

The **GSE** REPORT™

Special Supplement

Taxpayers v. Fannie Mae

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TAXPAYERS v. FANNIE MAE

To prevent another Savings and Loan debacle, Congress established the Office of Housing Enterprise Oversight (OFHEO) within HUD in 1992. OFHEO's mission is to minimize the chances that two shareholder-owned corporations that are backed by the federal government, Fannie Mae or Freddie Mac, default on their debts, forcing the taxpayers to make up any shortfalls. Back then, OFHEO records show that these two government-sponsored enterprises (GSEs) together had \$194 billion in debts outstanding. By the end of 1998, their debts had exploded to \$747 billion. Risks to the taxpayers have risen accordingly. *At the rate Fannie Mae and Freddie Mac are borrowing, their outstanding debts will exceed the national debt in the next decade.* Only OFHEO's independent judgment stands between taxpayers and a staggering GSE debt burden that falls on the public if the GSEs miscalculate their risk.

After years of work, OFHEO put out for public comment proposed "risk-based capital standards" designed to limit dangers to taxpayers. The idea is to require Fannie Mae and Freddie Mac to put up sufficient capital so that they can remain in business in the event their private investments sour. Without adequate capital, the Treasury will have to payoff some portion of their \$747 billion in debts. OFHEO's role is no different than that played by other federal financial regulators like the FDIC or the Federal Reserve. All must set necessary standards to protect taxpayers if officers of highly leveraged corporations act imprudently. If anything, OFHEO should be more diligent than other regulators. Private insurance premiums generate receipts to fill the FDIC's Bank Insurance Fund to repay depositors when banks fail. No privately funded insurance pool exists to backstop taxpayers if GSE losses overwhelm their capital cushions.

Equal Capital Treatment for Equal Risk

Regulators commonly set several standards because things can go wrong. Banks and thrifts face regulatory risk-based capital requirements of 4% for prudently underwritten mortgages held on-balance sheet and off-balance sheet. They must also meet a baseline leverage capital standard, usually 4%, for their total on-balance sheet assets.

By comparison, the GSEs have "minimum" leverage standards of 2.5% for their on-balance sheet assets, and only 0.45% for their off-balance sheet assets. The majority of the GSEs' on-balance sheet risk is for the mortgages they own; their off-balance sheet risk is for the mortgages they guarantee.

OFHEO's new rule will require a risk-based capital requirement for the GSEs too. This is an important first step toward uniform capital standards applied to all regulated financial institutions for equivalent assets with equivalent risk.

Fannie Mae is the largest financial institution in the United States, but size and soundness are unrelated concepts. At the end of 1998, Fannie Mae publicly reported total on-balance sheet assets of \$485 billion, of which \$474 billion were investment assets, including mortgages. It guaranteed an additional \$637 billion of mortgage-backed securities (MBSs). Its capital totaled \$16.2 billion, or only 1.45% of combined on-balance sheet assets and guaranteed MBSs. *This equals a leverage ratio of 69 to 1, compared to 24 to 1 for a bank's mortgage portfolio. This is a significant difference.*

OFHEO's new rules will not require the GSEs to lower their core leverage ratios, although that would increase taxpayer safety. Instead, the rules will establish another measurement, "risk based capital standards," that take into account the volatility of the assets the GSEs own. While rigorous analysis of OFHEO's proposed rule is just beginning to be done, let's hope OFHEO makes the standards sufficiently rigorous to reduce default risks. Standard and Poor's gave both companies AA- ratings. Importantly, these ratings overstate their financial strength because they take into account that the federal government is the implied guarantor of their debts. In the words of Standard and Poor's –

“ Both companies maintain capital levels that are relatively low when compared with what Standard and Poor's would expect to see at fully private companies with similar risk profiles at the 'AA-' rating level “

S&P adds later -

“Their ability to issue debt instruments with “agency status” enables Fannie Mae and Freddie Mac to access the capital markets even in time of financial stress, resulting in a high level of financial flexibility not experienced by fully private companies.”

S&P's rating was not based on their capital adequacy, but rather on their ability to issue debt, even in times of financial stress, because of their status as a government-sponsored enterprise.

Strong GSE Regulation Protects Investors and Consumers

The need for OFHEO to make independent judgments of the companies it regulates is even more important because the GSEs are exempt from SEC regulations. They are not required to provide disclosure statements to investors for debt and equity issues, and they do not file comprehensive 10-Q and 10-K reports. In addition, they are excused from conforming to international securities regulations and disclosure requirements. GSE debt issuance now exceeds the debt issued by the U.S. Treasury, and a growing amount of GSE debt is sold to foreign investors who rely on the implied U.S. government guarantee to pay them back. Only OFHEO defends the “thin green line” on behalf of investors and taxpayers.

Fannie Mae Tried to Defeat OFHEO Before the Agency Made its Views Publicly Known

Recently, Fannie Mae took the unusual step of criticizing OFHEO's proposed agency rule, even before it was published. By law, federal employees must keep their internal discussions over proposed rules secret, raising the question of how the company knew enough to try to preempt what it considered to be "unfair" proposed "risk based capital standards." The efforts of corporations to bend regulators to their will is not a new story. However, in a surprising slight of its regulator, Fannie Mae began attacking OFHEO's capital rule even before it was made public.

There may be selfish motivations behind their aggressive behavior. The company feared that OFHEO would require Fannie Mae to put up more capital. Investors could be disappointed. Fannie Mae shareholders want to employ maximum financial leverage to maximize their private profits if their calculations prove sound, safe in the knowledge that the government will absorb the losses if they miscalculate. If Fannie Mae must put up more capital, this action will dilute earnings per share and potentially cause its stock price to fall, harming shareholders. OFHEO's job is to defend taxpayers, not to further enrich Fannie Mae shareholders.

Who Should be in Charge?

Fannie Mae wants the company's computer model to be used to set capital standards, not OFHEO. It complains that OFHEO has created its own risk-based capital model rather than relying on Fannie Mae's. Given the state of financial modeling today, including the recent failure of models designed by Nobel prize-winning economists at Long Term Capital Management, OFHEO is being prudent in insisting on independent assessment of the capital strength of Fannie Mae, one of the largest and most leveraged companies in the world.

To comply with the 1992 law, OFHEO followed common sense reasoning and built its own risk model. OFHEO's model is being subjected to public scrutiny by all affected parties, plus academics and other experts. Fannie Mae would prefer to run its own internal model to meet the specified stress tests --a secret model that says that thrifts would have to increase their capital by half to meet Fannie Mae's internal standard and the mortgage industry would run out of capital in three to four years. We are supposed to accept these conclusions without question. Outside experts have no access to the proprietary black box that shows Fannie Mae, with 1.49% capital, is better capitalized than banks and thrifts that hold several times that amount of capital and mortgage insurers that have higher credit ratings, capital and reserve requirements than GSEs. This raises the question of who should be in charge of establishing capital standards --a profit-oriented, shareholder-controlled company --or an independent Congressionally designated regulator?

Fannie Mae is Holding Affordable Housing Hostage to Win the Argument

Fannie Mae warned of unspecified but serious consequences if the OFHEO model required it to increase capital. It hinted at having to “curtail capital-intensive activities,” including programs that benefit low- and moderate-income homebuyers. “If Fannie Mae is required to hold more capital against targeted loans,” the GSE stated, “the returns on these products will be further depressed, possibly to the point where they would not be profitable at all.”

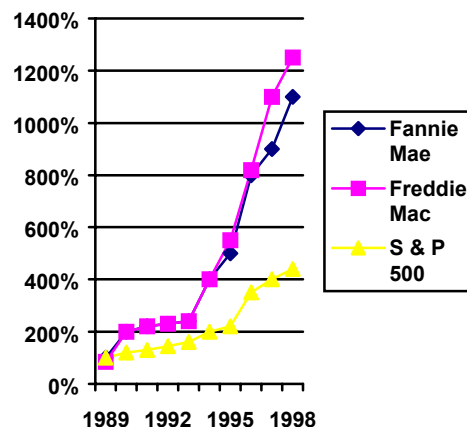
This argument is unfounded. Increasing an institution’s capital level has no impact on the performance of the underlying loan it purchases. Capital requirements do not make loans either more or less profitable. The profitability of a loan is determined by the consumer’s payment performance. Fannie Mae’s real concern is, that a higher capital requirement against targeted loans will dilute its earnings per share.

Fannie Mae’s argument is contradicted by evidence as well as logic. The actions of large mortgage lenders show that well-capitalized institutions can profitably lend to disadvantaged borrowers. Compared to Fannie Mae, the private housing finance industry serves a greater proportion of disadvantaged borrowers, even though they hold a much higher percentage of capital. According to a July 1998 GAO, report, primary mortgage lenders lead both Fannie Mae and Freddie Mac in serving low-income borrowers, African American borrowers, and those living in underserved areas of the country. The GAO reported that HUD’s affordable housing goals do not require Fannie Mae to match the voluntary performance of fully private lenders. GAO notes that HUD established such conservative goals after conducting research “which found that *additional mortgage purchases required under the goals were modest and would not materially affect the enterprises’ financial condition*. If HUD already has set weak housing goals for Fannie Mae, threatening vulnerable borrowers is an indefensible tactic when trying to weaken the capital standards that protect American taxpayers.

It Is Time For Congress and OFHEO to Tell the GSEs Enough is Enough

In deciding who is right, OFHEO or Fannie Mae, it is important to consider the remarkable profits their shareholders have earned during the bull market and why they did so. Over the last ten years, both Fannie and Freddie Mac shareholders have enjoyed stock returns that are more than 250% higher than the S&P 500.

GSEs Beat the S&P by 250%



The Congressional Budget Office (CBO) estimates that Fannie Mae and Freddie Mac receive subsidies worth \$6 billion but only pass through \$4 billion to people who take out mortgages. Shareholders pocket one third of government subsidies. Overall, CBO reported that the net subsidies generated 42% of the GSEs profits. *Generous subsidies like these made it possible for Fannie Mae to achieve an above-market 25% return on equity in 1998.* It's easy to understand why when all the subsidies considered:

- They have lower capital requirements than their competitors, and therefore can maximize the use of leverage.
- 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.
- They are exempt from state and local taxes.
- They are exempt from filing with the SEC, saving both the expense of filing and the time needed to compile and write SEC disclosures.
- Private investors do not judge them with the same risk standard, providing lower funding costs and a much lower cost of capital.

If OFHEO's rule gives taxpayers more protection, Congress shouldn't worry that GSE shareholders are being unfairly treated. They have reaped more than ample rewards from their taxpayer subsidies over the last 15 years. Instead, it should hold oversight hearings to ensure that OFHEO has adequately protected the Treasury from inappropriate risk.

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