GAO

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General Government Division

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June 27, 1997

The Honorable James A. Leach
Chairman, Committee on Banking
and Financial Services
House of Representatives

Subject: Housing Enterprises: Investment Authority, Policies, and Practices

Dear Mr. Chairman:

In response to your request of April 10, 1997, we are conducting a review of non-mortgage investment practices at the Federal Home Loan Mortgage Corporation (Freddie Mac). Recently, you asked us to conduct a more limited review for comparative purposes at the Federal National Mortgage Association (Fannie Mae).

Specifically, you requested that we review Freddie Mac's and Fannie Mae's (the enterprises) (1) legal authority for making non-mortgage investments and oversight of that authority by the enterprises' regulators, (2) non-mortgage investment policies and practices, and (3) use of non-mortgage investments for arbitrage purposes.

You recently asked for an interim report on the results of our review to date. This letter responds to that request. At a future date, we expect to issue a more comprehensive final report.

RESULTS IN BRIEF

Information provided by the enterprises and their regulators, and our review of the enterprises' charters, indicate that the enterprises have broad investment authority. The Department of Housing and Urban Development (HUD) and the Office of Federal Housing Enterprise Oversight (OFHEO) have regulatory and enforcement authorities that could be used to limit the enterprises non-mortgage investments, at least in certain circumstances, but the extent of such authorities is not clearly stated in statute.

HUD has general regulatory authority over each enterprise and is charged with making such rules and regulations as shall be necessary and proper to ensure that

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the purposes of the respective charter acts are accomplished. HUD officials told us that HUD's regulatory activities have focused on establishing numeric goals for enterprise mortgage purchases serving low and moderate income and underserved borrowers and on fair lending. HUD historically has not focused attention on non-mortgage investment policies and practices at the enterprises but has recently requested information from Freddie Mac on its non-mortgage investments. With respect to limitations on enterprise investment activities, HUD officials said that they are considering a range of possible standards that could be appropriate and within the scope of HUD's statutory authority. On one end of the range being considered is a narrower standard based on an enterprise activity being reasonably related to the enterprise's mission and on the other end a broader standard based on an activity not conflicting with the enterprise's mission.

OFHEO has exclusive authority, without review or approval of HUD, over matters of enterprise safety and soundness and certain other matters. OFHEO thus could limit an enterprise's non-mortgage investments if the investments were not conducted in a safe and sound manner. With respect to the enterprises' non-mortgage investment policies and practices, OFHEO has concluded that these investments have not constituted a safety and soundness concern.

The enterprises each have investment policies[1] that specify permissible credit ratings, maturities, and concentration limits, and describe the relationship of investments to earnings and to achievement of the enterprise's housing finance mission.[2] Non-mortgage investments constituted about 15 percent of on-balance sheet assets at Fannie Mae and 9 percent at Freddie Mac as of December 31, 1996. The enterprises' non-mortgage investments, as reported, included cash and cash equivalents, asset-backed securities, private corporate securities, and state and municipal bonds. According to enterprise officials, most holdings had maturities under 2 years, and all were investment grade securities.[3]

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[1]We do not report specific details of these investment policies because of the proprietary nature of such enterprise information.

[2]Credit rating agencies such as Standard and Poor's give securities ratings related to the credit risk associated with the investment. Concentration limits place a cap on the maximum share of assets that can be accounted for by investments in a single company's securities.

[3]Credit rating agencies such as Standard and Poor's rate bond issuers with ratings ranging from AAA for the highest credit rating to CC for highly speculative. Investment grade securities are those that have a credit rating of BBB or above.

Enterprise officials indicated that non-mortgage investments are held for two principal reasons: (1) cash management purposes and (2) as an investment vehicle to employ capital for future demand to fund residential mortgages. In March 1997, Freddie Mac created a non-mortgage investment fund to invest in securities with maturities exceeding 5 years to be funded by matched maturity non-callable debt.[4] Although Fannie Mae's investment policies differ from Freddie Mac's, its publicly disclosed securities holdings indicated non-mortgage investment holdings with maturities exceeding 5 years. Based on our work to date, neither enterprise appears to have actively traded its non-mortgage investments.

Regarding the use of non-mortgage investments for arbitrage purposes, we are defining the term "arbitrage" to mean using the funding advantage from government sponsorship to raise funds for making non-mortgage investments. To date, we have not examined in detail specific non-mortgage investments nor the debt issuance to fund such investments at either enterprise. Thus, based on the work we have done to date, the degree to which enterprise non-mortgage investments represent arbitrage with enhanced earnings as the primary result, or merely another tool to accomplish the enterprises' special purposes, is not clear.

INVESTMENT AUTHORITY RESIDES IN EACH ENTERPRISE BUT IS SUBJECT TO HUD AND OFHEO OVERSIGHT

Each enterprise has broad investment powers in its charter. The Freddie Mac charter act provides that the funds of the corporation, "may be invested in such investments as the Board of Directors may prescribe."[5] The Fannie Mae charter act empowers the corporation, among other things, "to enter into and perform contracts, leases . . . or other transactions, on such terms as it may deem appropriate; to lease, purchase, or acquire any property, real personal or mixed . . . and to sell, for cash or credit, lease or otherwise dispose of the same, at such time and in such manner as and to the extent that it may deem necessary and appropriate; and to do all things as are necessary or incidental to the proper management of its affairs and the proper conduct of its business."[6]

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[4]Bonds characterized as non-callable debt are bonds that are issued for a fixed-term until maturity; the issuer does not have the option to "call" the bond (i.e., buy the bond back from the investor) prior to its date of maturity.

[5]12 U.S.C. § 1452(d).

[6]12 U.S.C. § 1723(a).

One general rule of law is that a corporation's powers can be no broader than the purposes for which the corporation is organized. This rule is particularly relevant where, as in the case of the enterprises, the corporation is organized for special, as opposed to general, purposes. Thus, even though the enterprises have broad investment powers, the exercise of those powers must be related in some degree to the accomplishment of the special purposes for which the enterprises were created. Under general corporate law, this relationship has been described as the logical relation of the activity to the corporate purpose expressed in the charter.

HUD and OFHEO each have regulatory responsibilities for the enterprises. Under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the 1992 Act),[7] OFHEO is charged with the duty to ensure that the enterprises are adequately capitalized and operate safely and in accordance with the act. OFHEO has regulatory and enforcement authority, without the review or approval of HUD, with respect to matters generally related to enterprise safety and soundness and to a few specific matters, including certain capital distributions and executive compensation at the enterprises.[8] Therefore, OFHEO is responsible for supervising an enterprise investment that affects the enterprise's safety and soundness without consultation with HUD. Actions taken by OFHEO with respect to other matters not specified in the act as exclusive to OFHEO are subject to the review and approval of the Secretary of HUD.

Except for the specific powers granted OFHEO, HUD has general regulatory power over each enterprise and is charged with making such rules and regulations as shall be necessary and proper to ensure that those provisions of the 1992 Act that generally concern new mortgage programs and housing goals and the purposes of the respective charter acts are accomplished.[9] In conjunction with administering this provision, HUD is evaluating the scope of its authority with respect to the mission-relatedness of enterprise investments. With respect to regulatory limitations on enterprise investment activities, HUD officials said they are considering a range of possible standards that could be appropriate and within the scope of HUD's statutory authority. On the one end of the range being considered is a narrower standard based on an enterprise activity being reasonably related to the enterprise's mission and on the other end a broader standard based on an activity not conflicting with the enterprise's mission. Because both enterprises were created by Congress to accomplish the

[7]P. L. No. 102-550, Title XIII, codified at 12 U.S.C. § 4501.

[8]12 U.S.C. § 4513(b).

[9]12 U.S.C. § 4541.

purposes set forth in their charter acts, their investment powers appear to be limited to some degree by those purposes.

In previous reports, we have indicated that the rationale Congress has followed in establishing government-sponsored enterprises (GSE) has centered on the objective of focusing GSE activity on specific sectors of the economy in which there was thought to be some failure of the market.[10] Restraining the ability of the GSEs to use the benefits received from government sponsorship to engage in non-mission activities engaged in by other entities that do not have such benefits would be consistent with this rationale. Limiting the reach of the GSEs' activities, however, could limit their ability to undertake activities in other areas that may complement activities directly related to mission. For example, because the enterprises must specialize in the secondary mortgage market, they are limited in the extent to which they can diversify business risks by investing outside the housing market. While potential tradeoffs of this nature could create difficulties for GSE mission regulators, they would not necessarily create tradeoffs for OFHEO in carrying out its safety and soundness oversight.

OFHEO has concluded that each enterprise's non-mortgage investment policies and practices, including those reflected in Freddie Mac's new investment policy instituted in March 1997, have not constituted a safety and soundness concern. Its conclusion was largely based on how each enterprise matched the maturities (and related characteristics) of its debt obligations used to finance its non-mortgage investments with those investments, and the high credit standards and generally short maturities of the non-mortgage investments.

OFHEO recently reviewed Fannie Mae's mortgage protection plan (MPP), a proposed program that contains a non-mortgage investment in cash value life insurance. Under this proposed program, Fannie Mae would purchase a cash value life insurance policy on a first-time homebuyer after the borrower's residential mortgage was purchased by Fannie Mae. The policy would provide Fannie Mae and the home buyer protection from default and foreclosure due to the borrower's death as well as limited protection from default and foreclosure due to disability and job loss. As the mortgage is paid off, Fannie Mae would share in any payment in excess of the amount of the outstanding mortgage made upon the recipients' death. Due in part to potential tax benefits, and in part to Fannie Mae's relatively low cost of capital, Fannie Mae expects

[10]For example, see Enterprise Resource Bank Act (GAO/GGD-96-140R, June 27, 1996), p. 9.

that the aggregate payoff from these policies will be profitable.[11] OFHEO concluded that MPP would not create a "risk of significant deterioration of the financial condition" of Fannie Mae.[12]

HUD's mission regulation actions since the passage of the 1992 Act have focused on developing numeric goals governing enterprise purchase of mortgages serving very-low, low, and moderate income households and other underserved borrowers; promulgating rules containing numeric goals; and enforcing the numeric standards. HUD officials told us that the activities of HUD's Office of Government Sponsored Enterprise Oversight have continued to focus on the numeric goals and fair lending issues.

HUD officials told us that they had not focused attention on non-mortgage investment practices at the enterprises prior to the mid-April publicity surrounding Freddie Mac's investment in Phillip Morris bonds referred to in your request letter. At that time, HUD requested information from Freddie Mac on its non-mortgage investments and subsequently received a reply on April 28. HUD is currently considering how to proceed. To date, HUD has not sought information on Fannie Mae's non-mortgage investment policies and practices. As to Fannie Mae's MPP, HUD initially received information from Fannie Mae on April 25, 1997. The Secretary of HUD then determined that MPP constituted a new program and requested further information from Fannie Mae on May 14, 1997. By statute, new programs are subject to HUD's approval.[13] HUD approved MPP on June 23, 1997.

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[11]In this sense, Fannie Mae's investment is similar to other investments in cash value life insurance. The Department of the Treasury (Treasury), Office of Tax Policy, is investigating the tax consequences of this proposed plan. The issues Treasury is examining relate to those addressed by section 264 of the Internal Revenue Code that limits the deductions available to taxpayers in connection with certain life insurance policies that cover the lives of employees or other interested persons. During the week of June 9, 1997, legislation was introduced by the Chairman, House Committee on Ways and Means, that could have the impact of making tax treatment of MPP less favorable.

[12]Letter from Mark Kinsey to the Secretary of HUD (June 23, 1997). This determination by the Director of OFHEO is required by the 1992 Act prior to HUD's approval of a new mortgage program.

[13]This approval is required by 12 U.S.C. § 4542. A "new program" is defined as "any program for the purchasing, servicing, selling, lending on the security of or otherwise dealing in conventional mortgages" that either significantly differs from a program

THE ENTERPRISES STATE THAT THEY HOLD NON-MORTGAGE INVESTMENTS PRIMARILY TO IMPROVE CASH MANAGEMENT AND MEET FUTURE FUNDING DEMANDS

Both enterprises have investment policies that specify permissible credit ratings, maturities, and concentration limits, and describe the relationship of investments to earnings and achievement of the enterprise's housing finance mission. Non-mortgage investments constituted about 15 percent of on-balance sheet assets at Fannie Mae and 9 percent at Freddie Mac as of year-end 1996. Table 1 shows selected statistics on mortgage assets and stockholders' equity (i.e., capital) to provide further perspectives. For example, non-mortgage investments equated to about 2.6 percent of Freddie Mac's and about 6.3 percent of Fannie Mae's total mortgage servicing portfolio. Non-mortgage investments were more than double Freddie Mac's capital and more than four times Fannie Mae's capital.

As shown in table 1, over half of Freddie Mac's non-mortgage investments and over 40 percent of Fannie Mae's were short-term investments in cash, cash equivalents, term federal funds, and eurodollar deposits. Freddie Mac's and Fannie Mae's 1996 annual reports also showed overall non-mortgage investments by contractual maturity. About 78 percent of Freddie Mac's non-mortgage investments had maturities under 1 year, and about 93 percent had maturities under 5 years; the corresponding figures for Fannie Mae were 68 and 75 percent.[14] According to enterprise officials, all of their non-mortgage investments were investment grade securities. Based on our work to date, neither enterprise appears to have actively traded its non-mortgage investments.

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approved or engaged in before October 28, 1992, or represents an expansion of previously approved program limits. 12 U.S.C. § 4502(13). Fannie Mae disagrees with HUD's characterization of MPP as a new mortgage program.

[14]Fannie Mae does not report its financial statistics in as much detail as Freddie Mac does. Therefore, the statistics are not directly comparable. For example, we understand that for Fannie Mae the "other" category includes corporate debt, auction rate preferred stock, and state and municipal bonds. In addition, the Freddie Mac and Fannie Mae data on maturities are not directly comparable. For example, Fannie Mae's annual report does not indicate the maturities of asset-backed securities. The percentages we report include asset-backed securities in total non-mortgage investments. Since we cannot determine the value of asset-backed securities that have short-term maturities, the percentages we report may understate the short-term maturity shares for Fannie Mae.

Table 1: Selected Financial Data for the Housing Enterprises as of December 31, 1996

Millions of dollars

	Freddie Mac	Fannie Mae
Total assets	$173,866	$351,041
Stockholders' equity	6,731	12,773
Mortgage servicing portfolio	610,820	834,039
Non-mortgage investments		
-- Cash and cash equivalents	9,141	850
-- Term-federal funds and eurodollar deposits	1,330	21,734
-- Asset-backed securities	2,086	12,792
-- State/municipal bonds	2,009	a
-- Commercial paper	a	6,192
-- Corporate debt	819	a
-- Auction rate preferred stock	392	a
-- Other	243	11,239
-- Accrued interest receivable	64	a
Total non-mortgage investments	$16,084	$52,807

Note: The mortgage servicing portfolio includes mortgages purchased and held as on-balance sheet assets in retained portfolio plus mortgages purchased and pooled as off-balance sheet assets to back mortgage-backed securities. Repurchase agreements were excluded from non-mortgage investments based on our understanding that such agreements are mortgage related. Freddie Mac mortgage related securities held for trading were also excluded.

[a]These individual data elements are not reported; we understand that they are included in the "other" category.

Source: 1996 annual reports of Freddie Mac and Fannie Mae.

Freddie Mac officials told us that the primary purposes for holding non-mortgage investments with maturities of under 5 years is for cash management and to meet future anticipated demands for funding residential mortgages. About 7 percent of Freddie Mac's non-mortgage investments had maturities exceeding 5 years. These investments with longer maturities included many asset-backed securities that tend to be paid off, and thereby terminate, prior to their stated maturity dates.

In March 1997, Freddie Mac created a non-mortgage investment fund to hold securities with maturities exceeding 5 years to be funded by matched maturity non-callable debt.[15] Freddie Mac officials told us that the primary purpose of this new fund, which is authorized to contain up to $10 billion, is to meet future unanticipated demands for funding residential mortgages. Freddie Mac officials told us that its other non-mortgage investment funds, which generally have maturities under 5 years, would decline. In addition, they also made the following five points about the longer maturity investments in the newly created fund:

- Freddie Mac would not likely sell these longer maturity non-mortgage securities, because the fund is meant to provide a source for funding those mortgages whose demand is unanticipated;

- if unanticipated demands for funding mortgages did occur, the capital cushion necessary to support mortgage purchases would already be employed in the non-mortgage assets, and thus, would be available to support other investments; therefore, they observed, selling such non-mortgage assets, in such an event, could be done quickly in contrast to the time required to raise additional capital;

- longer maturity non-mortgage investments do not exhibit the prepayment risks associated with mortgages;

- match funding these investments would allow Freddie Mac to access the non-callable bond market without generating interest rate risk; and

- the investment portfolio would help stabilize income when necessary to counteract adverse earnings' impact from other forces.

Fannie Mae officials told us that the primary purposes for holding non-mortgage investments are for cash management; to provide a source of liquidity for managing the cash flows intrinsic to a business of its size; and to provide an additional capital cushion, in addition to that held to meet the internally generated risk-based capital standards. They told us that such a capital cushion enables them to respond to capital markets and fund residential mortgages. Fannie Mae officials told us that non-mortgage investments with maturities exceeding 5 years are a relatively small portion of its total business. They told us that most of these securities are asset-backed securities with variable interest rates and that the variable rate characteristic reduces the interest rate risk associated with fixed-rate long-term bonds. Fannie Mae officials

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[15]Before March 1997, Freddie Mac investment policies allowed purchase of securities with maturities of over 5 years.

told us, however, that bonds with the characteristics of the Phillip Morris bonds purchased by Freddie Mac could not have been purchased by Fannie Mae under its investment guidelines, because the purchase would not have met Fannie Mae requirements for maturity, credit quality, and concentration limitations.

NON-MORTGAGE INVESTMENTS DIFFER IN THE DEGREE TO WHICH THEY GENERATE ARBITRAGE PROFITS AND RELATE TO MISSION

Financial analysts generally define arbitrage as profiting from differences in price when the same security is traded on two or more markets. However, arbitrage can also arise if securities have different yields by virtue of differences in government provided benefits between those securities. We are using this latter definition of arbitrage in considering enterprise non-mortgage investments.[16] In a previous report, we concluded that the largest enterprise benefit from government sponsorship flows from the market perception of an implied guarantee on enterprise obligations, because this perception generates a funding advantage–a reduction in yields on enterprise debt.[17] In that report, we indicated that the funding advantage could be in the range of 30 to 106 basis points.

To date, we have not examined in detail specific non-mortgage investments nor the debt issuance to fund such investments at either enterprise. We note, however, that, under our definition of arbitrage, Freddie Mac has made at least one investment that would have generated arbitrage profits.[18] This investment was in Phillip Morris bonds.

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[16]Our definition of arbitrage is similar to the definition of an arbitrage bond defined in a section of the U.S. tax code. 26 U.S.C. § 148. In this section of the tax code, the definition is in reference to state and local governments whose funding costs are lowered by virtue of federal income tax exemption for interest on state and local bonds. In section 148, an arbitrage bond "means any bond issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of the issuance of the bond) to be used directly or indirectly-(1) to acquire higher yielding investments, or (2) to replace funds which were used directly or indirectly to acquire higher yielding investments."

[17]Housing Enterprises: Potential Impacts of Severing Government Sponsorship (GAO/GGD-96-120, May 1996).

[18]If enterprise non-mortgage investments had different credit risks and maturities than the enterprise debt issued to finance such investments, we would have adjusted for those differences.

The Phillip Morris bonds, which had an A rating, were purchased by Freddie Mac and were funded by Freddie Mac bonds with the same maturity.[19] The yield difference was slightly over 60 basis points.[20] Freddie Mac officials told us that investments in its non-mortgage investment fund holding securities with maturities exceeding 5 years is authorized to contain up to $10 billion.[21] Freddie Mac officials told us that Freddie Mac's long-term non-mortgage investments are generally funded with matched maturity non-callable debt. Applying, as an example, the interest rate differential of slightly more than 60 basis points between the matched Freddie Mac and Phillip Morris debt issues, a $10 billion fund could generate as much as $60 million annually in profits–about 4.8 percent of Freddie Mac's 1996 net income.[22]

Based on our work to date, the various non-mortgage investments appear to fall along a continuum representing the degree to which they clearly relate to the enterprises' mission. On one end are investments with characteristics like the Phillip Morris bonds which generate arbitrage profits but whose relationship to mission is not readily clear; on the other end are short-term non-mortgage investments, such as term federal funds, whose relationship to mission in enhancing liquidity is clear, although they might also

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[19]Recently, the Standard and Poor's (S&P) credit rating agency rated each enterprise for its government risk rating, which is based on the probability that the federal government would be called upon in the event of an enterprise default on its obligations. Each enterprise received an AA minus rating. S&P indicated that the rating for each enterprise still accounted for some benefits, namely liquidity of enterprise obligations, due to government sponsorship. If the enterprises were privatized, S&P said that each would likely have to raise additional equity capital to maintain an AA minus rating.

[20]A basis point is one one-hundredth of a percentage point.

[21]Freddie Mac officials told us that current holdings in the fund have a value of $400 million and that Freddie Mac's forecasted level for year-end 1997 is $2 billion.

[22]The funding advantage is similar to that estimated between enterprise non-callable debt and non-callable debt issued by A rated corporations (the benchmark security) in a study commissioned by HUD. See Brent W. Ambrose and Arthur Warga (Ambrose and Warga), "Implications of Privatization: The Costs to Fannie Mae and Freddie Mac," in HUD, Studies on Privatizing Fannie Mae and Freddie Mac (May 1996), pp. 180-182. Ambrose and Warga estimates of the funding advantage, based on a AA benchmark security, are lower and were in a range around a value of about 40 basis points.

generate arbitrage profits. Other enterprise non-mortgage investments fall somewhere in between these extremes.[23]

Although longer maturity, non-mortgage investments may generate arbitrage profits, enterprise officials are of the opinion that they also contribute to fulfilling mission. Both enterprises told us that longer maturity, non-mortgage investments are a vehicle to employ capital that represents a cushion above the capital held for current mortgage purchases. In this regard, Freddie Mac's Chairman stated the following: "Freddie Mac's investment in longer-term non-mortgage securities provide a potential source of readily available funds in the event of a market disruption. Under these circumstances, Freddie Mac could maintain our commitment to provide mortgage funds by liquidating our longer-term investments and purchasing long-term mortgages."[24]

Based on the work we have done to date, the degree to which enterprise non-mortgage investments represent arbitrage with enhanced earnings as the primary result, or merely another tool to accomplish the enterprises' special purposes, is not clear.

ENTERPRISE, HUD, AND OFHEO COMMENTS AND OUR EVALUATION

On June 20, 1997, we obtained oral comments on a draft of this letter from senior officials at Freddie Mac and Fannie Mae and senior officials responsible for enterprise oversight at HUD and OFHEO. Specifically, we met with Freddie Mac's Vice President for Industry Relations and Corporate Treasurer; Fannie Mae's Deputy General Counsel, Corporate Treasurer, and Vice President for Regulatory Activities; HUD's Director of Government Sponsored Enterprise Oversight and Associate General Counsel for Finance and Regulatory Enforcement; and OFHEO's Acting Director, General Counsel, Chief Economist, and Acting Director of Examinations.

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[23]The major characteristics of bonds in the category of the Phillip Morris bonds are maturities over 5 years, investment grade, and higher yield than maturity matched enterprise bonds. The continuum we have identified is inclusive of both enterprises' non-mortgage investments.

[24]Letter from Leland C. Brendsel to the Honorable Nicholas P. Retsinas (April 28, 1997).

Enterprise Comments and Our Evaluation

The Freddie Mac officials objected to our definition of arbitrage. They said that according to our definition, any financial institutions that match funds [based on maturity] would perform arbitrage while financial institutions that do not match funds would not be considered to perform arbitrage. We made changes to our draft to clarify that by arbitrage we mean using the funding advantage from government sponsorship to raise funds for non-mortgage investments.

The Freddie Mac officials also said that our representation of non-mortgage investments as representing points on a continuum is not correct. They said that the long-term non-mortgage investments are all liquid investments that serve mission purposes. Based on the work we have done to date, there appear to us to be differences among non-mortgage investments in the extent to which they appear to be clearly related to the enterprises' mission. Our discussion of a continuum in this interim report is provided as a preliminary analytic framework for describing those apparent differences. As we examine a wider range of non-mortgage investments in particular detail as our work progresses, it remains to be seen if such a continuum will continue to be a useful analytic framework or whether some other framework (or no clear pattern) will emerge.

The Freddie Mac officials commented on our discussion of non-mortgage investments as a share of (1) on-balance sheet assets, (2) mortgage servicing portfolio, and (3) capital as reported in table 1. They stated that the only relevant base was mortgage servicing portfolio, because non-mortgage investments serve to support all mortgage purchases. We have not to date reached a conclusion about how best to describe the relative share of the enterprises' financial activity represented by non-mortgage investments, but rather offer examples of the share as a percentage of different bases for illustrative purposes. We will further consider this issue, and take Freddie Mac's views into account, as our work progresses.

Both the Freddie Mac and Fannie Mae officials made the following comments. First, the officials said that enhancing earnings is not a primary purpose of non-mortgage investments. They stated that the primary purposes of non-mortgage investments are to achieve the statutory purposes, not to increase profits. We no longer attribute to the enterprise officials the statement that enhanced earnings are a principal reason for non-mortgage investments. Second, the Freddie Mac and Fannie Mae officials took exception to our indicated range of the enterprises' funding advantage on debt of 30 to

106 basis points, which is contained in a previous report.[25] The Freddie Mac officials incorporated, by reference, their comments on the funding advantage from our previous report. Our previous report addressed the enterprises' comments. In this interim report, we use the yield spread of slightly over 60 basis points from Freddie Mac's investment in Phillip Morris bonds as an example of what the funding advantage could be on long-term non-mortgage investments.

Fannie Mae officials made additional comments. They told us that they emphasize the mortgage investment component of MPP, especially as MPP relates to credit risk management of Fannie Mae's mortgage portfolio. Based on this emphasis, they characterize MPP more as a mortgage investment than a non-mortgage investment. We refer to MPP as a proposal with a non-mortgage investment component in cash value life insurance because this component is directly related to the topic of this letter. We added details, however, to help clarify MPP's link to Fannie Mae's mortgage activities and credit risk management.

The Fannie Mae officials disagreed with our analysis of HUD's regulatory authority under the 1992 Act. One Fannie Mae official stated that despite HUD's general regulatory power, which includes authority to ensure that the purposes of the charter acts are accomplished, he believes that HUD does not have authority to set standards governing Fannie Mae's investment activities. He stated that this limitation on HUD has existed since the enterprise became a privately-owned corporation under the Housing and Urban Development Act of 1968.[26] We disagree with the Fannie Mae official's conclusion regarding HUD's legal authority. The language of section 1321 of the 1992 Act appears to us to be clear. It provides that HUD has general regulatory authority over the enterprises and is charged with ensuring that the purposes of their charter acts are accomplished. We believe that this authority includes the power, at a minimum, to determine whether an enterprise activity conflicts with the statutory mission and to respond appropriately.

The Freddie Mac and Fannie Mae officials made a number of comments of a clarifying nature, which have been incorporated where appropriate.

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[25]Housing Enterprises: Potential Impacts of Severing Government Sponsorship (GAO/GGD-96-120, May 1996), pp. 42-44. Also see pages 49-53 for a related discussion in the section, "Enterprise Comments and Our Evaluation."

[26]Pub. L. No. 90-448.

HUD and OFHEO Comments and Our Evaluation

The HUD officials said that they are considering a range of possible standards that could be appropriate and within the scope of HUD's statutory authority. They also provided some clarifying comments. The OFHEO officials provided explanations and their perspectives that helped us clarify our discussion of (1) regulatory oversight of government-sponsored enterprises, (2) the enterprises' non-mortgage investment policies and practices, and (3) publicly available enterprise financial data.

We incorporated comments by HUD and OFHEO officials in our discussion where appropriate.

SCOPE AND METHODOLOGY

We interviewed officials at the enterprises, HUD, and OFHEO; reviewed the enterprises charters and relevant statutes; reviewed literature on the role of the enterprises in the residential mortgage market; and obtained and reviewed publicly available and proprietary information on Freddie Mac's investment policies, practices, and justification. To date, we have reviewed publicly available information on Fannie Mae's non-mortgage investments but not its proprietary information on investment policies, practices, and justification. We received verbal comments on this report on June 20, 1997, from senior officials at Freddie Mac, Fannie Mae, HUD, and OFHEO.

We do not report specific details of the enterprises' investment policies because of the proprietary nature of such enterprise information. We conducted our work for this interim report in Washington, D.C., between April and June 1997 at Freddie Mac, and beginning in June 1997 at Fannie Mae, in accordance with generally accepted government auditing standards.

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We are sending copies of this letter to HUD; OFHEO; the enterprises; the Ranking Minority Member of your Committee; the Chairman and Ranking Minority Member of your Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises; and the Chairman and Ranking Minority Member of the Senate Committee on Banking, Housing and Urban Affairs. We will also make copies available to others on request.

Please contact me at (202) 512-8678 or Bill Shear at (202) 512-4325 if you or your staff have any questions.

Sincerely yours,

Jean Gleason Stromberg

Jean Gleason Stromberg
Director, Financial Institutions
and Markets Issues

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