order to enrich

wealthy stockholders of private companies that earn billions of dollars. That's not a bad political argument either." (*ISI Morning Political Report*, "Fannie and Freddie Political Risk: This Time It's Different," Tom Gallagher and Andy Laperriere, 3/24/00)

Medley Report

- *Reuters* reported that influential investment advisor Richard Medley said in a report that the **markets should not downplay Treasury's recent statements suggesting a government attempt to eliminate some the GSEs' special advantages. Sources familiar with the report said that the report cited Washington officials saying that the White House, congressional forces and the Treasury strongly support efforts to reform and downsize the rapidly growing GSEs.** (*Reuters*, 3/29/00)
- According to *Reuters*, Medley said officials want to slow the growth of the GSEs to enhance "woefully inadequate capital"; limit or eliminate implicit or explicit public guarantees such as existing credit lines from the Treasury; and cut some issuing and buying power while letting banks increase market share. He cited a government official who said that the government would not want to bail out any of the GSEs if any of them got into trouble. He quoted a "very senior Washington official" saying there is at least a reason to be worried about a failure to address the GSEs' rapid growth. (*Reuters*, 3/29/00)
- Medley believes the Treasury Department is committed to reducing its ties to the GSEs. Traders said that spreads had moved to their widest levels of the past week on word of Medley's report. That report is "adding fuel to the fire. There's no question about that," one dealer said. (*Dow Jones Newswire*, Tyler Lifton, 3/29/00)
- Medley is a former managing director for hedge fund firm Soros Fund Management, and is known for his ability to tap well-placed government and global central bank sources. (*Reuters*, 3/29/00) According to the Medley Global Advisors website, Medley is Chairman of the firm. He was previously the managing director and the chief political advisor for Soros Fund Management. The website notes that Medley served as the Associate Director of the Yale University Center for International Finance from 1995-1998 and in the early 1980s, he was the Chief Economist for the House Banking Committee and Chief Economist for the Senate Democratic Leadership. (www.medleyadvisors.com)

Salomon Smith Barney

- Salomon Smith Barney analyst Tom O'Donnell said that even though Fannie and Freddie's political risk has risen, "the perception of the risk exceeds the reality." He believes that the political risk for Fannie and Freddie is the main fundamental factor causing weaknesses in the GSEs' stock. He believes that any negative political change (such as constraining the GSEs' entrance into new activities, fees imposed on the GSEs, or reduced government support for GSE debt) is years away "should it come at all."
- O'Donnell does, however, raise his current political risk assessment for Fannie and Freddie but notes that there is "an 85% chance or higher that nothing negative will occur" in the next seven years. He states, however, that "Admittedly, political risk is very difficult, if not impossible to measure." (*Dow Jones Newswire*, John Connor, 3/30/00)

As the national debt shrinks, GSE debt skyrockets

Fannie & Freddie want their debt securities to replace Treasurys 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)

GSE debt news:

Although Fannie & Freddie are issuing bonds to take advantage of the shrinking amount of Treasurys, Federal Reserve Chairman Alan Greenspan says that obligations of entirely private firms could serve as the alternative benchmark to Treasurys

Agency debt issuance increases 11% in 1999 to over \$7 trillion

Chicago Board of Trade, Chicago Mercantile Exchange, and Cantor Exchange start trading GSE debt futures - Some market participants expressed concerns that Fannie & Freddie are allowed to trade the contracts, giving them the ability to manipulate trading of these contracts.

Fannie plans changes to its Benchmark bills

Background:

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

GSE Debt news:

Although Fannie & Freddie are issuing bonds to take advantage of the shrinking amount of Treasurys, Federal Reserve Chairman Alan Greenspan says that obligations of entirely private firms could serve as the alternative benchmark to Treasurys

- Responding to a letter by Cong. Spencer Bachus (R-AL), Federal Reserve Chairman Alan Greenspan said that bonds issued by private firms could eventually replace Treasurys as benchmarks for the bond market. He added that this change would not impair the Fed's ability to execute monetary policy. "I am confident that the capital markets would create alternative benchmarks to fill the void left by disappearing Treasury debt," he said. **"Fannie Mae and Freddie Mac already have attempted to take advantage of this situation by issuing so-called 'benchmark' and 'reference' issues, but it is possible that obligations of entirely private firms eventually could serve as benchmarks."**
- He noted in this letter that the Fed may eventually have to ask Congress to make technical amendments to the Federal Reserve Act if the supply of government securities dropped to a point where it became necessary for the Fed to rely on high-grade private securities. "If at some future time it should become apparent that additional authority is desirable, we would request that the Congress make the technical changes in the Federal Reserve Act to permit transactions in a broader range of assets," he said. (*Dow Jones Newswire*, Joseph Rebello, 3/13/00)

Agency debt issuance increases 11% in 1999 to over \$7 trillion

- The Bond Market Association reported that debt issuance by the "agencies" (Fannie, Freddie, the FHLBank System, Sallie Mae, Farm Credit System, and Tennessee Valley Authority) increased 11% last year. Federal agency debt climbed to \$7.074 trillion in 1999 from \$6.348 trillion in 1998. The bulk of the 1999 debt was short-term (more than \$6.5 trillion), a 13% increase. The largest of the agency issuers was the FHLBank System. The FHLBank System's total debt issuance in 1999 was nearly \$3.1 trillion, up 21.2% from \$2.5 trillion in 1998. More than \$2.8 trillion of the 1999 total was short-term debt, much of it overnight debt. Freddie was next with \$1.75 trillion in debt issuance, down 18.6% from \$2 trillion in 1998. Freddie's issuance of short-term debt was down 19.5% last year, dropping to \$1.6 trillion from more than \$2 trillion in 1998. Freddie also reduced long-term debt issuance to \$121 billion from nearly \$126 billion in 1998. Fannie increased its debt issuance 51.3% in 1999 to \$1.27 trillion from about \$843 billion in 1998. Fannie increased its short-term borrowing 63.3% to \$1.1 trillion in 1999 from \$695 billion in 1998. Fannie's long-term debt borrowing was down 5.7% in 1999, compared to \$147 billion in 1998. (*Dow Jones Newswire*, John Connor, 2/29/00)
- In related news, the FHLBank System's Office of Finance is not pleased with the way the Bond Market Association reports the System's short-term debt. The FHLBank System's short-term debt is reportedly the only category with respect to which the Bond Market Association uses its own estimates, rather than numbers supplied directly by the issuer. The FHLBank System would prefer that the gross debt issuance number not be used in the Bond Market Association's reports and that debt outstanding figures, which are far smaller, be used instead. The System feels it is misleading to tally overnight financing as the Bond Market Association does. Others say the short-term debt issuance figures reflect the issuer's presence in the market. "Numbers that include overnight issuance are indicative of the institution's presence in the market and are very valid and significant measures," said Thomas Stanton, a Washington, DC attorney, who has written extensively on the GSEs. (*Dow Jones Newswire*, John Connor, 3/3/00)

Chicago Board of Trade, Chicago Mercantile Exchange, and Cantor Exchange all begin trading futures on GSE debt - Some market participants expressed concerns over the fact that Fannie and Freddie are allowed to trade the contracts. CBOT last month asked the dealer community for its comments concerning the possibility of the GSEs manipulating the trading of these contracts

- In mid-March both the Chicago Board of Trade and the Chicago Mercantile Exchange launched similar versions of futures on GSE debt. Fannie Treasurer Linda Knight and CME President James McNulty rang the bell marking the launch of five- and 10-year agency futures at the CME on March 14. The Chicago Board of Trade followed suit on March 15 with its 10-year contract and plans to begin trading five-year agency futures. To encourage trading at the CBOT, the exchange waived all transaction fees for members and non-members for the agency contracts through the end of the year. Both the CME and CBOT agency futures are sized at \$100,000, listed with quarterly expirations and settled by physical delivery rather than cash. The CBOT's contracts are similar to the Treasury note futures listed at CBOT. In addition to having identical size, expiration, and delivery characteristics, the Treasury and agency futures at the CBOT carry a 6% notional coupon, while the CME agency contracts carry a 6.5% notional coupon. Some market participants expressed concerns over the fact that Fannie and Freddie are allowed to trade the contracts. CBOT last month asked the dealer community for its comments concerning the possibility of the GSEs manipulating the trading of these contracts. An official at Freddie said the company had a vested interest in not having any hint of manipulation in the contracts, while a Fannie official said it was up to the marketplace to decide the parameters of the contracts. (*Dow Jones Newswire*, Tyler Lifton, 3/14/00; *Dow Jones Capital Markets Report*, Tyler Lifton and Debbie Carlson, 3/21/00)
- The Cantor Exchange, a joint venture between eSpeed Inc. and the New York Board of Trade, began trading futures in mid-March on Fannie and Freddie's debt securities. The New York Board of Trade said no fees will be charged for the first six months of Fannie and Freddie's futures trading as an incentive program. The five and 10-year note futures contracts, which have a face value of \$100,000 will list with the standard quarterly expiration dates in March, June, September and December. As another incentive, customers who trade 1,000 to 3,000 futures contracts daily will receive a credit of 50 cents to their account towards trading any Cantor Fitzgerald product, and customers who trade more than 3,000 contracts daily will receive 75 cents credit. (*Dow Jones Newswire*, 3/15/00)

Fannie plans changes to its Benchmark bills

- Fannie is now providing investors the option of cash settlement on the same day for its weekly auctions of three- and six-month Benchmark bills in addition to the regular, or next-day, settlement currently offered by Fannie. Fannie is also reducing the minimum bid size to \$50,000 from \$1 million. "This will make us better able to accommodate a broader range of investors than could previously participate in the auctions," he said. (*Dow Jones Newswire*, 3/27/00)

Moody's Investors Service says Fannie & Freddie's purchases of subprime loans are "clouding the credit outlook for mortgage-backed securities"

- Moody's Investor Service reported that the GSEs' increased purchases of alternative-A loans are "clouding the credit outlook for mortgage-backed securities supported by alt-A loans." Moody's said originators have confirmed that the GSEs increased their alt-A purchases in 1999, but that purchases are made under private agreements on a case-by-case basis. "Because the characteristics of the Alternative-A loans purchased by the GSEs remain undisclosed, as does the volume from specific originators or in the aggregate, it is not possible to ascertain if the GSEs' Alternative-A purchases lie at the top, middle, or bottom of the credit risk spectrum," Moody's said. How the

GSEs' activity will affect alt-A credit quality is "a significant question" for the private-label sector," said the author of the report, Moody's Vice President and Senior Analyst Keith Wofford. (*National Mortgage News commentary by Terry Peters, National Mortgage News Daily, 2/2/00*)

Increased use of Fannie & Freddie's automated underwriting technology limits consumer choice

- Technology advances such as automated underwriting systems allow consumers to get quicker rates and presumably better rates, however, it can make it increasingly difficult for lenders to stand out. Most significant, observers say, that the automated underwriting systems of Fannie and Freddie [which control 95% of the automated underwriting market share] have given large and small lenders across the country essentially the same market in which to sell loans and the same information at the same time about the market. "There's not a lot of difference in what lenders can approve," said Daniel Scheuble, Executive Vice President and Chief Information Officer of HomeSide Lending. "They're [lenders] all sending loans out to one of two of three very large engines [automated underwriting systems] and they're all getting back the same answers." (*American Banker, 3/23/00*)
- The *Wall Street Journal* noted that Fannie's automated underwriting system is hailed by some mortgage lenders because it speeds up the loan process but some critics question whether the software discriminates against minorities. HUD is also conducting a fair lending review of the system. (*Wall Street Journal, 3/24/00*) [See earlier *GSE Reports* for more information on HUD's fair lending investigation of Fannie & Freddie's automated underwriting systems.]

Despite higher interest rates, Fannie & Freddie brought in double-digit earnings in the first quarter

[Editorial Note: Fannie & Freddie claim that any reform of the GSEs would cost consumers money, yet the GSEs only pass along a fraction of their subsidies to consumers. Consumers, rather than shareholders, could benefit from additional cost savings if the GSEs were to pass along more of the benefit of their subsidies.]

- Despite higher interest rates and a politically charged atmosphere, Fannie & Freddie brought in double-digit earnings growth in the first quarter of 2000. Fannie's projected earnings are up 15% while Freddie's are up 16%. (*Dow Jones Newswire, 4/4/00*)
- Fannie and Freddie could pass along more savings to consumers. According to the Congressional Budget Office, Fannie and Freddie's federal subsidies were worth \$6.5 billion in 1995, more than \$2 billion of which the GSEs retained as profit. "As a means of funneling federal subsidies to home buyers, therefore, the GSEs are a spongy conduit – soaking up nearly \$1 for every \$2 delivered." (Congressional Budget Office, "*Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac*," May 1996) Based on the Congressional Budget Office's 1996 study, AEI's Peter Wallison and consultant Bert Ely estimate that Fannie and Freddie's 1999 subsidy from its GSE status is now worth approximately \$10 billion. (See March 10, 2000 *GSE Report* for more details.)

Fannie & Freddie make a series of technology announcements

Microsoft joins forces with Freddie, Chase Manhattan, GMAC-RFC, Norwest Mortgage, and Bank of America to form a new company – HomeAdvisor Technologies Inc.

Fannie makes its MORNETPlus technology network Internet-accessible – Allows lenders to access Fannie’s controversial automated underwriting system through Fannie’s website

Fannie & Freddie enhance their servicing tools

Freddie approves OnePipeline.com (the web-based system of Real Estate Brokers Lending Service) as a seller of its products

Microsoft joins forces with Freddie, Chase Manhattan, GMAC-RFC, Norwest Mortgage, and Bank of America to form a new company – HomeAdvisor Technologies Inc.

- Microsoft is teaming up with Freddie, Chase Manhattan, GMAC-RFC, Norwest Mortgage, and Bank of America. Preliminary information is that the venture will establish a new business-to-business e-commerce platform to automate steps in the homebuying process, such as credit checks, appraisals, and underwriting decisions. The new process is expected to save homebuyers more than \$2,000 over the course of a loan and cut the closing process from more than a month to just 10 days. The HomeAdvisor Technologies will include Tuttle Decision Systems, which Microsoft recently acquired. Tuttle will enable the platform to provide risk-based, lockable loan rates from multiple lenders. The new loan platform will debut on HomeAdvisor.com, Microsoft’s real estate website, sometime in April.
- Microsoft will have a majority stake in HomeAdvisor Technologies; Chase, GMAC-RFC, Norwest and Bank of America will also be taking an equity interest in the new venture, and Freddie has provided significant technology contributions and has a financial interest in the new company. (*Freddie press release, 3/16/00; Real Estate Finance Today, 3/20/00; Wall Street Journal, 3/16/00; Washington Post, 3/16/00*)

Fannie makes its MORNETPlus technology network Internet-accessible – Allows lenders to access Fannie’s controversial automated underwriting system through Fannie’s website

- Fannie announced that it would provide lenders Internet access to its automated underwriting system and other mortgage origination transaction services by placing its MORNETPlus technology network on the web. MORNETPlus on the Web will be accessible through Fannie’s website (fanniemae.com). (*Fannie press release, 3/24/00*) Fannie also announced that it added Caledon Capital’s automated underwriting system, Second Source™ to Fannie’s MORNETPlus network. (*Fannie press release, 3/23/00*) MORNETPlus allows lenders to pay one fee (to Fannie) for access to multiple automated underwriting systems that Fannie approves to be on the MORNETPlus system.

Fannie adds servicing tools to its website

- Fannie announced its new Asset Servicing and Investor Accounting website (<http://www.fanniemae.com/asia>), which will provide servicers with online access to investor-reporting information and instruction on various servicing functions. (*National Mortgage News Daily, 2/18/00*)

Freddie enhances its servicer software

- Freddie released an enhanced version of its predictive models – Version 4.0 of Early Indicator - to assist servicers in managing their collection and loss mitigation efforts that includes models to analyze delinquent subprime loans and government-guaranteed (FHA and VA) loans. Early Indicator helps servicers determine which delinquent loans are most likely to go onto more serious stages of delinquency and pose the greatest risk of loss. Freddie also announced plans to enhance Workout Prospector II, its predictive model to assist servicers in analyzing and delivering workouts and reduce credit losses from defaulted mortgages. (*National Mortgage News Daily*, 2/21/00; *Freddie press release*, 2/17/00)

Freddie approves OnePipeline.com (the web-based system of Real Estate Brokers Lending Service) as a seller of its products

- Freddie approved OnePipeline.com as a seller of Freddie's loan products and services. The approval enables OnePipeline to offer instant online loan approvals, customized rates, and real-time rate locks using Freddie's automated underwriting system, Loan Prospector. OnePipeline.com is the web-based system of Real Estate Brokers Lending Service. (*National Mortgage News Daily*, 3/10/00)

IMX to go public

- IMX Exchange announced an initial public offering of common stock. IMX wants to raise \$57.5 million. The stock is expected to trade in the NASDAQ exchange under stock symbol IMXX. A date for the IPO has not been set. (*Inman News*, 3/9/00; *National Mortgage News Daily*, 3/10/00) As reported in previous *GSE Reports*, IMX has a pilot program with Freddie that allows brokers to receive an automated underwriting decision from Freddie's automated underwriting system, Loan Prospector, before the lender bids and wins the right to originate a mortgage. IMX also announced an alliance that will let brokers with Calyx Software's POINT origination product list their loans on IMX's exchange. With these deals, IMX expects to give 70% of the nation's mortgage brokers, who together represent annual loan volume of \$450 billion, access to the exchange. (*American Banker*, 3/21/00)

Fannie Mae

Fannie announces a pledge to fund \$2 trillion in new mortgages over the next 10 years

Mike House, Executive Director of Fannie/Freddie watchdog group FM Watch, said "it's not a stretch" for Fannie to make \$2 trillion in loans to disadvantaged families as part of its ordinary business. "If it's nothing but their normal course of business, [the announcement] is nothing but a PR gimmick."

- Fannie announced that it will underwrite \$2 trillion of new mortgages during the next 10 years for minorities, young families, woman-headed families, immigrants and others whose homeownership rates lag behind the general population. Fannie did not provide specifics on how they planned to meet that goal or how they counted the numbers. Some critics of Fannie were skeptical of Fannie's announcement and questioned whether the new loans targeted at disadvantaged families are above and beyond what Fannie would have made anyway during the next several years. Mike House, Executive Director of Fannie/Freddie watchdog group FM Watch, said he has been told by lenders that "it's not a stretch" for Fannie to make \$2 trillion in loans to disadvantaged families as part of

its ordinary business. “If it’s nothing but their normal course of business, [the announcement] is nothing but a PR gimmick.” (*Wall Street Journal*, Patrick Barta, 3/16/00)

Fannie appoints Economist Dr. Barbara Ryan as Vice President of Industry Analysis

- Fannie announced the appointment of Dr. Barbara Ryan as Vice President of Industry Analysis in the Corporate Development division. She was most recently Vice President at Capital Economics, which she joined in 1997. From 1994 to 1996, she served as Economic Advisor to the Chairman of the International Trade Commission. (*Fannie press release*, 3/27/00)

Fannie names 27 new members to its 45-member National Advisory Council

The new Chair of the Council is the past President of the National Association of Realtors, Sharon Millett

- Fannie named 27 new members to the company’s National Advisory Council. Members of the Council meet three times a year with Fannie’s senior management to advise the corporation on housing and mortgage finance industry issues and the expansion of homeownership opportunities. The council has 45 members, including mortgage bankers, commercial bankers, thrift industry and investment banking executives, real estate agents, homebuilders, government and community leaders, and housing authority officials. Council members serve two-year terms, with approximately half of the membership rotating off at the end of each year.
- The new chair of the Council is Sharon Millett, the immediate past president of the National Association of Realtors (NAR) and owner of Millett-Potvin Realty.
- The following new members have been appointed to serve until October 2001:
 - (1) **David Bochnowski**, Chairman and CEO of Peoples Bank, SB, a community bank in Munster, Indiana. Currently, Mr. Bochnowski serves as the Vice Chairman of the America’s Community Bankers (ACB) and has served on its Board of Directors since 1994;
 - (2) **Steve Brobeck**, Executive Director of Consumer Federation of America (CFA);
 - (3) **The Honorable Lee P. Brown**, mayor of Houston;
 - (4) **Diana Bull**, broker/owner of RE/MAX Santa Barbara, California. In 1999, Ms. Bull served as president of the California Association of REALTORS, which has more than 100,000 members. She was named California REALTOR of the YEAR for 1999;
 - (5) **Ernest Clark Jr.**, is the 21st president of the National Association of Real Estate Brokers (NAREB); she is President and owner of Seville Real Estate and Lake Merritt Professional Offices in Oakland, CA;
 - (6) **Craig S. Davis**, President, Mortgage Banking & Financial Services groups for Washington Mutual, Inc. He also serves on the national board of directors for the Local Initiative Support Corporation (LISC);
 - (7) **Frank P. Filippis**, Chairman and CEO of Radian Group, Inc., and its principal subsidiary, Radian Guaranty Inc. Mr. Filippis also serves as a director of Impac Mortgage Holdings, Inc., and Impac Commercial Holdings, Inc;
 - (8) **Renée Lewis Glover**, Executive Director of The Housing Authority of the City of Atlanta;
 - (9) **Terry C. Havens**, Chairman and CEO of Reilly Mortgage Capital Corporation;
 - (10) **William J. Inman**, President and CEO of NVR Mortgage Corporation;

- (11) **Louis W. Jennings**, Executive Vice President of Mortgage Operations of Navy Federal Credit Union, the world's largest credit union;
- (12) **Susan C. Keating**, President of Allfirst Financial Inc. in Baltimore, Maryland;
- (13) **Stanford L. Kurland**, President and CEO of Countrywide Home Loans, Inc. He is also senior managing director and chief operating officer of the parent company, Countrywide Credit Industries, Inc. and serves on its Board;
- (14) **Zoila Levis**, President and COO of Doral Financial Corporation, the holding company for HF Mortgage Bankers, Doral Mortgage Corporation, Centro Hipotecario, Sana Investment Mortgage Bankers, Doral Bank and Doral Securities;
- (15) **David B. Lowman**, President and COO of Citicorp Mortgage (CMI), Inc. Previously, Mr. Lowman managed CMI's Origination and Servicing functions;
- (16) **Regina M. Lowrie**, President and CEO of Gateway Funding Diversified Mortgage Services;
- (17) **Richard A. Mendenhall**, realtor/owner of RE/MAX Boone Realty of Columbia, Missouri, a real estate firm specializing in single-family and commercial brokerage. He has been elected as the 2000 president-elect for the National Association of Realtors;
- (18) **Stewart Morris Jr.**, President of Stewart Title Company;
- (19) **James M. Murphy**, Founding Principal and President of New England Realty Resources, Inc. He is currently Vice President of the MBA and is a member of its Commercial Board of Governors and Board of Directors;
- (20) **Jeff L. Plagge**, President and CEO of First National Bank of Waverly, Iowa. In addition, he is chairman and CEO of The First National Bank of Cedar Falls, Iowa. Mr. Plagge serves on the Board of Directors of the America's Community Bankers (ACB), as well as on the Board of Directors of the Iowa Agriculture Finance Corporation;
- (21) **The Honorable Paul Schell**, Mayor of Seattle;
- (22) **A. William Schenck**, Chairman and CEO of Fleet Mortgage Group;
- (23) **Bruce C. Smith**, President of Smith Quality Homes. He is also is first vice president of National Association of Home Builders (NAHB);
- (24) **Donald W. Sowell**, President and CEO of Don Sowell Interests, Inc.;
- (25) **Julia Stasch**, Chief of Staff, Office of Mayor Richard M. Daley of Chicago;
- (26) **Debra M. Warren**, President of First Union Mortgage Corporation; and
- (27) **Lawrence P. Washington**, Senior Executive Vice President of First Nationwide Mortgage Corporation located in Frederick, Maryland. He is currently the chairman of the MBA's Financial Institutions Liaison Committee and is an active member of its Financial Management Committee and the GSE Capital Rule Task Force.

Returning members of the National Advisory Council include:

Emily Annerino, president of LHI Mortgage, Inc.;

Mary Frances Burlison, president of Ebby Halliday Realtors;

Reverend Emanuel Cleaver II, former mayor of Kansas City, MO;

John A. Courson, president and chief executive officer of Central Pacific Mortgage Company;

Timothy R. Eller, chairman and chief executive officer of Centex Homes;

Virginia S. Ferguson, co-owner and broker of Heritage Valley Mortgage, Inc.;

Charles H. Foster, chairman and chief executive officer of Land America Financial Group, Inc.;

Robert I. Gulledge, chairman, president and chief executive officer of Citizens' Bank, Inc.;

Joseph Haskins, Jr., president and chief executive officer of The Harbor Bank of Maryland;

General Robert T. Herres, chairman and chief executive officer of USAA;

R. Scott Jones, president and chief executive officer of Signal Financial Corp.;

Thomas H. Mann, president and chief executive officer of GE Capital Mortgage Corporation;

Alden J. McDonald Jr., president & chief executive officer of Liberty Bank & Trust Company;

Sharon Millett, broker & owner of Millett of Potvin Realty;

Robert L. Mitchell, first vice president of the National Association of Home Builders (NAHB) and chairman and chief executive officer of Mitchell Best Group;

Richard T. Roberts, commissioner of New York City's Department of Housing Preservation and Development;

Richard S. Swanson, president and chief executive officer of Continental Savings Bank; and

James B. Witherow, president and chief executive officer of First Horizon Home Loan Corporation (formally FT Mortgage Companies). (*Fannie press release, 3/27/00*)

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 holds press conference with the Federal Reserve Bank of Cleveland and the OTS. As part of a new initiative with Fannie in the Pittsburgh area, the Federal Reserve Bank of Cleveland will track the initiative, and the OTS will provide education and outreach to OTS-regulated savings institutions and other banks in the target counties about Fannie's initiatives

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."

Fannie says it plans to expand the number of its partnership offices to 60

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). According to a Fannie press release, the company plans to expand the number of partnership offices to 60. (*Fannie press release, 3/15/00*)

Cong. William Coyne (D-PA), Pittsburgh Mayor Tom Murphy, the Federal Reserve Bank of Cleveland, Office of Thrift Supervision, the NAACP, and Countrywide

- Fannie held a press conference with the above named officials and representatives from the Federal Reserve Bank of Cleveland, the OTS, the NAACP, and Countrywide to announce an initiative to assist homebuyers in the African-American communities of Pittsburgh and Allegheny, Westmoreland, Beaver, Fayette, Washington and Butler counties. Under the initiative, Fannie and Countrywide will partner to offer diverse mortgage products. The Federal Reserve Bank of Cleveland – Pittsburgh branch will provide technical support and data analysis, with specific responsibility for devising a tracking mechanism and outcome measurement tools. They will work

in conjunction with other partners to monitor the impact of the initiative's public education and outreach efforts. The NAACP will conduct outreach efforts to African-American communities and will work with faith-based organizations to promote homeownership and provide homebuyer educational and informational sessions. The OTS has pledged to provide education and outreach to OTS-regulated savings institutions and other banks in the target counties about Fannie's initiatives. The OTS will also help in the creation of working relationships among various community groups, bankers, interfaith organizations, private entities, and government agencies and assist with homeownership counseling and education. Merrill Lynch will be responsible for organizing financial seminars and providing financial planning services for attendees. Fannie also announced that it contributed \$1,000 towards funding of a Freedom Corner Memorial in honor of those who fought for social justice during the Civil Rights movement. (*Fannie press release, 3/27/00*)

Senator Barbara Boxer (D-CA)

- Fannie held a press conference with Senator Boxer, the Natural Resources Defense Council, and Countrywide to announce that the Bay Area will have access to Fannie's Location Efficient Mortgage (CM) product. (*Fannie press release, 3/13/00*)

Senator Jeff Bingaman (D-NM) – Fannie makes an equity investment in another housing development

- Fannie held a press conference with representatives from the Santo Domingo tribe, the Enterprise Foundation, the Enterprise Social Investment Corporation, the New Mexico Mortgage Finance Authority, and the Santo Domingo Tribal Housing Authority. Additional partners participating include HUD, the FHLBank of Dallas and the Century Bank. The press conference was held to announce a "ground-breaking" of a new single-family development at the Pueblo in Sandoval County. The residences will be two-, three-, and four-bedroom single-family detached homes, and available to those earning at or below 40% of the area's median income. Fannie made a \$1 million Low-Income Housing Tax Credit equity investment in the project. A statement of support by Sen. Bingaman was included in the press release. (*Fannie press release, 3/24/00*)

Cong. Spencer Bachus (R-AL)

- Fannie announced that it would purchase \$51.9 million of the \$75 million tax-exempt single-family mortgage revenue bond issued by the Alabama Housing Finance Authority. A statement of support by Cong. Bachus was included in the press release. (*Fannie press release, 4/3/00*)

Cong. Bob Barr (R-GA)

- Fannie announced that Cong. Barr was joining the company in hosting a housing forum with lenders, real estate professionals, home builders, nonprofit housing organizations, local Chamber officials and other housing advocates on March 20. (*Fannie press release, 3/15/00*)

Cong. Kay Granger (R-TX)

- Fannie announced mortgage relief provisions for tornado victims in Fort Worth, Arlington, and surrounding areas. A statement of support by Cong. Granger was included in Fannie's press release. (*Fannie press release, 3/29/00*)

Cong. Martin Frost (D-TX)

- Fannie held a press conference with Cong. Frost and the North Central Texas Housing Finance Corporation (HFC) to announce a \$23.75 million mortgage revenue bond agreement between the HFC and Fannie. Fannie purchased the mortgage revenue bond issued by the HFC, 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 4% of the loan amount. (*Fannie press release, 3/17/00*)

Cong. James Clyburn (D-SC) – Fannie makes another investment in a commercial bank

- Fannie announced that as part of its CDFI initiative, the company made a \$100,000 deposit investment in the South Carolina Community Bank, the state's only minority-owned commercial bank. A statement of support by Con. Clyburn was included in Fannie's press release. (*Fannie press release, 3/20/00*)

Congresswoman Louise Slaughter (D-NY)

- Fannie announced that Cong. Slaughter would be joining the company in hosting a Housing 2000 Symposium on March 27 at the Kenneth Key Federal Building. (*Fannie press release, 3/24/00*)

Cong. Bennie Thompson (D-MS)

- Fannie announced that fifty Mississippi school teachers are now homeowners thanks to Fannie and the state of Mississippi through an Employer Assisted Housing (EAH) plan in conjunction with the Mississippi Department of Education and the Mississippi Home Corporation. A statement of support by Cong. Thompson was included in Fannie's press release. (*Fannie press release, 3/20/00*)

Cong. Stephanie Tubbs Jones (D-OH)

- Congresswoman Tubbs Jones held a Community Development Corporation conference in her congressional district on March 20 called "A Day in Washington in Cleveland." The conference will bring federal agencies to her district to meet with area CDCs. Speakers included Stacy Davis, President of the Fannie Mae Foundation. Fannie and Freddie representatives were also there to review mortgage lending programs for low to moderate income persons. (*PR Newswire, 3/7/00*)

Cong. Leonard Boswell (D-IA)

- Fannie announced that Cong. Boswell was joining the company in hosting a housing roundtable with community leaders on April 1. (*Fannie press release, 3/31/00*)

Mayor of Fort Worth, TX Kenneth Barr

- Fannie held a press conference with Fort Worth Mayor Barr and representatives from United Cerebral Palsy and the Texas Home of Your Own Coalition (HOYO) to announce the Tarrant County Home of Your Own Coalition. The Coalition helps individuals with disabilities through homebuyer education, counseling and grants for down payment, closing costs, access modifications, and property repair. (*Fannie press release, 3/9/00*)

DC Council Members

- Fannie held a press conference with DC Council Members Sandy Allen, Charlene Drew Jarvis, Kevin Chavous, and David Catania to announce a Public Benefit Corporation (PBC) Employer Assisted Housing initiative to give employees of DC General and its area clinics the opportunity to receive a grant that will match up to \$2,000 of their own savings to assist with down payment and closing costs. Fannie will purchase the loans originated under the initiative and will also provide a \$5,000 grant to the Housing Counseling Services of Washington, DC to assist in funding homebuyer education and education services for employees. (*Fannie press release, 3/22/00*)

Freddie Mac

Freddie invests in a luxury high-rise apartment building on the shore of Lake Michigan in Chicago

Apartment rents range in price from \$885 to \$3419 per month

Amenities include: (1) panoramic views of the Chicago skyline, Lake Michigan and Grant Park from each of the 600 apartments; (2) indoor swimming pool covered by a skylight and an outdoor sundeck; (3) a full-service fitness center; (4) grocery store with free delivery; (5) dry cleaners; (6) video rental machine; (7) cash station; (8) 24 hour doorman; (9) reserved or valet parking; (10) and central air conditioning included in rent

- Freddie and Glaser Financial Group closed a \$65.4 million bond credit enhancement transaction on the North Harbor Tower, a 55-story, 660-unit Chicago luxury apartment building on the shore of Lake Michigan. Freddie provided substitute credit enhancement for the mortgage underlying the property. The mortgage was originally financed with tax-exempt proceeds from a bond sold by the Illinois Housing Development Authority. (*Freddie press release, 3/1/00*)
- The North Harbor Tower apartment rents range in price from \$885 to \$3419 per month. Amenities include: bay windows provide panoramic views of the Chicago skyline, Lake Michigan, and Grant Park from each of the 600 apartments; full service health club; indoor pool; grocery store with free delivery; cable ready; dry cleaners; storage lockers; video rental machine; cash station; on-site management; 24 hour doorman; 24 hour emergency maintenance; reserved or valet parking; receiving room; central air conditioning included in rent; mini blinds; dishwasher and garbage disposal; bicycle room; 24 hour laundry room; frost free refrigerator (*Fujikawa Johnson and Associates, Inc.; www.mcs.net/~fujikawa/norhar.htm; CAMCO website, www.camcoinc.com/norharbor.html*)

Expanding beyond its mission, Freddie increases its purchasing of subprime loans

Freddie's purchasing of B and C loans increased 370%

- Freddie's purchases of loans in the lower end of the prime market increased 159% in 1999 to \$7 billion. Its purchases of B and C loans increased 370% to \$4 billion. (*American Banker, 3/23/00*)

Freddie approves direct wholesale lender OnLoan.com to issue loans without the customary use of a third-party lender

- OnLoan.com announced that it has been approved by Freddie as a seller/servicer to sell home mortgages and related products and services without the customary use of a third-party lender. OnLoan.com will be able to underwrite its own loans and collect borrowers' mortgage payments directly. OnLoan.com is a direct wholesale lender. (*Inman News, 3/21/00*) OnLoan.com also recently signed an agreement with Greenwich Capital for a \$100 million secured warehouse credit facility. (*Business Wire, 3/22/00*)

Consumer complains about Freddie's controversial HomeSteps program

HUD is currently investigating Freddie's HomeSteps retail mortgage center as a program that potentially expands beyond Freddie's charter

- In a letter-to-the-editor, a homebuyer wrote that she did not agree with a recent article by Lew Sichelman in the *Los Angeles Times*, that Freddie makes an effort to help first-time homebuyers. She wrote the following:

“As a first-time pre-approved moderate-income buyer, I put in an offer on a HomeSteps condo in mid-January before the unit came on the market. All comps and other listing prices in that same complex supported an offer between \$90,000 and \$95,000. I also offered to take the unit ‘as is’ and save Freddie Mac around \$4,000 to bring the unit up to a livable condition. Much to my surprise, Freddie Mac listed the unit an outrageous and unsubstantiated price of almost \$137,000. They never took the time or had the courtesy to respond to my offer. I then sent a certified letter with my supporting sales comps to plead my case. To date, I have not received a reply....I am completely disillusioned with the program.” - Barbara Kaye, Los Angeles (*Letter-to-the-Editor, Los Angeles Times, 2/27/00*)

Freddie increases its dividend to shareholders

- Freddie's Board of Directors raised the company's quarterly dividend from \$.015 per share to \$.017 per share on the corporation's voting common stock. The board also declared the following preferred stock dividends: \$.765625 for its 6.125% stock; \$.7675 for its 6.14% stock; \$.72625 for its 5.81% stock; \$.6475 for its 1998 and 1999 5.1% stock; \$.625 for its 5.0% stock; \$.6625 for its 5.3% stock; \$.72375 for its 5.79% stock; \$.64 for its 1996 and 1998 variable-rate stock; and \$.74625 on its 1999 variable-rate stock. The dividends will be payable on March 31. (*National Mortgage News Daily website, 3/6/00*)

Federal Home Loan Banks

FHLBank System's Mortgage Partnership Finance (MPF) program continues to grow – the program is likely to grow nationwide

MPF program loans increased 146% in the first quarter and master commitments rose 267%

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

ACB's Director of Policy and Economic Research Brian Smith says competition between the MPF program and Fannie & Freddie will help the mortgage lending market.

- An official with America's Community Bankers noted that the FHLBank System's MPF program is likely to grow into a nationwide program as performance rises and more mortgage lenders join the program. “The nation is going to be blanketed with this program or similar programs in the near future,” said Brian Smith, ACB's Director of Policy and Economic Research. “MPF has addressed the needs of [certain lenders]. Now it's a big program,” he added.

FHLBank is a competitor to Fannie & Freddie

- 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). MPF claims that institutions can also boost their profits under the MPF program by not having to pay loan guarantee fees to Fannie and Freddie. Under the MPF program, the FHLBank purchases the mortgage from the lender and assumes the interest rate risk, while the lender retains some credit risk not covered by mortgage insurance and servicing. "It makes a bigger and more liquid market for loans to low-income families," said Alex Pollock, President and CEO of the FHLBank of Chicago.
- According to Smith, the MPF program targets financial institutions that offer high-quality loans, as opposed to the high-quantity loan market that Fannie and Freddie target. "The market niche for the MPF program is the few players who are not getting attention from Freddie Mac and Fannie Mae." Smith said competition between the MPF program and Fannie and Freddie will help the mortgage lending market. "Competition is a good thing. It's like Microsoft and Linux. Freddie Mac and Fannie Mae are the giants who dominate the market."

The MPF program is increasing in popularity

- In related news, the FHLBank of Chicago (sponsor of the MPF program) announced that outstanding loans for the MPF program increased 146% during the first quarter of 2000 to more than \$4.4 billion, up from \$1.8 billion at year-end. MPF master commitments (indicator for future volume) also rose sharply to \$24.2 billion from \$6.6 billion three months ago, an increase of 267%. The MPF program is currently offered by half of the FHLBanks (six) and two more FHLBanks are expected to offer the program shortly. Currently 126 members are approved to fund MPF loans, and an additional 78 are in the process of joining the program. Over 150 more members are in discussions to join. (*BNA Daily Report for Executives*, Kenneth Talley, 2/23/00; *FHLBank of Chicago press release*, 4/3/00)

<p>Treasury Department recommends higher deposit insurance premiums on banks and thrifts with secured borrowings (e.g., advances) from FHLBanks</p>
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- According to *National Mortgage News Daily*, the Treasury Department is calling for higher deposit insurance premiums on banks and thrifts with secured borrowings from FHLBanks. Treasury Assistant Secretary Gregory Baer testified before a House Banking Committee that "We believe the FDIC should have more flexibility to improve the pricing of deposit insurance... Since the FDIC stands in line behind secured creditors in the resolution of a failed bank, the FDIC should be permitted to take account of a bank's secured liabilities in determining premiums. For example, a bank that replaces unsecured borrowing with Federal Home Loan Bank advances or repurchase agreements has effectively moved the FDIC to a lower position in claims on the bank's assets, yet the FDIC has received no compensation for the increased risk." In addition, he recommended that Congress take away the FHLBank's "superlien" on member assets. "We see no reason to continue giving a government sponsored enterprise credit protection unavailable to any other creditor, especially since it could put the FDIC in a worse position." [Treasury Under Secretary Gary Gensler also testified recently that Congress should eliminate the superlien – see earlier story in this *GSE Report*.] (*National Mortgage News Daily*, 2/16/00; *Treasury Assistant Secretary Gregory Baer to House Banking Subcommittee on Financial Institutions and Consumer Credit*, 2/16/00)

FHLBank membership rules eased

Small banks will be able to pledge small business loans and small farm loans as collateral

FHFB left it to the 12 FHLBanks to decide how much small business and farm loans will be discounted

- The FHFB relaxed the membership requirements on small banks with less than \$500 million in assets to become members of a FHLBank. The FHFB approved an interim rule on February 23 that implements provisions of the Gramm-Leach-Bliley Act. Small banks will no longer be required to have 10% of their assets in residential mortgages and will be allowed to pledge new types of collateral – including small business loans and farm loans – in exchange for FHLBank advances. The interim rule also provides for voluntary membership for thrifts starting May 12, and for equal access to FHLBank advances for all members, regardless of their qualified thrift lender status. The rule, technically an “interim final rule,” takes effect immediately, but the FHFB will accept comments on or before April 14, 2000. (*National Mortgage News Daily*, 2/23/00; *American Banker*, 2/24/00; *Federal Register*, pages 13866-13871, 3/15/00) The FHFB also issued a proposed rule on April 3 that amends the election regulation for FHLBank Directors. The FHFB will accept comments until May 3, 2000. (*Federal Register*, pages 17458-17471, 4/3/00)
- The FHFB is leaving it up to the 12 FHLBanks to decide how much small business and farm loans pledged as collateral will be discounted (“hair cuts”). FHFB Chairman Bruce Morrison said he expects the FHLBanks to take a conservative approach in valuing small business and farm loans. In its proposed rule, the FHFB defined what is an eligible small-business or small business loan. Agricultural loans, both farm and agri-business, may have an original value of up to \$500,000 and small business credits may run up to \$1 million. Caps are lifted, however, for loans that meet SBA eligibility requirements. The proposal also eliminates a cap on the amount of non-mortgage collateral that a FHLBank can accept. FHLBanks can currently accept real estate related collateral other than mortgages from their members, but the maximum amount of advances that a member may obtain with such collateral cannot exceed 30% of the member’s capital. The 30% cap would be deleted under the proposed rule. (*American Banker*, 3/23/00; *Dow Jones Newswire*, 3/22/00)

FHFB extends the FHLBank System’s Office of Finance’s authority to issue debt through the end of the year

This is part of a proposed rule to reorganize the Office of Finance so that FHLBanks, instead of the FHFB, have direct responsibility for the issuance of all FHLBank debt, starting January 2, 2001

Part of the reason for the change is to limit the potential liability of the US to lawsuits from irate investors – The FHFB cited the Orange County bankruptcy suit in which the FHFB was sued

Some are concerned that the change could increase borrowing costs and that an investor-suitability provision could leave the System vulnerable to investor lawsuits

Background:

- The Federal Housing Finance Board (FHFB) issued a proposed rule that gives the FHLBanks direct responsibility for the issuance of all FHLBank consolidated debt obligations (COs) starting January 2, 2001. The FHLBanks would continue to be jointly and severally liable for the debt. Under current practices, the FHFB must approve CO issuances by the Office of Finance. The proposal would also allow the office to manage joint obligations of the 12 FHLBanks and the Office of Finance would prepare the combined financial reports of the FHLBanks (*National Mortgage News website*, posted 12/15/99; *National Mortgage News*, 12/20/99; *American Banker*, 12/15/99; *BNA Daily Report for Executives*, Kenneth Talley, 12/15/99; *Federal Register*, 1/4/00, pages 324-338)
- On February 23, the FHFB approved a final rule that extends the System's Office of Finance's authorization to issue COs from April 1, 2000 to December 31, 2000. The current authorization expires March 31, 2000. As it has been in the past, the debt authorization contains no dollar limit on the amount of borrowing that may be conducted on behalf of the FHLBank System. The comment period on the proposal to transfer issuance functions is expected to close soon. (*BNA Daily Report for Executives*, Kenneth Talley, 2/24/00; *Dow Jones Newswire*, John Connor, 2/23/00)

FHFB would like to limit its liability

- The FHFB would like to transfer the issuance functions in an effort to limit the potential liability of the US to lawsuits from irate investors. (*Dow Jones Newswire*, John Connor, 3/10/00) The FHLBank of Cincinnati is concerned that the transfer could increase the potential cost in the system's debt. "Even a small change in investment perception of the credit and legal risks of owning the FHLBank securities could lead to increases in the relative cost of debt versus other federal agencies," warned the Cincinnati bank. The Western League of Savings Institutions said "it would be in no one's interest if these changes were to result in increased borrowing costs." The FHLBank of Dallas supports the transfer so long as it can be done under clear legal authority and with "a high degree of certainty" that will not have a negative impact on the cost of funds. The Dallas bank and several others suggested that the transfer be made through legislation and not regulation. FHFB Chairman Bruce Morrison believes that the board has the legal authority to make the change under regulation and that "the bottom line" was that "it is wrong to have the United States issuing GSE debt." The FHFB was sued by Orange, CA in the wake of its 1994 bankruptcy filing. The lawsuit was settled in 1998 with the payment by Merrill Lynch of an undisclosed sum to the county. The Orange County suit was explicitly cited by the FHFB in proposing the transfer of debt authority. (*Dow Jones Newswire*, John Connor, 3/10/00)

Investor-suitability provision is a concern

- An investor-suitability provision in the proposed rule has also raised concerns that irate investors might sue the FHLBanks. The FHLBank of Topeka said the provision "carries with it potentially dangerous implications for the future." The Topeka Bank said that "although the Orange County litigation was settled before the argument became necessary, it may have been possible for the banks to argue successfully that, as a matter of law, they had no obligation to determine whether the notes at issue there were a suitable investment for Orange County, or for any other investor for that matter." The FHLBank of New York said the FHLBanks "may have been able to argue successfully in the now-settled Orange County litigation that, as a matter of law, they had no liability to determine whether FHLB system structured notes were suitable for Orange County or any other purchaser. By imposing a requirement to implement investor-suitability standards in the proposal, the FHFB may undercut the use of this type of argument in similar cases in the future," said the New York Bank. "At a minimum, the FHFB may want to state expressly that the

suitability requirement doesn't create any private right of action in a third party that wouldn't exist in the absence of the requirement." America's Community Bankers says it is "very concerned" about the provision and that suitability requirements "aren't themselves suitable" to the current conditions of the FHLBank System and wouldn't eliminate the threat of future lawsuits. (*Dow Jones Newswire*, John Connor, 3/15/99)

FHLBank of Atlanta hires former staffer to Senator Chuck Hagel (R-NE) as its top lobbyist

- The FHLBank of Atlanta hired Senator Chuck Hagel's (R-NE) chief banking aide, Brian Smith, as its top lobbyist. Smith helped develop Senator Hagel's FHLBank reform plan, part of which was included in the Gramm-Leach-Bliley Act. The bank has not had a full-time lobbyist before. (*American Banker*, 2/14/00)

Farm Credit System/Farm Credit Banks

Supreme Court declines consideration on whether or not Farm Credit Associations are exempt from state sales and income taxes

American Bankers Association (ABA) Working Group has noted that the relatively favorable tax treatment given to Farm Credit System institutions gives these institutions a competitive advantage over community bankers

[Editorial Note: Fannie & Freddie are also exempt from paying state and local income taxes thereby giving them an unfair advantage over community banks and other financial institutions.]

Fannie Chairman Franklin Raines says if the company had to pay taxes, the cost would have to be passed on to consumers [Editorial Note: If Raines' theory is correct, then all financial institutions should enjoy a "tax holiday" so that consumers could save more money.]

- The Supreme Court declined to consider whether states can impose sales and income taxes on Farm Credit Associations (part of the Farm Credit System). Without comment, on March 27, the Justices left intact an Arkansas Supreme Court ruling (*Arkansas v. Farm Credit Services of Central Arkansas*) that said production credit associations were exempt from state taxes. The courts are split on the issue. A New Mexico state appeals court ruled February 1 that Farm Credit Associations are subject to state income and franchise tax, while the Missouri Supreme Court on January 25th ruled otherwise. Several states reportedly wrote amicus briefs that noted that Congress explicitly exempted farm credit association "notes, debentures and other obligations" from state and federal taxes. However, they argued that the Arkansas Court went too far when it ruled that Congress meant for farm credit associations to be exempt from state income and sales taxes. (*Dow Jones Newswire*, Scott Ritter, 3/27/00)

ABA has stated that the tax exemption gives the Farm Credit System institutions an unfair advantage

- The American Bankers Association's (ABA) Community Bankers Council Working Group for Tax Simplification released a report in January, "*Compliance, Competition and the Community Bank Tax Burden*," that identified heavy regulatory burdens and a lack of tax fairness among banks, credit unions and Farm Credit System institutions. The report noted that the tax code is characterized by disparate treatment among financial service providers and believes that there

should be tax parity between banks, credit unions, and Farm Credit System institutions. The report noted that over the past five years, community banks have paid nearly \$26 billion in state and federal income taxes. On a daily basis, these same community banks must compete against competitors, such as credit unions and the Farm Credit System, which generally do not pay income taxes. **“This relatively favorable tax treatment afforded credit unions and FCS lenders gives these institutions potentially tremendous pricing advantages over community banks.”** The report notes that the FCS’s tax exemption of \$430 million in 1997 translates into 92 basis point pricing advantage on farm real estate loans. The tax exemption allows these institutions to build capital tax-free. **“This enables these institutions to grow faster and to expand their market share at the expense of community banks. There is no justification for the tax-exempt status for credit unions and certain FCS entities while community banks, which must compete in the same markets, are subject to taxation,”** the report stated. (ABA press release, 2/8/00; “Compliance, Competition and the Community Bank Tax Burden – Blueprint for Reform,” ABA, January 2000; *American Banker*, 2/8/00)

Fannie Chairman says consumers would have to pay the cost of taxes

- In an interview with “Fox Morning News” in Washington, DC on March 15, Fannie Chairman Frank Raines was asked why Fannie shouldn’t be paying taxes in the district. The following is Raines’ response: “Well, actually we do. We pay property taxes everywhere that we are but what we don’t pay is income taxes at the local level because what that would mean is that any state could raise our taxes and then have that passed around to every homeowner in the country. Congress decided that wasn’t a good idea but that’s up to Congress to decide if they want to have any state or the district able to levy a tax on mortgaggers around the country.” (*“Fox Morning News” transcript*, 3/15/00)

The new Chairman and CEO of the Farm Credit System is examining alternatives to its controversial (Customer Choice) proposal that would remove geographic boundaries and allow farm credit banks to compete

Farm credit lenders inside and outside the Farm Credit System are concerned about the proposal and bank groups worry that the Farm Credit System would have a bigger advantage over commercial banks in lending to farm customers

- The new Chairman and CEO of the Farm Credit System Michael Reyna is considering alternatives to the System’s controversial Customer Choice proposal, which removes geographic boundaries and allows farm credit system lenders to compete. Reyna replaced Marsha Pyle Martin as CEO after her death in January. Ms. Martin championed the Customer Choice proposal. Reyna said he is also committed to eliminating geographic barriers, but he is not wedded to Customer Choice and has ordered his staff to examine alternatives. “It’s important to the viability of the system that the lines come down,” he said, “but whether it’s accomplished through this proposal or another mechanism...doesn’t matter.”
- Lenders inside and outside the System are concerned about the proposal. Banks are reportedly not willing to compromise and have long accused Farm Credit lenders of using their tax-exempt, GSE status to lowball rates. Bank groups are also worried that the Farm Credit System would get a bigger advantage over commercial banks in lending to farm customers. “Even if he [Reyna] can find some compromise to appease the system, there’s at least one huge group that will still oppose it – us,” said John Blanchfield, Director of the American Bankers Association’s Center for Agricultural and Rural Banking.

- Many of the approximately 200 small Farm Credit lenders are concerned that if the geographic barriers fell, the six largest Farm Credit banks would use their deep pockets to penetrate other markets and cherry-pick the best accounts. Although it is one of the largest lenders in the Farm Credit System, the Farm Credit Bank of Texas, is also one of the most vocal opponents. “We’ll do whatever we must to protect our exclusivity in our states,” said Bill Zimmerman, General Counsel and Senior Vice President at the Farm Credit Bank of Texas. “If that means litigation or some other alternative, then so be it.” Many are hoping that the proposal goes away. During a public comment period last year, the Farm Credit Administration received 228 letters, most of them opposed. Even if Reyna finds a compromise, the Farm Credit Bank of Texas would still be opposed. “We don’t see any way that this proposal could be modified that we’d be satisfied, short of deferring its implementation so far out that it wouldn’t pose an imminent threat,” said Zimmerman. (*American Banker*, Craig Woker, 3/15/00; 2/3/00; *BNA Daily Report for Executives*, Kenneth Talley, 2/300)

Farm Credit Administration extends the comment period on its proposed risk-based capital rule

- The FCA extended its comment period on its proposed risk-based capital requirements for Farmer Mac. Comments are due by June 12, 2000. (*Federal Register*, page 9223, 2/24/00)

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