

# The **GSE** REPORT™

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## Contents of GSE Report™

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**“The bottom line is that these gargantuan companies [Fannie & Freddie] can do just fine without the Treasury/taxpayer as co-signer. It’s time to let market forces prevail. [Cong. Richard] Baker knows it, the executives who reap the fruits of that subsidy know it. Cooperating with the next administration to phase in reform and phase out the taxpayer will be infinitely less painful.” - *Atlanta Journal and Constitution Editorial*, 12/21/00**

### **Major Events**

- Cong. Richard Baker (R-LA) says an upcoming Congressional Budget Office (CBO) study will show that Fannie & Freddie receive at least \$10 billion a year in benefits from their GSE status (*p. 5*)
  - While Fannie & Freddie claim they use their federal GSE benefits to lower the cost of homeownership, a similar 1996 CBO study estimated that the GSEs’ subsidy was worth \$6.5 billion, of which \$2.1 billion (approximately 1/3) went to Fannie & Freddie’s shareholders and management, rather than passing through to homebuyers
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  - Fannie reportedly lobbied for the GAO study
- Freddie succeeds in getting Congress to weaken HUD’s newly adopted affordable housing goals for the GSEs (*p. 10*)
  - HUD opposed Freddie’s efforts to weaken the GSE affordable housing goals
  - OMB and Treasury Department join HUD “in being unequivocally opposed to any dilution of Freddie Mac’s affordable housing goal requirements”
  - HUD warned that lowering Freddie’s affordable housing goals would disadvantage 130,000 families over the next three years

### **All GSEs**

- Shadow Financial Regulatory Committee (independent panel of financial services experts) asks President-elect George W. Bush and Congress to undertake a serious examination of the GSEs (p. 12)
  - The GSEs benefit from an implied government guarantee and distort the allocation of credit
  - Unlimited bank investment in GSE securities may create systemic risk
  - "...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"
- Morgan Stanley Dean Witter analyst sees little political risks for the GSEs in 2001 (p. 13)
  - Treasury Department is the biggest risk factor for the GSEs
- *Credit Union Journal's* "Washington Watch" reports that competition in the secondary market could benefit credit unions (p. 14)
  - *Journal* reports that the GSEs' potential role in mortgage originations is "no small matter as each [Fannie & Freddie] has developed and begun marketing its own loan origination software which some see as opening the door into the originations area"

### ***Fannie Mae and Freddie Mac***

- *Wall Street Journal* editorial warns that Fannie & Freddie may be too big to fail (p. 15)
  - "...one might wonder whether we really need two companies [Fannie & Freddie] engaged in making private profits with the help of public subsidies to accomplish a task that is no longer necessary (liquidity) while falling down on a public-policy mission they've agreed to perform (promote home owning by minorities). Two companies with humongous debt that have, in all likelihood, a call on a taxpayer bailout."
- *Atlanta Journal and Constitution* editorial calls for Fannie & Freddie to cut ties to taxpayers (p. 16)
  - "The bottom line is that these gargantuan companies [Fannie & Freddie] can do just fine without the Treasury/taxpayer as co-signer. It's time to let market forces prevail. [Cong. Richard] Baker knows it, the executives who reap the fruits of that subsidy know it. Cooperating with the next administration to phase in reform and phase out the taxpayer will be infinitely less painful."
- OFHEO proposes a series of "housekeeping" measures clarifying its oversight of Fannie & Freddie (p. 17)
 

The measures include:

  - (1) Proposed rule clarifying OFHEO's authority to block Fannie & Freddie from paying excessive compensation to their executives;
  - (2) Proposed rule clarifying OFHEO's authority to take enforcement action against the GSEs (including issuing cease and desist orders and imposing civil money penalties);
  - (3) Policy guidance to the GSEs on non-mortgage investments;
  - (4) Policy guidance on safety and soundness policies (reflecting the examination procedures currently employed by OFHEO); and
  - (5) Proposed rule codifying OFHEO's existing practice of assessing oversight fees on the GSEs
- SEC proposes rule that would allow investment funds to purchase GSE securities (defined in the proposed rule as government securities) during a syndicated offering in which an affiliated underwriter participates (p. 19)
  - A law firm, Brown & Wood, requested that the SEC allow affiliated funds to purchase Fannie & Freddie securities in syndicated underwritings
- OFHEO extends its public comment period on systemic risks to the financial system that may be caused by Fannie & Freddie (p. 20)
- As the national debt shrinks, GSE debt skyrockets (p. 20)
  - 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) Long-term GSE debt volume down by 32% from last year
- (2) Traders say that the dwindling in agency debt reduces its potential to become a legitimate benchmark replacement for Treasury bonds
- (3) Freddie plans to increase its debt issuance in 2001
- (4) Fannie & Freddie to start issuing subordinated debt early in 2001 (Freddie expects to have issued \$8 billion to \$10 billion in subordinated debt the end of 2003. Fannie expects to have issued as much as \$15 billion in subordinated debt by the end of 2003.)
  - Questions and concerns remain as Fannie & Freddie prepare to issue subordinated debt (e.g., what risk weighting will be required for the GSEs' subordinated debt and whether the market perceives the subordinated debt as carrying an implied government guarantee (like Fannie & Freddie's senior debt
  - Fannie's subordinated debt receives a prospective rating of Aa2 from Moody's Investor's Service and

- a rating of AA- from Standard & Poor's based on its GSE status (technically a split rating)
- "The difference in opinion between the two ratings agencies...speaks to the perception of an implied guarantee"
- Fannie expects to list its subordinated debt on the Luxembourg Stock Exchange
- A European study on subordinated debt might shed some light on the concerns that Fannie & Freddie's subordinated debt would likely carry an implied government guarantee similar to the GSEs' senior debt. The European study finds that subordinated notes and debentures investors are sensitive to European bank risk, with the exception of European public banks (similar to GSEs). These public banks benefit from a significant government subsidy, including an implied government guarantee, in the form of a lower cost of subordinated debt issues, the value of which has been increasing over time.

- E-business advisory firm says secondary mortgage e-marketplaces have the potential to become a transforming influence on the secondary mortgage market, but to do so, they will have to overcome fierce competition from firms with deep roots in the industry, like the GSEs (p. 26)
  - GSEs, such as Fannie & Freddie, through their dominance of the market, could limit the amount of opportunity for secondary mortgage e-marketplaces
- Chicago Board of Trade (CBOT) approves new futures contracts based on Fannie & Freddie mortgage-backed securities (MBS) (p. 26)
  - MBS market cautious about new CBOT mortgage contracts
- Most subprime securitizations use bulk mortgage insurance, but that could change as Fannie & Freddie continue to expand further into the subprime market (p. 27)
- Fannie & Freddie begin financing loans with zero down payments (p. 27)
- NHEMA members urged to be aware of competition from Fannie & Freddie (p. 28)
- Former Treasury Department Economist advocates that the Social Security Trust Fund invest in GSEs (p. 28)
- Former Comptroller of the Currency calls the Baker/GSE deal a "good package for safety" of the GSEs (p. 29)

### **Fannie Mae**

- Fannie personally attacks the influential advisory firm Medley Global Advisors (p. 29)
  - Medley has issued several reports to clients warning that concerns about the size of Fannie & Freddie are widespread in Washington
- Fannie CEO Franklin Raines says Fannie plans to increase its revenues by increasing its "touch" on loans, at the expense of the private sector (p. 30)
- Celeris Financial Services (a business-to-business online mortgage unit) establishes a technology partnership with Fannie that will allow non-mortgage professionals – such as tax return preparers, stockbrokers, or real estate agents – to originate mortgage using the Celeris system (p. 30)
  - The partnership with Fannie allows Celeris access to decision engines and their databases
  - [Editorial Note: Partnership allows Fannie to expand its technology beyond its customers (mortgage lenders)]
  - Celeris allows "trusted financial advisors" to receive "on-the-spot" approvals and reduce closing times and can also be used to provide home equity credit lines, credit cards, and other financial products
- Congressman Rick Lazio (R-NY) to work for Fannie? (p. 31)
- Fannie says that a new accounting rule for derivatives (FAS 133) will not alter Fannie's use of derivatives (p. 31)
- Fannie invests in online commercial real estate technology provider, MortgageRamp (p. 32)
- Fed's latest interest rate cut sparks a surprising drop in Fannie & Freddie's stock price (p. 33)
  - Prior to the Fed's rate cut, Fannie & Freddie's stock had climbed to record highs leading two analysts to downgrade their ratings on Fannie
- President Clinton to appoint former Congressman Esteban Torres as member of Fannie Board (p. 33)
  - *National Journal* reports that the naming of Torres to Fannie's Board "seems designed to help protect Fannie's...backside in coming months"
- Fannie opens new e-Business Center – a separate business unit (p. 34)
  - Fannie announces new e-business management team for Fannie Mae/eBusiness
  - Fannie Mae/eBusiness will work to further leverage Fannie's technology to get closer to the point-of-sale
- Fannie launches online geocoding service (p. 34)
- Fannie begins purchasing reverse loans in TX (p. 35)
- Associate General Counsel at Fannie appointed to Board of Directors of the DC Housing Finance Agency (p. 35)

## **Freddie Mac**

- Freddie plans to increase its net retained portfolio by \$50-\$60 billion in 2001 and increase its total portfolio growth in excess of projected 8-9% growth in the mortgage market, in part through increased expansion into subprime market (p. 35)
- During last eight weeks of the election, Freddie contributes \$350,000 in soft money to Democrats and \$250,000 to Republicans (p. 35)
- President Clinton names James Free to Freddie's Board (p. 36)
- Office of Personnel Management Deputy Director to work at Freddie (p. 36)
- Freddie names a new company Treasurer (p. 36)

## **Federal Home Loan Banks**

- Washington Mutual Bank (WaMu) seeks membership in the FHLBank of Dallas, while retaining its membership in the FHLBank of San Francisco (p. 36)
  - WaMu's request is believed to be the first request ever for dual FHLBank membership
- President Clinton appoints Allan Mendelowitz as Chairman of the FHFH (p. 37)
  - Mendelowitz should be able to serve as Chairman until President-elect George W. Bush can appoint his own Chairman or get his nominee confirmed by the Senate
  - Former FHLBank of Dallas President George Barclay is being mentioned as a candidate for Chair of the FHFH
  - FHFH has been without a full-time Chairman since July 2000
- Council of FHLBanks elects Seattle FHLBank Chairman Michael Radway as next Chairman (p. 38)
- Financial Services Roundtable met with Presidents of the 12 FHLBanks to discuss the future of the FHLBanks' mortgage purchase programs (p. 38)
  - The FHLBanks' mortgage purchase programs – such as the Mortgage Partnership Finance (MPF) program – are competitors to Fannie & Freddie in the secondary mortgage market
  - FHLBanks' MPF volume rises to about \$16 billion – volume could increase by \$46 billion in 2001
- Four FHLBanks ease their collateral rules (p. 39)
- FHFH issues proposal to let it impose cease-and-desist orders, assess civil money penalties, and issue subpoenas (p. 39)
- Idaho State Tax Commission finds that dividends on FHLBank stock is taxable (p. 39)
- Independent Community Bankers of America submits policy recommendations to President-elect George W. Bush (p. 39)
  - ICBA lists improved access to capital through the FHLBank System and the Farm Credit System among its priorities
- FHLBank of Atlanta takes steps to address predatory lending (p. 40)

## **International "GSEs "**

- Under pressure from the European Commission, Germany's public sector banks (similar to US GSEs) are thinking openly about reforming themselves (p. 40)
  - *The Economist* writes, "change is in the German's own best interest. It is one thing for taxpayers, through the state banks, to subsidise regional economic development. It is quite another for them to guarantee banking activities that ought to be carried out on a commercial footing – not least when those guarantees disadvantage other German banks."

## *Major Events*

**Cong. Richard Baker (R-LA) says an upcoming Congressional Budget Office (CBO) study will show that Fannie & Freddie receive at least \$10 billion a year in benefits from their GSE status**

**While Fannie & Freddie claim they use their federal GSE benefits to lower the cost of homeownership, a similar 1996 CBO study estimated that the GSEs' subsidy was worth \$6.5 billion, of which \$2.1 billion (approximately 1/3) went to Fannie & Freddie's shareholders and management, rather than passing through to homebuyers**

- According to *Dow Jones Newswire*, Cong. Richard Baker (R-LA) said an upcoming CBO study is expected to show that Fannie and Freddie receive about \$10 billion in subsidies from their GSE status. "It's in the \$10 billion-plus range," said Cong. Baker. He said he received a staff briefing from the CBO on its upcoming study and noted that the CBO is still finalizing that number. A CBO Spokeswoman said it had briefed Cong. Baker's staff on the methodology of the study but had not given any estimates. According to *National Mortgage News Daily*, the CBO study is expected to show that Fannie and Freddie receive substantial federal subsidies due to lower borrowing costs than private sector mortgage companies and from their exemption from state and local taxes and securities registration fees. Cong. Baker requested the study in May of 2000. A Spokesman for Cong. Baker said it would be several weeks before the study was released.
- The CBO conducted a similar study in 1996 using 1995 data. While Fannie and Freddie claim they use their federal advantages to lower the cost of homeownership, the 1996 CBO study estimated that \$2.1 billion of the then \$6.5 billion annual subsidy went to Fannie and Freddie's shareholders and management.

### Response from Fannie & Freddie

- Freddie's Spokesperson Sharon McHale claims that the methodology used by CBO for the 1996 study was "flawed." "We do not get...one cent from the taxpayers," she said. "Any 'subsidy' that we get is more than passed on to the home buyers we serve." In response, Freddie released a report concluding that the GSEs "promote significantly greater" consumer benefits than they receive in government subsidies. James Miller, former OMB director and Director of the Law and Economics Consulting Group in Washington, and James Pearce, a consultant and former Federal Reserve Bank and FHLBank economist wrote the report. The Freddie report claims that the 1996 CBO study understated the consumer benefits and overestimated the amount of subsidies the GSEs receive. Freddie's report estimates that the current amount of subsidies from its GSE status is between \$2.3 billion and \$7 billion a year. The CBO study adds that Freddie's activities drive down mortgage rates, saving homebuyers between \$8.4 billion and \$23.5 billion a year. The report says that Fannie enjoys a nearly four-to-one share of these lower borrowing costs compared to Freddie. Finally, the report says that even using the lowest estimate of consumer benefits and the highest estimate of their funding advantages, the value of consumer cost savings that Fannie and Freddie provide to consumers exceeds the value of their funding advantages. In its press release, Freddie claimed that eliminating the GSEs' Congressional charters would increase "market distortion" in the mortgage market, because federal subsidies of federally insured depository institutions are "actually less efficient and more likely to result in misallocation of resources." [The Freddie study by Miller/Pearce is available on Freddie's website at the following address: [www.freddiemac.com/news/analysis/pdf/cbo-final-pearcemiller.pdf](http://www.freddiemac.com/news/analysis/pdf/cbo-final-pearcemiller.pdf)]

- Fannie’s Spokesperson David Jeffers said, “We haven’t seen the [2001 CBO] study and we know of no existence of a number because it hasn’t been completed.” Jeffers stated, “We believe the study is far from complete, which leads us to believe there’s no way that any preliminary estimate of a number exists anywhere in Washington... We will comment when there is a study.” [Editorial Note: Fannie claims it will not comment on the CBO study until it is released, however, Fannie included a critique of the CBO’s study by First Manhattan Consulting Group on its website at the following web address: [http://www.fanniemae.com/markets/stock/current\\_issues/index\\_ci.html](http://www.fanniemae.com/markets/stock/current_issues/index_ci.html)] (*Bloomberg*, 1/4/01; *Dow Jones Newswire*, Jennifer Corbett Dooren, 1/4/01; *National Mortgage News Daily*, 1/4/01; *Reuters*, 1/4/01; *Washington Post*, Kathleen Day and Sandra Fleishman, 1/5/01; *Wall Street Journal*, Patrick Barta, 1/10/01; *Reuters*, 1/10/01; *Washington Post*, 1/10/01; *BNA Daily Report for Executives*, 1/11/01; *Freddie press release*, 1/10/01; *National Mortgage News Daily*, 1/10/01)

**Cong. Richard Baker (R-LA) may chair subcommittee of new Financial Services Committee**

**Subcommittee may have jurisdiction over GSEs**

**Cong. Baker is expected to re-introduce a GSE bill that creates a single regulator to oversee Fannie, Freddie, and the FHLBanks**

- On January 3, the House voted 215-206 to create a new Financial Services Committee with unprecedented jurisdiction over banking, insurance, and securities policy. The vote was part of a rules package that abolished the old House Banking Committee, to create a new Financial Services Committee that combines the House Commerce Committee’s securities and insurance jurisdiction with all of the House Banking Committee’s jurisdiction. The House Republican Conference appointed Cong. Michael Oxley (R-OH) on January 4 to chair the new Financial Services Committee. At a press briefing following his appointment, Cong. Oxley confirmed that Cong. Richard Baker would chair a subcommittee. Republican staff sources told *BNA* that Cong. Baker’s subcommittee will oversee a revamped capital markets subcommittee with jurisdiction over GSEs. Sources said Cong. Baker will retain much of the jurisdiction he enjoyed as former chair of the House Banking Committee’s Capital Markets Subcommittee. Staff sources also noted that the subcommittee could include securities. (*BNA Daily Report for Executives*, Adam Wasch, 1/5/01, 1/4/01)
- Cong. Baker, who introduced a GSE bill during the 106<sup>th</sup> Congress, said he plans to move quickly ahead with legislation to create a single, more powerful regulator to oversee Fannie, Freddie, and the FHLBanks. (*Dow Jones Newswire*, Jennifer Corbett Dooren, 1/4/01)

## OFHEO completes work on its risk-based capital rule for Fannie & Freddie

### Rule to be released after OMB gives final clearance

**Rule not expected to be published in the *Federal Register* until at least spring 2001, and will not be enforceable until one year after publication**

**After the rule is published, OFHEO does not intend to publicly disclose whether Fannie & Freddie meet the new risk-based standards until the rule becomes effective (in one year), but OFHEO will consider early disclosure if the GSEs do not object**

**It has taken six years to complete the rule**

- It has been six-years in the making, but according to OFHEO Director Armando Falcon, the agency completed its risk-based capital rule for Fannie and Freddie. The rule, however, is not expected to be issued and published in the *Federal Register* until at least spring 2001, and would not be enforceable until one year after publication in the *Federal Register*. “The rule is done,” said Falcon. “Hopefully, OMB will finish its review quickly so we can get it out.” OFHEO is working with the OMB to get clearance. OFHEO has been in informal discussions with the OMB since shortly before Thanksgiving. OMB must sign-off on the new rule, and Falcon estimated the rule could be published in the *Federal Register* sometime in spring, 2001. Falcon noted that one “wild card” in this timeline is what will happen within the OMB bureaucracy when the administration of President-elect Bush takes power. In the past, some incoming administrations have placed temporary moratoriums on new rules in process until they’ve had a chance to review them.
- Falcon said the final rule “essentially” mirrored OFHEO’s most recent proposal (issued in early 1999) with some changes to take into account objections raised by Fannie and Freddie. Falcon declined to provide further details. In addition to sharing the rule with the OMB, OFHEO has shared the rule with Deloitte & Touche, which is testing OFHEO’s computer models. Otherwise, the rule will remain private until it is published, said Falcon. “We haven’t shared this with anyone outside of OFHEO,” he said. “No one has been involved insofar as Capitol Hill.” **Falcon would not reveal whether Fannie or Freddie already meet the capital standards imposed by the new rule. After the rule is published, OFHEO does not plan to publicly release whether Fannie and Freddie meet the risk-based capital standards, until the rule becomes effective (in one year). Falcon added that he would consider early disclosure, however, if the GSEs do not object.** (*National Mortgage News Daily*, 12/18/00; *Dow Jones Newswire*, Jonathan Nicholson, 12/18/00; *Reuters*, 12/18/00; *Wall Street Journal*, Yochi Dreazen, 12/19/00; *BNA Daily Report for Executives*, Adam Wasch, 12/19/00; *American Banker*, Rob Garver, 12/19/00)

### Background

- OFHEO was created in 1992 and was tasked by Congress to create a risk-based capital rule for Fannie and Freddie to be completed by December 1994. OFHEO worked six years on the proposal. At issue, the risk-based capital proposal would determine the amount of capital Fannie and Freddie would be required to set aside to remain solvent during a 10-year period of severe credit and interest rate stresses. The comment period on OFHEO’s proposed risk-based capital proposal for Fannie and Freddie closed on March 10, 2000 after 11 months and two extensions. The comment periods were extended at the request of Fannie and Freddie. OFHEO also sought

reply comments in response to the comments that were submitted by the March 10 deadline. The deadline for the reply comments closed on April 14, 2000.

## **Federal Housing Finance Board (FHFB) finalizes capital rule for the FHLBank System**

### **FHFB will revisit the tax implications of the new rule**

### **Fannie & Freddie criticize the FHLBank System's capital rule**

- On December 20, 2000, the FHFB unanimously adopted a final rule implementing a new capital structure for the FHLBank System over the next three years. The 12 FHLBanks each have nine months (270 days) to submit their individual capital structure plans to the FHFB, which must approve the submissions. Each FHLBank will then have three years to implement its new capital structure once it has been approved. The Internal Revenue Service and the Federal Accounting Standards Board will also have to weigh in on the tax and accounting ramifications of each FHLBank's new structure. The American Bankers Association, America's Community Bankers, and the Council of FHLBanks praised the FHFB for incorporating their suggestions into the final capital rule.
- Establishing a new capital structure for the FHLBanks was mandated by Title VI of the Gramm-Leach-Bliley Act. The new rules would replace the FHLBanks' current subscription capital structure with a more flexible risk-based capital structure. Under the Gramm-Leach-Bliley Act and the final rule, the FHLBanks will have to establish two classes of stock. Class A stock will be redeemable with six months notice, and Class B stock will be redeemable on five years' notice.
- Under the final rule, Class A and Class B stock is not tradable and must be redeemed at par. The rule will require member financial institutions to make a minimum stock investment. Each FHLBank will have to maintain a minimum ratio of total capital to total assets of at least five percent and no FHLBank may redeem stock if it fails to meet any of its minimum capital requirements. Each FHLBank may weight its permanent capital at 1.5 times paid-in value to meet the five percent test, as long as its total capital, excluding such weighting, is not less than four percent of its total assets. Each FHLBank must also have enough permanent capital to meet the rule's risk-based capital requirements for credit risk, market risk, and operations risk. The rule also lowers the capital charge on long-term advances (more than 10 years) from 45 basis points to 35 basis points. It also lowers the capital charge on seven- to 10-year advances from 40 basis points to 30 basis points.
- The final rule reflects changes from the proposed rule. The final rule eliminates provisions in the proposed rule concerning the payment of a membership fee instead of a minimum stock purchase, and it dropped a proposal that would have limited stock purchases by a single member. Also removed from the proposed rule is the 40 percent limit on how much stock a member can hold in a FHLBank, and other provisions that would have changed the directorship structure. Under the final rule, voting rights in director elections remain the same, and will be based on number of shares required to be held by each member, with adjustments to allow for state-wide averages for both Class A and Class B stock. (*National Mortgage News Daily*, 12/20/00; *National Mortgage News*, Brian Collins, 1/2/01; *BNA Daily Report for Executives*, 12/21/00; *BNA Daily Report for Executives*, 12/1/00; *Dow Jones Newswire*, Jennifer Corbett Dooren, 12/20/00; *Bloomberg*, 12/20/00; *FHFB press release*, 12/20/00)

### MPF loan treatment under final rule

- Regarding the FHLBanks' mortgage purchase programs (such as the Mortgage Partnership Finance (MPF) program), the final rule leaves it up to the individual FHLBanks to decide if they want to impose an activity-based stock purchase requirement. If the FHLBanks have different stock requirements for mortgage purchases, it could become an issue that generates competition for members, said America's Community Bankers Lobbyist Eric Mondres. "That is an issue that still has to be dealt with," said Mondres. A Spokesman for the FHLBank of Chicago said that the issue of activity based stock requirements should be left to the individual banks. The Chicago Bank was, however, disappointed that the FHFB increased the capital charge on MPF loans from 55 basis points to 60 basis points in the final rule. The FHLBank of Chicago Spokesman noted that MPF loans are credit enhanced and higher quality than Fannie and Freddie loans. However, OFHEO only requires a 45 basis point capital charge for the mortgage loans held by Fannie and Freddie. (*National Mortgage News, Brian Collins, 1/2/01*)

### FHFB will revisit tax implications

- According to *BNA*, there are still remaining concerns about the tax implications for banks affected by the new capital rule. The FHFB agreed to review the issue in February after banks and the Internal Revenue Service have had a chance to implement their plans. (*BNA Daily Report for Executives, 12/21/00; BNA Daily Report for Executives, 12/1/00*)

### Fannie & Freddie criticize the FHLBank System's capital rule

- In comment letters to the FHFB on its proposed risk-based capital rule, Fannie and Freddie criticized the proposed rule, claiming the rule was not tough enough. Fannie and Freddie claim that the proposal gave too much latitude to the regional FHLBanks to create their own capital plans, and in turn offers little protection for the entire FHLBank System. "This is especially critical because the regional banks are jointly and severally liable for each others' debt obligations. A weakness in one could threaten the entire FHLB System," wrote Freddie in a November 20 comment letter. Freddie claims that the proposal fails to tie capital to risk, does not provide for "true" permanent capital and could allow a few large members to take control of a FHLBank.
- According to Fannie and Freddie, the proposal did not contain an adequate safety net to keep pace with the FHLBank System's new business activities, such as the FHLBank's MPF program. "We do not believe the FHFB's capital proposal has given adequate consideration to the new direction the Federal Home Loan Banks are taking in terms of risk, the rapid growth of the new programs, and whether the banks' capital structure is adequate for any substantial growth in such programs," said Fannie in its November 20 comment letter. Fannie claims that the FHLBanks' mortgage purchase programs are riskier than the FHLBanks' traditional advance business and the FHLBanks do not have real equity capital that other lending institutions rely on as a cushion against losses. Freddie's primary concern was the FHLBanks' mortgage purchase programs (e.g., MPF program).
- Fannie and Freddie also argued that the proposal would put smaller members of the FHLBank System at a disadvantage because large members could control a district's board. (*Reuters, Richard Leong, 12/5/00; National Mortgage News, 12/4/00; National Mortgage News Daily, 11/29/00*)

**General Accounting Office (GAO) to study FHLBank System's capital structure and the FHLBanks' mortgage purchase programs (e.g., the FHLBanks' MPF program)**

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

**GAO will also compare the risk-based capital standards for the FHLBank System to OFHEO's proposed risk-based capital rules for Fannie & Freddie**

**Fannie reportedly lobbied for the GAO study**

- Included in the Omnibus Appropriations bill (H.R. 4577) that passed Congress right before it adjourned for the year, is a provision requiring GAO to study the risks associated with future growth of the FHLBank System's mortgage purchase programs (e.g., the FHLBank System's Mortgage Partnership Finance (MPF) program). The MPF program, started by the FHLBank of Chicago, is a competitor to Fannie and Freddie in the secondary market.
- The results of the study are to be submitted to Congress no later than six months after the date of enactment of the legislation. According to the provision in H.R. 4577, the GAO is instructed to examine "risks associated with future growth in the direct acquisition of mortgages by the Federal Home Loan Bank System." In addition, the GAO will examine the adequacy of the capital structure of the FHLBank System in relation to the MPF program and certain other activities. On December 20, the FHFB finalized a capital rule for the FHLBanks that allows the FHLBanks to require activity-based stock purchase for members who want to sell mortgages to their FHLBank. In terms of credit risk, the final rule sets a 60-basis-point capital charge for AA rated mortgages.
- The GAO will also compare the Federal Housing Finance Board's capital standards for the FHLBanks to OFHEO's proposed risk-based capital proposal for Fannie and Freddie. (*Dow Jones Newswire*, John Connor, 12/19/00; *National Mortgage News Daily*, 12/20/00)
- According to Brian Collins with *National Mortgage News*, several sources said Fannie lobbied to have the GAO study added to the Omnibus bill, even though any Senator or Representative could simply request a GAO study by writing a letter to GAO. (*National Mortgage News*, Brian Collins, 1/2/01)

**Freddie succeeds in getting Congress to weaken HUD's newly adopted affordable housing goals for the GSEs**

**HUD opposed Freddie's efforts to weaken the GSE affordable housing goals**

**OMB and Treasury Department join HUD "in being unequivocally opposed to any dilution of Freddie Mac's affordable housing goal requirements"**

**HUD warned that lowering Freddie's affordable housing goals would disadvantage 130,000 families over the next three years**

- As reported in the November 3 *GSE Report*, HUD issued a final rule establishing new affordable housing rules for Fannie and Freddie for 2001 through 2003. The new goals feature a higher target for low- and moderate-income housing assistance (50% of mortgages purchased instead of 42%).

The rule took effect January 1, 2001, with no transition period. (*Dow Jones Newswire*, John Connor, 10/31/00; *Federal Register*, pages 65044-65229, 10/31/00)

#### Freddie weakened its affordable housing goals

- According to *National Mortgage News*, Freddie was successful in getting Congress to weaken HUD's newly released GSE affordable housing goals. Freddie was able to secure a provision in the Omnibus Appropriations bill (H.R. 4577) that orders HUD to increase Freddie's temporary adjustment factor/bonus points from 1.25 to 1.35 in counting multifamily units towards the new affordable housing goals. This means that for every multifamily unit Freddie finances, it gets 1.35 points for every unit, compared with Fannie, which gets one point for every unit under the affordable housing goals.
- Under HUD's recently released GSE affordable housing goals, HUD gave Fannie and Freddie bonus points to increase their participation in multifamily lending. Fannie and Freddie would receive bonus points for helping to finance 2-4 unit owner-occupied properties that contain rental units and multifamily properties with 5-50 units. In a special concession to Freddie, HUD awarded Freddie a temporary adjustment/bonus point on large multifamily loans with more than 50 units in very low-, low-, and moderate-income areas. Freddie would have received 1.25 points for every unit financed compared to only one point for Fannie. For example, if Freddie bought a loan for an apartment building with 55 units, the company earns credit for 66 low-income loans. The Omnibus Appropriations bill increased the multifamily bonus for Freddie from 1.25 to 1.35, and applied it to new loans. HUD's original affordable housing goals apply to loans Freddie purchases in very-low-income areas, low- and moderate-income areas, and what HUD calls "underserved" areas. The Omnibus language increases the bonus points applied to loans Freddie makes in these "underserved" areas.
- In 1999, Congress told HUD to provide a special concession for Freddie as a "temporary adjustment factor," which recognizes that Freddie has a much smaller multifamily program than Fannie. According to Freddie's Senior Vice President of Government Relations Mitchell Delk, it would take a multiplier of 1.35 to account for Freddie's disparity with Fannie in the size and character of its multifamily portfolio. Freddie Spokeswoman Sharon McHale noted that Fannie's multifamily portfolio is two-and-a-half times larger than Freddie's, even though Freddie has been increasing its multifamily lending at an annual rate of 20%. "Even with that growth rate, it would still take us about 10 years under ordinary circumstances," to catch up with Fannie, she said. [See October 29, 1999 *GSE Report* for information regarding the language inserted in the HUD- VA Appropriations Conference Report that essentially tells HUD to provide a special concession to Freddie.] (*National Mortgage News*, 11/6/00, 1/2/01; *National Mortgage News Daily*, 11/30/00, 12/18/00; *American Banker*, Erick Bergquist, 12/4/00)

#### HUD objects to Freddie's efforts to weaken the affordable housing rules

- **HUD Assistant Secretary William Apgar in a November 30 letter to House leaders warned that Freddie's changes to the affordable housing rule are not minor. He wrote, "In addition to increasing the adjustment factor, the proposed legislation would also extend the special treatment to the 'underserved area goal,' effectively reducing the requirements for Freddie Mac lending in minority and other low-and moderate-income areas. Overall the proposed change would lower Freddie Mac's affordable housing goals, as set by the Department, to the disadvantage of 130,000 families over the next three years."**

- **Apgar claims that Freddie’s changes “would provide Freddie Mac with a special advantage that would reduce by 40 percent their commitment to financing new affordable housing” required under HUD’s affordable housing rule. Apgar noted that the “Office of Management and Budget (OMB) and the Department of Treasury join HUD in being unequivocally opposed to any dilution of Freddie Mac’s affordable housing goal requirements.”**
- Apgar said the final affordable housing rules are fair and that Freddie should not be allowed to “overturn a carefully considered, well-documented, and complex regulatory decision made with the benefit of full and open public comment and deliberation.” Apgar further noted that among the 250 public comments HUD received on the affordable housing rule, Freddie was the only commenter to support increasing and expanding the adjustment factor. (*HUD Assistant Secretary William Apgar to House Leaders, 11/30/00*)

### ***All GSEs***

**Shadow Financial Regulatory Committee (independent panel of financial services experts) asks President-elect George W. Bush and Congress to undertake a serious examination of the GSEs**

**The GSEs benefit from an implied government guarantee and distort the allocation of credit**

**Unlimited bank investment in GSE securities may create systemic risk**

**“...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 Shadow Financial Regulatory Committee urged President-elect George W. Bush and the 107<sup>th</sup> Congress to address a number of important financial and regulatory issues through Administration policy, legislation, and regulatory action. Included in its “Open Letter” to the President-elect and Congress, the Committee recommended 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 last year 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)

- **Peter Wallison, a former Treasury official, who serves as an American Enterprise Institute (AEI) resident fellow, and member of the Shadow Financial Regulatory Committee, states, “We have expressed again and again our concern that the GSEs have been growing larger and larger and increasing the risk to taxpayers.” He stated, “Investment in GSE securities is a problem, because it isn’t a good measure on how much debt is held by banks.”** Janice Smith, a Spokeswoman for Fannie, dismissed the Committee’s proposal, saying that banks should not be limited in the types of securities in which they invest. “Fannie Mae believes, as the OCC has also noted, that imposing a limit on the bank investment and GSE securities would potentially drive banks to invest in riskier securities, thus increasing exposure to the financial system,” she said. (*Real Estate Finance Today*, Mike Sorohan, 12/11/00)

Members of the Shadow Financial Regulatory Committee include:

George G. Kaufman, Loyola University of Chicago  
Robert E. Litan, Brookings Institution  
Richard C. Aspinwall, Economic Adviser  
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

**Morgan Stanley Dean Witter analyst sees little political risks for the GSEs in 2001**

**Treasury Department is the biggest risk factor for the GSEs**

- In a recent report, Morgan Stanley Dean Witter analyst Kenneth Posner says he sees limited political risks for the GSEs in 2001. Posner expects certain headline events over the next six months, including the release of a new CBO study, issuance of OFHEO’s risk-based capital regulations, and more GSE hearings next spring to create “headline noise.” However, Posner notes that these headline events appear manageable and of little risk to the GSEs.

- Posner believes that the risks of legislation addressing the GSEs appears low since a divided Congress is not likely to take action that could disadvantage the GSEs at the risks of potentially harming the housing market. He further believes that the new Administration is unlikely to place the issue of GSEs high on its priority list of agenda items.
- Posner expects that Senate Banking Committee Chairman Phil Gramm (R-TX) will hold GSE hearings in April or May. Posner notes, however, that hearings do not necessarily mean legislation and that legislation wouldn't necessarily be harmful to equity investors. Politicians have more recently been focused on the need for a new GSE regulator – a direction that Posner does not think poses risk to equity investors. Although there appears to be agreement that the GSEs need a new regulator, Posner is doubtful that there will be quick progress in this area in the next six to twelve months, since there does not appear to be a consensus emerging over how the regulator should be structured. Posner argues that the GSEs' current regulator, OFHEO, is respected for its technical skills but people do not believe OFHEO has enough political clout to address the GSEs. The most commonly discussed regulatory structure is to place the GSE regulator as a bureau under Treasury. However, there is disagreement over whether the same body should regulate the FHLBank System.
- **According to Posner, “the next Secretary of Treasury will have significant influence over the GSE debate.” Posner notes that the Fed “appears to be quietly trying to keep pressure on the GSEs, although we sense that it isn’t interested in direct confrontation.” Posner writes that “Treasury acting in concert with the Fed could increase the risk of unfavorable legislative momentum.”**
- Posner notes that “mission creep,” although an important issue for banks and financial institutions, is “less important for politicians,” and he expects that banks will have a hard time prevailing on mission creep arguments. Finally, Posner sees little threat from the FHLBanks' MPF program as a competitive threat to Fannie and Freddie in 2001, however, he will consider the MPF program as an issue for 2002. (*Morgan Stanley Dean Witter Report, “Watch Risk Factors, but Own the Stocks,”* Kenneth Posner, 12/1/00)

***Credit Union Journal's* “Washington Watch” reports that competition in the secondary market could benefit credit unions**

***Journal* reports that the GSEs' potential role in mortgage originations is “no small matter as each [Fannie & Freddie] has developed and begun marketing its own loan origination software, which some see as opening the door into the originations area”**

- In the *Credit Union Journal's* “Washington Watch” section, the *Journal* noted that efforts by Congress to tighten the reins on Fannie and Freddie would continue in 2001. The *Journal* noted that credit unions have a large stake in this issue because they sell billions of dollars to the secondary markets as well as hold over \$50 billion in GSE debt. A proposal by Cong. Baker during the last Congress could have had “enormous implications for the mortgage market, especially those large institutions that want to bypass Fannie and Freddie and carve out their own share of the secondary market.” The *Journal* noted that some credit unions have begun securitizing their own mortgage for sale, and with the advent of such additional players, as well as the FHLBanks' mortgage purchase program, this means greater competition. **The *Journal* argued that “Greater competition could benefit credit unions by expanding the market for their mortgage paper.”**

- Even though the GSEs claimed at last year’s GSE Roundtable hosted by Congressman Baker that “increased costs for them through higher borrowing expenses would translate into lower prices paid to buy mortgages, that may be tempered by increasing competition in the market for mortgage paper. Fannie and Freddie may be forced to lower their pricing, but another secondary market player could surface to better their pricing.” The *Journal* added, **“After all, if true competition is introduced into the secondary mortgage market wouldn’t that translate into better pricing? ...That’s one of the main motives of the recently formed FM Watch, a Washington lobby sponsored by several large financial services companies seeking to reign in the GSE giants.”**
- According to the *Journal*, the GSEs’ potential role in mortgage originations **“is no small matter as each has developed and begun marketing its own loan origination software, which some see as opening the door into the originations area.”** (*Credit Union Journal*, “Washington Watch”, 10/9/2000)

### *Fannie Mae and Freddie Mac*

***Wall St. Journal* editorial warns that Fannie & Freddie may be too big to fail**

**“...one might wonder whether we really need two companies [Fannie & Freddie] engaged in making private profits with the help of public subsidies to accomplish a task that is no longer necessary (liquidity) while falling down on a public-policy mission they’ve agreed to perform (promote home owning by minorities). Two companies with humongous debt that have, in all likelihood, a call on a taxpayer bailout.”**

- The *Wall St. Journal* ran an editorial on December 6, 2000 that questioned the need for Fannie and Freddie’s government subsidies. As the editors noted, Fannie and Freddie currently have a total outstanding debt of \$2.3 trillion while owning or guaranteeing a “substantial majority” of middle-class mortgages. However, “to keep the double-digit growth that pleases Wall Street, they are getting even bigger and, thus, attracting attention to their practices, mission and reason for being.” While this may not be a problem for most big companies, the *Journal* noted that Fannie and Freddie have an odd profile: they call themselves private companies and trade stock on the Stock Exchange, yet also receive many government perks such as no state or local income tax, not having to register their securities with the SEC, and a line of credit with the US Treasury. **“All this suggests to investors that their debt (do remember that \$2.3 trillion number) is backed by the full faith and credit of the government that, in turn, translates into low borrowing costs. This subsidy alone is estimated to be worth about \$10 billion a year.”**
- The *Journal* noted that during 2000 several different government officials became somewhat uncomfortable with the GSEs’ expansion plans. Chairman of the Federal Reserve Alan Greenspan was concerned that the GSEs’ subsidies diverted too much money into housing and away from more productive investments. In addition, Congressman Richard Baker (R- LA), Chairman of the House Banking Committee’s subcommittee on government sponsored enterprises, called for the elimination of the GSEs’ line of credit with Treasury. Certain financial institutions grew concerned about Fannie and Freddie’s attempts to enter the subprime market. Others became concerned about the GSEs’ systemic risk – worrying that if Fannie and Freddie were to falter they would **“take down other financial institutions and perhaps the whole system. Unless the government bails them out, of course. (Shades of the thrift debacle.)”**

- In addition, the *Journal* noted that three economists – including one at the Federal Reserve – published a paper that suggests that the securitization of mortgages does not necessarily result in lower mortgage rates or costs for consumers. Additional economists and industry analysts have also began to argue that the GSEs’ original mission – to promote liquidity in the mortgage market – is no longer necessary, with the market well-served by fully private companies. In addition, the Department of Housing and Urban Development released a study of neighborhoods in Chicago and Washington, DC that found that Fannie and Freddie lag in buying mortgages from non-white areas. “In Chicago, for example, Fannie and Freddie bought 37% of all eligible loans in mostly white areas, but just 26% of such loans in minority areas, despite the fact that HUD requires them to devote 42% of their purchases to low- and moderate-income families.”
- The *Journal* then added, **“All told, then, one might wonder whether we really need two companies engaged in making private profits with the help of public subsidies to accomplish a task that is no longer necessary (liquidity) while falling down on a public-policy mission they’ve agreed to perform (promote home owning by minorities). Two companies with humongous debt that have, in all likelihood, a call on a taxpayer bailout.”**
- To conclude, the *Journal* noted that Fannie and Freddie’s response to all their criticism has been to increase their lobbying efforts and to launch a large ad campaign. **“Simply put, they are not going to go quietly. And why should they? A portion of their subsidies – probably one dollar of every three they garner – goes straight into their profits, where it is available for juicy executive salaries...The stage is set for a rather protracted struggle, one that promises to go on way past the magic moment when we inaugurate a President.”** (*Wall St. Journal*, editorial page, 12/6/00)

***Atlanta Journal and Constitution* editorial calls for Fannie & Freddie to cut ties to taxpayers**

**“The bottom line is that these gargantuan companies [Fannie & Freddie] can do just fine without the Treasury/taxpayer as co-signer. It’s time to let market forces prevail. [Cong. Richard] Baker knows it, the executives who reap the fruits of that subsidy know it. Cooperating with the next administration to phase in reform and phase out the taxpayer will be infinitely less painful.”**

- An editorial in the *Atlanta Journal and Constitution* outlines the recent challenges the GSEs have faced with members of the government. According to the editorial, the biggest battle involving the House Banking Committee this past December was not between the two candidates for Chairperson – Congresswoman Marge Roukema and Congressman Richard Baker – but between Fannie Mae and Cong. Baker. The *Constitution* notes that Fannie supported Cong. Marge Roukema (R-NJ), while the other candidate, Cong. Richard Baker (R-LA) is Fannie’s “personal Grinch.”
- The *Constitution* noted that Baker has long been a critic of the GSEs – “campaigning tirelessly for greater scrutiny of Fannie and Freddie, and rightly so.” The paper noted that Fannie Mae and Freddie Mac have a “government-backed” leg up on their competition because of lower borrowing rates due to various subsidies. Fannie and Freddie have a \$2.25 billion line of credit with the US Treasury, as well as an outstanding debt of \$2.3 trillion, which many analysts predict will overtake Treasury debt by 2004. The GSEs also are exempt from state and local income tax, as well as SEC registration. Further, according to HUD, the GSEs’ ties to government has “helped them to get the highest credit rating to reduce their borrowing costs, and has boosted investor confidence in the two companies, thereby helping to increase their earnings.”

- Congressman Baker proposed a bill last year that would curtail some of the GSEs' government perks. The bill – HR 4703, the Housing Finance Regulatory Improvement Act – would have cut the GSEs' line of credit with the Treasury as well as consolidate GSE regulation from two seemingly contradictory regulatory agencies to one regulatory body. In addition, Baker's attempts to cut the line of credit at the Treasury would likely end the GSEs' advantage of lowered borrowing costs due to the GSEs' implicit government backing – an estimated \$10 billion annual subsidy. Out of this subsidy, it has been estimated that the GSEs retain 1/3 for executive compensation and stockholders. The remainder is passed on to homeowners – usually upper- and middle-class Americans.
- Despite the clout that Fannie and Freddie retain in Washington, the editorial noted that Congressman Baker's bill has gained several important allies including administration officials and even Federal Reserve Chairman Alan Greenspan.
- The editorial concluded by noting, **“the bottom line is that these gargantuan companies [Fannie & Freddie] can do just fine without the Treasury/taxpayer as co-signer. It's time to let market forces prevail. [Cong. Richard] Baker knows it, the executives who reap the fruits of that subsidy know it. Cooperating with the next administration to phase in reform and phase out the taxpayer will be infinitely less painful.”** (*The Atlanta Journal and Constitution*, editorial, 12/21/00)

**OFHEO proposes a series of “housekeeping” measures clarifying its oversight of Fannie & Freddie**

**The measures include:**

- (1) Proposed rule clarifying OFHEO's authority to block Fannie & Freddie from paying excessive compensation to their executives;**
- (2) Proposed rule clarifying OFHEO's authority to take enforcement action against the GSEs (including issuing cease and desist orders and imposing civil money penalties);**
- (3) Policy guidance to the GSEs on their non-mortgage investments;**
- (4) Policy guidance on safety and soundness policies (reflecting the examination procedures currently employed by OFHEO); and**
- (5) Proposed rule codifying OFHEO's existing practice of assessing oversight fees on the GSEs**

**Executive Compensation**

- OFHEO proposed a rule with a 90-day comment period that clarifies the procedures it uses in overseeing the compensation of Fannie and Freddie. OFHEO said the proposed rule largely formalizes processes currently used by OFHEO in performing its executive compensation oversight. The 1992 law that created OFHEO requires that OFHEO prohibit Fannie and Freddie from providing compensation to any executive officer that is not reasonable and comparable with what is paid by similar businesses to executives doing similar work. Businesses used for comparison include publicly held financial institutions or major financial services companies. In addition to prohibiting excessive executive compensation, OFHEO is empowered to approve individual termination packages provided by the GSEs to their executive officers. The deadline for comments on the proposed rule is March 27, 2000. (*Dow Jones Newswire*, John Connor, 12/20/00; *Federal Register*, pages 81771-81776, 12/27/00)

## **Rule on enforcement action against the GSEs**

- OHFEO proposed a rule with a 60-day comment period on revisions to its rules governing administrative enforcement proceedings. The rule is intended to clarify the scope of OFHEO's authority to issue cease and desist orders and to impose various corrective and remedial sanctions, including civil money penalties, on Fannie and Freddie, and their executive officers and directors. OFHEO says it seeks to promote greater transparency by describing the grounds on which enforcement actions may be instituted and examples of the terms and conditions it may impose.
- According to OFHEO, the 1992 Act that created the agency essentially grants OFHEO the same administrative enforcement authority as the Federal bank regulatory agencies, including the power to issue cease and desist orders and to impose civil money penalties. Grounds for issuing cease and desist orders include unsafe or unsound practices or conditions, any conduct that violates a written agreement between the GSEs and OFHEO, and any action that violates the charters of the companies. Civil money penalties may be imposed if OFHEO finds that "a violation or conduct was knowing and caused or would be likely to cause a substantial loss to the enterprise, and the director may impose penalties on an enterprise of up to \$1,000,000 per day of violation or conduct or on an executive officer or director of up to \$100,000 per day of violation or conduct." Prior to issuing a cease and desist order or imposing civil money penalties, OFHEO must conduct a public hearing, unless its director determines that an open hearing would be contrary to the public interest. Final orders in cease and desist proceedings or civil money penalty proceedings are also made public, unless the Director determines in writing to delay public disclosure for a reasonable time if immediate disclosure would seriously threaten the financial health or safety of the GSEs. The comment period ends February 26, 2001. (*Dow Jones Newswire*, John Connor, 12/20/00; *Federal Register*, pages 81775-81780, 12/27/00)

## **Guidance on non-mortgage investments**

- OFHEO issued a policy guidance on information regarding non-mortgage, liquidity investments of Fannie and Freddie. The supervisory guidance details initiatives with the enterprises regarding OFHEO's safety and soundness expectations for their non-mortgage investment activities. OFHEO is urging the GSEs to adopt written policies with regard to their non-mortgage liquidity investments and to provide greater disclosure about the investments. The policy guidance issued by OFHEO includes a sample disclosure for non-mortgage investments. In its policy guidance, OFHEO says "appropriate non-mortgage liquidity investments are characterized by both creditworthiness and low price volatility."
- OFHEO listed the following types of assets as appropriate non-mortgage liquidity investments:
  - (1) Treasury debt;
  - (2) US Government agency debt;
  - (3) State and municipal general obligation debt and revenue obligations;
  - (4) Corporate debt instruments;
  - (5) Money market instruments;
  - (6) Non-mortgage asset-backed securities; and
  - (7) Reverse repurchase agreements.
- OFHEO noted, however, that the list is "subject to revision over time as new asset types are introduced and/or market activities change." OFHEO also noted that the presence of an asset on a list does not mean it will necessarily consider any and all investments in these assets to be safe and sound, "especially if they fail to meet appropriate credit quality, maturity and diversification objectives." OFHEO said its guidance did not address investments in mortgage-backed securities,

mortgage revenue bonds, or other investments secured by housing “since these assets are not principally held for liquidity purposes.” In addition, OFHEO noted that with respect to activities not covered under its guidance on non-mortgage liquidity investments, “there should be no inference drawn about OFHEO’s views.” (*Dow Jones Newswire*, John Connor, 12/19/00; *National Mortgage News Daily*, 12/28/00; *OFHEO’s Director’s Advisory, Policy Guidance – Non-Mortgage Liquidity Investments*, Doc. # PG-00-002, 12/19/00)

### **Guidance on safety and soundness issues**

- OFHEO issued a policy guidance on safety and soundness policies required to be maintained by Fannie and Freddie. The guidance provides illumination of the broad areas and types of practices that are expected to be addressed by the GSEs to meet the minimum safety and soundness requirements. The policy guidance is not intended to reflect a change in OFHEO’s policies; the announced minimum requirements reflect the basic underlying criteria OHFEO uses to assess the operations and managerial quality of Fannie and Freddie. (*OFHEO’s Director’s Advisory, Policy Guidance – Minimum Safety and Soundness Requirements*, Doc. # PG-00-001, 12/19/00)

### **Assessments**

- OFHEO issued a proposed rule with a 30-day comment period regarding OFHEO’s annual assessment of oversight fees on the GSEs. The deadline for comments is January 26, 2001. (*Federal Register*, pages 81768-81771, 12/27/00)

**SEC proposes rule that would allow investment funds to purchase GSE securities (defined in the proposed rule as government securities) during a syndicated offering in which an affiliated underwriter participates**

**A law firm, Brown & Wood, requested that the SEC allow affiliated funds to purchase Fannie & Freddie securities in syndicated underwritings**

- According to John Connor with *Dow Jones Newswire*, the SEC issued a proposed rule that would allow investment funds to purchase GSE securities during a syndicated offering in which an affiliated underwriter participates. The proposal would include “government securities” under a current exemption from a basic provision of the Investment Company Act that prohibits an investment fund from purchasing any securities during an underwriting or selling syndicate if the fund is affiliated with the principal underwriter for the security. The prohibition was designed to protect funds and their investors from the “dumping” of unmarketable securities on a fund in order to benefit the fund’s affiliated underwriter. The SEC noted that “government securities” are defined by the act to include obligations issued by the GSEs, such as Fannie and Freddie. The SEC said those securities were not included in the exemption to the basic prohibition because, until recently, there was little need to do so. “In 1998, however, at least two government-sponsored enterprises began to offer their securities through syndicated underwritings,” said the SEC, citing Fannie and Freddie programs initiated at the time. The SEC noted that it received a request from the law firm of Brown & Wood to permit affiliated funds to purchase these securities in syndicated underwritings. The deadline for comments on the proposed rule is February 15, 2001. (*Dow Jones Newswire*, John Connor, 12/7/00; *Federal Register*, pages 76189-76194, 12/6/00)

## **OFHEO extends its public comment period on systemic risks to the financial system that may be caused by Fannie & Freddie**

- Fannie and Freddie's safety and soundness regulator – OFHEO – extended its public comment period by a month on any systemic risks to the financial system, and US housing finance markets, in particular, that may be caused by Fannie and Freddie. OFHEO said it will examine whether and to what extent Fannie and Freddie contribute to or mitigate systemic risk and actions that OFHEO and others could take to limit any systemic risk the GSEs may pose. OFHEO said it is extending the period for public comment through January 29, 2001 from December 29, 2000. (*Dow Jones Newswire*, John Connor, 12/19/00; *Federal Register*, pages 79904-79905, 12/20/00)

### **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) Long-term GSE debt volume down by 32% from last year**
- (2) Traders say that the dwindling in agency debt reduces its potential to become a legitimate benchmark replacement for Treasury bonds**
- (3) Freddie plans to increase its debt issuance in 2001**
- (4) Fannie & Freddie to start issuing subordinated debt early in 2001 (Freddie expects to have issued \$8 to \$10 billion in subordinated debt by the end of 2003. Fannie expects to have issued as much as \$15 billion in subordinated debt by the end of 2003.)**
  - **Questions and concerns remain as Fannie & Freddie prepare to issue subordinated debt (e.g., what risk weighting will be required for the GSEs' subordinated debt and whether the market perceives the subordinated debt as carrying an implied government guarantee (like Fannie & Freddie's senior debt)**
  - **Fannie's subordinated debt receives a prospective rating of Aa2 from Moody's Investor's Service and a rating of AA- from Standard & Poor's based on its GSE status (technically a split rating)**
  - **"The difference in opinion between the two ratings agencies...speaks to the perception of an implied guarantee"**
  - **Fannie expects to list its subordinated debt on the Luxembourg Stock Exchange**
  - **A European study on subordinated debt might shed some light on the concerns that Fannie & Freddie's subordinated debt would likely carry an implied government guarantee similar to the GSEs' senior debt. The European study finds that subordinated notes and debentures investors are sensitive to European bank risk, with the exception of European public banks (similar to GSEs). These public banks benefit from a significant government subsidy, including an implied government guarantee, in the form of a lower cost of subordinated debt issues, the value of which has been increasing over time.**

#### 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 Treasuries because of the implicit government guarantee of Fannie and Freddie’s securities. Fannie and Freddie would like to replace Treasuries 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)

#### **Long-term GSE debt down 32% from last year**

- According to John Connor with *Dow Jones Newswire*, a report by the Bond Market Association found that the volume of long-term “agency” debt securities issued in the first nine months of 2000 totaled \$306 billion, down nearly one-third from the \$452.7 billion issued in the same period last year. The Bond Market Association said long-term agency debt issuance was down 32.4% from a year earlier. At the same time, the group said long-term agency debt issuance increased 25% in the third quarter from the second. Issuers in the agency market are Fannie, Freddie, the FHLBank System, Farm Credit System, the Student Loan Marketing Association (Sallie Mae), and the Tennessee Valley Authority. Fannie, Freddie, and the FHLBank System had the sharpest declines in long-term debt issuance through the first three-quarters of this year. Michael Decker, an official with the Bond Market Association, attributed the decline to the interest rate environment and its impact on housing finance.
- The FHLBank System issued \$148.6 billion of long-term debt securities over the first nine months of 2000, down 29.2% from a year ago. Freddie issued \$51.9 billion of long-term debt securities, off 48.4% from the same period last year. Fannie issued \$75.2 billion of long-term debt securities, down 32.1% from the total of the first three quarters of last year.
- Short-term agency debt outstanding increased slightly to \$541.6 billion in the third quarter of this year from \$539.6 billion in the second quarter, with increases in short-term debt outstanding by Fannie and the Farm Credit System largely offset by reductions in the outstandings of other agencies. (*Dow Jones Newswire*, John Connor, 11/30/00)

#### **Traders say that the dwindling in agency debt reduces its potential to become a legitimate benchmark replacement for Treasury bonds**

- According to Thomson Financial Securities Data, the agency bond market is likely to post its worst performance in six years. Callable agency new issuance volume year-to-date is \$59 billion, a steep 59% decrease from the \$142.2 billion posted at this point in 1999, while the actual number of new issues has falling by 40%. Christopher O’Leary with *Investment Dealers Digest* reports that barring an explosion of new deals in the month of December, which he felt was unlikely, the year 2000 will be the slimmest agency callable debt market since 1995.

- Analysts said that a combination of political uncertainty surrounding Fannie and Freddie and most of all a series of Federal Reserve interest rate hikes earlier this year helped to shrink the agency market. O’Leary writes that although Fannie and Freddie were able to reach a compromise in the fall, bankers note that “the instability may have driven some agency buyers out of the market and depressed trading.” O’Leary further notes that the interest rate hikes earlier this year “slammed the brakes on the mortgage market, hence the agency market, too.”
- **O’Leary writes, “the dwindling in agency debt has also reduced its potential to become a legitimate replacement for Treasury bonds as a bond pricing reference. Several traders said that any inroads agency issuers made in the market in 1999 were erased this year because issuance dried up so suddenly. A main concern about the viability of agency debt as a market benchmark has been that there will not be enough regular issuance.” He further writes, “Agency debt could still be considered a viable alternative to Treasuries, but damage has been done.” The recent political compromise by Fannie and Freddie “puts agencies back in the running but they’re way behind,” said Michael Youngblood, head of Mortgage Research at Banc of America Securities. “It will take them a year or more to requalify as an alternative. Swaps are clearly the preferred instrument, as issuers are even pricing home equities to swaps now.”** (*Investment Dealers Digest*, Christopher O’Leary, 11/27/00)

#### **Freddie plans to increase its debt issuance and its retained mortgage portfolio in 2001**

- Freddie announced that it plans to issue \$90 billion of dollar-denominated reference notes and bonds in 2001, up sharply from the \$58 billion it sold in 2000. According to Tyler Lifton with *Dow Jones Newswire*, if you include Freddie’s issuance of euro-denominated debt and subdebt, the amount of Freddie’s planned debt issuance is even higher. Including the euro-denominated debt and subordinated debt, Lifton says Freddie plans to issue \$103 billion in dollar- and euro-denominated debt for 2001, compared to \$68 billion in 2000. On top of the \$90 billion in dollar-denominated issuance, Freddie will sell at least EUR10 billion, roughly \$9 billion worth, of euro-reference notes and \$3 billion to \$4 billion in subordinated debt.
- Louise Herrle, Freddie’s Vice President and Treasurer, said the increase is due to balance sheet growth as well as the maturation of existing reference debt for the first time since the program’s inception in 1998. In 2001, \$12 billion in principal payments will come due. Freddie claims that political turmoil during the year 2000 kept Freddie from issuing its full targeted amounts of debt in some cases. “Due to the political situation (in 2000), we felt it was better to reduce the sizes rather than push the market to our target,” she said. Herrle claims that if not for the market upheaval, Freddie’s reference note and bond program would have totaled about \$65 billion in 2000. Since the inception of its reference note program in 1998, Freddie has issued a total of \$127.5 billion of non-callable dollar-denominated notes and bonds. Fannie said it expects to sell more than \$75 billion of non-callable benchmark notes and bonds in 2001. Fannie also plans to sell up to \$140 billion in long-term debt securities, including subordinated debt. Fannie sold \$77 billion in 2000, up from \$54.75 billion in 1999 and \$42.25 billion in 1998. (*Reuters*, Lynn Adler, 12/20/00; *Dow Jones Newswire*, Tyler Lifton, 12/20/00; *Freddie press release*, 12/20/00)
- **Freddie’s plans to increase debt issuance met with mixed reactions. Given the fragility of the political situation, “I think it’s not the right year to do this,” said Andy Brenner, Senior Vice President of Global Fixed-Income at Fimat USA. Others believe that the political situation on Capitol Hill won’t keep the GSEs from growing their balance sheets aggressively, but rather homeowners that will feel the pain. Ultimately, the GSEs “are going to pass on the cost” of the political volatility on to mortgage holders,” said Ron D’Vari, Senior Vice**

**President and Portfolio Manager at State Street Research and Management in Boston.** One buysider noted, however, that the decreasing supply of Treasurys will give a shot in the arm to the agency market. (*Dow Jones Newswire*, Tyler Lifton, 12/20/00)

### **Fannie & Freddie to issue subordinated debt in 2001**

#### **Freddie**

- On December 15, 2000, Freddie announced key aspects of its forthcoming subordinated debt securities program, called Freddie SUBS. (The subordinated debt program is part of Fannie and Freddie's voluntary risk management initiative announced in October 2000. See November 3, 2000 *GSE Report* for more details on the initiative.) Freddie says it expects to make its initial entry into the market in the first quarter of 2001 by issuing a 10-year noncallable maturity in a minimum amount of \$1 billion. During the first year of the program, Freddie expects to issue subordinated debt at least twice to raise approximately \$3 to \$4 billion. Freddie plans to issue subordinated debt at least twice yearly, and over a three-year phase-in period the amount of Freddie subordinated debt outstanding is expected to grow to a range of \$8 to \$10 billion. Freddie has retained Goldman Sachs as an advisor in developing the subordinated debt program.
- Freddie also will be requesting ratings from both Moody's Investors Services and Standard and Poor's on its subordinated debt. The weighted average outstanding maturity of the securities issued under the program will be at least five years. Program maturities may be from 2 through 30 years. Freddie plans to issue subordinated debt securities in an amount such that the sum of core capital and outstanding subordinated debt will equal or exceed 4% of on-balance sheet assets and 0.45% of off-balance sheet mortgage securities, following a three-year phase-in period. Freddie may reopen outstanding issues or reintroduce new issues to the market and anticipates that the subordinated debt securities will be represented in appropriate Agency/Government bond indices. (*Freddie press release*, 12/15/00; *BNA Daily Report for Executives*, Adam Wasch, 12/18/00; *National Mortgage News*, Brian Collins, 1/2/01)

#### **Fannie**

- On December 22, 2000, Fannie announced details for its new subordinated debt program, called Subordinated Benchmark Notes. Fannie will begin issuing a regular series of Subordinated Benchmark Notes in early 2001. Fannie plans to issue Subordinated Benchmark Notes quarterly during the course of 2001, and on at least a semi-annual basis thereafter. Fannie expects to issue as much as \$15 billion in Subordinated Benchmark Notes over the three-year phase-in period that ends at the close of 2003. Initial subordinated debt maturities will result in a weighted average maturity of outstanding debt of at least five years. New issues will range from \$1 billion to \$2 billion. Issuance will be done via both new deals and reopenings. Fannie announced that Morgan Stanley Dean Witter would be an advisor and arranger, and chose Goldman Sachs & Co., Morgan Stanley Dean Witter, and Salomon Smith Barney as joint-lead managers for the inaugural transaction expected in early 2001. Fannie expects to list Subordinated Benchmark Notes on the Luxembourg Stock Exchange. Fannie's Chairman Franklin Raines said, "Market analysts are estimating that our sub-debt will trade at interest rates of 20 to 30 basis points higher than our senior benchmark securities." (*Fannie press release*, 12/22/00; *National Mortgage News*, Brian Collins, 1/2/01)

### **Questions remain as Fannie & Freddie prepare to issue subordinated debt**

- **According to Tyler Lifton with *Dow Jones Newswire*, there are critical questions remaining as Fannie and Freddie prepare to issue subordinated debt. One remaining question is what**

**risk-weighting requirement will the subordinated debt carry.** The current risk-weighting – or amount of capital that must be held in reserve – for loans provided by banks and thrifts, GSE debt has a 20% risk-weighting requirement. This compares to the 100% risk-weighting requirement for loans to other corporations, making GSE debt a more attractive investment. People familiar with the regulatory process expect the GSEs' subordinated debt to receive a 100% risk-weighting, however a 20% risk-weighting could be assigned. Risk-weighting is being “actively considered by bank regulatory agencies, but no decision has been made,” said a Federal Reserve spokesman. GSE debt market professionals agree that the risk-weighting is a critical issue since it will affect demand for the subordinated debt securities.

- **Another unanswered question is the extent to which the market perceives the subordinated debt as carrying an implied government guarantee.** Lifton noted that preliminary ratings from Moody's and Standard & Poor's were technically a split rating, although many in the market downplayed the ratings difference. **Lifton wrote, “The difference in opinion between the two ratings agencies, though not large, speaks to the perception of an implied guarantee.”** (*Dow Jones Newswire*, Tyler Lifton, 1/4/01)
- Fannie's Subordinated Benchmark Notes received a prospective rating of Aa2 from Moody's Investor's Service and a rating of AA- from Standard & Poor's. S&P said its rating is based on the company's consistently strong operating performance, low risk asset profile, extraordinary access to low-cost funding and adequate risk adjusted capitalization. S&P said management of interest rate risk is facilitated by Fannie's status as a government-sponsored enterprise, which allows it to source funds at an economical cost over a wide array of maturities and terms on a global basis. Moody's said that Fannie's government-sponsored status and significant public policy role in US housing were important credit considerations in its rating. (*Fannie press release*, 12/22/00; *Reuters*, Lynn Adler, 12/22/00; *S&P press release*, 12/22/00; *National Mortgage News*, Brian Collins, 1/2/01)
- **Tyler Lifton with *Dow Jones Newswire* noted that for the subordinated debt to be viewed as an indicator of the GSEs' financial strength – it must be viewed as completely subordinate and with no implied government guarantee.** Some market professionals note that this is where the program could fall short. In fact, Moody's raised the issue of the assumed government support that the market prices into the senior GSE notes. Moody's said its ratings of Fannie's subordinated debt reflects “the effective subordination and lower implied support enjoyed by this financial institution relative to senior debt,” but Fannie's GSE status and its significant public policy role in the US housing marketplace are also important credit considerations.
- One market watcher agreed that it may be difficult to differentiate the senior and subordinated GSE debt. Lou Crandall, Chief Economist for Wrightson Associates, noted that while the interest rate payments will be subordinated, the principal payments will not. “You could make an argument for not differentiating between it and the senior debt,” he said. This is because any potential government bailout of a GSE would entail not making bondholders whole but rather taking steps to prevent the GSE from failing. Therefore, it is highly unlikely, in the event of a GSE insolvency, that the senior debtholders – but not the subordinated debtholders - would receive their principal payments, said Crandall. (*Dow Jones Newswire*, Tyler Lifton, 1/4/01)

**European study on subordinated debt issuance by public banks (similar to GSEs) may shed some light on concerns about Fannie & Freddie's subordinated debt issuances**

- **According to John Connor with *Dow Jones Newswire*, a study published by the Federal Reserve “might shed some light, albeit indirectly, on questions relating to plans by Fannie Mae and Freddie Mac to issue subordinated debt.” As Connor notes, the GSEs recently announced plans to issue subordinated debt as part of a voluntary risk management initiative saying this “will promote market discipline and provide a supplement to capital that will further strengthen the companies’ financial position.” Yet, doubt persists whether Fannie and Freddie’s subordinated debt would carry the same implied government guarantee as its senior debt.** Fannie and Freddie’s safety and soundness regulator, OFHEO, has also raised doubts. OFHEO Director Armando Falcon stated, “Currently all enterprise securities carry an explicit statement that they are not backed by the full faith and credit of the US government,” he observed. “Yet the market treats these securities as though they are government guaranteed. How and why would the markets treat sub debt any differently?” [See November 3, 2000 *GSE Report* for more information regarding concerns about Fannie and Freddie’s subordinated debt issuances.]
- In a recent report on the Fed’s website entitled: “*Testing for Market Discipline in the European Banking Industry: Evidence from Subordinated Debt Issues*,” Connor notes that the study may shed some light on the concerns about Fannie and Freddie’s subordinated debt issuance. The paper is located at the following web address: <http://www.federalreserve.gov/Pubs/FEDS/2000/200040/200040pap.pdf> The paper, prepared by Andrea Sironi, an Associate Professor at Bocconi University in Milan, was published as part of the Fed’s Economics and Finance Discussion Series. As Connor notes, the views are those of the author and not of the Fed.
- The European study found that “The question of whether private investors can discriminate between the risk taken by banks is empirically investigated by testing the risk sensitivity of European banks’ subordinated notes and debentures (SND) spreads,” the author explained. She found that “Empirical results support the hypothesis that SND investors are sensitive to bank risk, with the exception of SND issued by public banks., i.e., government owned or guaranteed institutions,” the study said. As Connor notes, Fannie and Freddie are not government-owned institutions, but they do enjoy an implied government guarantee from their GSE status.
- The author’s results were threefold: “First, SND investors appear to rationally discriminate between the different risk profiles of European banks. Second, the risk sensitivity of SND spreads has been increasing over time, suggesting that implicit guarantees such as the TBTF (too-big-to-fail) policies were present in the first half of the nineties and became weaker or vanished during the second part of the decade. Third, European public banks benefit from a significant government subsidy, in the form of lower cost of SND issues, the value of which has been increasing over time.”
- In the author’s analysis of whether SND investors actually price European banks’ risk profiles, the author found evidence to suggest that European public banks pay approximately 40 basis-points less on SND than their risk profile would imply.
- **In closing, the author stated that the implicit government support enjoyed by the European public banks “represents a violation of the ‘level playing field’ principle that was originally set forth by the Basel Committee as one of the two main goals of the 1998 Capital Accord.”** (*Dow Jones Newswire*, John Connor, 11/15/00; “*Testing for Market Discipline in the European Banking Industry: Evidence from Subordinated Debt Issues*,” Andrea Sironi, July 2000)

**E-business advisory firm says secondary mortgage e-marketplaces have the potential to become a transforming influence on the secondary mortgage market, but to do so, they will have to overcome fierce competition from firms with deep roots in the industry, like the GSEs**

**GSEs, such as Fannie & Freddie, through their dominance of the market, could limit the amount of opportunity for secondary mortgage e-marketplaces**

- According to MA-based IDC, an e-business advisory firm, the secondary mortgage e-marketplace has the potential to become a transforming influence on the secondary mortgage market, but to do so, it will have to overcome fierce competition from existing offline brokerage firms with deep roots in the industry. IDC says GSEs, such as Fannie, through their dominance of the market, could limit the amount of opportunity for secondary mortgage e-marketplaces. IDC believes that independent e-marketplaces will need to “mount aggressive marketing efforts, partner with key service providers, and present a complete and compelling value propositions to customers” to provide enough value-added services to induce traders to switch. Otherwise, IDC forecasts that independent e-marketplaces will have only about 4% of the total secondary market for whole loans by 2004. In the mortgage-backed securities market, where the restraints are not as severe, IDC predicts a 55% share. (*Credit Risk Management Report*, 103/0/00)

**Chicago Board of Trade (CBOT) approves new futures contracts based on Fannie & Freddie mortgage-backed securities (MBS)**

**MBS market cautious about new CBOT mortgage contracts**

- The Chicago Board of Trade (CBOT) approved new mortgage futures and options contracts based on Fannie and Freddie MBS. The CBOT said it expects to launch mortgage futures and options contracts in the first quarter of 2001 on its “open outcry” trading floor and on its new electronic trading platform as well. The new contracts are tied to the MBS market, unlike the CBOT’s Treasury and agency debt contracts. CBOT Senior Economist John DiClemente said the MBS futures and options contracts will complement the CBOT’s existing market for futures and options contracts based on Fannie and Freddie debt issues, as well as Treasury-related contracts.
- According to Joy Shaw with *Dow Jones Newswire*, the MBS community is giving mixed reviews to the new mortgage contracts. Some analysts and traders praised the objectives of the contracts and their designs, while others wondered whether the new contracts would be liquid enough and may not serve an urgent need, given that there are existing MBS hedging tools, from Treasuries and agency debt securities to interest-rate swaps. There was a failed attempt in the 1970s based on Ginnie Mae securities, but the new contracts will track prices of conventional Fannie and Freddie MBS. “One of the problems we had in the past is, if you simply focus on one (type of) coupon, you can get dislocated, whereas in this case, up to three (types of) mortgage coupons will be used,” said Alec Crawford, an MBS analyst at Morgan Stanley Dean Witter. “I do think there’s a good chance of succeeding,” he said. However, David Montano, an analyst with Credit Suisse First Boston is not as optimistic. “My first impression is that it’s not going to succeed,” he said. Montano says the big question is who will buy or trade the mortgage contracts. He noted that mortgage options already exist and are traded among dealers and mortgage banks. And the MBS’ TBA (To be Announced) market currently acts as a futures contracts market. (*Reuters*, 12/4/00; *National Mortgage News Daily*, 12/6/00; *Dow Jones Newswire*, Joy Shaw, 12/6/00; *National Mortgage News*, 1/2/01)

## **More subprime securitizations use bulk mortgage insurance, but that could change as Fannie & Freddie continue to expand further into the subprime market**

- According to Bonnie Sinnock with *National Mortgage News*, “bulk deal” mortgage insurance has been increasingly used with private-label subprime transactions, but at least one mortgage insurer says that Fannie and Freddie’s expansion further into the subprime market could change that trend. In the primary market, most mortgage insurance is provided on a “flow” or loan-by-loan basis. Tim Edwards, Capital Markets Manager for Mortgage Guaranty Insurance Corp., noted that private-label subprime issuers prefer insuring a large group of individual loans at one time in secondary market transactions (“bulk deal”). In addition to insuring private label subprime securitizations in bulk, MGIC has provided insurance in a more traditional flow basis to subprime loans in Fannie and Freddie deals. A MGIC Spokesman said that the company’s CEO Curt Culver recently noted in a webcast Lehman Brothers Financial Services Conference that as the GSEs expand their underwriting criteria to include more loans of this type, the number of private label bulk insurance deals may decrease. The *National Mortgage News* article also reported that PMI Mortgage Insurance Co. has limited the extent to which it will insure subprime products. Through September 30, 14% or \$2.5 billion of a total \$21 billion in new insurance written by PMI has been A-minus product. A Spokesman for PMI noted that about half of this came from Fannie or Freddie deals, and the other half from Wall Street transactions. (*National Mortgage News*, Bonnie Sinnock, 12/18/00)

## **Fannie & Freddie begin financing loans with zero-down payments**

- Freddie announced it will now regularly purchase first-mortgage loans with zero down payments of up to \$252,700 [presumably now up to the new conforming loan limit of \$275,000]. The new Freddie Mac 100 Mortgage program will come with several key conditions: Borrowers will need to have excellent credit histories, and consumer debt-to-income ratios no higher than 41%. The loans will generally carry interest rates comparable to those on regular mortgages, but may carry slightly higher fees. (*Bloomberg*, 10/26/00)
- Freddie is also offering a new mortgage product, called Alternative Stated Income Mortgage, for self-employed borrowers. The product allows borrowers to get a loan with no documentation of income. The loans, which have large down payments, require only that the borrower provide the amount and source of income on the loan application. The product will have minimum down payment of 25%, more than the traditional 20%. Freddie also announced a third new type of loan called a Financed Permanent Buydown Mortgage which allows borrowers to put additional cash into the loan after it closes, in order to lower the monthly payments. The loans are available in both fixed and floating rates. (*Bloomberg*, 10/26/00; *National Mortgage News Daily*, 10/26/00)
- Fannie is launching a \$2 billion affordable housing pilot program, called “MyCommunityLoans” The program, which began December 1, calls for Fannie to purchase \$2 billion of mortgages and lets participating lenders accept a higher loan-to-value ratio and smaller down payments, and it permits borrowers to have more debt overall than is usually allowed. Lenders will get approval recommendations from Fannie on loans that previously would have been negotiated on an individual basis. Pilot mortgage lenders include Bank One, First Nationwide, First Union, and North American Mortgage Co. Private mortgage insurers MGIC, PMI and Radian helped develop the underwriting guidelines for the loans and have agreed to insure the loans.

- The following are the basic product options for “MyCommunityLoans”: (1) Community 97 is a new 97% loan-to-value mortgage for single-unit borrowers who need to devote more of their income to housing; (2) Community 100 is a new 100% loan-to-value option for single-unit borrowers who lack cash and reserves, but have good credit; (3) Community 2-Family offers underwriting flexibility for 2-unit properties to 95% loan-to-value; (4) and Community 3- and 4-Family offers underwriting flexibilities for 3- and 4-unit properties to 90% loan-to-value. (*American Banker*, Lisa Daigle, 10/31/00; *Reuters*, 10/30/00; *National Mortgage News Daily*, 10/30/00; *Inman News Feature*, 10/31/00)

#### **NHEMA members urged to be aware of competition from Fannie & Freddie**

- According to Brad Finkelstein of *Origination News*, subprime lenders were urged to become aware of competition from the GSEs at the Northeast Atlantic Conference of the National Home Equity Mortgage Association (NHEMA). Finkelstein noted that Mortgage Amenities Corp. Senior Vice President Robert A. Briden gave a speech which warned lenders that Fannie and Freddie’s automated underwriting systems have brought them into competition with subprime lenders. He also noted that this is not a new phenomenon – and it has been occurring for several years.
- When asked how much of “our business” is going to the GSEs, Briden estimated between 20-25%. Glenn Tourtellot of Mortgage Amenities, stated that anyone who fills out a 1003 will be capable of using Fannie’s Desktop Underwriter (DU) and Freddie’s Loan Prospector (LP). Tourtellot was asked the differences between the two products. He noted that DU will tell the lender what is needed to complete the mortgage origination process. LP is “more lenient on credit, and it ‘goes deeper’ on credit for loans it approves. If someone is severely ‘dinged’, LP is more likely to approve the loans than DU.” (*Origination New*, Brad Finkelstein, 11/20/00)

#### **Former Treasury Department Economist advocates that the Social Security Trust Fund invest in GSEs**

- According to Kurt Ritterpusch with *BNA*, Francis Cavanaugh, former Federal Retirement Thrift Investment Board Executive Director, told the National Economists Club November 15, that the Social Security Trust Fund should invest in GSEs, such as Fannie and Freddie. Cavanaugh explained that the decreasing supply of Treasuries will continue to cause the Social Security Trust Fund to earn less on Treasury investments. He argued that investing in GSEs would be a desirable alternative to both Treasury investment and allowing individuals to invest a portion of their payroll taxes. Cavanaugh said the Social Security Trust Fund should be invested in either GSEs or the stock market. He preferred investments in GSEs because federal trust fund investment in GSEs is already allowed and the GSE market has been growing rapidly. He advocated investing the Social Security Trust Fund in an index of GSEs based on total capitalization, allowing for an “arms-length” relationship in which the Treasury would be dealing with the index, and not the GSEs directly. He said investing in GSEs would increase the investment income of Social Security because interest rates on GSEs are, and will, be significantly higher than rates on Treasury securities, while still maintaining the viability of the Treasury securities market by allowing the securities to be issued to the market. Cavanaugh spent 30 years as a Treasury Department economist and now is a private consultant in Washington, DC. (*BNA Daily Report for Executives*, Kurt Ritterpusch, 11/16/00)

**Former Comptroller of the Currency calls the Baker / GSE deal a “good package for safety” of the GSEs**

- An op-ed in the *American Banker* by former Comptroller of the Currency Eugene Ludwig, called the deal between Fannie, Freddie and Rep. Richard Baker (R-LA) “a fine example of compromise.” Ludwig also called it a “victory for all of us who are concerned about the safety and soundness of the financial system.” Ludwig also called for “both sides [to] take a bow for this historic step.”
- According to Ludwig, the deal will improve the GSEs’ safety and soundness in important ways. The first, by agreeing to a three-year phase in plan to issue subordinated debt equal to 4% of on-balance sheets, the GSEs will strengthen their capital position while giving markets another tool to discipline the GSEs. According to Ludwig, the semiannual issuance of debt will “be an important signal of the markets’ view of these enterprises’ financial health.” Ludwig also praised the GSEs’ willingness to maintain more than three months of liquidity, noting that “liquidity weakness – not insolvency – typically lays financial institutions low. Strengthening liquidity...ensures that Fannie and Freddie gave a substantial cushion, which would give them and other players time to act if financial difficulties arise.”
- In addition, Ludwig noted that until the permanent risk-based capital regulations are adopted by OFHEO, the GSEs have agreed to submit to an interim test based on parameters set by 1992 legislation. And, “this approach to safety and soundness – stress testing of an institution’s capital position – is strongly endorsed by the Basel committee.” Ludwig also said that the GSEs’ willingness to disclose the monthly results of interest rate sensitivity analysis “may well set a world record on frequency of disclosure.” This disclosure is also supplemented by Fannie and Freddie’s quarterly disclosure of credit risk sensitivity – another likely “worldwide first” according to Ludwig.
- Ludwig noted that the GSEs’ agreement to a financial condition rating from nationally recognized rating organizations would allow the government to assess the risk to the government posed by the GSEs. To conclude his piece, Ludwig noted that “taken individually, each of these steps is important for strengthening safety and soundness...and are likely to be templates for action by other financial institutions.” More importantly, “taken as a whole these measures form a package that supplies a much stronger safety net under Fannie and Freddie.” (*American Banker*, Robert Ludwig, 12/29/00)

***Fannie Mae***

**Fannie personally attacks the influential advisory firm Medley Global Advisors**

**Medley has issued several reports to clients warning that concerns about the size of Fannie & Freddie are widespread in Washington**

- According to Tyler Lifton with *Dow Jones Newswire*, Fannie has taken the unusual step of personally attacking one of its critics - the influential macro-political advisory firm Medley Global Advisors. Lifton notes that Medley has released several reports to its clients, warning that concerns about the size of Fannie and Freddie are widespread in Washington.

- *Dow Jones Newswire* obtained a letter by Fannie that was written to Wall Street analysts, criticizing a recent report by Medley that warns of the political risks faced by Fannie and Freddie. According to Lifton, “the letter paints Medley as a latter day analyst who cried wolf.” The Fannie letter notes that “Over the past year, Medley Global Advisors has periodically written alarmist newsletters about Fannie Mae. Medley has a poor record when it comes to political forecasting about us...In a continuation of his effort to create political noise where none need exist, Mr. Medley returned his focus to Fannie Mae in a new article that cobbles together a set of six unrelated ‘pieces of news.’”
- **Lifton notes, however, that “despite Fannie Mae’s efforts to undermine the firm’s reports, they [Medley] have proven to be very influential, and news of their release has tended to have an immediate impact on the market.”** (*Dow Jones Newswire – Capital Markets Report*, Tyler Lifton, 12/21/00)

**Fannie CEO Franklin Raines says Fannie plans to increase its revenues by increasing its “touch” on loans, at the expense of the private sector**

- In an October 2000 meeting with securities analysts, Fannie Chairman Franklin Raines said Fannie has plenty of room to increase its revenues by increasing its “touch on the mortgage revenue stream.” Fannie estimates that in 1999 approximately \$136 billion was spent industrywide on risk management. Of that total, Raines claims Fannie nets just 4.7% of the revenue spent for risk management industrywide. Raines argues that this gives Fannie plenty of room to grow its business. **To achieve its growth targets, Fannie hopes to obtain a larger share of the [private sector’s] revenue associated with managing credit and interest rate risk that is shared between the secondary market agencies, investors, servicers, and mortgage insurance firms.**
- Fannie estimated that \$136.3 billion of the mortgage industry’s revenue is used for risk management, either from credit loss exposure or interest rate exposure. Out of this amount, Fannie estimates its share on a gross basis is 9.4%. However, Fannie also claims that over half of its \$12.7 billion of risk-management revenue is shared with Fannie’s “risk sharing partners” such as mortgage insurers. Citing these figures, Raines told the analysts that Fannie has plenty of room to grow. The company plans to increase its risk management revenue from 4.7% to 5.7% by 2003. **Then “Fannie Mae can continue to achieve double-digit earnings per share growth.”** As *Mortgage Servicing News* reports, **“that share increase could come at the expense of mortgage insurers and investors who take on interest rate exposure.”** *Mortgage Servicing News* further notes that Fannie is already increasing its share of interest rate risk by increasingly holding more loans in portfolio rather than guaranteeing securities backed by the loans. This shifts interest rate risk exposure to the GSEs. (*Mortgage Servicing News*, November 2000; *National Mortgage News*, Ted Cornwell, 10/16/00)

**Celeris Financial Services (a business-to-business online mortgage unit) establishes a technology partnership with Fannie that will allow non-mortgage professionals – such as a tax return preparers, stockbrokers, or real estate agents – to originate mortgages using the Celeris system**

**The partnership with Fannie allows Celeris access to decision engines and their databases**

**[Editorial Note: Partnership allows Fannie to expand its technology beyond its customers (mortgage lenders)]**

**Celeris allows “trusted financial advisors” to receive “on-the-spot” approvals and reduce closing times and can also be used to provide home equity credit lines, credit cards, and other financial products**

- FleetBoston created a new business-to-business online mortgage unit called Celeris Financial Services that allows customers (“trusted financial advisors”) to receive “on-the-spot” origination approvals and reduce closing times. According to Mike Murray with *Real Estate Finance Today*, Celeris has a technology partnership with Fannie. William Naryka, Chief Executive Officer of Celeris Financial Services, said that it has found through its partnership with Fannie that the average homebuyer is reluctant to complete the mortgage process online without any consultation with a trusted advisor. “Our approach from day one has been to provide this technology to various trusted advisors and that is where you get the B2B (business-to-business),” said Naryka. **Celeris, however, is unique in its definition of “trusted advisors.” Naryka explained that, “We have simplified the mortgage process so much that non-mortgage professionals could also originate mortgages. Our approach is very broad for distribution centers.” He stated, “Our definition [of trusted advisors] is a little broader than brokers or mortgage bankers,” said Naryka. “A trusted advisor could be a tax return preparer or a stock broker.” Celeris is accessible to anyone from real estate agents to mortgage brokers to online lenders to financial consultants.**
- The partnership with Fannie allows Celeris access decision engines and their databases. “In some cases, we are able to waive the appraisal requirements on these loans,” said Naryka. “That further reduces the documentation for some of our borrowers.” In the worst-case scenario, the loan would require only a drive-by appraisal. “The only thing we require is a year-to-date pay stub and a bank statement showing that the borrower has the funds for a down payment,” said Naryka.
- Celeris allows customers (trusted financial advisors) to receive “on-the-spot” approvals and reduce closing times and can also be used to provide home equity credit lines, credit cards and other financial products. According to Celeris Spokeswoman Mary Alice Rogers, Celeris can also be used to provide home equity credit lines, credit cards and other financial products. “We think that during this time, when the mortgage is quoted and processed, there is a real opportunity to cross-sell other mortgage-related products to the customer,” said Naryka. He said that Celeris is looking into products like homeowners’ insurance and moving services.
- Celeris has also developed its technology for use on a Palm computer. Real Estate Agents with a broker’s license could use the system to apply for loans for consumers through wireless handheld devices.
- Celeris recently signed agreements to provide its web-based system to First Preference Mortgage Co., in Waco, TX; Lafayette Bank & Trust in Lafayette, IN.; and Coastal Mortgage in Charlotte, NC. Other customers include Intuit’s Quicken Loans and Dublin, CA-based Ellie Mae, which provides websites for mortgage brokers. (*Real Estate Finance Today*, Mike Murray, 12/11/00, Mike Murray, 9/3/00; *Inman News Feature*, 11/29/00)

**Congressman Rick Lazio (R-NY) to work for Fannie?**

- According to *National Mortgage News*, industry sources note that Congressman Rick Lazio (R-NY), who ran against First Lady Hillary Rodham Clinton for the open New York Senate seat, is

seeking housing-related employment, and is even talking to Fannie about employment. It is unclear what Cong. Lazio would do at Fannie, but the company is well known for hiring influential Capitol Hill insiders to help manage “political risk.” Cong. Lazio served as Chairman of the Housing Subcommittee of the House Banking Committee. (*National Mortgage News*, 12/11/00)

### **Fannie says that a new accounting rule for derivatives (FAS 133) will not alter Fannie’s use of derivatives**

- Fannie said that a new accounting rule for derivatives - Financial Accounting Standard 133 (FAS 133) – is not expected to alter Fannie’s use of derivatives. During a conference call with financial analysts, Fannie’s Chief Financial Officer Tim Howard said that he had heard that some companies intend to do considerably less hedging than they were previously in response to FAS 133. “That won’t be Fannie Mae’s response,” said Howard. “Our business has been built on the extensive use of interest rate and credit risk hedging, and even with FAS 133 we will continue to be heavy users of risk management techniques, including derivatives.” FAS 133 requires that firms report on their balance sheets the fair market value of their holdings in derivatives and that they be marked to market to reflect the prevailing value at the date of reporting.
- According to Joe Niedzielski with *Dow Jones Newswire*, one of the potential impacts on Fannie from FAS 133 is expected to come from its use of purchased options. Fannie primarily uses options on interest rate swaps, known as swaptions, to synthetically create callable debt. Currently under FAS 133, the time value component of an option’s premium must be recognized in earnings. Fannie has been asking the FASB to amend FAS 133 to allow corporations to amortize an option’s premium over its life in reported income if they can demonstrate that they plan to hold the option until maturity. Any changes in the difference between the premium’s fair value and the amortized value would be posted to other comprehensive income, rather than to earnings. Fannie is hopeful that the FASB will address and change the accounting for purchased options next year.
- Fannie also plans to add a new line item to its income statement next year to reflect the implementation of FAS 133. Fannie will publish an operating earnings per share measure that excludes the effects of the mark-to-market of purchased options. Fannie will also publish a separate line item that excludes a one-time transition adjustment. (*Dow Jones Newswire*, Joe Niedzielski, 12/6/00)

### **Fannie invests in online commercial real estate technology provider, MortgageRamp**

- MortgageRamp, the online commercial real estate technology provider, announced it had secured \$50 million in its second round of funding. Banc of America Mortgage Capital Corp., Deutsche Bank, Allied Capital Corp, Bank United, Compaq Computer Corp., Fannie Mae, Moody’s Investor Services Inc., and VerticalNet invested alongside GMAC Commercial Mortgage. MortgageRamp said the funds would be used to support technology enhancements and product developments. Michael Greco, CEO of MortgageRamp, said some of the funds are earmarked to develop technology platforms for Europe, Asia, Canada and Latin America. MortgageRamp is a mix of five businesses – offering out-sourced underwriting technology, underwriting templates, appraisal and due diligence services, a technology platform for institutional partners to originate loans over the Internet as well as the loan origination site, MortgageRamp.com. (*National Mortgage News*, James Faucett, 12/4/00; *Private Equity Week*, 12/4/00; *Inman News Features*, 12/1/00)

## **Fed's latest interest rate cut sparks a surprising drop in Fannie & Freddie's stock price**

**Prior to the Fed's rate cut, Fannie & Freddie's stock had climbed to record highs leading two analysts to downgrade their ratings on Fannie**

- According to Ted Cornwell with *National Mortgage News*, the Federal Reserve's unexpectedly early and large interest rate cut in early January sparked a surprising drop in Fannie and Freddie's stock price. Prior to the Fed's interest rate cut, Fannie and Freddie's stocks had been climbing to record highs. However, the market rally following the Fed's rate cut apparently tempted money managers to move money out of the GSEs and into riskier segments of the market, such as technology stocks. (*National Mortgage News*, Ted Cornwell, 1/8/01)
- Prior to the Fed's rate cut, Erick Bergquist with the *American Banker* reported that decreasing mortgage rates and a temporary cease-fire on Capitol Hill sent Fannie's stock price soaring, leading two analysts to lower their rating on Fannie. The analysts noted that the stock price increases were limited, making the stock less attractive. David Graifman of Keefe, Bruyette & Woods downgraded Fannie's stock from a "buy" rating to "outperform," while Gary Gordon of UBS Warburg downgraded Fannie from "strong buy" to "buy." The two analysts insisted that the change in their stock rating, did not reflect a cooling in their assessment of Fannie's strength and value. (*American Banker*, Erick Bergquist, 12/29/00)

## **President Clinton to appoint former Congressman Esteban Torres as a member of Fannie Board**

***National Journal* reports that the naming of Torres to Fannie's Board "seems designed to help protect Fannie's...backside in coming months"**

- President Clinton announced that he intends to appoint Esteban Torres as a member of the Fannie Board. Torres is a former Congressman. He was first elected in 1982, he served eight terms before his retirement at the end of 1998. During his 16 years in Congress, he was a member of the House Appropriations Committee and the House Banking Committee. Following his retirement from Congress, Cong. Torres has been active in consulting and the development of private business ventures. (*White House press release*, 1/8/01)
- **According to the *National Journal*, the naming of Torres to "the board of embattled mortgage marketing colossus Fannie Mae seems designed to help protect Fannie's, er, backside in coming months." The *National Journal* notes that "Republican control at both ends of Pennsylvania Avenue gives free-marketers their best chance yet to trip the federal perks" of the GSEs.** Fannie's "main Congressional nemesis," Cong. Richard Baker, seems destined to head a subcommittee in the Financial Services Committee, while Fannie's "passionate defender" Cong. Maxine Waters may leave the Banking Committee to go to the Appropriations Committee. Torres was a member of the Appropriations Committee and the Banking Committee and the Hispanic Caucus before retiring, "which could bolster support among Democrats and in an ethnic group that the GOP has been courting relentlessly." (*National Journal*, 1/13/01)

## **Fannie opens new e-Business Center – a separate business unit**

### **Fannie announces new e-business management team for Fannie Mae/eBusiness**

#### **Fannie Mae/eBusiness will work to further leverage Fannie’s technology to get closer to the point-of-sale**

- Fannie announced the opening of the company’s new E-business unit located at 4520 Connecticut Avenue, NW in Washington, DC. Fannie Mae/e-business, led by Michael Williams, President, was established as a separate business unit in July 2000. The company’s goal is to consolidate its e-commerce activities and make Fannie the premier e-Business partner in the secondary mortgage market. (*Fannie press release, 11/17/00*)
- Fannie also announced the formal organizational structure and management team of Fannie Mae/eBusiness. Fannie Mae/e-business is led by Michael Williams, President; Vada Hill, Chief Marketing Officer; David Voth, Chief Product Development Officer; Earl Thomas Booker, Managing Director, Business Development; Terri Davis, Managing Director, Sales and Consulting; Daniel Packer, Managing Director, Systems Development; and Harvey Trimble, Managing Director, eSolutions. The division’s management team also includes: Richard McGhee, Managing Director, Technology Strategies; Charlotte Haberaecker, Managing Director, eMortgage Solutions; and Elizabeth Schamber, Managing Director, Technology Products. (*Fannie press release, 11/27/00*)
- Michael Williams, President of Fannie’s new E-Business said with the launch of the online versions of Desktop Originator and Desktop Underwriter, customers are asking Fannie to help them further leverage the technology to get closer to the point-of-sale. “We’ll be doing a lot of work in the very near term in enhancing those products, putting in many of the features our customers want, expanding on the reliability and 7/24 access that you need for the Web.” Longer-term plans, he said, include working with the MBA and others to determine the standards and guidelines needed to facilitate electronic loan sale and delivery to Fannie. (*National Mortgage News, James Faucett, 12/11/00*)

## **Fannie launches online geocoding service**

- Fannie launched its new online geocoding service – the Fannie Mae Property GeoCoder. Geocoding assigns a latitude and longitude to a property address to identify its geographic location. The Property GeoCoder can geocode up to 10 properties at a time. The service provides lenders and other housing professionals information to quickly determine whether a property is located in an area that qualifies for its FannieNeighbors mortgage option. FannieNeighbors is a mortgage option designed to increase homeownership and revitalization in areas designated by HUD as underserved. The Property GeoCoder also provides selected population data, income data and other demographic characteristics about the census tract in which the property is located, including specifics about whether it is designated as underserved, low to moderate income, or minority. Lenders can access the Property GeoCoder through Fannie’s Housing and Community Development home page at [www.fanniemae.com](http://www.fanniemae.com). (*Fannie press release, 10/17/00; National Mortgage News Daily, 10/17/00; Origination News, 12/00*)

### **Fannie begins purchasing reverse loans in TX**

- In a November 7 letter, Fannie announced that it would begin purchasing Fannie Mae Home Keeper and FHA-insured home equity conversion mortgages (HECM), effective immediately. The letter came one day after HUD issued “additional instructions” on HECM loans made on properties in Texas. The FHA and HUD had been working for nearly a year to perfect the lending guidelines and loan documentation for Texas reverse mortgages. Fannie is a major investor in HECMs, but the company has been very cautious about entering the Texas market because state penalties for noncompliance are so severe. Texans amended their state constitution in 1997 to allow reverse mortgages for the first time, but to really open the door to reverse mortgages, the state had to pass a corrective amendment in 1999 that was acceptable to HUD and Fannie. (*National Mortgage News Daily*, 11/9/00; *National Mortgage News*, 11/13/00)

### **Associate General Counsel at Fannie appointed to the Board of Directors of the DC Housing Finance Agency**

- Kathleen Miles, an Associate General Counsel at Fannie, was appointed by DC Mayor Anthony Williams and confirmed by the City Council, to the Board of Directors of the DC Housing Finance Agency. (*PR Newswire*, 12/21/00)

### ***Freddie Mac***

### **Freddie plans to increase its net retained portfolio by \$50-\$60 billion in 2001 and increase its total portfolio growth in excess of projected 8-9% growth in the mortgage market, in part through increased expansion into subprime market**

- Freddie told investors that it expects to grow its total mortgage portfolio in 2001 at a rate faster than the estimated growth in residential mortgage debt outstanding, adding \$50 billion to \$60 billion to its net retained portfolio, as compared to anticipated growth of \$40 billion to \$50 billion in 2000. The mid-point of the 2001 range equates to a 15% growth rate for the portfolio. Greg Parseghian, SVP of Corporate Finance and CIO of Freddie stressed the importance of new market (alt A and subprime) and other “heterogeneous” products (such as hybrid ARMs) in driving rapid portfolio growth.
- In a recent report, Morgan Stanley Dean Witter analysts Kenneth Posner and Gail Daniel, said they believe that Freddie is successfully penetrating new product markets, thanks to its technology. Freddie’s automated underwriting approval rates of over 90% “suggests that the company is purchasing significant volumes of niche loans that would have been previously rejected because of minor flaws.” Freddie’s EVP Paul Peterson said Freddie expects to increase its total portfolio faster than the 8-9% growth projected for the US mortgage market in 2001. Freddie’s growth will be supported by new market penetration (largely subprime and alt-A) and increasing bulk transaction volumes. (*Morgan Stanley Dean Witter report, “Freddie Mac; Sun, Moon, Stars Moving into Alignment,”* 12/13/00; *Dow Jones Newswire*, Tyler Lifton, 12/20/00)

### **During last eight weeks of the election, Freddie contributes \$350,000 in soft money to Democrats and \$250,000 to Republicans**

- According to reports filed with the Federal Election Commission, Freddie contributed \$350,000 in soft money to Democrats and \$250,000 to Republicans during the period from October 19 to November 27. (*Washington Times*, 12/21/00)

#### **President Clinton names James Free to Freddie's Board**

- President Clinton appointed Washington lobbyist and former Carter administration aide James Free to Freddie's Board of Directors. Free is President and CEO of the Smith-Free Group. After serving four years in the Carter Administration as Special Assistant to the President for Congressional Affairs, he joined Walker/Free Associates in 1981 as the Vice-Chair. The 18-member Freddie board consists of five presidential appointees, who are named annually, and 13 members elected by shareholders. (*American Banker*, Megan Ptacek, 12/12/00; *White House press release*, 12/8/00)

#### **Office of Personnel Management Deputy Director to work at Freddie**

- Office of Personnel Management Deputy Director John Sepulveda is leaving the Administration to work for Freddie Mac, where he will work with housing and urban development community groups. He was at HUD before joining OPM in 1998. (*Washington Post*, Al Kamen, 1/3/00)

#### **Freddie names a new company Treasurer**

- Freddie promoted its Vice President of Funding Louise Herrle to the additional position of Treasurer. Herrle will be responsible for all of Freddie's funding execution in the domestic and global-fixed income markets and the execution function for futures, treasuries, and swaps supporting Freddie's interest rate risk management activity. Prior to joining Freddie in 1999, Herrle, was Senior Vice President of the FHLBank of Pittsburgh. (*National Mortgage News Daily*, 11/29/00)

### ***Federal Home Loan Banks***

#### **Washington Mutual Bank (WaMu) seeks membership in the FHLBank of Dallas, while retaining its membership in the FHLBank of San Francisco**

##### **WaMu's request is believed to be the first request ever for dual FHLBank membership**

- The Federal Housing Finance Board (FHFB) announced that it received a petition from the FHLBank of Dallas for FHFB approval of an application for membership in the FHLBank of Dallas by Washington Mutual Bank, currently a member of the FHLBank of San Francisco. WaMu is acquiring Bank United and would like to assume Bank United's membership in the FHLBank of Dallas. By approving Washington Mutual Bank's membership in the FHLBank of Dallas, Washington Mutual Bank would be members of both the FHLBank of Dallas and the FHLBank of San Francisco.
- *National Mortgage News Daily* reported that the request by WaMu is believed to be the first request for dual membership, and is expected to be controversial because Bank United is the largest shareholder in the FHLBank of Dallas and WaMu is the largest shareholder in the FHLBank of San

Francisco. *Dow Jones Newswire* reported that never in the FHLBank System's history has a financial institution belonged to more than one of the 12 FHLBanks. In a legal opinion, Washington Mutual Bank argues that the company is allowed to be a member of a FHLBank where its principal place of business is located, as well as in an adjoining district. There is a common border between the San Francisco and Dallas FHLBanks. (WaMu's holding company is also a significant member of the FHLBank of Seattle, but reportedly that is not an issue.) The FHFBB noted that "The petition raises numerous fundamental legal, political and policy issues of first impression that are critical to the structure of the Bank System." According to the FHFBB, any FHLBank or member who "believes its rights may be affected" by the petition has 45 days from the date the petition was filed to make a "Request to Intervene" to the FHFBB. (*National Mortgage News Daily*, 12/27/00; *National Mortgage News*, 12/18/00; *Dow Jones Newswire*, John Connor, 12/27/00; *Federal Register*, pages 81661-81662, 12/27/00)

**President Clinton appoints Allan Mendelowitz as Chairman of the FHFBB**

**Mendelowitz should be able to serve as Chairman until President-elect George W. Bush can appoint his own Chairman or get his nominee confirmed by the Senate**

**Former FHLBank of Dallas President George Barclay is being mentioned as a candidate for Chair of the FHFBB**

**FHFBB has been without a full-time Chairman since July 2000**

- President Clinton announced the appointment of Allan Mendelowitz as Chairman of the FHFBB. President Clinton first announced the nomination of Mendelowitz in June 2000, shortly after FHFBB Chairman Bruce Morrison stepped down. The Senate did not act upon the nomination, so President Clinton made a recess appointment of Mendelowitz on December 28, 2000. Mendelowitz was a career General Accounting Officer Managing Director from 1996-98. He most recently served as the Executive Director for the US Trade Deficit Review Commission. According to *National Mortgage News Daily*, Mendelowitz should be able to serve as Chairman until President-elect George W. Bush can appoint his own Chairman or get his nominee confirmed by the Senate. It is not likely that Bush will make any appointments to the FHFBB until February (currently there are three vacant spots on the five-member FHFBB).
- According to Paul Muolo with *National Mortgage News*, George Barclay, a former President of the FHLBank of Dallas, is being mentioned as a candidate for the Chair of the FHFBB. Barclay stepped down as President of the FHLBank of Dallas this past summer, but has been acting as an advisor to the current FHLBank of Dallas President.
- The FHFBB has been without a Chairman since Bruce Morrison resigned as Chairman in July 2000. HUD Assistant Secretary William Apgar has been serving as the acting FHFBB Chairman since Morrison's resignation. (*National Mortgage News Daily*, 12/29/00; *National Mortgage News*, Paul Muolo, 1/2/01)

**Council of FHLBanks elects Seattle FHLBank Chairman Michael Radway as next Chairman**

- The Council of FHLBanks (the lobbying group for 10 of the 12 FHLBanks) elected Michael Radway as its next Chairman. Radway, a financial services consultant, is currently Chairman of

the Seattle FHLBank. Radway previously worked on Capitol Hill for over 20 years as a House Banking Committee staffer and a Legislative Director for Cong. Paul Kanjorski (D-PA) and former Member Norman D'Amours (D-NH). (*National Mortgage News Daily*, 12/26/00)

**Financial Services Roundtable met with the Presidents of the 12 FHLBanks to discuss the future of the FHLBanks' mortgage purchase programs**

**The FHLBanks' mortgage purchase programs – such as the Mortgage Partnership Finance (MPF) program – are competitors to Fannie & Freddie in the secondary mortgage market**

**FHLBanks' MPF volume rises to about \$16 billion – volume could increase by \$46 billion in 2001**

- According to *National Mortgage News Daily*, the Financial Services Roundtable met with the Presidents of the 12 FHLBanks to discuss the future of the FHLBanks' mortgage purchase programs. The group hoped to discuss the FHLBanks' plans to expand the mortgage purchase programs, such as the Mortgage Partnership Finance (MPF) program – a competitor to Fannie and Freddie in the secondary mortgage market. “Our members are always looking for better ways to serve their customers,” said Roundtable Government Affairs Director Lisa McGreevy. (*National Mortgage News Daily*, 1/4/01)
- In related news, the FHLBanks now hold some \$16 billion of single-family mortgages under the MPF program, and program volume could increase by roughly \$46 billion in 2001. Some 180 FHLBank System member financial institutions are currently participating in the program. Scott Smith of the FHFB's staff estimated that about half of some \$92 billion of operative master commitments could be filled in 2001, for a volume estimate of about \$46 billion. (*Dow Jones Newswire*, John Connor, 11/30/00)

Background on mortgage purchase programs

MPF program

- The MPF program gives banks and thrift members an alternative to selling conventional and FHA loans to Fannie, Freddie and Ginnie Mae, and instead permits them to sell the loans to participating FHLBanks. The program was initiated by the FHLBank of Chicago as a pilot program, and was capped at \$9 billion (\$750 million for each of the 12 FHLBanks). On July 29, 2000, the FHFB approved a final rule that gave the program permanent status and lifted the \$9 billion cap. The program is now offered by nine of the 12 FHLBanks.

MPP program

- The FHLBanks of Indianapolis, Cincinnati, and Seattle have created a mortgage purchase program, called the Mortgage Purchase program (MPP). There is a temporary volume limit of \$300 million per FHLBank, but no business has been done under the program yet. Like the FHLBank of Chicago's MPF program, MPP is a competitor to Fannie and Freddie in the secondary mortgage market. According to Chief Financial Officer of the FHLBank of Indianapolis Milton Miller, the FHLBank System is expected to purchase up to \$2 billion in MPP home loans from member institutions in 2001. The three FHLBanks will begin testing the program with selected customers and will expand testing to all members sometime in 2001.

**Four FHLBanks ease their collateral rules**

- Four of the 12 FHLBanks – the Dallas, Topeka, Des Moines, and Seattle FHLBanks – are planning to expand the types of loans that small member banks can pledge as collateral for advances. The four FHLBanks advised the Federal Housing Finance Board (FHFB) that they will allow member institutions with less than \$500 million of assets to use small-business, farm and agriculture-business loans as collateral. The plans to broaden the collateral rules do not require the FHFB’s approval, and other FHLBanks can adopt similar plans at any time. (*American Banker*, Lisa Daigle, 12/1/00) [Editorial Note: Under the Financial Services Modernization bill (Gramm-Leach-Bliley Act), signed by President Clinton on November 12, 1999, the FHLBanks were allowed to expand the types of loans that can be pledged as collateral for advances by banks with less than \$500 million in assets.]

**FHFB issues proposal to let it impose cease-and-desist orders, assess civil money penalties, and issue subpoenas**

- The FHFB issued a proposal to let it impose cease-and-desist orders, assess civil money penalties, and issue subpoenas as part of its supervision of the FHLBank System. According to the *American Banker*, Congress authorized these enhanced enforcement powers with the passage of the Financial Services Modernization bill in November 1999. The new powers would bring the FHFB in line with Fannie and Freddie’s regulator – OFHEO. The deadline for comments on the proposed rule is January 17, 2001. (*American Banker*, 12/1/00; *Federal Register*, pages 78994-79013, 12/18/00)

**Idaho State Tax Commission finds that dividends on FHLBank stock is taxable**

- According to *State Tax Review*, the Idaho State Tax Commission found that dividends received by a taxpayer on FHLBank stock are subject to Idaho corporate franchise (income) tax because neither the Internal Revenue Code nor Idaho law provides a tax exemption for such dividends. A federal statute that exempts assets and income of the FHLBank does not exempt taxation of dividends paid by the FHLBank. Also, a federal statute exempting stocks and bonds of the US government from state taxation that would require the interest on the obligation to be considered in computing tax did not apply to dividends on FHLBank stock. [Decisions Nos. 14315 and 14316, Idaho State Tax Commission, 5/23/00, received November 2000]. (*State Tax Review*, 12/11/00)

**Independent Community Bankers of America submits policy recommendations to President-elect George W. Bush**

**ICBA lists improved access to capital through the FHLBank System and the Farm Credit System among its priorities**

- According to the *BNA*, the ICBA submitted a list of policy recommendations to President-elect George W. Bush on December 15. Among its priorities, the ICBA included improved access to capital through the FHLBank System and the Farm Credit System. (*BNA Daily Report for Executives*, Adam Wasch, 12/18/00)

**FHLBank of Atlanta takes steps to address predatory lending**

- According to Brian Collins with *National Mortgage News*, the FHLBank of Atlanta has announced that it will not accept predatory loans as collateral for advances and will not invest in privately

issued mortgage-backed securities that contain such loans. Under the new policy, member banks and thrifts must certify that the collateral they are pledging for advances does not include high cost loans as defined by the Home Ownership and Equity Protection Act (HOEPA). In addition, MBS and loans used as collateral must not have the following: prepaid single premium credit insurance; points or fees that exceed 5% of the loan amount (excluding discount points); or prepayment penalties if the interest rate is 300 basis points higher than the conventional rate. (*National Mortgage News*, Brian Collins, 12/4/00)

## ***International "GSEs"***

**Under pressure from the European Commission, Germany's public sector banks (similar to US GSEs) are thinking openly about reforming themselves**

***The Economist* writes, "change is in the German's own best interest. It is one thing for taxpayers, through the state banks, to subsidise regional economic development. It is quite another for them to guarantee banking activities that ought to be carried out on a commercial footing – not least when those guarantees disadvantage other German banks."**

- According to an *Economist* article, under pressure from the European Commission, Germany's public sector banks are thinking openly about reforming themselves. For years, the European Commission has launched several investigations into the system of state support for Germany's public-sector banks. But all suggestions of unfair competition have been rejected by most of the country's politicians and by the banks themselves. However, lately the public-sector banks "united front" has started to crack. The largest of the 12 "landesbanks" and Germany's fourth largest bank by assets – Westdeutsche Landesbank (WestLB) – is now discussing openly about the possibility of restructuring itself. And, the German Savings Bank and Giro Association (DSGV), which represents Germany's 564 *Sparkassen* (or savings banks) now says that the system of state guarantees for the landesbanks and *Sparkassen* ought to be negotiable.
- The European Commission has been investigating for some time whether the guarantees provided to public-sector banks constitute illegal state aid. In particular, the Commission is examining a complaint by an association of Europe's private-sector banks against three institutions – including WestLB and Stadtparkasse Koln (the second-largest *Sparkasse*) – that these guarantees provide the public-sector banks with an unfair competitive advantage over private-sector banks. The case against the public-sector banks appears strong. Thanks to these guarantees, the public-sector banks enjoy AAA ratings for their long-term debt, even though their underlying financial strength is far less credit worthy.
- In November WestLB said it is planning to restructure itself, in the hope of heading off the European Commission's investigation into its guarantees. The WestLB is examining several models of discussion, the favorite of which is to create a subsidiary without state guarantees, which would take over the bank's commercial business. The parent company would continue to be the central bank for local *Sparkassen* and the development bank for the state. Soon after WestLB's plans were revealed, the DSGV said that guarantees ought to be negotiable.
- The *Economist* notes however, statements by WestLB and DSGV, "are not exactly prodding the landesbanks into coming out with their hands up." The article goes on to say, "It says that time will be needed to build up the public sector banks' capital if the guarantee is removed. The banks have been unable to tap equity markets to build up their balance sheets; and state governments have been largely unwilling to inject more capital. The landesbanks have consequently become

increasingly reliant on subordinated debt for their “tier-one” capital; most, if not all, say analysts at Merrill Lynch, are now at the limit allowed by central banks for this form of capital.”

- Change in the structure of the landesbanks is likely to be slow, and the result will be the sum of several forces. One is the effect that the removal of explicit guarantees would have on the public sector banks’ ratings, and hence on their competitiveness. A second is the response of the individual landesbanks (some of which do not feel the model suggested by WestLB would be appropriate). And third, and most important, is politics in Brussels and Germany. State parliaments will have to approve any changes in the legal status of both the landesbanks and the *Sparkassen*. The European Commission appears to be well disposed to WestLB’s plans and statements made by the DSGV in this early stage. However, in Germany, political resistance to tampering with the public sector banks remains fierce.
- **The *Economist* concludes, “Yet change is in the German’s own best interest. It is one thing for taxpayers, through the state banks, to subsidise regional economic development. It is quite another for them to guarantee banking activities that ought to be carried out on a commercial footing – not least when those guarantees disadvantage other German banks.”**  
(*The Economist*, 12/9/00)

January 12, 2001

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