

The **GSE** REPORT

Fannie Mae and Freddie Mac

- ***Fannie & Freddie's Technology Dominates the Mortgage Industry:***

The following section outlines how Fannie Mae and Freddie Mac are increasingly using technology (automated underwriting, credit scoring, and mortgage origination websites) to “intensify” their dominance over the mortgage industry. Fannie Mae and Freddie Mac understand the strength and advantage that technology affords any organization, and are putting in place systems that will expand their presence in the mortgage marketplace. As a result of their duopoly status, Fannie Mae and Freddie Mac will most likely, over time, use technology and possibly the online mortgage process to control the “platform,” ultimately controlling all data and access to consumers. Fannie and Freddie’s GSE status and the fact that the conforming mortgage market is captive to their standards create a significant barrier for private sector technology competition.

Moody’s (rating agency) Calls Conforming Market Captive to the GSEs:

- Moody’s recently released a mortgage banking industry report. The report noted that Fannie Mae and Freddie Mac’s overwhelming influence over the mortgage banking industry will “intensify” as their technologies become standard and as they move into the Alternative A and subprime market. The mortgage industry is increasingly relying on technology at all levels from Internet origination to automated underwriting. Moody’s believes that the use of Fannie and Freddie’s AU systems for conforming and (increasingly) non-conforming mortgage origination is improving the efficiency and lowering the cost of the underwriting function. However, there have been concerns expressed about the potential over-reliance on automated systems. “The quality of the input that determines the underwriting conclusion is often hard to monitor, and can lead to poor overall risk assessment.” Moody’s believes that the “conforming sector of the mortgage industry is highly dependent on Fannie Mae and Freddie Mac to purchase or securitize most of their mortgage production, and thus the industry is largely captive to these two GSEs in setting the standards for their product.” The report notes that “Fannie Mae and Freddie Mac have become the primary influence in the mortgage industry: they are the two largest purchasers of residential mortgages in the US. Approximately 40% of

total mortgages serviced and about two-thirds of MBS include mortgages bought and pooled by Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac compete intensely with each other, but they “enjoy formidable barriers to entry from competitors.” (*Moody’s Investor Services, “US Mortgage Banking Industry – Industry Outlook,”* August 1998)

How the Mortgage Industry is Increasingly Reliant on Technology:

- The *Dow Jones Newswire* ran a five-part series called “Hotwired Homebuying,” that examined the impact of technology on mortgage banking. The author, Frank Byrt believes that the mortgage finance industry, which has been historically slow to change, will be swept up in a major transformation thanks to technology and the Internet. Some mortgage industry experts say it isn’t far-fetched to believe that in a few years a “face-to-face” meeting could mean an Internet connection to a mortgage banker. Already a growing number of consumers are attracted to online systems for their speed, convenience, and cost savings, and the innovations have helped to keep costs down amid the year’s record pace of refinancings. Although somewhat in its infancy, the Internet mortgage origination business is expected to grow and represent a significant portion of the market. Jules Street of Killen Associates in Palo Alto, CA notes that Internet mortgage origination is only about 1% of the total now, but a survey by his firm found that mortgage lenders themselves expect that figure will reach 30% by 2005. David Weisman, an Internet retail services analyst for Forrester Research, a MA-based technology firm, estimates that Internet originations will jump to \$25.5 billion in 2001 from \$265 million in 1997.
- Fannie Mae and Freddie Mac understand the strength and advantage that technology affords any organization. Speaking at a MBA conference in May, David Glenn, President and Chief Operating Officer of Freddie Mac said the intricate technology changes will “cause a revolution” in how the mortgage industry works. “We see that technologies both promise and threaten to replace whole functions” now performed by mortgage bankers. Failure to adapt in the new mortgage marketplace will result in a competitive disadvantage, he said. “We see the possibility of a variety of new entrants bringing innovative strategies for diverting customers.”
- All of the efficiencies and streamlining brought by technology will inevitably cause consolidations in the industry. “We’ll see wholesale firms and securitization firms become one” due to the economies of scale, said Scott Cooley, founder of Contour Software, Inc., one of the largest providers of software to mortgage originators. The author of the *Dow Jones Newswire* series, Frank Byrt, calls the new technological advances to the market a “brave new world for mortgage bankers,” who must keep up with the advances or they will be left “swimming for their lives.”

Automated Underwriting

Fannie and Freddie Duopolize Automated Underwriting Technology (Control 89.8% of Business):

- Already one of the most significant changes affecting the mortgage industry is automated underwriting (for which the GSEs control 89.8% of the entire market). Several of the largest private mortgage originators, such as Norwest and Countrywide, have successfully used their own versions of AU for several years. However, within the past two years, Fannie and Freddie have launched systems that [sic] “have had a far-reaching impact throughout the rest of the industry, not least because between them Fannie Mae and Freddie Mac dominate the purchase of mortgages for resale as securities to investors.”

- Freddie Mac claims its AU system, Loan Prospector, has 700 active lenders as of July 1998, and is scoring more than 1,000 mortgage transactions per week. Fannie Mae claims its system, Desktop Underwriter, has more than 1,000 mortgage originators using the system as of June 1998, and is processing more than 10,000 transactions per month. Fannie Mae and Freddie Mac are also expanding digital communications and technology tools that link lenders, title companies, real estate agents and credit information providers. (*Dow Jones Newswire, “Hotwired Homebuying” Series, 8/17-8/21/98*).

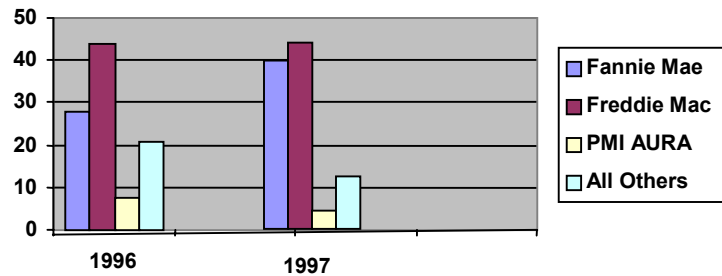
- According to Mortech, Fannie and Freddie have an 89.8% market share of the automated underwriting business. The following is a market share analysis illustrating Fannie and Freddie’s domination of the automated underwriting market:

Percentage of Lenders Using Automated Underwriting (overall):

	Freddie Mac – Loan Prospector	Fannie Mae – Desktop Underwriter	PMIAURA	All other responses
1996	43.7%	27.9%	7.4%	20.8%
1997	43.9%	39.5%	4.4%	12.3%

Source: Mortech 97

Percentage Of Lenders Using AU:

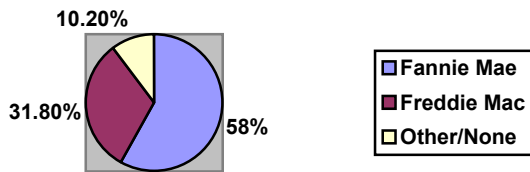


Overall Market Share:

	Overall Market Share	Among Lenders that Originate more than \$1 billion in originations
Fannie Mae	58%	40.9%
Freddie Mac	31.8%	31.8%
Total	89.8%	72.7%

Source: Mortech 97

Overall Market Share



Who Has the Fastest Automated Underwriting Service or Are They Virtually the Same?

- According to an article in *Mortgage Technology*, Freddie Mac claimed during a closed-door meeting that they could return an automated underwriting decision in two minutes, while they claimed Fannie Mae required 45 minutes to return a decision on an identical loan. (Fannie Mae disputes this 45-minute timing figure.) Linda Terrasi, Senior Vice President for Flagstar Bank, suggests that the difference in response between Fannie and Freddie is probably closer to four minutes than the 43 minutes that Freddie claimed. According to the article, **some mortgage professionals suggest the differences between the two systems are disappearing.** Terrasi noted that that Fannie Mae’s system used to require more data input than Freddie Mac’s system, however, that gap has narrowed, and “Fannie very soon will require the same information.” The article notes that there will be little difference between the two systems in a few months.

Fannie and Freddie Create Incentives to Make Sure Lenders Use their Systems (Private AU market cannot compete against GSEs):

- (By using incentives (e.g., less reps and warranties), the GSEs make it almost a business necessity to use their automated underwriting systems and therefore make it easier to monopolize the automated underwriting industry.) “Because we use automated underwriting, we anguish less over underwriting decisions because the GSEs make them, and they are aggressive,” says Becky Poisson, Executive Vice President of Operations for Headland Mortgage. “We receive better reps and warranties as a result.” (*Mortgage Technology*, 7/98)
- St. Francis Capital had looked at other automated underwriting packages, but a price reduction convinced the company to sign a contract with Fannie Mae. The article noted that until recently, banks paid \$60 to \$70 for every loan processed through Fannie’s Desktop Underwriter, whether or not it was approved. The processing fee applied even if the bank

didn't want to sell the loan to Fannie Mae but intended to keep the loan on the books. James Eckel, senior vice president of lending for St. Francis said, "Those were costs we could not justify." So, Fannie made two changes to convince the bank to use their system. The first change was a reduced fee, which Eckel wouldn't disclose. Fannie also lowered the cost to process loans the bank doesn't want to sell to Fannie Mae, allowing St. Francis to run the loan through their system to see if it should be approved without being charged the same as if it were selling the loan. "And if Desktop Underwriter gives the loan an 'accept' rating, Fannie Mae will buy the loan and never require the bank to buy it back if the borrower defaults. Two other ratings mean the bank could be required to repurchase the loan if it goes bad." M&I Mortgage Corp. decided to use Freddie Mac's automated underwriting system, Loan Prospector, it says because it is a better match with their bank's existing software. "We have investors who buy our loans, then sell them on the secondary market to Fannie or Freddie," said Scott Happ, president of M&I Mortgage. "As long as we have one of the services checking our loans, they are acceptable for sale." (Milwaukee *Business Journal*, 7/6/98)

- ***Morgan Stanley Report Believes Fannie Mae is Making Its Technology "Ubiquitous" Throughout the Origination Community To Expand Market Share At the Expense of Niche Product Players:***

- ***Fannie Mae is Pushing its AU System Onto Brokers:***
 - Morgan Stanley Dean Witter recently released a report stating that Fannie Mae was aggressively pushing its point-of-sale underwriting technology, Desktop Originator (DO), onto brokers. Fannie's DO system is the point-of-sale complement to its automated underwriting system, Desktop Underwriter. DO software allows independent mortgage brokers to enter loan application information into a desktop or laptop and then receive over a phone line, an approval from Fannie Mae as well as pricing information and a rate lock commitment from a wholesale mortgage bank.

 - "We are very serious about including brokers in our technology strategy," said Michael Koch, director of marketing for customer technology services at Fannie Mae. He noted, however, that they have a partnering strategy with their lenders whereby brokers can only get the necessary software through their lender-sponsors. According to Koch, there are 32 lenders that are registered to sponsor brokers, with 16 others in the pipeline – double the number of last year.

 - Fannie Mae's aggressive push of its DO on the broker channel should create tremendous returns, since more than 50% of originations are said to come through brokers now. According to Morgan Stanley, Fannie's origination system now generates about \$6 billion a year in production volume, equivalent to approximately 1% of originations by brokers – but Morgan Stanley expects Fannie's desktop origination system volume to grow by at least 400% in 1999. Currently automated underwriting accounts for close to 50% of Fannie's bulk purchase, up from 25% last year. According to the author of the Report, Kenneth Posner, VP at Morgan Stanley, "Just about everybody is going to have to use automated underwriting, or they'll be falling behind."

- Posner believes that there are more important benefits for Fannie Mae than just fees in pushing their technology onto brokers. “More important, portfolio growth should be strong, as more and more brokers become equipped with Fannie Mae technology and push Fannie Mae product.” Posner stated that **“As the benefits of technology become more visible to the market, we would expect additional expansion.”** Posner further comments that **Fannie Mae “should be able to roll out new products more quickly through DU and DO and thus expand market share at the expense of niche product players. Finally, by making its systems ‘ubiquitous’ throughout the origination community, we believe the agency positions itself to build electronic commerce functions with fee income potential into its systems.”** (*“Fannie Mae: Brokers Enthusiastic About Underwriting Technology,” Morgan Stanley, Dean Witter Market Watch, 8/20/98; American Banker, 8/19/98*)

Credit Scoring

Fannie Mae and Freddie Mac are Pushing the Industry to Use Credit Scoring:

- Increasingly, credit scores are impacting the type of deal a borrower receives on a home loan. Retailers have been using credit scoring for years for credit cards and car loans, but the home mortgage finance industry only started using the process a couple of years ago. According to the *St. Petersburg Times*, “the practice has grown, partly because the two agencies that buy mortgages from lenders, Fannie Mae and Freddie Mac, have been requiring that all the loans they buy go through a credit-scoring process.”
- Credit scoring is the process in which a computer model analyzes a person’s borrowing and bill-payment history, along with a variety of other items (such as how long a person has spent at an address or in a job). The models use mathematical tables, which were developed by looking at the credit habits and characteristics of thousands of borrowers, to assign a number to each item and create a composite score.
- Proponents of the system say that credit scoring is good because it helps credit-worthy borrowers get home loans quickly, often with less paperwork, and it is colorblind (neither race nor neighborhoods are supposed to be part of the formulas used to calculate scores). However, critics believe that “home buyers are at the mercy of a number derived from mysterious formulas.” Peggy Twohig, assistant director for credit practices at the Federal Trade Commission, “generally favors credit scoring” because it generates more uniform decisions than loan officers and that probably means fairer, faster decisions about whom to lend money to. However, Twohig wonders what information credit bureaus are using and what weights the models give to different factors. “It’s too much of a black box to consumers,” she said “That needs to be talked about and explained more, particularly by lenders.” But lenders are also confused by some of the results of the credit scoring models. “It’s very confusing,” said Steve O’Connor, senior director of residential finance for the Mortgage Bankers Association. “And it’s not just confusing for consumers; lenders and Realtors get baffled. They don’t understand why one person gets one score and another gets another one.” A loan officer can look toward other sources of mortgage money that don’t use credit scoring but might charge higher interest rates, presumably because they carry more risk. However, according to the *St. Petersburg Times* article, “Even though both Freddie Mac and Fannie Mae insist mortgage officers are not bound by credit scores alone, lenders

worry that going their own way will come back to haunt them if they make the loan and the customer defaults.” (As noted earlier in this Report, Fannie Mae and Freddie Mac have been “requiring that all the loans they buy go through a credit-scoring process.”) (*St. Petersburg Times*, 8/29/98)

Related Story – “Fannie Mae Toughens Rules on Bankruptcies” - - Mortgage Industry Analyst Says Both Fannie & Freddie are Increasingly Relying on Credit Scores

- Mortgage industry analyst, David Beadle, reported that Fannie Mae has come out with new guidelines this month that further restrict the ability of an individual who has filed for a Chapter 7 bankruptcy to obtain a mortgage loan (Fannie Mae Announcement 98-04). In its most recent guidelines (explaining loans that Fannie Mae will purchase and which loans it will not), Fannie Mae said that most of the time, a bankruptcy must have been discharged for four years before a borrower will be able to get financing at the most competitive rates. Previously, there was a two-year waiting period in most cases. Fannie Mae said it based its new guidelines on a review of the performance of mortgages in its portfolio, which indicate that a past bankruptcy is an even more significant indicator that future problems will occur than earlier believed.
- Beadle reported that while Freddie Mac’s rule book “was not as detailed as the one from Fannie Mae, the fact of the matter is that both agencies are increasingly relying on credit scoring to make decisions on whether or not to purchase a loan from a lender.” Beadle notes that generally a credit score of 620 is required to receive favorable consideration, and bankruptcies often force that score below that line, “which in turn makes it more difficult for underwriters to stick their necks out and approve a marginal application.”
- In its new guidelines, Fannie Mae said it would also accept a shorter elapsed period of two years to re-establish good credit in the case of a successfully completed Chapter 13 bankruptcy and when the bankruptcy resulted from extenuating circumstances that can and must be documented. Fannie Mae defined extenuating circumstances as those that “are created by nonrecurring events that are beyond the applicant’s control, which result in a sudden, significant, and prolonged reduction in income or catastrophic increase in financial obligations.” Fannie Mae also “recommends that lenders use a FICO bureau score of 660 or higher as an indicator of successfully re-established credit” and “lenders can approve an applicant with a lower score if there is no additional layering of risk and there are compensating factors to justify the approval.” (Of course, Fannie Mae does not say that they will buy the loan if the score drops below 660.) In the announcement, Fannie Mae also included: (1) guidelines on how NAFTA workers should be treated in determining eligibility for mortgage financing; (2) clarified that a refinance to buy-out the interests of one’s domestic partner or fiancée qualifies as a “limited cash-out” refinance if it meets certain conditions; (3) clarified a secondary wage earner’s income when an employer transfers a primary wage earner to a new location; (4) and clarified “gifts” as a source of funds for the downpayment or closing costs. (*Compliance Matters*, September 1998; *Reuters*, 8/28/98)

Online Mortgage Origination

Fannie Mae has already entered the online mortgage market, while Freddie Mac is beginning its development of an alternative system. Fannie Mae's entry into the online mortgage market has been through Fannie's new iQualify website. The new website has raised some eyebrows in the mortgage industry. As one industry person asked, is this trampling against the spirit of Fannie's charter by positioning the consumer, not the lender, as Fannie Mae's customer?

- ***Consumers Have Direct Access to Fannie Mae's Automated Underwriting***

- Fannie Mae's new website, iQualify (<http://www.iqualify.com>), a partnership with Finet Holding Company, is a mortgage website program with a new twist. It provides potential homebuyers direct access to Fannie Mae's automated underwriting system, *BEFORE* the consumer chooses a lender.
- IQualify links Fannie Mae's HomePath.com website (www.homepath.com), Fannie Mae's automated underwriting system (Desktop Underwriter) and Finet's iQualify. At [iqualify.com](http://www.iqualify.com), operated by Monument Mortgage (owned by Finet), consumers can submit a streamlined mortgage application using Fannie Mae's Desktop Underwriter and receive a loan decision and requirements for closing in minutes. The approvals are good at any "participating Fannie Mae lender" (lender participating in website program). To be eligible, lenders pay a fee for being listed on the iQualify site. Finet claims that 40 lenders are participating in the program, but after checking the website (8/25/98) there only appears to be 17 lenders that are listed on the iQualify website from which consumers can choose. The following are the lenders listed on iQualify's website (as of 8/25/98):
 1. American Federal Mortgage Corp.
 2. American Home Finance, Inc.
 3. Coastal States Mortgage (owned by Finet)
 4. Flagship Mortgage Services
 5. Headlands
 6. Hibernia Mortgage
 7. Home Financing Center
 8. Home Loan Direct
 9. Homenet Mortgage
 10. Maple Park Mortgage
 11. Metrociti Mortgage
 12. MICAL (owned by Finet)
 13. Monument Mortgage (owned by Finet)
 14. Seattle Mortgage
 15. US Mortgage
 16. Washtenaw Mortgage
 17. Zions Mortgage

Loans Steered to Lenders Chosen by Finet

- In an earlier *Inside Mortgage Finance* article, Finet declined to reveal the program's terms of participation. According to James Noack, chief information officer at Finet, some of the lenders receive a qualified lead while others receive a completed online application. Noack said some of the applications are referred to Monument Mortgage (their company), but most are not. Finet claims that consumers choose a lender. Yet, this same article reported that the system refers the Fannie Mae AU-approved homebuyer to participating lenders based on geography and capacity - *Finet monitors lender turnaround time to make sure the customer is referred to a lender that can handle the business.*
- Just this month, Lee Decker, president of iQualify, said he expects that as now-disparate technologies begin to interact, there will be a blurring between what real estate firms, mortgage originators and financial firms offer, particularly over the internet. "And I think there will be a consolidation of the whole consumer financial experience. And once a company grabs on to a consumer they'll want to hold on," which means trying to capture all their financial needs, from credit cards and car loans to mortgages and investments, Decker said.

Cost of Fannie Mae/Finet Program

- The lender who closes the loan absorbs the cost of running an application through Fannie Mae's Desktop Underwriting system. Finet absorbs the cost if the loan is not closed. The system pulls a merged credit report, and the borrower pays a \$39 fee online for up to three tries at the underwriting system.

Freddie Mac Working on Similar System

- Freddie Mac in its initial phase of their Online Mortgage Explorer (OME) project will allow potential borrowers to submit a profile of their credit needs anonymously to a web site. Software at the web site will then compare the borrower's input to the program criteria listed by participating lenders, and refer the borrower to a list of participating Freddie Mac lenders. (Freddie Mac has already begun the first phase of this project. Freddie Mac has partnered with MPACT Immedia (a Toronto firm) and GHR Systems (a PA-based provider of fully automated mortgage origination systems). According to a press release by GHR Systems, GHR and MPACT will operate OME, a multilender mortgage origination website. Initially, the site will feature access to seller/servicers on Freddie Mac's GoldWorks network. GHR will manage and distribute the loan product and pricing information from the GoldWorks lenders on the OME site.)
- In the second phase of the project, the loan applications will be run through Freddie Mac's Loan Prospector, said Robert Habert, vice president of strategic alliances at MPACT Immedia, the Toronto firm that is building the Internet connection. The lenders will be available from Freddie Mac's GoldWorks subscribers. Freddie Mac has also begun discussing a program in which Loan Prospector would be available directly to consumers through the Internet and fees for Loan Prospector could be waived to encourage lenders to participate in the program.
- OME is similar to Fannie Mae's HomePath Network in that, like HomePath, Fannie Mae connects borrowers directly with 65 lenders. Under OME, the plans is to connect the

borrower with 900 lenders over the Internet. But Freddie Mac's Griff Straw, said Freddie Mac is still not interested in dealing directly with consumers, but "our only role is in providing the network for the lender to get to OME," he said. "All we're providing is the network." But while Freddie's program is far from a fully digital transaction, it is the first time the secondary mortgage market has turned directly to the Web to provide origination assistance. (*Business Wire*, 9/3/98; *Inside Mortgage Finance*, 1/30/98; *Dow Jones Newswire*, 8/21/98; *National Mortgage News*, 2/2/98; *Inman News Feature* 2/4/98; *Mortgage Marketplace*, 2/2/98; *Washington Times Home Guide*, 2/6/98; *Real Estate Finance Today*, 2/2/98)

- Related Note – Fannie Mae is Increasing its Internet Exposure - Fannie Mae's Homepath website will be available on Realtor.com – Realtors Are Worried About this New Arrangement:
 - Fannie Mae entered into a partnership with RealSelect, Inc., operator of Realtor.com, one of the "premier" real estate sites on the Internet. Realtor.com has over 1.25 million listings (more than 90% of the 1.3 million homes that are up for sale around the country). Realtor.com also has distribution deals with five of the top seven portals, including AOL, Netscape, Netcenter, Excite, Infoseek and Lycos. According to Relevant Knowledge, an Internet commerce market researcher, Realtor.com is now reaching 25% of the market that is looking to purchase a home. In May, some 3 million computer-users visited the website. Beginning later this year, Fannie Mae's education materials and information about the home financing process and promotions about Fannie Mae-owned/foreclosed homes will be available on Realtor.com. Previously, this information was only available on Fannie Mae's www.homepath.com website. Fannie Mae sells more than 20,000 foreclosed properties per year.
 - Some real estate agents and real estate association executives are nervous about RealSelect's new arrangement with Fannie Mae and other recent deals with Intuit and others. RealSelect has also been criticized for placing Realtor.com listings near FSBO properties and home loan sites. In response to concerns, RealSelect CEO Stuart Wolff sent out talking points and Q&As to real estate executives to address "rumors, myths and inaccurate statements circulating recently in the industry." One of his documents addresses the charges that the National Association of Realtor's (NAR) control "isn't real" and that "Realtor.com isn't Realtor friendly." Wolff's memo says that: "We promote Realtors, we help consumers find Realtors, we are an online real estate company and we will not disintermediate Realtors." The memo also notes that RealSelect and NAR have a lifetime agreement that "ensures that Realtor.com is Realtor friendly," and that the NAR contract includes "1,000 pages of numerous related agreements." Recently, a group of MLS organizations visited with one of Realtor.com's competitors, Microsoft HomeAdvisor. At one of the sessions, a presentation included examples of where Realtor.com was mixing homes and loans and where its listings were positioned next to FSBO listings. (*Forbes ASAP*, 8/24/98, Vol. 162, No. 4; *Inman News Feature*, 8/25/98, 8/28/98; *PR Newswire*, 8/24/98)

Fannie Also Increases Web Presence by Dominating Homepages of Libraries:

- As we stated in the June 5th *GSE Report*, one of Fannie Mae's strategies to increase its web presence is hyperlinking its hompath.com Web site to public libraries. Mona Simons, deputy director of Fannie Mae's Columbus, OH, partnership office says, "Not everyone has ready access to a computer... The local library is one place where any person can link up with the Internet." In only a few months, Fannie Mae has created links to library webpages in New York, Chicago, Baltimore, and Los Angeles. Fannie is also currently extending the network in Ohio and is promoting the program to other library systems through its 30 partnership offices. Fannie also has plans to provide links with local computer labs, community colleges and centers that provide computer training. The hompath.com page was created a year ago by Fannie Mae and is averaging approximately 26,000 hits a day. The site provides addresses and names of local counselors, details different Fannie Mae mortgages, and provides a listing of lenders who offer Fannie Mae products. Consumers can also e-mail questions to Fannie Mae. "It's much easier for consumers to find a lender if the bank is listed on the site," says Bruce Cornelius, Fannie Mae's director of electronic commerce. "They can click on lists of local or out-of-state lenders and there's a special 'quick access' site with icons of 86 lenders." According to Cornelius, "Fannie Mae's consumer resource center in Washington, DC, counsels applicants, saving branch officers the time it takes to do the same work." (*American Banker*, 6/3/98)
- Fannie Mae and Freddie Mac are using technology (automated underwriting, credit scoring, and online mortgage origination websites) to expand their market share, control the "platform," and move closer to directly accessing consumers.

Private Sector Items to Note:

- ***Private Sector Introduces New Low Downpayment Loans for Jumbo Mortgages:***
 - Commonwealth Bank's subsidiary, ComNet Mortgage Services, announced that the company will be offering a new 3% downpayment jumbo mortgage loan. The 97% LTV Jumbo Residential Mortgage is patterned after Fannie Mae's Flex 97 program, but will be offered for mortgages up to \$400,000. (Fannie & Freddie's limit is \$227,150.) The company will use computerized underwriting to evaluate the credit risk and determine documentation requirements. ComNet President Peter Kehoe said the company is "comfortable with the predicative nature of credit scoring models and wanted to expand the availability of a 3% downpayment mortgage beyond Fannie Mae/Freddie Mac loan limits." (*National Mortgage News website*, posted 8/21/98)
- ***Private Sector May Create Secondary Market for Home Loans From Relatives (Private Mortgage Notes):***
 - J.G. Wentworth, a Philadelphia firm, is exploring the possible creation of a secondary market for private mortgage notes (loans that are originated by relatives or other investors). The process would be similar to that used by Fannie and Freddie and would be designed to support loans for borrowers who normally wouldn't qualify for loans. The

loans would likely be targeted to farmers or urban buyers who do not meet conventional credit standards or don't want to deal with banks or subprime mortgage lenders. If the program becomes more visible, it could also result in low rates, according to Michael Goodman, COO of Wentworth. Wentworth estimates that 200 basis points could be shaved from mortgage notes if the products were made more visible. Marc Smith, President of the Mortgage Bankers Association, says the plan could add liquidity to today's market and could also incorporate traditional lenders. These private transactions are estimated to account for about \$1 billion annually in loans. Industry members acknowledge that there are challenges to the new concept, such as developing underwriting and appraising standards, and making sure certain lending standards are set. (*American Banker*, 8/20/98)

Fannie Mae

- ***Fannie Mae Explores Corporate-Owned-Life Insurance (Mortgage Protection Plan) Proposal Again:***

- A corporate-owned life insurance (COLI) proposal developed by Fannie Mae, the "Mortgage Protection Plan," was "killed" by Congress last year when legislators modified the Taxpayer Relief Act to amend Sec. 264(f) of the Internal Revenue Code, effectively "killing" the Fannie Mae plan. The Sec. 264(f) provision limited most interest deductions for businesses investing in cash-value life insurance linked to home mortgages. However, the *Insurance Accountant* reported that several sources told them that Fannie Mae is now exploring ways to sidestep those restrictions and is working on a revised COLI plan.

Fannie Mae Plan Would Sidestep Tax Restrictions:

- According to a key government official who was made aware of the plan by Fannie Mae staffers, the revised plan would allow Fannie Mae to invest in life insurance contracts which would be designed to minimize the tax risk related to the application of Section 264(f). As under the original Mortgage Protection Plan, Fannie Mae would receive death benefits tax-free (including premium invested and any investment income on the premium) when the insured person died. However, the life insurance policies would be structured to minimize the risk that they would have "unborrowed policy cash values" within the meaning of Section 264(f). Therefore, according to the source, if the policies did not have "unborrowed policy cash values," then Fannie Mae would be able to deduct the interest, on its corporate debt, because Section 264(f) would not apply to limit those interest deductions. "Fannie Mae would have a way to circumvent the interest disallowance provision that Congress enacted last year," said the source.

Fannie Mae Denies Working on New COLI Plan:

- Fannie Mae officials deny that they are working on a new COLI plan and Fannie Mae's partners in the original Mortgage Protection Plan – New York Life and Minnesota Mutual – said they were not aware of any plans to revise the original COLI plan. "I can guarantee that is not going on," said Brian Graham, a Vice President at Fannie Mae. "The law says that (MPP) is disallowed." However, the government official insisted that

a Fannie Mae staffer had contacted the Treasury Department and the Internal Revenue Service earlier this spring to seek tax information in order to structure the new COLI product.

COLI Plan Could Mean Lots of Money for Fannie Mae:

- If Fannie Mae can make a deal with life insurers, Treasury, Congress, and other federal agencies on this new COLI product, the GSE will receive a huge tax break, restricted only by limits imposed by the Office of Federal Housing Enterprise Oversight (OFHEO) on the amount of money they invest each year in securities. The original MPP proposal called for Fannie Mae to invest \$3.2 billion over a period of 10 years with an initial investment of \$250 million. The plan was to raise as much as \$650 million for Fannie Mae by year 20 and \$1 billion by year 30. The Joint Committee on Taxation estimated that the 1997 tax benefit would be worth approximately \$2 billion for Fannie Mae and the FHLBanks over the 10-year period. “This interest deduction is substantial to Fannie Mae,” because the GSEs are substantially leveraged, a government source said.

Freddie Mac Would Likely Develop a Similar COLI Plan:

- A government attorney in the housing industry who was willing to confirm the story but wanted to remain unidentified believes that the revised COLI proposal would also be available to Freddie Mac. “Unless it was proprietary, it would be an unusual circumstance that it would apply only to one (company),” he said, “There is no practical difference between the two organizations.” He added that he believed HUD would also approve this revised COLI since HUD approved the original MPP proposal. A government attorney, however, noted that the Treasury Department is likely to oppose the revised COLI proposal, because it would take too much money out of tax coffers. (*Insurance Accountant – American Banker*, 6/98)

Comments from House Banking Comm. Chairman on Original Fannie Mae COLI Plan:

- In a letter to HUD last year, Chairman of the House Banking Committee Jim Leach (R-IA) called Fannie Mae’s original COLI plan, the “Mortgage Protection Plan,” a way for Fannie Mae to “bypass its charter by effectively allowing it to lend money raised at agency rates to the insurance industry under the guise of life insurance.” Leach believes that the lending effect stems from the MPP’s allowance of Fannie Mae to recover its initial outlay – “that is, the premium paid to the insurance company – plus interest on the premium upon the death of a covered participant.” Leach believes “these are unusual terms for a life insurance policy.”
- Leach also notes that internal documents prepared by Fannie Mae on the MPP plan suggest that their charter does not preclude the GSE from offering the insurance plan. However, as Leach points out, “If Fannie Mae were allowed to pursue all businesses not specifically precluded by its charter, its range of activity would be limitless.” Fannie Mae’s internal documents also concede that the MPP may be perceived as a new activity and beyond its mission and therefore the internal documents indicate that “Fannie Mae must keep the lowest possible profile, maintain a minimal and clear role in the structure, and balance the speed of program introduction with the need to maintain control over expectations and public perceptions.”

- By using the MPP program, Leach believes that “Fannie Mae is precariously close to entering into the life insurance business.” Leach noted that some insurance companies raised concerns about the MPP plan, and he also referenced a *Wall Street Journal* article reporting that consumer advocates also question whether such insurance is even necessary. **FIC Insurance Group wrote to Congressman Lloyd Doggett of Texas that “Fannie Mae can create massive leverage and destroy the concept of fair competition in the life insurance industry and secondary mortgage market” and that by “using its position with the government, Fannie Mae can create a virtual monopoly in the mortgage redemption niche of the life insurance market, putting Family Life and other life insurance companies at a major competitive disadvantage and threatening numerous jobs throughout the nation...In addition, mortgage lenders will have a new incentive to send loans to Fannie Mae [because of the fee paid to lenders who utilize the program], leaving less loans available for the other secondary mortgage lenders,” possibly inflating mortgage rates.**
- Leach noted that his analysis of the MPP plan was based on Fannie Mae’s internal documents and that Fannie Mae has said that their MPP plan in “no way relies on borrowed funds, special funding advantages, or deductibility of life insurance premiums.” Leach stated that “If this is the case, and the proposal described in internal Fannie Mae documents has been substantially modified, perhaps not all of the above analysis applies to the final outline of Fannie Mae’s proposed MPP program. **But it remains difficult to foresee how the MPP can be redesigned to be anything except an unauthorized insurance product offering.**” (*Chairman Leach’s Letter to HUD Secretary Andrew Cuomo, 4/23/97*)
- ***HomeCapital Considers Filing a Counter-Claim Against Fannie Mae:***
 - ***HomeCapital Disputes \$84.9 Million Fannie Mae Claim***
 - ***(Background: Fannie Mae’s Termination of HCAP’s Seller/Servicing Contract and Loan Repurchase Agreement in March of this Year, Caused HCAP to File for Bankruptcy in May):***

Fannie Mae’s Claim:

- HomeCapital announced that it would “vigorously dispute” the \$84.9 million claim (subject to credits) lodged by Fannie Mae in connection with the bankruptcy reorganization proceedings of HomeOwners Mortgage & Equity, the wholly owned subsidiary of HomeCapital. HomeCapital is also considering “substantial” counter-claims against Fannie Mae. Austin-based Home Capital Investment Corporation (Nasdaq: HCAP) is the holding company for HOME, a consumer finance company that originates, purchases, and sells home-improvement loans and second mortgages, primarily FHA Title I home improvement loans
- According to a HomeCapital press release, Fannie Mae’s claim, lodged on August 31st, claims to be based upon loans sold that Fannie Mae alleges were ineligible, contained breaches of warranty or are otherwise nonperforming and other breaches of contract. The press release also states that Fannie Mae acknowledges that much of the claim is unliquidated, contingent or unmatured, and that a substantial portion of the claim is based upon “projection.”

- HomeCapital said they would dispute Fannie Mae’s claim because, among other reasons, it is speculative, does not make appropriate allowance for the residual value of the criticized loans, and apparently does not account for FHA insurance recovery on nonperforming loans.

Actions by Fannie Mae Cause Company to Declare Bankruptcy:

- As we previously reported in the April 10th and May 8th issues of the *GSE Report*, Fannie Mae unexpectedly terminated their Selling and Service Contract and Loan Repurchase Agreement with Home on March 24, 1998, causing HomeCapital to file Chapter 11 Bankruptcy on May 4th, 1998.
- HOME’s FHA Title 1 home improvement loans were typically sold to Fannie Mae. Fannie Mae demanded that HomeCapital repurchase \$6 million of the loans, according to the company. Fannie Mae had purchased \$206 million in home improvement loans that were being serviced by HomeCapital at the end of 1997 for resale to investors in the secondary market. Fannie Mae also complained to HomeCapital that too many of its home improvement loans were for multifamily residences rather than preferred single-family. In March, Fannie Mae notified its termination of its mortgage selling and servicing contract and its loan repurchase arrangements with HOME and efforts by HCAP have failed to restore the seller/servicer contract with Fannie Mae. HCAP announced in April that it was continuing to liquidate loans, cut staff and reduce overhead in an effort to return to profitability. Fannie Mae has declined to discuss why it quit doing business with HCAP. (*Austin American Statesman*, 5/6/98; *Business Wire*, 5/5/98; *Dow Jones Newswire*, 5/5/98, 9/3/98; *PR Newswire*, 9/3/98; *Reuters*, 5/5/98, 9/3/98)
- ***Fannie Mae Takes Advantage of Market Turmoil and Reopens Benchmark:***
 - Fannie Mae took advantage of market turmoil with a \$2 billion reopening of its 10-year dollar benchmark issue it made in May. Fannie Mae’s Benchmark notes are marketed as alternatives to Treasurys. Fannie Mae reopened the 6% benchmark due May 15, 2008, boosting the issue to \$7 billion from \$5 billion. The new tranche pays a spread of 58.5 basis points over US Treasurys and was priced at 102.224.
 - According to the *Financial Times*, with the 10-year swap spread having widened to 85 basis points – the widest since 1990 – Fannie Mae can offer a decent spread to fixed income investors while exceeding its sub-Libor funding target after having swapped the deal. The original bond was launched a spread of 33 basis points over the Treasury while the swap spread was less than 55 basis points. “Fannie Mae, in other words, has achieved cheaper funding than on the original offering.” The *Dow Jones Newswire* reported that “market jitters linked to the turmoil in Russia have pushed spreads to their widest levels for some time, meaning that Fannie Mae has nothing to lose and everything to gain by borrowing more money.” One official thought the Fannie Mae “has chosen just the right moment to take advantage of the global turmoil,” since “both European and US investors are clamoring for AAA paper.”
 - Unlike other noncallable deals brought to market in the past eight months, this note went predominately to US investors, said John W. The Losen, Vice President of Debt Marketing at Fannie Mae. According to The Losen, there was some European interest

but not as much as for the expansion of a five-year issue at the beginning of August that received the largest international distribution of any security in Fannie's benchmark program.

- With this new reopening, Fannie Mae has launched \$30.25 billion of notes in their Benchmark program since January, making it one of the largest borrowers in the bond markets. (*American Banker*, 9/1/98; *Dow Jones Newswire*, 8/31/98; *Financial Times*, 8/28/98)
- ***Fannie Mae Offers 1-Stop Defeasance Option – Believes Product will Protect Multifamily Investors Against Prepayments:***
 - Fannie Mae announced that it is offering borrowers in the multifamily market, the only “one-stop” defeasance option for fixed-rate mortgages with a term of ten years or less. According to Fannie Mae, defeasance occurs when a borrower substitutes US Treasury or other qualified securities as collateral for a mortgage loan in return for release of a lien on the borrower's property. Fannie Mae also noted that defeasance is now being widely used in the commercial and multifamily mortgage market.
 - The new Fannie Mae defeasance program will use one Fannie Mae debt instrument per defeased loan, and Fannie Mae “will designate an entity to assume the borrower's mortgage obligation after defeasance, thus releasing the borrower's property and releasing the borrower from its obligations under the loan.” Fannie Mae said that loans with defeasance “insulate investors in multifamily securities from the uncertainty of having to reinvest their funds in the event of a borrower's prepayment, and uncertainty they would face in a loan with yield maintenance,” another prepayment protection option that Fannie Mae said it will continue to offer. Fannie Mae claims its product is the lowest cost defeasance option in the multifamily market. (*National Mortgage News website*, posted 8/27/98)

Not Surprisingly, Freddie Mac Follows with Defeasance Announcement

- Just one week after Fannie Mae made its announcement, Freddie Mac announced a \$235 million Multifamily Gold PC with a defeasance option. The Gold PC is backed by 25 mortgages – secured by 38 multifamily properties – originated by Reilly Mortgage Group Inc. for a major real estate developer in the Southeast. The 30-year mortgages were structured with various special features including the defeasance option. Other features of the \$235 million Gold PC include the rights to substitute and to sell mortgage properties. “Without these features, the sale or refinance of a managed property would require the borrower to prepay the mortgage and the associated yield maintenance premium, which could be substantial,” said H.L. Van Varick, Vice President of Freddie Mac's Multifamily Negotiated Transactions Department.” (*National Mortgage News website*, posted 9/3/98)

- ***Fannie Mae Announces “HouseColorado” Program with Cong. David Skaggs (D-CO) and DNC General Chairman/Governor Roy Romer (D-CO)***
- ***Article Notes Fannie’s Mae’s New Program is Not Altruistic:***
 - Fannie Mae announced its new \$15 billion five-year affordable housing program, “HouseColorado,” with Cong. David Skaggs (D-CO) and DNC General Chairman and Governor of Colorado Roy Romer on August 24th. Some \$5 million of the money will go to a venture capital fund for making equity investments in neighborhood developments that lack access to traditional financing. The state also plans to pair with Fannie Mae and put as much as \$7 million into a three-year trust fund to finance affordable housing construction costs. And Fannie Mae is working with companies to develop employer-assisted housing in rural and resort communities. While advocates for affordable housing applauded the multi-billion effort, some also said the Fannie Mae program focuses too heavily on middle-income families and too little on the poorest families. “The money usually gets targeted a step or two above the homeless and leaves the lowest-income people at risk,” said Jack Real, director of education and advocacy at the Colorado Coalition for the Homeless. “We hope that this can open doors to the low, low income people – the forgotten folks.” The article states, “The program is not an altruistic endeavor. Fannie Mae, a federally chartered private corporation traded on the New York Stock Exchange, plans to make money on its investment.” (*Denver Post Online*, 8/25/98)
- ***Top Democrat Fundraiser Appointed to Fannie Mae Board:***
 - In a *Fortune* magazine article, author Jeffrey Birnbaum describes how the Year 2000 Presidential candidates are currently racing to court the top political (high-dollar) fundraisers because “the presidential candidates who raise the most money get the nomination.” Birnbaum believes that Vice President Gore is currently “taking care to please the right people” in his quest for the nomination. The article notes the although President Clinton nominated Tom Leonard, a Philadelphia money raiser, to the board of Fannie Mae – “one of the choicest appointments” – it was Gore who called Leonard to deliver the good news. (*Fortune Magazine*, 9/7/98)
- ***Fannie Mae Has More than 24,000 Reverse Mortgages in its Portfolio:***
 - Two main reverse mortgage programs – Home Equity Conversion Mortgage (HECM) and Home Keeper Mortgage - offer reverse mortgages through various approved lenders. The reverse mortgage program, introduced by the federal government as part of a pilot program in 1987, allows people older than 61 to convert the equity in their homes into cash without selling their property or taking on new monthly mortgage payments. Fannie Mae has more than 24,000 reverse mortgages in its portfolio, with HECM loans making up about 90%, and more than \$1 billion in balances. Spokeswoman Mercy Jimenez said demand for reverse mortgages has grown 20% to 25% annually over the past three years. A recent survey indicated that the market for reverse mortgages will exceed more than 1 million people over the next five years, she added. (*Dow Jones Newswire*, 8/25/98)

- A *Denver Post* article reported that in a National Reverse Mortgage Lenders newsletter, Fannie Mae defined six consumer segments in the seniors population when it comes to reverse mortgages:
 - *Maintainers*: Seniors of middle income (\$25,000 to \$60,000 per year) who love financial independence, like current lifestyle and would use a reverse mortgage to keep it.
 - *Enhancers*: Seniors of lower income (\$25,000 or less per year), who are not as well off as expected, like the idea of reversible mortgages and want to use them to improve lifestyle.
 - *Money Wise*: Upper income (\$60,000 plus), financially sophisticated, may use reverse mortgage.
 - *Maybes*: Generally lower income and conservative financially. Not sure if a reversible mortgage is a good idea.
 - *Last Resorters*: Upper income seniors who consider a mortgage a last resort.
 - *Haters*: Middle income seniors who don't like the reverse mortgage concept. (*Denver Post*, 8/18/98)
- ***Fannie Mae Foundation Sponsors Latin-American Homebuyer Fair:***
- The Fannie Mae Foundation and the Latin-American Coalition sponsored a free multilingual homebuyer fair on August 29th in Charlotte, NC. More than ten mortgage lenders also participated in the homebuying fair. (*PR Newswire*, 8/26/98)

Freddie Mac

- ***Freddie Mac Warned by EEOC on Civil Rights:***
- Following a 20-month investigation, the EEOC issued a three-page finding in an August 14th letter, concluding that Freddie Mac's "discriminatory environment is the result of a lack of interest in promoting equal opportunity among Black employees." The EEOC accused the firm of showing a "disregard for the civil rights of black employees" in its hiring and promotion practices and of creating a "hostile work environment." The EEOC will attempt to negotiate a settlement. If that fails, the EEOC has the option of filing a formal complaint against Freddie Mac in federal court. The EEOC ruling was made public on September 2nd by attorneys for Tony Morgan, the former Freddie Mac manager whose discrimination complaint led to the investigation. As we stated in the June 5th *GSE Report*, Morgan was a former Director of Executive Corporate Relations at Freddie Mac, who filed a \$15 million civil lawsuit in US district court on June 3rd alleging that Freddie Mac had a "racially hostile" work environment. Morgan charged that his job was down-sized and he was terminated two years ago because he raised concerns about Freddie's "poor performance" in purchasing mortgages from low-income and minority homebuyers. Morgan's attorney, Debra Katz, alleges that top managers at Freddie Mac were aware of extensive racial misconduct, as well as efforts to curb investment in low income and minority mortgages. According to Katz, "People who raise questions about affordable housing and other minority-related issues are also being retaliated against." Katz said she would cite the EEOC finding in asking a judge to permit Morgan's case to

move forward as a class action suit. With this finding, the EEOC and Freddie Mac will schedule conciliation talks. (*Associated Press*, 9/3/98; *Wall Street Journal*, 9/3/98; *Washington Post*, 9/3/98)

- ***Freddie Mac Publication Focuses on Capital:***

- The July 1998 issue of Freddie Mac's *Secondary Mortgage Markets* (SMM) publication is called a "Special Issue on Capital." SMM opens with "Getting a Grip on Capital," written by Lawrence White, who served on the Federal Home Loan Bank Board from 1986 to 1989. Professor White's article is a description of capital from accounting and regulatory perspectives.
- Freddie Mac's deputy chief economist, Frank Nothaft, gives the reason for focusing on this special topic: "... an important but relatively abstract debate now going on in Washington, DC. The deliberations, which began a few years ago, focus on the amount of funds that regulated organizations involved in the housing-finance system must set aside – and keep readily available – to minimize the possibility of insolvency. ... The debate over risk-based capital rules initially concentrated on thrifts and banks. The focus, though, has broadened. ... No matter which financial institutions are considered in this debate, it is important for their respective regulators to arrive at well-thought-out decisions, for any mistakes could prove potentially costly to the public as taxpayers or as homeowners and renters." Mr. Nothaft argues in favor of capital standards that assure solvency, but warns that, if capital requirements are set too high, it will lead to higher interest rates for mortgage loans.
- Following Mr. Nothaft's article, Freddie Mac editors have taken excerpts from a speech made by Alan Greenspan at the Conference on Capital Regulation in the 21st Century. Dr. Greenspan argues: "Indeed, so long as we adhere in principle to a common prudential standard, it is appropriate that differing regulatory regimes may exist side by side at any point in time, responding to differing conditions between banking systems or across individual banks within a single system." He commends the use of internal risk analysis and capital allocation models, and the practice of securitizing assets to spread risk. Such arbitrage, he says, "... may appropriately lower the effective capital requirements against some safe activities that banks would otherwise be forced to drop by the effects of regulation." He lays out four principles of regulation: Capital standards should be structured along lines of business and degree of risk-taking; Regulators must incorporate internal risk management systems into their supervision practices; Regulators need to develop a successor to the risk-weighting approach to capital requirements now used; Regulators must press for increased quantity and quality of financial disclosures by institutions.
- Similarly, Freddie Mac editors take excerpts from "Bank Capital Requirements for Market Risk: The Internal Models Approach," written by Darryll Hendricks and Beverly Hirtle and published by the Federal Reserve Bank of New York. The authors argue that risk-based capital rules are an inappropriate standard for evaluating trading activities. Instead, the market-risk rule, which develops a capital requirement based on internal risk-measurement models. The market-risk rule requires frequent re-evaluations of trading portfolios to assure that capital allocations reflect market risk. They conclude: "From a

quantitative standpoint, the replacement of broad, uniform regulatory formulas with self-generated but independently validated assessments of risk should produce regulatory capital charges that align more closely with banks' actual risk exposures."

- Michelle Mattessich, a managing associate with PricewaterhouseCoopers, discusses risk-adjusted performance measure (RAPM), a loss probability distribution model which calculates a risk-adjusted rate of return for assets by line of business, in "When Only the Best Will Do." RAPM, or value-at-risk, uses historic data to: capture interest rate risk, market risk, and default risk; account for diversification; and analyze risk-event probability. She concludes: "By embracing a RAPM approach to capital adequacy and allocation that is complemented by stress testing and sensitivity analysis, companies can make increasingly accurate assessments of the risks they face, determine the probability that those risks will occur and efficiently put capital to work where it is needed most."
- Mark A. Kinsey, acting director of the Office of Federal Housing Enterprise Oversight (OFHEO), wrote "Evaluating the Capital Adequacy of Freddie Mac and Fannie Mae." He describes OFHEO's development of a risk analysis and a ten-step stress test model that can be used as a risk-based capital standard for the housing enterprises. He states: "Due to the implicit guarantee the debt market imposes significantly less discipline on the enterprises than it does on fully privatized companies . . . A risk-based capital standard would go a long way toward providing the enterprises with market-like incentives."

The remaining articles are written by Freddie Mac employees:

- Amy Crews Cutts and Robert Van Order, Freddie Mac economists, wrote "Equal Capital for Equal Risk," which argues that capital standards should be set at levels that recognize credit risk and line of business risk. Their analysis includes a description of the various regulatory agencies charged with supervising housing finance lenders
- Michael R. McCabe, director of industry analysis, wrote "All Capital Is Not Created Equal." He argues for the need to test the quality of capital through stress testing. Mr. McCabe's article includes an attack on the Federal Home Loan Banks: "The Federal Home Loan Bank (FHLB) System, which is unique among major financial institutions, provides an interesting case study of how the quality of capital can alter an organization's protection from various sources of risk. As a 1993 Congressional Budget Office study concludes, the 'most striking feature of the capital of the FHLB system is that it cannot absorb much risk.' . . . FHLB System capital comes up short on the permanency trait. Most of the members can choose to rescind their membership and, over time, withdraw their paid-in contribution. . . FHLB capital fails the exclusivity test because the very same capital that supports the thrift's or bank's assets is simultaneously used to support the FHLB's assets. . . The third test for high-quality capital – whether or not capital creates a drag on earnings – also is problematic for the FHLB System. . . If the FHLB System were to reduce or discontinue its dividends during a period of economic stress, this could lead to membership rescissions and capital withdrawals at precisely the wrong time. The dividend yield paid by the FHLB System potentially creates a drain on the system's earnings that is atypical of common equity, pushing it closer in quality to a debt obligation."
- Donald Solberg, director of pricing and capital analysis, wrote, "No Fair! Their Capital's Lower Than Mine," stating: "Thrifts, on the one hand, must comply with an 8-percent

risk-based capital standard. Freddie Mac and Fannie Mae, though, operate at a lower capital ratio. Naturally enough, some observers mistakenly conclude that the statutory capital requirements for Freddie Mac and Fannie Mae are less stringent.” He cites a research study done by Sendero Corp., which showed that Freddie Mac survived ten-year stress tests that thrift institutions failed by year seven. The thrifts had less flexibility to deal with rapidly rising interest rates, and typically began to show financial stress by the third year of this scenario test.

- Edward Golding and Carol Wambeke of Freddie Mac’s financial research department, wrote, “A Timely Look at Financial-Soundness Measures,” which describes the strengths and weaknesses of leverage ratios, risk-based ratios, stress tests, and value-at-risk. They conclude: “For now, arguably the best approach to risk measurement combines the use of value-at-risk testing to evaluate certain risks under typical market conditions and stress testing to assess a firm’s vulnerability to extreme pressures.”
- Donald Solberg, director of pricing and capital analysis, and Vassilis P. Lekkas, senior economist, wrote “Drawing an Ellipse Around Risks.” This is a statistics-centered article directed to technicians, discussing the importance of recognizing the correlation between factors when doing statistical risk analysis. (*Secondary Mortgage Markets (SMM)*, July 1998, Vol. 15, Nos. 1 and 2)
- ***Freddie Mac Reorganizes Its Single-Family Securitization Group:***
 - Freddie Mac has reorganized its single-family securitization into five new divisions and hired a new chief credit officer. The group will now consist of the following divisions: (1) marketing, sales and promotion; (2) risk assessment and model development; (3) customer services and control; (4) investor and dealer services (IDS); and (5) portfolio management. The marketing, sales division will integrate functions previously performed in the Loan Prospector and Seller divisions. Executive Vice President John Fisk, who heads the single-family securitization group, will manage the marketing division until a senior vice president is recruited. Don Bisenius, a Senior Vice President who was formerly Vice President of mortgage credit policy, will head the risk assessment division. Michael May, a Senior Vice President, who previously headed the Loan Prospector division, will lead the customer services division. Investor and dealer services will continue to be led by Senior Vice President Patricia Dodson. And the new portfolio management division (focusing on “rebalancing Freddie Mac’s portfolio of risk”) will be led by Senior Vice President Henry Cassidy, formerly Vice President of single-family risk management. Freddie Mac also announced that David Andrukonis (formerly SVP of Freddie Mac’s seller division) was promoted to the chief credit officer post. Andrukonis will report to Freddie Mac’s President David Glenn. Steve Hopkins, Freddie Mac’s Senior Vice President and National Sales Director, plans to resign to pursue other interests. (*American Banker*, 8/28/98; *Freddie Mac press release*, 8/25/98; *National Mortgage News website*, posted 8/26/98)
- ***Freddie Buys Mortgage for Senior Housing:***
 - Freddie Mac announced that it is purchasing three loans totaling \$40 million on senior housing developments in Houston, TX. Mitchell Mortgage Company, one of Freddie Mac’s Program Plus lenders, originated the mortgages. Freddie Mac said it expects to buy more than \$200 million in senior housing mortgages by the end of the year. (As we

noted in the August 21st *GSE Report*, Freddie Mac just recently bought an \$11 million mortgage on a senior citizen housing facility in Lincoln, NE.) (*Freddie Mac press release*, 8/25/98)

- ***Prince George's County Executive Candidate Used to Write Tax Regs For Freddie Mac:***
 - The *Washington Post* ran a profile piece on Randy McRae, a candidate for Prince George's County Executive, who is running for the Democrat primary on September 15th as the sole challenger to incumbent Wayne Curry (D). The article portrayed McRae as "no angel." McRae graduated from law school from Catholic University in 1987 and went to work writing tax regulations for Freddie Mac, before going into private practice as a certified public accountant and personal injury lawyer. (*Washington Post*, 8/27/98)
- ***Freddie Mac Foundation Contributes to J.C. Nalle Elementary School:***
 - The Freddie Mac Foundation has committed to contribute nearly \$2 million per year to the J.C. Nalle Elementary School in the Marshall Heights area of Southeast DC. The Foundation also hired a "services director," Michael Watts, Jr., who is in charge of integrating programs from outside groups at Nalle. Freddie Mac is hoping to make the school a "community hub" to improve the entire neighborhood. There are a number of all-day enrichment programs and activities, and tutors are available even during the summer. Students have access to a therapist, a psychologist, sociologist and counselor. A dentist is available to clean teeth on the site and a nurse can immunize students. Parents are also able to get jobs, computer training, and parenting classes. If a parent passes a high school equivalency diploma program at Nalle by Southeastern University, they will be offered free tuition there. Just last year, J.C. Nalle was on the list of 16 schools to be slated for closing but Freddie Mac proved a "formidable obstacle" and the trustees backed down. Nalle was the only school on the list of 16 to get a unanimous vote to stay open. (*Washington Post*, 8/20/98)

Federal Home Loan Banks

- ***Senator Hagel's FHLBank Expansion Bill "Still in Play" on Financial Services Bill – Hagel May Add Investment Limits on FHLBanks:***
 - Senator Chuck Hagel (R-NE) had planned to attach his FHLBank bill to the financial services modernization bill (H.R. 10) that was scheduled to be marked-up on September 3rd. The Senate Banking Committee, however, postponed the mark-up and will schedule a new mark-up date sometime in the next two weeks to allow more time for the Senators to deliberate on the financial services package. It has been reported that the Senate Banking Committee Members were seriously considering a pro-bank compromise that included a provision providing community banks broader access to the FHLBank System. The *American Banker* noted that Senator Hagel added investment limits to overcome opposition from the Treasury and Senator Paul Sarbanes, the Banking Committee's

ranking Democrat, but “whether Senate Banking will adopt any Home Loan bank changes remains unclear.” (*American Banker*, 9/3/98)

- As we reported in earlier *GSE Reports*, just two months ago, Senator Chuck Hagel (R-NE) withdrew his FHLBank amendment from the Senate Regulatory Burden Relief bill (S. 1405) during a Senate Committee mark-up after it was determined that he did not have enough supporting votes. During the Regulatory Burden Relief bill mark-up, the Treasury Department weighed in against the amendments and the Senate Banking Committee’s Ranking Democrat Paul Sarbanes also opposed the amendments. Also, a number of think tanks and industry groups including AEI, Brookings, CATO, the Heritage Foundation, the National Taxpayers Union, and the Western League of Savings did not support the provisions. (Please see August 7th and 21st issues of the *GSE Report* for further information regarding Hagel’s FHLBank bill and the concerns addressed by Treasury and the think tanks.)
- ***Fiserv Will Buy Processing Business of the FHLBank of Topeka:***
 - Fiserv signed a letter of intent to acquire the item processing business of the Federal Home Loan Bank of Topeka, KS. Financial terms were not disclosed. According to a press release, Fiserv said the Topeka FHLBank had almost 200 employees at their item processing sites in Denver, Oklahoma City, Omaha and Topeka. The four centers process over 200 million items annually. Once the deal is final, Fiserv will be processing more than 4.3 billion items annually at facilities in 64 North American cities. In recent years, Fiserv made similar purchases from the FHLBanks of Atlanta, Chicago, Dallas, New York, San Francisco, and Seattle. (*American Banker*, 8/28/98; *Dow Jones Newswire*, 8/24/98)
- ***FHFB Encourages Tribal Banks to Join the FHLBank System:***
 - FHFB Chairman Bruce Morrison urged tribal-owned banks to join the FHLBank System, which will allow them to use advances as start-up funds. The FHLBanks can also invest in Small Business Investment Companies owned by Native American communities. “All Indian-owned institutions need to be part of the Home Loan System,” he said. (*American Banker*, 8/7/98)
- ***Rural and Urban Banks Both Expect to Use More Advances from FHLBanks:***
 - In an annual survey by the Federal Reserve Bank of Minneapolis, urban community banks and rural banks both expected to rely more heavily on the FHLBank for funding. Sixty percent of urban banks and 42% of rural banks said FHLBank advances would make up a larger portion of their funding in the next two years. Rural banks greatest competition was Farm Credit System lenders, which can offer cheaper loans to farmers. (*American Banker*, 8/27/98)

Ginnie Mae

- ***Increase in GNMA Guarantee Fee Included in Higher Education Reauthorization Act:***

- The Senate-passed Higher Education Reauthorization Act (H.R. 6) (which is reauthorized every four years) includes a provision to raise the Ginnie Mae guarantee fee 3 basis points (from 6 basis points to 9 basis points). The Senate version contains the “infamous” increase that had been considered but then dropped from the highway bill and the VA-HUD appropriations bill. The Mortgage Bankers Association thought they had killed the provision earlier this summer when it was dropped from a list of “pay fors” on the transportation bill. However, according to a column by Brian Collins of the *National Mortgage News*, the MBA “drew blood” again when the Senate voted down an amendment by Sen. Don Nickles (R-OK) that would have blocked a proposed increase in the FHA loan limit. Senator Nickles attached the GNMA fee increase to his FHA amendment to make up for lost revenues.
- The provision is now included in the Higher Education bill because the education committees are looking for \$600 million to cover the costs of subsidizing interest rates on student loans. And according to CBO, increasing the GNMA fee 3 basis points could raise \$200 million over five years. The GNMA fee increase would not go into effect, however, for four years, until October 1, 2002. According to *National Mortgage News*, the House/Senate conferees could move the effective date to October 1, 1998, in the search for revenues, and “if that can’t be done, the conferees can always follow the advice of the Mortgage Insurance Companies of America and increase the Ginnie Mae fee by 6 basis points.” The proposal was not included in the House-passed bill. The Conference Committee has not scheduled formal meetings yet. However, key committee staffs are meeting in advance of the Conference Committee meeting to resolve most of the differences between the two bills. (*National Mortgage News website*, posted 8/31/98; *Brian Collins Column, “Eye on DC”, 9/1/98*)

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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