

The ***GSE*** REPORT

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Special Supplement

**Consumers, Taxpayers and Industry at Risk:  
The Duopoly Danger Posed by Government-Sponsored  
Enterprises**

**July 1999**

## Consumers, Taxpayers, and Industry at Risk:

### The Duopoly Danger Posed by Government-Sponsored Enterprises

Decades ago, the government granted powerful government subsidies to two shareholder-owned corporations that now trade on the New York Stock Exchange – Fannie Mae and Freddie Mac. Mortgage market domination by this GSE duopoly gives consumers a bad deal. In 1989, consumers saved 0.6%<sup>1</sup> on their annual mortgage interest rates and Fannie and Freddie had earnings per share of \$.79 and \$.61, respectively. Today, those savings have been sliced to 0.25% while Fannie Mae and Freddie Mac reported 1998 earnings per share of \$3.23 and \$2.32, respectively.<sup>2</sup>

These two government-sponsored enterprises have the ability to hurt the home mortgage lenders they were created to help. They are using their federal subsidies to enter new markets by undercutting competitors and slashing profit margins. While consumer savings are shrinking and lender profits eroding, GSE federal subsidies, profits, and stock prices are soaring. In 1996, a Congressional Budget Office study found that 42% of Fannie Mae/Freddie Mac 1995 profits came from their federal subsidies. When the CBO methodology is applied to 1998 financial data, the numbers show that federal subsidies generated 45% of the GSEs' net earnings. Last year, these two publicly traded companies pocketed \$3 billion in annual federal subsidies between them. Using financial leverage denied to others by law, their market dominance, and the subsidies, the companies have produced stunning investment returns for a very long time. In 1982, Fannie Mae stock was worth only \$500 million. As of June 9, 1999 it had a market value of \$67.5 billion. Freddie Mac has seen its market value also soar, to \$38.5 billion. In just three years, from 1995 to 1998, Fannie Mae and Freddie Mac shareholders saw their investments leap by 149% and 200%, respectively.

For over fifty years, the federal government has sought to expand homeownership through a variety of tools. The two most important initiatives have been the mortgage interest personal income tax deduction and the FHA loan program. A third approach, first initiated in the 1960s, was to create two federally chartered private corporations – GSEs – Fannie Mae and Freddie Mac, to enhance private capital flows into the residential real estate market. Fannie Mae and Freddie Mac do this by offering mortgage lenders outlets to sell their mortgages. Policymakers believe that giving lenders a ready way to convert mortgages into cash will increase their willingness to supply mortgage funds, thereby enhancing supply. The successful development of a secondary mortgage market achieved this goal. As the influence of computers and telecommunications broaden the reach of global financial markets, regional shortages are a thing of the past. There is little need for federal support for this mature and vibrant market.

In the early years, the GSEs carried out this mission successfully and without controversy. These two corporations created to assist lenders, however, have grown so large so rapidly that they now menace

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<sup>1</sup> “Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac,” *Congressional Budget Office*, May, 1996.

<sup>2</sup> HSH Associates, Inc. HSH, Inc. data indicates that spreads were as low as 0.15% in 1997; EPS from Fannie Mae and Freddie Mac Annual Reports and S&P Compustat.

those very groups they were designed to help. This outcome is the logical outgrowth of the federal government supplying private companies with disproportionate advantages and few restraints. Today, thanks to these government benefits, Fannie Mae and Freddie Mac buy so many mortgages that they dominate the market. With such dominance, lenders now complain that the GSEs have become duopolists, with the power to dictate take-it-or-leave-it pricing.

The duopoly is using a powerful new tool to corner the mortgage market and to enter new ones, automated underwriting. Fannie Mae and Freddie Mac are using technology to automate their services, broaden product offerings sold over their technology pipelines, and eventually gain controlling market share in any line of business they choose to enter. Lenders have used proprietary systems for years, but now, Fannie Mae and Freddie Mac are using their market dominance to promote the GSE systems over others. By providing realtors and mortgage brokers their underwriting systems, the duopoly will diminish the role of mortgage lenders and reduce the profits these lenders earn. Ultimately, their expanding role will shrink profits for brokers and realtors, too, *but may not save consumers money*. Fannie Mae and Freddie Mac will maintain high prices that absorb the profits lost by lenders, brokers, and realtors.

The GSEs are aided by their 95% market share control of the automated underwriting market. Over half of the loans that Fannie Mae and Freddie Mac purchase are processed through these proprietary automated systems. Their ambitions have advanced to the point that they now say they won't buy certain loans unless their automated underwriting systems are used. These actions will have consequences.

Duopoly control leads to less competition. The GSEs can throttle private sector innovation by refusing to buy new products. Millions of homeowners who apply for conforming mortgages are losing the opportunity to choose cutting edge products introduced by private companies that would put more money into consumers' pockets. Fannie Mae and Freddie Mac have already decided that their products are better simply because those products boost their earnings. The GSEs can use their federal subsidies and duopsony power to drive down the profitability of the mortgage business, forcing private competitors to abandon the mortgage business. Less competition will give the GSEs even more market control than they have already, stifling the free market forces that assure cost savings and efficiencies are passed to the consumers instead of shareholders. Over time, consumers will not be able to find a "better deal" than a GSE loan because they will have no choice. If Fannie Mae and Freddie Mac extend their reach into new lines of business, such as home equity lending, insurance, and other products, the same thing will happen.

Dominance of both mortgage purchases and automated underwriting by the same duopoly is undermining mortgage competition. In the words of the Congressional Research Service,

"the charter used to correct one market failure can, if maintained, result in monopoly and a new misallocation of resources. . . . Once the assigned market has been saturated by the GSEs, the incentive remains to increase profits by increasing the extent of the subsidy. Attempts to enter other markets are logical to the corporation, regardless of whether any market failure exists in those markets. . . . Indeed, to the extent that a subsidized monopoly (or duopoly) captured a new market sector, economic theory indicates that the economy would be worse off than before."<sup>3</sup>

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<sup>3</sup> "Government-Sponsored Enterprises: The Issue of Expansion Into Mission-Related Business," *Congressional Research Service*, January 19, 1999.

Reliance on one or two automated “black box” underwriting systems can also produce unintentional discrimination. Many otherwise qualified borrowers could be left by the wayside because they do not fit the standard Fannie Mae/Freddie Mac mold. An independent report prepared for HUD found that Fannie Mae’s and Freddie Mac’s guidelines may be discriminatory, and do not serve low- and moderate-income minority borrowers as well as some private systems.<sup>4</sup> “Technology is a valuable tool, but the systems are only as good as the models they are built on, the data they use, and the people who interpret the data. An open, readily accessible network that will accept all of the automated underwriting systems offered by insurers, investors and [lenders] alike should be available. Competition among various systems will lead to better, fairer lending decisions.”<sup>5</sup>

Competitive underwriting systems also provide underwriters with a market check on risk. In a world dominated by two, not-very competitive systems, the GSEs don’t receive normal market signals that would check whether the risk they are assuming is appropriately priced. If their systems prove wrong, losses will mount, and taxpayers may be asked to pick up the tab.

It is long past due for policymakers, the media, and those concerned with making home ownership affordable to scrutinize these industry giants who want to exploit their unfair market power and subsidies to grow even larger at the expense of others. Rigorous competition checks risk and lowers costs to consumers. The housing enterprise duopolists must not be allowed to use their subsidies to crush the competition that has given the U.S. the most efficient and affordable mortgage and consumer financial services market in the world. *The time has come for policymakers to restrain the GSE giants – cutting short an alarming trend to nationalization that will harm consumers, taxpayers, and industry.*

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<sup>4</sup> “A Study of the GSEs’ Single Family Underwriting Guidelines,” *The Urban Institute*, April 1999.

<sup>5</sup> Comments by G.T. Barmore, [retired Chairman,] GE Capital Mortgage Corporation, *Urban Land*, November 1996.

## ***PART I:***

### **FEDERAL SUBSIDIES CUT GSE COSTS AND OPEN NEW MARKETS**

#### **The Early History: A Job Well Done**

In 1968 the mortgage finance industry was fragmented and illiquid. Families in some areas of the country could acquire financing only at steep rates due to insufficient deposits in local savings and loan institutions. Simultaneously, other savings and loans elsewhere had surplus funds and faced a shortage of qualified borrowers. Savings and loans also had to hold mortgage loans for their accounts for extended periods of time because there were no cost-effective way to sell them to other parties.

In 1968, President Johnson and Congress decided to act by spinning off the Federal National Mortgage Association (“Fannie Mae”), an agency inside the newly created Department of Housing and Urban Development, as a for-profit corporation. Reflecting its origins as a federal entity, the new privately owned company was granted a federal corporate charter and several unique powers. At the same time, this charter restricted Fannie Mae’s scope of activities to supplement the secondary market for residential mortgages, and required that public officials sit on its corporate board.

The Fannie Mae charter provided it with these special advantages and exceptions:

1. They have lower capital requirements than other financial institutions, and therefore can maximize the use of leverage.
2. They enjoy a lower cost of capital, either through direct access to the Treasury, or in the debt markets, where they are perceived to have implied government backing. The “implied federal guarantee” of their debt allows them to issue bonds whenever they find a need for funds, regardless of market conditions, at interest rates lower than those granted to the best fully private companies. Fannie Mae and Freddie Mac have doubled their outstanding long-term debt in less than two years.
3. Federal support allows them to increase their financial flexibility by issuing callable long-term debt.
4. They are exempt from state and local taxes.
5. They are exempt from filing with the SEC, saving both the expense of filing and the time needed to compile and write SEC disclosures. SEC exemption gives the GSEs the advantage of not having to properly disclose their financial data on a timely basis, and exempts them from laws such as the Foreign Corrupt Practices Act.
6. With an “implied federal guarantee” of GSE debt, private investors do not judge them with the same risk standard, providing a benefit to both their debt and their stock. The high leverage that they employ gives the GSEs exceptional returns on equity.
7. Their exclusive charters ensure their duopoly status.

In return, Fannie Mae was expected to smooth out the regional differences in mortgage credit availability and offer mortgage bankers a ready market to sell their loans at fair prices. This sale feature would allow the lenders to reliquify their balance sheets, permitting them to issue new mortgages, and to raise the return for lending to homeowners.

Freddie Mac has a similar history. It was created in 1970 as an affiliate of the Federal Home Loan Bank System. The Nixon Administration felt that Fannie Mae needed a competitor and that S&Ls needed a ready market to fund their mortgages. In 1988, Freddie Mac became a publicly traded corporation with a federal charter.

The early history of Fannie Mae and Freddie Mac shows how carefully coordinating government and private action advances public goals. Backed by Federal Government financial support, the GSEs played an essential role in developing the secondary mortgage market. The company perfected the design of the “pass through certificate,” which bundles individual mortgages into investment pools that are "cut up" and sold in the debt market, mostly to large institutional investors but also to mortgage lenders with excess funds. Lenders with local deposit shortages gained the ability to sell their mortgages to raise cash and relend. As a result, regional differences in mortgage loan availability long ago became a thing of the past. Furthermore, the guaranteed ability to resell mortgage loans drew more companies into the market, lowering home mortgage interest rates and making the market more efficient. These historic achievements are to be applauded. If only they had known when to stop. Now their duopoly muscle threatens to cause market inefficiencies.

### **From Little Acorns, Big Trees Grow**

In 1986, Fannie Mae reported total assets of \$100 billion and sold \$61 billion of mortgage backed securities (MBS). Freddie Mac had total assets of \$23 billion and issued \$100 billion of mortgage pass-through certificates. At year-end 1998, the two now had \$806 billion in assets and had over \$1.1 *trillion* in MBS outstanding! For the time being, they are second only to the federal government in debt securities outstanding. Under current trends, they will surpass the federal government by 2005.

**Table One: Key '97-'98 Financial Statistics for Fannie Mae and Freddie Mac**

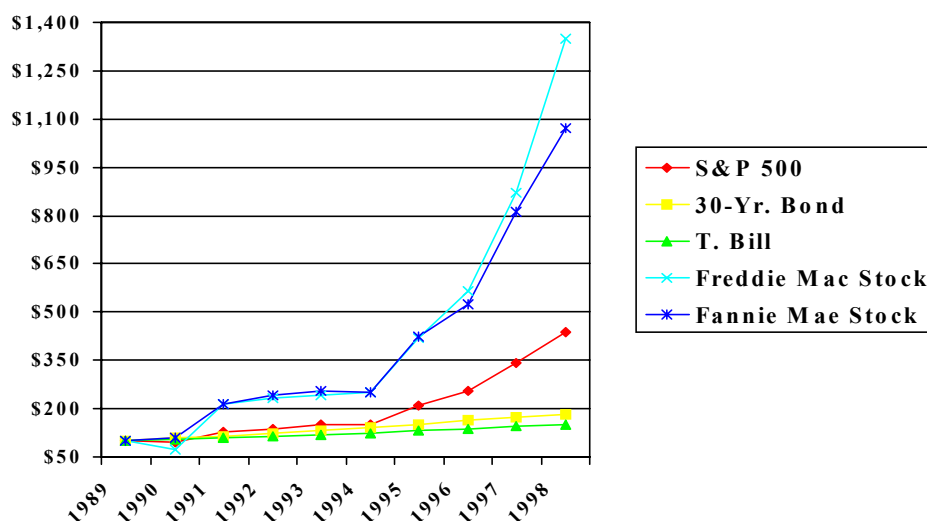
(\$ in billions)	Fannie Mae '97	Freddie Mac '97	Total 1997	Fannie Mae '98	Freddie Mac '98	Total 1998
<b>Total Assets</b>	\$391,673	\$194,597	\$586,270	\$485,014	\$321,421	\$806,435
<b>Guaranteed MBS</b>	\$579,138	\$579,385	\$1,158,523	\$834,518	\$646,459	\$1,480,977
<b>Stockholders Equity</b>	\$13,793	\$7,521	\$21,314	\$15,453	\$10,835	\$26,288
<b>Earnings</b>	\$3,056	\$1,395	\$4,451	\$3,418	\$1,700	\$5,118
<b>Return on Equity</b>	25%	22%		25%	24%	

Source: MBS includes GSE portfolio holdings of \$233 billion in 1997 and \$365 billion in 1998 as reported in Fannie Mae, Freddie Mac 1997 and 1998 annual reports; OFHEO.

### **Comprehensive Advantages Generate Exceptional Windfalls for GSE Shareholders**

It is well known that the stock market has generated remarkable returns over the last decade. The GSEs, however, have outdistanced the S&P 500 handsomely over the period. From 1988 to 1998, Fannie Mae and Freddie Mac achieved returns that were over 250% higher than the S&P 500. Over 40% of the profits earned by Fannie Mae and Freddie Mac come from government subsidies. This subsidy “kicker” has kept their stock among the top performers:

**Table Two: Yield of \$100 in Fannie Mae and Freddie Mac Stock vs. Other Investments**



Source: Standard & Poors Compustat; Intrinsic Value Associates, LLC; Council of Economic Advisers

Another way of demonstrating the power of these special advantages is to compare the GSEs' financial results with those of institutions they most resemble that do not enjoy special favors. Stock investments in these two GSEs show the highest five-year and ten-year returns among all large financial companies:

**Table Three: Comparative Stock Returns of Financial Companies Worth \$45 billion+ Ranked by Ten-Year Average Annual Rate of Return (Appreciation + Dividends)**

Company	Market Capitalization	One-Year Return	Five-Year Return	Ten-Year Return
<b>Fannie Mae</b>	\$76 billion	31.7%	33.6%	36.1%
<b>Freddie Mac</b>	\$45 billion	55.1%	40.9%	33.8%
<b>Citigroup</b>	\$112 billion	-6.8%	32.7%	31.8%
<b>Wells Fargo</b>	\$66 billion	5.0%	30.2%	29.6%
<b>First Union</b>	\$60 billion	22.1%	28.4%	23.3%
<b>Chase Manhattan</b>	\$60 billion	32.9%	32.6%	21.7%
<b>Bank One</b>	\$60 billion	6.5%	15.7%	20.5%
<b>BankAmerica</b>	\$104 billion	1.3%	23.2%	19.8%
<b>American Express</b>	\$46 billion	15.7%	33.2%	19.1%

Source: L.E.K. Consulting LLC, as reported in the *Wall Street Journal*

Returns this high were not generated by exceptional executive skill or the development of innovative products. Rather, the GSE management exploited the seven subsidies and pocketed 45% of the related profits. In 1995, the CBO calculated how much of the GSEs' profits resulted from just a few of these seven subsidies. It concluded that 42%, or \$2.1 billion, was due solely to preferential federal legislation. If the CBO were to undertake the study now, the corresponding figures now would be 45%, or \$3.1 billion:

**Table Four: Fannie Mae and Freddie Mac Subsidies**

	1995	1998
<b>Average Combined Debt Outstanding</b>	\$384.0	\$644.8
<b>Debt Subsidy (70 bps-Fannie/68bps-Freddie)</b>	\$2.7	\$4.5
<b>Average Combined MBSs Outstanding</b>	\$945.2	\$1,078.1
<b>MBS Subsidy (40 bps)</b>	\$3.8	\$4.3
<b>Total Subsidy</b>	\$6.5	\$8.8
<b>Conforming Mortgages Financed</b>	\$1,249.0	\$1,612.4
<b>Subsidy pass-through (35 bps)</b>	\$4.4	\$5.6
<b>Subsidy retained (\$)</b>	\$2.1	\$3.1
<b>GSE Pre-tax Income</b>	\$4.9	\$7.0
<b>Subsidy retained (% of Pre-tax Income)</b>	42%	45%

1995 data and subsidy rates are from the CBO Study; 1998 average balances are averages of 1997 and 1998 year-end balances

Their \$9 billion worth of subsidies fuel a duopoly engine that can vanquish any private competitor and allow the GSEs to keep prices high in their protected markets. The GSEs were major buyers of their own securities. Their balance sheet grew with assets that represented little incremental increase in homeownership, but boosted their interest rate and credit risk sensitivity, putting the taxpayer at risk for a future federal bailout. The GSEs' 1998 subsidy used following tactics to rapidly build assets:

### **The Housing GSEs Arbitrage Their Subsidized Debt for Profit**

Given their close federal ties, investors believe that the government will never allow either Fannie Mae or Freddie Mac to default on their debt obligations. This has long been known as an “implied guarantee.” Its usefulness to the GSEs is unquestioned. If the federal government is standing behind the GSEs, then creditors feel secure in treating their debts as if the issuer is, in fact, the federal government. Consequently, investors purchase this debt at interest rates only slightly above the U.S. Treasury rate. The GSEs are then free to take these funds and invest them in securities that have no direct or implied federal guarantee and so pay a much higher interest rate. The difference between the interest rate the GSEs pay for their subsidized debt and the interest rate they earn from the investments they buy is their “arbitrage profit.”

Most of the arbitrage profit comes from purchasing mortgages as intended. Borrowing with the government's credit card is very profitable. The interest “spread” enjoyed by the GSEs is much more profitable than that available to commercial banks because banks have to borrow without being backstopped by the federal government.

The GSEs, however, also used their unique access to unlimited credit at the cheapest rates in town for reasons having nothing to do with housing. In June 1997, the General Accounting Office (GAO) reviewed the investment practices used by Freddie Mac and Fannie Mae. The GAO presented its findings to House Banking Committee Chairman Jim Leach, who had requested the study after he learned that Freddie Mac had used GSE-backed funding to purchase \$340 million in Phillip Morris bonds. GAO declared that “non-mortgage investments were more than double Freddie Mac's capital and more than four times Fannie Mae's capital.” Following up this review with a full examination, GAO released a report in March 1998 that focused on the non-mortgage investment practices of Fannie Mae, Freddie Mac, and Farmer Mac. GAO concluded that the purchase of some long-term securities was clearly generating arbitrage profits unrelated to housing finance.

## Subsidized Debt is Fueling Asset Growth

One easy road to riches is to maximize the use of arbitrage, and this is the path that the GSEs have taken. As Senator Dirksen might have said, "Earning a 2% arbitrage profit on \$100 billion here and \$100 billion there and pretty soon you are talking about real money." In 1998, Fannie Mae and Freddie Mac liberally used their access to an almost limitless amount of inexpensive credit, borrowing an incredible \$3.0 trillion when rolled over short-term and long-term debt is combined. This easily outpaced the U.S. Treasury that borrowed or rolled over \$2.0 trillion. As reported by OFHEO, these funds were used to purchase \$910 billion of mortgages and mortgage backed securities (MBS).

**Table Five: Fannie Mae and Freddie Mac MBS and MBS Investment Growth**

(\$ in billions)	Fannie Mae			Freddie Mac		
	Total Mortgage Backed Secs.	MBS Held in Portfolio	Portfolio Investments/MBS Outstanding	Total Mortgage Backed Secs.	MBS Held in Portfolio	Portfolio Investments/MBS Outstanding
<b>Dec-93</b>	\$496	\$24	4.8%	\$455	\$15	3.3%
<b>Dec-94</b>	\$530	\$44	8.3%	\$491	\$31	6.3%
<b>Dec-95</b>	\$583	\$70	12.0%	\$515	\$56	10.9%
<b>Dec-96</b>	\$651	\$103	15.8%	\$554	\$81	14.6%
<b>Dec-97</b>	\$710	\$130	18.3%	\$579	\$103	17.8%
<b>Dec-98</b>	\$835	\$197	23.6%	\$646	\$168	26.0%

Source: Fannie Mae and Freddie Mac 1997 and 1998 Annual Reports. Total MBS includes GSE portfolio holdings.

Many of these mortgages were packaged into mortgage backed securities. As shown above, however, the big change in 1998 was the growth of GSE mortgage investment portfolios. The GSEs are issuing MBS and then buying them back for their own investment portfolios. *When the GSEs buy their own securities, they are not expanding homeownership opportunities. They are buying securities comprised of mortgage loans that have already been closed, and are priced at rates to attract private investors.* This strategy can be summarized as: Borrow and buy, then keep the spread.

**Table Six: Fannie Mae and Freddie Mac Asset/MBS Growth, 1993 - 1998**

(\$ in billions)	Fannie Mae			Freddie Mac		
	Total Liabilities	Mortgages/Investments	Mortgage Backed Securities	Total Liabilities	Mortgages/Investments	Mortgage Backed Securities
<b>Dec-93</b>	\$209	\$211	\$495	\$78	\$74	\$407
<b>Dec-94</b>	\$263	\$267	\$530	\$100	\$91	\$443
<b>Dec-95</b>	\$306	\$310	\$583	\$130	\$120	\$517
<b>Dec-96</b>	\$338	\$342	\$651	\$166	\$160	\$554
<b>Dec-97</b>	\$378	\$381	\$710	\$182	\$181	\$579
<b>Dec-98</b>	\$470	\$473	\$835	\$312	\$298	\$646
<b>% change '97-'98</b>	24.3%	24.2%	17.6%	71.4%	64.6%	11.6%

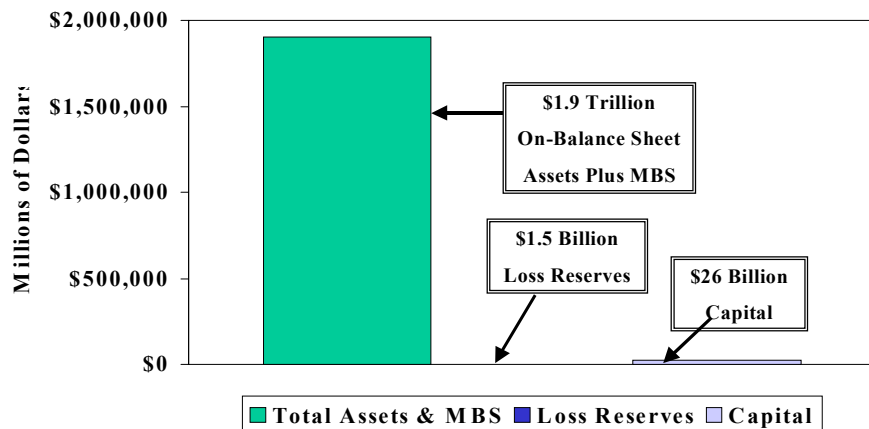
Source: Standard & Poors Compustat; Intrinsic Value Associates, LLC; Fannie Mae and Freddie Mac 1998 Annual Report; OFHEO; Freddie Mac Total Liabilities include Subordinated borrowings; Mortgage backed securities outstanding include MBSs held by the GSEs in their investment portfolios

The GSEs' MBS buying spree has made them the largest mortgage portfolio lenders in the U.S. According to OFHEO, Fannie Mae and Freddie Mac own more mortgages than the entire thrift industry. Today, the GSEs aggressive pursuit of their own assets is driving private capital away from the housing sector and concentrating risk in the two GSEs.

## The GSEs Make Maximum Use of Leverage

When corporations that do not receive preferential treatment want to expand, they have to raise equity capital to balance any new debt obligations they take on. Otherwise, lenders will demand increasingly higher interest returns as their creditworthiness approaches “junk” status. The GSEs do not face the same constraints as other private corporations. Due to their implied guarantee, lenders do not compel them to raise equity capital when they go on a borrowing spree. Instead, regulators are given the job of assessing appropriate capital standards. Their regulator, the Office of Federal Housing Enterprise Oversight (OFHEO) recently completed a long awaited proposed rule on the subject. Although Fannie Mae believes OFHEO has acted improperly, the truth is that the agency has been lenient because of the flawed statute under which OFHEO is required to regulate the GSEs. This statute allows the GSEs to maintain loss reserves that are less than .001% of their mortgage loan and MBS exposure and only 1.5% of aggregate mortgage investments and MBS. Also, the GSEs operate with excessively low equity capital requirements. At the end of 1998, Fannie Mae and Freddie Mac had combined capital of \$26 billion, equal to only 1.5% of their aggregate mortgage investments and mortgage backed securities exposure. By comparison, banks and other insured financial institutions had risk-based capital equal to 12.4%.<sup>6</sup>

**Table Seven: Capital and Reserves Supporting the 1998 Housing Enterprise Asset Base**



This disparity in capital gives the GSEs the means to boost its return on equity. If a bank and a GSE earn the same profit, the GSE achieves a higher return on capital, or equity committed to support the institution’s financial strength. The calculation showing the effect of higher capital (1.5% for GSEs, 12.4% for banks) on the return generated from a million-dollar profit follows on the next page:

<sup>6</sup> FDIC Quarterly Banking Profile, Second Quarter 1998.

**Table Eight: The Effect of Lower Capital Levels on Return on Capital**

	GSE	Bank
<b>Profit</b>	\$1,000,000	\$1,000,000
<b>Capital (1.5% GSE/12.4% bank, expressed as \$millions)</b>	\$1,500,000	\$12,400,000
<b>Return on Capital (Profit/Capital)</b>	67%	8%

By committing less equity to support equivalent earning assets, the GSEs can produce higher returns on equity than fully private financial companies. In 1997, the top fifteen U.S. financial institutions achieved an average return on equity (ROE) of 16%, with the most profitable companies reaching 19% to 20% ROE. With their capital subsidy, the GSEs consistently return more than 20% on their equity.

Excessive leverage helps to send returns to private shareholders soaring when times are good. However, it needlessly puts taxpayers at risk by raising both the likelihood of a federal bailout and the cost of making good on GSE debt obligations. The size and market dominance of Fannie Mae and Freddie Mac will be used to justify a government bailout when the need arises someday. To minimize the risk of such a catastrophe, Congress ordered the GSEs' regulator, OFHEO, to create risk-based capital guidelines for Fannie Mae and Freddie Mac. OFHEO completed its draft regulation in 1998, but its publication was held up for months by bureaucratic delays – and possibly political pressure from Fannie Mae.

OFHEO's risk-based capital model incorporates a "stress test" that projects whether or not Fannie Mae and Freddie Mac remain solvent if the economy takes a severe downturn or interest rates soar suddenly. To comply with their regulator's stress tests, the GSEs will be counting on their implied federal government support to give them the market access and investor confidence to issue debt whenever they need it. They will take advantage of government subsidies to keep their interest costs low and give them flexibility in managing their capital structure.

### **The GSEs Have Unique and Ready Access to Callable Debt**

The GSEs enjoy yet another financial advantage: the unusual opportunity to issue inexpensive callable debt. Callable debt issues have a provision that allows the borrower to repay the debt before it matures. This is an important right when interest rates are falling. It allows the GSEs to repay the investors that purchased callable bonds, then issue new debt at lower interest rates without penalty. As described by the Congressional Budget Office, "(federal government) sponsored status also enables GSEs to issue callable debt that is regarded as free of the risk of default. That quality of credit makes those securities much easier to sell than callable debt offered by private firms. The lack of comparable private issues is part and parcel of the advantages of GSE status to the enterprises."<sup>7</sup> Some private companies have issued callable securities. However, according to a New York money manager quoted in a February 1999 story for *Dow Jones Newswires*, "There's very little trading volume. They're okay for individuals who bought them (as new issues), but for institutions, there's just not enough liquidity."

Fannie Mae Vice Chairman, Jamie Gorelick, specifically identified the importance of callable debt in a February 19, 1999 letter to the Office of Management and Budget: "We employ interest-rate risk management tools and financial instruments, such as callable debt, that enable us to closely match the duration of our assets and liabilities. Depository institutions do not have access to callable debt, and

<sup>7</sup> "Assessing the Public Costs and Benefits of Fannie Mae and Freddie Mac," *Congressional Budget Office*, May 1996.

therefore they cannot structure their businesses as we do to manage risk.” Fannie Mae and Freddie Mac issued \$181 billion of callable debt in 1998 – over half of the net funds raised. The Federal Home Loan Banks, another housing GSE not regulated by OFHEO, issued another \$177 billion.

Without an implied government guarantee, private firms cannot depend on callable debt as a reliable source of financing.

### **The GSEs Have a Permanent Tax Holiday**

It turns out that the expression, “Nothing is certain but death and taxes” is wrong. The two housing GSEs are exempt from state and local income taxes. The exemption from District of Columbia taxes saves Fannie Mae \$300 million a year. Freddie Mac’s exemption from Virginia income taxation allows it to send shareholders and Freddie Mac executives an additional \$100 million a year.

### **The GSEs are Exempt from SEC Registration Requirements**

Preparing audited and certified financial statements necessary to pass SEC muster is expensive. Filing fees used to defray SEC expenses are costly as well. The SEC treats the GSEs as if they were the U.S. Treasury. If there is no chance of default, due to the implied guarantee, why make the registrants file?

History shows us why. In 1994, Orange County, California declared bankruptcy when rising interest rates caused its GSE-concentrated investment portfolio to lose nearly \$1.6 billion. Orange County claims that GSEs, including Fannie Mae and Freddie Mac, failed to adequately disclose the risks involved with their securities. Merrill Lynch, the firm that sold the GSE securities to Orange County, eventually paid a \$420 million settlement related to the bankruptcy.

Today, investors are buying billions of dollars of GSE securities, counting on the safety and soundness provided by the “implied federal guarantee.” A growing number of these investors are foreign, and may well not understand how GSEs are structured. At the same time, the GSEs are flooding the debt markets, raising funds to purchase mortgage assets that increase their interest rate risk and credit risk sensitivity. They are entering into new ventures with unmeasured risk profiles. The need for SEC compliance for Fannie Mae and Freddie Mac is more pressing than ever.

### **The GSEs’ exclusive charters ensure their duopoly status**

The exclusivity of their charters ensures that no other private player in the marketplace can compete against the duopoly. The GSEs’ charters give them substantial advantages in pricing, liquidity, tax and regulatory exemptions that add up to a package which reinforces their duopoly position. Their duopoly control over the market gives them the ability to dictate price, terms and conditions to borrowers and market participants. Only a GSE can compete against a GSE.

**PART II:**

**GSE GROWTH PLANS UNDERMINE PRIVATE INDUSTRY AND HARM CONSUMERS**

**The Liberators Are Becoming the Dominators**

Fannie Mae and Freddie Mac have grown to dominate the conforming market that they were chartered to support. Their 1998 loan purchases of \$621 billion represent a 64% share<sup>8</sup> of their immediate market.

**Table Nine: Fannie Mae/Freddie Mac Loan Purchases and Market Share**

<b>(Loan data in \$billions)</b>	<b>1997</b>	<b>1998</b>
Conforming Mkt, net of FHA/VA/RHS government programs	\$481	\$978
Mortgage Purchases	\$280	\$621
Increase in GSE Purchases	17.1%	121.8%
GSE Purchases/Conforming Market net of government programs	58.2%	63.5%
Conforming loan limit for a mortgage	\$214,600	\$227,150

Source: SMR Research Corporation, OFHEO; GSE loan limit is the amount in effect for the greater part of the year, since increases are announced intermittently

They stretch their boundaries when the conforming loan limit rises. Since 1996, the loan limit has increased by 16%, from \$207,000 to \$240,000. These rapid conforming loan limit increases have expanded the GSEs' market reach, and the GSEs have suffered only slight dilution of their market share. The higher loan limit of \$240,000, put into effect in January, will continue to enlarge the market that Fannie Mae and Freddie Mac dominate.

In January 1999, the Congressional Research Service published its own conclusions about how Fannie Mae and Freddie Mac are discouraging competition:

“Because their costs are lower than for non-favored companies, GSEs can reap greater-than-competitive profits, even while undercutting pricing of potential competitors. . . . In short, the special charters confer benefits on the GSEs that increase in value as a company’s business volume and risk increase. This leads to incentives not only to dominate the assigned market but also to expand into related markets to the detriment of efficient competitors that do not have GSE charters.”<sup>9</sup>

<sup>8</sup> GSE market does not include FHA/VA/RHS loan closings. (See Tables 12 and 13.)

<sup>9</sup> “Government-Sponsored Enterprises: The Issue of Expansion Into Mission-Related Business,” *Congressional Research Service*, January 19, 1999.

## **The GSE/Lender Relationship is Evolving**

The secondary market created by Ginnie Mae (FHA/VA), Fannie Mae and Freddie Mac gave lenders a way to sell the loans they originated, creating a new source of liquidity for lenders. Most mortgage lenders and servicers understood the GSE “public mission” to be one of assuring the availability of affordable mortgages for American homebuyers through active support of the secondary mortgage market. Under these terms, private lenders forged cooperative sales relationships with GSEs that profited both parties. Lenders liked the flexibility and instant liquidity provided by the GSE-dominated secondary market. It increased their options.

In the nineties, things changed. The lenders were told that Fannie Mae and Freddie Mac have a far-reaching public mission allowing them to enter almost any line of business. The Mortgage Bankers Association recently polled its members, and found that 71% believe that Fannie Mae and Freddie Mac plan to originate business directly from homebuyers.

Today, the GSEs’ overwhelming market presence is giving lenders and consumers fewer choices, not more. Lenders learn that if they do not use the GSEs’ proprietary underwriting systems, they must take back more risk when they sell their loans --or they can forget selling the loans to the GSEs. Consumers who do not fit the GSE “black box” automated underwriting (AU) model either pay a higher interest rate or get no loan at all. Other consumers never find out about innovative new programs being developed in the mortgage industry, because the GSEs kill the product by refusing to buy the loans.

Lenders are discovering that Fannie Mae’s growing “brand name” identity with consumers and brokers, especially through their online pipeline, MornetPlus, is developing GSE “distribution networks,” which means loans are referred to them only if they agree to “do business the GSE way.” Freddie Mac uses the Internet, but like Fannie Mae, they are leveraging their duopoly power to more quickly vertically integrate the mortgage industry and expand horizontally into new lines of business. The GSEs’ actions will displace lenders in the mortgage process, reducing their roles to keypunchers and servicers. Over time, GSE expansion plans will exert control over real estate appraisers, brokers, realtors, and other professionals now being invited into “partnerships” with the GSEs.

## **Technology is the Duoplies’ Force Multiplier**

Fannie Mae and Freddie Mac are using technology to automate their services, broaden product offerings sold over their technology pipelines, and eventually gain controlling market share in any line of business they choose to enter. Their special status and indirect federal subsidies allows the GSEs to demand that their systems and software become the market standard if lenders want access to the conforming secondary market.

The GSEs began by inducing lenders to use their automated systems by temporarily waiving certain financial commitments normally required of lenders, such as a reduction in processing fees they must pay, or a waiver of certain “representations and warranties” lenders have been required to make, or volume discounts and rebates – incentives that no other private competitor could offer. The GSEs’ ambitions have now advanced to the point, however, that they say they won’t buy certain loans unless their AU systems are used. Once the GSEs’ market dominance is assured, then they raise prices to exploit their market position, sometimes above what the market might otherwise have charged consumers.<sup>10</sup>

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<sup>10</sup> “Mortgage Automation Threat,” *The Region*, Ron Feldman, Federal Reserve Bank of Minneapolis, December 1996.

AU uses statistical methods to evaluate the creditworthiness of a loan applicant by comparing the loan data to others with similar loan structures, property, and credit characteristics. The GSEs' automated underwriting systems, which now command a 95% market share, are being used by mortgage lenders for over 50% of the loans purchased by Fannie Mae and Freddie Mac. Since the GSEs are allowed to keep their data nontransparent, the duopoly is able to use their "black box" automated underwriting systems to continually redefine the mortgage product to fit their market expansion goals. These systems are the GSEs' most effective tool for extending their public mission into new products and services. Their "black box" AU systems allow the agencies to downscale their credit-scoring models and penetrate a variety of new mortgage market sectors, such as alt-A, A-, and low-downpayment loans. Together, they these new markets will almost double the universe of mortgages they can buy.<sup>11</sup>

AU increases the GSEs' control of the mortgage process, thereby enhancing their leverage over lenders, appraisers, title insurers and others the mortgage closing and servicing process. In the past, lenders did their own evaluation of loans, conforming to the standards set in the secondary market, then brought them to the GSEs. Now, lenders are using statistical models designed by the GSEs to determine loan feasibility for over 50% of residential loans. The GSEs apparently feel that independent credit, title, and appraisal judgement are no longer needed to sell a loan in the secondary market; their systems are assuming the underwriter's role. The loan processors just pay a fee, put numbers into their computers, and read the result. The following are examples of GSEs' use of technology to link and control the mortgage process. Once their systems are fully deployed, the GSEs will use their "technology pipeline" to more quickly vertically integrate the mortgage industry and expand horizontally into new lines of business, charging consumers hidden "user fees" along the way. Competitive products are being driven from the market in the GSEs quest to boost their returns to shareholders.

- In 1998, Fannie Mae partnered with Finet Holding Company to create [www.iQualify.com](http://www.iQualify.com), an Internet gatekeeper that uses Fannie Mae's AU to qualify its applicants. iQualify loans are referred to a group of affiliated lenders who agree to accept the on-line AU. iQualify is also linked directly to realtors, who can secure loans for homebuyers through the website.
- Freddie Mac is piloting an online system for the [www.multilender.com](http://www.multilender.com) website.
- Fannie Mae has invested in Homestore.com, the owner of [www.realtor.com](http://www.realtor.com), a premier Internet site affiliated with the National Association of Realtors. It carries over 90% of the homes listed in the United States, claims a 25% homebuyer market share, and has distribution arrangements with AOL, Netscape, Netcenter, Excite, Infoseek and Lycos.
- In March 1999, the Lenders Interactive Online Network (LION) announced a program to automate transactions between mortgage brokers and lenders with Fannie Mae technology. Brokers will have direct access to Desktop Originator and Desktop Underwriter through LION's web portal ([www.lioninc.com](http://www.lioninc.com)).
- The GSEs' Internet strategy puts them in position to establish their brand name and reach directly consumers who have the knowledge and equipment to shop on the world wide web. Forrester Research predicts that the web mortgage market will grow from \$20 million this year to almost \$100 million by 2003.

According to Morgan Stanley Dean Witter, Fannie Mae's CEO Franklin Raines has described the automated underwriting system as the "killer app" of the mortgage industry – meaning a technology that revolutionizes how business gets done in a particular sector, thus providing an important competitive

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<sup>11</sup> "Mortgage Finance: Rates are Up, But Mortgage Industry Looks Strong," Morgan Stanley Dean Witter, July 9, 1999.

advantage to the firm that controls it.<sup>12</sup> The GSEs maintain their hold on this new “killer app” by restricting access to the information and evaluation methods their automated systems use to make an approval decision and by declining to make their approved loan data available to the public. Their “black box” has unquestioned authority to approve or decline loans. Loan applicants, particularly those with low credit scores from the GSEs’ automated systems, have little recourse or appeal. This is wrong. Government subsidies helped pay for the systems the GSEs plan to use to control their markets. *The GSEs’ systems should be open and data that affects the lives of millions of homeowners should be transparent and available.*

GSE dominance of AU and increased control over loan referrals has threatened to turn conforming mortgage lenders into a role of providing routine tasks while control over business decisions and the associated profits shift to the GSEs. Lenders/servicers will then depend on the GSEs to provide a stream of business from the GSEs’ distribution systems; they will lose their independence as well as a portion of their existing business. The credit approval decision will be given through a “black box” approval system and without their input, so today’s lenders and servicers will operate with the primary goal of protecting their diminished franchises by staying in the good graces of the GSEs who will decide the amount of business they receive and the terms on which it will be given.

The strategic alliances that Fannie Mae and Freddie Mac are forming with brokers, realtors, and Internet gatekeepers will evolve into similar dependency relationships as the GSEs gain more control over loan approval, consumer contact and distribution. Ultimately, the GSEs, acting as a central clearing houses, will be the central repositories for information on homes with links to the necessary service providers, like mortgage insurers, servicers, lawyers, or others.<sup>13</sup> They will then use their market power and technological dominance to penetrate deeper into the mortgage market, enter others, and then leverage their subsidies to undermine their new competitors.

When the GSEs’ position in the AU market is firmly established, it will be difficult to break up Fannie Mae’s and Freddie Mac’s duopoly control over the market. Once the GSEs’ systems are incorporated in the loan approval process, it will be costly for originators to switch to an alternative system because of the high transaction costs.<sup>14</sup> Ultimately, however, consumers will have fewer product choices and face higher prices than otherwise would have been charged in a competitive environment.

### **Automated Systems, New Consumer Focus Undermine Mortgage Competition**

Fannie Mae and Freddie Mac are undertaking expansion plans that alter their relationship with the lenders they were chartered to support. As these traditional GSE/customer roles are redefined, lenders that have originated loans for the secondary market are finding that their federally supported GSE financial intermediaries are now competitors with billion dollar subsidies to buy their way into new lines of business. While developing the secondary mortgage market, the GSEs cultivated lenders as key customers – their source of loans that they packaged to sell to investors as mortgage backed securities. By building direct access to the homeowning consumer, the GSEs’ focus is shifting to new customers. The GSEs now define their mission as serving consumers any way possible, even to the detriment of the traditional GSE customers – lenders.

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<sup>12</sup> “Government Sponsored Enterprises – Technology Usage Ramping Fast; Look for Growing Fee Income,” Morgan Stanley Dean Witter, February 22, 1999.

<sup>13</sup> Fannie Mae’s Chief Technology Officer, Mike Williams, stated that it’s a matter of “connecting all of the databases of information at one place;” “NetTrends: The Elusive Push-Button Home Purchase;” *Reuters*, July 20, 1999.

<sup>14</sup> “Mortgage Automation Threat,” *The Region*, Federal Reserve Bank of Minneapolis, December 1996.

The healthy relationship between the GSEs and private lenders has eroded as Fannie Mae and Freddie Mac have taken their eyes off their traditional customers – the lenders. From the beginning of the secondary market, the two GSEs have competed to purchase loans from lenders by offering the best price and the cleanest execution. GSEs are giving priority to their new customer – the consumer. Their old customers, lenders turned “order takers,” are the partners they use to reach the consumer.

This new GSE strategy makes the consumer more aware of Fannie Mae and Freddie Mac. In the past, a borrower compared lenders, and chose the one that offered the best combination of interest rate and service. This borrower usually did not know if the lender would sell his mortgage to a GSE, or which GSE would buy the loan. He did know that the lenders were able to provide him an affordable loan. The consumer outreach programs of Fannie Mae and Freddie Mac employ several important tactics:

- Set up partnership agreements with lenders that assure a steady flow of secondary market product and allow the GSE to widen its marketing scope;
- Use Internet and MornetPlus web sites to reach browsing consumers directly;
- Make “loan pre-approval” based on a proprietary underwriting model readily available on the Internet, encouraging loan “pre-selection” through GSE automated underwriting systems;
- Tell consumers about GSE-specific loan programs to direct them to lenders that will originate that product;
- Create new loan programs that “cross-sell” other GSE fee opportunities. For example, the GSEs are collecting additional credit enhancement fees for high-LTV programs that cut mortgage insurance coverage, and are collecting “user fees” on a variety of loan products;
- Require GSE proprietary automated underwriting with such special loan programs, permanently tying that loan to the GSE that provided the underwriting;
- Refuse to buy competing products that save consumers more than similar GSE products do;
- Sponsor homeownership and charity initiatives through foundations that raise each GSE’s name identity with the general public;
- Use direct advertising to raise brand name awareness; in 1998, Fannie Mae and the Fannie Mae Foundation together spent \$34.5 million on advertising; and
- Protect their subsidies through lobbying and building comfortable relationships with legislators.

By tying the mortgage loan to new products, the GSEs broadly expand their fee income potential. This can be seen with the new 97%-90% LTV loan products, introduced by Fannie Mae and Freddie Mac as loans that would serve the low/mod income markets.

**Table Ten: A Comparison of GSE High LTV Product to Standard Industry Product**

<b>GSE Flex/Alt 97%-90% LTV Programs</b>	<b>Standard Conforming Mortgage</b>
• <i>GSE Automated Underwriting required, with GSE earning an underwriting fee</i>	• <i>GSE will earn underwriting fee only if lender chooses GSE AU</i>
• <i>Delivery fee paid to GSE or added to loan through a higher interest rate</i>	• No delivery fee paid to GSE
• Guarantee fee paid by lender	• Guarantee fee paid by lender

**The GSEs’ products assume a significant portion of the risk previously assumed by MIs, and are often more costly to consumers. PMI products are either cancelable under federal law or, if not, appropriate consumer disclosures are given.**

The GSEs will only purchase *their* 97%-90% LTV loans. Competing products developed by private lenders and mortgage insurers that put more money in the consumers' pockets are being killed because the GSEs are refusing to buy those loans. These consumer-friendly products are simply not as lucrative to the duopoly. Consumers who need low-down payment loans cannot benefit from the lower prices and product innovation that are the natural outcomes of full competition. The GSE duopolists set the market terms, and are beginning to bar other entrants.

As the GSEs use their duopoly muscle to drive competitive products from the market, consumers will suffer. The table below illustrates that the GSEs' fees increase the consumers' costs by 15 basis points when compared to a competing product offered by a private lender.

**Table Eleven: A Comparison of GSEs' "Alt-A" Loans to Private Lender Product**

<i>Product</i>	<i>Fannie Mae</i>	<i>Freddie Mac</i>	<i>Private Lender</i>
80/10/10	0.50%	0.50%	0.35%
Investor to 80% LTV	2.00%	2.00%	1.85%
Investor to 90% LTV	2.50%	2.50%	2.35%

**Fannie Mae's pricing is 15-basis points higher than the private lender's product.**

The logical outcome of allowing the GSEs to write all the rules and reducing lenders to order takers is the emergence of only two real lenders, Fannie Mae and Freddie Mac. This process is already well underway. While some may say it doesn't matter if preferentially treated private corporations unfairly drive others out of the market, it will be homebuyers who suffer from higher mortgage rates and fewer product choices as competition dries up. As the duopoly captures profits from the private sector, jobs now available the country will be consolidated into the two GSEs, headquartered in the Washington, D.C. metropolitan area.

### **GSEs Use New Alliances to Extend Their Reach**

Fannie Mae is taking an additional strategy of appealing directly to brokers and consumers. Fannie Mae has launched media and print advertising campaigns designed to give the GSE a "brand name" that motivates homeowners to ask for a "Fannie Mae loan" from their local lender. Fannie Mae is maintaining control of its new channels of consumer access, and allowing its lender partners access to a Fannie Mae system – for a fee. On April 20<sup>th</sup>, Fannie Mae announced that it was opening up its technology pipeline, MornetPlus, so that select lenders could offer their automated underwriting systems to brokers who access the site. This arrangement illustrates Fannie Mae's plans to entice distributors onto their MornetPlus marketing channel, a channel over which they have exclusive control. Lenders must pay "user fees" to Fannie Mae to gain access to Fannie Mae's technology pipeline in order to sell product to consumers. Ultimately, the Fannie Mae's "user fees" will most likely be paid for by consumers in the form of slightly higher interest rates on loans. Freddie Mac's appears to have a similar business strategy.

Fannie Mae's largest partnership was announced on July 9<sup>th</sup> by Countrywide Credit, an independent mortgage lender that was the third largest loan producer in 1998. Fannie Mae will accept loans underwritten by Countrywide using its internal systems, and will pay a greater portion of loan servicing fees to Countrywide at closing. In exchange, Countrywide has agreed to sell a substantial portion of its loan production to Fannie Mae. Together, they intend to "explore" opportunities to market Countrywide's mutual funds, brokerage services, and full service insurance products over Fannie Mae's MornetPlus to all of Fannie Mae's consumer customers.

Why should the GSEs stop at lender alliances? With their federally subsidized market muscle, they can make brokers and realtors their distribution “partners” too, doling out the loan requests and servicing to lenders who have accepted the duopoly market rules.

### **Mortgage Market Share Shifts Emphasize the Homeowner Over the Homebuyer**

The residential mortgage market can be broken into three segments: Government loans from FHA/VA and the FHMA; Mortgages up to the GSE conforming limit, net of Government loans, which is the GSE market; and “Jumbo” mortgages with balances above the GSE conforming limits.

**Table Twelve: Residential Mortgage Market, 1994 to 1998 (in \$billions)**

Residential Closings, New Loans & Refinancings – GSE Conforming, Gov’t & Jumbo Market

<b>Residential Mortgage Market</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>
<b>Loans for Home Purchases</b>	359.3	345.7	392.6	432.6	513.5
<b>Mortgage Refinancings</b>	244.4	160.1	239.7	280.4	837.5
<b>Total Residential Mortgages Closed</b>	603.7	505.8	632.3	713	1,351
<b>GSE Market – Up to the Conforming Loan Limit, net of FHA/VA/RHS</b>					
<b>Loans for Home Purchases</b>	223.9	216.8	239.7	254.6	302.3
<b>Mortgage Refinancings</b>	162.1	110.2	170.9	226.3	675.9
<b>GSE Residential Mortgages Closed</b>	386.0	327.0	410.6	480.9	978.2
<b>Government Market – FHA/VA/RHS Loan Programs</b>					
<b>Loans for Home Purchases</b>	62.7	65.2	78.6	84.2	99.9
<b>Mortgage Refinancings</b>	22.9	8.9	14.8	16.0	47.8
<b>Gov’t Residential Mtgs. Closed</b>	85.6	74.1	93.4	100.2	147.7
<b>“Jumbo” Loans – Mortgages Above the Conforming Loan Limit</b>					
<b>Loans for Home Purchases</b>	72.7	63.7	74.3	93.8	111.3
<b>Mortgage Refinancings</b>	59.4	41.0	54.0	38.1	113.8
<b>Jumbo Residential Mtgs. Closed</b>	132.1	104.7	128.3	131.9	225.1

Source: SMR Research Corporation

The 1998 mortgage market produced record loan volume, but it was dominated by borrowers who were refinancing existing mortgages. Freddie Mac reported that 64% of the loans it purchased were refinancings, compared with 31% in 1995.

**Table Thirteen: Percentage Breakdown of Loan Segment Market Share**

	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>
<b>GSE Market – Up to the Conforming Loan Limit, net of FHA/VA/RHS GSE Market</b>					
<b>Total GSE Mortgages Closed</b>	63.9%	64.7%	64.9%	67.4%	72.4%
<b>Loans for Home Purchases</b>	62.3%	62.7%	61.1%	58.9%	58.9%
<b>Mortgage Refinancings</b>	66.3%	68.8%	71.3%	80.7%	80.7%
<b>Government Market – FHA/VA/RHS Loan Programs</b>					
<b>Total Gov’t Mortgages Closed</b>	14.2%	14.7%	14.8%	14.1%	10.9%
<b>Loans for Home Purchases</b>	17.5%	18.9%	20.0%	19.5%	19.5%
<b>Mortgage Refinancings</b>	9.4%	5.6%	6.2%	5.7%	5.7%
<b>“Jumbo” Loans – Mortgages Above the Conforming Loan Limit</b>					
<b>Total Jumbo Mtgs. Closed</b>	21.9%	20.7%	20.3%	18.5%	16.7%
<b>Loans for Home Purchases</b>	20.2%	18.4%	18.9%	21.7%	21.7%
<b>Mortgage Refinancings</b>	24.3%	25.6%	22.5%	13.6%	13.6%

Source: SMR Research Corporation

While refinancings have actually fallen in both the Government and Jumbo segments during the past two years when lower interest rates have favored refinancing, the GSE market share has grown rapidly. This reflects a shift in mission focus away from new home purchases to existing borrowers.

**With Competition Falling, Refinancings Give the GSEs Larger Fees, But Less Risk**

Just how much leverage do the GSEs already have over lenders? The empirical evidence says it is a lot. Some of the safest home loans that can be made are refinancing existing home loans at lower interest rates. After all, the risk of non-payment has to decline if consumers' monthly cost to service their mortgages is declining. Freddie Mac data shows that only 48% of refinancing borrowers in 1998 increased their loans by 5% or more. The percent of loans that the GSEs have bought that were refinancings has grown as interest rates have declined, inducing consumers to refinance. Despite this favorable development, Fannie Mae has been collecting substantial guaranty fees for low-risk business, incremental increases in loan exposure to existing borrowers. Margins on Fannie Mae's guaranty business have rocketed. In 1998, when assets grew by 38% and MBS outstanding rose 24%, the company's loss reserves actually fell. Fannie Mae's loss provision increased income in 1998:

**Table Fourteen: Fannie Mae's Profitable Guaranty Fee Business**

(\$ in millions)	1991	1992	1993	1994	1995	1996	1997	1998
<b>Guaranty Fees</b>	\$675	\$834	\$961	\$1,083	\$1,086	\$1,196	\$1,274	\$1,229
<b>Loss Provision</b>	\$370	\$320	\$175	\$155	\$140	\$195	\$100	(\$50)
<b>Gty Fees/Loss Provision</b>	182.4%	260.6%	549.1%	698.7%	775.7%	613.3%	1,274.0%	<i>Infinite</i>

Source: Fannie Mae Annual Reports

GSE market domination does not guarantee lower prices for consumers. It does, however, assure improved bottom lines for Fannie Mae and Freddie Mac, and fatter stock gains for shareholders. Instead of lowering guarantee fees so that consumers can get a greater interest savings, the duopolists are raking in high profits. This is the danger of a lack of competition. Once the duopoly sets prices, it has no motivation to lower them.

**The GSEs Will Not Meet Profit Goals by Trading Duopoly Market Share**

The expanding mortgage refinancing market has helped Fannie Mae and Freddie Mac post healthy growth and profitability during the past two years. Both companies expect to continue this track record. In May, Fannie Mae President Franklin Raines told Wall Street analysts to expect earnings per share growth to be even better than the past five years. Earlier this year, he predicted that Fannie Mae's share of the entire mortgage market would rise to 28% in five years. Freddie Mac is predicting that it will gain secondary mortgage market share, too.

During the past ten years, the duopoly has split the secondary mortgage market, with Fannie Mae taking 57% and Freddie Mac, 43%. During the first half of 1999, Freddie Mac's share grew to 45% by establishing alliances with large lenders who can provide a steady volume of business. Both GSEs were predicting growth by increasing their share of a duopoly market, and were willing to shave temporarily

the duopoly rents generated by guaranty fees to gain market share. Competition between the two giants, however, seems to have been short-lived. Market share seems to be drifting back to the historical 57%/43% split that has existed over the last ten years. The reduction in the GSEs' guaranty fee income that resulted from the brief spurt of competition in the first half of this year is now beginning to be offset by a variety of new "user fees" that the GSEs are imposing on a range of products. Consumers will have no choice but to pay GSE "user fees," hidden in the interest rate, if they want a loan.

The GSEs' plan to stay at the top of Wall Street's "buy" list by moving into new markets, not by temporarily raiding each other's share of their existing markets. While capturing profits through envelopment technology now going to lenders is paying off, the GSEs will have to enter new markets to keep their share prices on a meteoric tear. There is no other choice.

The three other ways to boost shareholder profits offer poor prospects for rapid growth. The GSEs' traditional lines of business, the secondary mortgage market and their own mortgage loan portfolios, give them three growth channels:

- **Grow with their market.** Currently, 67% of Americans own the homes they live in. If this percentage remains constant, then the number of households requiring loans will grow with the population. This is not a very plausible source of growth; the U.S. population is growing at less than 1% per year.
- **Increase average mortgage size.** If housing prices escalate, the GSEs can increase the total amount they finance or credit enhance as the average size of mortgages rises with housing prices. This will increase inflation-adjusted profits, however, only if the market value of houses rises faster than inflation, or the GSE conforming loan limit rises faster than the market. With national inflation low, this is not a promising long-term strategy.
- **Expand Home ownership.** The GSEs can try to increase the percentage of households that purchase rather than rent their homes. However, this 67% ownership ratio has increased only slightly in the 1990s.

If the GSEs use their secondary market base as a springboard into new markets, their growth horizons explode. They can continue to develop and cross-sell products that fit with their secondary market role, creating new sources of fee income. They can exert duopoly strength to control more and more of the channels of distribution of anything that they rationalize to be mortgage-related. They can use duopsony power to drive down the prices their "partners" can charge, if these partners want to retain access to GSE purchase and distribution channels. Meanwhile, the GSEs keep their prices as high as they can. Their "partners" make less money, *but consumers may see little or none of the savings negotiated by the GSEs.*

### **GSE Expansion Plans Will Squeeze Private Companies Out of Their Own Markets**

With their traditional sources of growth eliminated, the GSEs have re-interpreted their public mission to allow them to expand into any business tangentially related to mortgages. It would be one thing if the only result of these arrangements were to waste \$2 billion to \$3 billion in taxpayers' funds while exposing taxpayers to potentially the largest bailouts in U.S. history. However, the GSEs have acquired sufficient power to dominate new markets by exploiting their seven subsidies, using technology control and exerting duopoly muscle to gain the upper hand in competition with other private companies.

During 1998 and 1999, Fannie Mae and Freddie Mac pursued several new ventures:

- Fannie Mae and Freddie Mac aggressively moved into the \$475 billion home equity and subprime market, skimming off the highest quality A- credits that otherwise would have been purchased or securitized by the fully private lenders. They voice every intention of expanding their home equity and subprime market participation.
- In October 1998, Freddie Mac sought Congressional approval to offer mortgage insurance -- clear evidence of its intent to enter this \$125 billion market by taking business away from the companies that have provided coverage to GSE homebuyers for over forty years. As the shareholders of publicly held mortgage insurance companies learned last October, Wall Street investors are so sure of GSE market power that Freddie Mac's incursion into their line of business caused stock prices to drop by a third overnight.
- Both GSEs have developed loan programs that lowered mortgage insurance requirements, and have tied these programs to their proprietary automated underwriting.
- Rebounding from its last attempt in 1997, when Congress barred the GSE from offering a life insurance option with its loans, Fannie Mae has sought approval to underwrite mortgage credit life insurance, making another run at this \$4 billion market.
- Fannie Mae and Freddie Mac nearly doubled their multifamily financing in 1998, participating in \$22 billion of loans. In September 1998, Fannie Mae closed its first multi-property line of credit facility to a REIT. In March 1999, Freddie Mac closed a \$33 million multi-property credit facility to The Town and Country Trust, a multi-family REIT. These REIT programs will enable them to exceed their 1998 multifamily loan closings by several multiples.
- Calling its website the "First E-Commerce Internet Site for Multi-Family Lenders," Fannie Mae is now taking multi-family mortgage loan applications directly over the Internet.
- For the past two years, Fannie Mae has been developing a specialty line of business in Real Estate Owned (REO) management and disposition. In addition to handling the REO that it acquires in the course of its own business, Fannie Mae is contracting its services to others. In October 1998, it started managing and selling REO for the U.S. Marshals Service.
- Fannie Mae is making direct equity investments in other companies, purchasing 833,354 shares of HomeStore.com. The company is developing E-commerce venues for the National Association of Realtors.
- As part of its alliance with Countrywide Credit, Fannie Mae will broaden its product line to include appraisals, title insurance, flood plain determination, full service insurance agency, and mutual fund management, and use Fannie Mae's technology pipeline, MornetPlus, to market these services.
- Both GSEs are enhancing their automated underwriting models to perform appraisals and complete title research, generating new fee income while they eliminate the requirement for independent appraisals and title insurance.
- Fannie Mae is establishing relationships with correspondent lenders to offer warehouse lines of credit;
- Fannie Mae has begun to expand into home improvement lending and construction lending, and is making equity investments in residential and commercial projects, including planned communities.
- Both GSEs are investing in Community Development Financial Institutions (CDFIs) as a large-scale means of meeting their affordable housing goals.

Fannie Mae and Freddie Mac have expanded their lines of business. They are redirecting their customer focus away from the lender toward the consumer, using a network of brokers and realtors who will open new markets to the GSEs. In reaction to this change in customer focus, lenders are looking for new secondary market outlets that do not minimize their role or intrude on a lender's borrower and broker relationships. *They are finding alternatives.*

### ***PART III:***

## **OTHER GSEs TAP INTO GOVERNMENT SUBSIDIES**

### **The Federal Home Loan Banks Get a Piece of the Secondary Market**

The Federal Home Loan Banks (FHLBanks) gained access to new markets in 1998. Most significantly, regulators gave the FHLBank of Chicago the nod to expand its Mortgage Partnership Finance (MPF) pilot from \$750 million to \$9 billion. The MPF program gives the FHLBanks the ability to purchase mortgage loans from their members – giving lenders another conduit for their conforming loans. As a GSE with many of the preferences granted to Fannie Mae and Freddie Mac, the Chicago FHLBank believes it can compete in the duopoly-dominated secondary market. In 1999, other regional FHLBanks are joining the MPF, broadening its market reach. There are now five FHLBanks offering the program – the FHLBanks of Chicago, Dallas, Atlanta, New York, and Pittsburgh.

Fannie Mae has opposed FHLBank expansion into the secondary market, arguing that the FHLBanks are not adequately capitalized to take on this mortgage risk. The FHLBanks' current capital/assets ratio substantially exceeds that of Fannie Mae and Freddie Mac.<sup>15</sup> Even accounting for the differences in the composition of the FHLBanks' balance sheet, the FHLBanks have the financial strength to support secondary market exposure higher than the \$9 billion pilot:

**Table Fifteen: FHLBs Asset/Equity/Income Growth, 1994 – 1998**

<b>(\$ in billions)</b>	<b>Total Assets</b>	<b>Consolidated Obligations</b>	<b>Capital Stock</b>	<b>Capital/ Assets Ratio</b>	<b>Capital/ Assets+MPF Ratio</b>	<b>Net Income</b>
<b>Dec-94</b>	\$239	\$200	\$13	5.4%	5.2%	\$1
<b>Dec-95</b>	\$273	\$231	\$15	5.5%	5.3%	\$1
<b>Dec-96</b>	\$292	\$251	\$17	5.8%	5.6%	\$1
<b>Dec-97</b>	\$349	\$304	\$19	5.4%	5.3%	\$1
<b>Dec-98</b>	\$434	\$377	\$22	5.1%	5.0%	\$2

Consolidated for the twelve Federal Home Loan Banks. Source: Federal Housing Finance Board.

Fannie Mae argues that the FHLBanks are not adequately capitalized. In response, Bruce Morrison, the Chairman of the Federal Housing Finance Board, has called for equivalent capital requirements for the housing GSEs. He believes that the FHLBanks should be judged by the same regulatory standards used for Fannie Mae and Freddie Mac. In addition, he is pressing for uniform regulation of GSE investment portfolios.

Regional FHLBanks are engaging in pilot programs and received expanded regulatory authority for promising new avenues of business, including letters of credit, small business lending, and community development loans. Their “mission creep” is being bolstered by various legislative initiatives pending on Capitol Hill in the Congressional banking and tax-writing committees that ease membership requirements and allow the FHLBanks to expand into new lines of business.

<sup>15</sup> The Federal Home Loan Bank System is a cooperative; member capital contributions can be withdrawn.

### **Farmer Mac Joins the Big Board**

On Friday, June 18, the New York stock exchange began to trade shares of Farmer Mac. Henry D. Edelman, the company's President, lauded the move as giving the company better access to the "capital we need to grow." This follows a GAO study released in May that placed Farmer Mac's market share at 1.2% of outstanding agricultural mortgage loans.

### **Little Change for Other GSEs in 1998**

Other GSEs stayed on course to expand their business opportunities, gaining legal and regulatory authority for new programs. Community bankers are expressing growing concerns about Farm Credit Bank competition in their markets. They claim that Farm Credit Banks are taking their best customers by offering loan rates that private lenders cannot match.

Some industry watchers cast a wary eye on The Postal Modernization Act (H.R. 22), a bill that would allow the Post Office to buy a thrift institution and move into E-commerce. This bill did not receive enough support to be passed during the 105<sup>th</sup> Congress. The House Government Reform Postal Services Subcommittee has approved H.R. 22. However, several subcommittee members, including ranking member Henry Waxman (D-CA), are planning to make changes to the bill that limit what businesses the Postal Service may enter before the full Government Reform and Oversight Committee votes for approval.

### **Fannie Mae and Freddie Mac Discourage GSE Competition but Inhibit Private Competition**

Fannie Mae and Freddie Mac have vocally opposed other GSE expansion. They argue that the FHLBanks have insufficient capital. They say other GSEs are not adequately regulated. They warn that actions preventing Fannie Mae and Freddie Mac from carrying out their public mission as they see fit will hurt the homebuyer.

From the views espoused by Fannie Mae and Freddie Mac, any action that might harm them hurts the consumer. If lenders do not follow the rules set by the housing enterprises, the consumer will pay. Certainly, Fannie Mae and Freddie Mac understand the secondary market and know that works there. However, they don't appear to know that private competition, not rules set by two giant companies, is best for the consumer.

***PART IV:***  
**SUMMARY**

**Competition Should Determine Who Wins – *NOT* the Duopoly**

Even special charters and \$9 billion worth of government subsidies cannot insulate Fannie Mae and Freddie Mac from certain realities of the competitive marketplace. It's time to restrain the mortgage duopoly. The GSEs' creative and anti-competitive use of federal subsidies is undermining the world's most vibrant mortgage market – ironically, a market they helped create. Competition will give us a better deal than duopoly power does. The rules of the market should be set by the give-and-take that occurs with real competition – not by the fiat rule of two companies that maintain their control through federal subsidies.

There is also taxpayer risk to consider. So far, we have been satisfied to let two privately owned companies take \$9 billion dollars worth of subsidies, and keep \$3 billion for themselves and their shareholders. To finance their growth, Fannie Mae and Freddie Mac are on track to become the world's biggest debtors in 5 years. Foreign and domestic investors are loading up on debt that has the U.S. taxpayers' contingent support. If the market turns on the GSEs, as it did in the early '80s, the private stockholders who have pocketed years of outsized profits and stock gains will walk away, leaving the government to clean up the disaster.

***Failure to act will hurt consumers, taxpayers, and industry.***

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