

The **GSE** REPORT TM

Contents of GSE Report TM

“There was a time when Fannie and Freddie were an essential part of the American dream for many Americans. That day is gone.” - *Washington Business Journal* editorial, April 13-19, 2001

“The Fed is the ultimate regulator of complex financial systems, with a strong and reputable eye toward financial risk. It’s well positioned to help put some brakes on these overgrown entities.” - *The Christian Science Monitor*, editorial, 4/24/01

Major Events

- Warren Buffet says that potential “icebergs” at Fannie & Freddie spurred his firm, Berkshire Hathaway, to sell nearly all of its shares of Fannie & Freddie in 2000 ([p. 5](#))
 - Buffet says he became “uncomfortable” with the risks at Fannie & Freddie
 - In the Berkshire Hathaway annual report, Buffet blasted unnamed companies that make “fancy” earnings predictions. “For a major corporation to predict that its per-share earnings will grow over the long term at, say, 15% annually is to court trouble...I tend to be leery of companies run by CEOs who woo investors with fancy predictions...A few of these managers will prove prophetic – but others will turn out to be congenital optimists, or even charlatans.”
 - *Bloomberg* notes that in May 1999, Fannie’s Chairman Franklin Raines promised investors that the company would double its earnings-per-share over the next five years, or 15% a year
 - Regarding Buffet’s Berkshire Hathaway sale of nearly all of its shares of Fannie last year, Raines states, “I can’t imagine what he [Buffet] was thinking.”
- Community bankers support Cong. Richard Baker’s (R-LA) bill to strengthen regulation of Fannie & Freddie (HR 1409) ([p. 6](#))
 - America’s Community Bankers and eight other community banking associations send a letter in support of the bill
 - The trade groups warn that because the GSEs have “government advantages,” they “have the economic power to drive the private sector out of the market which could, effectively, nationalize the entire credit extension business.”
- Free Congress Foundation announces its membership in HomeEC (a coalition of taxpayer groups that raises questions about the activities and regulation of Fannie & Freddie) ([p. 7](#))
 - Other members of HomeEC include: Citizens Against Government Waste, the National Taxpayers Union, the 60 Plus Association and the Competitive Enterprise Institute
 - Free Congress Foundation urges Congress to rein in Fannie & Freddie
- Senate Banking Committee’s Housing Subcommittee plans May 8 hearing on GSEs ([p. 8](#))
 - Housing Subcommittee Chairman Wayne Allard (R-CO) says the hearing will be a general oversight hearing of the GSEs
 - Senator Allard says the decision on whether the Senate will match Cong. Baker’s proposed GSE bill depends on Senate Banking Committee Chairman Phil Gramm (R-TX)
 - Senator Gramm has not yet taken a position on Cong. Baker’s bill
 - House Financial Services Committee Chairman Michael Oxley (R-OH) says he would like to take a measured approach to the GSE issue
 - A recent report by Medley Global Advisors cites broad consensus between Cong. Baker, Senator Gramm, and Cong. Oxley on the need for further regulation of Fannie & Freddie
- Citizens Against Government Waste tells Congressional Members it is concerned about allegations that Fannie & Freddie threatened financial institutions for criticizing the GSEs ([p. 10](#))
 - Chief Executives of Wells Fargo, American International Group (AIG), and GE Capital were all recently quoted in the *Wall Street Journal* as stating that Fannie & Freddie threatened to withdraw business from the companies for criticizing the GSEs

- CAGW calls for an “examination” of these allegations and holding the GSEs “accountable for their actions”
- “If true, this behavior is completely unacceptable. Any organization chartered by the government and implicitly backed by the taxpayers must be barred from punishing private competitors and those who criticize their activities,” says CAGW President Thomas Schatz
- Federal Reserve Bank of Chicago will discuss GSEs at its annual conference May 9-11 ([p. 11](#))
 - The conference will include the following public policy questions related to GSEs: “Concerning implicit guarantees, how can GSE oversight best be handled? Is bank-like oversight appropriate? What is the extent of the subsidy associated with the current government guarantees? Should the activities of the GSEs be constrained? And finally, do the markets believe a too-big-to-fail policy is still in effect?”
- Shadow Financial Regulatory Committee (independent panel of financial services experts) will hold a May 7 press briefing on the use of explicit guarantees by the GSEs ([p. 13](#))
 - The Shadow group has asked the Administration and Congress to undertake a serious examination of the GSEs
- Freddie buys Tuttle technology from Microsoft’s former subsidiary (HomeAdvisor Technologies) ([p. 14](#))
 - FM Watch says Freddie’s purchase of a “major player” in the electronic marketplace raises “serious questions about who is overseeing the mission of Fannie & Freddie”
 - FM Watch claims Freddie will now be in the business of selling software services, a function for which it was never intended
 - “Consumers will be the biggest losers if the giant GSEs are allowed to acquire companies and drive out competition,” said FM Watch Executive Director Mike House
- Fannie announces “MORNETPlus Connections” – a Web network for lenders to order services such as appraisals, flood certificates, title insurance, and closing and escrow costs ([p. 16](#))
 - Title Appraisal Vendor Management Association raises concerns about the GSEs’ competitive advantage over other vendors for title and appraisal services
 - FM Watch asks regulators to review Fannie’s new program
 - “Once again, the government sponsored enterprises are encroaching into private market functions. And once again FM Watch will call upon the Department of Housing and Urban Development and the Office of Federal Housing Enterprise Oversight to review this latest example of mission creep,” said FM Watch Executive Director Mike House
- *Washington Business Journal* editorial says the “risks posed by Fannie and Freddie now outweigh the benefits...It’s time to let the private sector take over.” ([p. 18](#))
 - Editorial states, “There was a time when Fannie and Freddie were an essential part of the American dream for many Americans. That day is gone.”
 - *Washington Business Journal* also prints a comprehensive article by Eric Winig outlining the growing concerns about the safety and soundness of the GSEs, warning that Fannie & Freddie may have “cracks in their foundation”
 - “Fannie and Freddie were set up to provide a badly needed service to the US financial system. It is ironic that they may wind up becoming its biggest threat.”
 - “If the markets ever were to lose faith in the two organizations...it could set off a panic to get out of their bonds. Because these securities are held in large quantities by all manner of banks and investment firms, this could precipitate a crisis on the scale of the Long-Term Capital Management implosion in the fall of 1998.”
- *Christian Science Monitor* calls for the Fed to regulate the GSEs ([p. 22](#))
 - “When any financial institution gets so big that its collapse could rattle the markets and shake up the economy, it’s time for the Federal Reserve to regulate it.”
 - “Americans will be better off when: Congress and the Treasury make it clear that they will never bail out Fannie Mae and Freddie Mac. The two are regulated by an agency with the money, muscle, and expertise to do the job.”

Fannie Mae and Freddie Mac

- Fannie & Freddie oppose a provision in Cong. Richard Baker’s GSE bill (HR 1409) that would require them to register their securities with the SEC ([p. 23](#))
 - Freddie’s Chairman Leland Brendsel says the proposal lacks a “public benefit”
 - However, the CBO notes that requiring the GSEs to register their securities with the SEC would protect investors “by ensuring full disclosure of uniform financial information” and “would reduce the competitive advantage that the enterprises have over other firms”
 - The CBO notes that originally the GSEs were exempted from registering their securities with the SEC in part to relieve them of the cost of registration until they became accepted names in the market. The CBO states, “That rationale no longer applies: the four exempt GSEs are well known in financial markets”
 - In 1992, the Department of Treasury, the Federal Reserve, and the SEC supported requiring the GSEs to register their securities with the SEC, saying “investors need the same basic financial information about GSEs as they would need from any other company in order to evaluate the merits of an investment”

- Congressman Baker calls for modest reform of Fannie & Freddie ([p. 25](#))
 - Cong. Baker lays out his reasoning for introducing his GSE bill (HR 1409) and warns his fellow Congressional Members that the GSEs pose a potential “systemic risk” to the country and a “local risk” to their constituents
- HUD Secretary Mel Martinez is reviewing Cong. Baker’s bill (HR 1409) to strengthen regulation of Fannie & Freddie but is reluctant to “tinker” with the GSEs ([p. 26](#))
- Senator John Corzine (D-NJ) says he prefers that the Treasury Department regulate Fannie & Freddie ([p. 26](#))
 - Cong. Baker’s bill would abolish Fannie & Freddie’s current safety and soundness regulator (OFHEO) and make the Federal Reserve Board the regulator of Fannie & Freddie
- Fannie & Freddie’s current safety and soundness regulator, OFHEO, defends its ability to regulate the GSEs ([p. 27](#))
 - OFHEO Director Armando Falcon provides his views on Cong. Baker’s GSE bill
- Fannie & Freddie senior officials collect record compensation ([p. 28](#))
 - Freddie’s Senior Vice President in charge of funding and investments “earned just shy of \$13 million in 2000”
 - Freddie’s Chairman earned almost \$8 million in 2000; Fannie’s Chairman earned \$6.09 million
- Fannie & Freddie’s subordinated debt receives a 20% risk weighting from bank regulators – the same risk weighting as Fannie & Freddie’s senior debt ([p. 29](#))
 - The GSEs’ subdebt will now carry a lower risk weight than other comparably rated debt securities, giving the GSEs’ securities a preferential treatment over other private sector securities
 - There was speculation earlier in the year by many participants in the debt market that the subordinated debt would be assigned a 100% risk weighting
- Fannie & Freddie are expanding into HELOCs (Home Equity Lines of Credit) ([p. 30](#))
 - The GSEs are starting to purchase home equity loans in the secondary market that are mainly used to pay off credit card debt or to make home improvements. “Home equity loans do not help families on the cusp of home-ownership get into homes.” (*Citizens Against Government Waste*, Leslie Paige)
- Brian Collins with *National Mortgage News* compares Fannie to a “fat lady who prefers mirrors that make her look thin” ([p. 31](#))
 - Collins notes that Fannie executives claim that Fannie & Freddie control only 10% of the mortgage market. However, “most industry executives just snicker when Fannie Mae executives tout this line. Anyone in the know understands that these two government-sponsored enterprises control about 70% of the conventional conforming market.”
- *Insight Magazine* reports that Fannie & Freddie are in the “hot seat” again ([p. 32](#))
 - Fannie & Freddie are facing legislation in Congress to strengthen their regulation, are facing scrutiny from the FEC for possible illegal campaign contributions, facing allegations that the two GSEs threatened financial services firms for criticizing the GSEs, and facing criticisms that the GSEs are on course to own or guarantee more than half of all residential mortgages in the US “putting taxpayers on the hook for an astronomical bailout should there be a real-estate bust”
- *Wall Street Journal* reports that large lenders are afraid that Fannie & Freddie’s technology “threatens to drive many of them out of home lending” ([p. 33](#))
 - Keith Gumbinger, a market analyst at HSH Associates, warns that the GSEs “could literally wipe out the role of lenders”
- Fannie & Freddie announce record earnings in first quarter ([p. 35](#))
 - Fannie & Freddie increase their holdings of their own MBS in their retained mortgage portfolios to drive up profits
 - The Bush Administration recently noted that Fannie & Freddie “face challenges to sustaining their high rates of profit growth” and noted that Fannie & Freddie have achieved strong profits, primarily by holding increasing amounts of their own MBS in their retained portfolios, which “may imply increased interest rate exposure”
 - CRS and GAO have both testified that Fannie & Freddie’s repurchase of their own MBS does not put people into homes and had more to do with maximizing profits
 - [Editorial Note: Fannie & Freddie’s repurchase and retention of their own MBS does nothing to promote homeownership. It increases the interest rate risk for Fannie & Freddie and increases the concentration of risk by having only two companies hold most of the mortgages on their books. It is the principal way Fannie & Freddie make money, but does nothing for homeownership.]
- As the national debt shrinks, GSE debt skyrockets ([p. 38](#))
 - With the fading supply of Treasuries, Fannie & Freddie are issuing massive amounts of debt in an effort to have GSE debt replace Treasuries as the new benchmark in the bond market

GSE debt news:

 - (1) Federal Reserve Chairman Alan Greenspan says as the supply of Treasuries dwindles, the Fed may start purchasing Ginnie Mae mortgage-backed securities for its administration of monetary policy
 - (2) Bond Market Association survey reports that interest-rate swaps, not GSE debt, may become the leading candidate for the new benchmark alternative to Treasuries
 - (3) International Monetary Fund analysis says it is unclear what will replace Treasuries as “the US dollar safe

haven” – notes that swaps, agency debt, and corporate issues are being used as reference points for the quoting and pricing of new debt issues

(4) Freddie to start buying back its own debt to arbitrage profits – Will Fannie & Freddie issue more debt to fund their debt buybacks?

(5) Central banks increase their holdings of GSE debt – 70 percent of central banks and multilateral institutions own agency securities

- The *American Banker* reports that lenders of all sizes are concerned about the GSEs’ “lower cost of funding” over the private sector which allows them to dominate any market they enter ([p. 43](#))
 - Pete Wissinger, chief executive officer of Wells Fargo Home Mortgage, states that the GSEs’ “funding advantages represent a real threat to many mortgage companies...With their leverage ratios and cost of capital, you’re not on a level playing field with them.”
- Congresswoman Stephanie Tubbs Jones (D-OH) defends Fannie & Freddie ([p. 44](#))

Fannie Mae

- Fannie nominates Donald Marron to its Board of Directors ([p. 44](#))
- *Washington Business Journal* ranks Fannie as the leading business philanthropist in the Washington area, contributing \$20.6 million ([p. 45](#))
 - [Editorial Note: Fannie Mae Foundation’s contribution of \$20.6 million is only a fraction of what Fannie & Freddie would contribute to the Washington community if they were not exempt from state and local corporate income taxes by virtue of their GSE status. The GAO estimated that in 1995, Fannie & Freddie’s exemption from state and local income taxes was worth approximately \$300 million a year.]
- 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. 45](#))
 - Fannie names former staffer to Cong. Richard Baker (R-LA) to head its Louisiana Partnership Office
 - Fannie has 44 Partnership Offices open across the country
 - Financial consultant Bert Ely believes Fannie’s media events raise ethical questions. “This is an extension of not only their lobbying but also their political action committee contributions,” he said. “Everybody knows what they’re doing. It’s something that many of us find offensive, but that’s how they play the political game.”
 - Fannie claims its partnership offices were created “to get away from Washington,” yet *Real Estate Finance Today* reports that during the first eight months of 2000, Fannie held no fewer than 87 media opportunities across the country with Congressional Members

Freddie Mac

- Freddie’s CEO says he has second thoughts about Freddie’s strategic alliances with major mortgage companies ([p. 50](#))
 - Analysts say Freddie would be making a big mistake if it broke these alliances

Federal Home Loan Banks

- FHLBanks are expanding into economic development ([p. 52](#))
- Community banks increase their use of the FHLBanks’ Mortgage Partnership Finance (MPF) program ([p. 52](#))
 - MPF program is becoming a strong competitor to Fannie & Freddie in the secondary market
 - 10 of the 12 FHLBanks now offer the program

Farm Credit Administration/Farm Credit Banks

- Farm Credit System’s income up ([p. 53](#))
- FCA says it will examine non-bank lenders that make loans under the Department of Agriculture’s Business and Industry Guaranteed Loan Program ([p. 53](#))

Major Events

Warren Buffet says that potential “icebergs” at Fannie & Freddie spurred his firm, Berkshire Hathaway, to sell nearly all of its shares of Fannie & Freddie in 2000

Buffet says he became “uncomfortable” with the risks at Fannie & Freddie

In the Berkshire Hathaway annual report, Buffet blasted unnamed companies that make “fancy” earnings predictions. “For a major corporation to predict that its per-share earnings will grow over the long term at, say, 15% annually is to court trouble...I tend to be leery of companies run by CEOs who woo investors with fancy predictions...A few of these managers will prove prophetic – but others will turn out to be congenital optimists, or even charlatans.”

Bloomberg notes that in May 1999, Fannie’s Chairman Franklin Raines promised investors that the company would double its earnings-per-share over the next five years, or 15% a year

Regarding Buffet’s Berkshire Hathaway sale of nearly all of its shares of Fannie last year, Raines states, “I can’t imagine what he [Buffet] was thinking.”

- As reported in the March 16, 2001 *GSE Report*, investor Warren Buffet’s Berkshire Hathaway Inc. sold nearly all of its holdings in Fannie and Freddie last year, according to his annual letter to shareholders. During last year, Berkshire sold nearly all its shares of Freddie, which were worth about \$2.8 billion in 1999. Berkshire now only owns 0.3 percent of Freddie Mac, down from 8.6 percent at the end of 1999. Berkshire also sold an undetermined amount of Fannie Mae. Buffet provided no explanation for the decision to shed the issues in his annual shareholders letter, released in March. (*Dow Jones Newswire*, Richard Gibson, 3/10/01; *Reuters*, Bill Rigby, 3/1//01)
- **Buffet has now shed some light on why his company sold its holdings in the GSEs. Buffet recently told a crowd of about 12,000 at Berkshire’s annual meeting in Omaha that potential “icebergs” in Fannie and Freddie spurred his Berkshire Hathaway to sell shares in the GSEs. Buffet told the participants that he decided to sell the shares after he became “uncomfortable” with the risks at Fannie and Freddie. “We felt the risk profile had changed somewhat, we’re quite sensitive to risk in banks, insurance companies, or government-sponsored entities, there’s so much you don’t know,” said Buffet. “We’re never sure if there’s an iceberg situation or not. We figured we’d never see it until it’s too late.”** (*Washington Post*, 4/30/01)
- Though Buffet did not mention any companies by name in his annual report, he blasted unnamed companies that make “fancy” earnings predictions. “For a major corporation to predict that its per-share earnings will grow over the long term at, say, 15% annually is to court trouble,” he stated in his letter. “I tend to be leery of companies run by CEOs who woo investors with fancy predictions,” he said. “A few of these managers will prove prophetic – but others will turn out to be congenital optimists, or even charlatans.” (*Bloomberg*, Jonas Bergman, 3/14/01)
- In May 1999, Fannie’s Chairman Franklin Raines promised investors that the company would double its earnings-per-share over the next five years, or 15 percent a year. (*Bloomberg News*, 3/14/01) In an October 2000 speech, Raines stated, “We are on track to deliver our second consecutive year of 15 percent operating EPS growth, keeping us on track to meet our goal of doubling EPS by 2003. (*Raines speech before New York Society of Security Analysts*, 10/11/00) In

a press release announcing its fourth quarter 1999 earnings, Freddie's Chairman Leland Brendsel states, "we remain committed to mid-teens earnings growth over the next few years." (*Freddie press release*, 1/18/00)

- **In response to the news that Buffet's Berkshire Hathaway sold "nearly all" of his Fannie shares last year, Fannie Chairman Franklin Raines stated, "I ought to talk to Warren, he must have been having a bad day." He added, "Depending on when he sold it last year, it was a very bad idea if he sold it any time up until the very end of the year, because our stock rose dramatically...Some people are saying Fannie Mae growth will be twice that of the S&P 500 over the next five years. I can't imagine what he was thinking."** (*Bloomberg News*, 3/14/01)

Community bankers support Cong. Richard Baker's (R-LA) bill to strengthen regulation of Fannie & Freddie (HR 1409)

America's Community Bankers and eight other community banking associations send a letter in support of the bill

The trade groups warn that because the GSEs have "government advantages," they "have the economic power to drive the private sector out of the market which could, effectively, nationalize the entire credit extension business."

- America's Community Bankers and eight other community banking associations sent a letter to Congressional Members in support of Cong. Baker's new GSE bill (HR 1409). **The letter states, "We strongly support your objectives to assure adequate safety and soundness regulation of Fannie Mae and Freddie Mac and to define more sharply their missions and the programs and services they may offer to carry out that mission."** The groups pledged that they would work with members of their state delegations "to try to convince them of the importance of HR 1409."
- **The trade groups warn that because the GSEs have "government advantages," they "have the economic power to drive the private sector out of the market which could, effectively, nationalize the entire credit extension business."** The trade groups note, "Only Congress can establish the proper balance in public policy by sharply defining the agencies' mission and authorizing a credible regulator to enforce it. We believe the regulator should be required to consider the impact on efficient private sector competitors as one factor in approving products and programs."
- *Reuters* notes that state groups from Ohio and Texas signed the letter, which may increase pressure on House Financial Services Committee Chairman Michael Oxley (R-OH) and Senate Banking Committee Chairman Phil Gramm (R-TX) to take a close look at Cong. Baker's bill.
- The trade groups signing the letter include: America's Community Bankers; Heartland Community Bankers Association; Community Bankers of Louisiana; Maine Association of Community Banks; Michigan League of Community Banks; Community Bankers Association of New York State; Ohio League of Financial Institutions; Texas Savings and Community Bankers Association; and the Western League of Savings Institutions.

- **ACB's Director of Government Relations Robert Davis notes that the banks represented in the letter lend for mortgages, consumer credit, and small businesses. "When the regulatory structure was set up, no one anticipated a Fannie Mae or Freddie Mac of the size or scope of activities that they engage in today," said Davis. ACB has doubts about Cong. Baker's choice of the Federal Reserve Board to be Fannie and Freddie's new regulator, although the thrift trade group has not come up with an alternative. Mission oversight by HUD has been ineffective, according to the ACB. However, part of the problem is that the GSEs' charters do not delineate between permissible and nonpermissible activities. "The GSEs have been left to their own devices," said Davis. "And there isn't a regulator who is willing to step up and say what needs to be done. That is what the Baker bill is about." ACB would like the new GSE regulator to protect private sector firms from encroachment by Fannie and Freddie. ACB also likes Cong. Baker's bill because it does not change the regulatory structure of the FHLBanks and it does not harm the GSEs. "In many areas, our business success will depend on their continued success and viability," said Davis. (ACB Letter to Congressman Richard Baker, 4/27/01; Reuters, Mark Felsenthal, 4/27/01; National Mortgage News Daily, 4/30/01; National Mortgage News, 5/7/01)**

Free Congress Foundation announces its membership in HomeEC (a coalition of taxpayer groups that raises questions about the activities and regulation of Fannie & Freddie)

Other members of HomeEC include: Citizens Against Government Waste, the National Taxpayers Union, the 60 Plus Association and the Competitive Enterprise Institute

Free Congress Foundation urges Congress to rein in Fannie & Freddie

- **The Free Congress Foundation announced that it has joined the Homeowners' Education Coalition (HomeEC). Other HomeEC members include: Citizens Against Government Waste, the 60 Plus Association, the Competitive Enterprise Institute and the National Taxpayers Union. Founded in 1970 by Paul Weyrich, the Free Congress Foundation is a culturally and economically conservative think tank dedicated to preserving traditional American values. Free Congress doesn't think that Fannie and Freddie, with their tax-free status and implied government guarantees, are good for America. "Fannie Mae and Freddie Mac have continued to exploit their GSE status and pose a significant risk to the American taxpayer," said J. Bradley Jansen of the Free Congress Foundation. "Given our longstanding commitment to privacy, we are particularly concerned that the GSEs have carved out an exemption to the privacy protections contained in the Gramm-Leach-Bliley Act. This loophole is just one of many ways the GSEs receive special treatment and this trend has to stop." Jansen added, "The Free Congress Foundation looks forward to working with HomeEC to increase oversight of the housing GSEs." (Free Congress Foundation press release, 4/17/01; Insight Magazine, Catherine Edwards and Stephanie Taylor, 5/21/01)**

Senate Banking Committee's Housing Subcommittee plans May 8 hearing on GSEs

Housing Subcommittee Chairman Wayne Allard (R-CO) says the hearing will be a general oversight hearing of the GSEs

Senator Allard says the decision on whether the Senate will match Cong. Baker's proposed GSE bill depends on Senate Banking Committee Chairman Phil Gramm (R-TX)

Senator Gramm has not yet taken a position on Cong. Baker's bill

House Financial Services Committee Chairman Michael Oxley (R-OH) says he would like to take a measured approach to the GSE issue

A recent report by Medley Global Advisors cites broad consensus between Cong. Baker, Senator Gramm, and Cong. Oxley on the need for further regulation of Fannie & Freddie

- The Senate Banking Committee's Housing Subcommittee plans to hold a May 8 hearing on the regulation of Fannie and Freddie. Senator Wayne Allard (R-CO) is the Chairman of the Subcommittee. Senator Allard's aide John Carson said the hearing is designed to be a general oversight hearing of Fannie and Freddie's safety and soundness regulator, OFHEO. The hearing also plans to address the voluntary risk management measures that Fannie and Freddie agreed to last year with Congressman Richard Baker (R-LA). "The focus of the hearing will be oversight of OFHEO, safety and soundness of the housing GSEs and discussion of their six voluntary agreements," said Carson. Among those testifying at the hearing are Fannie's Chairman Franklin Raines, Freddie's Chairman Leland Brendsel, and OFHEO Director Armando Falcon. When asked if Senator Allard was considering legislation, Carson replied "no." (*Bloomberg*, 4/17/01)
- An aide to Senator Allard said that Cong. Baker's GSE bill (HR 1409) would not be the focus of the hearing. "It's a general oversight hearing and we just wanted to take a look at everything and see how OFHEO is operating," the aide said. The Senate has not heard testimony on OFHEO oversight since 1996, the aide added. "We view this as a chance to get in and have a look at the issues and get a handle on the environment out there," the aide said. (*Reuters*, 4/19/01)
- In an interview with *Bloomberg*, Senator Allard stated that he was not going into the hearing with "any kind of agenda." He stated, "I think we have to exercise our oversight responsibilities...It's been a long time since there's been an oversight hearing." Neither Fannie nor Freddie has been before the Senate Banking Committee since 1996. "The only reason we're having it [hearing] is, we want to get to know them [Fannie and Freddie]," he stated. Senator Allard noted that he has not yet read Cong. Baker's GSE bill. (*Bloomberg News*, 5/1/01)
- **According to *Reuters*, a decision on whether the Senate will match Cong. Baker's proposed GSE bill depends on Senate Banking Committee Chairman Phil Gramm (R-TX). "I haven't looked at Congressman Baker's piece of legislation and I don't know whether we'll get into any of that or not, but it will depend on the chairman of the banking committee," Senator Allard told *Reuters*.** Senator Allard noted that the Senate's upcoming hearing was mainly a "get-to-know-you" session. "We're going to have a hearing and listen to what they have to say," said Senator Allard. **"How they view their problems, what they're going to do for solutions, hear**

from their regulator, see what kind of problems he views out there and what he may view as the solution and get the committee and myself up to par.” Senator Allard said he had no preconceptions about whether Fannie and Freddie’s size and dominant position in the mortgage markets are a national concern. “I haven’t made up my mind,” he said. “After we’ve had some hearings maybe I’ll have an answer.” He also has not determined whether future hearings will be necessary. (*Reuters*, Mark Felsenthal, 5/1/01)

Senator Gramm has not yet taken a position on Cong. Baker’s bill

- According to *Reuters*, Senator Gramm says he has not taken a position on Cong. Baker’s GSE bill (HR 1409) that would strengthen regulation of Fannie and Freddie. “I’m still deciding where I stand on it,” Senator Gramm told *Reuters*. Peggy Peters, a spokeswoman for House Financial Services Committee Chairman Michael Oxley (R-OH), “doesn’t think the bill is ready to move any time in the near future.” Peterson said Oxley, Gramm, and Baker met about a month ago as part of routine meetings they hold regarding shared areas of jurisdiction. Cong. Oxley feels that work on the bill should now continue to take place at the subcommittee level. (*Reuters English News Service*, 4/24/01)

Cong. Oxley says he would like to take a measured approach to the GSE issue

- Congressman Oxley said he would not hold a full hearing on the GSEs before his committee “in the short term.” Speaking at the annual Bond Market Association meeting, Congressman Oxley said, “Nothing is going to happen in the short term.” He stated that he wanted to be an “honest broker” and take a measured approach to the GSE issue. Congressman Oxley said he recognized the importance of legislation to investors and the “secondary market.” He added that there is “no time frame for a full hearing.” Cong. Oxley told *Reuters*, “This is not one of those slam-bam things.” He added, “We’re going to be working on this very carefully. There are a lot of sensitive issues we’ve got to deal with and a lot of traps you’ve got to run.” Cong. Oxley praised Cong. Baker’s groundwork on the bill, but added that Congressman Baker “has got a long way to go” in the process. (*Reuters English News Service*, 4/26/01; 4/27/01) Cong. Baker’s bill would abolish Fannie & Freddie’s current safety and soundness regulator (OFHEO) and make the Federal Reserve Board the regulator of Fannie & Freddie. “There are those who feel that a different regulator is called for. But the jury is still out on that,” Congressman Oxley told reporters. “A lot will depend on how the Fed feels about taking that responsibility and how the GSEs feel about it as well,” he said. “I want to make certain that if we do this we do it right.” (*Bloomberg News*, 4/27/01)

Medley Global Advisors report cites broad consensus among lawmakers

- According to *Dow Jones Newswire*, a Global Medley Advisors report cites consensus among lawmakers regarding the need for further regulation of Fannie and Freddie. A person familiar with the Medley Report said the report noted that there is increasing political agreement on certain issues including the need to: slow the balance sheet growth of Fannie and Freddie; increase the GSEs’ capital base; end their implicit subsidy; and, bring in the Federal Reserve as their regulator. The report cites broad consensus among Cong. Baker, Senator Gramm, and Cong. Oxley. Medley Global Advisors did not comment on the report.
- Senator Gramm’s spokesperson Christi Harlan said that Senator “Gramm says he’s still praying over (the issue).” While he hasn’t made any decisions regarding regulatory oversight of the GSEs, it is not accurate to suggest that Senator Gramm is in agreement with the other two lawmakers. “He is still considering his options,” she said. A spokeswoman for the House Committee on

Financial Services wasn't available for comment. And Cong. Baker's spokesperson Michael DiResto stated, "Having not seen the report, I doubt that we can confirm or deny anything." (*Dow Jones Newswire*, Tyler Lifton, 4/23/01)

- Richard 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)

Citizens Against Government Waste tells Congressional Members it is concerned about allegations that Fannie & Freddie threatened financial institutions for criticizing the GSEs

Chief executives of Wells Fargo, American International Group (AIG), and GE Capital were all recently quoted in the *Wall Street Journal* as stating that Fannie & Freddie threatened to withdraw business from the companies for criticizing the GSEs

CAGW calls for an "examination" of these allegations and holding the GSEs "accountable for their actions"

"If true, this behavior is completely unacceptable. Any organization chartered by the government and implicitly backed by the taxpayers must be barred from punishing private competitors and those who criticize their activities," says CAGW President Thomas Schatz

- Citizens Against Government Waste sent letters to Congressional Members expressing its concerns about recent reports that Fannie and Freddie have threatened financial institutions for criticizing the GSEs. CAGW President Thomas Schatz notes, "according to recent news accounts, Fannie Mae and Freddie Mac may be using their market dominance to threaten private financial institutions that have criticized their activities. The chief executives of several financial groups that do business with these mortgage giants are on record stating that they have faced threats of retaliation in their business relationships with Fannie Mae and Freddie Mac for questioning the GSEs' market power and expansion efforts." Schatz continues, "It is ludicrous that the Justice Department would waste millions of taxpayer dollars prosecuting Microsoft based on allegations of monopoly power because of their success in the free market, while Fannie Mae and Freddie Mac employ their government-chartered near-monopoly to allegedly threaten private organizations." **Schatz writes, "If true, this behavior is completely unacceptable. Any organization chartered by the government and implicitly backed by the taxpayers must be barred from punishing private competitors and those who criticize their activities."**
- **Schatz concludes, "I look forward to an examination of any inappropriate actions taken by Fannie Mae and Freddie Mac and their being held accountable for their actions."** (*CAGW Letter to Congressional Members*, 3/10/01)

Federal Reserve Bank of Chicago will discuss GSEs at its annual conference May 9-11

The conference will include the following public policy questions related to GSEs: “Concerning implicit guarantees, how can GSE oversight best be handled? Is bank-like oversight appropriate? What is the extent of the subsidy associated with the current government guarantees? Should the activities of the GSEs be constrained? And finally, do the markets believe a too-big-to-fail policy is still in effect?”

- The Federal Reserve Bank of Chicago will be holding its 37th Annual Conference on Bank Structure and Competition on May 9-11 in Chicago. The theme of the conference will be the financial safety net: its role, benefits and costs.
- The Federal Reserve Bank of Chicago notes that “numerous concerns” have been expressed about the appropriate role of the GSEs. A brochure for the conference notes, “For example, Fannie Mae and Freddie Mac have established lines of credit with the US Treasury, and it is widely perceived that their debt is guaranteed by the US government. This gives them a funding advantage in debt markets and in their capital requirements compared with other purely private market participants. The competitive advantages and potential taxpayer liability implied by this arrangement have brought these institutions under close scrutiny by both Congress and the industry. Similar concerns have been raised about the Federal Home Loan Banks (FHLB) as more and more banks join the FHLB System.”
- The brochure for the conference raises the following public policy questions about the GSEs: “Concerning implicit guarantees, how can GSE oversight best be handled? Is bank-like oversight appropriate? What is the extent of the subsidy associated with the current government guarantees? Should be activities of the GSEs be constrained? And finally, do the markets believe a too-big-to-fail policy is still in effect?” The 2001 conference will focus on these and other questions related to the financial safety net.
- According to an agenda, the conference includes the following speakers on the GSE issue:

Thursday, May 10

Panel: The Impact of GSEs on the Underlying Markets

Moderator: Alex Pollock, President and CEO, FHLBank of Chicago

The Simple Microeconomics of Government-Sponsored Enterprises

Wayne Passmore, Board of Governors of the Federal Reserve System
Roger Sparks, Mills College

The Effects of Purchases of Mortgages and Securitization by Government-Sponsored Enterprises on Mortgage Yield Spreads and Volatility

Alden Toevs, First Manhattan Consulting Group
Andy Naranjo, University of Florida

Do Federal Home Loan Bank Membership and Advances Lead to More Bank Risk?

Dusan Stojanovic, Federal Reserve Bank of St. Louis

Mark D. Vaughan, Federal Reserve Bank of St. Louis
Timothy J. Yeager, Federal Reserve Bank of St. Louis

Friday, May 11

Panel: GSEs: The Impact on Mortgage Markets

Moderator: Robert R. Bliss, Federal Reserve Bank of Chicago

The CBO's analysis of the Federal Subsidy to Housing GSEs

Deborah Lucas, Chief Economist, Congressional Budget Office

Marvin Phaup, Deputy Assistant Director, Microeconomic and Financial Studies, Congressional Budget Office

Fannie Mae and the Mortgage Market: Setting the Record Straight

Tim Howard, Executive Vice President and Chief Financial Officer, Fannie Mae

GSEs as Instruments of Federal Policy: Public Benefits and Public Costs

Thomas H. Stanton, John Hopkins University

Costs and Benefits of Mortgage GSEs

James C. Miller, III, Director, Law and Economics Consulting Group

The Structure of Federal Subsidies: Deposit Insurance versus Sponsorship of GSEs

Richard Scott Carnell, Fordham Law School

- The Luncheon Speaker on Friday, May 11 will be OFHEO Director Armando Falcon.
- Federal Reserve Board Chairman Alan Greenspan will be the keynote speaker on May 10. It is not known whether Chairman Greenspan, who has commented on the GSEs previously, will discuss the GSEs during the address. (*Federal Reserve Bank of Chicago brochure and conference agenda for its 37th Annual Conference on May 9-11, 2001*)
- According to *Dow Jones Newswire*, the two economists from the Congressional Budget Office have backed out of the conference because the CBO's report on the GSEs' subsidies has not yet been completed. The CBO was expected to release its report estimating the amount of subsidies that Fannie and Freddie receive. "We can't speak about something that's not finished," said Melissa Merson, CBO's Spokeswoman in explaining why the CBO pulled out of the conference. She said she expected the study to be released later this month. In 1996, the CBO found that Fannie and Freddie receive \$6.5 billion annually in federal benefits and estimated that only \$2.1 billion was passed along to homebuyers. Cong. Richard Baker (R-LA) requested that the CBO update its 1996 study. Earlier this year, Cong. Baker said he believe the subsidy was now in the "\$10 billion-plus range." (*Dow Jones Newswire*, Jennifer Corbett Dooren, 5/2/01)

Shadow Financial Regulatory Committee (independent panel of financial services experts) will hold a May 7 press briefing on the use of explicit guarantees by the GSEs

The Shadow group has asked the Administration and Congress to undertake a serious examination of the GSEs

- The Shadow Financial Regulatory Committee will hold a press briefing and luncheon on May 7 to highlight among other things, “the use of explicit guarantees by the government sponsored enterprises.” (*Shadow Financial Regulatory Committee press release, 4/16/01*)
- As reported in the January 12, 2001 *GSE Report*, the Shadow Committee urged the Administration and the 107th Congress to address a number of important financial and regulatory issues, including a limitation and better targeting of the federal subsidies of GSEs.
- **The Committee stated, “As Federal Reserve Board Chairman Greenspan has pointed out, the GSEs benefit from the implicit backing of the federal government and, in the process, distort the allocation of credit.” The Committee further notes that if any of the GSEs were threatened with insolvency, there would be strong political pressures to bail out the holders of its debt and any securities it guaranteed. The Committee claims that the risk to taxpayers is likely to grow even greater because the amount of GSE debt issued and guaranteed by the GSEs is rising at double-digit rates. “Accordingly, if full privatization is not feasible at this time, the Committee urges the next Administration and the Congress to consider and implement measures that will limit taxpayer risk, while also more carefully targeting the benefits conferred by the GSEs on those who truly need the assistance to purchase homes,” the Committee said.**
- **The Committee further noted that there is a possibility – as pointed out by testimony by the Treasury Department – that unlimited bank investment in the securities of the GSEs might be creating systemic risk.** The Committee recommends gathering further information to evaluate this issue. “Accordingly, two possible initiatives deserving immediate attention are changes to bank call reports that would require banks to disclose their investments in GSE securities and other securities guaranteed by the GSEs and investment limits on securities of both types (analogous to current ‘loan-to-one borrower’ limits for conventional loans) that would keep banks from excessive exposure to such securities and allay any systemic risk such investments might entail.” (*Dow Jones Newswire, Jonathan Nicholson, 12/4/00; Statement of the Shadow Financial Regulatory Committee on “An Open Letter to the New President and Congress on an Agenda for Financial Reform,” Statement No. 166, 12/4/00; National Mortgage News Daily, 12/5/00*)

Members of the Shadow Financial Regulatory Committee include:

George G. Kaufman, Loyola University of Chicago
Robert E. Litan, Brookings Institution
George G. Benston, Emory University
Charles W. Calomiris, AEI and Columbia University
Franklin R. Edwards, Columbia University
Scott E. Harrington, University of South Carolina
Richard J. Herring, University of Pennsylvania

Paul M. Horvitz, University of Houston
Roberta Romana, Yale Law School
Hal S. Scott, Harvard Law School
Kenneth E. Scott, Stanford University
Peter Wallison, AEI

Freddie buys Tuttle technology from Microsoft's former subsidiary (HomeAdvisor Technologies)

FM Watch says Freddie's purchase of a "major player" in the electronic marketplace raises "serious questions about who is overseeing the mission" of Fannie & Freddie

FM Watch claims Freddie will now be in the business of selling software services, a function for which it was never intended

"Consumers will be the big losers if the giant GSEs are allowed to acquire companies and drive out competition," said FM Watch Executive Director Mike House

- Freddie announced that it is purchasing Tuttle Decision Systems from Microsoft's former subsidiary, HomeAdvisor Technologies. Freddie says the acquisition will soon allow Freddie to offer mortgage lenders of all sizes technologies that will enable them to provide on-line mortgage services on their own Web site. No purchase price was disclosed on Freddie's purchase of Tuttle Decision Systems from HomeAdvisor Technologies.
- Freddie claimed that Tuttle Decision Systems' sole business was in the development and distribution of mortgage software for lenders and mortgage investors, and will now operate under Freddie's charter prohibitions.
- Microsoft will sell separately its Tuttle Decision Systems subsidiary, Tuttle Risk Management Services, Inc., which will not be acquired by Freddie. Freddie's Spokeswoman said that Freddie's buying of the risk management unit would have been "inappropriate" for Freddie because it would give the company a glimpse of clients' portfolios. *Real Estate Finance Today* reported that Freddie already holds exclusive licensing rights to Tuttle's risk analysis software, which Freddie helped to develop but HomeAdvisor held ownership of the company. (*National Mortgage News Daily*, 4/19/01; *National Mortgage News*, James Faucett and Scott Kersnar, 4/23/01; *Freddie press release*, 4/19/01; *American Banker*, Erick Bergquist, 4/20/01; *Origination News*, May 2001)

Freddie may be building a front- to back-end loan delivery system

- **With the acquisition of Tuttle Decision Systems, *Real Estate Finance Today* notes that Freddie will have assembled all the assets it needs to build a front- to back-end loan delivery system. "It does seem like they are assembling the pieces for an end-to-end automated platform," said Aaron McPherson, an analyst at IDC, Framingham, MA. "If they had control over the end-to-end process, they would hold enormous market power."**
- *Real Estate Finance Today* notes that the other components of the end-to-end system would include Freddie's relationship with front-end provider LendingTree and a \$1.3 million integration contract agreement with back-end solutions Ultrarise Corp. [Freddie came under criticism for a \$2.5 million loan to LendingTree.com. See March 30, 2001 *GSE Report* for more details.]

Ultraprise is reportedly merging with LoanTrader which when complete, could provide a sizable broker interface. Thus, LendingTree would provide the consumer interface; LoanTrader provides the broker interface; Tuttle adds the risk analysis piece; and Ultraprise's exchange technology ties it all together with Freddie's existing secondary market systems.

- **With the acquisition of Tuttle, according to Peter Wallison a fellow at the American Enterprise Institute, Freddie will have assembled most of the technology it needs to build a system to deliver loans from consumers, through brokers, and into the secondary market.** Wallison notes that the GSEs' charters have "a lot of room for interpretation." He believes at the time Congress wrote the charters, the language was as specific as it could have been. **However, "Congress could not anticipate how technology and the Internet would make it possible to take the banker out of the mortgage process."** (*Real Estate Finance Today*, Chris De Reza, 4/16/01, 4/23/01)

FM Watch says the acquisition raises "significant public policy questions"

- FM Watch says Freddie's acquisition of a "major player in mortgage systems [Tuttle Decision Systems] raises significant public policy concerns." **FM Watch notes that Tuttle Decision Systems provides origination and investor software and that with its acquisition, "Freddie Mac goes into the business of selling software services, a function for which it was never intended."** FM Watch argues that because the GSEs receive special benefits not available to truly private companies, they have taken advantage of their benefits to dominate the secondary mortgage market. **"Now, with Freddie Mac entering the mortgage systems business, that same clout could result in their dominance of the electronic mortgage marketplace."** FM Watch Executive Director Mike House states, **"Consumers will be the big losers if the giant GSEs are allowed to acquire companies and drive out competition."**
- **FM Watch also noted the acquisition raises concerns about the regulation of Fannie and Freddie.** "Freddie's acquisition of a major player in the electronic mortgage marketplace raises serious questions about who is overseeing the mission of the GSEs or if the GSEs alone are able to decide what they can and cannot do," said Mr. House. "For Freddie Mac to engage in the merger and acquisition business without giving its regulator the courtesy of a prior review is a strong indication of the urgent need for a single and effective regulator." FM Watch noted that under the current regulatory structure, HUD is required to review Fannie and Freddie's new programs to see if they meet their charters and ensure that the new ventures are in the public interest. FM Watch notes that "there is no indication that any GSE regulator had a chance to review the program in advance. In contrast, banks must clear their new ventures well ahead of time with their regulators to be sure that no safety-and-soundness or public interest concerns are raised."
- **"Without effective supervision, what's to stop Fannie Mae or Freddie Mac from going out and buying any type of company and then using its taxpayer-granted benefits to shut out competitors,"** House asked. "We have only Freddie's word for it that this acquisition complies with the explicit prohibition on mortgage origination. That's not good enough. Congress should act quickly to create an effective regulator that ensures the GSEs use their benefits solely to support a liquid secondary market for conforming mortgage loans." (*FM Watch press release*, 4/20/01)

Freddie responds to criticisms

- “FM Watch has once again demonstrated that it doesn’t understand our business,” said a Freddie spokesman. “Our business simply is the secondary market and making it better for lenders and their consumer-customers.” (*American Banker*, 4/24/01)
- Pete Maselli, Senior Vice President of business development at Freddie said he anticipated criticisms from FM Watch but added that Freddie’s role is to help consumers, not to protect the business of certain lenders. He called criticism of Freddie “unfortunate” and said it may have a “sinister intent” because the critics appear to be attempting to slow innovation and to protect their market positions. (*American Banker*, Erick Bergquist, 4/20/01)
- A Freddie spokesperson said the company informed regulators about the transaction. An OFHEO spokeswoman said, “We reviewed it and feel it is consistent with safety and soundness.” (*National Mortgage News Daily*, 4/20/01) [Editorial Note: There were no reported comments from Fannie and Freddie’s mission regulator, HUD, on the transaction.]

Fannie announces “MORNETPlus Connections” – a Web network for lenders to order services such as appraisals, flood certificates, title insurance, and closing and escrow costs

Title Appraisal Vendor Management Association raises concerns about the GSEs’ competitive advantage over other vendors for title and appraisal services

FM Watch asks regulators to review Fannie’s new program

“Once again, the government sponsored enterprises are encroaching into private market functions. And once again FM Watch will call upon the Department of Housing and Urban Development and the Office of Federal Housing Enterprise Oversight to review this latest example of mission creep,” said FM Watch Executive Director Mike House

- Fannie announced “MORNETPlus Connections” – an “open platform” that will allow lenders to order and manage appraisal, flood, title, and closing services from a single source. Fannie claims the Web network will give lenders access to over 3,800 service provider and agents – making it the largest network of service providers on the Web. It will also provide Fannie a new earnings stream.
- According to the *American Banker*, Fannie will provide the network through partnerships with RealEC Technologies Inc., which runs a network of real estate and mortgage service providers, and First American Corp., which operates a network of title insurance and real estate companies.
- Fannie said MORNETPlus will let lenders order, service, and manage the ancillary requirements of a mortgage online. J. Harvey Trimble, Jr., managing director of e-solutions at Fannie said the network is a step toward automating the mortgage process. “This is setting up for where we hope to be very soon: A system of paperless mortgages,” he said. Access to the network is currently free for lenders. Fannie receives a portion of the fees that its partners charge the service providers for membership.

- Trimble noted that the network will be usable for any type of loan, not just the conforming products that Fannie can buy. (*American Banker*, Tom Fernandez and Robert Julavits, 4/18/01; *Fannie press release*, 4/18/01)

Title Appraisal Vendor Management Association raises concerns

- **According to *Housing Affairs Letter*, critics and sources for the title-and-appraiser-vendor industry said that Fannie’s network puts government-subsidized Fannie in direct competition with vendors for title and appraisal services. “It’s a competitive business, and they have a significant advantage over everybody else,” said Jeffrey Schurman, Executive Director of the Title Appraisal Vendor Management Association. (*Housing Affairs Letter*, 4/20/01)**

FM Watch criticizes Fannie’s MORNETPlus

- **“Once again, the GSEs are encroaching into primary market functions,” said Mike House, Executive Director of FM Watch. “And once again, FM Watch will call upon HUD and OFHEO to review this latest example of GSE mission creep. If the GSEs were private companies no one would question this new program but they aren’t and Congress never set the GSEs up to use their government advantages and taxpayer subsidies to compete and eliminate private enterprise.”**
- **FM Watch posed a series of questions for the GSEs’ regulators “about this latest example of government – subsidized competition” including:**
 - (1) **“Fannie Mae’s chartered role is to provide funding for conforming mortgages in the secondary mortgage market. Does Fannie Mae have the authority to provide, or even facilitate, vendor management services for the primary market? Did Congress intend for Fannie Mae to charge vendors’ access to their technology and their seller/servicers, choose only certain vendors to be on the system, and thus control the primary market’s access to these vendors?”**
 - (2) **Does every vendor that wants to participate in Fannie Mae’s new program have the opportunity to be included in the system? If not, is a government-sponsored enterprise steering business to preferred firms and penalizing others? Does that meet federal competitive process requirements?**
 - (3) **Why should Fannie Mae be supporting transactions for mortgages that it is not eligible to purchase (nonconforming loans)? Is that outside their charter?**
 - (4) **Using their government advantages and taxpayer subsidies, can’t Fannie Mae or any other GSE for that matter, lower costs for any service currently provided by private enterprise? Will that force private companies already providing these services out of the market? What happens to the consumer when all private companies are gone and only the GSE is left?” (*FM Watch press release*, 4/19/01)**

Fannie’s response to criticisms

- A Fannie spokeswoman said it announced the service as MortgageLinks in December 1997 and that on April 18, 2001 it introduced additional providers and Web access. “It provides an easy link for all lenders that want to use it, from the smallest community thrift to the largest national bank,” the spokesman said. That FM Watch “stumbles on this nearly four years later underscores the

staleness of all their arguments. It's ironic that they are criticizing innovations that lenders want and value," he added. (*American Banker*, 4/20/01)

***Washington Business Journal* editorial says the "risks posed by Fannie and Freddie now outweigh the benefits...It's time to let the private sector take over."**

Editorial states, "There was a time when Fannie and Freddie were an essential part of the American Dream for many Americans. That day is gone."

***Washington Business Journal* also prints a comprehensive article by Eric Winig outlining the growing concerns about the safety and soundness of the GSEs, warning that Fannie & Freddie may have "cracks in the foundation"**

"Fannie and Freddie were set up to provide a badly needed service to the US financial system. It is ironic that they may wind up becoming its biggest threat"

"If the markets ever were to lose faith in the two organizations...it could set off a panic to get out their bonds. Because these securities are held in large quantities by all manner of banks and investment firms, this could precipitate a crisis on the scale of the Long-Term Capital Management implosion in the fall of 1998."

Washington Business Journal editorial

- **The *Washington Business Journal* published an editorial stating that "the risks posed by Fannie and Freddie now outweigh the benefits."** In the *Journal's* view, Fannie and Freddie "have served a noble cause...making home ownership an option for those who wouldn't otherwise be able to afford it," however, **"It's time to let the private sector take over."**
- The *Journal* notes that the two GSEs have grown tremendously, while "their mission has become blurred." The *Journal* writes, "No longer are they simply focused on providing home ownership opportunities, they've succumbed to the pressures of Wall Street. Along the way, they've turned to building market share and profits by venturing into high-risk areas such as subprime and home-equity loans."
- **"They're not prepared to handle it if the whole thing comes crashing down. Because for every \$10,000 in Fannie Mae's \$1.3 trillion book of business, it has reserved only \$6 to cover losses," warns the *Journal*. "That scares us, and it should scare you, too. The S&L bailout is only a decade old. How quickly we forget."**
- **"The risks of allowing Fannie and Freddie to continue to operate as they have for decades far outweigh the benefits these days. What the two provide can easily be absorbed by the private sector. That would spread the risk around and remove the implication that if the cards come tumbling down, the federal government will step in and bail out the system. It would return the American mortgage market to the private sector where it belongs."**
- The *Journal* supports privatization of the GSEs and does not believe that more regulation is the answer.

- **The *Journal* concludes, “There was a time when Fannie and Freddie were an essential part of the American dream for many Americans. That day is gone.”** (*Washington Business Journal*, April 13-19, 2001)

Washington Business Journal reports on the growing criticism of Fannie & Freddie

- A recent comprehensive article in the *Washington Business Journal* by Eric Winig outlines the growing concerns about the safety and soundness of the GSEs. **Winig notes that “a growing contingent of critics – from scholars at the conservative American Enterprise Institute to überliberal Ralph Nader – contends that Fannie Mae and its sister organization, Freddie Mac, have outgrown their usefulness. They charge that the government subsidies these government-sponsored enterprises (GSEs) receive – estimated by the Congressional Budget Office at \$6.5 billion a year – often wind up not in the pockets of prospective home buyers, but in the coffers of Fannie, Freddie and their shareholders...More ominously, some say the two housing GSEs have grown so large and taken on so much risk that they pose a systemic risk to the entire US economy, akin to the savings and loan debacle of a decade ago.”**
- Winig notes that the GSEs are increasingly turning to riskier areas of the market such as subprime and home-equity loans in order to maintain their high growth rates, which critics charge, “increases the odds of a costly taxpayer bailout.” The controversy over the GSEs has attracted the attention of Cong. Richard Baker (R-LA) who introduced legislation that would strengthen regulation of Fannie and Freddie. Fannie and Freddie executives have vowed to fight Cong. Baker’s bill and state that critics’ claims are merely “alarmist and inaccurate” and that they run two of the safest institutions in the nation.

GSEs are creating a “real estate bubble of historic proportions” that threatens to collapse the GSEs

- **Long-time GSE critic, Doug Noland, an analyst at David Tice & Associates, warns, “these institutions will collapse.” Noland says Fannie and Freddie have increasingly been the “buyer of last resort” for the financial market and have grown so large and so unwieldy that a large-scale bailout is unavoidable.** Their aggressive lending has created a real estate bubble of historic proportions as consumers have leveraged themselves at the highest levels in history on the assumption that home prices will continue to rise. However, Winig notes, “the harrowing tale of the Nasdaq has shown [that] bubbles don’t last forever. When this one finally bursts, Noland says, we will have ‘one hell of a mess’ on our hands.”
- Noland notes that the GSEs have increased their holdings of financial assets by \$870 billion in the past three years and that Fannie has a total book of business of over \$1.3 trillion, with only \$809 million reserved as an “allowance for losses.” Winig notes that this equals \$6 held in reserve for every \$10,000 exposed.

Are the GSEs’ a looming bailout?

- **Winig notes that critics fear another bailout may be necessary should the GSEs fail.** Critics from various independent think tanks such as the American Enterprise Institute, CATO Institute, the Heritage Foundation, and the Competitive Enterprise Institute have published papers that question the current regulatory system. Winig notes that the problem stems from the market’s view that the US government implicitly backs the GSEs because of their link to the Treasury Department through a \$2.5 billion line of credit. This perceived link accounts for the GSEs’ ability to borrow money at roughly the same rate as the Treasury, and at much lower rates than any other large company. **Winig adds, “If the markets ever were to lose faith in the two organizations,**

however, it could set off a panic to get out their bonds. Because these securities are held in large quantities by all manner of banks and investment firms, this could precipitate a crisis on the scale of the Long-Term Capital Management implosion in the fall of 1998.”

- Winig notes that although the federal government did not bail out the LTCM, the Federal Reserve Bank of New York helped organize a \$3.65 billion, 14-bank bailout. And even at its peak, the LTCM fund only controlled contracts worth \$160 billion – small potatoes compared with the GSEs \$1.7 trillion in outstanding debt. **Winig adds, “a similar event involving the GSEs could cause markets to freeze up and essentially stop functioning. Huge financial institutions would almost certainly face insolvency, they would be forced to mark down bonds they previously had considered to be virtually risk-free. Were such an event to occur, it is almost unthinkable that the federal government would let Fannie and Freddie fail, as it could endanger the entire global financial architecture. The government in fact has a history – with LTCM being just the latest example - -of bailing out institutions considered ‘too big to fail.’”**
- Wining notes that Fannie and Freddie’s \$2.5 billion line of credit with the government encourages them to be unusually risky with their investments. This risk benefits the shareholders and executives of the GSEs because it leads to higher profits, but also greater possibility of collapse. One way that GSE executives and sympathizers try to deny risk is to point to stress test results that have shown that the GSEs do not pose a risk. Winig notes that both Fannie and Freddie have developed stress test models that model the impact of a 5 percent decline in housing prices nationwide, and both claim to be financially sound should such a decline occur. However, Winig notes, “tests are, by design, based on past experience and have no way of predicting what stresses might occur in the future.” For example, LTCM had “incredibly complex” models that were developed by several Nobel laureates that showed the firm would never lose more than \$35 million in one day. Of course on August 21, 1998, the firm lost \$533 million. **“The problem is that markets, especially under very stressful conditions, often fail to act in the smooth, continuous manner predicted by computer models.”**

Is there a need for the GSEs?

- Fannie and Freddie have come under attack by various groups, including that National Association for Business Economics, a group of more than 3000 individuals representing over 1500 businesses. A NABE study found that 60 percent of the group’s members feel there are risks associated with the GSEs’ subsidies. In addition, 28 percent said there was a need to prevent the GSEs from entering into new markets such as home equity and subprime lending. Others doubt the need for the GSEs. **CEI President Fred Smith is quoted as stating, “There is absolutely no reason for them to exist.” Peter Wallison of AEI notes that Fannie and Freddie served their mission so well that there is no longer a need for them in the secondary market—many other private companies have “mastered the art of securitization.”**
- Fannie and Freddie claim that their presence stabilizes the market. Fannie’s CEO Franklin Raines states, “We [take] what we call unruly cash flows from consumers and turn them into more predictable cash flows for investors...So far there’s no evidence of a Wall Street mechanism that can do that...In other countries they don’t have that, and that’s why they don’t have 30-year, fixed rate mortgages.” However, Winig notes that there are other markets, such as the US jumbo market where Fannie and Freddie do not participate, where consumers can still obtain 30-year fixed rate mortgages. Raines conceded that point to Winig, but added that his company lowers rates by 100-

125 basis points. Winig then notes, “It is possible that Fannie and Freddie, because of their ability to borrow money at below-market rates, do indeed serve to lower mortgage rates. But the question becomes: Is this an effective use of taxpayer money?”

- **Some, such as Wallison of the AEI, say no. The GSEs subsidies are capitalized into the price of the house, benefiting developers and builders. If true, notes Winig, taxpayer’s money is being used to raise home prices. And while borrowers may get a lower mortgage rate, they make up for that by paying more for their homes. A Federal Reserve staffer is quoted as stating, “If the intent is to subsidize homeowners...this is truly a roundabout way to do it.”** Other groups claim that the GSEs have helped create a real estate bubble that would “dwarf the recently ended Nasdaq mania.” Some says that the GSEs are actually creating money. Noland claims that the GSEs help to create money by borrowing from the money markets, which are willing to give almost unlimitedly to the GSEs. The GSEs use this money to purchase more mortgages and MBS from banks, who then get the cash off their books by making new loans. Once that money is lent – new money is in the system. “Fannie and Freddie have the ability to print money,” says Michael Shamosh, Senior Fixed Income Strategist with Tucker Anthony. Shamosh says all this extra cash creates distortions in the market. Fannie and Freddie strongly deny this.
- **Winig notes that “perhaps the most troubling aspect of Fannie and Freddie has to do with their belief that they can take a risky asset—mortgage debt and turn it into a virtually risk-free one – GSE debt.” Although many have tried to turn risk assets into nonrisky assets, “none has had a happy ending” (e.g., Long Term Capital Management).** Winig adds that Fannie and Freddie claim that investors buy their debt because they are so well managed and are a good investment opportunity. Others say investors are merely counting on the GSEs’ implied guarantee. In order to address this issue, the GSEs recently began issuing subordinated debt. While the government does not officially back both the GSEs’ sub debt and senior debt, Standard & Poor’s recently gave Fannie Mae’s sub debt an AA- rating, which is “extremely high.” And while S&P did not assume that Fannie’s sub debt would be backed by the government, it “operated under the assumption that all of Fannie’s other advantages would stay in place.”

Reform options for the GSEs

- Winig concludes by listing three reform options for the GSEs. **The first, promoted by the GSEs themselves, is to do nothing. The second option is to privatize the two companies, cutting all ties to the government such as the GSEs’ line of credit.** A version of this plan involves splitting the GSEs into smaller companies, much like the breakup of AT&T in the 1980s or the proposed split up of Microsoft. **However, Winig concludes that the third option is the most likely: Fannie and Freddie will continue operations, but under a strengthened regulatory structure.** Winig notes that Cong. Baker’s proposed legislation would shift GSE regulation to the Federal Reserve. Some feel the Fed would be a stronger, less politicized, and therefore more effective, regulator. **Winig concludes, “Whatever the verdict, it is important for people to understand the current debate. Fannie and Freddie were set up to provide a badly needed service to the US financial system. It is ironic that they may wind up becoming its biggest threat.”**
(*Washington Business Journal*, Eric Winig, April 13-19, 2001)

Christian Science Monitor calls for the Fed to regulate the GSEs

“When any financial institution gets so big that its collapse could rattle the markets and shake up the economy, it’s time for the Federal Reserve to regulate it.”

“Americans will be better off when:

- **Congress and the Treasury make it clear that they will never bail out Fannie Mae and Freddie Mac.**
- **The two are regulated by an agency with the money, muscle and expertise to do the job.”**

- A recent editorial in the *Christian Science Monitor* calls for stronger regulation of the GSEs. The *Monitor* notes, **“When any financial institution gets so big that its collapse could rattle the markets and shake up the economy, it’s time for the Federal Reserve to regulate it.”**
- The *Monitor* adds that this is the reasoning behind Cong. Baker’s GSE bill (HR 1409) that would shift regulation of the GSEs to the Fed. The *Monitor* notes that currently Fannie and Freddie are regulated by an office within HUD (OFHEO) that “was fine a decade ago” when Fannie and Freddie “were much smaller.” Since then, however, Fannie and Freddie “have become the largest financing source for home mortgages” and Fannie and Freddie’s debt levels have risen 24 percent per year in the past three to four years. The *Monitor* adds, **“At that pace, their debt will overtake the federal debt in 2005, and reach a whopping \$2.7 trillion.”**
- The *Monitor* warns, “while these two companies are not fully backed by the US Treasury, the financial markets apparently perceive that they are. The ‘implied’ guarantee is what’s understood to be a mostly symbolic line of credit.” The GSEs also receive other perks such as exemption from state and local income taxes, exemption from registering their securities with the SEC, and a \$2.25 billion line of credit from the US Treasury.
- **The *Monitor* notes that “Americans will be better off when:**
 - **Congress and the Treasury make it clear that they will never bail out Fannie Mae and Freddie Mac.**
 - **The two are regulated by an agency with the money, muscle and expertise to do the job.**
- The *Monitor* adds that Cong. Baker’s bill does not call for an outright repeal of the GSEs’ line of credit, but does call for a study on the matter. Last year the Clinton Treasury Department testified before Congress that it supported removing the line of credit. The bond markets were shaken by this news – which is “perhaps a sign that investors might be nervous about the government-backed safety of Fannie and Freddie.” Certainly, “the two giants have been criticized for using the suggestion of possible market instability as a convenient tool to keep more-powerful regulatory fingers off them.”
- **The *Monitor* concludes, “The Fed is the ultimate regulator of complex financial systems, with a strong and reputable eye toward financial risk. It’s well positioned to help put some brakes on these overgrown entities.”** (*The Christian Science Monitor*, editorial, 4/24/01)

Fannie Mae and Freddie Mac

Fannie & Freddie oppose a provision in Cong. Richard Baker's GSE bill (HR 1409) that would require them to register their securities with the SEC

Freddie's Chairman Leland Brendsel says the proposal lacks a "public benefit"

However, the CBO notes that requiring the GSEs to register their securities with the SEC would protect investors "by ensuring full disclosure of uniform financial information" and "would reduce the competitive advantage that the enterprises have over other firms"

The CBO notes that originally the GSEs were exempted from registering their securities with the SEC in part to relieve them of the cost of registering until they became accepted names in the market. The CBO states, "That rationale no longer applies: the four exempt GSEs are well known in financial markets."

In 1992, the Department of Treasury, the Federal Reserve, and the SEC supported requiring the GSEs to register their securities with the SEC, saying "investors need the same basic financial information about GSEs as they would need from any other company in order to evaluate the merits of an investment"

- Freddie's Chairman Leland Brendsel said he opposes provisions in Cong. Richard Baker's new GSE bill (HR 1409) that would require the GSEs to register their securities with the SEC (albeit free of cost). [Other financial institutions must register their securities with the SEC and pay a fee.]
- "If there is a public benefit that would be served by that I think we can sit down and talk about that," said Brendsel. "So far, I've never seen a public benefit to it." Brendsel claims that the company already meets or exceeds market standards for disclosure and transparency.
- Fannie also opposes the SEC registration proposal.
- Cong. Baker has a different perspective. "Fannie and Freddie should be subject to the same disclosures as every other publicly traded company, and investors should be aware of the fact insofar as it relates to market discipline," said Cong. Baker in an earlier statement on his bill. (*BNA Daily Report for Executives*, Adam Wasch, 4/19/01; *National Mortgage News*, 4/23/01)

CBO says requiring the GSEs to register their securities with the SEC would protect investors and reduce the GSEs' competitive advantage over other companies

- While Cong. Baker's bill would only require the GSEs to register their securities with the SEC (without paying any registration fees), the Congressional Budget Office in its most recent annual report to Congress indicated that requiring the GSEs to register their securities and pay fees to the SEC would raise \$2 billion over a 10-year period. The CBO has identified this in its 1999 and 2000 annual reports to Congress. (*Budget Options*, Congressional Budget Office, February 2001; *Budget Options*, Congressional Budget Office, March 2000; "Maintaining Budgetary Discipline: Spending and Revenue Options," Congressional Budget Office, April 1999)

- The CBO notes that currently the federal government explicitly subsidizes four GSEs – Fannie, Freddie, the FHLBank System, and the Farm Credit System – by exempting them from the registration requirements of the Securities Act of 1933. (A fifth GSE, Farmer Mac, is not exempt from SEC registration.) **In 1992, the Department of Treasury, the Federal Reserve, and the SEC advocated requiring the four GSEs to register their securities with the SEC.**
- **The CBO notes that originally the GSEs were exempted from registering their securities with the SEC in part to relieve them of the cost of registering until they became accepted names in the market. “That rationale no longer applies: the four exempt GSEs are well known in financial markets.”** Repealing the exemption would not impose significant regulatory burdens on the GSEs because registration can be done electronically. **CBO also said that requiring the GSEs to register their securities “would reduce the competitive advantage that the enterprises have over other firms that finance loans by issuing debt or mortgage-backed securities.”** The report stated, **“a more level playing field would probably lead to a more efficient allocation of credit.”** Further, the CBO notes that requiring issuers to register their securities with the SEC protects investors **“by ensuring full disclosure of uniform financial information.”**
- The CBO estimates that requiring the GSEs to register their securities with the SEC and to pay the requisite registration fees would raise \$287 million in 2002, \$1.4 billion over five years, and \$2 billion by 2011. According to CBO, “To register with the SEC, each of the four GSEs would pay about 2.5 cents for every \$1,000 (about 2.5 basis points) in securities it issued in 2002.
- The CBO notes that the proposal does not appear to increase the cost of housing. “Competition from wholly private firms and between the enterprises would limit the GSEs’ ability to recoup the cost of paying registration fees by raising the interest rates on the loans they finance. Fully absorbing the costs of registration would have little effect on either the enterprises’ profits or the interest rates paid by the borrowers they serve.” (*Budget Options*, Congressional Budget Office, February 2001; *Dow Jones Newswire*, John Connor, 2/28/01)

In 1992, the Department of Treasury, the Federal Reserve, and the SEC supported requiring the GSEs to register their securities with the SEC

- **In a joint report on the government securities market, the Department of Treasury, SEC and Federal Reserve said they “support legislation removing the exemptions from the federal securities laws for equity and unsecured debt securities of Government-sponsored enterprises (“GSEs”), which would require GSEs to register such securities with the SEC.”** The agencies **“believe that the exemptions under the federal securities laws for equity and unsecured debt securities of GSEs should be eliminated.”**
- The agencies note that the securities of GSEs are “generally exempted from certain provisions of the federal securities laws, due primarily to the credit quality of the securities, which eliminates the need for disclosure of information relating to the financial condition of the issuer.” However, debt securities issued by the GSEs “do not have the unquestioned credit quality that justifies the exemption for government securities under the federal securities laws.”
- The agencies explain, **“All the GSEs except for one small entity are now completely privately owned, and the value of GSE equity securities rests primarily on their financial condition and value as going concerns. Therefore, investors need the same basic financial and operational**

information about the GSEs as they would need from any company in order to evaluate the merits of an investment in its equity securities. All this information should be provided in the same form, and under the same time frames, as for similar securities of other issuers. For these reasons, the Agencies support repeal of the exemption of GSE equity and unsecured debt securities under the federal securities laws.” (*Joint Report on the Government Securities Market, Department of Treasury, Securities and Exchange Commission, Board of Governors of the Federal Reserve System, January 1992*)

Congressman Baker calls for modest reform of Fannie & Freddie

Cong. Baker lays out his reasoning for introducing his GSE bill (HR 1409) and warns his fellow Congressional Members that the GSEs pose a potential “systemic risk” to the country and a “local risk” to their constituents

- In an editorial in *The Hill*, Congressman Richard Baker outlined his reasoning for introducing his GSE bill (HR 1409) to strengthen regulation of the GSEs. According to Cong. Baker, the GSEs have played an important role in promoting homeownership in America. However, “historical precedent and near-term financial world developments...should give Congress cause to consider modest reform of its oversight.” **Cong. Baker noted that because the GSEs have a government charter that calls on them to provide liquidity in the mortgage market, they “accordingly enjoy some privileges. But it’s precisely because of these government-bestowed roles and privileges that unjustifiably leads, as Federal Reserve Board Chairman Alan Greenspan wrote me last year, to ‘a presumption by market traders that in the event of default the GSE’s liabilities, notwithstanding current law, would...be guaranteed by the federal government.’”**
- **Cong. Baker listed several key facts that support the view that the GSEs may pose a “systemic risk” to the country.** For example, he notes that over 87 international institutions – including foreign central banks -- invest in the GSEs; and over 41 percent of American commercial banks and savings banks have invested 100 percent of their capital in GSE securities. In addition, the GSEs’ combined debt has risen from \$196 billion in 1992 to over \$1.07 trillion in 2000 – a 24 percent annual increase. The debt is projected to surpass the Treasury’s debt at over \$2.7 trillion by 2005. Cong. Baker noted that these facts lead to a possibility of “systemic risk” – a scenario described by the President’s budget which warns that “financial trouble of a large GSE could cause strong repercussions in financial markets, affecting federally insured entities and economic activity.” **Cong. Baker also warned fellow members of Congress that the GSEs may pose “local risk” should the GSEs ever fail, “that not only would taxpaying constituents likely be tapped to cover a trillion-dollar tab, many local banks might go belly-up from overreliance on GSE-based capital reserves.”**
- Cong. Baker compared the GSEs’ potential problems to those suffered by the Long Term Capital Management hedge fund, which in 1998 had a Fed-arranged private bailout. Noting that he is not trying to make undue comparisons between the LTCM “risky” management and the soundness of the GSEs, but “Nor can I call it completely impossible that distant unforeseen economic conditions could find Fannie and Freddie facing a similar fate.” He notes that LTCM had some of the finest financial minds in the world. Cong. Baker adds, **“few recall that from 1978 to 1984 Fannie Mae was technically involvement. It can happen. And consider this: Fannie and Freddie now are**

more highly leveraged, with \$32 of debt for every dollar of capital, than LTCM was, with a ratio of 25-1, one month before its collapse.”

- Cong. Baker also compared the GSEs to the first documented case of a financial “bubble” – the South Sea Company – that in 1700 was granted a government charter by the English crown to promote trade with the New World. The company was also the primary issuer of benchmark debt and its stock rose exponentially, with investors perceiving that government ties made the company “too big to fail.” Of course, the company failed, causing the Bank of England to assist in the bailout. **The lesson learned from the South Sea Company: “When with the best intentions government sanctions a company’s capacity for profound and positive real-life consequences, it equally raises government’s responsibility to safeguard against harmful unforeseen ones.”**
- Cong. Baker concluded by noting that he introduced HR 1409 to help “strengthen oversight of Fannie and Freddie while promoting greater market discipline to help dispel the ‘implicit guarantee’ that American taxpayers stand behind the GSEs massive obligations.” Cong. Baker continues, **“Fellow free-market Republicans may count it odd that I am aiming to increase regulation on free enterprise. With an estimated \$10 billion yearly federal government subsidy, GSEs hardly fit the description of free enterprise. Like home ownership, our core values surely also include righting lopsided arrangements wherein any profits companies make they keep, while major losses are the taxpayer’s to pay.”** To those who believe it is not the right time to rein in the GSEs, Cong. Baker adds a friendly reminder: **“Fallout from the English public’s outcry when the South Sea bubble burst landed on the government officials who had promoted and defended the arrangement...which in turn landed them in the Tower of London.”** (*The Hill*, Cong. Richard H. Baker, 4/25/01)

HUD Secretary Mel Martinez is reviewing Cong. Baker’s bill (HR 1409) to strengthen regulation of Fannie & Freddie but is reluctant to “tinker” with the GSEs

- HUD Secretary Mel Martinez said he is reviewing Cong. Baker’s GSE bill (HR 1409) but is reluctant to tinker with the GSEs. “The GSEs have been very successful and they’ve played a useful role,” he told reporters after a hearing. “So I think anything that tinkers with success needs to be carefully looked at.” He noted that there are already aspects of Cong. Baker’s bill that he doesn’t like. Secretary Martinez said there is a “tremendous need” for the GSEs to be “proactively involved” in creating affordable housing for low- to moderate-income people. “If there are some things in the bill which might bring a greater participation of the GSEs in the arena of affordable housing, then I would welcome that,” he said. (*Reuters English News Service*, 4/26/01)

Senator John Corzine (D-NJ) says he prefers that the Treasury Department regulate Fannie & Freddie

Cong. Baker's bill would abolish Fannie & Freddie's current safety and soundness regulator (OFHEO) and make the Federal Reserve Board the regulator of Fannie & Freddie

- Senator John Corzine says he expects the Senate Banking Committee to focus on oversight of Fannie and Freddie. "There's going to be a lot of hootin' and hollerin' about Fannie Mae and Freddie Mac," he predicted. "People think they're too large," he stated. Senator Corzine made it clear, however, that he supports the GSEs and prefers that they be regulated by the Treasury Department, not the Federal Reserve Board (as proposed by Cong. Baker). (*Dow Jones Newswire*, Judith Burns, 4/27/01)

Fannie & Freddie's current safety and soundness regulator, OFHEO, defends its ability to regulate the GSEs

OFHEO Director Armando Falcon provides his views on Cong. Baker's GSE bill

- In an interview with *BNA*, OFHEO Director Armando Falcon discussed Congressman Baker's GSE bill (HR 1409) and defended his agency's ability to regulate Fannie and Freddie. [Cong. Baker's bill would abolish OFHEO and make the Federal Reserve Board the regulator of Fannie & Freddie. The bill abolishes OFHEO one year after the bill's enactment, but transfers all OFHEO employees and property to the Fed. The Fed would be responsible for oversight of safety and soundness and charter review. HUD would maintain authority over Fannie and Freddie's affordable housing goals.] "To try to dismantle this agency not in order to try to get at safety and soundness issues, but at mission issues, I think would be detrimental to the safety and soundness concerns that resulted in OFHEO being created in the first place," stated Falcon. "I think that it will eventually start to develop that this really isn't about safety and soundness. It's about mission and there's nothing that the new regulator would do to get at the safety and soundness issues that we aren't already doing."
- "The 1992 act has language that says HUD should prior approve new activity, which it defines as new mortgage programs," said Falcon. "So, that's what [Baker's] bill is trying to beef up. The bill is trying to get at tighter mission regulation to make sure that the activities of the enterprises do not go beyond the bounds of what some people think is allowed under their charters...Baker's bill does a lot to expand [mission supervision]. It gets rid of the notion of new mortgage programs and broadens it to include any new activity, investment, or product. So, it runs the gamut of all that the enterprises do."
- Falcon said HUD's existing mission compliance authorities are enough to do the job. "HUD is the mission regulator," said Falcon. "They have the prior approval authority...There's a lot of authority there that hasn't had life breathed into it by an aggressive regulator. One could come in with that authority and do a lot with it."
- Falcon stated that HUD was the proper home for OFHEO. "Our independence is respected here," he said. Falcon claimed that if regulation of the GSEs' mission fell to the Fed, the Fed's primary

responsibility for managing monetary policy could affect the regulation of the GSEs. “If OFHEO was part of any other department in town, I question whether regulatory policy would be driven not by what is the best regulatory policy with respect to the GSEs, but whether or not GSE regulatory policy would be driven by some other purpose, some other goal,” he stated. (*BNA Daily Report for Executives*, Adam Wasch, 4/17/01)

Fannie & Freddie senior officials collect record compensation

Freddie’s Senior Vice President in charge of funding and investments “earned just shy of \$13 million in 2000”

Freddie’s Chairman earned almost \$8 million in 2000; Fannie’s Chairman earned \$6.09 million

Freddie Mac

- The top earner at Freddie Mac last year was Freddie’s Senior Vice President in charge of funding and investments, Greg Parseghian, according to *National Mortgage News*. According to Freddie’s proxy statement to shareholders, Parseghian “earned just shy of \$13 million in 2000.” Most of the compensation was in the form of restricted stock awards. Parseghian had a base salary of \$816,083 and “all other compensation” of \$58,797. But Parseghian was awarded restricted stock worth \$12.1 million. Parseghian’s total compensation was \$12.99 million, according to the proxy statements. Compared to the previous year, his compensation increased by 2,053%.
- From 1997 through 1999, Parseghian earned no restricted stock, according to proxies from the last two years. In 1999, his total compensation was \$603,808.
- When asked about Parseghian’s compensation, a Freddie spokesman said, “The results speak for themselves.” As a company, Freddie earned a record \$2.55 billion last year.

Freddie’s Top Earners for Year 2000

| | Greg Parseghian | Leland Brendsel | David Glenn |
|----------------------------|-----------------|-----------------|-------------|
| Salary | \$816,083 | \$1,1016,667 | \$806,667 |
| Bonus | na | \$1,710,000 | \$1,009,000 |
| Misc. Comp. (1) | \$58,797 | \$336,279 | \$139,806 |
| Restricted Stk. Awards (2) | \$12,122,933 | \$4,859,494 | \$2,380,718 |
| Total | \$12,997,813 | \$7,922,440 | \$4,336,191 |
| % Change from 1999 | 2,053% | 94% | 136% |

Notes: (1) Misc. compensation includes what Freddie Mac calls “other annual compensation” and “all other compensation.” (2) Restricted stock awards are based on the market price on the date they are granted.

Source: Freddie Mac annual proxy statement/*National Mortgage News* [as reported in *National Mortgage News*, Paul Muolo, 4/23/01)

- Freddie’s Chairman Leland Brendsel had a base salary of \$1.01 million and restricted stock awards of \$4.86 million. Brendsel’s total compensation for 2000 – including salary, stock awards, and bonuses – came to \$7.92 million. Overall, Parseghian owns \$27 million in Freddie’s restricted

stock, while Brendsel owns \$15 million. (*National Mortgage News Daily*, 4/18/01; *National Mortgage News*, Paul Muolo, 4/23/01)

Fannie Mae

- According to *National Mortgage News*, Fannie's Chairman Franklin Raines earned \$6.09 million in total compensation in 2000, a 45% increase from 1999 and a 148% increase from 1998. Total compensation includes salary, bonus, stock awards, and other payouts. Raines earned \$3.47 million in salary and bonuses. The balance of his compensation came from stock options. Fannie granted Raines 207,810 options. Fannie's Chief Operating Officer Daniel Mudd, Vice Chairman Jamie Gorelick, and Chief Financial Officer Timothy Howard earned \$3 million or more last year. (*National Mortgage News Daily*, 4/26/01; *National Mortgage News*, 4/30/01)

Fannie & Freddie's subordinated debt receives a 20% risk weighting from banking regulators - the same risk weighting as Fannie & Freddie's senior debt

The GSEs' subdebt will now carry a lower risk weight than other comparably rated debt securities, giving the GSEs' securities a preferential treatment over other private sector securities

There was speculation earlier in the year by many participants in the debt market that the subordinated debt would be assigned a 100% risk weighting

- US banking regulators have assigned a 20% risk weighting to the subordinated debt securities issues by Fannie and Freddie, the same risk weighting as Fannie and Freddie's senior debt. The weighting is lower than the 100% risk weighting that was once expected by many participants in the agency debt market.
- A risk weighting determines how much a bank has to keep in reserve capital against certain investments. A lower risk weighting allows banks to own the debt while holding a lower amount of capital against it and makes the securities more attractive to investors.
- There was speculation earlier this year that Fannie and Freddie's subordinated debt (rated AA-minus from Standard & Poor's and Aa2 by Moody's Investor Service) would be assigned a higher risk weighting than its senior debt (rated AAA), possibly as high as 100%.
- In letters to Fannie and Freddie on April 19, the banking regulators noted that the GSEs' subordinated debt carries "limited credit risk" and that a 20% risk weighting makes it consistent with the weighting assigned to senior GSE debt. "In addition, a 20% risk weight is consistent with a proposed revision to the standardized approach under the Basel Capital Accord," which will assign a 20% risk weighting to corporate debt with ratings of "AAA" and "AA," the regulators wrote. "Further a 20% risk weighting is appropriate given the high current credit quality of the Subordinated Securities," said the letters.
- The regulators noted that they would monitor the credit quality and terms of the subordinated debt securities, as well as banking organizations' holding of the debt, as part of the overall supervision of banking organizations. Officials from the Office of the Comptroller of the Currency, the Federal Reserve, Office of Thrift Supervision, and the Federal Deposit Insurance Corporation signed the letters.

- The more favorable risk weight assigned to the GSEs' sub debt is expected to broaden the investor base that buys those securities. "Given the risk weigh uncertainty, few banks (previously) invested in sub-debt," said Mary Rooney, a strategist at Merrill Lynch & Co. "Going forward, we expect greater bank demand, particularly in Europe and Asia, where banks are very sensitive to the amount of capital they must reserve against assets." Rooney also noted that the GSEs' subdebt should also benefit from the fact that it will carry a lower risk weight than other, comparably rated debt securities until the new Basle Accord is implemented in 2004. Rooney pointed out that in the banking sector, "the difference between spreads of 20% and 100% assets of the same credit is around 15 basis points in 10 years." (A basis point is a hundredth of a percentage point.) (*Dow Jones Newswire*, Tyler Lifton, 4/20/01, 4/23/01; *Bloomberg News*, 4/20/01; *Reuters*, 4/23/01)

Fannie & Freddie are expanding into HELOCs (Home Equity Lines of Credit)

The GSEs are starting to purchase home equity loans in the secondary market that are mainly used to pay off credit card debt or to make home improvements. "Home equity loans do not help families on the cusp of home-ownership get into homes." (*Citizens Against Government Waste*, Leslie K. Paige)

- Analysts said that Fannie and Freddie changed the role they played in the HELOC securitization market in 1999 and 2000. The GSEs are said to be "slowly immersing themselves" in the market in order to grow their alliances and better understand the product," said Karen Kostiw, an analyst for Standard & Poor's. The GSEs will continue to be involved in the market on an opportunistic basis, she said. (*Real Estate Finance Today*, Chris De Reza, 4/16/01)
- In related news, Option One Mortgage Corp. is readying a \$1.4 billion asset-backed bond pooling home equity loans, market sources said. The issuer and guarantor of the planned offering is Freddie. (*Reuters*, 4/16/01)
- **The GSEs are starting to purchase home equity loans in the secondary market that are mainly used to pay off credit card debt or to make home improvements. "Home equity loans do not help families on the cusp of home-ownership get into homes."** (*Citizens Against Government Waste; Government Waste Watch*; Winter 2001, Leslie K. Paige)
- **FM Watch notes, "The GSEs read their charters as allowing them to purchase home equity loans , even though only about 30 percent are used for home improvement...A study by the Consumer Bankers Association found that over 70 percent of home equity loans are used for debt consolidation or other purposes not related to home improvement. The GSEs are exploiting loopholes in their charter to expand beyond the mission Congress intended when they purchase home equity loans. By definition, home equity loans go to borrowers that already own a home, and these loans finance a wide range of consumer spending."** ("*GSE Mission Creep: The Threat to American Consumers*," *FM Watch*, March 2001)

Brian Collins with *National Mortgage News* compares Fannie to a “fat lady who prefers mirrors that make her look thin”

Collins notes that Fannie executives claim that Fannie & Freddie control only 10% of the mortgage market. However, “most industry executives just snicker when Fannie Mae executives tout this line. Anyone in the know understands that these two government-sponsored enterprises control about 70% of the conventional conforming mortgage market.”

- Brian Collins wrote a column on the GSEs on the *National Mortgage News* website. In his column, Collins compares Fannie and Freddie to a “fat lady” who likes to look at herself in trick mirrors that make her look thin. **Collins notes that Fannie executives claim that Fannie and Freddie control only 10% of the mortgage market. However, “most industry executives just snicker when Fannie Mae executives tout this line. Anyone in the know understands that these two government-sponsored enterprises control about 70% of the conventional conforming mortgage market.”** The GSEs are growing as well – expanding into subprime, home equity, and manufactured housing loans.
- **Collins notes that the President’s first budget proposal politely notes Fannie and Freddie have a “size” problem.** The budget commentary reads: **“the large size of some GSEs is also a potential problem. Financial trouble of a large GSE could cause strong repercussions in financial markets, affecting federally insured entities and economic activity.”**
- Collins notes that the budget commentary hints that Fannie and Freddie have been steadily “bulking up” on mortgage products. The on-balance sheet mortgage investments of the GSEs have doubled in just 3 years to \$936 billion --which Collins notes is almost 20% of all outstanding mortgage debt in the US. To finance these portfolios, the GSEs are issuing debt at an annual rate of 24% --running up over \$1 trillion in debt. **Collins notes, “Are the two running up an ugly tab and can’t stop eating? They used to be content with eating at Wall Street. But even Wall Street couldn’t keep up with their demand for corporate financing. So now they sell their debt globally and eat in London and Tokyo.”**
- Collins notes that the President’s budget commentary questions whether the two GSEs will be able to maintain their 15% annual growth rate. The budget states, “Fannie Mae and Freddie Mac face challenges to sustaining their high rates of profit growth.” **Collins concludes by noting, “every regulator knows that rapidly growing companies are going to run into problems somewhere down the road.” He argues that Cong. Richard Baker (R-LA) has been trying to get Congress and the Bush administration to take preventive steps by introducing a bill to impose stronger regulation and supervision of the GSEs while they are well managed and highly profitable.** However, Collins states that the President’s budget does not address this issue and assumes the GSEs will always get their fill and keep their shareholders satisfied. Indeed, the budget concludes, “the benefit of government sponsorship, however, is one factor that may help Fannie Mae and Freddie Mac to maintain relatively high profitability.” (*National Mortgage News Daily*, Brian Collins, 4/17/01)

Insight Magazine reports that Fannie & Freddie are in the “hot seat” once again

Fannie & Freddie are facing legislation in Congress to strengthen their regulation, are facing scrutiny from the FEC for possible illegal campaign contributions, facing allegations that the two GSEs threatened financial services firms for criticizing the GSEs, and facing criticism that the GSEs are on course to own or guarantee more than half of all residential mortgages in the US, “putting taxpayers on the hook for an astronomical bailout should there be a real-estate bust.”

- An article in *Insight Magazine* by Catherine Edwards reports that Fannie and Freddie “are in the hot seat once again.” Edwards notes that Fannie and Freddie “face criticisms ranging from bullying banks to setting taxpayers up for a trillion-dollar bailout.”
- Edwards notes that Fannie and Freddie are facing legislation in Congress to strengthen their regulation, are facing scrutiny from the FEC for possible illegal campaign contributions, and are facing allegations that the two GSEs have tried to threaten banks for criticizing the GSEs. In addition, critics continue to express concern that the GSEs are on course to own or guarantee more than half of all residential mortgages in the US, “putting taxpayers on the hook for an astronomical bailout should there be a real-estate bust.”
- Peter Wallison, resident fellow at the American Enterprise Institute, claims that the GSEs have “outlived their usefulness.” Wallison states, “There are many private banks that would like to be in the secondary-mortgage market.” Wallison also noted that studies show that the GSEs’ performance in financing low-income mortgages, especially in minority communities, is worse than private banks. Edwards quotes him as stating, “despite the fact that Fannie and Freddie receive subsidies to perform a government mission, in this case in support of low-income housing, their need for incentives to retain a high level of profitability is an obstacle to their performance.” Edwards quotes Tom Schatz, president of the Citizens Against Government Waste as noting, “Today, the secondary-mortgage market is a mature, thriving industry...However, Fannie and Freddie continue to operate under a congressional charter and, as such, place the American taxpayer at enormous risk.”
- Edwards notes that Congressman Richard Baker (R-LA) has introduced legislation this year to tighten regulation of the GSEs (HR 1409). The bill would make the Fed the regulator of Fannie and Freddie. The bill would also give the Fed more bank-like regulatory powers over the GSEs and would require the GSEs to register their securities with the SEC (but not pay a registration fee). FM Watch Executive Director Mike House states, “there is no reason why they should not report to the SEC.” Edwards noted that if the GSEs were truly private, the cost of SEC registration would cost billions of dollars.
- Edwards notes that in March several board members of FM Watch resigned from the board, citing threats by the GSEs as the reason for their resignation. [The *Wall Street Journal* reported that financial executives from the American International Group, GE Capital, and Wells Fargo stated that Fannie and Freddie had threatened to withdraw business from them for criticizing the GSEs.] Edwards reports, “these are major figures in banking, underscoring the unchecked power of the GSEs. And there is no question about the intimidation.” She notes that the *Wall St. Journal* also reported that JP Morgan & Chase executive William Harrison told several other Wall Street executives that Fannie had threatened

retaliation for his association with FM Watch. The group dissolved its board shortly thereafter. **FM Watch Executive Director Mike House told Edwards “the board members [who resigned] decided for themselves. They wanted to make a statement that you can’t threaten people and get away with it.”** Edwards notes that Fannie strongly denies any type of threats. A spokesperson told Edwards “their assertions are rather bizarre... These companies are some of our biggest business partners today and we hope we will be well into the future.”

- On another front, the National Taxpayers Union – a GSE critic for over 25 years – is alleging that Fannie and Freddie might have given illegal political contributions to several national party committees. The NTU filed a complaint in March with the FEC. Edwards notes, “Despite the fact that these are federally created entities backed by billions in US credit, from 1997 to 2000, Freddie Mac gave more than \$2.84 million in soft money to national party committees, and Fannie Mae gave more than \$1.47 million.” Edwards reports that as congressionally chartered corporations, Fannie and Freddie are not allowed to make contributions to the election-related accounts of national party committees. The sole exception to this prohibition in law is a contribution to a national or state party to build an office facility not acquired to influence the election of a candidate in any particular election. NTU has charged that Fannie Mae gave at least \$340,000 and Freddie Mac gave \$400,000 to non-building accounts and that other funds were diverted.” While Fannie and Freddie both deny any wrongdoing, matters are pending with the FEC.
- Taken together, Edwards adds that **“it is hard to argue with critics that, with a potential \$1 trillion taxpayer bailout floating around, someone needs to keep a closer eye on the GSEs.”** She noted that last year Congress asked the GAO to determine if the GSEs were subject to enough oversight by their two regulators – OFHEO and HUD. GAO concluded that the regulators lack key enforcement and corrective measures of bank regulators and advised changing the system. However, no action has taken place yet. Edwards concludes by noting that the GSEs control over 70 percent of conventional mortgages and will likely control more than half of all mortgages by 2003. She quotes Cong. Baker as saying that this statistic is more than enough reason to strengthen regulation of the GSEs. At his press conference announcing his bill, he noted, **“I believe in the public-policy benefits of this effort, and I will stay on the job until there is establishment of a regulatory office to protect the taxpayers of this nation.”** (*Insight Magazine*, Catherine Edwards, 5/14/01)

***Wall Street Journal* reports that large lenders are afraid that Fannie & Freddie’s technology “threatens to drive many of them out of home lending”**

Keith Gumbinger, a market analyst at HSH Associates, warns that the GSEs “could literally wipe out the role of lenders”

- A *Wall Street Journal* article by Patrick Barta outlined the fears that some large mortgage lenders have about Fannie and Freddie. Barta began his article by noting that the GSEs have been under fire lately after allegations by senior executives of Wells Fargo, AIG, and GE Capital that Fannie and Freddie threatened to withdraw business from them for criticizing the GSEs. Barta noted that these allegations – first written in the *Wall Street Journal* last month – have “spurred talk of greater regulation of Fannie and Freddie.” **However, there is a deeper problem on the minds of some mortgage lenders, noted Barta. “The institutions fear that new technology created by Fannie and Freddie threatens to drive many of them out of home lending.”** Fannie’s CEO Franklin Raines response was, **“I can’t account for paranoia.”**

- Barta noted that since the mid-1990s, the influence of the GSEs' automated systems could be felt all over the mortgage industry. "The online technology, provided for a modest fee, has quietly fragmented the lending business and shifted power to brokers by allowing them to perform some of the services once provided exclusively by banks." Barta further noted that some large banks have begun to fear that Fannie and Freddie are aiming to take them out of the equation all together. "According to this scenario, Fannie and Freddie would in effect become lenders themselves, relying on an army of brokers and small mortgage companies – some of them operating online as field agents." **Barta quoted Keith Gumbinger, a market analyst at HSH Associates as warning that the GSEs "could literally wipe out the role of lenders."**
- Barta noted that Fannie and Freddie claim that their software increases efficiency and competition in the market. The GSEs also claim that most complaints come from large lenders who feel their business is threatened. Barta quoted Pete Maselli, senior vice president at Freddie as stating, "We don't see our role as protecting the turf of anybody, particularly the largest lenders."
- **However, Barta noted that others in the industry say that automated underwriting has another effect: "By aiding brokers and diminishing the market muscle of banks, Fannie and Freddie have strengthened their own relative position. This strengthening comes at the expense of traditional lenders that have resisted selling mortgage loans to Fannie and Freddie...If brokers armed with automated underwriting software were allowed to sell loans directly to Fannie and Freddie – cutting banks out of the loan-making business – that will make it easier for the two companies to feed their huge appetites for loans. If that happened, the technology could lead not just to greater efficiency and cost-saving, but a radical reshaping of the mortgage market."**
- **While Fannie and Freddie claim to have no interest in cutting banks out of the system, other banking executives feel differently. Barta noted that several mortgage executives have had private conversations with Fannie's CEO and other Fannie executives during which Fannie's CEO Frank Raines "has stopped short of predicting the elimination of banks from the mortgage process...But he has compared the relationship between Fannie and Freddie and traditional lenders to that of big soft-drink companies such as Coca Cola and PepsiCo, Inc. and their bottlers – with banks as bottlers, serving a restricted role."** In response to this analogy, Barta quoted Angelo Mozilo, CEO of Countrywide Credit Industries, Inc. as stating "I perceive a bottler as a subordinate to the person who makes the syrup...After building a company for 32 years, I don't like being in a subordinate role." However, Raines confirmed that he spoke with Mozilo but said that he was just trying to illustrate an "alliance" that he hoped to form under which Countrywide would sell all its loans to Fannie. Mozilo, whose company has since agreed to sell most of its loans to Fannie, says he now roughly agrees with Raines' interpretation of their conversation.
- **Barta noted that Fannie and Freddie's steady growth and profitability stems from the various advantages they receive from their GSE status.** Many financial services companies have formed a lobbying group, FM Watch, to push for tighter regulation of the GSEs. A major source of concern for some banks is the GSEs' automatic underwriting software that Fannie and Freddie have made available to thousands of mortgage brokers, noted Barta. FM Watch Chairman Gerald Friedman is quoted as stating, "my resentment is that government-sponsored enterprises are accelerating the process' of making brokers and other small players a threat to larger banks."

Another official at a large national lender, speaking anonymously, noted that the GSEs' AU systems "basically marginalize(s) the role of a player like us." Barta added that many large banks spent millions of dollars in the early 1990s to build automated underwriting systems that were eclipsed by Fannie and Freddie's systems. (*Wall St. Journal*, Patrick Barta, 4/5/01)

Fannie & Freddie announce record earnings in first quarter

Fannie & Freddie increase their holdings of their own MBS in their retained mortgage portfolios to drive up profits

The Bush Administration recently noted that Fannie & Freddie "face challenges to sustaining their high rates of profit growth" and noted that Fannie & Freddie have achieved strong profits, primarily by holding increasing amounts of their own MBS in their retained portfolios, which "may imply increased interest rate exposure"

CRS and GAO have both testified that Fannie & Freddie's repurchase of their own MBS does not put people into homes and had more to do with maximizing profits

[Editorial Note: Fannie and Freddie's repurchase and retention of their own MBS does nothing to promote homeownership. It increases the interest rate risk for Fannie and Freddie and increases the concentration of risk by having only two companies hold most of the mortgages on their books. It is the principal way Fannie and Freddie make money, but does nothing for homeownership.]

Fannie Mae:

- Fannie reported operating net income for the first quarter of 2001 of \$1.238 billion, a 16.6 percent increase compared with the first quarter of 2000. Operating earnings per diluted common share of \$1.20 were 17.6 percent above the same period in 2000. Fannie's operating income excluded a one-time gain resulting from the implementation of FAS 133 (new derivatives accounting rule). Under FAS 133, Fannie's adjusted net interest income was \$1,643 million in the first quarter of 2001, a 20.6 percent increase above the first quarter of 2000.
- Fannie also announced a stunning increase in fees generated from its automated underwriting systems. According to Fannie, fees and other income in the first quarter of 2001 rose \$26.8 million to \$27.3 million, up from only \$500,00 a year ago. The majority of the increase stemmed from Fannie's Desktop Originator and Desktop Underwriter technology services. Technology fees in the first quarter of 2000 were \$37.3 million compared with \$16.7 million during the first quarter of 2000. Loans processed through Fannie's technology services in the first quarter of 2001 were more than double the number processed in the same period last year.
- Fannie said its total business volume – which reflects the total value of all the mortgages the company bought or issued as securities during the quarter – soared to \$105.6 billion in the quarter (more than double the \$50.8 billion total a year earlier). The first quarter's business volume consisted of \$58.7 billion in portfolio purchases and \$46.9 billion in MBS issues acquired by investors other than Fannie's portfolio. Retained commitments to purchase mortgages were \$76.3 billion in the first quarter of 2001, more than triple the \$25.1 billion in commitments in the first quarter of 2000, and \$11.8 billion higher than the previous record in the fourth quarter of 1998.

Fannie now owns or guarantees \$1.37 trillion of home loans, up from \$1.22 trillion a year ago. Fannie's mortgage portfolio grew to \$640.7 billion at the end of the first quarter, compared with \$607.4 billion in the fourth quarter and \$536.9 billion a year earlier. The company said it guaranteed a total of \$1.10 trillion of mortgage-backed securities at the end of the first quarter, up from \$1.06 trillion in the fourth quarter and \$975.8 billion a year earlier. Total credit losses amounted to \$28.9 million, compared with \$28 million during the same period a year earlier. Fannie said the company sees growth of more than 14.9 percent in earnings per share for 2001 and is still aiming to double earnings per share in the five years ending in 2003. (*Wall Street Journal*, Patrick Barta, 4/18/01; *Fannie press release*, 4/17/01; *Dow Jones Newswire*, 4/17/01)

Freddie Mac:

- Freddie announced operating earnings for the first quarter of 2001 of \$719 million, compared to \$608 million for the same period a year ago and \$663 million for fourth quarter 2000. Diluted operating earnings per common share were \$0.96 for first quarter 2001, a 19 percent increase over first quarter 2000 diluted earnings per common share of \$0.81. Freddie's operating earnings and operating earnings per share excluded a one-time gain resulting from the implementation of FAS 133 (new derivatives accounting rule). Accounting for FAS 133, Freddie reported net income of \$837 million, or \$1.13 a diluted share, compared with \$608 million, or \$0.81 cents a share, a year earlier (a 38% increase).
- Freddie's new business purchase volume (excluding purchases of Freddie Mac's own MBS for its retained portfolio) totaled \$81 billion in the first quarter of 2001, compared to \$36 billion for the first quarter 2000, and \$70 billion for the fourth quarter 2001. Freddie's total mortgage portfolio grew at a 13 percent annualized rate from \$962 billion at December 31, 2000 to \$994 billion at March 31, 2001. The retained mortgage portfolio grew at a 36% annualized rate, increasing from \$386 billion at December 31, 2000 to \$421 billion at March 31, 2001. This growth was driven by record retained mortgage portfolio purchase commitments of \$53 billion for the first quarter 2001. Given the first quarter's robust growth, Freddie upwardly revised its retained mortgage portfolio growth for 2001 to \$70 to \$85 billion from the previous projection of \$65 to 75 billion.
- Revenue increased 33 percent to \$1.42 billion from \$1.07 billion. Freddie also disclosed for the first time the interest-rate risk sensitivity in its portfolio as part of its voluntary risk-management agreement with Cong. Baker. (Freddie says that it has now implemented all six of the voluntary commitments on risk management.) In March, 3.54 percent of Freddie's portfolio could be impacted by a one-half percentage point move in interest rates, up from February's 3.46 percent. (*Freddie press release*, 4/24/01; *Reuters*, 4/24/01; *WSJ.com news roundup*, 4/24/01)

Fannie & Freddie's purchasing of their own MBS does not put people into homes but only maximizes profit and creates more interest rate risk

- **During a July 25, 2000 House Budget Committee Housing Task Force hearing, representatives from the Congressional Research Service, the Government Accounting Office and Financial consultant Bert Ely all testified that the GSEs' purchase of their own mortgage-backed securities had very little to do with the GSEs' mission and more to do with maximizing profits. All agreed that the purchase of MBS by the GSEs was not mission critical to the GSEs. The panelists were asked specifically whether the repurchasing of mortgage-backed securities advances homeownership and whether it puts a new person in a home? Barbara Miles with Congressional Research Service stated, "I would say no. I do not think so." Thomas McCool with the GAO responded, "We would, I think, agree that there is**

no clear advancement of the mortgage market by repurchasing mortgage-backed securities.” Financial consultant Bert Ely responded, “Mortgage repurchases are not mission critical.”

- When asked as a follow-up, then whether the repurchasing the mortgage-backed securities was done for profits and for shareholders, the panelists gave the following responses: “By and large,” said CRS’ Barbara Miles; “Again, we have not really studied that specifically, but I would suspect that, again, it is a risk/return tradeoff that is probably driving it,” said GAO’s Thomas McCool; “Yes,” said financial consultant Bert Ely.
- During the Budget Committee hearing, Barbara Miles with Congressional Research Service stated that the GSEs’ repurchase of their own MBS provides profit and risk for the GSEs and does little for the mortgage market. “While it is clear that this increases shareholder value, it is difficult to understand what, if anything, it does for mortgage markets,” she stated. Miles further noted that when a GSE issues a MBS, it is selling off the interest rate risk, but when the GSE purchases its own MBS, it is buying back or “repatriating” the interest rate risk back onto its books. During a September 12, 2000 GSE Roundtable, Miles also testified that the GSEs’ repurchase of their own MBS does not appear to have a housing rationale behind it. There is nothing that the GSEs do in purchasing their own MBS that would result in the form of lower mortgage rates to homebuyers, she noted. (*Dow Jones Newswire*, Jerry Guidera, 7/25/00; *Testimony before House Budget Committee House Task Force Hearing*, 7/25/00; *Testimony before GSE Roundtable*, 9/12/00)

Bush Administration says Fannie & Freddie face challenges to sustaining their high rates of profit growth and by increasing their retained portfolios, may imply increased interest rate exposure for the GSEs

- President Bush’s FY 2002 budget, released on April 9 noted, “Fannie Mae and Freddie Mac face challenges to sustaining their high rates of profit growth” and that the “total mortgage debt financed by Fannie Mae and Freddie Mac have been increasing more quickly than residential mortgage debt outstanding, which suggests that their charters could eventually limit the GSEs’ ability to expand their mortgage asset portfolios. There may also be limits to the amount of mortgage securities the GSEs can finance with debt at attractive margins and the amount of counterparty risk exposure to Fannie Mae and Freddie Mac that other market participants are willing to absorb.” The Administration further noted that Fannie and Freddie have achieved strong growth in profits in recent years, “in large part by rapidly growing their debt-financed holdings of mortgage assets.” The Administration noted, “From September 1997 to September 2000, their mortgage asset portfolios more than doubled in dollar volume. **Increased retained portfolios may imply increased interest rate exposure.** In recent years, both Fannie Mae and Freddie Mac have tried to limit the interest rate risk on their portfolios by issuing long-term callable debt and by entering into interest rate swaps and other hedging transactions. Hedges, however, do not eliminate all the risk associated with funding long-term, mostly fixed-rate assets that have uncertain payment streams.” Finally, the Administration noted that uncertainties about the Federal Government’s liability have increased in some areas, noting that “the large size of some GSEs” is a “potential problem.” **The budget notes, “Financial trouble of a large GSE could cause strong repercussions in financial markets, affecting Federally insured entities and economic activity.”** (*President Bush’s FY 2002 Budget, “Analytical Perspectives,”* 4/01)

OFHEO says Fannie & Freddie are purchasing their own MBS to increase earnings as the mortgage market slows which increases interest rate risk

- In its Year 2000 Report to Congress, Fannie and Freddie’s safety and soundness regulator, OFHEO, said Fannie and Freddie have increased their earnings per share at double-digit rates in recent years by primarily increasing their retained mortgage portfolios, and also by expanding the range of loans they buy, offering new services to lenders, and lowering their debt costs (through their benchmark securities programs). However, the enterprises’ ability to sustain double-digit earnings growth is uncertain. For example, “[t]here are limits to the ability of Fannie Mae and Freddie Mac to increase earnings by expanding their retained mortgage portfolios,” OFHEO said. “In recent years each Enterprise’s net interest margin has declined, as at times its purchases of its own mortgage securities have exceeded the supply of newly issued securities backed by recently originated loans... To sustain earnings growth, the enterprises have been buying non-enterprise mortgage securities, but there are limits on that market, too. At some point, the volume of outstanding conforming mortgage debt will constrain the size of the retained portfolios.” **OFHEO also noted, “as the retained mortgage portfolios of Fannie Mae and Freddie Mac grow, the interest rate risk each Enterprise must manage also increases, as does its potential exposure to losses from a failure in the systems and procedures it uses to manage that risk.”** (*OFHEO 2000 Annual Report to Congress*)

As the national debt shrinks, GSE debt skyrockets

With the fading supply of Treasurys, Fannie & Freddie are issuing massive amounts of debt in an effort to have GSE debt replace Treasurys as the new benchmark in the bond market

GSE debt news:

- (1) **Federal Reserve Chairman Alan Greenspan says as the supply of Treasurys dwindles, the Fed may start purchasing Ginnie Mae mortgage-backed securities for its administration of monetary policy**
- (2) **Bond Market Association survey reports that interest rate swaps, not GSE debt, may become the leading candidate for the new benchmark alternative to Treasurys**
- (3) **International Monetary Fund analysis says it is unclear what will replace Treasurys as “the US dollar safe haven” – notes that swaps, agency debt, & corporate issues are being used as reference points for the quoting and pricing of new debt issues**
- (4) **Freddie to start buying back its own debt to arbitrage profits - Will Fannie & Freddie issue more debt to fund their debt buybacks?**
- (5) **Central banks increase their holdings of GSE debt – 70 percent of central banks and multilateral institutions own agency securities**

Background on GSE debt

- As reported in previous *GSE Reports*, as the national debt shrinks, GSE debt has been skyrocketing. As the national debt is paid down, the supply of Treasury securities shrinks. Investors, traders, borrowers, and even the US Federal Reserve are being forced to find new benchmark securities to replace the shrinking number of Treasurys. Among possible alternatives as a benchmark are the debt securities of Fannie and Freddie. Investors view them as “almost” as good as US Treasurys because of the implicit government guarantee of Fannie and Freddie’s securities. Fannie and Freddie would like to replace Treasurys as a benchmark security and the agencies both have bond issuance programs (Fannie – Benchmark bond program; Freddie-Reference bond program) that mirror traditional Treasury operations in size and regularity.

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

Federal Reserve Chairman Alan Greenspan says as the supply of Treasurys dwindles, the Fed may start purchasing Ginnie Mae mortgage-backed securities for its administration of monetary policy

- In an April 27 videoconference to the Bond Market Association, Federal Reserve Chairman Greenspan said that as the supply of Treasurys falls, the Fed is looking at alternatives for its day-to-day administration of monetary policy, including the purchase of Ginnie Mae mortgage-backed securities. "Other changes that are already allowed under current statutes could be implemented to substitute, to a limited extent, for our holdings of Treasury securities," said Chairman Greenspan. "For example, the Federal Reserve could purchase, outright, Ginnie Mae securities, which are fully backed by the Treasury."
- *National Mortgage News* reports that the Fed maintains a \$500 billion investment portfolio that it uses to manipulate interest rates. Most of that portfolio is in US Treasurys and only a small fraction is in federal agency securities (\$10 million in Fannie Mae corporate debt and no Ginnie Mae MBS). The Fed has allowed its holdings of government-sponsored enterprise debt to run off, said a Federal Reserve Bank of New York Spokesman.
- Chairman Greenspan expressed confidence in the ability of US financial markets to adapt to the growing scarcity of Treasury securities. The loss of Treasury securities as benchmarks seems unlikely to result in major difficulties for market participants because alternative benchmarks are easy to envision," he said. "For example, in European bond markets swaps are already the most common benchmark." Chairman Greenspan also suggested that senior tranches of very high quality corporate debt could produce a "nearly riskless" security that could serve many of the investment purposes currently performed by Treasury debt. "I am confident that US financial markets, which are the most innovative and efficient in the world, can readily adapt to a paydown of Treasury debt by creating private alternatives with many of the attributes that market participants value in Treasury securities," said Chairman Greenspan. (*National Mortgage News Daily*, 4/30/01; *American Banker*, Rob Garver, 4/30/01; *Dow Jones Newswire*, Joseph Rebello, 4/27/01)
- As reported in the March 2, 2001 *GSE Report*, in his semi-annual report to Congress, Federal Reserve Chairman Greenspan said that as the supply of Treasurys falls, the Fed is looking at alternatives for its day-to-day administration of monetary policy, including bonds from US states and foreign governments. Greenspan testified that the Fed last year "initiated a study of alternative approaches to managing our portfolio." Officials throughout the system, both at the 12 regional Federal Reserve Banks and at the Fed board in Washington, are involved. Greenspan further noted

that on January 31, the Federal Open Market Committee (FOMC) asked staff members “to explore the possible mechanisms for backing our usual repurchase operations with the collateral of certain debt obligations of US states and foreign governments.” Greenspan said, however, the Fed will consult with Congress before taking any further consideration of such transactions. One of the Fed’s key concerns is that it does not want its operations to affect the prices of any private-sector securities.

- In the Fed’s separate report to Congress, it noted that the Treasury market has become “somewhat less liquid” than several years ago and noted that the GSEs continue to issue large amounts of debt. “Trading volume and dealer positions in agency securities have risen considerably since 1998,” said the report. “Fannie Mae and Freddie Mac continued to issue large amounts of debt under their Benchmark and Reference debt programs, which are designed to mimic characterizations of Treasury securities – such as large issue size and regular calendar of issuance – that are believed to contribute to their liquidity,” the Fed said. “By the end of 2000, the two firms together had more than \$300 billion of notes and bonds and more than \$200 billion of bills outstanding under these programs,” the Fed observed. “Also,” several exchanges are listing options and futures on agency debt securities, said the Fed. “Open interest on some of those futures contracts has picked up significantly, although it remains small compared to that on futures contracts on Treasury securities.” (*Reuters*, Chris Sanders, 2/13/01; *Reuters*, 2/23/01; *Dow Jones Newswire*, Jonathan Nicholson, 2/13/01; *Dow Jones Newswire*, John Connor, 2/13/01; *Washington Post*, John Berry, 2/20/01)

Interest rate swaps becoming alternative benchmark to Treasuries

- A survey of top fixed-income players released on April 26 by the Bond Market Association found that interest rate swaps are pushing out federal agency debt as a possible future benchmark security. Heather Ruth, current president of the BMA, told reporters at a press conference at the group’s annual meeting that there was “wide agreement that the swap curve actually already has emerged as an alternative to Treasuries.” The BMA survey notes that “Instead of agency securities, the swap curve has now emerged as the benchmark of choice with half of respondents expecting the swap curve to arise as the most widely used benchmark.” Last year’s survey found that 79 percent of respondents viewed agency debt such as Fannie and Freddie as a “supplement” to Treasuries as a benchmark security in 2000, while the 2001 poll found only 39 percent of respondents believing agency debt would be “the most widely used benchmark” in the future. (*Reuters*, Ross Finley, 4/26/01; *Bond Market Association Research report on 2001 Personal Opinion Survey on the Outlook for the Fixed Incomes Markets*, Michael Decker, Lori Trawinski, Jennifer Ribarsky, Marcelo Vieira)

International Monetary Fund analysis says it is unclear what will replace Treasuries as “the US dollar safe haven”

- According to Damian Milverton with *Dow Jones Newswire*, a recent IMF analysis said that a number of securities could readily replace US Treasuries as global benchmarks. However, the IMF analysis found that it is “less clear what instruments might serve as the US dollar safe haven.” The IMF analysis, contained in the IMF’s “World Economic Outlook” notes that markets are already successfully shifting away from Treasuries. “In the US dollar markets, a variety of non-treasury benchmarks, including swaps, securities issued by large US ‘agencies’ (such as Fannie Mae, Freddie Mac, and the Federal Home Loan Bank), and some large corporate issues, can be and are being used as reference points both for *quoting* yields on new and existing fixed-income instruments and for the *pricing* of new issues.” The analysis notes that financial market

participants, the Federal Reserve, and other central banks are already adapting to a world in which US Treasuries may not exist. The analysis notes, “it is clear that private securities can readily serve as the benchmark and in most other roles in the US dollar markets, as they did before the treasury market existed. It is less clear what instruments might serve as the US dollar safe haven. Market participants might use bank deposits or high-grade corporate bonds, although neither has the minimal credit risk and strong market liquidity of US treasuries. Alternatively, they might use whatever the Federal Reserve decides to use in place of treasuries in its operations.”

- In related news, Milverton with *Dow Jones Newswire* noted that Treasury Secretary Paul O’Neill seemed to raise the possibility that that government might continue to issue new debt securities, if only to keep the market open for future needs. The proceeds of these debt issues – should the government continue to accumulate budget surpluses after the debt is retired – could be returned as tax cuts. (*Dow Jones Newswire*, Damian Milverton, 4/26/01; *IMF World Economic Outlook*, May 2001)

Central banks increase their holdings of GSE debt – 70 percent of central banks and multilateral institutions own agency securities

- According to a survey of central banks conducted by UBS Warburg, central banks could own nearly the entire supply of marketable US debt by the end of 2006 at their current pace of increasing Treasury holdings, likely giving other alternatives such as US agency debt, corporate bonds, and asset-backed securities a boost. UBS Warburg said that the Federal Reserve and other central banks already own about half of all marketable Treasuries. Only a little more than half of the central bank respondents said they were looking at alternatives to Treasuries, and just 21 percent said they had begun making new asset allocations. Debt from the GSEs (Fannie and Freddie) was mentioned as the mostly likely substitute to Treasuries. Already 70 percent of central banks and multilateral institutions own US agency securities, up from 54 percent in 1998. Corporate bonds and asset-backed securities would also receive extra demand from a further decline in Treasuries. UBS Warburg notes that the percentage of central banks owning corporate bonds has already increased to 10 percent from 2 percent in 1998, while the percentage of asset-backed securities has increased to 38 percent from 17 percent. (*Reuters*, Eric Burroughs, 4/23/01)

Freddie to start buying back its own debt to arbitrage profits

- On April 26, Freddie announced a program to periodically repurchase its off-the-run Reference Notes and Bonds, beginning in the second quarter of 2001. The periodic repurchase operations will focus exclusively on older, off-the-run issues while preserving the supply of active, on-the-run Reference Notes and Bonds. “Periodic repurchases will allow Freddie Mac to further pursue its asset/liability management strategies while ensuring that our investors can continue to depend on the predictability and liquidity of our Reference issuance program,” said Jerome Lienhard, Senior Vice President of Investment Funding. Freddie said it expects to conduct repurchases at least once every calendar quarter, provide overnight advance public notice of repurchase activity, and post results-including the amounts of each security the company has repurchased – within 15 minutes after completing the repurchase operations. Freddie’s announcement comes on the heels of Fannie’s first debt buyback in late March. (*Freddie press release*, 4/27/01; *Reuters*, Lynn Adler, 4/26/01)

Fannie recently announced a similar program

- As reported in the March 30, 2001 *GSE Report*, on March 23, Fannie announced that it would begin periodically repurchasing its off-the-run Benchmark Notes and Benchmark Bonds for

asset/liability management purposes. The company said it wouldn't buy back more than 20% of any outstanding issue and will not allow issues with a maturity of less than 10 years to slip below \$3 billion in size and issues with a maturity of more than 10 years to fall below \$2 billion in size. Fannie said there would be no buybacks conducted within two weeks prior to a scheduled benchmark announcement if the maturity of the bond targeted for repurchase is similar to the non-callable benchmark scheduled to be sold. Subordinated benchmarks are excluded from the buyback program.

- On March 27, Fannie announced that it had bought back \$410 million of long-term maturity debt, its first-ever buyback of older benchmark debt. Fannie bought back \$300 million of 6.25% issues maturing in May 2029, \$85 million of its 7.125% bonds maturing in January 2030, and \$25 million off its 7.25% bonds maturing in May 2030. The respective issues now have \$3.95 billion, \$4.739 billion and \$4.475 outstanding. The dollar amounts given are based on the original value of the bonds when they were sold. **Fannie did not provide what it actually cost the company to buy back the bonds or how the buyback was funded.** Fannie was seeking to buy back as much as \$600 million of bonds maturing in May 2029, January 2030, and May 2030, according to traders handling the transaction.
- When Fannie made its announcement, it was reported that by cutting available supply, Fannie might be able to raise the market value of its other outstanding debt. **Fannie's debt repurchase program could help Fannie capture an arbitrage by allowing it to buy back a portion of its older securities more cheaply while securing stronger prices for the new issues.** Indeed, Fannie's notes and bonds rallied after the company announced that it would start buying back older securities from its benchmark notes and bonds program. Traders said their yields narrowed as much as 5 basis points relative to Treasury yields. Investors are betting that as Fannie buys back debt, their scarcity will make them more valuable. Like many newer Treasuries, newer "on-the-run" Fannie benchmark debt, which is not subject to buybacks, is often priced slightly higher than "off-the-run" debt because it is easier to trade. **While Fannie said the repurchases are aimed at helping it manage its mortgage portfolio, it was reported that the buyback plan could allow Fannie to profit from arbitraging off-the-runs against on-the-runs.** (*Bloomberg News*, 3/23/01; 3/27/01; *Dow Jones Newswire*, 3/23/01, 3/26/01; *Reuters*, 3/27/01)

Will Fannie & Freddie issue more debt to fund their debt buybacks?

- **"What we're trying to figure out is where the money is coming from for these buybacks,"** said Jim Kellerman, Director of Portfolio Management for Criterion Investment Management Co. Presumably, the program will be funded by issuing new debt, he said. **Fannie's Vice President for Debt Funding John The Losen declined to comment on how Fannie plans to fund its debt buybacks. As *Dow Jones Newswire* reports, "one key difference between Fannie's buyback and those of the US Treasury is that, while Uncle Sam is aiming to pay down its debt, Fannie Mae is actually increasing its amount of bonds outstanding."** (*Dow Jones Newswire*, Tyler Lifton, 3/26/01)

The *American Banker* reports that lenders of all sizes are concerned about the GSEs' "lower cost of funding" over the private sector which allows them to dominate any market they enter

Pete Wissinger, chief executive officer of Wells Fargo Home Mortgage, states that the GSEs' "funding advantages represent a real threat to many mortgage companies...With their leverage ratios and cost of capital, you're not on a level playing field with them."

- **Laura Mandaro, a reporter for the *American Banker*, notes that GSEs' "lower cost of funding" is not a new concern, "but it is the common denominator for lenders of all sizes that are concerned about the GSEs' influence in the market. Mandaro notes, "Bankers and trade groups say their business is squeezed by the lower cost the agencies pay for capital." Due to the GSEs government subsidies -- including state and local tax exemptions, exemption from SEC filing fees and "the perception that the government would step in with support if either faced financial collapse"—the GSEs pay less for money than other banks and thrifts. The GSEs are also able to make loans more cheaply than other banks while still maintaining a healthy profit margin.**
- **Mandaro quotes Pete Wissinger, chief executive officer of Wells Fargo Home Mortgage as stating that the GSEs have done a nice job in their "traditional" role in the secondary market. However, the GSEs' "funding advantages represent a real threat to many mortgage companies...With their leverage ratios and cost of capital, you're not on a level playing field with them...They have a charter to help foster homeownership in America, but when they expand into other products and other issues, you have to ask, 'Why should they continue to leverage those government benefits, because they're really outside that mission.'"**
- **Louis Nevins, president of the Western League of Savings Institutions states that his companies cannot "fund a loan profitably at the rate Fannie Mae or Freddie Mac can." Nevins also told Mandaro that Fannie and Freddie are "competing with us with advantages that are impossible for us to match."**
- **Mandaro notes that many in the financial services industry distrust the GSEs – fearing that the GSEs may eventually deploy their funding advantages on the origination side of the business. While the GSEs deny any such designs, Mandaro notes that the GSEs have begun to expand past the "plain-vanilla fixed-rate mortgage market." The GSEs have begun to purchase more subprime loans and are also increasing their holdings in the multifamily markets. There is also fear that Fannie and Freddie will enter into the adjustable-rate-mortgage market.**
- **While Fannie and Freddie scoff at the idea that they are taking over the market, Freddie spokesperson Sharon McHale is quoted as stating, "We are not in the market to make banks more profitable." Fannie also commented to Mandaro regarding the subprime market. Spokesperson Janice Dau told Mandaro that because of Fannie's automated underwriting system "we are able to purchase riskier loans" than previously. In addition, Dau said that subprime lending "fits well within the agency's mission of helping as many borrowers get mortgages as possible."**
- **The GSEs' use of technology also has competitors riled up, notes Mandaro. She notes that FM Watch recently criticized Freddie's decision to make its automated underwriting systems available to real estate agents. The agents then could use the systems directly with consumers. McHale**

denied to Mandaro that her company has any desire to go directly to borrowers. She stated that Freddie's technology makes it possible for small and nontraditional lenders enter into the business. (*American Banker*, Laura Mandaro, 3/30/01)

Congresswoman Stephanie Tubbs Jones (D-OH) defends Fannie & Freddie

- Congresswoman Stephanie Tubbs Jones (D-OH) wrote a Letter to the Editor in a recent issue of *The American Banker* in response to their March 26th article entitled "GSE Creep into Subprime Could Hurt Margins." Congresswoman Tubbs, also the Chairperson of the Housing Task Force for the Congressional Black Caucus, wrote in support of the GSEs' entry in the subprime market.
- Congresswoman Tubbs notes that the House Financial Services Subcommittee on capital markets held a hearing on March 27th on the GSEs and extensive hearings on the GSEs in the 106th Congress. She stated that "the GSEs' presentations during these hearings confirmed my belief that they operate safely and soundly. Their success is America's success."
- Congresswoman Jones quoted a passage from the *American Banker* article that noted that some lenders are concerned that Fannie and Freddie will shrink profits in the subprime market, causing them to lose business. In response, Congresswoman Jones notes, "If these GSEs can work to better rates for consumers, why not let them help those who have been locked out of our nation's prosperity? Moreover, their participation in the subprime market has been erroneously referred to as 'mission creep' by some. In point of fact they are in no way exceeding their congressional charter to lead the mortgage finance industry in making credit available for low-and moderate-income families."
- Congresswoman Jones concludes by claiming that the Congressional Black Caucus believes that the GSEs are "committed to helping all Americans, especially low-income and minority families, in making credit available. We will continue to hold them to that commitment." (*Congresswoman Stephanie Tubbs Jones, Letter to the Editor, American Banker, 4/27/01*)

Fannie Mae

Fannie nominates Donald Marron to its Board of Directors

- Fannie announced that Donald Marron has been nominated for election as a member of its Board of Directors at the company's 2001 annual meeting of shareholders on May 22, 2001. Marron would fill the board seat vacated by Roger Birk, who will be retiring at the end of his term. Marron is Chairman of UBS PaineWebber Inc. He was Chief Executive Officer of PaineWebber Incorporated from 1980 until its merger with UBS in November 2000. He is also managing general partner of Lightyear Fund, an independent private equity fund. Marron is a former director of the New York Stock Exchange, and former governor of the Securities Industry Association. He is currently a director of Shinsei Bank and the National Association of Securities Dealers. Fannie's Board of Directors consists of 13 shareholder-elected directors and five members appointed by the President of the United States. (*Fannie press release, 4/20/01*)

Washington Business Journal ranks Fannie as the leading business philanthropist in the Washington area, contributing \$20.6 million

[Editorial Note: Fannie Mae Foundation's contribution of \$20.6 million is only a fraction of what Fannie & Freddie would contribute to the Washington community if they were not exempt from state and local corporate income taxes by virtue of their GSE status. The GAO estimated that in 1995, Fannie & Freddie's exemption from state and local income taxes was worth approximately \$300 million a year.]

- The Fannie Mae Foundation and Fannie Mae topped the *Washington Business Journal's* annual list of the leading business philanthropists in the Greater Washington area. The Fannie Mae Foundation was ranked as the top contributor with \$20.6 million in "community investment" in the region. (*PR Newswire*, 3/30/01)
- **[Editorial Note: Fannie's contribution is only a fraction of what Fannie and Freddie would contribute to the Washington community if they were not exempt from state and local corporate income taxes by virtue of their GSE status.]** According to the GAO, "if the enterprises had paid state and local corporate income taxes at an average rate of 8 percent in 1995 and if no other costs, capital levels, or operating strategies had changed, we estimated that this would have resulted in a combined increase in expenses for the enterprises in the range of \$367 million to \$256 million, again depending upon the enterprises' treatment of the increases in their federal tax returns." (*Housing Enterprises, Potential Impacts of Severing Government Sponsorship*, GAO, GAO/GGD-96-120, May 1996)

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 name former staffer to Cong. Richard Baker (R-LA) to head its Louisiana Partnership Office

Fannie has 44 Partnership Offices open across the country

Financial consultant Bert Ely believes Fannie's media events raise ethical questions. "This is an extension of not only their lobbying but also their political action committee contributions," he said. "Everybody knows what they're doing. It's something that many of us find offensive, but that's how they play the political game."

Fannie claims its partnership offices were created "to get away from Washington," yet *Real Estate Finance Today* reports that during the first eight months of 2000, Fannie held no fewer than 87 media opportunities across the country with Congressional Members

Fannie names former staffer for Cong. Baker

- Fannie named Tim Carpenter as Director of its Louisiana Partnership Office. Since 1999, Carpenter has served as Director of Regional Management for Fannie's housing and community development in Washington, DC where he was responsible for managing Fannie's national affordable housing initiatives through Fannie's partnership offices. Prior to joining Fannie,

Carpenter worked as finance director for the Republican National Republican Congressional Committee. Carpenter also spent seven years on Congressman Richard Baker's staff where, according to Fannie's press release, he "managed all congressional, legislative and constituent services for the Congressman." (*Fannie press release, 4/24/01*)

Fannie claims its partnership offices were created "to get away from Washington," yet Fannie and its partnership offices hold numerous press conferences with Congressional Members

- Fannie's Betsy Hildebrandt claims that Fannie's media events with Congressional Members "are not directed from Washington." She said most of the events happen in their Partnership Offices and "are basically product introductions where the member of Congress has asked us to participate in a program." She claims the Partnership Offices were created to develop relationships in local communities. "The idea of the Partnership Offices was to get away from Washington," she said. "It's been a wildly successful initiative."
- Research by *Real Estate Finance Today* found that during the first eight months of 2000, Fannie held no fewer than 87 media opportunities across the US with Congressional Members. This compares with 60 media events in all of 1999. The events in both years have involved 29 members of the Senate (of whom 12 were up for re-election in 2000) and 95 Members of the House (most of whom face contested re-election bids). Since 1999, Fannie has held media events with at least 13 Members of the House Banking Committee and seven Members of the Senate Banking Committee. (*Real Estate Finance Today, Michael Sorohan, 9/11/00*)

Fannie's media events raise ethical questions

- Financial consultant Bert Ely said that while Fannie's media events demonstrate the company's influence with Congress, they also raise ethical questions. "This is an extension of not only their lobbying but also their political action committee contributions," he said. "Everybody knows what they're doing. It's something that many of us find offensive, but that's how they play the political game." (*Real Estate Finance Today, Michael Sorohan, 9/11/00*)

Fannie has 44 partnership offices

- According to Fannie's Web site, the company has 44 partnership offices open across the country (http://www.fanniemae.com/contact/partnership_offices.html, 4/11/01)

Senator Charles Schumer (D-NY) and Buffalo, NY Mayor Anthony Masiello

- Fannie held a press conference with the above named officials and CitiMortgage to announce a new partnership to provide \$200 million in affordable mortgage lending to families in Erie and Niagara Counties over the next five years. The partnership is part of a \$12 billion national initiative to provide flexible mortgage products through all CitiMortgage affiliates and their business partners. (*Fannie press release, 4/30/01*)

Senator Charles Schumer (D-NY), Congresswoman Louise Slaughter (D-NY) and Rochester, NY Mayor William Johnson

- Fannie held a press conference with the above named officials and CitiMortgage to announce a new partnership to provide \$200 million in affordable mortgage lending to families in Monroe County over the next five years. The partnership is part of a \$12 billion national initiative to provide flexible mortgage products through all CitiMortgage affiliates and their business partners. (*Fannie press release, 4/23/01*)

Senator John Ensign (R-NV)

- Fannie held a press conference with Senator Ensign to announce a new technology partnership with Nevada Bank & Trust and PHH Mortgage Services. The partnership enables Nevada Bank & Trust to offer its customers loan decisions in minutes through a new Home Buyer's Assistance Web site accessible through the bank's existing Web site. This online lending solution is made possible through PHH Mortgage Services' proprietary lending platform, which is powered by Fannie's automated underwriting technology. (*Fannie press release, 4/11/01*)

Senator Harry Reid (D-NV)

- Fannie held a press conference with Senator Reid to announce a \$350,000 federal grant for Opportunity Village, a nonprofit organization providing vocational and independent life skills training to people with disabilities. The funds will be used to provide down payment and closing cost assistance to individuals with special needs in conjunction with Fannie's HomeChoice mortgage product. (*Fannie press release, 4/16/01*)

Senator Craig Thomas (R-WY)

- Fannie held a press conference with Senator Thomas and First Interstate Bank to announce a partnership between First Interstate and Fannie. Under the partnership, First Interstate Bank will help meet its CRA requirements by investing in Fannie's MBS that are backed exclusively by these loans. Since January, First Interstate has invested \$816,680 in these Special CRA-targeted MBS. (*Fannie press release, 4/17/01*)

Senator Ben Nelson (D-NE) and Allen, NE Mayor Rick Smith

- Fannie joined the above named officials and the Nebraska Rural Development Commission and other housing agencies at a breakfast to recognize the Allen Development Group, Inc. and the Village of Allen for more than ten years of making homeownership and housing a focus of the local economic development. (*Fannie press release, 4/19/01*)

Congressman Paul Gillmor (R-OH) and Mayor of Fostoria, OH John Davoli (**announce product that requires no mortgage insurance**)

- Fannie held a press conference with the above named officials and representatives from Sky Bank to announce a new initiative – "GoodStart Mortgage" – a new no downpayment mortgage with limited closing costs and no requirement for mortgage insurance. The GoodStart Mortgage also allows families to purchase and renovate the loans. SkyBank will originate the loans and Fannie will purchase the loans. Self-Help has agreed to purchase loans that may not meet traditional underwriting guidelines. Fannie agreed to purchase the loans Self-Help acquires. (*Fannie press release, 4/30/01*)

Senator Richard Durbin (D-IL), Cong. Jim Leach (R-IA), Cong. Ron Kind (D-WI)

- Fannie issued press releases announcing mortgage relief provisions for flood victims in Illinois, Iowa, and Wisconsin. Statements of support by the above named officials were included in Fannie's press releases. (*Fannie press releases, 4/25/01*)

Congresswoman Eddie Bernice Johnson (D-TX)

- Fannie joined Congresswoman Eddie Bernice Johnson and representatives from the city of Dallas and 12 local lenders to announce the availability of below-market rate mortgage financing, and down payment and closing cost assistance grants for low- and moderate-income first-time homebuyers living in the city of Dallas. The financing is made possible through a \$15 million

mortgage revenue bond purchase agreement between the City of Dallas Housing Finance Corporation and Fannie. Participating mortgage lenders include: Chase Manhattan Mortgage; Countrywide Home Loans; First Horizon Home Loan Corporation; Home Loan Mortgage Corporation; Mortgage Portfolio Services, Inc.; Ryland Mortgage Company; Sterling Capital; Summit Mortgage Corporation; Temple-Inland Mortgage Corporation; TCF Mortgage; US Home Mortgage Corporation; and Wells Fargo Home Mortgage. (*Fannie press release, 4/20/01*)

Cong. Bob Clemont (D-TN)

- Fannie held a press conference with Cong. Clemont and Affordable Housing Resources, Inc. (AHR), Metropolitan Development and Housing Authority (MDHA), and HUD to announce the Section 8 to Homeownership Program (SHP). SHP allows working families that are graduates to comprehensive self-sufficiency programs to use their HUD Section 8 rental assistance vouchers toward homeownership. Fannie will make a 10-year debt investment of \$200,000 to recapitalize AHR's Section 8 to Homeownership Program. AHR will work with various Nashville lenders to originate the first mortgages. Fannie expects to purchase these first mortgages from participating lenders. (*Fannie press release, 4/9/01*)

Cong. Mike Pence (R-IN)

- Fannie convened a housing roundtable with Cong. Pence and East Central Indiana employers to describe the value of implementing Employer Assisted Housing benefit plans for their employees. (*Fannie press release, 4/18/01*)

Cong. Bill Luther (D-MN) and Apple Valley, MN Mayor Mary Hamann-Roland

- Fannie joined the above named officials to announce Fannie's purchase of \$42.25 million in tax-exempt, single-family, mortgage revenue bonds issued by the Dakota County Community Development Agency. Through the Dakota County Community Development Agency, the bond proceeds will be used to provide financing for 30-year, fixed-rate mortgages with an interest rate of 6.25 percent. Participating mortgage lenders in the Dakota County First Time Homebuyer Program include: Bell Mortgage; Bremer Mortgage; Burnet Home Loans; Chase Manhattan Mortgage; Dakota Mortgage; Edina Realty Mortgage; Hampton Bank; Irwin Mortgage; Prestige Mortgage; Provincial Bank; Pulte Mortgage; Signal Bank; TCF Mortgage, and Wells Fargo Home Mortgage. (*Fannie press release, 4/19/01*)

Congresswoman Grace Napolitano (D-CA)

- Fannie issued a press release to announce that Cong. Napolitano joined North American Mortgage Company (NAMCO) in hosting a free homebuying fair on April 21. Fannie said Cong. Napolitano's district office worked with NAMCO and Fannie to develop the seminar. (*Fannie's press release, 4/18/01*)

Congressman Albert Wynn (D-MD)

- Fannie held a press conference with a number of local elected Maryland officials to announce the opening of a senior living apartment facility built by St. Paul Community Development Corporation and the Bozzuto Group with equity tax credits syndicated by Lend Lease Real Estate Investments, Inc. Fannie made a \$6.8 million equity investment in the property that qualifies for Low Income Housing Tax Credits through Lend Lease Real Estate Investments. Fannie also purchased a \$4 million first mortgage from Berkshire Mortgage Finance. A statement of support by Cong. Albert Wynn was included in the press release. (*Fannie press release, 4/27/01*)

Fannie names 25 new members to the company's Housing Impact Advisory Council.

- The 2001 Housing Impact Advisory Council will be co-chaired by The Honorable Ron Gonzales, mayor of San Jose and Claira Monier, executive director of the New Hampshire Housing Finance Authority, who is serving her first term.
- The following new members were appointed to serve on the Housing Impact Advisory Council through November 2002:

Gary E. Acosta, San Diego, CA, co-founder of the National Association of Hispanic Real Estate Professionals;

Vanessa Baker-Latimer, Ames, IA, housing coordinator for the City of Ames, Department of Planning and Housing;

Michael Bodaken, Washington, DC, president of the National Housing Trust;

Salvador Bonilla-Mathe, Miami, FL, chief executive officer of Gulf Bank;

Robert C. Brown III, Sugar Land, TX, chairman of the Greater Fort Bend Economic Development Council;

Lee Chira, Orlando, FL, sole principal of Lee Chira & Associates;

Sheila Crowley, Washington, DC, president of the National Low Income Housing Coalition;

Michael H. Dulan, Charlotte, NC, president of community development banking for Bank of America;

Steven N. Fayne, San Francisco, CA, managing director of ARCS Affordable Housing Division, ARCS Commercial Mortgage;

Kenneth Gamble, Philadelphia, PA, founder and chairman of Universal Community Homes;

Ellen Lazar, Washington, DC, executive director of the Neighborhood Reinvestment Corporation;

H. Thomas Llewellyn, Billings, MT, broker/owner, Llewellyn Associates, Yellowstone Group, Realtors;

Mercedes F. McCall, Orlando, FL, region executive of Banco Popular North America;

Phyllis McDonough Robinson, Park City, UT, executive director of Mountainlands Community Housing Trust;

Claira P. Monier, Bedford, NH, executive director of the New Hampshire Housing Finance Authority;

Ann O'Hara, Boston, MA, co-founder and associate director of the Technical Assistance Collaborative, Inc.;

Melville "Mel" Oniyide, Frederick, MD, senior vice president for risk management and community reinvestment act programs for First Nationwide Mortgage Corporation;

Theresa A. Parker, Sacramento, CA, executive director of the California Housing Finance Agency;

Antonio Perez, Milwaukee, WI, secretary/executive director of the Housing Authority City of Milwaukee;

Terrence L. RedFox, New Town, ND, chief executive officer for the Three Affiliated Tribes, Fort Berthold Reservation;

Daniel Russell III, Gaithersburg, MD, senior vice president and managing director of emerging markets for Fleet Mortgage;

Eileen G. Stenerson, Charlotte, NC, vice president/senior relationship manager of community development lending group for First Union National Bank;

Stanley Tate, North Miami, FL, chief executive officer of Tate Enterprises;

Alan Wiener, New York, NY, chairman of American Property Financing, Inc.;

Malcolm Young Jr., Baton Rouge, LA, executive vice president of the Louisiana REALTORS Association;

- Returning members of the advisory council include: Bert Belanger; Gale Cincotta; Larry H. Dale; Augustin Dominiquez; Kristin L. Faust; Robert Flowers; Perry J. Franklin; Al Gold; The Honorable Ron Gonzales; Yvonne "Bonnie" Gonzalez; Frances R. Grossman; The Honorable Patsy Jo Hilliard; Rodrigo López; The Honorable Roberto Maldonado; Susan "Suse" Nakata; The Honorable Jesse Norwood; Dennis Penman; Michael Rubinger; Councilwoman Charleta Tavares; Reverend Richard Tolliver; Scott Van Dellen; Gary Washington; Mark Alan Willis; and Donna Wilson. (*Fannie press release, 4/23/01*)

Freddie Mac

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| <p>Freddie's CEO says he has second thoughts about Freddie's strategic alliances with major mortgage companies</p> |
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| <p>Analysts say Freddie would be making a big mistake if it broke these alliances</p> |
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- *National Mortgage News* reported that Freddie's Chairman and CEO Leland Brendsel has second thoughts about Freddie's exclusive strategic alliances with major mortgage companies. Freddie had high expectations two years ago when it entered into these alliances but there has been some difficulty in getting two companies to work together. "Frankly, there have been some wins out of those strategic alliances and there have been some disappointments," said Brendsel. "I would have liked it to move faster."
- In 1999, both Fannie and Freddie were competing to create exclusive strategic alliances with their large mortgage customers in exchange for lower guarantee fees. Brendsel admits that it takes hard work to change back-office operations and bureaucratic processes to achieve the efficiencies he wants.
- Wells Fargo Home Mortgage Chairman Mark Oman, said his company's relationship with Freddie has been beneficial. "We entered into our historic alliance with Freddie Mac with the goal of working together to develop new programs and products aimed at increasing homeownership opportunities and lowering costs to borrowers. This relationship has proven to be very beneficial, not only to both of our organizations, but to our customers and the industry as a whole," said Oman. (*National Mortgage News, 4/23/01*)
- The *American Banker* reported that analysts believe that no matter how exasperating it may be for Freddie to have alliances with large mortgage lenders, such as Wells Fargo and Bank of America, it would be making a big mistake if it broke them. Several observers say the benefits of these alliances outweighs any payback or loan expansion Freddie could get from reorganizing or terminating the alliances. Sanford C. Bernstein senior research analyst Jonathan Gray said Freddie's deal with Wells Fargo and Bank of America helped it raise its market share considerably and keep pace with Fannie. "Those two alliances came very close to eliminating any market advantage that Fannie Mae had, bringing Freddie close to parity, if not at parity," said Mr. Gray. Gray also noted that the alliances helped reduce the guarantee fees that lenders pay the GSEs.

- Merrill Lynch’s Director of Equity Research for the mortgage industry Joy D. Palmer said the alliances’ main benefits to Freddie will be the resources they provide to the GSEs’ technology efforts. “Long-term, these alliances have been great to help Freddie develop those technologies,” she said. Fannie and Freddie are positioning themselves to dominate the mortgage processing technology market, and that domination “will provide additional purchase opportunities and revenues through fee income.” She noted that one of Freddie’s major goals is to give lenders access to its services in every step of the mortgage process. A spokeswoman from Freddie acknowledged that the alliances were essential to the company’s technology projects and that Mr. Brendsel’s comments shouldn’t be construed as indicating any wholesale strategic change. “The frustration that Mr. Brendsel was expressing was around the fact that he wished things could move even more quickly,” the spokeswoman said. “All in all, they are working very, very well.” (*American Banker*, Tom Fernandez, 5/4/01)

Federal Home Loan Banks

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| FHLBanks are expanding into economic development |
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- According to a *Bond Buyer* article by Ola Kinnander, some of the 12 FHLBanks have assisted the housing bond market for several years by buying taxable bonds directly from housing agencies and providing standby letters of credit to enhance mortgage revenue bonds. **Until recently, however, the FHLBanks’ involvement was limited to housing. Now some of the FHLBanks are increasingly getting involved with other areas of economic development.**
- The Minneapolis Community Development Agency (MCDA) first contacted the FHLBank of Des Moines in 1996 to assist them with economic development in Minneapolis. Since then, MCDA has borrowed money from the FHLBank of Des Moines and passed on the funds to small manufacturing companies – the most recent of which was a loan for \$700,000 to TLC Precision Wafer Technology Inc., which makes telecommunications products. Currently, the FHLBank of Des Moines’ involvement has not led to bond issuance, however, the MCDA said that may change soon. Robert Lind, Manager of the Business Finance Department at the MCDA said he plans to ask the FHLBank of Des Moines whether it would provide standby letters of credit for revenue bonds to benefit smaller manufacturing projects. Lind stated, “A more traditional letter of credit and a more traditional bond issuance are pretty pricey. So the FHLBank is quite appealing.”
- The FHLBank of Chicago appears to be the only FHLBank that so far has provided standby letters of credit for other types of economic development bonds. Michael Liu, a community investment staffer, said the FHLBank of Chicago has provided letters of credit backing for about 25 economic development bond deals. This includes a \$5.3 million standby letter of credit to credit-enhance a \$6.1 million, 30-year conduit bond issue sold by the Illinois Development Finance Authority. The financial arrangement was designed to renovate and equip a steel product factory. The letter of credit is called “standby” because a commercial bank, Manufacturer’s Bank, provides the immediate letter of credit. The standby letter of credit ensures the FHLBank pays bondholders if the company that received the bond proceeds, Coburn Steel Products, Inc. and the Manufacturer’s Bank failed to service the debt. **Liu said the FHLBank would like to look into whether it can provide a letter of credit directly to a development finance agency to enhance a revenue bond, without going through a commercial bank. “I bet you that there would be value in it,” he**

said. **“It’s just that no one has yet worked out the mechanics.”** (*The Bond Buyer*, Ola Kinnander, 4/01/01)

Community banks increase their use of the FHLBanks’ Mortgage Partnership Finance (MPF) program

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

10 of the 12 FHLBanks now offer the program

- The FHLBank of Chicago announced that community bankers increasingly are finding the MPF program an attractive alternative to selling their mortgage loans into the secondary market. [The MPF program offers banks and thrifts an alternative to selling their loans to Fannie and Freddie in the secondary market.] Mortgage lenders with assets of less than \$500 million accounted for 79% of the FHLBank members, which delivered conventional loans to the MPF program in the first quarter of 2001. MPF funded loans during the quarter from these community financial institutions totaled \$218 million, almost eight times the amount of the first quarter of 2000, and about two and half times the previous quarter. “As we always expected, community bankers prefer to be paid to manage the credit risk of loans to their customers, as they are with the MPF program, rather than paying a secondary market agency to take over that risk,” said Alex Pollock, President and Chief Executive Officer of the FHLBank of Chicago, which developed the program.
- The amount of MPF program conventional loans outstanding increased 17% in the first quarter from year-end, a 68% annualized growth rate. The volume of new MPF conventional loans funded during the quarter rose 98% to \$733 million compared to \$371 million during the previous quarter. The total number of approved MPF participating institutions rose to 212 at the end of the first quarter, up 67% from one year earlier. Over 100 FHLBank members are in the process of joining the program, while over 200 more members are in discussions to join.
- At the end of March 2001, the total amount of outstanding MPF loans was \$15.7 billion, up from \$4.4 billion one year ago, and from \$15.4 billion at year-end.
- **The FHLBank of San Francisco recently became the tenth FHLBank to offer the MPF program to its members. *National Mortgage News* reported that the FHLBank of San Francisco counts as its members some of the largest thrift institutions in the US and could really give the MPF program a real boost. “We think it has broad appeal as an alternative to Fannie Mae and Freddie Mac,” said FHLBank of San Francisco Senior Vice President Steve Traynor. (MPF press release, 4/20/01; *National Mortgage News*, 4/16/01)**

Farm Credit System/Farm Credit Banks

Farm Credit System's income up

- According to the FCA, the Farm Credit System reported a combined net income of \$1.42 billion, an increase of \$189 million over the \$1.23 billion reported in 1999. Overall capital grew to more than \$14 billion, which is equal to 15.3 percent of total assets. Loan volume rose \$5.2 billion to \$75.2 billion, a 7.5 percent increase from the 1999 loan volume of \$70 billion. Non-performing loans decreased by \$227 million to \$879 million, compared with \$1.1 billion in 1999. Nonaccrual loans declined \$244 million to \$710 million, compared with \$954 million in 1999. (*FCA press release, 4/12/01*)

FCA says it will examine non-bank lenders that make loans under the Department of Agriculture's Business and Industry Guaranteed Loan Program

- FCA announced that it has agreed to examine several non-bank lenders that participate in making loans through the Department of Agriculture's Business and Industry Guaranteed Loan Program. The FCA Chairman and the RBS Acting Administrator signed an interagency agreement between FCA and the Rural Business-Cooperative Service (RBS). Under this agreement, FCA will help RBS increase its oversight and will examine loans made by the lenders under the B&I Guaranteed Loan Program, as well as lender compliance with USDA rules, policies, and procedures. (*FCA press release, 4/12/01; American Banker, Ben Jackson, 4/18/01*)

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