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The **GSE** REPORT

Special Supplement

"GSE Duopoly Power Threatens Private Financial Companies"

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Fannie Mae and Freddie Mac are the two largest privately held government-sponsored enterprises (GSEs). Congress has given them the responsibility of assuring ready availability of affordable mortgage loans for American homebuyers. Until 1998, they have expanded their businesses without facing resistance from fully private companies. Their remarkable and unchallenged growth has put them among the ranks of the most profitable U.S. companies.

GSE expansion is no longer limited to increasing their participation in the conforming residential mortgage market - loans up to \$240,000 with high quality credit underwriting. They are moving into new lines of business, taking market share from others:

- In 1998, Fannie Mae and Freddie Mac aggressively moved into the \$475 billion 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 subprime market participation.
- In October 1998, Freddie Mac almost obtained 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 twenty years. In January, Fannie Mae has introduced loan plans that cut the mortgage insurance requirements in half, but is not passing those savings along to consumers. Fannie Mae is pocketing an up-front premium being charged to consumers for its shareholders.
- In September 1998, Fannie Mae closed its first multi-property line of credit facility to a REIT. This program is a direct assault on commercial real estate lenders. Fannie Mae is marketing these credit facilities to large investors and publicly-held REITs, offering revolving commitments up to \$ 100 million.

These are the real business threats faced by lenders and insurers. More are rapidly developing:

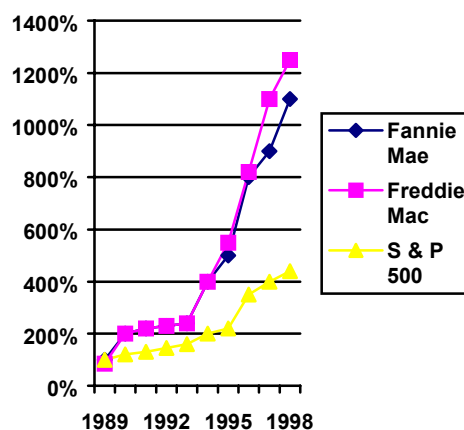
- Fannie Mae and Freddie Mac plan to leverage their multi-billion technology investment, using the Internet and their automated underwriting to bypass mortgage lenders and develop direct contacts with consumers and mortgage brokers. They are building a “pipeline” that will deliver a wide range of financial products through various distributions systems, giving the GSEs control over all data and access to consumers. Ultimately, their taxpayer-subsidized “pipeline” will make fully private companies dependent on GSE technology for distributing their products and services, giving the GSEs the ability to use their duopoly power to cut prices both on the suppliers and distributors of those products, or even circumvent many of today's suppliers and distributors.

- The GSEs' vast taxpayer-subsidized investment in automated underwriting has given them a 90% share of this market, making the systems developed by private companies appear duplicative. Portfolio lenders who choose to use another evaluative system will soon be forced to double their underwriting costs, since Fannie Mae and Freddie Mac are starting to require their underwriting analysis for loans they purchase.
- Lack of competition in automated underwriting systems will produce unintentional discrimination -- which will be blamed on lenders, not the GSEs. Fannie Mae and Freddie Mac's automated underwriting systems will ratchet up the fair lending liability lenders face. As the GSE duopoly takes over automated underwriting, they will create an "underclass" of special circumstances borrowers who do not conform to their credit-scoring mold. Potentially, the GSEs could use their risk-based pricing models to serve marginal borrowers by pricing them up the risk curve, but without a wide range of lenders with competing underwriting systems seeking their business, these borrowers will be left with fewer product choices and higher prices.
- Fannie Mae is making another run at the \$4 billion credit life insurance market, rebounding from its last attempt in 1997, when Congress barred the GSE from offering a life insurance option with its loans.

The GSEs Overcome Their Competition with Their Massive Government Subsidies

The GSEs enjoy generous federal subsidies that allow them to monopolize the mortgage-backed securities business. These subsidies provide nearly half of the exceptional profits earned by Fannie Mae and Freddie Mac. The Congressional Budget Office found that Fannie and Freddie save \$6 billion in annual borrowing costs because of their agency status, yet pass on only \$4 billion to consumers. Their foremost advantage is the capital market's impression that GSEs have their debt backed by the full faith and credit of the federal government. Despite the fact that GSEs are very thinly capitalized, the yield to maturity on their bonds is only 35 basis points higher than Treasury bonds. The GSEs are exempt from SEC filing requirements, and they pay no state or local income taxes. As their accelerating use of cheap funds has exploded, their market shares in portfolio lending and mortgage-backed securities have soared along with their share prices. In 1982, Fannie Mae had a market value of \$500 million. Its value has jumped 14,000% in 16 years, and today the company is worth \$70 billion.

- **Fannie Mae Stock appreciated 1,053% From 1989 to 1998**
- **Freddie Mac stock appreciated 1,260% from 1989 to 1998**
- **The S&P 500 appreciated 413% from 1989 to 1998, experiencing the longest bull market in history**



GSEs' Expansion Into the Subprime and Home Equity Markets Abuses their Charter For Minimal Consumer Benefit

Relying on an “implied federal government guarantee,” Fannie Mae and Freddie Mac issued over \$150 billion in long-term debt in 1998. They have used these funds to buy mortgages for their own investment portfolios, which will grow 28% this year, rising from \$480 billion to \$615 billion. They are exerting greater dominance on the mortgage market indirectly through their guarantee of mortgage-backed securities and directly through their ever-increasing loan purchases.

The value of the GSEs’ “implied federal guarantee” of their debt became obvious during the third quarter of 1998. Exchange rate volatility and economic troubles in the emerging markets spurred a global flight to quality that drove up interest rate spreads for mortgage-backed securities and inverted the yield curve. By contrast, Fannie Mae and Freddie Mac had no problem raising billions of dollars in funds at stable spreads. Implied government guarantees made a safe haven when investors fled to quality. The GSEs took advantage of their quasi-government status to lock in spreads on their growing residential mortgage portfolios.

While the GSEs made striking profits during the crisis, they are receiving public acclaim for keeping mortgage rates affordable when fully private lenders were struggling! Fannie Mae has widely published its opinion that the liquidity it provided during this period of market turbulence kept mortgages available and affordable for conventional homebuyers, during a time when the spread between conforming and non-conforming mortgages rose from 23 basis points to 49 basis points. Fannie Mae did not publicize that its arbitrage of “implied federal guarantee” funds, when spreads were at a twelve-year high, locked in profits on \$15 billion dollars of loans purchased. Fannie Mae contends that its market presence kept mortgage funds available at rates that “saved” borrowers up to 26 basis points, but its arbitrage activities actually “earned” the firm up to an extra 50 basis points on the loans it purchased for its portfolio.

Using the turbulence that occurred in the markets last fall as an excuse, the GSEs are increasing their penetration into the home equity and subprime market. Although these new lines of business will give the GSEs subsidy-laden profit opportunities, consumers will get very little. They already have a wide range of loan programs available to them from thousands of lenders. A .2% interest subsidy does not amount to much. Considering that the average home equity loan is \$26,000, a .2% interest savings would put \$52 in the pocket of an individual that already owns their home. The subprime segment of the home equity market has a higher average balance -- \$63,000 - giving the borrower an annual interest subsidy of \$126. Once the GSEs dominate the market, however, it is not clear that they will pass along even these meager savings to consumers, but they will pocket billions for their shareholders.

Clearly, the government subsidies provided to Fannie Mae and Freddie Mac when they were chartered have given them the power to dominate the mortgage market - and any other market they choose to enter. These subsidies are now combined with the market strength that the GSEs have accumulated over ten years of phenomenal growth and profitability. The GSE expansion threat is quite real and alarmingly imminent.

The GSEs Use Their Lending Partners to Enter New Lines of Business

When Fannie Mae and Freddie Mac enter a new business, they proceed slowly, usually forming partnerships with their potential competitors. These partners often profit in the short term because the GSEs share the value of their subsidies during this pilot period. However, after the GSEs have learned the basics, they venture out on their own. Their government subsidies give them the ability to underprice their former partners and still keep a portion of subsidy value to enhance their profitability. The GSEs make more money, while their former partners are forced to cut their own margins.

GSE expansion into new ventures threatens asset quality as well as gross margins. Fannie Mae and Freddie Mac carefully choose the “cream of the crop,” taking the highest quality business away from private lenders. They are now keeping the “best of the best” for their own investment portfolios.

Government Sponsored Enterprises - Partners or Competitors?

- The GSEs started working with private lenders in 1995 to purchase subprime and home equity loans. By 1997, it became clear that they intended to purchase loans directly. Responding to industry concerns about loss of market share, Freddie Mac President, Leland Brendsel, said, “Those that try to create barriers from that happening are ultimately going to fail.”
- Investors understand the GSE threat. Freddie Mac's October 1998 “middle of the night” maneuver to enter the mortgage insurance business caused MI equity values to drop 30% in a matter of days.
- Since 1995, Fannie Mae and Freddie Mac have worked closely with their “partners” in the lending and brokerage community to develop the automated underwriting systems that now dominate the market and are giving the GSEs more control over underwriting, pricing, and distribution.

Congress Will Curb GSE Growth, If Industry Leaders Voice Their Opinions

Nothing will change unless the GSE subsidies are challenged. Government policymakers are ready to tackle important regulatory and legislative initiatives that would restrict GSE arbitrage and investment practices, strengthen regulation, impose higher capital standards on the GSEs, eliminate some of the government subsidies, and evaluate the consumer impact of their non-competitive “black box” underwriting systems. These issues will not gain momentum, however, until industry leaders encourage the Administration and Congressional policymakers to act.

With half their profits on the line, the GSEs are poised to defend their subsidies. Fannie Mae and Freddie Mac have hired politically connected staff, board members, and lobbyists to argue their case. Fannie Mae is ramping up expensive advertising campaigns to build its brand name and enhance its public image. Both GSEs are continuing to contribute large amounts of money to both individual Members and the Republican and Democratic parties, and conduct high-profile press conferences with Members of Congress that claim personal credit for the products and programs developed by private financial service providers.

The GSEs' expansion plans need to be reigned in. The competitive free market, not a duopoly, provides consumers with the greatest range of products from which to choose. Their broadening use of government subsidies in new markets is a clear competitive threat to private companies that have served these markets well. In the short run, consumers and some companies that form partnerships with the GSEs appear to profit. In the long run, competition is reduced, gross margins are diminished, but most importantly consumers will have fewer choices and higher prices.

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