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# The ***GSE*** REPORT

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Special Supplement

***“GSE Expansion into Subprime and Home Equity Lending:  
Private Gain at Public Cost”***

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The attached paper examines the consequences of Fannie Mae’s and Freddie Mac’s expansion into the subprime and home equity lending markets.

**GSE EXPANSION INTO SUBPRIME AND HOME EQUITY LENDING:  
PRIVATE GAIN AT PUBLIC COST**

Within the last few months, Fannie Mae and Freddie Mac, the two largest government sponsored enterprises (GSEs), have begun a public campaign extolling their growing role in the riskiest segment of the home lending market. This should not be a cause for cheer. Their forays into this market put taxpayers at risk, raise government borrowing costs, lower federal revenue, and represent an abuse of the special powers granted to them by Congress. Their motivation to enter this market is to continue a phenomenal record of amazing shareholder enrichment. Given the danger to the taxpayers, and the asymmetrical sharing of benefits – some consumers who already own their home save only \$52 a year while private shareholders reap large rewards – Congress should end this hazardous practice.

**Characteristics of the Home Equity Market**

Finance companies have been making home equity loans since the 1960s, but real estate-secured consumer lending remained a specialty market until 1987, after passage of the Tax Reform Act of 1986. That Act prohibited tax deductibility of interest on consumer loans, but allowed tax deductibility for mortgage and home equity loans. The home loan’s after-tax cost to consumers abruptly fell far below the cost of other loans. At year-end 1998, consumers had taken out 19 million home equity loans and lines of credit, totaling \$495 billion, with an average size of \$26,000. More than 13,000 different companies are in this mature business that is almost forty years old.

Lenders offer two types of home equity loan products, both secured by a lien on the borrower’s residence. A home equity loan is a “closed-end loan” that is funded to the consumer in one lump sum, then repaid in equal monthly combined interest and principal payments over several years. A home equity line of credit makes a maximum amount of money available to a borrower, who draws the loan down as it is needed, and repays a minimum amount of principal every month, along with any interest due.

According to the Consumer Bankers Association and the University of Michigan’s Survey Research Center, the most frequent use of home equity loan proceeds is debt consolidation. Consumers obtain home equity loans and use the proceeds to pay off existing credit card, auto, and other personal debts:

**Table One: Uses of Home Equity Loan Proceeds, by Percent**

<b>Year</b>	<b>Debt Consolidation</b> (% of lines/% of loans)	<b>Home Improvement</b> (% of lines/% of loans)	<b>Other Purposes</b> (% of lines/% of loans)
1991	36 – 43	28 – 29	26 – 28
1992	34 – 43	31 – 27	35 – 30

1993	31 – 36	27 – 25	42 – 39
1994	30 – 43	22 – 24	48 – 33
1995	35 – 39	31 – 27	34 – 34
1996	36 – 40	27 – 29	37 – 31
1997	40 – 44	23 – 25	37 – 31

Source: Consumer Bankers Association

### **High-Risk Subprime Loans Offer the Fastest Growth in Home Equity Lending**

An important segment of the home equity lending market is considered to be “subprime,” requiring borrowers to pay lenders a premium because they have serious credit problems. Of total home equity outstandings, \$187 billion, or 38%, is classified as “subprime”. This has been a fast-growing market. In ten years, the subprime market increased by over four times -- from \$44 billion (1988) to \$187 billion (1998).

SMR Research Corporation surveys demonstrate that over 70% of the companies offering subprime loans to consumers are portfolio lenders who do not sell the loans, but originate them to hold as investments. Most subprime portfolio lenders are large, financially sound, traditional consumer finance companies.

Ten years ago, mortgage bankers began bundling subprime mortgages and selling them to investors. Thus, home equity mortgage banking began with the first Wall Street securitization of \$656.6 million by Household Finance in January 1989. The subprime home equity loan securities market grew slowly at first, then began to explode in 1995:

**Table Two: Subprime Loan Securitizations**

<b>Year</b>	<b>Securities Issued (\$ Millions)</b>
1989	2,399
1990	4,698
1991	9,374
1992	4,835
1993	6,349
1994	9,448
1995	15,207
1996	30,049
1997	47,034
1998	39,950

Source: SMR Research Corporation

This booming market has attracted the attention of the GSEs. Its growth and profitability are appealing. However, it represents substantial risks, too – well above what the GSEs have seen in conforming home mortgage loans.

Subprime lenders through the 1980s typically accepted borrowers with less-than-pristine credit histories, but limited loan-to-value to 75% or less. By the mid-1990s, most subprime

lenders had pushed this up to 85%, and some began lending to 125% of equity. The easing of credit standards in home equity lending is translating into greater delinquency rates and chargeoffs. As Table Three documents, all segments of home equity lending are getting riskier.

**Table Three: Moody's Home Equity Credit Indices**

<b>Index</b>	<b>6/30/98</b>	<b>6/30/97</b>	<b>Change, 97-98</b>	<b>% Change, 97-98</b>
<b>Loans Past Due &gt; 60 days, as % of interest receivable:</b>				
Composite Index	6.5%	5.0%	1.3%	26.2%
Subprime only	7.2%	5.2%	1.0%	14.7%
High LTV only	2.8%	1.7%	1.1%	63.6%
Traditional LTV/Credit	3.8%	2.6%	1.2%	48.4%
<b>Chargeoffs, as a percent of loan dollars:</b>				
Composite Index	0.6%	0.4%	0.3%	75.0%
Subprime only	0.5%	0.3%	0.2%	80.8%
High LTV only	2.0%	1.1%	0.9%	80.2%
Traditional LTV/Credit	0.6%	0.4%	0.2%	67.6%

Source: Moody's Investor Service; Composite Index includes Subprime Loans, Loans with LTV ratios above standard underwriting, and Loans conforming to traditional LTV and credit standards

### **GSE Entrance into the Subprime Market is Risky for Taxpayers**

By its very nature, lending to overextended or undercollateralized borrowers is risky business. The mortgage insurance industry has found that the probability of a homeowner defaulting doubles as the percentage of equity in his house falls in half. Thus, a borrower with only 5% equity in his house is twice as likely to default as someone with 10% equity and four times as likely to default as someone with 20% equity. The vast majority of mortgages held by the GSEs now are at the lower end of this risk spectrum; their borrowers typically have 20% or more in equity or the GSEs have private mortgage insurers standing between them and losses on lower downpayment loans. Even at this low-risk end of the market, the GSEs have a smaller capital base to protect them against defaults. Regulated institutions that hold residential mortgages in portfolio are required to maintain capital ratios that are two to three times higher than GSE capital.

If the GSEs barely hold enough capital for their low-risk loans, they are certainly not prepared to take on the subprime market. Experienced subprime lenders know that they must maintain enough capital to cushion losses that will come with the credit risks they take on, and liquidity to cover their cash flow needs when their delinquencies rise. All the major players in this market hold strong equity positions. As the following table shows, the major players have two to ten times as much equity, as a share of total assets, than do the GSEs.

**Table Four: Subprime Lender and GSE Year-to-Year Equity as % of Assets**

	<b>Financial</b>	<b>Shareholders</b>	<b>Financial</b>	<b>Shareholders</b>
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<b>Company</b>	<b>Stmt. Date</b>	<b>Equity/Assets</b>	<b>Stmt. Date</b>	<b>Equity/Assets</b>
<b>Associates Corp.</b>	11/98	12.3%	11/97	12.0%
<b>Household</b>	11/98	13.4%	11/97	17.3%
<b>Money Store</b>	5/98	23.3%	5/97	24.8%
<b>IMC Mortgage</b>	11/98	9.5%	11/97	8.0%
<b>FirstPlus Financial</b>	8/98	17.3%	8/97	14.5%
<b>Advanta</b>	11/98	16.7%	11/97	13.1%
<b>Aames</b>	11/98	36.7%	11/97	35.2%
<b>New Century</b>	11/98	15.6%	11/97	13.9%
<b>Associates First</b>	11/98	10.5%	11/97	11.1%
<b>Green Tree</b>	11/98	34.2%	11/97	13.2%
<b>Fannie Mae</b>	12/98	3.0%	12/97	3.3%
<b>Freddie Mac</b>	12/98	3.4%	12/97	3.9%

Sources: SEC-regulated public company information obtained from SEC reports; Fannie Mae and Freddie Mac annual and quarterly reports; Fannie Mae 12/98 Shareholders Equity estimate obtained from Morgan Stanley Dean Witter analysis dated January 13, 1999

Fannie Mae and Freddie Mac are the dominant players in one of the highest quality, most conservative lending markets there is – conforming home mortgages. The regulator for Fannie Mae and Freddie Mac, the Office of Housing Enterprise Oversight (OFHEO) is currently writing risk-based capital standards for the GSEs that reportedly will increase the capital they need for this low-risk line of business. With their current capital position, the GSEs are playing with fire as they experiment with home equity loan programs, especially the subprime segment.

These are high stakes. If the GSEs fail, the taxpayers will be asked to cover billions in losses. Public shareholders will walk away, after pocketing dividends earned over ten to fifteen years of subsidy-laden profits. Cleanup of the S&L mess, which was caused by private companies, cost the public \$300 billion. Savings and Loans invested in low-quality junk bonds, home loans, and commercial real estate. They used their FDIC \$100,000 deposit guarantee to raise cash for these investments. Even though regulators oversaw their investment and loan practices, these S&Ls failed when the market turned against them. It can happen again. Fannie Mae and Freddie Mac are putting their guarantees on mortgage-backed securities supported by these risky loans. They might choose to hold subprime loans in their growing investment portfolios as well. Both options expose them to new risks.

Despite dealing in conservatively structured loans, Fannie Mae nearly failed in the early 1980s. Had it done so, the taxpayers would have picked up the tab, or the intrinsic value of all GSE debt would have been destroyed. Given this track record, it is unwise to grant these companies new risky lending opportunities unless they put up sufficient capital to safeguard taxpayer interests. Instead of building their capital positions as rapidly as possible, the GSEs are paying million-dollar executive salaries and distributing earnings to shareholders as dividends.

### **GSE Borrowings are Already Driving Up Federal Borrowing Costs**

Because the GSEs are federally chartered, investors believe that the federal government is the ultimate guarantor of GSE debts. Investors' beliefs in these "implied government guarantees" are so strong that they willingly lend vast sums to these undercapitalized companies at very low rates, only a few basis points above a "risk-free" U.S. Treasury rate, and well below what event the strongest fully private companies pay. The GSEs can also hedge their risk more easily because counterparties believe that they are really dealing with the U.S. government. GSE debt is considered to be of comparable quality to debt issued by the federal government itself. When the GSEs borrow funds in the credit markets, they are competing with the government for investors who seek the highest credit quality instruments for investment. The only way the government can attract the \$3.4 trillion it needs in competition with the GSEs is to offer higher yields to lure investors away. Any expansion of GSE borrowing, used to finance the purchase of home equity and subprime home mortgages or for any other purpose, raises taxpayers' interest costs.

Competition between the federal government and Fannie Mae and its sibling housing enterprises, Freddie Mac and the Federal Home Loan Banks, is not academic. The GSEs already have flooded the public markets with \$1 trillion in debt obligations the market believes is functionally the equivalent to Treasury securities. If the GSEs raise borrowing costs by only 0.1%, they boost federal spending for interest on the government's debt by \$3.4 billion a year. Since the GSEs plan on expanding their supply of bonds, the impact on the price that Treasury must pay to secure funds must grow even higher. The GSEs carry a heavy burden of proof in establishing why their opportunity to earn more profits takes precedence over limiting federal borrowing costs.

**Table Six: Outstanding Debt, Quarter-end 1998, through September (\$ billions)**

<b>Key Categories/Debt Balances:</b>	<b>First Qtr '98</b>	<b>Second Qtr '98</b>	<b>Third Qtr '98</b>
Housing GSE debt outstanding	884	927	1,003
Housing GSE MBS outstanding	1,624	1,692	1,770
Treasury debt outstanding	3,797	3,780	3,746
Corporate debt outstanding	3,459	3,548	3,649
Mortgage debt outstanding	3,847	3,935	4,024
Consumer debt outstanding	1,278	1,295	1,317
Municipal debt outstanding	1,143	1,163	1,181
Total Debt Outstanding	15,439	15,674	15,907
<b>Debt Balance Breakdown by %:</b>			
Housing GSE debt outstanding	5.7%	5.9%	6.3%
Housing GSE MBS outstanding	10.5%	10.8%	11.1%
Treasury debt outstanding	24.6%	24.1%	23.5%
Corporate debt outstanding	22.4%	22.6%	22.9%
Mortgage debt outstanding	24.9%	25.1%	25.3%
Consumer debt outstanding	8.3%	8.3%	8.3%
Municipal debt outstanding	7.4%	7.4%	7.4%
Total Debt Outstanding	100.0%	100.0%	100.0%

GSE data provided by Fannie Mae, Freddie Mac, and FHLB Office of Finance; all other data from the Federal Reserve Bank statistical series

Today, GSEs dominate new debt issues. Fannie Mae, Freddie Mac and the Federal Home Loan Banks, issued almost three times more debt than the U.S. Treasury in 1998, making these GSEs among Wall Street's biggest customers.

**Table Seven: Public Debt Issued in the first nine months of 1998 (\$ billions)**

<b>Key Categories of Debt Issued:</b>	<b>First Qtr '98</b>	<b>Second Qtr '98</b>	<b>Third Qtr '98</b>
Housing GSE debt issued			
Short term	1,206	1,252	1,294
Long term	128	131	127
GSE MBSs/CMOs issued	146	222	215
Ginnie Maes issued	34	44	44
Treasury debt issued			
Short term	386	364	360
Long term	130	110	97
Agency debt issued	230	133	192
Corporate bonds issued	254	189	112
Asset backed securities issued	46	56	47
Municipals issued	76	89	49
Total debt issued	2,636	2,590	2,537
<b>Issuance Breakdown by %:</b>			
Housing GSE debt issued			
Short term	45.8%	48.3%	51.0%
Long term	4.9%	5.1%	5.0%
GSE MBSs/CMOs issued	5.5%	8.6%	8.5%
Ginnie Maes issued	1.3%	1.7%	1.7%
Treasury debt issued			
Short term	14.6%	14.1%	14.2%
Long term	4.9%	4.2%	3.8%
Agency debt issued	8.7%	5.1%	7.6%
Corporate bonds issued	9.6%	7.3%	4.4%
Asset backed securities issued	1.7%	2.2%	1.9%
Municipals issued	2.9%	3.4%	1.9%
Total debt issued	100.0%	100.0%	100.0%

Source: The Bond Market Association

### **GSE Home Equity & Subprime Participation will Wastefully Drain Revenue from the Treasury**

According to the Congressional Budget Office, government subsidies already provide 42% of the profits Fannie Mae and Freddie Mac earn. In 1998, these two GSEs reported profits of over

\$6 billion; approximately \$2.5 billion was derived from special preferences such as “implied government guarantee” of their debt. These subsidies do provide a small interest rate benefit to consumers. Since 1993, the difference between the “conforming” interest rates in markets supported by the GSEs and “non-conforming” interest rates has normally been slightly over .2%.

To the extent that the GSEs are successful in penetrating the home equity and subprime market, they will raise federal borrowing costs and cost the Treasury tax revenue. By enlarging the secondary market for such loans, the GSEs will stimulate more of them. Although this new line 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 that homeowner’s pocket annually.

If Fannie Mae and Freddie Mac expand the market beyond what existing lenders offer, they will cost the federal government far more than they save the consumer. Home equity mortgage borrowers now pay an interest rate of approximately 10%. Assuming the borrower is in the lowest tax bracket, 15%, then any new loans stimulated by the GSEs will generate \$2,600 in federal income tax deductions, costing the Treasury \$390 a year. The government’s direct cost is almost eight times the amount a new home equity borrower would save on interest!

The subprime segment of the home equity market has a higher average balance -- \$63,000 -- giving the borrower an annual interest subsidy of \$126. However, the high interest rates charged on these loans will give the borrower a tax deduction that costs the U.S. Treasury up to ten times the amount of interest saved. Assuming these loans have a higher interest rate than home equity -- 14% compared to 10% -- the annual interest expense for the average loan is \$8,820. If the interest is fully deductible, Treasury's loss at a 15% marginal tax rate is \$1,323 -- ten times the subsidy value. If only 75% of the interest is deductible, as in the case of high-LTV loans, Treasury's loss is \$992, or eight times the subsidy value.

### **GSE Subprime Lending Abuses their Charter – For Minimal Consumer Benefit**

Besides being wasteful, it is questionable whether the GSEs are on solid legal ground in seeking to deviate from their Congressionally chartered mission: To bring liquidity to the mortgage market that assures the availability of loans to help Americans purchase homes. The single largest use of home equity and subprime loan proceeds is to pay off other debts. Home equity and subprime mortgages do not encourage home ownership. Instead, they give existing homeowners expanded opportunities to have the federal government subsidize their personal consumption expenditures.

### **Subprime Risk Extends Beyond Credit Underwriting**

American consumers learned last year that the financial troubles of a foreign country can affect what loans might be available to them. Throughout the year, investors harbored concerns about financial conditions in the third world economies. In August 1998, after the Moscow

Stock Exchange suspended trading and Boris Yeltsin’s government renegotiated sovereign debt, investors lost confidence. Almost overnight, there was a global “flight to quality.” By the end of the month, the Dow Jones Industrial Average dropped to 7539 as investors pulled funds from the equity market to buy whatever low risk securities they could find. Risk premiums soared, which means that investors wanted higher interest rates to buy any securities backed by high-risk loans such as subprime debt. Subprime mortgage bankers discovered that loans they had booked just weeks before had to be sold at a discount – if they were to be sold at all. Securitization deals became financially unfeasible, and the closure of the securitization market was devastating to poorly capitalized mortgage bankers. They could not afford to sell the loans they had, so they could not free up lines of credit to make new loans.

Lacking liquidity to continue operations, several large mortgage bankers failed. Since these companies had no financial capacity to keep loans, they counted on a secondary market to buy them. They had bet that investor interest could substitute for capital – and they lost. There is no substitute for the flexibility provided by strong capital and liquidity. Fortunately, subprime mortgage bankers made up only 30% of the subprime market in 1998. The lenders who close and own 70% of subprime loans have the financial flexibility to survive hard times and continue to serve their customer.

**The GSEs’ Flawed Argument Supporting Their Entrance into Home Equity & Subprime**

During September and October of 1998, Fannie Mae and Freddie Mac made broad use of the “implied government guarantee” of their debt. In a volatile market that put a high value on safety, the implied guarantee allowed the GSEs to sell debt at very low rates, while other non-subsidized private financial companies could not find similarly inexpensive funding sources. In turn, the GSEs’ low funding costs kept conforming mortgage rates stable. For several weeks, the difference between conforming mortgages sold to the GSEs and non-conforming loans sold to other investors rose from approximately .2% basis points to almost .5%. This was temporary. The difference between conforming and non-conforming rates has returned to approximately .2%

The markets have returned to normal, but the memory lingers. The GSEs claim that their entrance into the home equity and subprime market will help consumers because existing lenders are too weak to adequately serve their markets. If you base your facts on what happened to 11% of the home equity market, the subprime mortgage banking segment, you might reach this conclusion – but this is misleading.

Although subprime lenders suffered losses on some of their assets during 1998, there is no evidence that borrowers were abandoned. Last year, subprime borrowers walked into thousands of retail offices of Associates First Capital, Household Finance, American General, Commercial Credit Corp., Avco, and others – including hundreds of credit unions, banks and thrifts. There is no shortage of loans for subprime borrowers because lenders who know this business are making profitable loans, despite the market upset of 1998. Rather than being weak, most subprime borrowers posted higher earnings for the first nine months of 1998 than they did in 1997:

**Table Seven: Subprime Lender Nine-month Profitability, 1998 v. 1997 (\$ in millions)**

Company Name	Net Income, 9/30/98	Net Income, 9/30/97	% Change
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American General Associates	\$146.0	\$127.0	15.0
AVCO	\$891.5	\$753.7	18.3
Commercial Credit	\$136.7	\$144.4	-5.3
Household Finance	\$212.0	\$167.0	26.9
	\$810.4	\$627.5	29.1

Source: SMR Research Corporation

Only one lender segment – subprime mortgage bankers – experienced major financial hardship in 1998. This relatively new sector of the industry is the most fragile, as shown by a comparison of the first nine months of 1998 to 1997:

**Table Eight: Subprime Mortgage. Banker Nine-month Profitability, 98 v. 97 (\$ in millions)**

Company Name	Net Income, 9/30/98	Net Income, 9/30/97	% Change
Aames Financial	\$0.4	\$13.1	-96.6
American Business Fin.	\$3.4	\$3.2	8.5
BNC Mortgage	\$2.5	\$2.2	13.6
Contifinancial	-\$108.2	61.7	Not calc.
Delta Financial	\$6.5	\$22.1	-70.8
First Alliance	\$11.9	\$23.7	-50.0
Firstplus	-\$34.3	\$117.7	Not calc.
IMC Financial	\$33.6	\$33.1	1.5
Life Financial	\$6.7	\$7.7	-13.3
Long Beach Financial	\$21.1	\$17.3	21.8
New Century Financial	\$22.3	\$14.5	54.4
Novastar Financial	\$5.6	-\$0.7	Not calc.
Ocwen Financial	\$9.4	\$56.0	-83.3
Pacific America	-\$14.5	12.6	Not calc.
United Companies	\$34.2	\$71.0	-51.9

Source: SMR Research Corporation

*Some subprime mortgage bankers failed; some weakly capitalized lenders have cut back their operations. Consumers have barely noticed.* These companies have been replaced by banks, thrifts, finance companies, and even internet lenders who are anxious to increase their share of this business. Contrary to GSE predictions that borrowers will not find the loans they need, Olson Research expects home equity lending to increase by 8% in 1999.

Subprime mortgage bankers made a high-stakes bet when they first established their businesses. They lack the financial capacity to keep loans, so they depended on the continuing appetite of secondary market investors. They made this bet on a young and shallow secondary market. In 1998, the odds went against them. Wall Street investors walked away from subprime securities and put their money into safer investments.

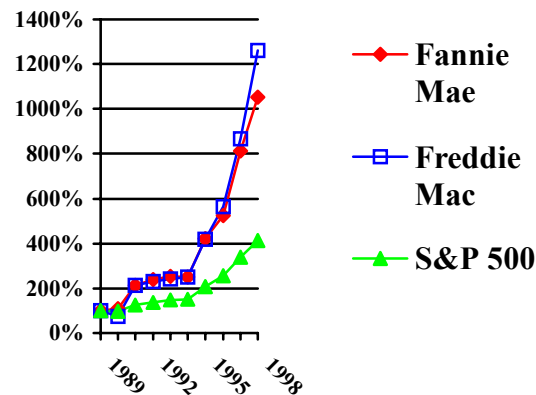
Fortunately for credit-impaired consumers, the subprime mortgage banking failures of 1998 had nothing to do with the remaining home equity and subprime lending market, which is still full of companies clamoring to do business. Home equity and subprime lending is alive and well – dominated by the lenders that have always done this business and know the market thoroughly.

### **The GSEs' Real Agenda: Continue Phenomenal Growth and Profits**

In just fifteen years, the value of Fannie Mae stock has risen by 14,000%, outperforming 99.8% of all U.S. equity investments. Freddie Mac's shareholders have done even better than Fannie Mae's over the past ten years.

These spectacular returns were not earned by inventing a novel computer application platform, as Microsoft did, or successfully patenting miracle biotechnology breakthroughs. Fannie Mae, a corporation of 3,700 employees, has outperformed by exploiting its ability to make the federal government its cosigner on \$1 trillion in debt. It uses the government's exceptional credit rating to secure funds at rates no other private company can match, then it buys secure, but much higher yielding assets, and pockets the difference.

**GSEs Beat the S&P by 250%+**



### **It's Time for Taxpayers to Say No to GSE Corporate Welfare**

GSE shareholders have benefited handsomely from their ability to compel the federal government to become the guarantor of the GSEs' \$1 trillion in debts. Congress and industry leaders should fight their planned expansion into home equity and subprime loans, a market already well-served by highly competitive private sector. Such risky lending will endanger taxpayers who must make good on the GSE debts if they once again get into trouble. It will raise federal borrowing costs. It will lower federal tax receipts. These real costs and risks aspects vastly outweigh the private gains received by GSE private shareholders or the \$52 a year saved by some households. It's time to tell the GSEs enough is enough.

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**Canfield & Associates, Inc.**  
801 Pennsylvania Ave., NW, Suite 625  
Washington, DC 20004  
Phone: (202) 661-2100  
Fax: (202) 661-2101  
[www.canfieldassoc.com](http://www.canfieldassoc.com)