

# The **GSE** REPORT™

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## Contents of GSE Report™

**“Make no mistake,” said Cong. Richard Baker (R-LA): The federal subsidy provided to Fannie & Freddie “is real, it’s large, and has far-reaching implications.” (Cong. Baker press release, 5/23/01)**

**CBO Director Dan Crippen: “The federal subsidy to the GSEs is unusual in that it is not explicitly appropriated by the Congress in legislation nor does in appear in the budget as outlays. In fact, as Alan Greenspan has noted, the subsidy is largely determined by the GSEs’ own actions. Nonetheless, it is real. It represents costs to the American public and is highly valued by recipients.” (CBO Director Dan Crippen’s Testimony at House Financial Services Committee’s Capital Markets Subcommittee hearing, 5/23/01) [CBO estimates that Fannie, Freddie and the FHLBanks receive a substantial federal subsidy as a result of their special GSE status (\$13.6 billion in 2000), yet only pass through some, but not all, of that subsidy to mortgage borrowers.]**

### **Major Events**

- CBO study found that Fannie & Freddie received a substantial increase in federal subsidies since the CBO’s 1996 study ([p. 6](#))
  - Cong. Richard Baker (R-LA) holds May 23 hearing to discuss the results of the CBO study
  - The CBO study finds that Fannie & Freddie received \$10.6 billion in subsidies from the federal government last year (1996 estimate was \$6.5 billion)
  - The CBO study finds that Fannie & Freddie pass about 63% of the subsidy on to home buyers in the form of lower mortgage prices but retain more than a third of the subsidy (37%) for their shareholders and employees
  - Cong. Baker says he will hold an additional hearing in approximately one month so that the GSEs and any other interested parties may comment on the CBO study. On June 14, he is holding a hearing with Wall Street analysts on another issue but may expand that hearing to address the role that financial analysts play in the GSEs’ securities activities
- Citizens Against Government Waste (CAGW) castigates Fannie & Freddie for pocketing huge taxpayer subsidies ([p. 13](#))
  - CAGW President Tom Schatz says the CBO study “confirms that Fannie Mae and Freddie Mac have aggressively leveraged their government charters, and the huge windfall that comes with them, to accrue monumental amounts of debt, reap above-market rates of return, invade and undercut other financial services sectors, all the while shifting the risk to taxpayers”
  - “Congress and President Bush must turn their attention to this problem before the taxpayers are bailing out another ‘too-big-to-fail’ financial institution,” says Schatz
- Competitive Enterprise Institute (CEI) says the CBO study estimating that Fannie & Freddie receive more than \$10 billion in subsidies exemplifies the significant “moral hazard” posed by the GSEs ([p. 14](#))
  - “Whatever original purpose the GSEs served in the secondary mortgage market has long been fulfilled. The unique public-private role of the GSEs is no longer needed or appropriate,” says CEI President Fred Smith
- Free Congress Foundation “cries foul on Fannie Mae and Freddie Mac” ([p. 15](#))
  - “CBO’s latest figures should be a wake up call to Congress that Fannie Mae and Freddie Mac are the poster children for corporate welfare,” said J. Bradley Jansen of the Free Congress Foundation
  - Free Congress Foundation expressed disbelief that the CBO study estimating that Fannie & Freddie receive more than \$10 billion a year in federal subsidies did not include the GSEs’ privacy exemption

- National Taxpayers Union (NTU) is critical of the massive GSE subsidies ([p. 16](#))
  - “Fannie Mae and Freddie Mac have taken a \$10 billion government subsidy and used it to line the pockets of their top executives and shareholders,” observed NTU Director of Congressional Relations Eric Schlecht. “Every taxpayer should be outraged to learn of this blatant misuse of their tax dollars”
- FM Watch says the CBO study shows that the GSEs are an “inefficient system that needs to be reviewed by the Congress and the GSE regulators” ([p. 16](#))
  - “It is very clear that was once a ‘spongy conduit’ for increasing homeownership has become a revenue pipeline for Fannie and Freddie shareholders and executives,” said Mike House, Executive Director of FM Watch
- Fannie is developing a pilot program that consumer activists say could hurt people with marginal credit ([p. 17](#))
  - National credit industry leaders also call the pilot program dangerous and potentially harmful to borrowers and taxpayers
  - Rather than pulling a consumer’s credit report from all three of the national credit bureaus - Equifax, Experian and Trans Union – Under Fannie’s pilot program, only one credit report from one of the three credit bureaus will be required
  - Freddie is also reportedly considering a similar pilot program
  - Studies on credit scores have shown that variances of 50, 80, and even 100 points between different credit bureaus are not uncommon and can disqualify applicants for a home loan or push them into a “subprime” credit category, costing them thousands of dollars more in interest and fees over the life of the mortgage
  - “Fannie has the market power to be part of the credit-report nightmare solution instead of compounding the credit nightmare problem, as they are doing,” said Ed Mierzewski, Consumer Program Director for the US Public Interest Research Group
  - “How can the minimal savings this plan might provide consumers justify the potential overcharging of thousands of dollars in interest,” because of erroneous, negative information, said Terry Clemens, Executive Director of the National Credit Reporting Association
- HUD withdraws its plans to regulate Fannie & Freddie’s non-mortgage investments ([p. 20](#))
  - Although the plan could be reinstated, the *American Banker* reports that HUD Secretary Mel Martinez has taken a “laissez faire public stance, arguing that the private sector should seek its own solutions” [HUD is Fannie & Freddie’s mission regulator]
  - American Enterprise Institute Fellow Peter Wallison is concerned about HUD’s withdrawal of the plan to regulate Fannie & Freddie’s non-mortgage investments. “Unless there is an explanation from HUD as to why they are withdrawing, it is a worrisome fact,” he said.
  - A 1998 GAO Report recommended that HUD develop criteria in order to regulate the non-mortgage investments of Fannie & Freddie and that Congress should step in if adequate progress was not made
  - “To help ensure that the enterprises’ non-mortgage investments appropriately support their public missions, the appropriate congressional committees may wish to monitor HUD and FCA [Farm Credit Administration] actions to establish criteria and procedures for carrying out their general regulatory authorities. Such oversight is important to help ensure that corporate incentives to increase shareholder value do not erode the enterprises’ public mission. If adequate progress is not made in a timely way, Congress may wish to consider providing further guidance to the regulatory agencies.” (GAO Report, “*Federal Oversight Needed for Non-Mortgage Investments*,” GGD-98-48, 3/98)
- OFHEO does an “about-face” and withdraws Fannie/Freddie corporate governance rule ([p. 25](#))
  - According to John Connor with *Dow Jones Newswire*, “the action...smells after a couple of days of fertilization like a case of a regulator being muscled by the regulated entities”
  - Connor notes that the “buzz is that Fannie and Freddie (not nearly as warm and cuddly as their names sound) weren’t happy and let the regulator know they were prepared to go to the mat unless the corporate governance proposal went away”
- Real estate brokers would like regulators to examine Freddie’s REO (real-estate owned properties/foreclosed properties) business ([p. 26](#))
  - “It is appalling that the new HUD regulatory administration is not complying with its duty to effectively regulate the GSEs. It is unbelievable that HUD is continuing to allow the first federally subsidized real estate brokerage operation to remain in business,” said Bruce Koklich, an REO marketing specialist in Long Beach, CA
  - REO professionals are supporting Cong. Richard Baker’s (R-LA) GSE bill to strengthen oversight of the GSEs
  - HUD requested information about Freddie’s HomeSteps programs about a year and a half ago because it was concerned that the activity might be a new program outside the GSEs’ mission (HUD has not yet responded after a year and half of investigation)

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

- American Enterprise Institute Fellow Peter Wallison and financial consultant Bert Ely will hold a briefing on June 4 to update their “Nationalizing Mortgage Risk” study and its implications for the future of Fannie & Freddie ([p. 28](#))
- *US Banker* column by Paul Muolo notes that FM Watch Executive Director Gerald Friedman said FM Watch’s ultimate goal is to work with Congress to implement a “tough, single regulator” for the GSEs to keep the GSEs focused on their core mission of providing liquidity in the secondary mortgage market, as opposed to expanding into other lines of business ([p. 28](#))
  - Muolo writes, “Don’t Fannie and Freddie already have a regulator? It does – the Office of Federal Housing Enterprise Oversight, an agency that is considered more or less a regulatory joke.” Muolo also noted that HUD, Fannie and Freddie’s mission regulator, is “considered slightly more attuned to what’s going on in the mortgage market than OFHEO, which isn’t saying much”
  - “One fact is for certain: the GSE charter, which was amended in 1992 is so vaguely written that the two can basically do anything they want, short of originating loans, as long as the activity, in some way, adds liquidity to the market and/or promotes homeownership”
  - One mortgage industry veteran who is involved tangentially with FM Watch said he does not want to shut down Fannie or Freddie. “I think the issue is that Fannie and Freddie have the power of the government behind them, but they are not playing by government rules. There have been threats and no one is holding them accountable. Think about it – if they were Microsoft the Attorney General would be all over them,” said the mortgage industry veteran.
- While Fannie & Freddie publicly announced that they would release more information on their exposure to interest-rate risks in their mortgage portfolios, they quietly began reducing the amount of information they used to routinely release in their monthly volume summary reports ([p. 30](#))
  - Fannie & Freddie have removed the detailed information on the various types of mortgages they purchase from their monthly reports
  - Howard Shapiro, an investment research analyst at Goldman Sachs & Co. said, “More information is always better...Certain things I did look for on a monthly basis, for example, the breakdown in purchases, is not there anymore...It would be more helpful to have it.” Shapiro noted that he uses the disclosures to get a sense of what types of products the GSEs are purchasing. “It kind of tells you what’s going on in the mortgage market and it tells you whether or not the investment opportunity is getting more or less attractive for the investment portfolio,” said Shapiro.
- Senator Paul Sarbanes (D-MD) is likely to be the next chair of the Senate Banking Committee – (Senator James Jeffords’ switch from Republican to Independent gives the Democrats control of the Senate and all of its Committees) ([p. 31](#))
  - Outlining his new agenda for the Committee, Senator Sarbanes says oversight of Fannie & Freddie is a top priority
  - Shares of Fannie & Freddie gain after news that the Democrats will take control over the Senate
  - Current Senate Banking Committee Chairman Phil Gramm (R-TX) says he is mulling over whether legislation is needed to strengthen regulation of the GSEs
- As the national debt shrinks, GSE debt skyrockets ([p. 32](#))
  - With the fading supply of Treasuries, Fannie & Freddie are issuing massive amounts of debt in an effort to have GSE debt replace Treasuries as the new benchmark in the bond market

GSE debt news:

  - (1) Fannie to start selling debt for individuals (directed at retirees) – Financial planning professionals are skeptical and say that individuals would be better served buying bond mutual funds
  - (2) Freddie may trade in agency futures for hedging purposes – *Investment Dealer’s Digest* reports that Congressional critics of Fannie & Freddie who have accused the GSEs of overstepping their charters “could have new ammunition with Freddie Mac’s recent moves into the agency futures.”
- Fannie & Freddie expand their technology to brokers, realtors, and consumers ([p. 35](#))

[Editorial Note: Such expansion conflicts with the Mortgage Bankers Association’s (MBA) policy statement on the GSEs – “The GSEs should not develop, distribute, or use technology in a way that bypasses their seller/servicers by going direct to the customers or vendors of those partners, including, but not limited to consumers, owners/developers of housing, mortgage brokers, and other real estate professionals.” (*MBA GSE Policy Statement*, 8/10/99)]

  - (1) *Business 2.0 Magazine* says Fannie “wants to dominate the Web” and wants to be “the infrastructure provider for the online mortgage market”
  - (2) Freddie announces it is developing a new Web-based site to streamline and automate steps in the mortgage origination process of lenders and brokers
  - (3) Fannie has a partnership with BET.com that creates a Web site for consumers to apply for a loan

- (4) ARC Systems – one of the automated underwriting system leaders in the non-conforming market (subprime, jumbo, Alt-A and home equity) – may assist Fannie & Freddie in finding a loan product for non-conforming customers and may also integrate Fannie & Freddie’s automated underwriting systems into its system
  - (5) HomeStore.com [of which Fannie is an investor] and Bank of America sign a \$10.5 million agreement to launch a new online “marketplace” for consumers
  - (6) RE/Maxx, a residential and commercial real estate company, announces an alliance with HomeSide Lending that will use Fannie’s automated underwriting technology to approve customers
  - (7) Mortgagebot claims to be the first online loan lender to accept consumer mortgage applications and deliver loan decisions using Freddie’s automated underwriting system
- Bill Bonner of the *Daily Reckoning Newsletter* notes, “[Warren] Buffet sold his Fannie Mae shares [and many of Freddie’s shares] last year, saying only that he could not calculate the risk. I cannot calculate the risk either, but my guess is that it is more than most people think.” [\(p. 38\)](#)
  - *Washington Post* ranks Fannie & Freddie as the top two largest public companies in the Washington, DC area [\(p. 39\)](#)
    - [Editorial Note: While Fannie & Freddie are the largest public companies in the Washington, DC area, they do not pay state and local corporate income taxes by virtue of their GSE status. The GAO estimated that in 1995, Fannie & Freddie’s exemption from state and local income taxes was worth approximately \$300 million a year.]
  - *Barron’s* article says Fannie & Freddie are expected to steadily grow their earnings, despite political pressure and an “uncertain market” [\(p. 39\)](#)
  - Consumer Federation of America joins Fannie & Freddie’s Homeownership Alliance [\(p. 40\)](#)
  - Although Sallie Mae is in the process of privatization, concerns are being raised that Sallie Mae (like Fannie & Freddie) is unfairly competing against the private sector and that more and more credit unions are being pushed aside by Sallie Mae [\(p. 40\)](#)
    - “It’s the exact same thing [as concerns expressed about Fannie & Freddie]... Suddenly, you have this entity [Sallie Mae] which was created by the federal government to serve certain purposes, then you have them switching and they are now cannibalizing these commercial entities they were created to serve,” said Richard George, President of Great Lakes Higher Education, Madison, WI
    - Steve Wesson, Vice President for the Purdue Employees FCU, states, “They’re [Sallie Mae] taking away a lot of business from everybody, from a lot of credit unions... They’re cutting out the middlemen,” said Wesson. “I wouldn’t be surprised if that is exactly what happens.”

### ***Fannie Mae***

- Mortgage Bankers Association and Fannie agree on a framework for the development of technology standards for electronic mortgages [\(p. 42\)](#)
  - MISMO – an independent industry group created by the MBA – will oversee the standards
- Fannie introduces a deferred-payment mortgage product (lenders must use Fannie’s automated underwriting system to offer the product) [\(p. 43\)](#)
  - [Editorial Note: This conflicts with the Mortgage Bankers Association’s (MBA) policy statement on the GSEs - “The GSEs should not develop, distribute, or use technology in a way that limits access to their programs or is a precondition for waivers or representations and warranties or waivers of program and documentation requirements.” (*MBA GSE Policy Statement*, 8/10/99)]
- 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 [\(p. 43\)](#)
  - Fannie to open a Partnership Office in Providence, RI
  - Fannie has 44 Partnership Offices open across the country
  - Financial consultant Bert Ely believes Fannie’s media events raise ethical questions. “This is an extension of not only their lobbying but also their political action committee contributions,” he said. “Everybody knows what they’re doing. It’s something that many of us find offensive, but that’s how they play the political game.”
  - Fannie claims its partnership offices were created “to get away from Washington,” yet *Real Estate Finance Today* reports that during the first eight months of 2000, Fannie held no fewer than 87 media opportunities across the country with Congressional Members
- Fannie announces that it has fulfilled its pledge to purchase \$10 billion in CRA loans [\(p. 45\)](#)

### ***Freddie Mac***

- Freddie announces that it will change the prepayment accounting cycle for its mortgage-backed securities to a calendar month rather than a midmonth cycle ([p. 46](#))
  - 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 Bond Market Association protests the timing of the announcement and the implementation day of the accounting change
- Mortgage Bankers Association and Freddie announce a minority recruitment program ([p. 47](#))

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

- FHFB Chairman Allan Mendelowitz has two goals for the FHLBank System this year: (1) implement the FHLBank System's capital structure and (2) address the issue of dual FHLBank membership ([p. 47](#))
- FHLBanks' Mortgage Partnership Finance Program (MPF) is expected to grow ([p. 48](#))
  - One of the MPF's products – a loan that requires lenders to buy supplemental insurance to cover part of the credit risk they must retain on MPF loans – has been approved and is now available
  - MPF recently implemented an Internet platform – eMPF- that lenders can use to sell their loans into the program
  - MPF program is becoming a strong competitor to Fannie & Freddie in the secondary market
- FHFB issues proposed affordable housing rule that would give the FHLBanks more control over the \$100 million they contribute each year for affordable housing programs ([p. 49](#))
  - FHFB also approves new strategic plan and an interim final rule on the minimum number of FHLBank Director meetings

### ***Farm Credit Administration/Farm Credit Banks***

- Treasury Department urges the Farm Credit Administration (FCA) to withdraw its controversial national charter proposal ([p. 50](#))
  - The Independent Community Bankers of America applaud the Treasury's national charter letter. "The Treasury's letter makes several forceful points against national charters that ICBA has been raising for many months. FCA's proposal is inappropriate for a government sponsored enterprise and would dramatically change the structure and focus of the FCS. We hope the FCA will heed this wise advice and withdraw its national charter proposal," stated ICBA Chairman Bob Gullledge, President and CEO of Citizens' Bank Inc.

### ***Ginnie Mae***

- Ginnie Mae President George Anderson defends the agency's decision to allow its securities to clear and settle over the Fed wire ([p. 52](#))
  - Anderson remains hopeful that the 3 basis point increase in Ginnie Mae's guaranty fee will be repealed

### ***Tennessee Valley Authority (TVA)***

- GAO Report suggests that TVA's AAA bond rating is mainly because investors believe there is an implicit government guarantee of its bonds ([p. 53](#))
  - A Moody's Investors Service report found that although the federal government does not guarantee TVA's bonds, the government would not allow a default on TVA's debt because of the impact it would have on the cost of debt issued by government-sponsored enterprises, such as Fannie & Freddie

## *Major Events*

**CBO study found that Fannie & Freddie received a substantial increase in federal subsidies since the CBO's 1996 study**

**Cong. Richard Baker (R-LA) holds May 23 hearing to discuss the results of the CBO study**

**The CBO study finds that Fannie & Freddie received \$10.6 billion in subsidies from the federal government last year (1996 estimate was \$6.5 billion)**

**The CBO study finds that Fannie & Freddie pass about 63% of the subsidy on to home buyers in the form of lower mortgage prices but retain more than a third of the subsidy (37%) for their shareholders and employees**

**Cong. Baker says he will hold an additional hearing in approximately one month so that the GSEs and any other interested parties may comment on the CBO study. On June 14, he is holding a hearing with Wall Street analysts on another issue but may expand that hearing to address the role that financial analysts play in the GSEs' securities activities**

- The House Financial Services Committee's Capital Markets Subcommittee held a May 23 hearing to review a recent CBO study. The CBO study estimated the amount of subsidies that Fannie, Freddie, and the FHLBanks receive from the federal government, as well as the amount of the subsidy that is passed through to borrowers. The CBO study is an update of an earlier 1996 study. In the spring of 2000, Cong. Baker requested that CBO update its 1996 GSE subsidy study after receiving a letter from Federal Reserve Board Chairman Alan Greenspan suggesting the CBO update.
- Capital Markets Subcommittee Chairman Richard Baker (R-LA) chaired the hearing. CBO Director Dan Crippen was the only witness. Several Members of the Subcommittee, from both the Republican and Democratic side attended the hearing.

In summary:

1. **CBO study found that Fannie Mae and Freddie Mac received a substantial increase in federal subsidies since the CBO's 1996 study, while the GSEs retained about the same percentage of subsidies for themselves as found in the 1996 study.** The CBO found that Fannie and Freddie received \$10.6 billion in subsidies from the federal government last year (1996 estimate was \$6.5 billion). The study found that the two GSEs pass about 63% of the subsidy (\$6.7 billion) on to homebuyers in the form of lower mortgage prices but retain more than a third of the subsidy (37% or \$3.9 billion). By calculating the FHLBanks' subsidies, the CBO found that the housing GSEs combined (Fannie, Freddie, and the FHLBanks) received \$13.6 billion in subsidies last year (Fannie received \$6.1 billion; Freddie received \$4.5 billion; and FHLBanks received \$3 billion). About \$7.0 billion of the \$13.6 billion was passed through to borrowers. The 1996 study did not calculate the FHLBanks' subsidies.

**CBO estimates that GSEs have a 41 basis point borrowing advantage because of their special status and estimates that Fannie and Freddie have a 30 basis point advantage on MBS.** CBO estimates that the GSEs lower interest rates by approximately 25 basis points for conforming mortgage borrowers. **Crippen noted that the CBO's estimates were**

**conservative and, if anything, overestimated the GSEs' benefits and underestimated the GSEs' subsidies. Crippen repeatedly noted that Fannie and Freddie enjoy benefits that other companies "would be willing to pay for if offered at auction." Crippen also noted that Fannie and Freddie's ties to the government lower the GSEs' borrowing costs in the financial markets, but raise the cost of borrowing to the others in the market, including the Treasury.** CBO estimated that Fannie and Freddie control 71% of the conventional, conforming fixed-rate mortgage market. Crippen testified that the GSEs' market share number is still growing, which suggests the GSEs have a significant market power.

2. Cong. Baker said he would hold an additional hearing in approximately one month so that the GSEs and any other interested parties would have a chance to comment on the CBO study. On June 14, he is holding a hearing with Wall Street analysts on another issue, but may expand that hearing to address the role that financial analysts play in the GSEs' securities activities. Cong. Baker indicated that he might ask the CBO to estimate the total costs and benefits of the GSEs' subsidies to the overall market (not just the conforming mortgage loans that the GSEs purchase). **In his closing statement, Cong. Baker noted that the GSEs were a fairly expensive method of assisting housing and indicated that he was "not going away" on the GSE issue.**
3. **Cong. Baker suggested that Fannie and Freddie might not be investing in the low- to moderate-income underserved areas that they should, and are instead assisting high-income homebuyers.** He noted that in Freddie's information statement, the company said that 73% of Freddie's portfolio represented loans below 80% LTV. A financial statement by Fannie noted that 71% of its portfolio represented loans below 80% LTV. A \$275,000 Fannie/Freddie conforming loan limit and an 80% LTV ratio would then allow Fannie and Freddie to invest in a home worth \$343,000, which would buy a sizable house in Louisiana, noted Cong. Baker.
4. House Financial Services Committee Chairman Michael Oxley (R-OH) did not attend the hearing but released a statement saying that the GSEs are fulfilling their mission "efficiently and effectively."
5. Cong. John LaFalce (D-NY) who is not a Member of the Subcommittee, but is the Ranking Member of the full Committee, attended the hearing. He was not surprised that the GSEs receive a subsidy from their implied government guarantee because that is what Congress intended. He recommended that Congress not rush to judgment on the GSE issue.
6. **Cong. Chris Shays (R-CT) noted that there were two questions about the GSEs that should be examined: (1) are the GSEs passing along their subsidy to consumers; and (2) are the GSEs using their subsidies as a competitive advantage. Cong. Shays did not understand why Fannie and Freddie did not consider their \$2.5 billion lines of credit to the Treasury a subsidy. He also asked Crippen whether there was a perception in the market that the government backs them. Crippen responded yes. Cong. Shays observed, and Crippen confirmed, that this perception was a huge benefit to the GSEs.**
7. **Cong. Ron Paul (R-TX) noted that if Congress did not address the GSEs' \$2.5 billion lines of credit to the Treasury, it would be unfair to other financial services companies that don't enjoy the same advantage. He wondered whether the Fed's purchase of GSE securities sends a message to central banks and others in the market that the Fed will come to the rescue of the GSEs should they ever encounter problems.**

8. Many of the Democratic Members were supportive of the GSEs and repeatedly questioned whether CBO calculated the benefits that Fannie and Freddie provide to the overall mortgage market (and not just the mortgages that Fannie and Freddie purchase), such as calculating the benefit of the GSEs' affordable housing goals on the overall market. CBO Director Crippen repeatedly responded that he was only asked to look at conforming mortgage loans purchased by Fannie and Freddie rather than the entire mortgage market. And, if he did examine the benefits of the GSEs to the overall mortgage market, the CBO would also need to examine the costs of the GSEs to the overall market (such as the higher cost of borrowing to the Treasury). **Crippen noted that nothing is free and that the subsidies to the GSEs have an impact, which raises the cost of borrowing for private companies and the Treasury in the capital markets. Crippen noted during the Q&A that without the federal guarantee on their debt, the GSEs would not be as active in the debt markets.**
  
9. Many of the Democratic Members also questioned CBO as to whether Fannie and Freddie were meeting their missions and whether the GSEs were an effective program. Crippen noted that there are other ways to administer benefits to housing but that he was not asked to determine whether the GSE program was the best policy for housing or whether the GSEs were meeting their missions.

### Opening Statements

Capital Markets Subcommittee Chairman Cong. Richard Baker (R-LA)

- **Fannie and Freddie's subsidy is "real, it's large, and has far-reaching implications."**
- Defended the CBO, noting that there had been efforts over the past week "to publicly discredit the integrity and ability of the CBO."
- If the CBO can accurately forecast a budget surplus, "then surely it possesses the wherewithal to get a GSE subsidy estimate right."
- The CBO took several months to complete the study because it wanted to get the numbers right and clear away any doubt about its methodology. The CBO also subjected the study to a lengthy and rigorous peer-review process.
- **Those who attack the CBO's credibility and question the subsidies provided to the GSEs, place their "credibility at odds with no less than Fed Chairman Alan Greenspan, who first suggested CBO update its [1996] subsidy estimate" and compromise their integrity by attacking the institutions that CBO consulted to reach its conclusions (Treasury, the Federal Reserve Board, the Federal Reserve Bank of Minneapolis, the GAO, and CRS).**
- **More significant than the size of the subsidies provided to the GSEs, is what the CBO study tells Congress about how effectively the subsidy is being used to benefit its intended recipients (low- and moderate-income families in underserved areas). His "initial review of CBO's findings indicates that there's certainly room for improvement."**
- **"Is it not eye-opening to discover that \$3.9 billion, or about 37 percent, of Fannie's and Freddie's \$10.6 billion annual federal subsidy provides 'liquidity' to no one but themselves and their investors? Surely members of this subcommittee from both sides of the aisle can make use of CBO's findings and come together to determine ways to better direct the entire \$10.6 billion sum to African-American, Hispanic, and all lower-income communities who most need our help to close the 'American Dream' gap.**

- Other issues raised by the CBO study that should be examined under future hearings: (1) examine the portion of the subsidy that is passed through to homebuyers to determine if the subsidy is reaching those whom Congress intended to help; (2) how do the subsidies and implicit government guarantee increase taxpayer risk; (3) how do we measure what Chairman Greenspan referred to as the subsidies' "consequences for the structure and efficiency of the financial markets and the productive allocation of real resources?"; (4) talk to those concerned about affordable housing to account for the proper allocation of benefits entrusted to the GSEs; and (5) talk to market analysts as to how they came to criticize the CBO study before it was presented to Congress.

Ranking Member of the Subcommittee Paul Kanjorski (D-PA)

- Although the CBO changed the methodology it used in 1996, its ultimate conclusions remain approximately the same in this new report - Fannie and Freddie pass on about two-thirds of their federal subsidies to homebuyers in the form of lower mortgage prices.
- The CBO analysts have also determined that the size of the federal subsidy received by Fannie Mae and Freddie Mac has nearly doubled between 1995 and 2000 to \$10.6 billion. Some will contend that Congress should work to control this dramatic growth. The questions, however, are not on what caused the magnitude of the growth and how to control it, but rather on where the subsidy flows, what it buys, and how well the GSEs manage their risks and operate their businesses.
- CBO study confirms that the GSEs are performing a function that Congress wants them to perform (working to help to lower the costs of homeownership at no real monetary cost for the federal government).
- We could experience housing shortages in some parts of the country. The GSEs need to use their benefits to help us to attend to this looming need. If we did not have the GSEs to accomplish our nation's housing objectives efficiently, we would have to create new housing subsidy programs to address the imminent need of affordable housing, likely at a great cost to our federal government.
- No compelling reason for pursuing any legislation on these matters at this time.

Ranking Member of the House Financial Services Committee John LaFalce (D-NY)

- There is a misimpression that people have been attacking the integrity of the CBO over the GSE study. It's as if you can't question the CBO's work product without being accused of attacking the CBO.
- Not surprised that the GSEs received an economic benefit from the implied government guarantee. That is what Congress wanted them to have.
- "The energy plan the President submitted has a few subsidies and implied guarantees, so this is not entirely uncommon...I wonder if any other subsidy benefits taxpayers as greatly. The CBO has concluded that American taxpayers are receiving \$7 billion in benefits through lower home mortgages. Let's not rush to presumptuous judgment on something that has worked well."

Cong. Bob Ney (R-OH)

- Fannie and Freddie receive benefits from their government charters but they also must live with restrictions on their business.
- Important to look at the CBO study, but it's also important to consider how well the housing market is doing and how we can improve the market.

Cong. Ken Bentsen (D-TX)

- There is a subsidy provided to the GSEs but this didn't happen by accident.

- The question is not whether the GSEs receive a subsidy but compared to what.

Cong. Darlene Hooley (D-OR)

- Supports the role that Fannie and Freddie play to help people purchase homes that they otherwise would not be able to afford.
- If the GSEs' charters were revoked, not one additional dime would go back to Treasury.

Cong. Steve Israel (D-NY)

- Fannie and Freddie are doing a great job.
- Hopes the CBO study won't distract Fannie and Freddie from their work on homeownership.
- Cited Freddie's Miller/Pearce study that found that the GSEs promote significantly greater consumer benefits than they receive in government subsidies.

Cong. Gregory Meeks (D-NY)

- Congress has given the GSEs benefits, but also clear restrictions.
- Particularly since the GSEs recently reached a voluntary risk management agreement with Congress last year, the GSEs are models of efficiency and transparency.
- If anything, we should consider what we could do to help them be more successful in improving homeownership. Homeownership is at an all-time high.

**Panel I:**  
**CBO Director Dan Crippen**

CBO Director Dan Crippen

- **The federal subsidy to the GSEs is unusual in that it is not explicitly appropriated by Congress, nor does it appear in the budget as outlays, nonetheless it is real and represents costs to the American public and is highly valued by recipients. He points out that other financial firms would be willing to pay for the benefits that the GSEs receive.**
- The CBO study found that Fannie and Freddie received \$10.6 billion in subsidies from the federal government last year, and passed about 66 percent of the subsidy (\$6.7 billion) on to homebuyers in the form of lower mortgage prices but retained more than a third of the subsidy (37% or \$3.9 billion). By calculating the FHLBanks' subsidies, the CBO found that the housing GSEs combined (Fannie, Freddie, and the FHLBanks) received \$13.6 billion in subsidies last year (Fannie received \$6.1 billion; Freddie received \$4.5 billion; and FHLBanks received \$3 billion). About \$7.0 billion of the \$13.6 billion was passed through to borrowers. The 1996 study did not calculate the FHLBanks' subsidies.
- **The GSEs' debt and MBSs are more valuable to investors than similar private securities because of the perception of a government guarantee and because of other advantages from GSE status.** The largest portion of the GSEs' subsidies is the reduction in borrowing costs from the implicit federal guarantee of debt issued by the GSEs. **CBO estimates that GSEs have a 41 basis point borrowing advantage because of their special status and that Fannie and Freddie have a 30 basis point advantage on MBS.**
- CBO estimates that the GSEs lower interest rates approximately 25 basis points for conforming mortgage borrowers.
- **To those who say that the GSEs' do not provide any benefits or subsidy, "begs the question of why that association should be continued."**

- Not one independent person that reviewed the CBO study questioned the CBO's approach. If the CBO is so fundamentally wrong, then why didn't someone else notice?
- There were some assumptions the CBO made in its study that would have lowered the estimate of the GSEs' subsidies, but there were other assumptions that could have been made that would raise the GSEs' subsidies. **He believes that, if anything, the CBO erred more on the side of conservative and overstated the GSEs' benefits to homeowners and underestimated the GSEs' subsidies.**
- He is not surprised that Fannie's and Freddie's analysis came up with different results.
- CBO estimates that Fannie and Freddie have 71% of the conforming fixed-rate single-family mortgage market.

### Questions & Answers

#### **What would be the impact if you eliminated Fannie & Freddie? Are the GSEs meeting their mission?**

- Cong. Kanjorski asked what would be the impact of eliminating Fannie and Freddie. He repeatedly asked Crippen "to tell me what the problem is here" and whether there was something the GSEs could do better. Congresswoman Hooley and Cong. Meeks asked if the GSEs were meeting their missions.
- Crippen responded that the CBO was not asked to examine these issues and was only asked to examine very specific questions. He did not encounter any problems with the GSEs, but said the CBO wouldn't have found any problems with the GSEs, because the CBO was not looking for problems. He noted that instead of focusing on the question of a world without Fannie and Freddie, the question should be on whether Fannie and Freddie need a subsidy. Crippen said the CBO was not in a position to determine whether Fannie and Freddie are meeting their missions.

#### **CBO's comparison of Fannie and Freddie more heavily weighted toward A-rated rather than AA-rated issues raised the GSEs' subsidy estimates**

- Cong. Ney, Cong. Sandlin, and Cong. Ose all questioned the CBO about using this methodology.
- Crippen noted that the CBO's method was the most accurate way to make a comparison. Crippen noted that there are so few financial institutions that have a financial rating that is comparable to the housing GSEs (rated as a hypothetical AA-), which led the CBO to base the GSEs' debt funding advantage on a sample of non-GSE securities more heavily weighted toward A-rated rather than AA-rated issues. The CBO calculated the funding advantage of the GSEs by comparing rates on GSE debt with rates on debt issues from a sample of 70 large national financial institutions, eight of which were rated AA+, AA, or AA- and 62 of which were A+, A, or A-. That decision raised the value of the estimated subsidy compared with the value the CBO would have obtained if it only compared a handful of AA-rated securities.
- Cong. Baker noted that Fannie and Freddie's AA- rating is not a stand-alone rating outside government support, and that we do not truly know the GSEs' stand-alone rating. Therefore, the CBO's comparison of 71 firms is not without merit.

#### **Where does the GSEs' retained subsidy go?**

- Cong. Ney, Cong. Bentsen, Congresswoman Tubbs Jones all questioned Crippen about where the GSEs' retained subsidy goes (e.g, paying federal taxes, risk reserves)
- Crippen noted that the CBO was not asked this question and only looked at the total value of the subsidy. The CBO did not examine where the GSEs' retained subsidy went.

**Fannie and Freddie may provide additional benefits to the overall market that were not estimated by CBO, but they may also cause additional costs that were not estimated by the CBO**

- Cong. Sandlin, Congresswoman Tubbs Jones, Cong. Bachus, Congresswoman Hooley, and Cong. Meeks all questioned the CBO about whether it calculated the benefits that Fannie and Freddie provide to the overall market, such as calculating the benefit of the GSEs' affordable housing goals on the market. The Members suggested that the CBO also consider those mortgages that Fannie and Freddie did not purchase.
- CBO Director Crippen repeatedly responded that the CBO was only asked to examine the mortgage loans that Fannie and Freddie purchase (the fixed-rate conforming mortgage market - of which the CBO estimates Fannie and Freddie control 71% of this market) and not the entire mortgage market. And, if the CBO did examine the benefits of the GSEs to the overall market, the CBO would also need to examine the costs of the GSEs to the overall market (such as the higher cost of borrowing to the Treasury). **Crippen noted that nothing is free and that the subsidies to the GSEs have an impact, which raises the cost of borrowing for private companies and the Treasury in the capital markets. "Providing credit guarantees that lower the cost of capital to one entity tend to decrease the supply of credit to competing borrowers, including the federal government."**

**CBO's estimates that the GSEs lower interest rates approximately 25 basis points for conforming mortgage borrowers is consistent with recent studies**

- Cong. Ford and Cong. Crowley wondered if the CBO's estimates that the GSEs lower interest rates approximately 25 basis points for conforming mortgage borrowers is too low?
- Crippen noted that there is a preponderance of evidence in recent studies that the spread between jumbo and conforming mortgage rates is in the low 20s.

**Fannie & Freddie suggest that CBO not respond to Congressional Members' request**

- Cong. Baker asked the CBO to estimate the amount of subsidies that Fannie, Freddie, and the FHLBanks receive from the federal government and how much of the subsidy is passed through to borrowers, largely because he received a letter from Federal Reserve Board Chairman Alan Greenspan suggesting that the CBO study be updated in light of changing markets. Yet, Cong. Baker noted that in Appendix A of the CBO's study, it was noted that Fannie, Freddie, and their contractors suggest that the CBO not answer the Congressman's question, but instead focus on a different question.

**Citizens Against Government Waste (CAGW) castigates Fannie & Freddie for pocketing huge taxpayer subsidies**

**CAGW President Tom Schatz says the CBO study “confirms that Fannie Mae and Freddie Mac have aggressively leveraged their government charters, and the huge windfall that comes with them, to accrue monumental amounts of debt, reap above-market rates of return, invade and undercut other financial services sectors, all the while shifting the risk to taxpayers.”**

**“Congress and President Bush must turn their attention to this problem before the taxpayers are bailing out another ‘too-big-to-fail’ financial institution,” says Schatz**

- CAGW reacted to CBO’s study, which finds that Fannie & Freddie received \$10.6 billion in subsidies from the federal government last year, a 74% increase since 1995, and that 37% of the subsidies “never make to potential homeowners, but are pocketed by Fannie Mae and Freddie Mac stockholders.” The CAGW released the following statement castigating the GSEs for pocketing huge taxpayer subsidies: **“This analysis confirms that Fannie Mae and Freddie Mac have aggressively leveraged their government charters, and the huge windfall that comes with them, to accrue monumental amounts of debt, reap above-market rates of return, invade and undercut other financial services sectors, all the while shifting the risk to taxpayers,”** CAGW President Tom Schatz said. **“Congress and President Bush must turn their attention to this problem before the taxpayers are bailing out another ‘too-big-to-fail’ financial institution.”**
- **“Fannie Mae and Freddie Mac have a sweet financial deal and that their huge profits are a direct result of the perception by investors that the government backs their securities. Congress has a fiduciary responsibility to watch out for taxpayers’ interests. We don’t want a repeat of the S & L bailout. This CBO study gives taxpayers and their representatives in Congress a rare but valuable glimpse at the dealings of these housing giants,”** Schatz also said. **“We applaud Chairman Baker for persisting in getting this information out and continuing to work for taxpayers,”** Schatz concluded. **“The idea of supporting truly needy families on the cusp of homeownership is a laudable one, but funneling that support through a massive bureaucracy that keeps more than a third of the subsidy as profit is inefficient, rapacious, and wasteful. Certainly this is not what Congress had in mind when it created these institutions.”** (CAGW press release, 5/23/01)

**Competitive Enterprise Institute (CEI) says the CBO study estimating that Fannie & Freddie receive more than \$10 billion in subsidies exemplifies the significant “moral hazard” posed by the GSEs**

**“Whatever original purpose the GSEs served in the secondary mortgage market has long been fulfilled. The unique public-private role of the GSEs is no longer needed or appropriate,” says CEI President Fred Smith**

- **Fred Smith, President of CEI, released a statement on the recent CBO study on Fannie and Freddie. Smith noted that the latest figures from the CBO indicating that Fannie and Freddie receive more than \$10 billion in subsidies “exemplifies the significant ‘moral hazard’ posed by government-sponsored enterprises (GSEs).”**
- **“Clearly, Fannie Mae and Freddie Mac were created for ‘good’ purposes, to create a secondary market in mortgages and thus reduce housing costs. Now, however, the issue is whether such implicit government ‘insurance’ acts to distort and possibly destabilize the marketplace? Whether the private sector might take over this function? The answer to both questions is a resounding ‘yes.’”**
- **He notes, “Fannie and Freddie allocate government-protected capital to housing—and thus advance one American Dream. But that subsidized allocation frustrates other American Dreams (buying the new car, going to college, starting one’s own business) by making capital for these purposes less available and thus more costly.”**
- **Smith continues, “A free market has no more important task than that of allocating capital. Which investments merit support, which do not? Making such allocations is never an easy task, which is why the market rewards investors handsomely when they are right—and penalizes them severely when they are wrong. Government guarantees weaken that process, anaesthetize our financial risk sensitivities, and threaten serious capital misallocations. This is what happened in the S&L crisis and the costs were massive.”**
- **Smith concludes, “The whole concept of government-sponsored enterprises borders on oxymoronic. At best, this mixing of private profits and political insurance creates marketplace confusion; at worst, it leads to a serious misallocation of capital and an increasing risk for American taxpayers. Whatever original purpose the GSEs served in the secondary mortgage market has long been fulfilled. The unique public-private role of the GSEs is no longer needed or appropriate.” (CEI press release, 5/23/01)**

**Free Congress Foundation “cries foul on Fannie Mae and Freddie Mac”**

**“CBO’s latest figures should be a wake up call to Congress that Fannie Mae and Freddie Mac are the poster children for corporate welfare,” said J. Bradley Jansen of the Free Congress Foundation**

**Free Congress Foundation expressed disbelief that the CBO study estimating that Fannie & Freddie receive more than \$10 billion a year in federal subsidies did not include the GSEs’ privacy exemption**

- The Free Congress Foundation expressed disbelief that the new CBO study estimating that Fannie and Freddie receive more than \$10 billion in federal subsidies a year did not include the GSE's privacy exemption. The Free Congress Foundation noted that although the CBO study “sheds new light on the GSE's government-granted privileges, a key component of the GSE’s special benefits - their exemption from the Title V privacy standards of the Gramm-Leach-Bliley Act - was not included in the CBO's subsidy analysis.”
- **“CBO's latest figures should be a wake up call to Congress that Fannie Mae and Freddie Mac are the poster children for corporate welfare,” said J. Bradley Jansen of the Free Congress Foundation.** “By ignoring the back room privacy loophole the GSE lobbyists got in conference, the CBO report was out of date and incomplete before it was released.”
- **The Free Congress Foundation noted, “Despite the fact the GSEs keep more than a third of these taxpayer subsidies for themselves, Fannie Mae and Freddie Mac successfully lobbied to get an exemption from the federal privacy rules enacted by the Gramm-Leach-Bliley Act. Through their automated underwriting systems, Fannie Mae and Freddie Mac collect sensitive financial information about millions of Americans but are immune from the rules governing the use and exchange of that data.”**
- **“While Americans are sifting through more than 2.5 billion privacy notices that financial institutions are required by law to distribute, the GSEs are off the hook,” Mr. Jansen said.** “Because the CBO study was incomplete, we don't know how many millions of dollars the privacy loophole saves the GSEs. These cost savings should be accounted for in any future subsidy analysis conducted by the CBO.”
- **“As if the billions of dollars in government-granted perks were not enough, the GSEs routinely lobby Congress for more. The GSEs' exemptions that were carved out from federal privacy rules are a prime example of this special treatment,” continued Mr. Jansen. “Do we really need subsidized GSEs that can violate our financial privacy?”** (*Free Congress Foundation press release, 5/23/01*)

**National Taxpayers Union (NTU) is critical of the massive GSE subsidies**

**“Fannie Mae and Freddie Mac have taken a \$10 billion government subsidy and used it to line the pockets of their top executives and shareholders,” observed NTU Director of Congressional Relations Eric Schlecht. “Every taxpayer should be outraged to learn of this blatant misuse of their tax dollars.”**

- NTU was critical of the GSEs’ massive subsidies estimated by the CBO. **“Fannie Mae and Freddie Mac have taken a \$10 billion government subsidy and used it to line the pockets of their top executives and shareholders,” observed NTU Director of Congressional Relations Eric Schlecht.**

NTU noted that among the findings in the CBO report:

- By 1998 Fannie Mae and Freddie Mac owned or guaranteed nearly 74 percent of all conventional conforming mortgages;
  - The value of the government subsidies received by the two Government Sponsored Enterprises (GSEs) is nearly \$10.6 billion annually;
  - The portion of the government subsidy withheld by Fannie and Freddie, in large part benefiting stockholders and top executives, has risen from 33 percent in 1995 to 37 percent today.
- **“Every taxpayer should be outraged to learn of this blatant misuse of their tax dollars,” said Schlecht. “The worst part is that it is perfectly legal.”** (*NTU press release, 5/23/01*)

**FM Watch says the CBO study shows that the GSEs are an “inefficient system that needs to be reviewed by the Congress and the GSE regulators”**

**“It is very clear that what was once a ‘spongy conduit’ for increasing homeownership has become a revenue pipeline for Fannie and Freddie shareholders and executives,” said Mike House, Executive Director of FM Watch**

- FM Watch noted that the recent CBO study shows that Fannie and Freddie's annual federal subsidy has reached an all-time high of \$10.6 billion, and “even more astounding is the fact that 37% or \$3.9 billion of the Government-Sponsored Enterprises' (GSE) federal subsidies go directly into the pockets of the GSEs' shareholders and executives.”
- **“It is very clear that what was once a ‘spongy conduit’ for increasing homeownership has become a revenue pipeline for Fannie and Freddie shareholders and executives,” said Mike House, Executive Director of FM Watch. “In 2000 over \$3.9 billion went directly to GSE shareholders and executives. The GSEs need to explain how keeping any of their government subsidy puts Fannie in the ‘American Dream’ business and helps Freddie ‘open doors’ to homeownership.”**
- FM Watch noted that the CBO also found, **“If the GSEs continue to grow [as fast as the U.S. economy], their total annual subsidy will exceed \$20 billion by 2011.”** FM Watch noted that **“In fact, the GSEs have dramatically increased their portfolios in recent years at rates much**

faster than the growth of the U.S. economy. As a result, CBO's subsidy projection is very conservative.”

- “The GSE subsidies lower the mortgage interest rate of a homeowner with a \$100,000 mortgage from 7.5% to 7.25%, reducing the homeowner's costs by just \$17 per month. For that, they keep \$3.9 billion for themselves,” House said. “This is an inefficient system that needs to be reviewed by the Congress and the GSE regulators.” (*FM Watch press release, 5/23/01*)

**Fannie is developing a pilot program that consumer activists say could hurt people with marginal credit**

**National credit industry leaders also call the pilot program dangerous and potentially harmful to borrowers and taxpayers**

**Rather than pulling a consumer's credit report from all three of the national credit bureaus – Equifax, Experian and Trans Union – Under Fannie's pilot program, only one credit report from one of the three credit bureaus will be required**

**Freddie is also reportedly considering a similar pilot program**

**Studies on credit scores have shown that variances of 50, 80, and even 100 points between different credit bureaus are not uncommon and can disqualify applicants for a home loan or push them into a “subprime” credit category, costing them thousands of dollars more in interest and fees over the life of the mortgage**

**“Fannie has the market power to be part of the credit-report nightmare solution instead of compounding the credit nightmare problem, as they are doing,” said Ed Mierzwinski, Consumer Program Director for the US Public Interest Research Group**

**“How can the minimal savings this plan might provide consumers justify the potential overcharging of thousands of dollars in interest,” because of erroneous, negative information, said Terry Clemans, Executive Director of the National Credit Reporting Association**

- **Fannie is working on a pilot program that “national credit industry leaders call dangerous and potentially harmful to borrowers and taxpayers alike.” Rather than requiring examination of a borrower's detailed credit histories on file at all three of the national credit bureaus – Equifax, Experian and Trans Union – Fannie will buy mortgages underwritten with information from just one of the three national credit bureaus. Fannie plans to test the policy change in a pilot program with a limited number of lenders beginning later this year. (*Washington Post, Kenneth Harney, 5/12/01*)**

#### Consumer activists concerned

- **Consumer activists said the policy change might lead to riskier loans or drive more consumers into the subprime category. The activists note that a single-file requirement would leave borrowers at the mercy of credit reporting errors. “Fannie has the market power to be part of the credit-report nightmare solution instead of compounding the credit nightmare problem, as they are doing,” said Ed Mierzwinski, Consumer Program Director for the US Public Interest Research Group. Mr. Mierzwinski added that credit reports and**

scores are “notoriously inaccurate,” leaving consumers at the margins vulnerable. “It’s absurd for Fannie to consider results from only one repository instead of looking for anomalies between all three and determining which one is most accurate,” he said.

- David Berenbaum, Senior Vice President of the National Community Reinvestment Coalition, is also concerned about the pilot program because lower credit data requirements could lead to more subprime loans. He noted that consumers must be allowed to review their credit report prior to a credit check, and that “liberal standards” should be applied to ensure that “the most favorable report is used.” (*American Banker*, Tommy Fernandez, 6/1/01)

#### Credit industry experts concerned

- **Credit industry experts oppose the plan, calling it radical. They note that currently almost all the major lending organizations examine borrowers’ credit files from all three national credit bureaus because the information on each borrower varies from bureau to bureau, sometimes significantly. According to a statement by the National Credit Reporting Association, score variances of 100 points or more on the same consumer from different credit repositories are not uncommon. Studies on credit scores have shown that variances of 50, 80, and even 100 points are not uncommon and can disqualify applicants for a home loan or push them into a “subprime” credit category, costing them thousands of dollars more in interest and fees over the life of the mortgage.** (*Washington Post*, Kenneth Harney, 5/12/01; *National Credit Reporting Association, Inc. Position on Fannie Mae’s Proposed Single Pull Strategy*, January 2001)
- **Credit industry critics of Fannie’s pilot program warn that pulling only one credit file could open a Pandora’s box. “If only one file is [examined]...will that file be missing important [negative] information?”** said Terry W. Clemens, Executive Director of the National Credit Reporting Association. “Will a loan decision be based on credit data that does not even belong to the applicant? How can the minimal savings this plan might provide consumers justify the potential overcharging of thousands of dollars of interest” because of erroneous, negative information? Clemens expressed “deep concerns” over Fannie’s pilot program, saying it raises the prospect of greater risk in lending and more chance of unfairly giving borrowers worse credit ratings than they deserve. “It’s quicker and cheaper, but it’s really not doing Fannie Mae or the consumer justice,” said Clemens. “The quality of the loan decision is going to suffer, there’s no way around it.” (*Washington Post*, Kenneth Harney, 5/12/01; *Reuters*, Mark Felsenthal, 5/14/01)

#### Fannie claims its automated underwriting system will address concerns – Fannie acknowledges that credit report errors may have an adverse impact on consumers

- Credit industry experts note that the variances among the credit bureaus occur because each of the bureaus receives credit information, public records, and debt-collection reports from different networks of sources in each geographical region. **Only by accessing files at all three national bureaus, and then merging them, can a creditor be certain of getting everything on file about the consumer.** Fannie’s Senior Vice President Pamela Johnson does not dispute this, but said that the company’s “risk assessment tools are now so sophisticated that we are confident in our ability to [evaluate] risk” using just one credit bureau file. **A Fannie Spokeswoman, Raschelle Burton, said the company has been considering the policy change for three years. She acknowledged “clearly significant errors or omissions can have an adverse effect on a consumer’s ability to access credit at fair rates.”** However, she said the latest version of Fannie’s automated underwriting system, Desktop Underwriter, provides feedback to lenders that they can review with

consumers to identify any problems with their credit information. She stressed that the program is still “in the investigation and design phase” and has not “reached the pilot stage yet.” (*Washington Post*, Kenneth Harney, 5/12/01; *American Banker*, Tommy Fernandez, 6/1/01)

#### Freddie is also considering the pilot program

- Freddie is also reportedly considering changes to its guidelines that would accept a credit report from just one credit reporting agency, although it appears that Fannie is further along in the process. “We’re examining it but it’s not on the front burner,” said a Freddie spokeswoman. **As *National Mortgage News Daily* reports, “if the practice [of pulling only one credit report] becomes widespread the credit reporting agencies could face a major decline in business.”** (*National Mortgage News Daily*, 5/15/01)

#### National Credit Reporting Association raises concerns

- According to a statement by the National Credit Reporting Association, the primary concern with Fannie’s proposed strategy “is the continued trend in the mortgage industry to lower underwriting standards.” **NCRA contends that score variances of 100 points or more on the same consumer from different credit repositories are not uncommon.** The statement notes, “Merging multiple repository files is the only method to gather the accurate and full credit profile. In an environment in which even auto dealers are finding the need for multiple repository files to make better lending decisions, it is difficult to understand the proposed single pull strategy. History has provided us with examples of the costs associated with the lowering of underwriting guidelines due to previous policy changes; we urge that those lessons be considered as this proposed strategy is fully contemplated. Taxpayers who are still burdened by paying for the errors of the past are the same ones guarantying the quality of today’s loans. NCRA doubts that these taxpayers would approve of additional underwriting risk simply to create better profit margins for lenders who are exploring the unproven benefits of technologically driven commerce.”
- Another source of concern “is if a single repository file is to be used, considering the variances between them, how will it be determined which one of the three will be used?” NCRA notes, “If only one repository file is pulled will it contain the entire credit history of the applicant? Will the file be missing derogatory information or will it be missing positive information? Will a loan approval decision be based on mixed credit data that does not even belong to the actual applicant? Just as it is unreasonable to increase lending risk it is also unreasonable to punish a borrower with a higher than market interest rate due to insufficient data. **Where is the consumer savings when through the use of a two or three repository merged report the additional data would have earned the borrower a lower, more accurate, interest rate? How can the nominal savings this plan might provide consumers justify the potential overcharge of thousands of dollars in interest?”**
- Another concern of the NCRA “is that the single repository in-file is an increased risk for fraud” and finally, “there is concern that the nation’s network of credit reporting agencies, as it exists today, will be irreparably harmed by this proposed strategy for the sole purpose of reducing the lender’s marketing costs.” The NCRA notes, “No regard to the real impact on both the lending community and consumers alike is being thoroughly considered.”
- In terms of a solution, the NCRA noted that at an ACB sponsored meeting in November, a suggestion was made to pre-qualify with a single repository file and underwrite with all three. “NCRA believes this would be a viable option meeting the needs of both cost cutting and consumer protection.” NCRA also suggests that the lender pre-qualify with a single repository and

underwrite with a two repository merged report. “This option would help control the cost of credit to consumers while not sacrificing quality, accuracy or service. The two repository merged file would not significantly increase underwriting risk and would still provide the checks and balances needed for fraud deterrence.” The NCRA said it “strongly believes that any option short of a two repository merged file for underwriting, while [it] may provide some short term cost savings, will prove to be an irresponsible decision which will cost the mortgage lending industry and the American homeowner far more than the savings it provides.” (*National Credit Reporting Association, Inc. Position on Fannie Mae’s Proposed Single Pull Strategy*, January 2001)

#### **HUD withdraws its plans to regulate Fannie & Freddie’s non-mortgage investments**

**Although the plan could be reinstated, the *American Banker* reports that HUD Secretary Mel Martinez has taken a “laissez faire public stance, arguing that the private sector should seek its own solutions” [HUD is Fannie & Freddie’s mission regulator]**

**American Enterprise Institute Fellow Peter Wallison is concerned about HUD’s withdrawal of the plan to regulate Fannie & Freddie’s non-mortgage investments. “Unless there is an explanation from HUD as to why they are withdrawing, it is a worrisome fact,” he said.**

**A 1998 GAO Report recommended that HUD develop criteria in order to regulate the non-mortgage investments of Fannie & Freddie and that Congress should step in if adequate progress was not made**

**“To help ensure that the enterprises’ non-mortgage investments appropriately support their public missions, the appropriate congressional committees may wish to monitor HUD and FCA [Farm Credit Administration] actions to establish criteria and procedures for carrying out their general regulatory authorities. Such oversight is important to help ensure that corporate incentives to increase shareholder value do not erode the enterprises’ public mission. If adequate progress is not made in a timely way, Congress may wish to consider providing further guidance to the regulatory agencies.” (GAO Report, “*Federal Oversight Needed for Non-Mortgage Investments*,” GGD-98-48, 3/98)**

- HUD has withdrawn its plans to regulate Fannie and Freddie’s non-mortgage investments. HUD disclosed its plans in its semiannual regulatory agenda released on May 14. The plans, however, could be reinstated. Included in the introduction to its semiannual regulatory agenda, HUD noted that “withdrawal of a rule does not necessarily mean that HUD will not proceed with the rulemaking. Withdrawal allows the new HUD administration to further assess the subject matter and determine whether rule making for this subject matter is appropriate.” However, as the *American Banker* reports, although the plan could be reinstated, “HUD Secretary Mel Martinez has taken a laissez faire public stance, arguing that the private sector should seek its own solutions.” HUD officials declined comment on the regulatory agenda announcement.
- FM Watch Spokesperson Schulte said that the plan’s absence from HUD’s May 14 agenda “doesn’t necessarily indicate a policy reversal” on the GSEs. “It is our understanding that all regulations passed during the last weeks of the Clinton administration were withdrawn so that the new administration can take a look at them to see if they want to continue with them.”

- **However, Peter Wallison, a Fellow with the American Enterprise Institute, was less optimistic. “Unless there is an explanation from HUD as to why they are withdrawing, it is a worrisome fact,” he said. “We ought to hear from HUD for a coherent explanation as to why they are no longer looking at this situation.”**
- According to *Dow Jones Newswire*, HUD first announced its plans to move forward with establishing non-mortgage investment regulations in 1997, but has done little since then. In 1998, HUD solicited a private report that found “justifications for placing some restrictions on non-mortgage investments.”
- Meanwhile, the non-mortgage investments of Fannie and Freddie have grown over the past several years. As of April 30, Fannie’s mortgage portfolio totaled \$640 billion, while its non-mortgage investments totaled \$51 billion, according to Fannie’s Spokeswoman Janice Daue. Freddie’s non-mortgage investments totaled \$37 billion at the end of 2000, while its total mortgage portfolio was \$962 billion, said Freddie’s Spokeswoman Sharon McHale. (*Dow Jones Newswire*, Jennifer Corbett Dooren, 5/17/01; *American Banker*, Tommy Fernandez, 5/22/01)

### **Background on Regulation of GSEs’ non-mortgage investments**

#### Controversy over Freddie’s purchase of Phillip Morris bonds

- **A controversy over Freddie’s purchase of Phillip Morris bonds in 1997 drew attention to the non-mortgage investments of Fannie and Freddie for the first time.** Freddie sold the tobacco company bonds in the heat of publicity after then House Banking Committee Chairman Jim Leach (R-IA) asked HUD and congressional legislators to examine whether these investments in long-term corporate bonds were appropriate under the GSEs’ charters. In a April 23, 1997 letter to then HUD Secretary Andrew Cuomo, Chairman Leach requested that HUD and OFHEO review their policies relating to the size and composition of the short-term investment portfolios of Fannie and Freddie, with a focus on determining whether portfolio investments are housing-related or exceed what is necessary for liquidity purposes, and whether the instruments held are of appropriate investment grade. Chairman Leach also called for a GAO investigation of the investment practices of Fannie and Freddie. Chairman Leach indicated that the investment in the bonds represented a subsidy to the tobacco industry and that Freddie “used its privileged GSE status to go to the capital markets and borrow \$125 million at 6.99 percent. It then turned around and bought \$125 million in identical maturity Phillip Morris bonds at 7.68 percent.” Chairman Leach accused Freddie of using its special GSE status to make “easy money” from the “taxpayer subsidization of corporate arbitrage and, implicitly the tobacco industry.” Freddie said at the time that it sold the bonds to avoid tarnishing its image among legislators and the public. Chairman Leach also said that these ventures were signs that Fannie and Freddie were abandoning their charter of providing benefits to low-income citizens. (*Milwaukee Journal Sentinel*, 1/1/98; *BNA Daily Report*, 1/2/98; *National Mortgage News* web site, 1/6/98)

#### HUD issued an advance notice of proposed rule-making

- HUD issued an advance notice of proposed rulemaking on December 30, 1997 to consider expanding HUD’s oversight of Fannie and Freddie to include regulations on the GSEs’ non-mortgage investments. HUD sought comments on whether Fannie and Freddie should be permitted to make non-mortgage investments, and if so, what types of investments should be allowed. Also, HUD wanted to know whether it should set numerical or percentage-of-assets limits on non-mortgage investments. The comment period for the proposed rule closed on March 30, 1998.

HUD received 20 comment letters. (*Federal Register*, 12/30/97, pages 68060-68061) [See April 10, 1998 *GSE Report* for summaries of the comment letters.]

GAO released report recommending HUD regulate Fannie & Freddie's non-mortgage investments:

- **In March 1998, the GAO released its report to then Chairman Leach which “essentially accused the two firms [Fannie and Freddie] of running an ad-hoc arbitrage operation –using their government ties to borrow at preferential rates and then investing in higher-yielding obligations – instead of focusing exclusively on providing minimal-rate loans to low-income families.”** (*Dow Jones Newswire*, Jerry Guidera, 4/23/99)

GAO determines that HUD has regulatory authority over non-mortgage investments:

- The GAO Report found that the GSEs (defined as Fannie Mae, Freddie Mac, and Farmer Mac) had broad investment authority and that the GSE regulators had not considered whether the investments by the GSEs were mission-related but only on safety and soundness concerns. Although OFHEO and the FCA [Farm Credit Administration] have examined the safety and soundness implications of non-mortgage investments, HUD and the FCA had not prior to mid-April 1997 focused on non-mortgage investments with respect to the GSEs' charter mission (when Congressional questions were raised about Freddie's investment in Phillip Morris bonds). According to the GAO, Congress gave HUD and the FCA regulatory authority over the GSEs to ensure the GSEs fulfill their specific public missions. **The GAO found that HUD and the FCA could use their general regulatory authority over the missions of the GSEs to potentially limit the GSEs' non-mission investments. The GAO advised that this regulatory authority over the mission of the GSEs had become even more important, as Farmer Mac has substantially increased its holdings of nonagricultural-mortgage investments and Fannie and Freddie have proposed new types of non-mortgage investments.**

GAO recommended HUD develop criteria to regulate non-mortgage investments and that Congress step in if adequate progress was not made:

- **The GAO recommended that HUD develop criteria to help ensure that non-mortgage investments are consistent with the purposes expressed in the GSEs' charters. The GAO agreed with HUD's evaluation that it could use its general regulatory authority to potentially limit non-mortgage investments, but noted that HUD had not yet developed criteria for evaluating the non-mortgage investments to see if they are consistent with the agencies' charters.**
- **The GAO recommended that HUD continue developing its criteria for regulating non-mortgage investment through the rulemaking process to help ensure that the housing GSEs non-mortgage investments are consistent with their mission. The GAO also recommended that Congress monitor the actions of HUD in establishing criteria. The GAO concluded that Congressional oversight was “important to help ensure that corporate incentives to increase shareholder value do not erode the enterprises' public mission. If adequate progress is not made in a timely way, Congress may wish to consider providing further guidance to the regulatory agencies.”**

GAO found that non-mortgage investments generate arbitrage profits for the GSEs:

- **The GAO stated that “government sponsorship lowers their debt costs, and they can therefore generate arbitrage profits (i.e., profits resulting from their funding advantage) by investing in non-mortgage investments.”** The GAO found that the GSEs' non-mortgage investments could best be described along a continuum representing the degree to which they relate

to the housing enterprises' missions. The GAO put short-term non-mortgage investments (such as short term federal funds which facilitate liquidity) on one end of the continuum and longer-term investments on the other end that are "less clearly related to the enterprises' mission in facilitating liquidity in the secondary market, because fluctuations in their market value reduce their usefulness in responding to changes in capital and mortgage products." **The GAO noted that the GSEs' long term non-mortgage investments generate arbitrage profits and that some of the GSEs' short-term investments may also generate arbitrage profits.**

GAO found that the tension between the GSEs' shareholder profit and mission increased the need for effective oversight by the GSEs' regulators:

- **The GAO concluded that the GSEs "have incentives as private corporations to increase shareholder value; these incentives create a tension with achievement of the missions stated in the federal charters of the enterprises. It is this tension that highlights the importance of mission oversight. Without effective mission oversight, the incentives to use the benefits of government sponsorship to increase shareholder value could, over time, erode the public mission."**

Treasury recommended that HUD limit the GSEs' non-mortgage investments:

- **The Treasury Department recommended in a 1998 comment letter to the GAO that the enterprises' mission regulators should use their general regulatory authority to limit the enterprises' non-mortgage investment activity. The Treasury letter stated, "We believe that such regulations should limit a GSE's investments to those necessary and appropriate for normal business operations, such as cash management. In exercising its regulatory authority, each GSE regulator should remain mindful of the ready access to capital markets inherent in the GSEs' charters. Regulators should also give careful scrutiny and analysis to claims that a particular investment is mission-related. All investments should be scrutinized in light of the specific public purpose – and expressly approved lines of business – for which Congress has established each GSE." The Treasury Department also agreed with the GAO's conclusion that the GSEs' long-term non-mortgage investments generate arbitrage profits and that some of the GSEs' short-term investments may also generate arbitrage profits. (GAO Report GGD-98-48, "Government-Sponsored Enterprises: Federal Oversight Needed for Non-mortgage Investments," March 1998)**

Abt study finds justification for limiting the non-mortgage investments of Fannie & Freddie

- **In April 1999, news reports surfaced that HUD was writing a proposal to limit the non-mortgage investments by Fannie and Freddie and expected to release the plan in the summer of 1999. An independent study conducted by Abt Associates Inc., a consulting firm in Cambridge, MA, reportedly persuaded HUD to make its decision. The report was critical of Fannie and Freddie and found "justifications for placing some limits on non-mortgage investments," which the GSEs started making in the 1980s. Given Fannie and Freddie's mandates to support housing, the report questioned the appropriateness of Fannie and Freddie's push into non-mortgage-related investments. "Both the shift to include non-government securities and the large increase in magnitude of non-mortgage investments relative to the early years of the enterprises raise questions about the role and appropriateness of non-mortgage investments relative to the enterprises' charter purposes," the report said. The Abt report also said Fannie or Freddie could become insolvent "if there is no limit whatsoever on the types or amounts of non-mortgage investments." That risk, the report adds, would be avoided if the GSEs confined their non-mortgage holdings to cash or Treasury bonds. The report also noted that Fannie and Freddie's GSE status allows them to enjoy**

an exemption from state and local taxes and lower borrowing costs which allows them to earn more from instruments such as corporate bonds than could other investors. Also, due to an implied government guarantee from the US government, Fannie and Freddie are able to issue bonds at a very low yield relative to Treasury securities. The report examined the pros and cons of various options, including limits on the magnitude, maturities, or permissible asset classes of non-mortgage investments, and a requirement that the investments be considered “socially worthy purposes.” While the report recommends some form of regulation, it also cautions against micromanagement.

- **One senior federal official who spoke on condition of anonymity stated, “The report has persuaded HUD officials that limits on non-mortgage investments are necessary in order to protect the public interest...The only question now is the details” of the planned rules.** (*American Banker*, Marc Hochstein, 4/28/99; *BNA Daily Report for Executives*, Marc Selinger, 4/28/99; *Dow Jones Newswire*, Jerry Guidera, 4/23/99)

HUD delayed the rule, saying the rule would be out for public comment by midsummer of 2000

- **In late 1999, according to an article by Jerry Guidera with *Dow Jones Newswire*, HUD again delayed drafting new regulations to determine the types of non-mortgage investments Fannie and Freddie could pursue. Top agency officials said they expected to have a proposal for public comment by midsummer of 2000.** The delay was reportedly because HUD officials said a report by Abt Associates did not go far enough in calling for restrictions on Fannie and Freddie’s non-mortgage investments. HUD asked the consulting firm, Abt Associates, to create a detailed plan for a rule, but the report was delayed because HUD asked for a more detailed set of standards that could be used to determine the types of investments Fannie and Freddie should be allowed to pursue. When HUD first received the preliminary report from Abt Associates, HUD indicated that they expected to have a proposal for public comment by midsummer of 1999. However, HUD ordered a revised report from Abt because the rule did not go far enough in calling for restrictions on Fannie and Freddie’s non-mortgage investments. “The preliminary report didn’t cover everything we wanted it to,” said then HUD’s Spokesman Lamar Wooley. “We expect that the [new] report will be completed by the end of the year.”
- **“We’re taking a hard look at this issue,” said HUD’s then Spokesman Lamar Wooley in 1999, “and still expect to issue a regulation.”** HUD officials have reportedly said in the past that they are considering a number of options in order to limit the non-mortgage investments. One option that officials have said was being considered was capping the amount of the portfolios that can be devoted to such securities purchases, while another option would limit the types of investments to so-called “socially responsible” causes. HUD was urged to look at the issue after the GAO issued a “scalding review of HUD’s oversight of the non-mortgage investments” by Fannie and Freddie. (*Dow Jones Newswire*, Jerry Guidera, 11/29/99)

**OFHEO does an “about-face” and withdraws Fannie/Freddie corporate governance rule**

**According to John Connor with *Dow Jones Newswire*, “the action...smells after a couple of days of fertilization like a case of a regulator being muscled by the regulated entities”**

**Connor notes that the “buzz is that Fannie and Freddie (not nearly as warm and cuddly as their names sound) weren’t happy and let the regulator know they were prepared to go to the mat unless the corporate governance proposal went away”**

- **Fannie and Freddie’s safety and soundness regulator, OFHEO, quickly withdrew a proposed rule on the corporate governance of Fannie and Freddie just 10 days after issuance. According to John Connor with *Dow Jones Newswire*, “the action, announced...in mostly antiseptic ‘timing’ terms, smells after a couple of days of fertilization like a case of a regulator being muscled by the regulated entities.” Connor notes that the “precise sore spot(s) in the withdrawn proposal remain unclear, but the buzz is that Fannie and Freddie (not nearly as warm and cuddly as their names sound) weren’t happy and let the regulator know they were prepared to go to the mat unless the corporate governance proposal went away.”**
- On April 10, OFHEO first issued the proposed corporate governance rule to set forth minimum requirements with respect to “corporate governance” practices and procedures of Fannie and Freddie. “Corporate governance,” OFHEO said, involves the relationship between an Enterprise, its management, board of directors, shareholders, regulators and other stakeholders. OFHEO said it currently monitors such practices to ensure Fannie and Freddie accomplish their public policy purposes in a safe and sound manner.
- On April 20, OFHEO withdrew the proposed rule stating, “In light of the anticipated appointment by the President of the United States of new members of the boards of each Enterprise, the proposed rule is withdrawn at this time as it’s likely to result in untimely confusion for the appointees as to the standards applicable to their positions.” OFHEO said it anticipates reissuing the proposal but provides no timetable for reintroduction.
- Connor notes that Freddie had no comment on the issue and that attempts to obtain comments from Fannie and amplification from OFHEO weren’t immediately successful. (*Dow Jones Newswire-Capital Views*, John Connor, 4/20/01; *Federal Register*, page 20217, 4/20/01)

**Real estate brokers would like regulators to examine Freddie's REO (real-estate-owned properties/foreclosed properties) business**

**"It is appalling that the new HUD regulatory administration is not complying with its duty to effectively regulate the GSEs. It is unbelievable that HUD is continuing to allow the first federally subsidized real estate brokerage operation to remain in business," said Bruce Koklich, an REO marketing specialist in Long Beach, CA**

**REO professionals are supporting Cong. Richard Baker's (R-LA) GSE bill to strengthen oversight of the GSEs**

**HUD requested information about Freddie's HomeSteps programs about a year and a half ago because it was concerned that the activity might be a new program outside the GSEs' mission (HUD has not yet responded after a year and a half of investigation)**

- **According to Tommy Fernandez with the *American Banker*, "add real estate brokers to the list of businesses pushing regulators to curb the government-sponsored enterprises' activities." Brokers are concerned that two of Freddie Mac's companies – HomeSteps Asset Services and HomeSteps Home Buying Center – are exceeding their mandate and encroaching deep into broker territory. Fernandez reported that some real estate professionals believe that Freddie's companies "serve as a beachhead through which Freddie can take advantage of its size and clout to dominate the field.**
- Freddie officials say the two companies are using local brokers, lowering prices on foreclosure sales, and assisting communities. Brokers who sell foreclosed properties, however, believe that Freddie is doing more harm to them than good.
- HomeSteps Asset Services and the HomeSteps Home Buying Center provide services for banks, lenders, and others that want to unload foreclosed properties (real estate-owned properties or REO). HomeSteps Asset Services, of Dallas, consists of a network of real estate brokers, eviction attorneys, appraisers, and closing and title companies. HomeSteps Asset Services sells 10,000 homes a year. The HomeSteps Home Buying Center, in Moreno Valley, CA, is a one-stop center where consumers can purchase homes for sale. It offers financing and escrow services. A Freddie spokesman said the Home Buying Center is staffed by brokers from a licensed real estate firm with which Freddie has contracted and that only Freddie Mac properties are available through it.
- **Some real estate professionals argue that Freddie should not be in the REO business at all while others say they have no problem with the Home Buying Center – as long as it sells only Freddie foreclosures. But real estate professionals argue that through HomeSteps Asset Services, Freddie is seeking REO business for all types of loans from lenders all over the country, expanding its operations to include the sale of non-GSE foreclosures, which the brokers argue is shrinking their share of a small market.**
- **"People have left the REO business and have gone into selling regular housing," said Warren Adams, a broker with Security Pacific Real Estate in Sacramento, CA. Freddie's activity in this business has taken away about 20% of his business, said Adams. "If they were just into Freddie Mac-insured properties, I could understand their wanting to get rid of those themselves," said Adams. "But when they go after other entities for REOs and solicit their**

**business, they are in direct competition with me; I can't compete with a government-sponsored enterprise, which has billions."**

- **Fernandez reported that "traditional REO players are getting behind" Cong. Baker's new GSE bill to strengthen regulation of the GSEs. The bill would transfer regulation of the GSEs to the Federal Reserve Board. (HUD is currently Fannie and Freddie's mission regulator, while OFHEO is the safety and soundness regulator.)**
- **Critics of the GSEs, such as Steve Bartlett, President of the Financial Services Roundtable, said that without a new regulator there is little to prevent the GSEs from dominating a business outside their charter. It is "technically true" that HUD regulates Fannie and Freddie, said Mr. Bartlett, "but HUD has no teeth. Fannie and Freddie can engage in activities first and then dare HUD to stop [them]."**
- **"It is appalling that the new HUD regulatory administration is not complying with its duty to effectively regulate the GSEs. It is unbelievable that HUD is continuing to allow the first federally subsidized real estate brokerage operation to remain in business," said Bruce Koklich, an REO marketing specialist in Long Beach, CA. (*American Banker*, Tommy Fernandez, 5/25/01)**

HUD requested information about Freddie's HomeSteps programs about a year and a half ago because it was concerned that the activity may be a new program outside the GSEs' mission (HUD has not yet responded after a year and a half of investigation)

- As reported in a January 14, 2000 *GSE Report* - Concerned about expansion of the GSEs beyond their original charters, HUD requested more information from Fannie and Freddie on the GSEs' new initiatives. HUD sent letters dated December 21, 1999 to Fannie and Freddie saying that the GSEs began several new initiatives that HUD believes may be new programs. The letters noted that Fannie and Freddie must get HUD approval before implementing new programs. HUD has also asked Fannie and Freddie to explain how the GSEs' initiatives impact the mortgage market and private sector competitors and asks what authority the GSEs have to engage in these new initiatives under their charters. The letters, signed by then HUD Assistant Housing Secretary and Federal Housing Commission William Apgar, gave the GSEs a January 31, 2000 deadline in which to provide detailed information to HUD or face enforcement action or even suspension of the programs until the agency completes its review.
- In its letter to Fannie, HUD requested more information about Fannie's initiatives dealing with mortgage insurance, Internet access to Fannie's automated underwriting system – Desktop Underwriter – by mortgage brokers and consumers, and the Home Depot pilot program for home improvement loans. HUD requested information from Freddie on its initiatives dealing with mortgage insurance, Loan Prospector (Freddie's automated underwriting system) on the Internet, and Freddie's HomeSteps Buying Center in Morena Valley, CA, which HUD describes as a real estate brokerage unit. [Editorial Note: HUD has not yet responded after a year and a half of investigation.]
- **An earlier quote by HUD - "[The Home Depot and HomeSteps programs] may mark an entry by the GSEs into direct consumer contact, which would be an abuse of the competitive advantage given to them," says Lamar Wooley, then a Public Relations Spokesman for HUD. There is also concern that if the GSEs' attention were turned to the primary market, the secondary market would suffer. "HUD's job is to make sure the GSEs' appetite for profits**

doesn't compromise the secondary market," says Wooley. (*Credit Risk Management Report*, 1/24/00)

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

**American Enterprise Institute Fellow Peter Wallison and financial consultant Bert Ely will hold a briefing on June 4 to update their "Nationalizing Mortgage Risk" study and its implications for the future of Fannie & Freddie**

- In their March 2000 paper, "*Nationalizing Mortgage Risk*," Peter J. Wallison and Bert Ely projected that, in order to meet the 15 percent 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 United States by the end of 2003. AEI notes that the 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 initially projected. If the economy's weakening since late 2000 appreciably slows mortgage growth, Wallison and Ely predict that this process will reverse. Wallison and Ely will distribute and discuss their new data and its implications for the future of Fannie and Freddie on June 4 from 10 a.m. – 11:30 a.m. at the American Enterprise Institute. (*AEI announcement on "Updating Nationalizing Mortgage Risk"* [www.aei.org](http://www.aei.org))

***US Banker* column by Paul Muolo notes that FM Watch Executive Director Gerald Friedman said FM Watch's ultimate goal is to work with Congress to implement a "tough, single regulator" for the GSEs to keep the GSEs focused on their core mission of providing liquidity in the secondary mortgage market, as opposed to expanding into other lines of business.**

**Muolo writes, "Don't Fannie and Freddie already have a regulator? It does – the Office of Federal Housing Enterprise Oversight, an agency that is considered more or less a regulatory joke." Muolo also noted that HUD, Fannie and Freddie's mission regulator, is "considered slightly more attuned to what's going on in the mortgage market than OFHEO, which isn't saying much."**

**"One fact is for certain: the GSE charter, which was amended in 1992 is so vaguely written that the two can basically do anything they want, short of originating loans, as long as the activity, in some way, adds liquidity to the market and/or promotes homeownership."**

**One mortgage industry veteran who is involved tangentially with FM Watch said he does not want to shut down Fannie or Freddie. "I think the issue is that Fannie and Freddie have the power of the government behind them, but they are not playing by government rules. There have been threats and no one is holding them accountable. Think about it –if they were Microsoft the Attorney General would be all over them," said the mortgage industry veteran.**

- A *US Banker* column by Paul Muolo notes that until this year, a journalist would be hard-pressed to find a financial services executive that was willing to go on the record to complain about the GSEs' strong-arm tactics. However, now leaders of three sectors of industry – bank-owned

seller/servicers, mortgage insurers, and subprime lenders – have gone public with allegations that the GSEs wield too much power in the market. More importantly, adds Muolo, “they gripe about what they perceive as retaliation for their support of FM Watch.”

- Muolo notes that the *Wall Street Journal* ran a story in March of this year which quoted Hank Greenberg, chairman of American International Group and Richard Kovacevich, CEO of Wells Fargo & Co as saying that their companies had been threatened. Another CEO, William Harrison of JP Morgan Chase & Co., was quoted indirectly, saying he was asked to resign from the FM Watch Board of Directors, or else Fannie would reduce the amount of business it does with the company. While Harrison declined to confirm or deny the story, sources familiar with the story have confirmed the threat. What kind of leverage did Fannie have? Muolo notes that JP Morgan’s underwriting division sells billions of dollars of GSE debt, raking up hundreds of million of dollars in commissions.
- FM Watch Executive Director Gerald Friedman told Muolo that he had received “scores of phone calls from mortgage managers telling [him] how they have been intimidated by the two.” While **Friedman declined to give specific examples, he told Muolo that the group was planning some type of forum where the stories can be told “behind closed doors” to interested government officials. Friedman told Muolo that FM Watch’s ultimate goal is to work with Congress to implement a “tough, single regulator” for the GSEs to keep the GSEs focused on their core mission of providing liquidity in the secondary mortgage market, as opposed to expanding into other lines of business. But, Muolo asks, “Don’t Fannie and Freddie already have a regulator? It does – the Office of Federal Housing Enterprise Oversight, an agency that is considered more of less a regulatory joke. ”** Muolo also noted that **HUD, Fannie and Freddie’s mission regulator, is “considered slightly more attuned to what’s going on in the mortgage market than OFHEO, which isn’t saying much.”**
- Muolo notes that FM Watch’s members consist of representatives from commercial lenders, mortgage insurance companies and subprime lenders. Muolo notes that the companies fear that Fannie and Freddie are aiming to overtake their businesses. He notes that MI companies fear that new GSE products and loan arrangements that reduce the need for mortgage insurance “could spell an end to their livelihoods.” In addition, “an even larger fear...rarely publicized, is the possible entrance of Fannie and Freddie into the mortgage servicing arena.” Muolo notes, “If Fannie and Freddie enter the servicing arena (both have denied having any designs on this part of the business), it would put them in head-to-head competition with the firms they buy loans from.” There is also a fear that the GSEs will try to originate mortgages one day, despite their charters forbidding the practice. There are also fears that the GSEs’ automated underwriting systems will displace private systems, and allegations that the GSEs use their political donations to get favors on Capitol Hill.
- Muolo concludes, **“One fact is for certain: the GSE charter, which was amended in 1992 is so vaguely written that the two can basically do anything they want, short of originating loans, as long as the activity, in some way, adds liquidity to the market and/or promotes home ownership.” One mortgage industry veteran who is involved tangentially with FM Watch said he does not want to shut down Fannie or Freddie. “I think the issue is that Fannie and Freddie have the power of the government behind them, but they are not playing by government rules. There have been threats and no one is holding them accountable. Think about it –if they were Microsoft the Attorney General would be all over them,” said the mortgage industry veteran. (US Banker, Paul Muolo, 5/1/01)**

**While Fannie & Freddie publicly announced that they would release more information on their exposure to interest-rate risks in their mortgage portfolios, they quietly began reducing the amount of information they used to routinely release in their monthly volume summary reports**

**Fannie & Freddie have removed the detailed information on the various types of mortgages they purchase from their monthly reports**

**Howard Shapiro, an investment research analyst at Goldman Sachs & Co. said, “More information is always better...Certain things I did look for on a monthly basis, for example, the breakdown in purchases, is not there anymore...It would be more helpful to have it.” Shapiro noted that he uses the disclosures to get a sense of what types of products the GSEs are purchasing. “It kind of tells you what’s going on in the mortgage market and it tells you whether or not the investment opportunity is getting more or less attractive for the investment portfolio,” said Shapiro.**

- Joy C. Shaw with *Dow Jones Newswire* notes 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.
- “I don’t think any information [eliminated] really had any immediate impact [on trading], but they used to show a breakdown of 30-year, 15-year [mortgages] and ARMs [adjustable-rate-mortgages],” said Robert Young, a mortgage-backed securities analyst with Salomon Smith Barney. “To some extent it gives you some idea of what they are doing, and they could argue that dealers like us are not showing that kind of level of detail in any of our public disclosure so why should they have to?” Howard Shapiro, an investment research analyst at Goldman Sachs & Co. said, “More information is always better...Certain things I did look for on a monthly basis, for example, the breakdown in purchases, is not there anymore...It would be more helpful to have it.” Shapiro noted that he uses the disclosures to get a sense of what types of products the GSEs are purchasing. “It kind of tells you what’s going on in the mortgage market and it tells you whether or not the investment opportunity is getting more or less attractive for the investment portfolio,” said Shapiro. (*Dow Jones Newswire*, Joy C. Shaw, 5/22/01)

**Senator Paul Sarbanes (D-MD) is likely to be the next chair of the Senate Banking Committee – (Senator James Jeffords' switch from Republican to Independent gives the Democrats control of the Senate and all of its Committees)**

**Outlining his new agenda for the Committee, Senator Sarbanes says oversight of Fannie & Freddie is a top priority**

**Shares of Fannie & Freddie gain after news that the Democrats will take control over the Senate**

**Current Senate Banking Committee Chairman Phil Gramm (R-TX) says he is mulling whether legislation is needed to strengthen regulation of the GSEs**

- Senator James Jeffords (R-VT) formally announced May 24 that he is leaving the Republican party to become an Independent. Senator Jeffords' party switch will tilt the balance of power in the now 50-50 Senate to the Democrats. Senator Jeffords said he would officially become an Independent after Congress finishes the tax bill (effectively giving control of the Senate to the Democrats). According to *National Mortgage News*, before power can change hands from the Republican party to the Democratic party, the Senate must pass a resolution. Once the resolution is passed, the change in control would be immediate.
- News reports indicate that Senator Paul Sarbanes (D-MD) will likely be the next Chairman of the Senate Banking Committee, replacing current Senate Banking Committee Chairman Phil Gramm (R-TX). The share prices of Fannie and Freddie rallied on May 23 and May 24 in the wake of news that Senator Jeffords was leaving the Republican Party, tipping the balance of power in the Senate to the Democrats. On May 23, Fannie's stock rose 4.5% and Freddie's stock rose 4.4%. The rally continued on May 24 but then tempered a bit in late morning trading. Senator Sarbanes is considered friendly to the GSEs, said Salomon Smith Barney analyst Tom O'Donnell. "I think the market likes what it sees," he said. The possible shift in the Senate is "definitely" boosting the shares, said Makiko Coakley, an analyst with Lehman Brothers Inc. "It does suggest that in the event that any legislation that is negative towards Fannie Mae and Freddie Mac were to proceed from the House, it would likely meet more opposition in the Senate," said Lehman analysts in a note to clients. "You can be sure the party hats are on at Fannie," said one financial services industry lobbyist. "A GSE legislative package is now unthinkable," said the industry lobbyist. FM Watch Executive Director Mike House said the change in power "doesn't make my job any easier," but noted that the "shear size of Fannie and Freddie make it essential for any public official to take a good look at the situation."
- Senator Sarbanes held a press conference on May 24 to outline a new agenda for the Senate Banking Committee under his leadership. Senator Sarbanes placed his highest priorities on oversight of Fannie and Freddie. He said his top priority is "oversight of the condition of the financial system" including Fannie and Freddie. Senator Sarbanes said he would like to first review OFHEO's long-awaited risk-based capital rule for Fannie and Freddie, which is currently at the OMB under review. "We'd like to get that in place and then see what that looks like, see what the regulatory landscape looks like," said Sarbanes. "And in a sense I want to do one thing at a time and get that done." Senator Sarbanes stated, "OFHEO has finally brought that [risk-based capital rule] to culmination after a long time. And my own view is that [the risk-based capital rule] is what we out to focus on at this moment." He stated, "We ought to try to see if we can't move that regulation through to final completion in a form that is generally acceptable. And that's what

we intend to be paying attention to. And I don't really want to move off in another direction that would upset carrying through on that process and completing it. That's been a long time working, and if we get into other issues, we're liable to lose the momentum that we have in order to complete that." The regulation might address some of the criticisms about OFHEO, he said. [OFHEO Director Armando Falcon testified on May 8 that he expects that the long-awaited risk-based capital proposal for Fannie & Freddie to be published sometime this summer after an "unacceptable" five-year delay.] Senator Sarbanes did not say whether he supports Cong. Richard Baker's (R-LA) GSE bill that would strengthen oversight of Fannie and Freddie. Cong. Baker said he plans to discuss his bill with Senator Sarbanes, and that it's "premature" to suggest that Senator Sarbanes will oppose the bill. (*Bloomberg News*, 5/23/01; *Dow Jones Newswire*, John Connor, 5/29/01, Dawn Kopecki, 5/24/01; *National Mortgage News Daily*, 5/23/01, 5/24/01; *National Mortgage News*, 5/28/01; *Reuters*, Mark Felsenthal, 5/24/01; *Washington Post*, 5/28/01)

- Senate Banking Committee Chairman Phil Gramm (R-TX) said he was still mulling whether legislation was needed to strengthen regulation of Fannie and Freddie. "Until I've reached some conclusion that there's a problem, I don't intend to have anything to say about it," Senator Gramm told reporters after speaking at the Independent Community Bankers of America. Senator Gramm said he was still "praying" over such legislation and has not decided whether the GSEs are receiving too large a federal subsidy. "Maybe it's too small," he said. "But I doubt it." [Senator Gramm's remarks were reported prior to the release of CBO's estimate that Fannie and Freddie receive over \$10 billion in federal subsidies annually.] Senator Gramm said some of the concerns expressed about Fannie and Freddie may simply be "fears about the future." However, the importance of the issue warrants his close attention, he said. He said Fannie and Freddie are "fundamentally sound" but said that in a strong economy "everything is financially secure. Senator Gramm said he has held numerous meetings on the subject with the GSEs and their regulators. "I don't think anybody on this issue can claim that they've not been heard out," he said. Because the issue is "very sensitive" to investors, he has refrained from public comments. (*Reuters*, Mark Felsenthal, 5/22/01; *National Mortgage News Daily*, 5/22/01)

### **As the national debt shrinks, GSE debt skyrockets**

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

#### **GSE debt news:**

- (1) **Fannie to start selling debt for individuals (directed at retirees) - Financial planning professionals are skeptical and say that individuals would be better served buying bond mutual funds**
- (2) **Freddie may trade in agency futures for hedging purposes - *Investment Dealer's Digest* reports that Congressional critics of Fannie & Freddie who have accused the GSEs of overstepping their charters "could have new ammunition with Freddie Mac's recent moves into the agency futures."**

#### Background on GSE debt

- As reported in previous *GSE Reports*, as the national debt shrinks, GSE debt has been skyrocketing. As the national debt is paid down, the supply of Treasury securities shrinks. Investors, traders, borrowers, and even the US Federal Reserve are being forced to find new benchmark securities to replace the shrinking number of Treasurys. Among possible alternatives as

a benchmark are the debt securities of Fannie and Freddie. Investors view them as “almost” as good as US Treasuries because of the implicit government guarantee of Fannie and Freddie’s securities. Fannie and Freddie would like to replace Treasuries as a benchmark security and the agencies both have bond issuance programs (Fannie – Benchmark bond program; Freddie-Reference bond program) that mirror traditional Treasury operations in size and regularity.

- Criticisms of the GSEs’ skyrocketing debt have increased. “Efforts by Fannie Mae and Freddie Mac to become bigger players...raise concerns among some policy makers. The two firms are privately owned. Their securities are considered safe largely because the markets assume that the government, which created both agencies, will stand behind them. If this is true, it means taxpayers are assuming an ever larger risk as Fannie Mae and Freddie Mac expand, while the companies’ shareholders enjoy profits at taxpayers’ expense.” (*Wall Street Journal*, 2/3/00) Says Jim Murphy with *Dow Jones Newswire*, “Combined Fannie, Freddie, and the FHLBanks have \$2.6 trillion – T as in trillion – of outstanding debt...I can’t explain why the amount of outstanding debt is so huge. I would think that \$2.6 trillion would be enough to provide every man, woman and child in the US who doesn’t own a home with the equivalent of a custom-designed palace on two acres in the Hamptons.” (*Dow Jones Newswire*, Jim Murphy, 4/12/00)

#### **Fannie to start selling debt for individuals – directed at retirees**

- Fannie announced it would begin selling its senior debt securities, called Fannie Mae Investment Notes, directed at individual investors. Timothy Howard, Fannie’s Executive Vice President and Chief Financial Officer said, “With the introduction of Investment Notes, Fannie Mae will provide the individual investor with a high credit-quality investment alternative.” The first issue of Fannie’s Investment Notes will begin on May 14. The notes will have original maturities of 1-30 years, with various interest rates, payment and maturity dates, and redemption provisions. They will be offered at par with no accrued interest, and will be sold in minimum denominations of \$1,000 with \$1,000 multiples thereafter. Merrill Lynch will be the lead manager for the offerings, and notes purchased from Merrill Lynch by the selling group may be resold to individuals or other dealers. (*Fannie press release*, 5/10/01; *National Mortgage News Daily*, 5/10/01)
- “We have seen an increase in demand from retail clients,” said Linda Knight, Fannie’s Senior Vice President at Treasurer. The growing number of retirees may want bonds to reduce their exposure to stocks, she said. Individuals have been able to buy Fannie bonds before, though typically only the wealthiest have done so. The new notes are designed with a broader range of investors in mind, said Knight. Individuals now only own 2.9% of Fannie’s largest and most often traded bond issues, she said. Knight said that Fannie and its investment bankers would work to explain to retail customers the risks of investing in callable debt. “There will be a lot of information available to retail investors,” she said. **Financial planning professionals are skeptical, however, and say that individuals would be better served buying bond mutual funds rather than individual securities.** “From an investor standpoint, I see very little use for it,” said Harold Evensky, **Chair of the Certified Financial Planner Board of Governors and a Coral Gables, FL, financial advisor.** “There’s a need for retail brokers, because it makes a good story, and they can try to sell them at a pretty high mark-up,” he said. (*Bloomberg News*, 5/10/01) Fannie hopes the new program will help the GSE expand its distribution to individual investors beyond the current 1-3% level. The Independent Community Bankers of America believe investors will view Fannie’s new program as “an alternative to Treasury securities.” (*Origination News*, 5/25/01)
- As reported in the April 13, 2001 *GSE Report*, Freddie announced a similar program to attract individual investors. Freddie announced the introduction of FreddieNotes, a new callable medium

term note funding program. FreddieNotes, which may be purchased in a minimum amount of \$1,000 with increments of \$1,000 thereafter, are callable medium term notes with a unique estate-planning feature. In the event of the death of the beneficial owner, the survivor's option enables holders of FreddieNotes, through their authorized representatives, to redeem the securities at par. Certain limitations apply, including limitations on the amount of FreddieNotes that may be redeemed in any one year. If these securities are sold in advance of death or maturity, the seller may receive less than par value due to market conditions. FreddieNotes are unsecured AAA-rated senior debt offered on a best efforts basis once a week beginning March 26, 2001. "This new product, which was developed to meet investor demand for high quality fixed income offerings, diversifies our investor base," said Jerome Lienhard, Freddie's Senior Vice President of Investment Funding. (*Freddie press release, 4/2/01*)

### **Freddie may trade in agency futures for hedging purposes**

- Freddie announced that effective immediately, it might use agency debt futures trading for hedging purposes. Freddie said it would limit its aggregate position to the lesser of 10% of the open interest in any contract in which it trades or any applicable position limits established by the relevant exchange. (*Freddie press release, 5/3/01*) By making a public announcement about Freddie's participation in the market and limiting Freddie's position in agency futures, Freddie's Vice President and Treasurer Louise Herrle, said the company hopes to eliminate any concern that it could manipulate or dominate the agency futures market. (*National Mortgage News, Bonnie Sinnock and Ted Cornwell, 5/14/01*)
- Christopher O'Leary with *Investment Dealer's Digest* reports that Congressional critics of Fannie and Freddie who have accused the GSEs of overstepping their charters "could have new ammunition with Freddie Mac's recent moves into the agency futures." The article notes that some market analysts believe that Freddie's venture into the futures market seems to be within its charter and is far less controversial than the GSEs' entry into the subprime market. "Yet the agency futures market remains a hot topic," reports O'Leary. "Despite Freddie Mac's claim that the agency futures market has settled down and matured, market observers have instead termed the market's first year a disaster." O'Leary reports that when agency futures were announced in March 2000, both the Chicago Board of Trade and the Chicago Mercantile Exchange introduced competing agency futures contracts. "By all accounts, the programs have flopped," reported O'Leary. (*Investments Dealers Digest, Christopher O'Leary, 5/14/01*) Freddie's announcement that it will be using agency debt futures could lend credibility to the fledgling Chicago Board of Trade's 10-year agency contract (the only one of four CBOT agency contracts that survived its first year of trading), futures traders said. (*Reuters, Meredith Grossman Dubner, 5/3/01*)
- A Spokeswoman for Fannie said that it would not discuss its hedging strategy but acknowledged that it has "modestly" used the agency futures contracts to hedge in the past and "will continue to do so in the future." She said she could not quantify more specifically the extent to which Fannie has used or will use the contracts. (*National Mortgage News, Bonnie Sinnock and Ted Cornwell, 5/14/01*)

## Fannie & Freddie expand their technology to brokers, realtors, and consumers

[Editorial Note: Such expansion conflicts with the Mortgage Bankers Association's (MBA) policy statement on the GSEs – "The GSEs should not develop, distribute, or use technology in a way that bypasses their seller/servicers by going direct to the customers or vendors of those partners, including, but not limited to consumers, owners/developers of housing, mortgage brokers, and other real estate professionals." (MBA GSE Policy Statement, 8/10/99)]

### GSE technology news:

- (1) *Business 2.0 Magazine* says Fannie "wants to dominate the Web" and wants to be "the infrastructure provider for the online mortgage market"
- (2) Freddie announces it is developing a new Web-based site to streamline and automate steps in the mortgage origination process for lenders and brokers
- (3) Fannie has a partnership with BET.com that creates a Web Site for consumers to apply for a loan
- (4) ARC Systems – one of the automated underwriting system leaders in the non-conforming market (subprime, jumbo, Alt-A and home equity) – may assist Fannie & Freddie in finding a loan product for non-conforming customers and may also integrate Fannie & Freddie's automated underwriting systems into its system
- (5) HomeStore.com [of which Fannie is an investor] and Bank of America sign a \$10.5 million agreement to launch a new online "marketplace" for consumers
- (6) RE/Maxx, a residential and commercial real estate company, announces an alliance with HomeSide Lending that will use Fannie's automated underwriting technology to approve customers
- (7) Mortgagebot claims to be the first online loan lender to accept consumer mortgage applications and deliver loan decisions using Freddie's automated underwriting system

*Business 2.0 Magazine* says Fannie "wants to dominate the Web" and wants to be "the infrastructure provider for the online mortgage market"

- *Business 2.0 Magazine* reports that Fannie has built an application (automated underwriting system) that powers hundreds of banks' online mortgage systems. The article notes that this is "just one piece of an ebusiness strategy that reaches from the company's consumer services site, [www.homepath.com](http://www.homepath.com), to online securities auctions on [www.fanniemae.com](http://www.fanniemae.com)." The article notes that "Fannie Mae intends for its online loan authoring and underwriting software to help it emerge as a business-to-business software services company" and that "Fannie Mae is now positioned to be *the* infrastructure provider for the online mortgage market."
- While analysts do not expect Fannie to reap much direct revenue currently from its Web services – "that doesn't mean Fannie Mae rolled out its Web services as an act of industry charity." The article notes that Fannie "expects its investment to spawn a whole new supply of mortgages for it to purchase. By stimulating the online market with a common infrastructure for all lenders to use, Fannie is betting that many more loans will be originated and underwritten according to its own standards. There will be a huge new pool of loans for Fannie to add to its portfolio, and that strong portfolio will in turn allow Fannie to create more mortgage-backed securities-where the company really makes its money."

- The article notes that Fannie has competition from Freddie, which also has its own underwriting system – Loan Prospector. The article further explains that “Freddie actually has been a little faster to bring its B-to-B [business-to-business] services to the Web, and has an easier-to-navigate site” than Fannie. However, Fannie handles more mortgage volume than Freddie.
- Big banks, which don’t use Fannie and Freddie’s systems, are also moving aggressively to build their own Web-based mortgage operations. “But Fannie and Freddie have a big edge in making the Internet work for them by virtue of their link to thousands of lenders nationwide.”
- The article notes, “The Web could give Fannie Mae an opportunity to move into new areas of the mortgage market. Electronic document filings could begin cutting certain members of the mortgage community out of the loop. Or, as more data begins flowing from the Web into Fannie’s systems, online lenders could end up doing little more than simply collecting applications, say some analysts.” (*Business 2.0*, Douglas Gantenbeim and Sean Donahue, 3/20/01)
- In related news, Daniel Mudd, Fannie’s Vice Chairman and Chief Operating Officer told officials at a Mid-Atlantic Regional Conference of Mortgage Bankers that Fannie’s automated underwriting system – Desktop Underwriter (DU) – handled more loans in January and February of this year than all of last year. DU is now handling 90,000 applications a day. To handle the increased workload, Fannie is installing a new Unix server at a pace of one every two days. The company also has a full-time “pit crew” to install the servers. Fannie also established a command center with additional staff and a call center. (*Real Estate Finance Today*, Chris De Reza, 3/26/01) Fannie’s Chief Technology Officer Julie St. John said Fannie plans to hike its IT [information technology] staff by 10% in 2001, about 150 people. (*Information Week*, 4/23/01)

#### Threat to lenders

- FM Watch Chairman Gerald Friedman told participants at an annual Midwinter Conference in Park City, UT in 2000 that **“the real threat” to lenders of every size isn’t the possibility that the GSEs will become mortgage originators, but their ability to control information. “They don’t want to originate,” he said. “They want to control the gateways and establish the connections...If they control the channel, no one --- no matter how large -- will be able to compete with them.”** (*National Mortgage News Daily*, 2/07/00)

#### Freddie announces it is developing a new Web-based site to streamline and automate steps in the mortgage origination process for lenders and brokers

- Freddie announced that it is developing new Web-based tools to streamline and automate the mortgage origination process. The new tools include point-of-sale interest-rate pricing, rate locking, secondary-market funding and loan delivery to Freddie. The tools will be distributed to lenders and brokers through its Web site – [www.loanprospector.com](http://www.loanprospector.com). Freddie expects the Web site to be live this summer, initially with the web-based credit- and collateral-evaluation tools that currently compromise Loan Prospector on the Internet. Loanprospector.com will also feature such services as user updates, industry news, best practices, on-line training and on-line customer service. Freddie Mac Vice Chairman and President David Glenn stated, “Now that automated underwriting has become the industry standard for evaluating home loans, it is time to take the next big step – to automate and streamline the rest of the origination process for lenders and brokers. That is what Freddie Mac is intending to do, and loanprospector.com will be our primary vehicle for our new tools.” (*Freddie press release*, 5/7/01)

Fannie has a partnership with BET.com that creates a Web Site for consumers to apply for a loan

- BET.com, a Web site aimed at African-Americans, has joined with Fannie, HomeSide Lending, and Cendant Mortgage to create the "Owning a Home" channel (found at [owningahome.bet.com](http://owningahome.bet.com)). The new Web channel updates BET.com's former "Home Center" channel and offers the ability to apply online for mortgage loans or through toll-free numbers. In addition to new loans, the channel serves as a resource for current homeowners searching for information about refinancing existing mortgages or remodeling current homes. (*Advertising-AdWeek.com*, 5/9/01)

ARC Systems – one of the automated underwriting system leaders in the non-conforming market (subprime, jumbo, Alt-A and home equity) – may assist Fannie and Freddie in finding a loan product for non-conforming customers and may also integrate Fannie & Freddie's automated underwriting systems into its system

- An acknowledged automated underwriting system leader in the non-conforming market (subprime, jumbo, Alt-A, and home equity) is ARC Systems (Advanced Resource Computer Systems). Its Web-only rules-based Lendtech 2000 (LT2k) underwriting system, released in 1998, processed over \$9 billion of loan applications in 2000. If all of its pending deals are completed, ARC Systems expects to have market share comprising some 40% of automated underwriting for the subprime market by late spring. ARC is currently pursuing a project for the integration of Fannie and Freddie's automated underwriting systems (Desktop Underwriter and Loan Prospector) with ARC's own LTk2 system. (*Mortgage Technology*, Scott Kersnar, April 2001) ARC Systems is looking to potentially assist Fannie and Freddie in finding a loan product for customers that do not fit the ratios or the profile that lead to a conforming product, according to Mary Tipps, Marketing Director for ARC Systems. "We are looking at trying to develop those kinds of relationships," said Ed Jones, President and CEO of ARC Systems. (*Real Estate Finance Today*, Michael Murray, 4/16/01)

HomeStore.com [of which Fannie is an investor] and Bank of America sign a \$10.5 million agreement to launch a new online "marketplace" for consumers

- HomeStore.com and Bank of America launched a new online homeowners service, [www.bankofamerica.com/homesolutions](http://www.bankofamerica.com/homesolutions). The site is an online marketplace offering homebuying, financing, maintenance, and improvement services to consumers. The launch is part of the first phase of a multi-year \$10.5 billion agreement between the two companies. Consumers will be able to customize their home information and manage their needs online, from prequalifying and instant loan decisions to moving and home renovations. According to an article in *Inman News*, Bank of America's Home Solutions' online customers would be given access to HomeStore.com's property listings, which include 1.4 million new and existing homes. However, recently HomeStore.com pulled all its resale home listings from the Home Solutions Web site. Julie Davis, a Bank of America spokesperson said resale listings were part of the agreement. She did not know why the listings were pulled and was trying to get an answer from HomeStore.com. (*National Mortgage News*, 4/16/01; *American Banker*, 4/11/01; *Inman News Features*, 4/16/01)

RE/Maxx, a residential and commercial real estate company, announces an alliance with HomeSide Lending that will use Fannie's automated underwriting technology to approve customers

- RE/Maxx and HomeSide Lending struck an alliance agreement in which HomeSide's proprietary lending platform, supported by Fannie's underwriting technology, will provide a list of all available products before customers decide whether to proceed and pay any loan fees, and enables loan approval in as few as 10 minutes. (*Inman News Features*, 5/23/01)

Mortgagebot claims to be the first online loan lender to accept consumer mortgage applications and deliver loan decisions using Freddie's automated underwriting system

- Online mortgage lender, Mortgagebot, claims it is the first online mortgage lender to accept consumer mortgage applications and deliver loan decisions using Freddie Mac's automated underwriting system, "Loan Prospector on the Internet." Mortgagebot, a division of M&I Mortgage Corp., will blend the LPI feedback with its own underwriting evaluation to communicate the loan decision to the consumer. Mortgagebot also offers its mortgage lending platform to banks and credit unions on a private-label basis. (*National Mortgage News*, 3/12/01; *Inman News Feature*, 3/6/01)

**Bill Bonner of the *Daily Reckoning Newsletter* notes, "[Warren] Buffet sold his Fannie Mae shares [and many of Freddie's shares] last year, saying only that he could not calculate the risk. I cannot calculate the risk either, but my guess is that it is more than most people think."**

- Bill Bonner of the *Daily Reckoning Newsletter* notes that a reader of his column recently wrote in and asked him to take a look at Fannie and Freddie. The reader said that **"these two institutions are out of control. In only 3 and a half years their assets have grown by \$400 billion...What they do is buy up mortgages from banks...[The banks] don't have to worry about how risky the mortgage is, because they sell the mortgage to these GSEs. The banks then have the cash in the till that they lend out...they're creating new money. And taking on risks that they can't possibly cover. Of course, maybe they don't have to worry – ultimately you and I and other taxpayers will get the bill. We'll pay in two ways – by inflations and by being forced to bail them out when they run into trouble. This whole matter needs sober reflection."**
- Bonner adds that in the recent decade, finances were good, inflation was low, and more and more people were able to buy homes. If a borrower "slipped up" and couldn't make a mortgage payment, "both he and Fannie fell into a safety net so supple and so resilient that both bounced back almost immediately." However, conditions may not always be as ideal. And in their current state, the GSEs have equity ratios of about 3%. Fannie claims that it would be covered even if housing prices fell by 5% nationwide, and says it would only mean a "gross credit loss" of \$1.065 billion. Laying off most of the loss on counter-parties, or hedges, Fannie would still survive. **But, Bonner asks, "what if housing prices fall more than 5%? And what if the hedging institutions are in trouble themselves? Ultimately the taxpayer will pick up the bill."** Bonner quotes the an article in the *Washington Business Journal* (April 13-19, 2001) that questioned the GSEs' belief that they could turn a risky asset – mortgage debt—and turn it into a virtually risk-free one (GSE debt). As the *Washington Business Journal* noted, "There have been many times in the past that financiers thought they had figured out how to turn risky assets into non-risky ones. None that has a happy ending." **Bonner concludes, "[Warren] Buffet sold his Fannie Mae shares [and many of Freddie's shares] last year, saying only that he could not calculate the risk. I cannot calculate the risk either, but my guess is that it is more than most people think."** (*Daily Reckoning Newsletter*, Bill Bonner, 5/11/01)

**Washington Post ranks Fannie & Freddie as the top two largest public companies in the Washington, DC area**

**[Editorial Note: While Fannie & Freddie are the largest public companies in the Washington, DC area, they do not pay state and local corporate income taxes by virtue of their GSE status. The GAO estimated that in 1995, Fannie & Freddie’s exemption from state and local income taxes was worth approximately \$300 million a year.]**

- The *Washington Post* ranked Fannie #1 and Freddie #2 in its listing of the top 125 public companies in the Washington, DC area. The following are excerpts from the Washington Post’s top five listings of the top 125 Public Companies in the Washington, DC area:

| 2000 Rank | Company Name                | Revenue (millions) | Net income (millions) | Assets (millions) | Stock-holders equity (millions) |
|-----------|-----------------------------|--------------------|-----------------------|-------------------|---------------------------------|
| 1         | Fannie Mae                  | \$44,089.0         | \$4,448.0             | \$675,072.0       | \$20,838.0                      |
| 2         | Freddie Mac                 | \$29,969.0         | \$2,547.0             | \$459,297.0       | \$14,837.0                      |
| 3         | Lockheed Martin Corp.       | \$25,329.0         | (\$519.0)             | \$30,349.0        | \$7,160.0                       |
| 4         | General Dynamics Corp.      | \$10,356.0         | \$901.0               | \$7,987.0         | \$3,820.0                       |
| 5         | Marriott International Inc. | \$10,017.0         | \$479.0               | \$8,237.0         | \$3,267.0                       |

(*Washington Post’s Washington Business*, 4/30/01)

- [According to the GAO, “if the enterprises had paid state and local corporate income taxes at an average rate of 8 percent in 1995 and if no other costs, capital levels, or operating strategies had changed, we [the GAO] estimated that this would have resulted in a combined increase in expenses for the enterprises in the range of \$367 million to \$256 million, again depending upon the enterprises’ treatment of the increases in their federal tax returns.” (*Housing Enterprises, Potential Impacts of Severing Government Sponsorship*, GAO, GAO/GGD-96-120, May 1996)]

**Barron’s article says Fannie & Freddie are expected to steadily grow their earnings, despite political pressure and an “uncertain market”**

- Jim McTague with *Barron’s* predicted that Fannie and Freddie will remain steady earnings growers, despite a shaky stock market and political pressure. This despite investment icon Warren Buffett’s recent revelation that he had sold off holdings in both GSEs last year because of the perception that Fannie and Freddie are risky and charges by critics that the GSEs expose the taxpayers to massive risk while using implicit federal guarantees to unfair advantage against private competitors.
- According to McTague, both Fannie and Freddie had revenues over \$1 billion in the first quarter of 2001 and both forecast earnings growth in the mid-teens. McTague predicted that the GSEs will make their growth forecasts, even though the economy is flirting with recession and corporate profits are down. He noted, “**technological leaps**” are being made at both companies. “**Both of the old-economy standouts are quickly morphing into ‘Net-based superstars. They can deliver their mortgage services on the Internet for much less than Amazon.com can deliver a book, which is enabling them both to increase business rapidly.’**” McTague added that the

GSEs' on-line business is only a percentage of overall volume, yet is "multiplying like a virus." Last year Freddie Mac purchased 10 million loans from mortgage companies over the Internet and Fannie said it purchased an average of 44,000 mortgages a day via the Internet last year.

- McTague noted, **"Like Bill and Hillary Clinton, Fannie and Freddie have both rabid detractors and starry-eyed admirers."** FM Watch is their most ardent critic. The group contends that giants have unfair advantages by virtue of their federal charters. For example, Freddie and Fannie pay no local taxes, do not have to file reports with the Securities and Exchange Commission, and can raise funds cheaply because their Congressional charters make it seem that they have the backing of the federal government. McTague added that FM Watch would like to see the federal government regulate the GSEs more strictly.
- The GSEs have faced political risk for several years. McTague noted that it appears the risk has lifted for this year, but could pick up in 2002 when the Senate Banking Committee could consider a proposal that would shift GSE regulation to the Federal Reserve. McTague noted that **"none of the other critics have had the public relations impact of [Warren] Buffett"** who dumped a number of shares of Freddie and Fannie. (*Barron's*, Jim McTague, 5/14/01)

#### **Consumer Federation of America joins Fannie & Freddie's Homeownership Alliance**

- According to *National Mortgage News Daily*, the Consumer Federation of America joined the Homeownership Alliance – the group that Fannie and Freddie created to counter GSE critics. "The Consumer Federation of America supports the Homeownership Alliance's goal of promoting homeownership, particularly among lower-income families," said CFA Executive Director Stephen Brobeck. Homeownership Alliance President Rick Davis also announced that the National Association of Hispanic Real Estate Professionals and the World Floor Covering Association joined the alliance. (*National Mortgage News Daily*, 5/11/01)

**Although Sallie Mae is in the process of privatization, concerns are being raised that Sallie Mae (like Fannie & Freddie) is unfairly competing against the private sector and that more and more credit unions are being pushed aside by Sallie Mae**

**"It's the exact same thing [as concerns expressed about Fannie & Freddie]...Suddenly, you have this entity [Sallie Mae] which was created by the federal government to serve certain purposes, then you have them switching and they are now cannibalizing these commercial entities they were created to serve," said Richard George, President of Great Lakes Higher Education, Madison, WI**

**Steven Wesson, Vice President for the Purdue Employees FCU, states, "They're [Sallie Mae] taking away a lot of business from everybody, from a lot of credit unions...They're cutting out the middlemen," said Wesson. "I wouldn't be surprised if that is exactly what happens."**

- The *Credit Union Journal* published an article by Ed Roberts that asserted that credit unions are feeling pushed aside by Sallie Mae.
- Roberts notes that similar to criticism currently being raised about Fannie and Freddie, Sallie Mae is a "government sponsored enterprise, chartered to facilitate the secondary loan market" and is seeking "to broaden its mission to the potential detriment of credit unions, banks and other business partners." Roberts noted that this criticism sounds similar to that leveled against Fannie and

Freddie in recent years. However, unlike Fannie and Freddie that have kept their government charter, Sallie Mae's restructuring plan of three years ago will allow the "eventual shedding of the government charter [and] has enabled it to move into loan originations, an area never contemplated by the company's 1972 chartering." The company expects to originate over \$12 billion in student loans this year, which Roberts noted, is over 50% of the non-government share of the market. In comparison, the biggest mortgage originators, JP Morgan Chase and Wells Fargo, hold no more than 7% of the home loan market.

- Roberts noted that the other GSEs – Fannie and Freddie – have long raised the ire of critics who complain that Fannie and Freddie are poised to originate loans. While Sallie Mae's critics have not been as vocal as Fannie and Freddie's, Roberts noted that at least one player in the student-loan market is raising some questions. **"It's the exact same thing," said Richard George, President of Great Lakes Higher Education, Madison, WI. "Suddenly, you have this entity which was created by the federal government to serve certain purposes, then you have them switching and they are now cannibalizing these commercial entities they were created to serve."** Roberts added that Sallie Mae's increased originations have had a noticeable effect on its relationship with credit unions. **The number of credit unions that Sallie Mae does business with has fallen 60% percent to 120 since Sallie's restructuring. "More importantly, it is making it more difficult for credit unions to compete in the market without some approbation from Sallie Mae."**
- While Sallie representatives claim to be committed to working with credit unions and their other traditional partners, the company also acknowledges that it plans on seeking a larger share of the student loan market. **Sallie's tactics alarm many executives of credit unions, even those institutions with a comfortable share of the market. Steven Wesson, Vice President for the Purdue Employees FCU, which has one of the biggest student loan portfolios at \$31 million, is quoted as stating, "They're [Sallie Mae] taking away a lot of business from everybody, from a lot of credit unions."** Wesson also told Roberts he was particularly concerned with Sallie's relationship with Purdue University, the credit union's main sponsor group. Under the deal, Sallie has arranged a list of four preferred lenders, including the credit union, for university students, and to get listed as a preferred lender the institution must agree to sell all of the loans to Sallie. **"We don't have a choice...they went straight to the university and edged out everyone else...All competitors have to play by the same rules or you don't get to play."**
- Roberts noted that the preferred lender program is just one of the devices Sallie employs to lock up loans in a market where there is no rate competition, due to the federal government's guaranteed rate set by the Federal Family Education Loan Program, accounting for two thirds of the annual \$36 billion market. Sallie also uses its size to force credit union lenders to sell them loans. John Garey, product manager for CUNA Mutual's student loan program, told Roberts that Sallie offers credit unions a premium if they sell loans to Sallie. Roberts added that Sallie is also expanding into Internet lending. Sallie also made its wirescholar.com full-service lending online website available to credit unions over a new Internet portal for credit unions, called VirtualCU.
- **Roberts concluded his piece by noting that as long as Sallie continues to grow, competition will likely shrink in the student loan market. The prospects in this market are not bright for credit unions and other smaller players, according to several observers. "They're cutting out the middlemen," said Wesson. "I wouldn't be surprised if that is exactly what happens."** (*Credit Union Journal*, Ed Roberts, 4/20/01)

## *Fannie Mae*

### **Mortgage Bankers Association and Fannie agree on a framework for the development of technology standards for electronic mortgages**

#### **MISMO - an independent industry group created by the MBA - will oversee the standards**

- The MBA and Fannie announced that they have agreed on a framework for the development and deployment of transparent technology standards for electronic mortgage transactions. An independent industry body, the Mortgage Industry Standards Maintenance Organization (MISMO), will oversee the development, adoption, and implementation of the standards. MISMO, created in January 2000, is comprised of MBA members, technology companies, and key industry players, including Fannie and Freddie. Highlights of the agreement include: (1) Fannie will support the development and adoption of transparent industry data and transaction standards through MISMO; (2) Fannie will support the development and adoption of a uniform, industry wide public key infrastructure (PKI) security system through an independent industry wide body, the Real Estate Finance Security Management Organization (REFSMO); and (3) Fannie and MBA will work together on the development of an e-mortgage standardization effort, and Fannie intends to adopt the industry wide directives that emerge from this effort. (*MBA/Fannie joint press release, 5/7/01*)
- Fannie agreed to implement the MISMO standards “as published” but will retain the right to extend them with its own proprietary data. There have been some concerns recently that Fannie would develop its own standards. MBA Senior Staff Vice President Howard Glaser said MBA’s agreement with Fannie addressed industry concerns over the domination of technology standards by Fannie. “In the past we have seen the GSEs create proprietary technology and then impose that technology on the industry,” he said in an interview. “There was great concern about what would happen in the next frontier of technology leading to paperless mortgages.” (*American Banker, Tom Fernandez, 5/8/01*)
- The GSEs have been criticized for engaging in activities outside their mission, particularly in the area of technology. MBA President Andrew Woodward said, “This is the right way to resolve issues involving new technologies.” Mr. Woodward called the agreement the “blueprint for how the industry and the GSEs can work together to create a level playing field.” Both Fannie and Freddie have been criticized for imposing their automated underwriting systems onto the industry. That, “more than anything else, is what has created a lot of tension,” between the GSEs and the industry, said MBA Senior Staff Vice President Howard Glaser. Mr. Glaser told *National Mortgage News* that he sees Fannie’s agreement with the MBA as a Fannie pledge not to do business that way in the future. “We are going to work together with no one player in a dominant role,” he said. “That’s a very different approach.”
- Freddie has announced its commitment to MISMO but has yet to sign a definitive agreement with the MBA. However, Mr. Glaser said he “fully expects” Freddie and the MBA to come to similar terms shortly. Under the agreement, Fannie agreed to continue its support of REFSMO as the group responsible for creating key infrastructure security standards, however, a decision on whether or not Fannie will use the standards rests on the terms of the agreement the MBA is still negotiating with an un-named vendor. (*National Mortgage News, Lew Sichelman, 5/14/01*)

**Fannie introduces a deferred-payment mortgage product (lenders must use Fannie's automated underwriting system to offer the product)**

**[Editorial Note: This conflicts with the Mortgage Bankers Association's (MBA) policy statement on the GSEs – "The GSEs should not develop, distribute, or use technology in a way that limits access to their programs or is a precondition for waivers of representations and warranties or waivers of program and documentation requirements." (MBA GSE Policy Statement, 8/10/99)]**

- Fannie announced the introduction of the InterestFirst(SM) mortgage. The product, available through Fannie's lender partners, allows borrowers to obtain a 30-year fixed-rate mortgage that requires only payments of mortgage interest for the first 15 years of the loan. After 15 years, the mortgage payments are automatically recalculated, and the borrower makes higher payments that include principal and interest for the remainder of the loan term. The interest rate on an InterestFirst Mortgage will be higher than a standard 30-year loans. **According to Fannie, the loan is available for mortgages up to 95% of the appraised value of the home from selected lenders using Fannie's automated underwriting system.** (*Fannie press release, 4/23/01*)

**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 to open a Partnership Office in Providence, RI**

**Fannie has 44 Partnership Offices open across the country**

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

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

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

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

Members of the House Banking Committee and seven Members of the Senate Banking Committee. (*Real Estate Finance Today*, Michael Sorohan, 9/11/00)

#### Fannie's media events raise ethical questions

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

#### Fannie has 44 partnership offices

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

#### Senator Jack Reed (D-RI), Senator Lincoln Chafee (R-RI), Cong. Patrick Kennedy (D-RI), Lieutenant Governor Charles Fogarty and Secretary of State Edward Inman

- Fannie held a press event with the above named officials to announce a \$3 billion five-year housing and community development investment plan, "House Rhode Island." The company also announced the opening of its statewide Rhode Island Partnership Office that will be based in Providence. (*Fannie press release*, 5/21/01) The *Providence Journal Bulletin* noted that the \$3 billion investment plan breaks down to an average of \$600 million a year for each of the next five years. In comparison, Fannie did \$910 million in mortgages and refinancings last year. (*Providence Journal Bulletin*, Zachary Block, 5/22/01)

#### Senator Paul Sarbanes (D-MD), Senator Barbara Mikulski (D-MD)

- Fannie held a press event with the above named officials to announce a new non-profit organization, Solid Foundations, for assisting "at-risk homeowners." The group will provide charitable funds to aid families victimized by illegal and unethical real estate practices, or who lack resources to address emergencies that threaten their ability to remain in their homes. Struever Brothers, Eccles & Rouse and Fannie provided the initial seed money to help establish Solid Foundations. Struever Brothers, Eccles & Rouse, and Fannie Mae have now been joined by Andre Weitzman, First Mariner Bank, Freddie Mac, Greater Baltimore Board of Realtors, Maryland Association of Appraisers, Mimi Kapiloff, Ltd., National Fidelity Mortgage Corporation, and Shapiro, Sher, & Guinot as supporters of Solid Foundations. (*Fannie press release*, 5/11/01)

#### Senator Tim Johnson (D-SD)

- Fannie issued a press release to announce that Fannie, the South Dakota Rural Enterprise Inc., the South Dakota Bankers Association, and the Governor's Office of Economic Development will offer a training course to help local lenders and community organizations process small business loans. A statement of support by Senator Johnson praising Fannie Mae was included in Fannie's press release. (*Fannie press release*, 5/11/01)

#### Chicago Mayor Richard Daley, Cong. Bobby Rush (D-IL)

- Fannie held a press event with the above named officials to announce a seven-year, \$55 billion investment plan, "HouseChicago." (*Fannie press release*, 5/15/01)

#### Cong. Solomon Ortiz (D-T) and Harlingen, TX Mayor Pro Tem J.J. Gonzalez

- Fannie held a press event with the above named officials and the Rural Development and Finance Corporation (RDFC) and the Harlingen Community Development Corporation to announce a

\$512,000 loan participation agreement where Fannie will purchase 50 percent of a loan originated by the RDFC. The financing will provide 17 newly built and rehabilitated single-family and 25 rehabilitated rental units. (*Fannie press release, 5/19/01*)

Cong. John Sununu (R-NH)

- Fannie issued a press release to announce the renovation of the Smith & Dow Building, a revitalization effort in downtown Manchester. The building consists of 68 three-bedroom rental apartments. Fannie purchased \$3.97 million in tax exempt housing revenue bonds issued by the New Hampshire Housing Finance Agency to finance the first phase of the rehabilitation effort. A statement of support by Cong. Sununu was included in Fannie's press release. (*Fannie press release, 5/3/01*)

Cong. Brad Carson (D-OK)

- Fannie held a press event with Cong. Carson to announce that Fannie would purchase \$13 million in tax-exempt mortgage revenue bonds issued by the Roger County Housing Finance Authority and underwritten by Wells, Nelson and Associates of Tulsa. The proceeds of the mortgage revenue bonds will be made available through local lenders to offer mortgage financing for homebuyers in Rogers County. (*Fannie press release, 5/14/01*)

Cong. Sonny Callahan (R-AL) and Mobile, AL Mayor Michael Dow

- Fannie held a press event with the above named officials to announce the \$8 million renovation of South Bay and Cedar Bay apartments. Fannie provided credit enhancement for \$5.4 million in bonds issued by the Alabama Housing Finance Agency. (*Fannie press release, 5/7/01*)

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| <b>Fannie announces that it has fulfilled its pledge to purchase \$10 billion in CRA loans</b> |
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- Fannie announced that it had fulfilled its pledge to purchase \$10 billion in specially targeted CRA loans six months after it announced its pledge. In the spring of 1999, Fannie pledged to purchase at least \$10 billion in CRA loans by the end of the year 2002. (*Fannie press release, 5/7/01*)

## ***Freddie Mac***

**Freddie announces that it will 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 Bond Market Association protests the timing of the announcement and the implementation day of the accounting change**

- 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 will 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)
- 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)
- The Bond Market Association is protesting the timing of Freddie's announcement and sent a letter to Freddie on May 14. George Miller, a staff advisor at the Bond Market Association, 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 Bond Market Association 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)

### **Mortgage Bankers Association and Freddie announce a minority recruitment program**

- The MBA and Freddie announced a new "Path to Diversity" program to promote internship opportunities for minority students, provide scholarships to minority professionals to attend MBA's School of Mortgage Banking, and develop "best practices" for the real estate industry to increase cultural diversity. The MBA and Freddie will provide \$180,000 to fund 30 scholarships annually for a two-year period to minority mortgage professionals who want to attend MBA's School of Mortgage Banking. The scholarship program will begin January 1, 2002, but selected interns can benefit from MBA's educational services beginning this month. Minority students studying business, real estate finance, or a related field will be recruited from colleges and universities with high minority enrollment and from colleges and universities located near participating companies for the internship program. (*MBA press release*, 5/7/01)

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

### **FHFB Chairman Allan Mendelowitz has two goals for the FHLBank System this year: (1) implement the FHLBank System's capital structure and (2) address the issue of dual FHLBank membership**

- According to Brian Collins with *National Mortgage News*, FHFB Chairman Allan Mendelowitz has two goals for the FHLBank System this year: (1) implement the FHLBank System's new capital structure and (2) address the issue of dual FHLBank membership. The 12 FHLBanks of the FHLBank System are all in the process of converting to a new risk-based capital structure as required by the Gramm-Leach-Bliley Act. Each FHLBank must submit its final capital plans to the FHFB for approval by an October 29 deadline. Mendelowitz noted that two FHLBanks are close to filing their plans with the FHFB, possibly within the next four weeks and several FHLBanks have been sharing their plans informally with FHFB staff. Mendelowitz stated that the FHFB is finalizing guidance on what information needs to be included in the FHLBanks' capital plan, including supporting documentation. "We are trying to give them insight into questions we are going to be asking in evaluating the plans," he said.
- The FHFB also needs to address the issue of dual FHLBank membership. The FHFB already has a dual membership application by Washington Mutual Bank under consideration. WaMu is requesting to join the FHLBank of Dallas while retaining membership in the San Francisco FHLBank. WaMu wants to join the FHLBank of Dallas because it recently acquired Bank United, which was a member of the FHLBank of Dallas. "My reaction was this is not a singular event. This request is emblematic of the type of dramatic changes that are taking place in the industry," Mendelowitz said. Instead of addressing applications on a case-by-case basis, Mendelowitz ordered the drafting of a request for comments to flesh out the issues raised by industry consolidation and dual membership. "We want to develop criteria by which we would consider and approve or disapprove such applications," he stated. Mendelowitz notes that there has been a delay in issuing the request for comments on his insistence that the proposal be carefully crafted.

- Mendelowitz also noted that he is being held back because HUD has not assigned a representative to the FHFB (which is usually a HUD Assistant Secretary). At the time of the interview with Mendelowitz, the only HUD nominee confirmed by the Senate was HUD Secretary Mel Martinez. [On May 24, the U.S. Senate confirmed four of the president's nominees to fill top positions at the Department of Housing and Urban Development, including John Weicher to be commissioner of the Federal Housing Administration, Alphonso Jackson to be HUD deputy secretary, Richard Hauser to be general counsel, and Roy Bernardi to be assistant secretary for community planning and development.] Mendelowitz indicated that he plans to approach HUD officials soon about the dual FHLBank membership issue. [As also noted in previous *GSE Reports*, FleetBoston Financial Corp., currently a member of the FHLBank of Boston, recently applied to become a member of the FHLBank of New York – now that its acquisition of Summit Bank is complete. Summit Bank was a member of the FHLBank of New York.] (*National Mortgage News*, Brian Collins, 5/7/01)

**FHLBanks' Mortgage Partnership Finance Program (MPF) is expected to grow**

**One of the MPF's products - a loan that requires lenders to buy supplemental insurance to cover part of the credit risk they must retain on MPF loans - has been approved and is now available**

**MPF recently implemented an Internet platform – eMPF – that lenders can use to sell their loans into the program**

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

- Over the past six months, programs officials said the MPF's astronomical growth has slowed somewhat because it was retooling one of its products - a loan that requires lenders to buy supplemental insurance to cover part of the credit risk they must retain on MPF loans. An MPF Spokesman said the new loan product has now been approved and is now available, so the program is expected to concentrate on gaining market share. The Spokesman noted that business should pick up dramatically in the next few months since the product is popular with the program's biggest lenders, which in turn generate the largest volumes. The MPF program also recently implemented an Internet platform – called eMPF - which lenders can use to sell their loans into the program. The system is “nonproprietary” and “user friendly,” said Ken Gould, Executive Vice President of the MPF program. Lenders are able to modify the platform so it can communicate with their in-house systems. (*American Banker*, Tom Fernandez, 5/9/01) MPF program gives lenders an alternative to selling fixed-rate, conventional and guaranteed loans to Fannie and Freddie. It is currently offered by 10 of the 12 FHLBanks.
- In April, the FHLBank of Chicago announced that it was putting the MPF loan origination and servicing guides via the Internet on [www.AllRegs.com](http://www.AllRegs.com). (*Mortgage Servicing News*, 5/18/01)

**FHFB issues proposed affordable rule that would give the FHLBanks more control over the \$100 million they contribute each year for affordable housing programs**

**FHFB also approves new strategic plan and an interim final rule on the minimum number of FHLBank Director meetings**

- The FHFB unanimously approved a proposed affordable housing rule on May 4 that would give the FHLBanks more control over the \$100 million they contribute each year for affordable housing programs. Each FHLBank independently operates an Affordable Housing Program in accordance with the FHLBank Act. Funding for each program varies by FHLBank, but banks must set aside a minimum of 10% of their funding to affordable housing initiatives. The most significant rule change would nearly double the amount each FHLBank can set aside for its homeownership programs. The proposed set-aside limit is \$3 million, or 25% of a FHLBank's annual housing contribution, whichever is greater. Currently, those limits are the greater of \$1.5 million or 15% of the FHLBank's annual affordable housing contribution. The FHFB published the proposed rule in the May 10 *Federal Register* for public comments. The deadline for comments on the proposed rule is June 11, 2001. (*BNA Daily Report for Executives*, Adam Wasch, 5/11/01; *National Mortgage News Daily*, 5/8/01; *Federal Register*, pages 23864-23968, 5/10/01)
- The FHFB also unanimously approved on May 4 a revised five-year strategic plan and an interim final rule (discussed below) on the minimum number of board of directors meetings a FHLBank should hold annually.
- The FHFB approved a Five Year Strategic Plan covering the period from 2000 through 2005 that revises the previous Five Year Strategic Plan for 1998-2002. The new plan, which reflects changes made necessary by the Gramm-Leach-Bliley Act (GLB), is based upon the Finance Board's three goals to ensure: 1) the safety and soundness of the FHLBanks; 2) that the FHLBanks carry out their Congressionally-defined housing finance mission, and 3) that the FHLBanks are adequately capitalized and have access to capital markets.
- The FHFB, in response to requests by several FHLBanks, also approved an interim final rule that reduces the required minimum number of in-person board of directors meetings that an FHLBank must hold annually to six. Previously, the Finance Board required the FHLBanks' boards to hold a minimum of nine in-person meetings a year, or the number of meetings it averaged over the preceding three years. The interim final rule eliminates the averaging requirement and sets the minimum number of board meetings a year at six after a survey determined that is within range of the number of board meetings holding companies and the other housing GSEs hold a year. In addition, the FHFB determined that the FHLBanks' boards would be able to maintain their level of management oversight by holding longer meetings and placing greater reliance on board committees for the conduct of board business. The rule took effect on May 14, 2001 (date of its publication in the *Federal Register*). The FHFB will accept written comments on the interim final rule on or before June 13, 2001. (*FHFB press release*, 5/4/01; *Federal Register*, pages 24263-24264, 5/14/01)

## ***Farm Credit System/Farm Credit Banks***

### **Treasury Department urges the Farm Credit Administration (FCA) to withdraw its controversial national charter proposal**

**The Independent Community Bankers of America applaud the Treasury's national charter letter. "The Treasury's letter makes several forceful points against national charters that ICBA has been raising for many months. FCA's proposal is inappropriate for a government sponsored enterprise and would dramatically change the structure and focus of the FCS. We hope the FCA will heed this wise advice and withdraw its national charter proposal," stated ICBA Chairman Bob Gullede, the Chairman, President and CEO of Citizens' Bank Inc.**

- In a May 2 letter to the FCA's Chairman and CEO Michael Reyna, Treasury Department's Acting Under Secretary of Domestic Finance Donald Hammond says the agency continues to have concerns about the national charter proposal and recommends that the FCA withdraw the proposal. Traditionally, institutions in the Farm Credit System have been limited to certain geographical regions. Under the controversial proposal, individual farm credit lending institutions would be able to apply for a national charter, which would let them lend beyond their current regional geographic boundaries. The FCA formally proposed national charters in February and extended the public comment period in April, according to FCA Associate General Counsel Victor Cohen. The Treasury Department letter was submitted as part of the public comment process on the national charter proposal. The FCA said that it had received more than 1,400 letters in response to the proposal and that no date had been set to complete the review.
- Acting Treasury Under Secretary of Domestic Finance Donald Hammond writes, "First, we question whether allowing national charters would improve safety and soundness. In a cooperative network of lending associations that are jointly and severally liable for each other's debts, encouraging intra-System competition might be counter-productive to safety and soundness. As a general principle, of course, we strongly support increased competition in all credit markets. However, because all Farm Credit institutions derive their debt financing from the same source, they essentially have the same cost of funds. Consequently, price competition among associations for the same borrower can only lead to a reduction in margins, which will tend to decrease, not increase, safety and soundness."
- The Treasury further notes that the "FCA has also pointed to increased diversification - both in terms of products and geography - as a safety and soundness benefit associated with this proposal." However, writes the Treasury, "diversification of individual associations through national charters would not necessarily reduce risk significantly. As just noted, price competition will simply lower margins. Moreover, as the proposal does not add the System's product offering, intra-System competition does not add to the diversification of risk at the System level. And by operating outside of the area in which it is familiar, national charters could increase the operational risk of some associations."
- Second, the Treasury questions "whether national charters would provide benefits to all System borrowers because national charters could threaten the System's cooperative underpinnings. Member-owners of an association may no longer look upon each other as equal participants in the success of their lending cooperative. Instead, freed from the current limitations focusing service on the eligible borrowers within their service area, a Farm Credit association could pursue the most profitable borrowers, regardless of location, without the same sense of obligation to serve each

eligible member. In this way, national charters may indeed be beneficial to the largest, most financially sound System members - and may be a boom to the most aggressive and expansion-minded associations - while leading to the disenfranchisement of other borrowers served by the System today. Indeed, it is telling that FCA finds it necessary to require (as part of its proposed national charters regulation) that associations with a national charter serve their local area when the System's structure for its entire history has been designed to ensure that outcome.”

- Third, the Treasury questions “whether national charters are an appropriate response by the FCA to increased competition faced by System institutions. One often cited argument for national charters is the developing use of the Internet as a credit delivery mechanism. Without geographic restrictions, Farm Credit associations would be able to use the Internet and other new technologies to offer credit to eligible borrowers without the need for a physical presence. Indeed, it is clear that such technological advances may give System borrowers credit options unavailable before, including options to borrow from non-System institutions. It is less clear, however, whether national charters are an appropriate response. As a government sponsored enterprise (GSE), the System should exist to overcome a market failure in credit availability to agriculture. One might view the competition to System associations created by these new technologies as evidence that such market failures no longer exist.”
- The Treasury concludes, “For the reasons stated above we do not find the arguments in favor of a national charter convincing. And...we believe there are strong arguments against this policy...As we have considered the issue in recent months, we have concluded that the arguments in favor of national charters are, in fact, arguments that the 80-year-old System is outdated and in need of re-evaluation. (*Acting Treasury Under Secretary of Domestic Finance Donald Hammond Letter to FCA Chairman and CEO Michael Reyna, 5/2/01; American Banker, Ben Jackson, 5/10/01; Dow Jones Newswire, Rebecca Christie, 5/9/01*)

#### ICBA applauds the Treasury letter

- The Independent Community Bankers of America applauded the Treasury’s national charter letter. “The Treasury’s letter makes several forceful points against national charters that ICBA has been raising for many months. FCA’s proposal is inappropriate for a government sponsored enterprise and would dramatically change the structure and focus of the FCS. We hope the FCA will heed this wise advice and withdraw its national charter proposal,” stated ICBA Chairman Bob Gulledge, the Chairman, President and CEO of Citizens' Bank Inc., Robertsdale, AL. (*ICBA press release, 5/7/01*)

#### Background on the proposal

- Traditionally, institutions in the Farm Credit System have been limited to certain geographical regions. Under the controversial proposal, individual farm credit lending institutions would be able to apply for a national charter, which would let them lend beyond their current regional geographic boundaries. The FCA adopted the proposed rule at a January 11, 2000 meeting. In May 2000, the FCA issued a booklet to all system institutions providing guidance on applying for national charters. Several parties, including former House Banking Committee Chairman Jim Leach and the GAO raised procedural concerns that the FCA bypassed the formal rule-making process when issuing the rule. Responding to criticisms, in July 2000, the FCA published the booklet in the *Federal Register* for public comment. On January 11, 2001 the FCA adopted the proposed rule and sent it to the House and Senate agriculture committees for a 30-day review. The proposed rule was published in the *Federal Register* on February 16, 2001 for a 30-day comment period. The FCA then extended the deadline for comments to April 20, 2001.

- Both the Senate and House Agricultural Committees held hearings on the FCA’s controversial national charter proposal. During the February 26 Senate Agricultural Committee hearing, **Former House Banking Committee Chairman Cong. Leach (R-IA) testified that the proposal, if adopted, would “expand to 34 the number of government sponsored enterprises operating in the American economy and each of these new GSEs will have power greater than that of Fannie Mae or Freddie Mac.”** He called the proposal **“the single greatest act of administrative arrogance I have ever seen”** and believed that the proposal **“should be absolutely rejected.”** (*BNA Daily Report for Executives*, 3/22/01)

## *Ginnie Mae*

**Ginnie Mae President George Anderson defends the agency’s decision to allow its securities to clear and settle over the Fed wire**

**Anderson remains hopeful that the 3 basis point increase in Ginnie Mae’s guaranty fee will be repealed**

- Lew Sichelman with *National Mortgage News* reported that Ginnie Mae President George Anderson defended his agency’s decision to allow its securities to clear and settle over the Fed wire. Acknowledging that the agency had received criticisms for the decision, he stated that the decision was made “only after a thorough analysis” and “a clear conclusion that its benefits overwhelmingly outweighed its costs.” He noted that using the Fed wire would lower financing costs, and make Ginnie Mae securities more attractive to international investors. Ultimately, he thought the decision would lower the cost of homeownership. Anderson further noted that he was still hopeful that the 3 basis point increase in Ginnie Mae’s guaranty fee (goes into effect in 2004) would be repealed. “We certainly don’t think it makes sense to do so in a soft economy. And, most important, we don’t think it makes any sense at all to plan fee increases in advance without regard to what the market looks like when they take effect.” Anderson made his remarks during the Mortgage Banking Association’s National Secondary Market Conference. (*National Mortgage News*, Lew Sichelman, 5/14/01)

## *Tennessee Valley Authority (TVA)*

**GAO Report suggests that TVA's AAA bond rating is mainly because investors believe there is an implicit government guarantee of its bonds**

**A Moody's Investors Service report found that although the federal government does not guarantee TVA's bonds, the government would not allow a default on TVA's debt because of the impact it would have on the cost of debt issued by government-sponsored enterprises, such as Fannie & Freddie**

- The TVA Act states that the federal government does not guarantee TVA's bonds, however, a GAO Report notes that because TVA is a wholly owned government corporation, there is the perception in the investment community (including Moody's Investors Service and Standard & Poor's) that the federal government would support principal and interest payments on TVA debt if TVA's insolvency were to be seriously impaired. According to the *Wall Street Journal*, "the government isn't legally obliged to back TVA, but ratings analysts believe it would intervene in order to protect the ratings of government-sponsored enterprises, such as mortgage agencies, Fannie Mae and Freddie Mac, which could suffer if investors were given reason to believe the federal government wouldn't stand by them in the event of an emergency." Moody's and Standard & Poor's perceive that there is an implicit government guarantee of TVA bonds because they believe that the federal government would intercede to protect TVA's solvency.
- According to analysts at Moody's and Standard & Poor's, this perceived implicit guarantee is one of the primary reasons that TVA's bonds have received the highest possible bond rating (AAA). Take away the government's implied backing and the outlook changes. The TVA's "fairly high debt burden [\$26 billion] suggests that, on their own, they would not be rated AAA," said Standard & Poor's analyst David Bodek. A Moody's analyst decline to speculate on what the rating would be without the implicit support. Most of the 119 utilities covered by Moody's garner a single-A rating, two notches below TVA – which means they must shoulder higher interest costs on their debt than TVA.
- The GAO Report noted that in Moody's 2000 opinion update on TVA, the ratings agency noted, **"although the federal government does not guarantee TVA's bonds, the government would not allow a default on TVA's debt because of the impact it would have on the cost of debt issued by government-sponsored enterprises, such as Fannie Mae and Freddie Mac. As in the case of TVA, the government does not guarantee the debt of these enterprises. Also as with TVA, there is a perception in the investment community that the federal government would not allow these enterprises to default on their obligations."** (*Wall Street Journal*, Will Pinkston, 5/3/01; *GAO Report – "Tennessee Valley Authority: Bond Ratings Based on Ties to the Federal Government and Other Nonfinancial Factors*, GAO-01-540, April 2001)

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**Canfield & Associates, Inc.**  
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