

The **GSE** REPORT TM

Contents of GSE Report TM

“The two corporations [Fannie & Freddie], while receiving billions in federal subsidies, remain more powerful than the government that created them, even though it appears the private sector and community organizations help more black families buy houses.” (*The Skanner* (Portland, OR publication), Lisa Loving, 4/4/01)

“Fannie Mae and Freddie Mac are out of control, unrestrained by competition, market discipline, Congressional oversight or a strict enforcement of their charters.” (AEI paper updating its “Nationalizing Mortgage Risk” study, *AEI Fellow Peter Wallison and financial consultant Bert Ely*, 6/4/01)

Major Events

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 - “It is a real problem in the sense that one might argue that the benefits of government support are not necessarily accruing to ordinary citizens,” said Lindsey, “and I think that’s a matter of legitimate concern.”
- HUD Secretary Mel Martinez says the Bush administration would like to strengthen OFHEO ([p. 5](#))
 - “I don’t think there is any question that OFHEO needs to be a stronger regulator, and we’re very focused on insuring that that happens,” said Secretary Martinez
 - Secretary Martinez says the Bush administration supports OFHEO, not the Federal Reserve (as proposed under Congressman Baker’s GSE bill), as the proper regulator for Fannie & Freddie
 - [Editorial Note: HUD is Fannie & Freddie’s mission regulator, while OFHEO regulates Fannie & Freddie’s safety and soundness.]
- National Association of Realtors (NAR) and the California Association of Realtors (CAR) are lobbying to allow Fannie & Freddie to expand into the higher-income market ([p. 6](#))
 - NAR and CAR are lobbying to raise the limit on the loans that Fannie & Freddie are allowed to purchase from \$275,000 to \$412,500 in certain high-cost areas
 - [Editorial Note: By law, the conforming loan limit is \$275,000, while the limit in Hawaii, Alaska, Guam, and the US Virgin Islands is 50% higher (\$412,500).]
 - Financial Services Roundtable opposes raising the conforming loan limits
 - “Raising it would extend the subsidy of Fannie and Freddie to upper income home buyers,” said Steve Bartlett, President of the Financial Services Roundtable. “There’s nothing wrong with upper income people, but there should not be an implicit guarantee of the federal government to subsidize their mortgages.”
 - Mariel Donath, President of the Community Bankers Association of New York State and Louis Nevins, President of the Western League of Savings Institutions oppose raising Fannie & Freddie’s loan limits to help “the perceived needs of the ill-housed wealthy”
 - To afford a home requiring \$412,500 in mortgage financing, a borrower needs an income approaching \$200,000
 - “It is low-, moderate-, and middle-income citizens who have a problem finding adequate housing. Subsidizing the wealthy is not a good public policy,” argue Donath and Nevins
 - Donath and Nevins propose that the current \$275,000 ceiling should be frozen, so “GSE subsidies can be directed where they are needed the most. Four mortgages of \$100,000 could be subsidized for what it costs to subsidize one \$400,000 loan.”
 - Donath and Nevins suggest means-testing the GSEs’ mortgage programs because “it is likely that a large number of very rich people receive the subsidy, but only the GSEs know for sure”
 - For example, a homebuyer who recently bought a \$1.2 million home in Hawaii, benefited from the GSEs’ subsidy. While the homebuyer had enough cash to pay for the house outright, the homebuyer opted to borrow a portion of the total for tax reasons and settled on \$412,500 to take advantage of the lower interest rate in the conforming market.
 - Freddie & Freddie deny they are engaged in attempts to raise the loan limits, however, a spokeswoman for Freddie said the company supports raising the loan limits

- American Enterprise Institute Fellow Peter Wallison and financial consultant Bert Ely argue that even when the housing market was growing at historic levels in 1999 and 2000, Fannie & Freddie had to grow faster than the mortgage market and take on more risk in order to meet their promises to Wall Street ([p. 9](#))
 - A slowdown in the economy or the housing market could “squeeze” the GSEs’ profit growth and force them to take on an even greater amount of risk and expand beyond their charters into other areas of the economy
 - Fannie & Freddie will eventually acquire or guarantee substantially all the mortgages that the law permits them to acquire or guarantee - essentially nationalizing the residential mortgage market – in order to meet their promises to Wall Street. Unless Congress or HUD steps in, Fannie & Freddie could nationalize the mortgage market at some point this decade.
 - Wallison and Ely predict that by the end of 2003, Fannie & Freddie will control 91.5% of the conforming, conventional mortgage market and will hold more debt than the US government with about \$3.3 trillion in outstanding mortgage obligations. Wallison and Ely noted, “If the American people believe that the national debt is being reduced, they are in for a shock.”
 - Even after Fannie & Freddie nationalize the residential mortgage market, they will still need to take on more risk and expand into other areas of the economy in order to meet earnings promises to Wall Street, argue Wallison and Ely
 - “Down the road, they are going to run into some earnings growth problems – the market can’t grow the way it is, and they [Fannie & Freddie] can’t grow the way they have,” said Ely, unless the GSEs either enlarge the secondary market or break out of it
 - “The train wreck that we talk about is somewhere down the track...It may be 2005 or 2008 until they [Fannie & Freddie] hit the wall,” said Wallison
 - “Fannie Mae and Freddie Mac are out of control, unrestrained by competition, market discipline, Congressional oversight or a strict enforcement of their charters,” contend Wallison and Ely
 - Wallison and Ely urge Fannie & Freddie’s management to consider drafting privatization plans
 - In related news, *National Mortgage News* reports that Fannie & Freddie are on track to purchase 63% of all residential mortgage loans originated in the US this year (includes conventional, jumbo, subprime, Alt A, government, and other loan types)
- Europe’s mortgage banks urge the Basel Committee to provide the same risk-weighting for their securities to match the risk-weighting of the GSEs --- European banks want to be on a level playing field with the GSEs ([p. 14](#))
 - FM Watch urges the Basel Committee to level the playing field between the risk-weighting of Fannie & Freddie’s mortgage-backed securities (MBS) and private MBS
 - [Editorial Note: Currently, Fannie & Freddie’s MBS have a 20% risk-weight, while privately issued MBS rated “AAA” and “AA” have a less advantageous 50% risk-weighting. The new Basel proposal places all securities rated “AAA” and “AA” on a level playing field with Fannie & Freddie – all at a 20% risk-weight, making private MBS as attractive as the GSEs’ MBS]
 - FM Watch urges the Basel Committee to assess the actual financial risk of Fannie & Freddie and treat the two companies as private corporations for purposes of determining the risk-weighting used to set the capital requirements on GSE debt and MBS
 - FM Watch urges the Basel Committee to require “true stand-alone ratings” of Fannie & Freddie when capital requirements are set
 - “It is essential that international bank regulators set the capital requirements for bank holdings of GSE debt and mortgage-backed securities in relation to their risk, without regard to any Government rescue Fannie Mae or Freddie Mac might receive”
 - “Fannie Mae and Freddie Mac are shareholder-owned companies expanding every day into a range of ventures outside their mission,” said FM Watch Executive Director Mike House. “The capital rules must reflect this market reality, or Fannie Mae and Freddie Mac will have an undue advantage over other private companies without any positive impact on home ownership.”
 - America’s Community Bankers, however, recommends that the Basel Committee assign a 0% risk-weighting for obligations of Fannie & Freddie, while assigning obligations of banks a 20% risk-weighting
 - US federal regulators are also considering a proposal that would lower the risk-weighting for all US AAA-rated and AA-rated ABS and MBS to the same risk-weighting capital treatment as Fannie & Freddie’s MBS
 - Comment letters to US federal regulators indicate widespread support for leveling the playing field – with the exception of Fannie & Freddie. The GSEs are “up in arms” over the proposal.
 - Letters were sent by the American Bankers Association, America’s Community Bankers, Bond Market Association, Consumer Mortgage Coalition, Financial Services Roundtable, Mortgage Bankers Association, Mortgage Insurance Companies of America, and the National Home Equity Association in support of the federal regulators’ proposal

Fannie Mae and Freddie Mac

- The Portland *Skanner* asks, “Who’s regulating the giants? [Fannie & Freddie]” [\(p. 19\)](#)
 - Lisa Loving with the *Skanner* writes a 3-part “critical series about the role – or lack of a role – Fannie Mae plays in helping African Americans and low-income residents buy homes for their families”
 - “The two corporations, while receiving billions in federal subsidies, remain more powerful than the government that created them, even though it appears the private sector and community organizations help more black families buy houses”
- American Enterprise Institute’s Charles Calomiris and Peter Wallison state that contrary to the claims of the housing GSEs, Fannie & Freddie’s new subordinated debt offerings “do not cultivate market discipline nor create a cushion for losses” [\(p. 21\)](#)
 - Calomiris and Wallison support full privatization of Fannie & Freddie
 - As a “second-best alternative” to privatization, Calomiris and Wallison support credible regulation of Fannie & Freddie (preferably by the Treasury Department) and mandatory subordinated debt that “credibly bears risk”
- Senator Paul Sarbanes (D-MD) becomes the new chair of the Senate Banking Committee (Senator James Jeffords’ switch from Republican to Independent gave the Democrats control of the Senate and all of its Committees) [\(p. 23\)](#)
 - Senator Sarbanes says he is open to brokering a compromise between Fannie & Freddie & GSE critics – he would like to see how OFHEO’s new capital rules for Fannie & Freddie work before considering legislative action
 - *Bloomberg News* reports that Fannie executives and employees were Senator Sarbanes’ top contributors for his 2000 re-election
 - Fannie’s Chairman Franklin Raines noted that the Democrat’s control of the Senate would not affect Cong. Richard Baker’s (R-LA) legislation to strengthen regulation of Fannie & Freddie. “We never thought the Baker legislation was going to be enacted, no matter who was controlling Congress, so we don’t see a big change as a result of this,” said Raines
 - Cong. Baker says he will continue to push the administration and the Federal Reserve for tighter regulation of Fannie & Freddie
 - Cong. Baker says he will ask the Federal Reserve whether the financial benefits that the GSEs derive from their connection to the government distort financial markets
 - House Financial Services Committee’s Ranking Member John LaFalce (D-NY) says Senator Sarbanes’ chairmanship of the Senate Banking Committee means “there is less likely to be a jihad against the GSEs”
 - House Financial Services Committee Chairman Michael Oxley (R-OH) says he is moving methodically on considering the need for regulatory reform of Fannie & Freddie
- *National Mortgage News*’ Bonnie Sinnock claims that Fannie & Freddie are too big to “fly under the radar” [\(p. 25\)](#)
 - Sinnock advises that Fannie & Freddie would probably do well if they concentrated more on acknowledging rather than attempting to hide what they do, “because their actions increasingly hold ramifications for the market as a whole.”
- The new President and CEO of the Financial Services Forum – former Congressman Rick Lazio – says the group plans to open up a dialogue with the GSEs in order to develop a position on the issue [\(p. 26\)](#)
- Are Fannie & Freddie’s automated underwriting (AU) systems discriminatory? [\(p. 26\)](#)
 - *Wall Street Journal* article by David Wessel discusses the issue of AU and potential discrimination
 - Wessel believes that a solution to this issue is to find ways to predict the odds of repayment that don’t disadvantage blacks or other minorities
 - [Editorial Note: Another solution that has been discussed recently is ensuring that there are competing AU systems available for lenders to use in addition to Fannie & Freddie’s AU systems. A Mercer study concludes that if lenders had more choices among the AU systems, a greater number of prospective homebuyers would receive loan approvals. John Taylor, President and CEO of the National Community Reinvestment Coalition testified that the GSEs’ regulators “should encourage a wide diversity of credit scoring systems, competing against each other in developing sound and flexible underwriting criteria. This will open more doors to homeownership for minorities and low- and moderate income borrowers.”]
 - HUD has been conducting a fair-lending review of Fannie & Freddie’s AU systems for almost two years
- Reverend Jesse Jackson plans to push this year for the creation of institutions like Fannie & Freddie called “development banks” to invest and lend in underserved communities [\(p. 28\)](#)
 - Jackson took issue with Congressman Richard Baker’s (R-LA) efforts to strengthen regulation of Fannie & Freddie. “That’s a bad idea,” he said.
 - [Editorial Note: In past years, Jackson’s comments toward the GSEs were not as supportive. In 1998, Jackson advocated the creation of new entities like Fannie & Freddie, but in the context of creating a private-sector rival to Fannie & Freddie. That same year, Jackson urged shareholders to withdraw investments from Freddie

and for Congress to hold “oversight hearings,” amid a \$15 million race discrimination lawsuit filed by a former Freddie executive. Jackson also called upon the Clinton Administration and then HUD Secretary Andrew Cuomo to act. Jackson charged that while Freddie created a poor atmosphere for minority employees, the company also did a poor job of servicing minority homebuyers.]

- Fannie & Freddie are continuing to expand into the subprime market ([p. 31](#))
 - Fannie & Freddie’s automated underwriting systems are accepting more loans on the lower end of the credit spectrum
 - Subprime lenders are concerned that the GSEs are not adequately pricing subprime borrowers’ risk. “They are applying A-market-loan-to-values to very low FICO score credit,” said Charles Coudriet of Saxon Mortgage. “They’re taking on a lot of risk that eventually could be laid at the foot of taxpayers without proper assessment.”
 - Some critics of the GSEs’ entry into the subprime market believe that the GSEs are diluting the quality of Fannie & Freddie’s MBS by including the lower quality subprime loans with the regular conforming loans
 - Rating agency analyst says the GSEs’ entry into the subprime market will put subprime lenders at a disadvantage because the GSEs and lenders are not competing on a level playing field
 - Subprime lenders take issue with a statement by a Department of Justice official in support of the GSEs’ entry into the subprime market

Fannie Mae

- DC government tentatively agrees to pay \$15.7 million to resolve a dispute surrounding the city-owned John A. Wilson Building (Fannie was involved with the dispute) ([p. 33](#))
 - The vast majority of the \$15.7 million would pay back most of Fannie’s \$13 million investment in the project
- Fannie further expands its political reach by including Federal and State officeholders in its press conferences and press releases and increasingly using its partnership offices in press events ([p. 34](#))
 - Fannie hires the former district director to Congressman Paul Kanjorski (D-PA) (Ranking Member of the Financial Services Committee’s Capital Markets and GSE Subcommittee) to head its Northeastern and Central Pennsylvania Partnership Office
 - Fannie has 44 Partnership Offices open across the country
 - Financial consultant Bert Ely believes Fannie’s media events raise ethical questions. “This is an extension of not only their lobbying but also their political action committee contributions,” he said. “Everybody knows what they’re doing. It’s something that many of us find offensive, but that’s how they play the political game.”

Freddie Mac

- Despite objections from the Bond Market Association (BMA), Freddie is proceeding with its plan to change the prepayment accounting cycle for its mortgage-backed securities to a calendar month rather than a midmonth cycle ([p. 37](#))
 - The change will allow Freddie’s MBS to be based on the same prepayment calendar cycle as Fannie Mae and Ginnie Mae
 - Some MBS investors are expected to lose tens of millions of dollars as a result of Freddie’s switch in the prepayment accounting cycle
 - The BMA expresses “disappointment and concern” with the “timing and effective date of [the] change” and suggests Freddie postpone the effective date
 - Freddie’s representatives say they are implementing the change as of June in part because the company felt market conditions then would be the most conducive to relatively minimal market disruption
 - George Miller, Senior Vice President and Deputy General Counsel at the BMA, responds that current market conditions are ones that “from a corporate perspective favor Freddie Mac” and are “arguably the opposite for other market participants”
- President Bush appoints five people to serve on Freddie’s Board ([p. 39](#))
 - [Editorial Note: Unlike fully private corporations, the President of the US has the authority to appoint board members to Fannie & Freddie, which in part strengthens the government’s implied backing of the GSEs.]
- Freddie, in partnership with the Manufactured Housing Institute, has developed a template that can be used to qualify more manufactured housing loans for conventional financing ([p. 39](#))
- Freddie holds press conference with Cong. Edward Royce (D-CA) to announce a \$25 million initiative for California homebuyers ([p. 40](#))

Federal Home Loan Banks

- The salaries of the 12 FHLBank Presidents increased after a statutory requirement that the FHFB approve the FHLBank Presidents’ compensation packages was removed ([p. 40](#))

Major Events

President Bush's top economic adviser, Lawrence Lindsey, says concerns about the rapid growth and financial soundness of Fannie & Freddie are legitimate

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- President Bush's top economic adviser, Lawrence Lindsey, says concerns about the rapid growth and financial soundness of Fannie and Freddie are legitimate. However, because there are no clear solutions to questions about the size of the GSEs, the Bush administration is not likely to act on the issue in the near future. "When you actually have to prioritize, I think this is one on the list, but I'm not sure a clear solution presents itself. I don't think the problem's going to be solved right away," he said. Lindsey's remarks were in response to a question after a speech to the National Economists' Club. Lindsey said he believes it is valid to question whether the advantages that Fannie and Freddie receive from their GSE status are passed on to all ordinary citizens. "It is a real problem in the sense that one might argue that the benefits of government support are not necessarily accruing to ordinary citizens," said Lindsey, "and I think that's a matter of legitimate concern." Lindsey further noted that there also would be a potential cost to the public if there should be an event with "catastrophic consequences" that forced the government to bail out Fannie and Freddie.
- Lindsey noted that addressing this issue is highly complicated, and praised the efforts by Congressman Richard Baker (R-LA) and Federal Reserve Board Chairman Alan Greenspan on the issue. "I commend Congressman Baker for his efforts on this. I'm not sure that he has necessarily all the right solutions, but he's done a very good job in highlighting it and I applaud that," said Lindsey. "I think Chairman Greenspan has done a very good job highlighting these problems as well."
(*Reuters*, Mark Felsenthal, 6/14/01; *Wall Street Journal*, Damian Milverton, 6/14/01)

HUD Secretary Mel Martinez says the Bush administration would like to strengthen OFHEO

"I don't think there is any question that OFHEO needs to be a stronger regulator, and we're very focused on insuring that that happens," said Secretary Martinez

Secretary Martinez says the Bush administration supports OFHEO, not the Federal Reserve (as proposed under Congressman Baker's GSE bill), as the proper regulator for Fannie & Freddie

[Editorial Note: HUD is Fannie & Freddie's mission regulator, while OFHEO regulates Fannie & Freddie's safety and soundness.]

- HUD Secretary Martinez says the Bush administration would like to strengthen OFHEO. "I don't think there is any question that OFHEO needs to be a stronger regulator, and we're very focused on insuring that that happens." Secretary Martinez said he and Treasury Secretary Paul O'Neill have discussed ways to strengthen oversight to meet the demands of institutions as large as Fannie and Freddie. "That is part of what we want to see happen in the future," Secretary Martinez said. Secretary Martinez added that the Bush administration believes that OFHEO not the Federal Reserve is the regulator to do the job. "We think that is the right place for the regulation to take place."
(*Reuters*, Mark Felsenthal, 6/12/01)

National Association of Realtors (NAR) and the California Association of Realtors (CAR) are lobbying to allow Fannie & Freddie to expand into the higher-income market

NAR and CAR are lobbying to raise the limit on the loans that Fannie & Freddie are allowed to purchase from \$275,000 to \$412,500 in certain high-cost areas

[Editorial Note: By law, the conforming loan limit is \$275,000, while the limit in Hawaii, Alaska, Guam and the US Virgin Islands is 50% higher (\$412,500).]

Financial Services Roundtable opposes raising the conforming loan limits

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“It is low-, moderate-, and middle-income citizens who have a problem finding adequate housing. Subsidizing the wealthy is not a good public policy,” argue Donath and Nevins

Donath and Nevins propose that the current \$275,000 ceiling should be frozen, so “GSE subsidies can be directed where they are needed the most. Four mortgages of \$100,000 could be subsidized for what it costs to subsidize one \$400,000 loan.”

Donath and Nevins suggest means-testing the GSEs’ mortgage programs because “it is likely that a large number of very rich people receive the subsidy, but only the GSEs know for sure”

For example, a homebuyer who recently bought a \$1.2 million home in Hawaii, benefited from the GSEs’ subsidy. While the homebuyer had enough cash to pay for the house outright, the homebuyer opted to borrow a portion of the total for tax reasons and settled on \$412,500 to take advantage of the lower interest rate in the conforming market.

Fannie & Freddie deny they are engaged in attempts to raise the loan limits, however, a spokeswoman for Freddie said the company supports raising the loan limits

- **According to Miriam Elias with the *American Banker*, the National Association of Realtors (NAR) and the California Association of Realtors (CAR) are lobbying to raise the conforming limit on the loans that Fannie and Freddie are allowed to purchase from \$275,000 to \$412,500 in certain high-cost areas. Conforming loan limits (the maximum amount that Fannie and Freddie can purchase) are adjusted annually based on the national home price data. The conforming loan limits rise almost every year. During the 1970s, Alaska, Guam, Hawaii, and the US Virgin Islands were awarded higher loan limits because of the high cost of building there. Under the current formula, the maximum loan amounts that Fannie and Freddie may purchase in Alaska,**

Guam, Hawaii, and the US Virgin Islands are 50% higher than the limits for the rest of the country. (*American Banker*, Miriam Elijas, 5/17/01)

- CAR is lobbying heavily to qualify for the same terms as Hawaii and Alaska. “It’s a question of fairness,” said Marcia Salkin, Director of Public Policy for CAR. “Is it appropriate to single out states” like Hawaii and Alaska for special benefits, while other areas such as California also have exceptionally high home prices? Salkin said California, New York, New Jersey, Massachusetts, and possibly even Washington and Colorado should get higher loan limits to help ameliorate their recent price gains. Salkin estimated that raising the conforming loan limit to \$412,500 would allow as many as 85,500 additional families to be able to get a home priced under the conforming loan limit. (*Wall Street Journal*, Patrick Barta, 6/11/01)
- According to CAR’s Salkin, the CAR’s 98,000 members are working closely with NAR on the issue. Officials of NAR lobbied Washington in May to raise the conforming loan limits. NAR officially adopted a motion to change the limits in November 2000. George Griffin, NAR’s Managing Director of Policy, said the organization is “trying to get its arms around the issue.” CAR’s Salkin stated, “We are working on building awareness for the need to change,” noting that CAR recently met with 30 Congressional Members. (*American Banker*, Miriam Elijas, 5/17/01)

Raising the conforming loan limit may benefit the wealthy

- Tracy Stice, a broker at Century 21 All Islands in Maui and President of the Maui Board of Realtors noted that a homebuyer who recently bought a \$1.2 million home in Hawaii, benefited from the GSEs’ subsidy. While the homebuyer had enough cash to pay for the house outright, the homebuyer opted to borrow a portion of the total for tax reasons and settled on \$412,500 to take advantage of the lower interest rate in the conforming market. (*Wall Street Journal*, Patrick Barta, 6/11/01)

Financial Services Roundtable opposes raising the conforming loan limits

- Steve Bartlett, President of the Financial Services Roundtable, wrote a June 14 letter to the Chairman of the House Financial Services Committee Michael Oxley (R-OH) to express opposition to any attempts to raise the conforming loan limits. Bartlett said he was prompted by rumors that a raise was under consideration. “Raising it would extend the subsidy of Fannie and Freddie to upper income home buyers,” said Bartlett. He added, “There’s nothing wrong with upper income people, but there should not be an implicit guarantee of the federal government to subsidize their mortgages.” Bartlett noted that raising the conforming loan limit to \$412,500 would benefit home buyers with annual incomes in the \$150,000 to \$200,000 range. “Families with incomes of this high level do not need a subsidy to become a first time home owner,” he said. Raising the conforming loan limit would allow Fannie and Freddie to grow even larger and would drive out private lenders from the jumbo market [loans above the conforming loan limit]. (*Reuters*, Mark Felsenthal, 6/15/01)

Mariel Donath, President of the Community Bankers Association of New York State and Louis Nevins, President of the Western League of Savings Institutions oppose raising the conforming loan limits

- In a Letter-to-the-Editor to the *American Banker*, Donath and Nevins oppose raising Fannie and Freddie’s loan limits to help “the perceived needs of the ill-housed wealthy.” Donath and Nevins note, “It is low-, moderate-, and middle-income citizens who have a problem finding adequate housing. Subsidizing the wealthy is not a good public policy.”

- Donath and Nevins noted that arguments to raise the conforming loan limits seem to imply that homebuyers seeking loans in excess of \$275,00 are having difficulty finding mortgages. “That is simply not the case.” Those borrowers that are fortunate enough to afford housing in these price ranges are currently able to get competitive financing from a number of lenders. “They may not be able to get a 25-basis-point rate subsidy, but why should they? To afford a home that requires \$412,500 in mortgage financing, a borrower would need an income approaching \$200,000.” Donath and Nevins proposed freezing the current \$275,000 ceiling, so “GSE subsidies can be directed where they are needed the most. Four mortgages of \$100,000 could be subsidized for what it costs to subsidize one \$400,000 loan.”
- Donath and Nevins suggested means-testing the GSEs’ mortgage programs because “it is likely that a large number of very rich people receive the subsidy, but only the GSEs know for sure.”
- Dan Crippen, Director of the Congressional Budget Office, testified that the average loan-to-value ratio on loans purchased or securitized by Fannie is about 71% and 73% for Freddie – meaning that about half the borrowers who receive GSE subsidies have 30% or more equity in their homes. Donath and Nevins noted, “While this does not mean that half of the GSE-aided borrowers around the country are affluent, it strongly suggests that many of them are. This is hardly the image the agencies project in running advertisements in major newspapers and on television ads.”
- Raising the loan limits would decrease competition and force private-sector lenders out of the business. If the ceiling were raised in high-cost areas, “it is reasonable to assume that about 71% of the newly eligible mortgages” would either go to Fannie or Freddie. “In the short run, a great many very affluent borrowers would see a reduction in their mortgage rates. In the long run, however, there would inevitably be less competition in the mortgage market as more and more private-sector lenders abandoned it.”
- “We hope Realtors will reconsider their position on higher ceilings. It may not be in their long-term interest to expand, even further, the GSE role in mortgage finance...Federal housing subsidies, no matter how delivered, should be aimed lower, not higher,” concluded Donath and Nevins. (*American Banker*, “Letter-to-the-Editor,” by Mariel Donath and Louis Nevins, 6/1/01)

MBA is undecided on the issue

- An MBA spokesman acknowledged the issue is heating up but the MBA has no position yet. “We will hear from our members this summer,” he said. (*American Banker*, Miriam Elias, 5/17/01)

Fannie & Freddie deny they are engaged in attempts to raise the loan limits, however, Freddie supports raising the loan limits

- According to Rob Garver with the *American Banker*, officials at Fannie and Freddie denied that they are engaging in any attempts to raise the conforming loan limits. (*American Banker*, Rob Garver, 6/18/01) Freddie Spokesman Douglas Robinson said, “We did not and do not deny that some communities would benefit from higher loan limits, but we are not lobbying anyone” for them. (*American Banker*, Rob Garver, 6/18/01) An earlier report noted that **a spokeswoman for Freddie said that the company supports the change, but that it was not something that the GSE would focus on.** (*American Banker*, Miriam Elias, 5/17/01) Fannie Spokeswoman Janice Daue said, “There is no movement on Fannie Mae’s part to change the loan limits.” (*American Banker*, Rob Garver, 6/18/01) **“In their heart of hearts they are secretly positively disposed to this, but they**

may not see this as an issue they want to get out in front of,” said Congressman Brad Sherman (D-CA). (*American Banker*, Miriam Eljas, 5/17/01)

American Enterprise Institute Fellow Peter Wallison and financial consultant Bert Ely argue that even when the housing market was growing at historic levels in 1999 and 2000, Fannie & Freddie had to grow faster than the mortgage market and take on more risk in order to meet their promises to Wall Street

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“Down the road, they are going to run into some earnings growth problems – the market can’t grow the way it is, and they [Fannie & Freddie] can’t grow the way they have,” said Ely, unless the GSEs either enlarge the secondary market or break out of it

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Overview of Wallison and Ely’s update to their “Nationalizing Mortgage Risk” study

- Wallison and Ely held a June 4 AEI briefing to update their March 2000 paper, “*Nationalizing Mortgage Risk*,” and its implications for the future of Fannie and Freddie. Wallison and Ely projected that, in order to meet the 15% annual rate of profit growth promised to Wall Street, Fannie and Freddie would have to hold or bear the credit risk of almost half of all residential mortgages in the US by the end of 2003. They noted that their earlier study was based on 1998 data. **Now, two more years of data show that the principal trends identified in the study have continued; Fannie and**

Freddie are still growing faster than the secondary mortgage market and will eventually have to expand into other areas of the economy to sustain that growth. However, the unusually strong mortgage market in 1999 and 2000 allowed Fannie and Freddie to meet their profit goals without taking on as much new risk as Wallison and Ely had initially projected. If the mortgage market growth slows – as occurred at the end of 2000 and continues today – Fannie and Freddie will have take on even more risk in order to meet their earnings growth promises to Wall Street. “This will mean they will have taken on substantially more risk, for which the taxpayers of this country are ultimately liable...In addition, and perhaps equally important, Fannie and Freddie will have moved closer to the day when they will have acquired or guaranteed substantially all the mortgages in the United States that the law permits them to acquire or guarantee. When this point arrives, they will have nationalized the residential mortgage market.” (*AEI Briefing and Paper - updating “Nationalizing Mortgage Risk” study, Peter Wallison and Bert Ely, 6/4/01*)

Fannie & Freddie must expand and take on more risk to meet their promises to Wall Street

- **Fannie’s Chairman Franklin Raines promised Wall Street investors in a May 1999 speech that Fannie would double its earnings in five years, representing a compounded year-over-year growth in earnings of 15%. Wallison and Ely noted that this earnings growth could only be met if Fannie and Freddie substantially grow their revenues and their risk.** Raines also told Wall Street investors that at the end of 2003, Fannie would have 28% of the market. Wallison and Ely noted that in making this promise, Raines was assuming a certain rate of growth in the mortgage market over the next five years. If the market grew faster than predicted, Fannie could reach its profits goals without having 28% of the market at the end of the period, but if the market grew more slowly than predicted, Fannie would have to acquire a larger market share and take on more risk to meet its profits projections.
- The mortgage markets in 1999 and 2000 were exceedingly strong growth years for the mortgage markets - much stronger than Wallison and Ely had projected in their 2000 study. They had predicted a gradual decline in the growth of the mortgage market – from its 9.3% 1998 growth rate to 8% in 1999 and 7% in 2000. In reality, the mortgage market grew 10.1% in 1999 and 8.7% in 2000, enabling Fannie and Freddie to meet their profits projections by taking on less overall risk than Wallison and Ely had first projected in their original study. For example, they found that together Fannie and Freddie increased their retained portfolios by 48%, although they had projected growth of 57% by the end of 2000. The combined growth for GSEs’ retained and guaranteed mortgages, which Wallison and Ely had earlier projected to be 28%, turned out to be 23%. (*AEI Briefing and Paper - updating “Nationalizing Mortgage Risk” study, Wallison and Ely, 6/4/01*)

Even under a strong housing market, Fannie & Freddie had to grow faster than the mortgage market and take on more risk in order to meet their promises to Wall Street – Fannie & Freddie are an impending “train wreck” under a slower economy

- **Wallison and Ely noted that even when the mortgage market was growing at historic levels, Fannie and Freddie still had to grow much faster than the mortgage market and take on more risk to meet their earnings promises to Wall Street. They noted that while the mortgage market grew by 20% between 1998 and 2000, Fannie and Freddie’s shares grew by 23%. Wallison and Ely contended that a strong housing market in 1999 and 2000 boosted the earnings of and slowed down an impending crisis for Fannie and Freddie. “The mortgage market grew so fast in 1999 and 2000 that Fannie Mae and Freddie Mac did not have to price-cut so much to put business on their books, and thus could maintain the higher mortgage costs,” said Ely. However, a slower economy and the possibility of reducing the GSEs’ subsidies could cause their double-digit earnings growth to disappear and cause the GSEs to enter into a downward**

spiral. “Had the market declined, Fannie Mae and Freddie Mac would have to take on much more risk. Down the road, they are going to run into some earnings growth problems – the market can’t grow the way it is, and they [Fannie & Freddie] can’t grow the way they have,” said Ely. At some point, Ely and Wallison said that the GSEs would have to slow their growth to match the mortgage market “and disappoint Wall Street,” Ely added that the GSEs would either enlarge the secondary market or break out of it. “At some point something has to give,” said Wallison. “Wall Street is acting perfectly sensible in buying into a rate of profit growth of 15% per year,” said Wallison. But “the train wreck that we talk about is somewhere down the track,” said Wallison. “It may be 2005 or 2008 until they hit the wall. They have a little bit of time to rearrange themselves and expand into other markets.” (*Real Estate Finance Today*, Mike Sorohan, 6/11/01; *Dow Jones Newswire*, Dawn Kopecki, 6/4/01)

Over time, the GSEs will eventually own or guarantee nearly all mortgages in the US that the law permits them to acquire or guarantee, essentially nationalizing the residential mortgage market

- Wallison and Ely argued that when the mortgage market growth slows – as occurred at the end of 2000 and continues today – Fannie and Freddie will have to take on even more risk if they are to meet their earnings growth promises to Wall Street. Wallison and Ely noted that Fannie and Freddie will eventually saturate the US mortgage industry and will acquire or guarantee substantially all the mortgages that they law permits them to acquire or guarantee, essentially nationalizing the residential mortgage market. Unless Congress or HUD steps in, Fannie and Freddie could nationalize the mortgage market at some point in this decade. Wallison and Ely estimated that by the end of 2003, Fannie and Freddie will retain over half of all conventional/conforming mortgages (51.9%) and will have retained or guaranteed over 90% of all conventional, conforming mortgages (91.5%). (*AEI Briefing and Paper - updating “Nationalizing Mortgage Risk” study*, Wallison and Ely, 6/4/01)

Fannie & Freddie must expand into new markets to meet their promises to Wall Street

- Once Fannie and Freddie have acquired or guaranteed substantially all the mortgages in the US, in order to continue to meet their promises to Wall Street, the GSEs must either break out of the secondary market or substantially raise the conventional/conforming loan limit. However, even expanding the market by raising the conventional/conforming loan limit will only postpone the inevitable result that the GSEs will still have to grow faster than the mortgage market, and eventually will once again be confined by this market.
- The GSEs’ long-term strategy therefore must be to expand beyond the mortgage markets into other forms of finance. Wallison and Ely argued that they are already seeing evidence that Fannie and Freddie are moving into other forms of finance. They noted that the unnecessary effort by the GSEs to create a Fannie and Freddie “brand name” through advertising “foreshadows a program of dealing directly with consumers in the future.” Fannie and Freddie are also likely to make arrangements with real estate brokers that amount to mortgage origination, enter consumer finance based on home equity loans, or possibly enter into the commercial mortgage market. “Fannie and Freddie – even under the most favorable circumstances they are ever likely to encounter – must still continue to grow faster than the mortgage market if they are to meet their promises to Wall Street, and therefore must find new areas of profitable activity before they run out of the assets they are permitted to acquire or guarantee.” (*AEI Briefing and Paper - updating “Nationalizing Mortgage Risk” study*, Wallison and Ely, 6/4/01)

Fannie & Freddie's total debt and obligations keep growing – Fannie & Freddie's retained portfolios are also increasing

- **Wallison and Ely noted that Fannie and Freddie's outstanding indebtedness will increase significantly over the next few years due to continuing balance sheet growth caused by the GSEs' increased emphasis on holding mortgages and MBS on their portfolios. Wallison and Ely projected that by the end of 2003, Fannie and Freddie will hold more debt than the US government with about \$3.3 trillion in outstanding mortgage obligations. Wallison and Ely noted, "If the American people believe that the national debt is being reduced, they are in for a shock." Ely stated, "Is the Federal government really paying down its debt, or are we merely substituting one kind of public debt for another. Are we nationalizing risk?"** By the end of 2003, Wallison and Ely projected that Fannie and Freddie will have retained 27.0% of all residential mortgage loans (not just the conforming/conventional mortgages) in their portfolios and will have retained over half (51.9%) of all conventional/conforming mortgages on their books. Wallison and Ely explained that by purchasing their own MBS and whole loans for their portfolios, Fannie and Freddie are taking on more risk than simply guaranteeing a mortgage. By guaranteeing MBS, a GSE takes on credit risk. By purchasing their MBS and whole loans and retaining them in their portfolios, the GSE are taking on both credit and interest rate risk. (*AEI Briefing and Paper - updating "Nationalizing Mortgage Risk" study*, Wallison and Ely, 6/4/01; *Dow Jones Newswire*, Dawn Kopecki, 6/4/01)

Without their federal subsidies, Fannie & Freddie would not be as profitable

- **Wallison and Ely pointed out that the GSEs' retained portions of their federal subsidies are a substantial portion of Fannie and Freddie's high ROE. "When you pull the subsidies out, you see that these companies are not that profitable and, frankly, that should raise questions" about the efficiencies and efficacies of using the GSEs as a mortgage subsidy vehicle, said Ely.** (*Dow Jones Newswire*, Dawn Kopecki, 6/4/01; *AEI Briefing and Paper - updating "Nationalizing Mortgage Risk" study*, Wallison and Ely, 6/4/01) Wallison and Ely noted that using the CBO's recent estimates on the GSEs' federal subsidies, it is clear that Fannie's ROE in 2000 would have dropped by approximately one-third, from a reported 25.6% to 16.8%, absent its retained federal subsidy. **If Fannie had to meet a private-sector leveraging standard of equity capital equal to 4% of its on-balance sheet assets, its return on common equity would have dropped to about 13% for 2000.** "In effect, Fannie's superior ROE, relative to its private-sector competitors, flows entirely from its retained subsidy." The situation is similar at Freddie. Freddie's retained federal subsidy in 2000 raised its ROE from 13.3% to a reported 23.7%. Freddie's subsidy accounted for almost half of its ROE in 2000. **If Freddie had to meet a private-sector leveraging standard of equity capital equal to 4% of its on-balance sheet assets, its return on common equity would have dropped to about 10% for 2000. "Like Fannie, Freddie owes its superior ROE solely to its retained subsidy."** (*AEI Briefing and Paper - updating "Nationalizing Mortgage Risk" study*, Wallison and Ely, 6/4/01)

Wallison and Ely advocate privatization

- **Wallison noted that it would behoove the managements of Fannie and Freddie to consider privatization and come to Congress at some point with a plan. He advocated that this be done soon, since someone may move to break up Fannie and Freddie into smaller companies the longer they wait for privatization.** At their current size, Fannie and Freddie are probably "too-big-to-fail" even with privatization. There should be a serious discussion right now about breaking the GSEs into smaller companies to alleviate the "too-big-to-fail" problem. Ely noted that he would be surprised if Fannie and Freddie were not already looking at privatization. The question is what will push the GSEs over the edge.

- When asked by a Fannie representative, whether Citigroup and Bank of America should be privatized since they are larger than Fannie and Freddie and may be “too-big-to-fail,” Ely noted that Citigroup and Bank of America were not subsidized by the federal government and they are already fully private companies. Wallison noted that in FDICIA, there are specific provisions to try to address the issue of “too-big-to-fail” among banks, however no such thing exists currently for Fannie and Freddie. Also, Bank of America and Citigroup do not bear the high market share percentage of the mortgage market that Fannie and Freddie bear and that is why Congress would be more likely to rise to Fannie and Freddie’s rescue rather than these other companies. “There isn’t much of a chance, even if they [Fannie & Freddie] were privatized, that Congress wouldn’t come to their rescue,” said Wallison. (*AEI Briefing and Paper - updating “Nationalizing Mortgage Risk” study*, Wallison and Ely, 6/4/01; *Dow Jones Newswire*, Dawn Kopecki, 6/4/01) Ely also presented a working paper on privatizing Fannie and Freddie, exploring the option of privatizing Fannie and Freddie patterned after Sallie Mae’s privatization. (“*The Mechanics of Privatizing Fannie Mae and Freddie Mac*,” Bert Ely, May 2001)

Since Fannie & Freddie are exempt from SEC registration, AEI has provided a copy of Fannie’s proxy statement on its Web site as a public service (includes Fannie’s executive compensation)

- Wallison noted that so much of the GSEs’ executive compensation comes from stock compensation, making it more difficult to contain the GSEs’ growth. Unlike fully public companies, Fannie and Freddie do not have to register their securities with the SEC, nor make available the information they use to solicit proxies from their investors in connection with the election of their boards of directors. However, the rules of the New York Stock Exchange require them to solicit proxies, and to provide investors certain basic information about their operations, including compensation and stock ownership of their offices and directors. Both Fannie and Freddie have Web sites. However you cannot find the GSEs’ proxy statements on their Web sites. Wallison invited participants to view Fannie’s proxy statement on AEI’s Web site at www.aei.org/ann/fannieproxy.pdf. A copy of AEI’s comments on the proxy statement can be found at www.aei.org/ann/fannieproxy.htm. (*AEI Briefing on updating “Nationalizing Mortgage Risk” study*, Wallison and Ely, 6/4/01)

National Mortgage News reports that Fannie & Freddie are on track to purchase 63% of all residential mortgage loans originated in the US this year

- **According to a *National Mortgage News* analysis of Fannie and Freddie’s investments, the two GSEs are on track to purchase 63% of all residential loans originated in the US this year. (“All residential loans” includes conventional, jumbo, subprime, Alt A, government and other loan types.) The analysis was based on January to April loan purchases of Fannie and Freddie. During the first four months of the year, Fannie purchased \$210.4 billion in mortgages, while Freddie purchased \$121.6 billion. Extrapolating the data, the two GSEs combined could purchase \$953.6 billion out of an estimated \$1.5 trillion in originations this year, or about 63.6% of all residential loans produced. In 2000, Fannie and Freddie purchased 53% of all mortgages originated; in 1999, 63%; and in 1998, 52% of all loans originated. (*National Mortgage News*, Paul Muolo, 6/11/01)**

Europe's mortgage banks urge the Basel Committee to provide the same risk-weighting for their securities to match the risk-weighting of the GSEs -- European banks want to be on a level playing field with the GSEs

FM Watch urges the Basel Committee to level the playing field between the risk-weighting of Fannie & Freddie's mortgage-backed securities (MBS) and private MBS

[Editorial Note: Currently, Fannie & Freddie's MBS have a 20% risk-weight, while privately issued MBS rated "AAA" and "AA" have a less advantageous 50% risk-weighting. The new Basel proposal places all securities rated "AAA" and "AA" on a level playing field with Fannie & Freddie – all at a 20% risk-weight, making private MBS as attractive as the GSEs' MBS.]

FM Watch urges the Basel Committee to assess the actual financial risk of Fannie & Freddie and treat the two companies as private corporations for purposes of determining the risk-weighting used to set the capital requirements on GSE debt and MBS

FM Watch urges the Basel Committee to require "true stand-alone ratings" of Fannie & Freddie when capital requirements are set

"It is essential that international bank regulators set the capital requirements for bank holdings of GSE debt and mortgage-backed securities in relation to their risk, without regard to any Government rescue Fannie Mae or Freddie Mac might receive"

"Fannie Mae and Freddie Mac are shareholder-owned companies expanding every day into a range of ventures outside their mission," said FM Watch Executive Director Mike House. "The capital rules must reflect this market reality, or Fannie Mae and Freddie Mac will have an undue advantage over other private companies without any positive impact on home ownership."

America's Community Bankers, however, recommends that the Basel Committee assign a 0% risk-weighting for obligations of Fannie & Freddie, while assigning obligations of banks a 20% risk-weighting

US federal regulators are also considering a proposal that would lower the risk-weighting for all US AAA-rated and AA-rated ABS and MBS to the same risk-weighting capital treatment as Fannie & Freddie's MBS

Comment letters to US federal regulators indicate widespread support for leveling the playing field – with the exception of Fannie & Freddie. The GSEs are "up in arms" over the proposal

Letters were sent by the American Bankers Association, America's Community Bankers, Bond Market Association, Consumer Mortgage Coalition, Financial Services Roundtable, Mortgage Bankers Association, Mortgage Insurance Companies of America, and the National Home Equity Mortgage Association in support of the federal regulators' proposal

Background on Basel risk-weighting issue

- The Basel Accord proposes assigning a 20% risk weighting to privately-issued AAA- and AA-rated MBS. Currently, Fannie's and Freddie's MBS are assigned a 20% risk-weighting, while privately issued MBS, rated AAA and AA, are assigned a 50% risk-weighting. The Basel proposal

recommends that the GSEs' MBS and private MBS, rated AAA and AA, be assigned a 20% risk-weighting, thereby leveling the playing field.

Europe's mortgage banks urge the Basel Committee to provide the same risk-weighting for their securities to match the risk-weighting of the GSEs - European banks want to be on a level playing field with the GSEs

- *Reuters English News Service* reported that Europe's mortgage banks called for a level playing field with US issuers of MBS under a new capital agreement being negotiated by the Basel Committee. "The current proposals, influenced by the American off balance sheet approach, could put European mortgage lenders at a disadvantage," said Michael Zell, President of the European Mortgage Federation. Zell, who is also head of Sweden's Stadshypotek (the country's leading mortgage institution) said European borrowers were worried that under the Basel proposal their debt would be saddled with a 50% risk-weighting whereas securities issued by US borrowers, such as Fannie and Freddie, would carry a 20% risk-weighting, and Ginnie Mae a 0% risk-weighting. This "could create opportunities for capital arbitrage and could put portfolio lenders at a competitive disadvantage as it would be less capital intensive to buy mortgage-backed securities than to have a mortgage book," said Zell. "We would like the Basel Committee and [European] Commission to recognise the inherent character of mortgage loans with a risk weighting below the 50 percent standardised approach," said Zell. European mortgage banks were reportedly "stunned" by Freddie's entry into the euro debt market, where it has already issued half of its planned 20 billion euros borrowing program. "We want to achieve a level playing field, not least in terms of funding instruments," said Zell. (*Reuters English News Service*, Nick Antonovics, 12/1/00)

FM Watch urges level playing field

- **FM Watch urged the Basel Committee to permit U.S. regulators to treat Fannie and Freddie as private corporations for purposes of assigning capital requirements on GSE debt and MBS. FM Watch also urged the Basel Committee to require reliance on true stand-alone ratings of Fannie and Freddie when capital requirements are set. In a press release, FM Watch noted, "It is essential that international bank regulators set the capital requirements for bank holdings of GSE debt and mortgage-backed securities in relation to their risk, without regard to any Government rescue Fannie Mae or Freddie Mac might receive"**
- **"Fannie Mae and Freddie Mac are shareholder-owned companies expanding every day into a range of ventures outside their mission," said FM Watch Executive Director Mike House. "The capital rules must reflect this market reality, or Fannie Mae and Freddie Mac will have an undue advantage over other private companies without any positive impact on home ownership."**
- To prevent continuation of the current capital arbitrage with respect to debt and MBS issued by Fannie Mae and Freddie Mac, FM Watch urged the Basel Committee to:
 - "make it clear in the standardized and internal ratings-based models that any GSE that operates as a corporate enterprise under applicable law in its country of domicile should be treated as corporate, not GSE, risk for purposes of risk weighting"; and
 - "revise the risk weightings for GSEs deemed by home-country regulators to be corporate risk so that only true stand-alone ratings determine the risk weighting used to set the capital requirement. Failure to use a true stand-alone rating will render moot the Committee's intent to have the capital weightings based on real risk, not agency status."

- FM Watch noted, **“Currently, Fannie Mae and Freddie Mac's ratings are based not only on their financial condition, but also on their ties to the U.S. government. This means that their ratings are not comparable to those for truly private companies, which are assessed solely on the basis of their balance sheets.”**
- **“It is essential for the Basel Committee to rely on stand-alone ratings when setting capital rules related to bank holdings of GSE debt and MBS to prevent the market from further increasing its reliance on these companies. This would have the effect of increasing systemic risk,”** said House. (*FM Watch press release, 6/12/01*)

ACB recommends that the Basel Committee assign a 0% risk-weighting for obligations of Fannie & Freddie, while assigning obligations of banks a less advantageous 20% risk-weighting

- In a comment letter to the Basel Committee, America’s Community Bankers argues that a lower risk weighting not a higher risk-weighting is needed to keep the GSEs focused on their Congressional mandate. The ACB recommended that the Basel Committee assign a 0% risk-weight for obligations of Fannie and Freddie and a 20% risk-weight for the obligations of banks and depository institutions.
- The ACB letter stated the following: “ACB believes that GSEs within the United States serve an important mission: particularly facilitating and encouraging the development of housing markets. At the same time, we believe it is important for GSEs to operate within the bounds of their congressionally established missions. As such, we do not favor the treatment of GSEs in a manner similar to traditional corporations because we do not favor their corresponding transformation from limited-purpose, congressionally directed enterprises. The [Basel] Accord notes that national supervisors may elect to apply a zero weight to some GSE/PSE debt, and ACB encourages the Agencies to adopt this stance.” (*ACB letter to the Basel Committee, 5/31/01*) Michael Briggs, regulatory council for the ACB, said the group’s comments were unrelated to the amount of GSE debt held by banks and insisted that they were related to Fannie and Freddie’s “special mission and purpose.” (*Dow Jones Newswire, Tyler Lifton, 6/12/01*)

Federal regulators are also considering lowering the risk-weighting for AAA- and AA-rated mortgage-backed securities that would level the playing field with Fannie & Freddie

- Federal regulators (the Federal Reserve System, FDIC, OCC, and OTS) issued a proposed recourse rule that gives all AAA- and AA-rated MBS the same capital treatment as Fannie and Freddie’s MBS). The proposed rule was issued on March 8, 2000, with public comments due June 7, 2000. (*Federal Register, pages 12320-12352, 3/8/00*) The proposed rule reflects the views expressed in comments received in response to a proposal issued in 1997. The proposal would make AAA- and AA-rated private MBS as attractive of an investment as an investment in either of the GSEs’ MBS. The new proposed rule assigns a 20% risk-weighting to all AAA- and AA-rated MBS, thereby leveling the playing field between GSE MBS and private MBS.

Fannie & Freddie “are up in arms” over the proposed rule

- As noted in the July 7, 2000 *GSE Report*, Erick Bergquist with the *American Banker* reported that Fannie and Freddie “are up in arms” over the proposed rule. As Bergquist noted, under current rules, Fannie and Freddie’s lower risk-weighting has long supplied a strong incentive to buy their securities instead of privately issued MBS. (*American Banker, Erick Bergquist, 6/30/00*)
- In a June 7, 2000 letter, Fannie said it supports the proposal’s attempt to align regulatory capital more closely with transaction risk, however, the rule does not account for the credit risk differences

between AA and AAA-rated securities. Fannie recommended that its securities and AAA-rated corporate bonds be assigned lower credit risk weightings than AA-rated bonds and noted that the proposed recourse rule was “flawed.” The company also noted that regulators should be aware that private MBS currently requires a higher risk-weighting because mortgages carry higher interest rate risk.

- In a June 7, 2000 letter, Freddie noted that the rule would let banks “structure securitizations that reduce the capital requirements to a fraction of what they would otherwise be required to hold, even though the risk exposure remains the same.” (*American Banker*, Erick Bergquist, 6/30/00; *Mortgage-Backed Securities Letter*, Frank Musero, 6/12/00; *National Mortgage News Daily*, 6/27/00)

There is widespread support for the proposal

- **Bergquist noted that comment letters on the proposed rule indicate widespread support for leveling the playing field – with the exception of Fannie and Freddie. He noted that the Bond Market Association, the American Bankers Association, and the Consumer Mortgage Coalition sent letters supporting the proposal. The Bond Market Association says the proposal is “well justified.”** (*American Banker*, Erick Bergquist, 6/30/00)

Financial services trade groups send joint letter to the Fed supporting the proposal of lowering the risk-weighting of all investment grade private institutions to the same 20% risk-weighting as Fannie & Freddie

- As reported in the May 14, 1999 *GSE Report*, a joint financial services trade letter was sent to the Federal Reserve Board on May 11, 1999 requesting that the Federal Reserve and other bank regulators revise the risk-weightings so that all investment grade MBS be given a 20% risk-weighting to ensure that Fannie and Freddie MBS would not be treated more favorably under bank risk-based capital guidelines than private MBS with AAA and AA ratings. The letter notes that currently Fannie and Freddie’s MBS have “support from an array of government-granted benefits” which provides preferential treatment to GSE-supported MBS over other private sector MBS. “In addition to being among the limited class of securities insured depositories may hold, the risk based capital regulations afford their MBS [Fannie and Freddie’s] a favorable 20 percent risk weight, resulting in a 1.6 percent capital charge.” On the other hand, “MBS guaranteed by private institutions are assigned a risk weight of either 50 percent (equal to a 4 percent capital charge) or 100 percent, depending on the ‘prudential’ nature of the underlying mortgages.”
- The letter further notes, “Since banks and thrifts need to hold less capital against government sponsored enterprise (GSE) securities than other comparable investments, their required hurdle is lower, thereby making investments in Fannie Mae or Freddie Mac MBS preferred over other investment alternatives, even when they have identical investment ratings.” The letter concluded by stating, “We urge the Federal Reserve and other bank regulators to revise the risk-weightings so that all investment grade mortgage backed securities should be given a 20 percent risk weighting. This would further the process of reform of the risk-based capital system to more closely align ratings with real risk.” The letter was signed by the Financial Services Roundtable, America’s Community Bankers, American Bankers Association, Consumer Mortgage Coalition, Mortgage Insurance Companies of America, and the National Home Equity Mortgage Association. (*Joint Bank Trade Letter to Federal Reserve Board*, 5/11/99)

MBA supports the regulators' proposal

- As reported in the May 28, 1999 *GSE Report*, the Mortgage Bankers Association also sent a letter to the Fed in support of revising the risk weightings. Paul Reid, Executive Vice President of the Mortgage Bankers Association, sent a letter to Federal Reserve Board Chairman Alan Greenspan requesting that a reduction be given for the risk-weighting for highly rated (AAA and AA) private mortgage- and asset-backed securities (MBS/ABS) from 50 percent to 20 percent. Reid wrote that the “MBA feels strongly that by reducing the capital requirement for these types of securities, the agencies will have taken an important step toward meeting the goal stated in the rule’s preamble of adopting ‘capital requirements that more closely reflect a banking organization’s relative exposure to credit risk.’” Reid urged the regulatory agencies to carve out this section and rule on it separately “without waiting to include it in the final rule.” Reid wrote that “the current risk-based capital rule discourages a large number of potential investors (banks and thrifts) from investing in highly rated private label MBS. These investor groups face a significantly higher capital charge for investing in private label MBS than they do for other MBS of comparable credit quality which enjoy a 20 percent risk weighting.” Reid closed his letter by writing that “The MBA believes that remedial action *now* would clearly demonstrate that the Fed and the other regulators are truly committed to the goal of aligning risk ratings more closely to actual risk.” (*MBA Executive Vice President Paul Reid letter to the Federal Reserve Board, 5/24/99*)

Fannie Mae and Freddie Mac

The Portland *Skanner* asks, “Who’s regulating the giants? [Fannie & Freddie]”

Lisa Loving with the *Skanner* writes a 3-part “critical series about the role – or lack of a role – Fannie Mae plays in helping African Americans and low-income residents buy homes for their families”

“The two corporations, while receiving billions in federal subsidies, remain more powerful than the government that created them, even though it appears the private sector and community organizations help more black families buy houses.”

- Lisa Loving of the *Skanner* (Portland, OR) wrote a 3-part “critical series about the role – or lack of a role – Fannie Mae plays in helping African Americans and low-income residents buy homes for their families.” Loving began her series with a publisher’s note that outlined Fannie and Freddie’s GSE status and noted that the two companies received “tax breaks from taxpayers’ coffers” to “supposedly help families to participate in the American Dream by buying their own homes: However, **“too many studies document increased Black displacement from traditionally Black neighborhoods, and a gap in home loans made to African Americans. Do Fannie Mae’s rigid lending guidelines favor moderate-income White homebuyers at the expense of Blacks? Nationwide, critics charge that Fannie Mae and its brother competition Freddie Mac have dragged their feet in addressing these issues.”** (*The Skanner*, Lisa Loving, 4/4/01)

Part One:

- Loving noted that approximately a year ago, at the request of HUD, the GSEs released their records on minority borrowers for the first time. Several studies had already shown that the GSEs were not filling their mandated requirements for minority loans and their policies were, in fact, hurting minority borrowers. **After reviewing the studies, HUD asked Fannie and Freddie to provide statistics on their low-income and minority borrowing programs. The GSEs both stalled in releasing their numbers for over a year and finally released numbers only after HUD threatened them with fines. Loving noted that HUD planned to release a report that would either confirm or deny the GSEs’ critics. However, “the two corporations are so powerful, in fact, the silence on what HUD found in its audit is deafening. A year later, no HUD report has been issued.”** Loving also criticized HUD for failing to regulate Fannie and Freddie’s mission. **“The two corporations, while receiving billions in federal subsidies, remain more powerful than the government that created them, even though it appears the private sector and community organizations help more black families buy houses.”**
- Loving noted that most observers agree that Fannie and Freddie have helped increase homeownership in the US. However, “the statistics also betray a significant gap in African Americans’ ability to qualify for a bank loan that meets Fannie’s requirements. The corporations’ profits and protected government status beg the question – could they do more?” Fannie’s Vice President of Public Affairs, Janice Daue, denied that Fannie is not doing enough for the black community. Daue stated, “no other company does as much to finance affordable mortgage for African Americans than Fannie Mae.” Daue acknowledged a gap in homeownership rates, but said that Fannie is trying to close the gap. She also noted that the company has pledged to help 5 million new minority homeowners by 2010.
- However, not everyone agrees with Daue’s assessment of Fannie’s performance. **Loving noted that the company’s critics represent a wide ideological range. “From the National Black Chamber of**

Commerce to the National Conference on Mayors, from the Republican chair of the Congressional House Subcommittee on Capital Markets [Cong. Richard Baker, R-LA], to Green Party icon Ralph Nader and Martin Luther King III. Some charge that while Fannie Mae was created to help more minorities and low-income families buy homes, it has in some ways actually cashed in on gentrification.” Northeast Portland US Bank mortgage loan officer Clarence Bethune stated, “I would compare them, as far as having a monopoly, to Microsoft.”

- Loving noted that many of the GSEs’ critics are especially concerned about the GSEs’ “ability to make money without the risks that other lenders take. “Because they’re ‘sponsored’ by the federal government, Fannie and Freddie benefit from the perception – not specifically written or stated – that if they default, the government will make good on their debts. It seems a small point, but critics allege their ties to the federal government have allowed Fannie Mae and Freddie Mac to make record profits even as evidence mounts that they’re falling behind in their primary purpose, which is to make more home loans available to the under-served. The groundswell of criticism against Fannie Mae and Freddie Mac is growing across the nation.” (*The Skanner*, Lisa Loving, 4/4/01)

Part Two:

- Loving examined the difficulty some faith-based community groups have had in working with Fannie. According to Loving, the Tacoma, WA based Pacific Rim Development and its client, the Memphis-based Christian Methodist Episcopal Community Development Corp. (CDC) had been working for two years to develop a program with Fannie for low- and middle-income housing in the Tacoma area. In April, Fannie agreed in principle to work directly with the CDC in funding the faith-based organization’s affordable housing projects. **The new agreement, according to Arthur A. Fletcher, Ph.D., chair of the National Black Chamber of Commerce and promoter of the Tacoma development proposal “is nothing short of an end-run around HUD and the banking industry.” The effort with Fannie is new, because under this program, Fannie will work directly with the CDC in providing loans, rather than channeling loan making decisions through a bank or a mortgage broker,” according to Fletcher and John JJ Jones, Pacific Rim Vice President.** The director of Fannie’s community-based initiative, Richard L. Hayes, declined to go that far in his assessment of the project, saying that it was “under construction.”
- A Fannie spokesperson, Colleen Haggerty, expressed exasperation over the difficulty small organizations seem to have with Fannie’s partnership process. Haggerty stated, “You don’t just go to the government and make demands...you have to work through all the issues.”
- Loving noted that many community developers find fault with the whole system – not just Fannie. Fletcher stated, “while federal housing programs have shaped the entire affordable housing industry...what they’ve done is chalked up one of the most spectacular cycles of failure imaginable.” **Fletcher and Jones told Loving that the “government often locked out African-American church-based organizations that once did the most to offer services to the disadvantaged when market forces go haywire. Although Fannie Mae is a private corporation, that tendency has carried over to the present.”**
- Loving noted that the community groups still have faith that a partnership can be reached with Fannie. She noted that Fannie did funnel over \$190 billion into affordable lending programs last year alone, although not with the Tacoma group. Loving added, **“whether for good or ill, whether for the common man or corporate interests, Fannie Mae is such a dominating force in the lending**

industry that every time it shifts policy to address consumer concerns, lives and business fortunes are affected.” (*The Skanner*, Lisa Loving, 4/17/01)

Part Three:

- Loving stressed that “in the *Skanner’s* two-month investigation of Fannie, the most constant criticism heard from policymakers, developers and moneylenders is the need for a loosening of Fannie Mae guidelines to include more families with less-than-perfect credit.”
- Loving noted that in the past two years Fannie has appeared to try to reach out to minority communities with new initiatives and by pledging to finance \$2 trillion dollars of affordable loans. However, many are skeptical. **JJ Jones, Vice President of the Pacific Rim Development stated that he feels positive about Fannie’s new program, but he has “in the past been critical of the corporation and still regards the banking industry with a sharp eye.”** Jones stated, “Fannie Mae was an enabler to discriminatory practices. The Federal Community Reinvestment Act of 1977 laid out worthwhile guidelines to help minority homebuyers and other under-served communities. And here we are, 20-some years later, struggling with the same thing...We’re struggling with the same thing because the money has been diverted. The money should have solved the problem.”
- Loving noted that a 1996 Congressional Budget Office report found that Fannie and Freddie received over \$6.5 billion a year from their GSE status. But out of every \$2 spent to benefit homebuyers, over \$1 went to stockholders and company executives. In addition, added Loving, “between 1989 and 1998, Fannie Mae’s stock alone increased in value 1,053 percent, boosting the corporation from a market value of \$500 million in 1983 to \$70 billion by 1998.” [Editorial Note: The CBO study was recently updated and found that Fannie and Freddie received \$10.6 billion in subsidies from the federal government last year, and retained more than a third of the subsidy for their shareholders and employees.]
- Loving noted that today Portland is one of the least affordable housing markets in the US. But even in the years 1990-96 when housing in Portland was more affordable, home ownership among Black Portlanders grew zero percent, according to HUD. Loving noted, “Virtually all Fannie Mae’s new lending products over the past year were created in the wake of reports the corporation was not helping enough low-income and minority borrowers, but instead threw the bulk of its resources behind the White, middle-income buyers who replaced them in Portland over the past 10 years.” (*The Skanner*, Lisa Loving, 4/18/01)

American Enterprise Institute’s Charles Calomiris and Peter Wallison state that contrary to the claims of the housing GSEs, Fannie & Freddie’s new subordinated debt offerings “do not cultivate market discipline nor create a cushion for losses”

Calomiris and Wallison support full privatization of Fannie & Freddie

As a “second-best alternative” to privatization, Calomiris and Wallison support credible regulation of Fannie & Freddie (preferably by the Treasury Department) and mandatory subordinated debt that “credibly bears risk”

- AEI’s Charles Calomiris and Peter Wallison wrote an op-ed in the *American Banker*, criticizing one of the provisions of Fannie and Freddie’s voluntary risk management agreement that the GSEs struck with Cong. Baker last October. **Under the provision, Fannie and Freddie agreed to issue**

subordinated debt to foster more market discipline and increase their effective capital. Calomiris and Wallison noted, however, that Fannie and Freddie's new debt offerings "do not cultivate market discipline nor create a cushion for losses." Calomiris and Wallison argued that to be effective, such subordinated debt must be credibly protected and of sufficient size. "The subordinated debt issued by Fannie and Freddie fails on both counts," stated Calomiris and Wallison.

- Calomiris and Wallison, as well as their colleagues on the Shadow Financial Regulatory Committee, have advocated a 2% minimum subordinated debt requirement for large banks as sufficient to bring market discipline into the bank regulatory process. However, for Fannie and Freddie, the proportion should be larger. **Calomiris and Wallison noted that because Fannie and Freddie are not governed by regulatory restraints that normally apply to banks, a 2% subordinated debt issuance, as the Committee has recommended for banks, would not provide the same degree of market discipline for the GSEs.** The Shadow Committee recommended for Fannie and Freddie, a regulatory subordinated debt requirement of 10% of the sum of on-balance-sheet and off-balance-sheet mortgage assets and obligations of the GSEs.
- Even a larger subordinated debt requirement would not be sufficient, unless it were credibly subject to loss. **But there is no evidence that Fannie and Freddie's current subordinated debt programs will be any less protected than Fannie and Freddie's senior debt, as the yield spreads between the subordinated debt and senior debt are tiny. Further, the Federal Financial Institutions Examination Council gave the GSEs' subordinated debt the same 20% risk-weighting as the GSEs' senior debt for purposes of bank capital regulation, "making clear that it does not regard the debt as bearing significant default risk."**
- **Calomiris and Wallison recommended that "the imitation subordinated debt that Fannie and Freddie have issued could be made real by requiring that all subordinated debt payments may be suspended when the institution has drawn on its Treasury credit line or has impaired capital to any degree and by further requiring that any permanent government fund transfers to these entities be matched dollar-for-dollar writedowns of the subordinated debt's face value."** Calomiris and Wallison also recommended the following: (1) the subordinated debt offerings should be of a long maturity and that only outstanding debt that has more than a year of remaining maturity should count toward the subordinated debt requirement; (2) regular offerings of such debt, at least quarterly, should be offered; and (3) Fannie and Freddie should be prohibited from writing derivative contracts with subordinated debt holders that mirror the risks of these debts.
- **Calomiris and Wallison concluded, "Full privatization of Fannie and Freddie is the best solution to the problems posed by their mixing of private profitability and public protection. Regulation is a second-best alternative. Credible prudential regulation (preferably by the Treasury rather than the Fed, as proposed in the Baker bill), including mandatory subordinated debt that credibly bears risk, would go a long way toward controlling the risks these companies pose to taxpayers."** Calomiris and Wallison are co-directors of the Project on Financial Deregulation at the AEI. (*American Banker*, op-ed by Charles Calomiris and Peter Wallison, 5/14/01)

Fannie's response to the op-ed

- Arne Christenson, Senior Vice President for Regulatory Policy at Fannie, wrote a response to Calomiris and Wallison's op-ed for the *American Banker*. Christenson noted that "Fannie and Freddie are the first financial institutions in America actually to carry out what, for most, is still just at the concept stage." He claimed that Fannie instituted the subordinated debt program "because the market

discipline provided by issuing subordinated debt makes our companies more safe and sound than ever.” Christenson also claimed that “Fannie Mae’s subordinated debt is voluntary, revolutionary, and far more stringent than any bank subordinated debt program.” He further noted, “It is inarguable that, if all large financial institutions adopted our model – including our subordinated debt program – the entire financial system would be stronger for it.” (*American Banker*, op-ed by Arne Christenson, 5/25/01)

Senator Paul Sarbanes (D-MD) becomes the new chair of the Senate Banking Committee (Senator James Jeffords' switch from Republican to Independent gave the Democrats control of the Senate and all of its Committees)

Senator Sarbanes says he is open to brokering a compromise between Fannie & Freddie & GSE critics – he would like to see how OFHEO’s new capital rules for Fannie & Freddie work before considering legislative action

***Bloomberg News* reports that Fannie executives and employees were Senator Sarbanes’ top contributors for his 2000 re-election**

Fannie’s Chairman Franklin Raines noted that the Democrat’s control of the Senate would not affect Cong. Richard Baker’s (R-LA) legislation to strengthen regulation of Fannie & Freddie. “We never thought the Baker legislation was going to be enacted, no matter who was controlling Congress, so we don’t see a big change as a result of this,” said Raines.

Cong. Baker says he will continue to push the administration and the Federal Reserve for tighter regulation of Fannie & Freddie

Cong. Baker says he will ask the Federal Reserve whether the financial benefits that the GSEs derive from their connection to the government distort financial markets

House Financial Services Committee’s Ranking Member John LaFalce (D-NY) says Senator Sarbanes’ chairmanship of the Senate Banking Committee means “there is less likely to be a jihad against the GSEs”

House Financial Services Committee Chairman Michael Oxley (R-OH) says he is moving methodically on considering the need for regulatory reform of Fannie & Freddie

- On June 6, Senate Democrats officially stepped into their new role as the Senate’s majority party. As noted in the June 1, 2001 *GSE Report*, Senator James Jeffords (R-VT) formally announced May 24 that he was leaving the Republican party to become an Independent. Senator Jeffords’ party switch tilted the balance of power in the 50-50 Senate to the Democrats (50-49-1). With the Democrats’ ascension to power, they will now enjoy majorities on all of the Committees, although the details are still being negotiated.
- Senator Paul S. Sarbanes (D-MD) became the incoming Democratic Chairman of the Senate Banking Committee, replacing Senator Phil Gramm (R-TX) as Chairman. According to Michele Heller of the *American Banker*, Senator Sarbanes offered a strong hint that he would be open to brokering a compromise between Fannie and Freddie and the GSE critics. Before considering legislative action, Senator Sarbanes said he would like to see how OFHEO’s long-awaited risk-based capital proposal would work. The rules are expected to be finalized at the end of June. (Congressman Baker noted in

a *Reuters* article that the date might slip to later in the summer. (*Reuters*, Mark Felsenthal, 6/6/01))
“We need to focus on carrying that work through so we get this regulation...put it in place, and then we work with it and see how it applies,” he stated. “It would be a mistake to knock ourselves off that track.” Senator Sarbanes further stated, **“Generally I think they’ve [Fannie & Freddie] met their responsibilities. But they are very big actors, and obviously, with any big actors, you need to take a look at them from time to time,”** he said. Senator Sarbanes made his comments during a Homeownership Alliance press conference with Fannie and Freddie.

- **Speaking at the same press conference, Fannie’s Chairman Franklin Raines noted that the Democrat’s control of the Senate would not affect Cong. Richard Baker’s (R-LA) legislation to strengthen regulation of Fannie and Freddie.** “We never thought the Baker legislation was going to be enacted, no matter who was controlling Congress, so we don’t see a big change as a result of this,” said Raines. “The real question is, ‘Do people support our mission?’ Our experience has been that the vast majority of members of Congress, including” outgoing Senate Banking Chairman Phil Gramm **“do support our mission.”** (*American Banker*, Michele Heller, 6/5/01)

Bloomberg News reports that Fannie executives and employees were Senator Sarbanes’ top contributors for his 2000 re-election

- Rob Wells with *Bloomberg* reported that Fannie Mae will get a “friend” when Senator Sarbanes takes over the Senate Banking Committee. Wells reported that Senator Sarbanes doesn’t see a need for legislation on the GSEs, which explains why shares of Fannie and Freddie jumped more than 3% on May 23 when word of the Senate power shift spread. Wells further noted that Fannie’s executives and employees were Senator Sarbanes’ top contributors for his 2000 re-election, providing \$24,000 to his campaign, according to the Center for Responsive Politics. Overall, Senator Sarbanes raised \$1.85 million for his last re-election. (*Bloomberg News*, Rob Wells, 6/6/01)

Congressman Baker says he will continue to push for tighter regulation of Fannie & Freddie

- In an interview with *Reuters*, Congressman Baker said he will continue to push the administration and the Federal Reserve to strengthen regulation of Fannie and Freddie and will hold hearings and take other action to keep the issue current, despite fading prospects for Congressional action this year. “The Sarbanes chairmanship clearly means that this would be an issue that would be dealt with next year as far as any final resolution,” stated Congressman Baker. He added, “It might require a bit of change in our approach, but I am no less resolute to a favorable conclusion in this matter.”
- Congressman Baker noted on June 6 that he was scheduled to meet with a senior administration policy advisor to present his legislation and his arguments. “This is the first formal visit in relationship to the issue,” he stated. He also noted that he had made a presentation on the GSE issue to the Federal Reserve Advisory Council in May. **Congressman Baker reported that he would ask the Federal Reserve to comment on whether the financial benefits that the GSEs derive from their connection to the government distort financial markets.**
- **Congressman Baker said he was comforted by Senator Sarbanes’ comments that he would wait for results from OFHEO’s risk-based capital proposal before considering the GSEs’ regulatory structure.** “That is the first sign of recognition to me that something must be done.” (*Reuters*, Mark Felsenthal, 6/6/01)

Ranking Member Congressman LaFalce’s comments on the GSE issue

- Congressman LaFalce says Senator Sarbanes' chairmanship of the Senate Banking Committee means "there is less likely to be a jihad against the GSEs." When asked whether oversight of Fannie and Freddie should be kept at HUD or transferred to the Federal Reserve (as proposed in Congressman Baker's bill), Cong. LaFalce stated, "If you have a coin, I could resolve the problem." (*American Banker*, Michele Heller, 6/7/01) Congressman LaFalce believes there are more serious problems the House Financial Services Committee should consider than which agency should regulate Fannie and Freddie. "In the scheme of things, it's not what I think about at night," he said. (*Reuters*, Mark Felsenthal, 6/6/01)

Chairman Oxley's comments on the GSEs

- Chairman Oxley says he is moving methodically on considering the need for regulatory reform of Fannie and Freddie. In general, Congressman Oxley said he feels a need to tread lightly on the issue. "It is not fair or wise for me to stake out an early position" on issues before the Financial Services Committee. "I don't see my role as a proponent or opponent but as a facilitator for a bunch of different views." Thus, he will take no immediate action on whether Congress should shift regulation of the GSEs from OFHEO to the Fed. (*American Banker*, Michele Heller, 6/13/01) "If [Baker] needs to get from here to there, he's going to need some compromises and some ability to have a connect between the GSEs, the Senate, and the administration – and the chair – and I'm part of that process," said Cong. Oxley. (*BNA Daily Report for Executives*, Adam Wasch, 6/13/01)

***National Mortgage News'* Bonnie Sinnock claims that Fannie & Freddie are too big to "fly under the radar"**

Sinnock advises that Fannie & Freddie would probably do well if they concentrated more on acknowledging rather than attempting to hide what they do, "because their actions increasingly hold ramifications for the market as a whole."

- Bonnie Sinnock with *National Mortgage News* reported that Fannie and Freddie are too big to use the strategy of "flying under the radar." Sinnock described "flying under the radar" as a strategy that was used by some contestants on the television show "Survivor" because it allowed persons to avoid being perceived as a threat by other competitors and make it through votes to continue on the program. The "flying under the radar" strategy appeared to be effective early on, but as the game progressed "flying under the radar" did not seem like a strategic option and ultimately the strategy that seemed to work in the latter stages was being open about the power they held and demonstrating that they intended to wield it responsibly.
- Sinnock wondered whether Fannie and Freddie were using this "flying under the radar" strategy when it was reported that the GSEs began quietly reducing some of the information they used to routinely release in their monthly disclosures. The GSEs claim they were merely reducing the tracking of an increasingly unimportant part of their business. However, as Sinnock noted, "the problem is that any decrease in disclosure seems to be a less-than-strategic move at this point. Their [Fannie & Freddie] influence is becoming more and more apparent, so anything they do behind the scenes is more likely to draw scrutiny than evade it." Sinnock advised that Fannie and Freddie would probably do well if they concentrated more on acknowledging rather than attempting to hide what they do, "because their actions increasingly hold ramifications for the market as a whole." Sinnock concluded, "The more the GSEs do to keep the markets informed, the better their relationship with the private market seems to be." (*National Mortgage News*, Bonnie Sinnock, 6/11/01)

Background on Fannie & Freddie's decrease in their monthly disclosures

- As noted in the June 1, 2001 *GSE Report*, Joy C. Shaw with *Dow Jones Newswire* reported that as part of Fannie and Freddie's voluntary risk management agreement with Congressman Baker, Fannie and Freddie began voluntarily releasing their interest-rate risk exposure in their mortgage portfolios. However, at the same time, they also began quietly reducing some of the information they used to routinely release in their monthly volume summary reports. **Some Wall Street analysts speculated whether the change was made to avoid releasing information that would put the GSEs' trading operations at a disadvantage to other securities firms.** The GSEs say they reduced the amount of information to improve readability and usefulness of the monthly reports. Both GSEs noted that a breakdown in mortgage purchases would still be available in their quarterly reports. (*Dow Jones Newswire*, Joy C. Shaw, 5/22/01)

The new President and CEO of the Financial Services Forum - former Congressman Rick Lazio – says the group plans to open up a dialogue with the GSEs in order to develop a position on the issue

- The Financial Services Forum named former Congressman Rick Lazio as its President and Chief Executive Officer. The *American Banker* called the Forum an exclusive but enigmatic group of chief executives of 21 of the country's largest banks, securities firms, and insurance companies. Lazio succeeds George Vojta, a former Vice Chairman of Bankers Trust Corp. Phillip Purcell, the Chairman and Chief Executive of Morgan Stanley and Chairman of the Forum, established the group early last year from an informal alliance of executives that had pushed for enactment of the Gramm-Leach-Bliley Act in 1999.
- Mr. Lazio said the Forum is working to develop positions on issues such as the regulatory overhaul of the GSEs and consumer privacy. "The group is going to open up a dialogue with the GSEs," he said. "The goal now is to develop a position through dialogue and consensus as opposed to outright confrontation." (*American Banker*, Michele Heller, 5/3/01)

Are Fannie & Freddie's automated underwriting (AU) systems discriminatory?

***Wall Street Journal* article by David Wessel discusses the issue of AU and potential discrimination**

Wessel believes that a solution to this issue is to find ways to predict the odds of repayment that don't disadvantage blacks or other minorities.

[Editorial Note: Another solution that has been discussed recently is ensuring that there are competing AU systems available for lenders to use in addition to Fannie & Freddie's AU systems.

A Mercer study concludes that if lenders had more choices among the AU systems, a greater number of prospective homebuyers would receive loan approvals. John Taylor, President and CEO of the National Community Reinvestment Coalition testified that the GSEs' regulators "should encourage a wide diversity of credit scoring systems, competing against each other in developing sound and flexible underwriting criteria. This will open more doors to homeownership for minorities and low- and moderate-income borrowers."]

HUD has been conducting a fair-lending review of Fannie & Freddie's AU systems for almost two years

- David Wessel with the *Wall Street Journal* wrote a column on the issue of automated underwriting systems (AU) and potential discrimination. Wessel noted that AU systems are increasingly used to

automate the process of applying for a mortgage. Fannie runs half of the six million applicants it receives annually through its AU system - Desktop Underwriter. Wessel noted that the system is “colorblind, but rejects black applicants more often than white.” Wessel added that Fannie would not provide precise figures.

- Wessel asked, “Does reducing the direct role that humans have in decision-making reduce racial discrimination or perpetuate racial disparities by hard-wiring them?”
- Wessel noted that computers still reject blacks more often than whites because black applicants tend to make smaller down payments, have more blemishes on their credit histories and have less money in the bank, which statistics say increases the risk of default. Critics argue that they reflect the long-lived effects of racism, which are embedded into computer codes.
- Wessel believes that a solution to this issue is to find ways to predict the odds of repayment that don’t disadvantage blacks or other minorities. A suggestion is the creation of a registry that would track rent payments. The theory is that people who pay rent on time are likely to make mortgage payments on time. Wessel also noted that more blacks than whites are likely to be renters. (*Wall Street Journal*, David Wessel, 5/31/01)
- **[Editorial Note: One solution that could address concerns about discrimination in AU systems is to have more competing AU systems.**
- **A 2001 study by Mercer Management Consulting found that Fannie & Freddie’s AU systems resulted in a smaller percentage of loans for minorities and low-income borrowers than similar systems developed by private-sector companies. The study also found that private-sector companies’ AU systems, when compared with Fannie & Freddie’s AU systems, approved 10% more borrowers for loans than Fannie & Freddie’s AU systems. The study concluded that if lenders had more choices among the AU systems, a greater number of prospective homebuyers would receive loan approvals. (For more information on the Mercer study, please see the March 30, 2001 *GSE Report*.)]**

Others have also noted the dangers of only having two automated underwriting systems (Fannie & Freddie) with little competition

- **In testimony before the Capital Markets Subcommittee last year, John Taylor, President and CEO of the National Community Reinvestment Coalition stated that the GSEs’ regulators “should encourage a wide diversity of credit scoring systems, competing against each other in developing sound and flexible underwriting criteria. This will open more doors to homeownership for minorities and low- and moderate-income borrowers. In addition, the regulatory oversight agency should continue conducting fair lending testing of the GSE underwriting systems as HUD has just started doing.” (Testimony of John Taylor, President and CEO of the National Community Reinvestment Coalition before Capital Markets Subcommittee, 6/15/00)**
- **“Fannie and Freddie could gain dominance over the AU market and lower the level of competition that would otherwise have occurred. As a result, home buyers would pay more to buy a home than they would have otherwise.” – Ron Feldman, Senior Financial Analyst, Federal Reserve Bank of Minneapolis (“Mortgage Automation Threat,” *The Region – Federal Reserve Bank of Minneapolis*, 12/96)**

- “To the extent that the GSEs now finance a significant portion of their sector of the mortgage market, the willingness of a GSE to purchase a mortgage has become a far more significant factor in deciding whether to originate that mortgage. **The GSEs’ automated underwriting systems are increasingly becoming the means by which originators decide to lend. This technology will make the process more efficient. In the long run, however, this trend may result in less diversity in credit decisions and less price competition.**” – Former Treasury Under Secretary Gary Gensler (*Testimony of Treasury Under Secretary Gary Gensler before House Capital Markets Subcommittee, 3/22/01*)

HUD has been conducting a fair-lending review of Fannie & Freddie’s AU systems for almost two years

- HUD has been conducting a fair-lending review of Fannie and Freddie’s AU systems [which control 95% of the AU market] for almost two years. In February 1999, HUD sent letters to Fannie and Freddie requesting information to ensure that the GSEs’ systems comply with fair-lending standards. The GSEs did not release this information until January 31, 2000. A March 1999 Urban Institute study commissioned by HUD found that Fannie and Freddie’s underwriting guidelines might inadvertently have a disparate impact on minority borrowers. **The study also noted that Fannie and Freddie “do not appear to have gone as far as some primary lenders to serve low-income and moderate-income borrowers and to minimize disproportionate effects on minorities.”** The study found that, **“Primary lenders are making more aggressive efforts” to serve lower income and minority homebuyers “by offering loan products with underwriting guidelines that are more flexible than the GSEs’ guidelines.”** Further, the study found that **“depository lenders are serving low- and moderate-income borrowers better than the GSEs and so the percentage of loans purchased by the GSEs that are originated to low- and moderate-income borrowers is less than the percentage of loans originated in the primary market.”** The study also found that “there is some evidence that the GSEs’ purchase of loans made to black and Hispanic homebuyers have actually declined (in share and absolute number) over the last two years.” HUD was expected to complete its fair lending review of Fannie and Freddie’s automated underwriting systems by year-end 2000 but the review has still not been completed. (*HUD/Urban Institute Study, “A Study of the GSEs’ Single Family Underwriting Guidelines,” April 1999*)

Reverend Jesse Jackson plans to push this year for the creation of institutions like Fannie & Freddie called “development banks” to invest and lend in underserved communities

Jackson took issue with Congressman Richard Baker’s (R-LA) efforts to strengthen regulation of Fannie & Freddie. “That’s a bad idea,” he said.

[Editorial Note: In past years, Jackson’s comments toward the GSEs were not as supportive. In 1998, Jackson advocated the creation of new entities like Fannie & Freddie, but in the context of creating a private-sector rival to Fannie & Freddie. That same year, Jackson urged shareholders to withdraw investments from Freddie and for Congress to hold “oversight hearings,” amid a \$15 million race discrimination lawsuit filed by a former Freddie executive. Jackson also called upon the Clinton Administration and then HUD Secretary Andrew Cuomo to act. Jackson charged that while Freddie created a poor atmosphere for minority employees, the company also did a poor job of servicing minority homebuyers.]

- In an interview with the *American Banker*, Reverend Jesse Jackson said he plans to push this year for the creation of quasi-government “development banks” modeled after Fannie, Freddie, and overseas private investment corporations to invest and lend in communities underserved by the traditional financial services industry. The *American Banker* reported that investing in underserved low-income communities raises the issue of risk, however Jackson said he believes “development banks” have

shown that the higher-risk scenarios can be overcome. He noted that the “development banks” would operate under different rules than conventional banks because they would be able to lend over longer terms and at lower interest rates and be more inclined to forgive debt and refinance when borrowers stumble. Jackson took issue with Congressman Baker’s efforts to strengthen regulation of Fannie and Freddie. “That’s a bad idea he said; the government-sponsored enterprises ‘must be incentivized to do more.’” He stated that the idea of making Fannie and Freddie “less able to invest,” and limiting CRA, are “Confederate moves designed to constrict the flow of capital to those who need it the most.” (*American Banker*, Erick Bergquist, 6/7/01)

In 1998, Jackson advocated the creation of new entities like Fannie & Freddie, but in the context of creating a private-sector rival to Fannie & Freddie

- In June 1998, after accusing Freddie of racial discrimination, Jackson advocated the idea of creating a private sector rival to Fannie and Freddie to facilitate low- and moderate-income lending, generating low-cost capital to invest in low-income underserved communities without raising taxes. According to Jackson, “An entity similar to Fannie Mae and Freddie Mac could be positioned...to generate capital and invest in areas under-served, without raising taxes.” It is unclear whether this new “GSE” would seek tax breaks or some type of congressional charter. **According to the *American Banker*, Fannie and Freddie “bristled at the implication that they are not doing enough, though they acknowledged Mr. Jackson’s ideas had some merit.”** A Fannie spokeswoman called Jackson’s idea “an intriguing idea,” but noted that Fannie has a record of making more than \$110 billion investments through its partnership offices. (*American Banker*, 6/12/98; *Business Wire*, 6/10/98; *National Mortgage News website*, posted 6/15/98)

In 1998, Jackson urged shareholders to withdraw their investments in Freddie amid a \$15 million discrimination lawsuit filed by a former Freddie executive and urged Congress and the Clinton Administration to get involved

- **In June 1998, Jackson urged shareholders to withdraw investments from Freddie, charging that Freddie creates a poor atmosphere for minority employees and does a poor job of servicing minority homebuyers. He urged Congress to “conduct appropriate oversight hearings.”** (*Wall Street Journal*, Michael Frisby, 6/2/98; *Dow Jones Newswire*, 6/3/98) **Jackson recommended that the Clinton administration and Congress pressure Freddie to address what he called a history of concerns about the treatment of minorities.** (*Washington Post*, 6/4/98) **He also called upon then HUD Secretary Andrew Cuomo to act on the issue.** (*Associated Press*, Janelle Carter, 6/4/98) **Jackson said he believed that Freddie has a duty to be accountable to the public because of the benefits it receives as a GSE.** (*Dow Jones Newswire*, Jennifer Corbett Dooren, 6/4/98)
- Jackson’s comments came amid a \$15 million race discrimination lawsuit filed by a former executive at Freddie, Tony Morgan (former Director of Executive Corporate Relations). Jackson held a press conference in June 1998 with Morgan. In his lawsuit, **Morgan charged that he was discriminated against and ultimately let go for raising serious concerns about Freddie’s “poor performance in purchasing mortgages made to minority and low-income borrowers.”** (*National Mortgage News Web site*, 6/3/98) **Morgan said the dismissal occurred shortly after he wrote an internal memo that criticized Freddie’s lending practices for minorities. Morgan said he was asked to review the company’s loan purchase data in preparation for a report to HUD. “I wrote that I was struck by Freddie Mac’s poor performance in purchasing the mortgages of minorities and low-income people,” said Morgan. “When it came to African Americans, the company’s mortgage purchase performance was poor across all income categories.”** He stated, “I noted my concerns in a memo but received no response...Instead, I was excluded from attending further meetings. I did

not realize it then, but looking back **it was clear that my days at Freddie Mac were numbered after I raised concerns about racism in their lending practices.**" (*Washington Post*, 9/6/98)

EEOC has warned Freddie

- **In August 1998, the EEOC issued a three-page finding in an August 14, 1998 letter (following a 20-month investigation), concluding that Freddie’s “discriminatory environment is the result of a lack of interest in promoting equal opportunity among Black employees.” The EEOC accused Freddie of showing a “disregard for the civil rights of black employees” in its hiring and promotion practices and of creating a “hostile work environment.”** It was reported that the EEOC was attempting to negotiate a settlement, and if that failed, the EEOC had the option of filing a formal complaint against Freddie in federal court. With this finding, it was reported that the EEOC and Freddie would schedule conciliation talks. (*Associated Press*, 9/3/98; *Wall Street Journal*, 9/3/98; *Washington Post*, 9/3/98)
- **In 1999, *National Mortgage News* reported that the EEOC was preparing to file additional employment discrimination charges against Freddie. Morgan’s attorney, Debra Katz, noted that the new EEOC charges were similar to charges that have already been filed. The point of the charges, in her opinion, is that “Freddie Mac is not fixing the problem.” EEOC would not comment on the matter.** (*National Mortgage News*, 9/27/99)

In 2000, Freddie forms partnership with Rainbow Push Coalition/Wall Street Project (founded by Jackson)

- As reported in the May 5, 2000 *GSE Report*, Freddie and the Rainbow PUSH Coalition/Wall Street Project announced a joint \$1 billion campaign aimed at increasing homeownership among minority families. Under the partnership, Freddie agreed to purchase up to \$1 billion in mortgage loans made to minority families through Bank of America and minority-owned lenders in selected locations over the next five years. Freddie also pledged \$1 million to support the Minority Homeownership Initiative to help the Wall Street Project’s “One Thousand Churches Connected” economic literacy effort to educate minority families about the benefits of homeownership and about mortgage loan products available to them. (*BNA Daily Report for Executives*, Eileen Canning, 4/17/00; *Freddie press release*, 4/14/00)

In 2001, Citizens Fund adds Freddie to its list of “sin stocks” because of charges of racial discrimination at the company – did not believe that the discrimination situation at Freddie had been remedied

- According to Jeff Benjamin with *Investment News*, Citizens Funds, a socially conscious money management firm based in Portsmouth, NH, officially added Freddie to the list of “sin stocks”. Citizens Funds’ President and CEO John Shields said the company is eliminating Freddie’s stock from the \$800 million Large Cap Core Growth Fund, despite Freddie being one of the better stocks in its portfolio last year (gaining nearly 48% over the past 12 months). **Citizens Funds has been watching Freddie since 1997, when the EEOC began a two-year investigation into charges of widespread discrimination at the company. In November, 2000 a year after the EEOC confirmed the violations, Citizens conducted a final screen of the company to see if the situation had been remedied. “We started talking to management, and they weren’t moving,” said Shields. “This sends a message that these practices are being condoned.”** (*Investment News*, Jeff Benjamin, 2/19/01)

Fannie & Freddie are continuing to expand into the subprime market

Fannie & Freddie's automated underwriting systems are accepting more loans on the lower end of the credit spectrum

Subprime lenders are concerned that the GSEs are not adequately pricing subprime borrowers' risk. "They are applying A-market-loan-to-values to very low FICO score credit," said Charles Coudriet of Saxon Mortgage. "They're taking on a lot of risk that eventually could be laid at the foot of the taxpayers without proper assessment."

Some critics of the GSEs' entry into the subprime market believe that the GSEs are diluting the quality of Fannie & Freddie's MBS by including the lower quality subprime loans with the regular conforming loans

Rating agency analyst says the GSEs' entry into the subprime market will put subprime lenders at a disadvantage because the GSE and lenders are not competing on a level playing field

Subprime lenders take issue with a statement by a Department of Justice official in support of the GSEs' entry into the subprime market

Fannie & Freddie's automated underwriting systems are accepting more loans on the lower end of the credit spectrum

- According to Erick Bergquist with the *American Banker*, brokers and lenders are saying that Fannie and Freddie's automated underwriting systems are accepting more loans on the lower end of the credit spectrum. Some brokers and lenders are saying that the GSEs' acceptance of FICO scores of 580-620 is now commonplace. (The article notes that several sources indicated that the lowest credit score the systems used to accept was 720.) (*American Banker*, Erick Bergquist, 3/26/01)

Subprime lenders are concerned that the GSEs are not adequately pricing the subprime borrowers' risk

- **Subprime lenders are concerned that the GSEs have an unfair competitive advantage over them from the benefits they receive from their GSE status. The lenders also fear that the GSEs' expansion into the subprime market could hurt their margins and cost them business. The subprime lenders are also concerned that the GSEs are not adequately pricing these subprime borrowers' risk. "They are applying A-market-loan-to-values to very low FICO score credit," said Charles Coudriet of Saxon Mortgage. "They're taking on a lot of risk that eventually could be laid at the foot of the taxpayers without proper assessment."** (*American Banker*, Erick Bergquist, 3/26/01)
- **Jeffrey Zeltzer, Executive Director of the National Home Equity Mortgage Association, stated, "We are strongly concerned that Fannie Mae and Freddie Mac are purchasing a more risky product and that they may not be that familiar with it and are not pricing it properly and that the burden of loss falls on the taxpayer." Zeltzer noted that subprime lending is "more an art than a science" and does not lend itself to quick and easy credit scoring and automated underwriting.** (*Housing Affairs Letter*, 3/3/01)

Some critics of the GSEs' entry into the subprime market believe that the GSEs are diluting the quality of Fannie & Freddie's MBS by including the lower quality subprime loans with the regular conforming loans

- Adam Tempkin with the *Asset Securitization Report* noted that one controversy with the GSEs' entry into the subprime market is the fact that non-conforming loans have ended up in Fannie and Freddie's MBS pools without anybody knowing about it. A market player noted that if a Fannie-approved lender originated a loan that required more than 100 basis points of protection, the loan was put into a separate category. However, if it was less than 100 basis points of protection, the GSEs would put it into its MBS pools. "And we wouldn't know about it. Many of the critics do not necessarily have a problem with the agencies going into subprime but only with the fact that they are destroying the homogeneity of the MBS passthrough market," said the researcher. "For instance, there are many Alternative-A loans in MBS pools, but no way to distinguish them. And everybody knows those loans behave very differently than regular product."
- "The agency MBS buyers are worried that subprime is going to dilute the purity of historic Fannie/Freddie product," said another MBS observer from a leading mortgage company. "The quality of the pools continue to deteriorate, and it's a winnowing process where better borrowers get taken out by the GSEs, forcing rates and profit margins down."
- The GSEs also buy securitized product for their own portfolios. In a typical subprime deal, there is a conforming class and a non-conforming class. The conforming class goes into Fannie and Freddie's portfolio while the rest of the deal goes into a separate portfolio. "At least we think it does; it's not entirely clear," said the Street source. (*Asset Securitization Report*, Adam Tempkin, 4/01/01)

Rating agency analyst says the GSEs' entry into the subprime market will put subprime lenders at a disadvantage because the GSEs and lenders are not competing on a level playing field

- **"Because of their [Fannie and Freddie's] funding advantage, the GSEs will take away the better credit and put others at a disadvantage,"** said a rating agency analyst that wished to remain anonymous. **"Then, the private lenders will have to price those remaining loans even higher. After the agencies take the better-credit-quality obligors, that puts the lenders who have been in the market with the weaker obligors."** **If Fannie and Freddie receive business from A and A-minus borrowers, there will be a higher percentage of C and D obligors remaining, that will have a much higher probability of default. "The other lenders would not be competing on a level playing field,"** the analyst stated. **"If the GSEs have a zero cost of funds and someone else has 6% cost of funds, then they would be at a huge disadvantage."** (*Asset Securitization Report*, Adam Tempkin, 4/2/01)

Subprime lenders take issue with a Department of Justice official's support of the GSEs' entry into the subprime market

- On April 10, Alexander "Sandy" Ross, Special Litigation Counsel for the US Department of Justice's Civil Rights Division, riled some subprime lending managers when he said he hoped the GSEs' growing presence in the subprime market would create fairer prices for borrowers with poor credit. Ross said the GSEs could play a significant role in helping to determine what criteria of poor credit determine fair interest rates. Some lenders at the Mortgage Banking Association's Subprime Lending Conference were irked by the comments because they felt they have a better gauge on the needs of subprime borrowers. (*Real Estate Finance Today*, Chris De Reza, 4/16/01) This is the not the first time Ross has made such GSE supportive comments. Ross was quoted as stating at a 1999 conference of mortgage regulators that "Fannie and Freddie will drive the bad guys out and make it safe for the good guys to come in and make that loan." (*"Understanding Predatory Lending,"* October 1999,

Neighborhood Reinvestment Corporation, Joint Center for Housing Studies of Harvard University, as taken from *National Mortgage News*, 1999)

Fannie Mae

DC government tentatively agrees to pay \$15.7 million to resolve a dispute surrounding the city-owned John A. Wilson Building (Fannie was involved with the dispute)

The vast majority of the \$15.7 million would pay back most of Fannie's \$13 million investment in the project

- According to the *Washington Post*, the DC government tentatively agreed to pay \$15.7 million to resolve a protracted legal suit surrounding the city-owned John A. Wilson Building. The vast majority of the money would go to Fannie Mae. It is expected that the DC Mayor and the DC Council will be able to return to the building as early as July. The deal ends years of litigation between the DC Council, which controls the building, and the Washington Development Group, a partnership led by private developer T. Conrad Monts, who arranged the rehabilitation, at Pennsylvania and 14th Street. Monts' partner in the project was Fannie Mae. The tentative deal would pay back most of Fannie's \$13 million investment in the project, while providing Monts with a developer's fee. The Council would then drop its 1998 lawsuit against Monts and he would end his counterclaim against the District. Monts would also terminate his lawsuit against the General Services Administration filed in November, which claimed that returning the space to the District was illegal. The District would also terminate its efforts to condemn and seize the building.
- The legal cases stemmed from a complex series of contracts signed by a then-nearly insolvent District government in 1996, three years after officials began abandoning the decrepit building. The city agreed to lease the structure to Monts for 40 years, who in turn struck a deal with the General Services Administration to sublease about two-thirds of the building for 20 years to use for federal offices. Now back on its feet financially, the District government wanted to return to the restored building, but not as a minor tenant. The District government wanted the entire building, including the federal portion. With then President Clinton's help, the city won agreement to let it occupy the federal space in exchange for covering the feds' rent payments. **Monts, however did not like that deal, claiming it would cost his partner, Fannie Mae, millions of dollars in historical tax credits. Monts believed that deal would cost Fannie, which invested \$13 million in the project, up to \$20 million in historic preservation tax credits.** Under federal rules, an historic building's rehabilitation is ineligible for the tax write-off if the owner occupies more than 35% of the building. The DC government was prevented from returning to the building until the legal cases were settled. (*Washington Post*, 3/6/01, 1/21/01, 1/19/01)

Fannie further expands its political reach by including Federal and State officeholders in its press conferences and press releases and increasingly using its Partnership Offices in press events

Fannie hires the former district director to Congressman Paul Kanjorski (D-PA) (Ranking Member of the Financial Services Committee's Capital Markets and GSE Subcommittee) to head its Northeastern and Central Pennsylvania Partnership Office

Fannie has 44 Partnership Offices open across the country

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

Fannie's media events raise ethical questions

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

Fannie has 44 partnership offices

- According to Fannie's Web site, the company has 44 partnership offices open across the country (http://www.fanniemae.com/contact/partnership_offices.html, 5/25/01)

Fannie hires former district director to Congressman Paul Kanjorski (D-PA)

- Fannie announced that it has hired Joseph Terrana as director of its Northeastern and Central Pennsylvania Partnership office. Since 1992, Mr. Terrana was the district director in charge of Congressman Paul Kanjorski's activities in Northeastern and Central Pennsylvania. A statement of support by Cong. Kanjorski was included in Fannie's press release. (*Fannie press release*, 5/23/01)

Senator Pete Domenici (R-NM), Senator Jeff Bingaman (D-NM), Congresswoman Heather Wilson (R-NM), and Albuquerque Mayor Jim Baca

- Fannie's Chairman Franklin Raines held a press conference with the above named officials and First State Bank and Paradigm & Company for the dedication of lofts at Albuquerque High, a \$5.9 million conversion of two of the former old Albuquerque High School Buildings into 69 loft apartments. The current project will restore two of the property's five buildings by converting the structures into loft apartments. The remaining structures will be developed separately into residential and office space. Fannie and First State Bank are providing \$2.4 million in construction financing and permanent loan financing for the project through a loan participation agreement, under which Fannie will purchase 50% of the loan originated by First State Bank. The 69 loft buildings will rent for approximately \$500 to \$1400 per month. Apartments will have from 500 to 1400 square feet of living space and will feature high ceilings, large wood-framed windows, high-quality kitchens and baths, and spacious hallways and mirrors. (*Fannie press release*, 5/29/01)

Senator Debbie Stabenow (D-MI), Cong. Dave Kildee (D-MI), and Flint, MI Mayor Woodrow Stanley

- Fannie held a press conference with the above named officials and Mission of Peace Homeownership Counseling Agency, and representatives from Fifth Third Bank, Flagstar Bank, and Republic Bank to

announce a new \$3 million homeownership initiative – Fannie’s first faith-based initiative in the state of Michigan. (*Fannie press release, 5/20/01*)

Senator Chuck Schumer (D-NY)

- Fannie joined Senator Schumer and the New York Bankers Association and nine banks to announce a pilot partnership – House Equity Lending Project (HELP) - that will offer loans in lower-income New York City neighborhoods. The nine participating banks are: Bank of New York, Citigroup, J.P. Morgan Chase, European American Bank, FleetBoston, Greenpoint Financial, Hong Kong Shanghai Bancorp, M&T Bank, and NorthFork Bancorp. Under the partnership consumers will be able to call a toll-free line handled by the New York Bankers Association, which will forward borrower information to the participating banks through a private Web site. Fannie contributed \$20,000 toward the telephone operation and will offer “flexible” products through the banks participating in HELP. Fannie will also purchase the loans made through the program. The HELP initiative was announced at Senator Schumer’s office. (*American Banker, Erick Bergquist, 5/31/01*)

Senator Byron Dorgan (D-ND)

- Senator Dorgan joined the Fargo/Moorhead Chamber of Commerce and Mike Williams, President of eBusiness at Fannie for the “Telecommunications Technology in North Dakota Conference and Trade Show.” (*Fannie press release, 5/29/01*)

Senator Rick Santorum (R-PA)

- Fannie joined Senator Santorum and Reverend Dr. Floyd Flake, the Local Initiatives Support Corporation and Kingdom Development Inc. to announce the formation of Building United of Southwestern Pennsylvania (BUSP), a new non-denominational faith-based community development corporation for the Pittsburgh region. (*Fannie press release, 6/4/01*)

Congressman William Jefferson (D-LA) and New Orleans Mayor, Marc Morial

- Fannie joined with the above named officials to announce a new \$2 million “anti-predatory” mortgage lending pilot. The pilot was developed by the Greater New Orleans Fair Housing Action Center, New Orleans Legal Assistance, Hibernia National Bank, Neighborhood Housing Services of New Orleans and Fannie. Under the initiative, victims of “predatory lending” will have an opportunity to stay in their homes and refinance very high interest rates with affordable mortgage financing. NHS will work with the borrowers to provide homebuyer education. Fannie also held a press conference at the state capitol with Governor Mike Foster to announce its new five-year HouseLouisiana program. (*Fannie press release, 5/31/01*)

Congressman Leonard Boswell and Oskaloosa, IA Mayor Thomas Rielly

- Fannie joined with the above named officials to recognize the city of Oskaloosa and Panel Components Corporation for their commitment to making homeownership a focus of local economic development. (*Fannie press release, 6/1/01*)

Congressman Denny Rehberg (R-MT) and Billings, MT Mayor Chuck Tooley

- Fannie joined the above named officials to celebrate the grand opening of a senior housing apartment complex. The development was made possible through Low-Income Housing Tax Credit investments and financing from the Sparrow Group, SunAmerica Affordable Housing, the Montana Board of Housing, and Fannie. (*Fannie press release, 6/4/01*)

Congressman Bob Etheridge (D-NC) and Congresswoman Eva Clayton (D-NC)

- Fannie announced that a collaborative effort by North Carolina's key housing leaders and the North Carolina Community College System, families will have access to a homebuyer education course taught by industry professionals. Statements of support by the above named officials were included in Fannie's press release. (*Fannie press release, 6/5/01*)

Congressman Tom Udall (D-NM)

- Fannie announced that a family was the first homebuyer on Pojoaque Pueblo Land to obtain mortgage financing thanks to an initiative between the Pojoaque Tribe, Rural Housing Services, First National Bank, Bureau of Indian Affairs, and Fannie. A statement of support by Cong. Udall was included in Fannie's press release. (*Fannie press release, 5/22/01*)

Congresswoman Juanita Millender-McDonald (D-CA)

- Fannie held a press conference with Congresswoman Millender-McDonald and the Congressional Black Caucus Foundation to welcome a homebuyer into their first new home as part of the Congressional Black Caucus Foundation's "WOW" program. (*Fannie press release, 5/30/01*) Founding partners in the "WOW" initiative also include large national mortgage lenders, financial services trade associations, realtors, mortgage insurance companies, and community-based organizations.

Congressman Silvestre Reyes (D-TX)

- Fannie held a press conference with Congressman Reyes to welcome two first-time homebuyers in celebrating a new employer assisted housing benefit offered by the Fort Bliss Federal Credit Union. The Employer Assisted Housing (EAH) benefit is through a partnership with Fannie and the Fort Bliss Federal Credit Union. Under the credit union's EAH benefit program, employees have the opportunity to borrow \$5,000 for down payment and closing costs. The second loan is interest free and 100 percent forgivable over a 5-year period. Fannie will purchase the first mortgage under the initiative. (*Fannie press release, 5/31/01*)

Congresswoman Shelley Moore-Capito (R-WV)

- Fannie held a press conference with Congresswoman Moore-Capito and the West Virginia Housing Development Fund, and WesBanco Bank, Inc. to announce a new \$65 million mortgage revenue bond agreement between the WVHDF and Fannie. Fannie purchased \$32.5 million of single-family, tax-exempt mortgage revenue bonds from a \$65 million tax-exempt bond issued by the WVHDF. The bond proceeds, available through more than 150 mortgage lenders, will provide financing for 30-year, fixed-rate mortgages with a below-market interest rate of 6.39%. The WVHDF is also offering closing cost assistance of up to \$1,500 for eligible borrowers as an 8-year deferred payment loan. (*Fannie press release, 6/1/01*)

Congressman Ron Kind (D-WI)

- Fannie joined Congressman Kind in convening a community development roundtable to discuss Wisconsin's housing issues. (*Fannie press release, 6/1/01*)

Congressman Jim Maloney (D-CT)

- Fannie joined Congressman Maloney and the Neighborhood Housing Services of Waterbury and Webster Bank to announce a home rehabilitation mortgage product for historic Scovill rowhouses. Webster Bank will offer Fannie's HomeStyle mortgage product to help prospective homebuyers finance the purchase or refinance the renovation of a home with just one loan. (*Fannie press release, 6/9/01*)

Other local officials with whom Fannie held press opportunities:

- Fannie also held press opportunities with the following public officials:
 - (1) Governor of Louisiana Mike Foster (*Fannie press release, 5/31/01*)
 - (2) Oakland, CA Mayor Jerry Brown (*Fannie press release, 6/7/01*);
 - (3) Pasadena, CA Mayor Bill Bogaard and City Councilman Chris Holden (*Fannie press release, 6/5/01*);
 - (4) Baltimore, MD Mayor Martin O'Malley (*Fannie press release, 5/30/01*)
 - (5) Minneapolis, MN Mayor Sayles Belton and Metropolitan Council Chair Ted Mondale (*Fannie press release, 5/31/01*)
 - (6) Irvington, NJ Mayor Sara Bost, State Senator Ronald Rice (*Fannie press release, 5/22/01*); and,
 - (7) Casper, WY State Representative Rick Tempest (*Fannie press release, 6/6/01*)

Freddie Mac

Despite objections from the Bond Market Association (BMA), Freddie is proceeding with its plan to change the prepayment accounting cycle for its mortgage-backed securities to a calendar month rather than a midmonth cycle

The change will allow Freddie's MBS to be based on the same prepayment calendar cycle as Fannie Mae and Ginnie Mae

Some MBS investors are expected to lose tens of millions of dollars as a result of Freddie's switch in the prepayment accounting cycle

The BMA expresses "disappointment and concern" with the "timing and effective date of [the] change" and suggests Freddie postpone the effective date

Freddie's representatives say they are implementing the change as of June in part because the company felt market conditions then would be the most conducive to relatively minimal market disruption

George Miller, Senior Vice President and Deputy General Counsel at the BMA, responds that current market conditions are ones that "from a corporate perspective favor Freddie Mac" and are "arguably the opposite for other market participants"

- Bonnie Sinnock with *National Mortgage News* reported that despite objections from the Bond Market Association (BMA), Freddie is proceeding with its plan to change the prepayment accounting cycle for its mortgage-backed securities to a calendar month rather than a midmonth cycle. The timetable for implementing the change may be too soon for the BMA. **The BMA is concerned that "potential operational issues might be difficult to address and reconcile" in the "little more than seven weeks" the market has to adapt to the move, said George Miller, Senior Vice President and Deputy General Counsel at the BMA. The BMA has sent a letter to Freddie expressing "disappointment and concern" with "the timing and effective date of [the] change." Miller added that he would like Freddie to postpone the change (which is scheduled to become effective after June settlement) to a date "not earlier than September 8." Miller said the BMA "would**

have strongly preferred to prescribe a later implementation to minimize market disruption.” However, according to Miller, Freddie has indicated that it is “going ahead as planned.”
(*National Mortgage News*, Bonnie Sinnock, 5/28/01)

- **Freddie representatives said they were implementing the change as of June in part because the company felt market conditions then would be the most conducive to relatively minimal market disruption.** For example, premium securities (which were affected to a greater extent than other coupons) currently make up a relatively small amount of the market. Freddie’s officials felt less certain that market conditions further down the road would minimize disruptions. **In response, BMA’s Miller said that current market conditions are ones that “from a corporate perspective favor Freddie” and are “arguably the opposite for other market participants.”** (*National Mortgage News*, Bonnie Sinnock, 5/28/01)
- BMA’s Miller told *Dow Jones Newswire*, that the “main issue here really is one of the timing as opposed to the substantive aspect of the decision.” Miller said the BMA supports Freddie’s stated goal in the change, which is to achieve greater industry standardization, but the timing of the announcement and the implementation day of the change is ill conceived. Miller argued that the market is still in the middle of a refinancing wave and that combined with a steep Treasury yield curve, “really maximizes some of the economic and market dislocation.” Miller indicated that the association would recommend that Freddie delay the implementation of the decision to avoid impacting deals that have already been executed. “I think the general view is that had they specified a later implementation date, those effects would not have been as pronounced.” (*Dow Jones Newswire*, Joy Shaw, 5/11/01)

Background on Freddie’s accounting cycle change

- As reported in the June 1, 2001 *GSE Report*, effective July 1, Freddie will change its existing “midmonth” accounting cycle for mortgage prepayments to a calendar month accounting cycle. The change will allow Freddie’s MBS to be based on the same prepayment calendar cycle as Fannie Mae and Ginnie Mae. In connection with the revision, Freddie also announced that it would be releasing its PC factors on the fifth business day of every month (instead of the first business day of each month), and REMIC disclosures on the fifth business day instead of the seventh business day of each month. The change will affect approximately 84% of the company’s existing PCs. The change will be effective for single-family Gold and ARM PCs that were issued since September 1, 1995 and on multi-family PCs that were issued since December 1, 1997. In the first month of implementation, investors will receive prepayments for 45 days instead of 30 days. (*Dow Jones Newswire*, Joy Shaw, 5/9/01; *Reuters*, 5/9/01; *Freddie press release*, 5/9/01)

Some MBS investors are expected to lose tens of millions of dollars as a result of Freddie’s switch in the prepayment accounting cycle

- **According to Joy Shaw with *Dow Jones Newswire*, “some mortgage-backed investors are expected to lose tens of millions of dollars as a result of Freddie Mac’s switch in prepayment accounting cycle.”** Shaw notes, Freddie’s “unexpected announcement caused some confusion in the MBS market about whether the switch would change the time for investors to receive monthly cash flow and the extent of impact on structured products, such as collateralized mortgage obligations and mortgage derivatives. It also infuriated some investors who will inevitably incur losses because the change will cause a one-month spike in Freddie Mac prepayments in June.” Shaw notes, “Even though the spike in prepayments is only for one month, there’s still significant monetary impact.”

- Shaw contends that the biggest losers will be premium Gold PC holders, who will see a 50% increase in their securities prepaid at par on July 15. Lehman Brothers analysts estimated that the net impact to the market is a loss of around \$100 million, half of which will be absorbed by Freddie (the biggest holders of its own securities) and the other half mainly by investors of interest-only securities, or IOs. (*Dow Jones Newswire*, Joy Shaw, 5/10/01)

President Bush appoints five people to serve on Freddie's Board

[Editorial Note: Unlike fully private corporations, the President of the US has the authority to appoint board members to Fannie & Freddie, which in part strengthens the government's implied backing of the GSEs.]

- President Bush appointed five people to serve one-year terms on Freddie's board. Their terms will end on the date of the next annual meeting of the stockholders in 2002. According to the White House, four of the five members of Freddie who are appointed by the President are statutorily required to represent the indicated sectors. The following are the five people appointed by the President:
 - (1) William Dodd Powers of New York (Mortgage Lending) – former Chairman of the New York Republican State Committee;
 - (2) Cesar Benito Cabrera of Puerto Rico – President of Rocca Development, a real estate firm in San Juan (Real Estate);
 - (3) David James Gribbin III of Maryland – Chairman of the Prosperity Project in Washington (Public);
 - (4) Catherine Lynn Stepp of Wisconsin – co-owner and Vice President of First Stepp Builders (Homebuilding);
 - (5) Michelle Engler of Michigan – trustee of the JNL Investor Series Trust and wife of Governor John Engler (Community Interests).

(American Banker, Rob Garver; White House press release, 5/25/01)

Freddie, in partnership with the Manufactured Housing Institute, has developed a template that can be used to qualify more manufactured housing loans for conventional financing

- Working with the Manufactured Housing Institute, Freddie has developed a new template for a residential ground lease agreement so that a manufactured home on a leased site can be titled as real estate and qualify for conventional mortgage financing. According to Brian Collins with *National Mortgage News*, less than 20% of manufactured homes each year are titled as real estate and the majority are financed with personal property loans, which carry interest rates of 300-400 basis points higher than conventional mortgage loans.
- In 2000, Freddie purchased approximately \$500 million in loans with an average size of \$40,000. Coffey expects that in three years the percentage of manufactured homes titled as real estate could increase to 50%.
- Freddie also revised its seller/servicer guidelines for manufactured housing loans. “Freddie Mac will purchase only manufactured housing that is titled as real estate regardless of whether it is on land owned by the borrower or leased under a long-term recorded lease,” said the guide. (*National Mortgage News*, Brian Collins, 6/4/01)

Freddie holds press conference with Cong. Edward Royce (D-CA) to announce a \$25 million initiative for California homebuyers

- Freddie and Congressman Royce announced a \$25 million initiative for California families. The statewide effort combines a 30-year fixed-rate first mortgage with a very low market rate second loan that families can use to finance their downpayment or closing costs. Under the pilot, California families can finance the minimum 3% down payment with a below-market second mortgage from the California Housing Loan Insurance Fund (CaHLIF) that isn't repaid until the house is sold. Families earning up to 80% of their area's median income can also receive as much as \$2,500 toward closing through a grant from California Bank & Trust. Borrowers need to contribute 1% of the purchase price from their own personal funds towards either the downpayment or closing costs. (*Freddie press release, 5/31/01*)

Federal Home Loan Banks

The salaries of the 12 FHLBank Presidents increased after a statutory requirement that the FHFB approve the FHLBank Presidents' compensation packages was removed

- According to Rob Garver with the *American Banker*, there was a provision in the 1999 Gramm-Leach-Bliley Act that removed a statutory requirement that the FHFB approve the FHLBank Presidents' compensation packages. Garver notes that during the year 2000, the FHLBank Presidents with at least a year of experience in their positions received an average raise of 42.75%. Members of the FHLBanks' boards argue that the salary increases were needed to address years of unreasonably low pay and the need to retain talented executives in the face of coming overhaul of the FHLBank System's capital structure. Charles Smith, Chairman of the Board of the FHLBank of Boston, said that the restrictions placed on FHLBank President salaries by the FHFB before Gramm-Leach-Bliley had kept the salaries too low. "We think that the caps that were put on before were not fair," said Smith. "In the whole system you saw adjustments, but that doesn't mean you are going to see them again. You won't." (*American Banker*, Rob Garver, 5/2/01)

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