United States General Accounting Office

GAO

Report to the Chairman, Committee on Banking and Financial Services, House of Representatives

March 1998

GOVERNMENT-SPONSORED ENTERPRISES

Federal Oversight Needed for Nonmortgage Investments

GAO/GGD-98-48

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-277819

March 11, 1998

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

Dear Mr. Chairman:

This report responds to your request dated April 10, 1997, and supplemented on May 13, 1997, that we gather and analyze information on nonmortgage investment activities at three government-sponsored enterprises (GSEs): the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal National Mortgage Association (Fannie Mae), and the Federal Agricultural Mortgage Corporation (Farmer Mac) (called enterprises in this report).[1] In your request, you expressed concerns that these enterprises may be using their benefits in financial markets resulting from their government ties to make investments that may not serve the public purposes as expressed in their federal charters.[2] Specifically, you requested that we examine (1) the enterprises' legal authority for making nonmortgage investments and federal regulatory oversight of that activity, (2) the relationship between nonmortgage investment policies and practices and missions of the enterprises, and (3) the extent to which the enterprises have undertaken nonmortgage investments for arbitrage profits—using the funding advantage from government sponsorship to purchase nonmortgage investments that generate profits. In relation to the third objective, you also asked us to provide information on the enterprises' compensation structures for directors and senior managers and whether these structures create incentives for making nonmortgage investments.

Background

Congress created GSEs to help make credit available to certain sectors of the economy, such as housing and agriculture, in which the private market was perceived as not effectively meeting credit needs. GSEs receive benefits from their federal charters that help them fulfill their missions. Freddie Mac and Fannie Mae (the housing enterprises) have federal charters granting each of them explicit benefits, which include (1) exemption from registering their securities with the Securities and

[1]At Farmer Mac, nonmortgage investments are defined as investments other than those in agricultural mortgages (also referred to as nonagricultural-mortgage investments in this report).

[2]We provided the preliminary results of our work on Freddie Mac and Fannie Mae in our letter to you, Housing Enterprises: Investment Authority, Policies, and Practices (GAO/GGD-97-137R, June 27, 1997).

Exchange Commission (SEC), (2) exemption from state and local corporate income taxes, and (3) use of the Federal Reserve as a transfer agent. Farmer Mac is subject to SEC registration requirements, but it uses the Federal Reserve as a transfer agent, and Farmer Mac officials told us that it is exempt from state income taxes in most states. The most important benefit that all three enterprises receive is an implicit one stemming from investors' perception that the federal government would not allow the enterprises to default on their obligations. Due to this perception, investors do not demand yields on investments in enterprise debt and mortgage-backed securities that are as high as those on comparable financial instruments issued by corporations without government sponsorship. One result of government sponsorship, therefore, is a reduction in debt costs compared with debt costs in similar corporations without government sponsorship.

Freddie Mac and Fannie Mae were chartered by Congress to enhance the availability of residential mortgage credit across the nation. The housing enterprises accomplish this mission by purchasing residential mortgages from lenders. The housing enterprises retain some of the mortgages they purchase in their own portfolios, but a majority of the mortgages are pooled into mortgage-backed securities (MBS) that are sold to investors in the secondary residential mortgage market. As of December 1996, Freddie Mac had about $463 billion in MBS obligations and $156 billion in debt obligations outstanding. The corresponding figures for Fannie Mae were about $548 billion and $331 billion, respectively. Therefore, combined MBS and debt obligations of these housing enterprises totaled about $1.5 trillion.

Farmer Mac was chartered by Congress to enhance the availability of agricultural mortgage credit across the nation. Farmer Mac is making efforts to establish a secondary mortgage market for agricultural mortgages along the lines the housing enterprises have established for residential mortgages. Farmer Mac issues, and guarantees payment on, agricultural mortgage-backed securities (AMBS). One type of AMBS, called Farmer Mac I securities, is backed by agricultural mortgages not containing federally provided primary mortgage insurance. The other type of AMBS, called Farmer Mac II securities, is backed by agricultural mortgages containing primary mortgage insurance provided by the Department of Agriculture. Farmer Mac is a small financial institution in comparison to the housing enterprises. As of December 31, 1996, Farmer Mac had about $642 million in AMBS (of which about $226 million were owned by others, and about $416 million were held by Farmer Mac) and about $546 million in debt obligations outstanding. Therefore, combined AMBS owned by others and debt obligations of Farmer Mac totaled about $772 million.

The housing enterprises pass along, at least in part, the benefits they receive from government sponsorship, such as lower debt costs, to residential borrowers. In a previous study, we estimated that interest rates on single-family, fixed-rate, conforming mortgages were probably 15 to 35 basis points lower than they would have been without government sponsorship of the enterprises.[3] Limiting the activities of the housing enterprises primarily to funding conforming residential mortgages helps create a mechanism for the benefits they receive, such as lower debt costs, to be passed through to borrowers. Such limitations are consistent with the special purpose charters imposed by Congress. Congress gave the Department of Housing and Urban Development (HUD) general regulatory authority over the housing enterprises so that HUD can ensure that the missions of these enterprises as stated in their respective charter acts are being fulfilled. HUD also has regulatory authority to approve new mortgage programs proposed by the housing enterprises. In consideration of the potential risks to taxpayers from an enterprise default on its financial obligations, Congress created safety and soundness regulators for the enterprises. HUD's Office of Federal Housing Enterprise Oversight (OFHEO) is the safety and soundness regulator of the housing enterprises. The Farm Credit Administration (FCA), through its Office of Secondary Market Oversight (OSMO), has regulatory responsibility with respect to Farmer Mac, including specific authority over safety and soundness matters.

Results in Brief

Legally, the enterprises have broad investment authority. To date, regulatory oversight activities for the three enterprises have focused on whether nonmortgage investments are safe and sound and not on whether the nonmortgage investment policies and practices are mission related. OFHEO and OSMO have determined that the enterprises' nonmortgage investment portfolios do not raise safety and soundness concerns.

To ensure that the enterprises use their government-provided benefits to achieve a public purpose, Congress gave HUD and FCA mission regulatory authority. Recently, this oversight has become especially important

[3] Housing Enterprises: Potential Impacts of Severing Government Sponsorship (GAO/GGD-96-120, May 13, 1996). A single-family housing unit is defined as a housing unit in a structure with four or fewer total units. The housing enterprises are restricted in statute to purchasing residential mortgages below the conforming loan limit; in 1997, this limit was $214,600 on single-unit residences. A basis point is one one-hundredth of a percentage point.

because Farmer Mac has substantially increased its holdings of nonagricultural-mortgage investments and the housing enterprises have proposed new types of nonmortgage investments. As of June 30, 1997, nonmortgage investments constituted about 15 percent of on-balance sheet assets at Fannie Mae and 10 percent at Freddie Mac; 66 percent of Farmer Mac's assets were in nonagricultural-mortgage investments.

HUD has not developed criteria to determine if nonmortgage investments are consistent with enterprise charter purposes. In August 1997, HUD indicated its plan to promulgate regulations addressing the housing enterprises' nonmortgage investment activities and their relation to the housing enterprise mission. The advance notice of proposed rulemaking was published in December 1997.

In October 1997, FCA indicated that, for now, it did not have concerns that Farmer Mac's nonmortgage investment activity is inconsistent with its charter mission. However, FCA also stated that the debt issuance strategy associated with the investments is intended to be temporary and to develop over a reasonable period of time. Therefore, according to FCA, its position could change if over time evidence does not show that such investments play a role in helping Farmer Mac achieve its mission.

Enterprises have invested in nonmortgage assets to varying degrees with somewhat different rationales for how these investments further their charter purposes. Each enterprise has an investment policy[4] that specifies permissible credit ratings, maturities, and concentration limits and describes the relationship of investments to earnings and to achievement of the enterprise's mission.[5] As of June 30, 1997, nonmortgage investments constituted about 15 percent of on-balance sheet assets at Fannie Mae and 10 percent at Freddie Mac; 66 percent of Farmer Mac's assets were in nonagricultural-mortgage investments. The housing enterprises' nonmortgage investments, as reported, included cash and cash equivalents, asset-backed securities (ABS),[6] private corporate securities, and state and municipal bonds. Farmer Mac's nonagricultural-mortgage investments expanded in calendar year 1997 from $155 million to

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

[5]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.

[6]ABS are similar to MBS but are backed by nonmortgage assets, such as receivables on car loans and credit cards.

$931 million and now consist primarily of other government agency securities and corporate debt issues.

Freddie Mac officials indicated that its nonmortgage investments have been held for cash management purposes and as an investment vehicle, which could make capital available (i.e., employ capital) to help fund future anticipated demand for residential mortgages. This year, Freddie Mac created an investment fund to contain nonmortgage investments with maturities exceeding 5 years to make capital available to help fund future unexpected demand for residential mortgages. Fannie Mae officials indicated that nonmortgage investments are held for cash management purposes and as an investment vehicle to employ capital not currently needed to fund mortgages. In contrast, according to officials of Farmer Mac, its nonagricultural-mortgage investments are part of a debt issuance strategy designed to lower funding costs. By lowering funding costs, officials said that Farmer Mac will be able to better price its AMBS products in the secondary market, which these officials expect to trigger greater product demand and, thus, enable Farmer Mac to better meet its mission.

The relationship between longer term nonmortgage investments and the enterprises' mission goals is not always clear, because long term nonmortgage investments may not facilitate liquidity in the residential mortgage market as well as short-term investments.[7] However, it is clear that nonmortgage investments generate arbitrage profits. In this report, we are defining the term "arbitrage" to mean using the funding advantage from government sponsorship to raise funds for making nonmortgage investments (see app. I). In our analysis, we found that the various nonmortgage investments fall along a continuum representing the degree to which they facilitate liquidity in the residential mortgage market and thus are more clearly related to the enterprises' missions. On one end are short term nonmortgage investments, such as term federal funds, which facilitate liquidity although they might also generate arbitrage profits. On the other end are long-term investments that generate arbitrage profits but whose relationship to the mission in facilitating liquidity is less clear. Although arbitrage profits on nonmortgage investments are relatively small in percentage terms at the housing enterprises, such profits presently are a primary income source at Farmer Mac.

[7]A market is more liquid if investors can buy and sell large amounts of holdings without affecting the prices of traded securities. Liquidity allows the housing enterprises to fund residential mortgages during different market conditions. Longer term nonmortgage investments are less liquid than shorter term investments in the sense that their market values are subject to larger fluctuations with changes in interest rates.

Our review of compensation practices and board member responsibilities at the enterprises suggests that individual incentives to generate corporate profits are structured in a manner that is fairly typical of major corporations and financial institutions without federal charters limiting their activities (see app. II). These incentives, by their close tie to corporate earnings, can create tensions between increasing shareholder value and fulfilling the public mission. It is this tension that highlights the importance of mission oversight. Without effective mission oversight, the incentives to use the benefits of government sponsorship to increase shareholder value could, over time, erode the public mission. If this were to occur, long term nonmortgage investments could become an increasing part of the housing enterprises' portfolios and Farmer Mac's temporary approach could become a permanent strategy even if it does not enhance Farmer Mac's ability to purchase agricultural mortgages.

Scope and Methodology

We reviewed the enterprises' charters and relevant statutes to examine the enterprises' legal authority for making nonmortgage investments and regulatory oversight of that activity. We obtained and analyzed publicly available and proprietary information on the enterprises' investment policies, practices, and justification of those policies and practices to examine the relationship between nonmortgage investment policies and practices and missions. We reviewed literature on the role of the housing enterprises in the residential mortgage market to examine the extent to which the enterprises have undertaken nonmortgage investments for arbitrage profits. We also interviewed officials at the enterprises, HUD, OFHEO, and FCA; and we received written responses to questions submitted to the Department of the Treasury.

We obtained and analyzed information the enterprises considered to be proprietary that included information packages prepared for board members of the enterprises; detailed information on nonmortgage investments, their yields, and maturity; yield and other characteristics of enterprise debt issued to fund the nonmortgage investments; and compensation policies for senior officers and board members. We do not report specific details of the enterprises' investment policies and practices or compensation policies because of the proprietary nature of such enterprise information.

Our interviews with officials at OFHEO and FCA on their regulatory oversight of nonmortgage investments included discussion of proprietary information relied upon by the regulators in making their safety and soundness determinations regarding nonmortgage investments. We did not verify their findings leading to the safety and soundness determinations. Generally, the financial practices that the housing enterprises used to limit the interest rate and credit risks of their nonmortgage investments were fairly straightforward. From the data we collected at the housing enterprises and interviews with housing enterprise and OFHEO officials, we obtained a general understanding of OFHEO's determinations. In contrast, the financial practices that Farmer Mac used to limit the interest rate risk of its nonagricultural-mortgage investments were not as straightforward and were not fully captured by the specific data we collected from Farmer Mac. Therefore, we were not able to obtain as complete an understanding of FCA's determinations.

We obtained written comments on a draft of this report from each of the three enterprises, HUD, OFHEO, FCA, and Treasury. Their comments are discussed near the end of this report and are reprinted in appendixes III through IX. We conducted our work in Washington, D.C., from April 1997 through October 1997 in accordance with generally accepted government auditing standards.

Each Enterprise Has Broad Investment Authority but Is Subject to Regulatory Oversight

The charters of all three enterprises provide them with broad investment powers. OFHEO has clear authority to regulate investments by the housing enterprises if such investments pose a safety and soundness concern. HUD has general regulatory authority over the housing enterprises and is charged with making such rules and regulations as shall be necessary and proper to ensure that the purposes of the respective charter acts are accomplished. In addition to general regulatory authority, HUD also has authority to approve new mortgage programs that could contain nonmortgage investment components. FCA, through OSMO, has safety and soundness and general regulatory authority with respect to Farmer Mac.

The Enterprises Have Broad Legal Authority to Make Investments

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."[8] 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

[8]12 U.S.C. § 1452(d).

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 or 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."[9]

The Farmer Mac charter act empowers it to, among other things, " . . . purchase or sell any securities or obligations . . . necessary and convenient to the business of the Corporation."[10]

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 should not be unrelated 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.

OFHEO and FCA Have Clear Authorities to Limit Nonmortgage Investments for Safety and Soundness Reasons

OFHEO, as safety and soundness regulator, is charged with ensuring that the housing enterprises are adequately capitalized and operate safely and in accordance with the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the 1992 Act).[11] 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.[12] Therefore, OFHEO has authority to supervise 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 1992 Act

[9]12 U.S.C. § 1723a(a).

[10]12 U.S.C. § 2279aa-3 (c) (12). For the purpose of this report, we take no position as to whether Farmer Mac's investment authority is limited pursuant to 12 U.S.C. § 2279aa-6(e)(2), which states as follows: "The Corporation (and affiliates) may issue debt obligations solely for the purpose of obtaining amounts for the purchase of any securities (guaranteed by Farmer Mac and backed by pools of qualified loans), for the purchase of qualified loans . . . and for maintaining reasonable amounts for business operations (including adequate liquidity) relating to activities under this subsection . . . ." FCA officials explained to us their view that the provision has a specific purpose and does not limit Farmer Mac's investment authority.

[11]P. L. No. 102-550, Title XIII, codified at 12 U.S.C. §§ 4501-4641.

[12]See 12 U.S.C. § 4513(b).

as exclusive to OFHEO are subject to the review and approval of the Secretary of HUD.

FCA, through OSMO, has regulatory responsibility for Farmer Mac. Among other things, OSMO is responsible for ensuring that Farmer Mac holds adequate capital for the activities it performs and operates in a safe and sound manner. OSMO is also responsible for supervising the safety and soundness of Farmer Mac's program and investment activities.

The Enterprises' Nonmortgage Investments Have Not Created a Safety and Soundness Concern

OFHEO has concluded that each housing enterprise's nonmortgage investment policies and practices 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 nonmortgage investments with those investments and the high credit standards and generally short maturities of the nonmortgage investments.

As of April 1997, OSMO concluded that Farmer Mac's nonagricultural-mortgage investment activities had not raised a safety and soundness concern. OSMO found that the size of Farmer Mac's investment portfolio was not unsafe and unsound relative to the statutory capital requirement, and the composition of the portfolio was not unsafe or unsound.

Regulators Have Not Focused on Nonmortgage Investments and Their Relationship to Charter Missions

Although OFHEO and FCA have examined safety and soundness implications of nonmortgage investments, HUD and FCA told us that prior to mid-April 1997 they had not focused on nonmortgage investment policies and practices in carrying out their general regulatory authority with respect to the enterprises' charter missions. The scope of HUD's general regulatory authority as it relates to nonmortgage investments is not clearly defined in statute. However, as discussed later in this report (see p. 11), HUD has initiated action to determine how it should implement this authority. FCA has general regulatory authority that would allow oversight of Farmer Mac's investment activities. However, FCA said it has no activities under way that are expected to culminate in regulation of Farmer Mac's investments.

HUD Has General Regulatory Authority

Section 1321 of the 1992 Act provides that except for the specific powers granted OFHEO, HUD has "general regulatory power" over each housing enterprise.[13] HUD also is charged with making "such rules and regulations

[13] 12 U.S.C. § 4541.

as shall be necessary and proper to ensure" that the provisions of the 1992 Act concerning new mortgage programs and housing goals and the purposes of the respective charter acts are accomplished.[14]

The scope of HUD's authority under this section is not defined. With respect to investments, the statute does not set forth any criteria other than the charter acts themselves as a basis for HUD's exercise of its general regulatory power and rulemaking authority. As discussed previously, the charter acts provide Fannie Mae and Freddie Mac with broad authority to make investments. This raises a question about the extent to which HUD has authority to regulate nonmortgage investments by the housing enterprises.

Fannie Mae expressed the legal opinion, as supported by an opinion letter from legal counsel, that HUD may not "prospectively regulate" Fannie Mae's investment discretion. Fannie Mae based its opinion on, among other things, the legislative history of provisions formerly contained in the Fannie Mae and Freddie Mac charter acts. With respect to HUD's general regulatory authority, these provisions contained language substantially identical to that set forth in the 1992 Act.[15] The Committee reports accompanying these provisions stated as follows:

> "It is the intent of the committee that the regulatory powers of the Secretary will not extend to (the enterprise's) internal affairs, such as personnel, salary, and other usual corporate matters, except where the exercise of such powers is necessary to protect the financial interests of the Federal Government or as otherwise necessary to assure that the purposes of the (charter act) are carried out."[16]

Fannie Mae asserted that its investment practices are internal corporate affairs subject to its broad discretion. Thus, according to the enterprise, the above-quoted legislative history and other Congressional statements indicate Congress' intention that HUD should not exercise its general regulatory authority with respect to Fannie Mae's investment activities except in the "extreme situation" where those activities endanger its statutory mission.

It is unclear that Congress intended to limit HUD's authority with respect to nonmortgage investments, particularly in light of the special purposes of

[14] Id.

[15] See 12 U.S.C. § 1452(b) (1991 Supp.) (Freddie Mac); 12 U.S.C. § 1723a(h) (1988) (Fannie Mae).

[16] See S. Rep. No. 1123, 90th Cong., 2d Sess. 82 (1968); H.R. Rep. No. 1585, 90th Cong., 2d Sess. 71 (1968); H.R. Rep. No 54, pt. 3, 101st Cong. 1st Sess. 2 (1989).

the housing enterprise charters and the broad statutory language establishing the Secretary's general regulatory power and rulemaking authority. But even if, as Fannie Mae contends, nonmortgage investments are usual corporate matters, HUD could take regulatory action, such as requiring reports of nonmortgage investment activities, in cases where HUD appropriately determines the action is necessary to ensure the accomplishment of the enterprises' charter acts.

HUD Has Begun a Rulemaking Effort

Since April 1997, HUD has been evaluating the scope of its authority with respect to the mission-relatedness of enterprise investments. HUD officials said they are considering a range of possible regulatory standards for enterprise investments 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 is a broader standard based on an activity not conflicting with the enterprise's mission.

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 Enterprises Oversight have continued to focus on the numeric goals and fair lending issues.

HUD officials said that they had not focused attention on nonmortgage investment practices at the enterprises prior to the mid-April 1997 public disclosure of and publicity surrounding Freddie Mac's nonmortgage investment in long-term Phillip Morris bonds. At that time, HUD requested information from Freddie Mac on its nonmortgage investments and received a reply from Freddie Mac on April 28. In our August 1997 discussion with HUD, officials told us they have decided to use their general regulatory authority to request reports from the housing enterprises on their investment policies and practices. HUD's plan is to monitor investment trends so that it can determine if the investments are consistent with the enterprises' missions and purposes as defined in their charters. On November 13, 1997, HUD's Director of Government Sponsored Enterprises Oversight made her first request for a report on nonmortgage investment activity from the housing enterprises.

In August 1997, HUD told us it had reached the decision to begin a rulemaking effort by publishing an advance notice of proposed rulemaking soliciting comments on how HUD should carry out its general regulatory authorities with respect to nonmortgage investments by the housing enterprises. HUD received executive branch approval and published the advance notice on December 30, 1997.

FCA Has General Regulatory Authority

FCA has general regulatory authority over Farmer Mac. Under the Farm Credit Act of 1971, FCA has general regulatory authority over institutions in the Farm Credit System,[17] one of which is Farmer Mac.[18] FCA officials told us that the agency implements this authority through OSMO. As required by statute, the Director of OSMO is selected by and reports to the FCA Board.[19] Moreover, the statute charges FCA with ensuring that OSMO is adequately staffed to supervise Farmer Mac's secondary market activities, although, to the extent practicable, the personnel responsible for supervising the corporation should not also be responsible for supervising the banks and associations of the Farm Credit System. This regulatory structure provides for a degree of separation between FCA's general regulatory responsibilities and its safety and soundness responsibilities with respect to Farmer Mac. However, the structure does not appear to limit FCA's general regulatory authority.[20]

During our review, we conducted three interviews with FCA and OSMO officials that included discussion of general regulatory authorities as they apply to nonagricultural-mortgage investments. Over the course of these interviews, we observed an evolution in their thinking on this topic. At the beginning of our review, the OSMO director told us that its focus in examining nonagricultural-mortgage investments had been on matters pertaining to safety and soundness. Toward the end of our review, it appeared to us that FCA and OSMO officials began to focus some attention on the relationship between nonagricultural-mortgage investments and mission achievement.

[17] FCA is charged with providing "for the examination of the condition of, and general regulation of the performance of the powers, functions, and duties vested in, each institution of the Farm Credit System" and has general rulemaking authority and incidental powers to carry out the purposes of the Farm Credit Act of 1971. 12 U.S.C. §§ 2243, 2252.

[18] 12 U.S.C. § 2279aa-1(a)(2).

[19] 12 USC 2279aa-11(a)(3)(c).

[20] FCA's regulatory role with respect to Farmer Mac raises a concern about regulatory conflict of interest. The Farm Credit System is a major portion of the primary market for agricultural mortgage loans, and Farmer Mac is the secondary market for these loans. As regulator of both markets, FCA may be subject to conflicts of interest. See H.R. Rep. No. 102-210, pt. 2, at 17-19, pt. 1 at 5-6; Government-Sponsored Enterprises—Federal Agricultural Mortgage Corporation (GAO/T-GGD-91-62, July 24,1991), before the Subcommittee on Policy, Research, and Insurance of the House Committee on Banking, Finance, and Urban Affairs. OSMO's role is intended to address this potential conflict of interest.

In October 1997, FCA indicated that, for now, it did not have concerns that Farmer Mac's nonmortgage investment activity is inconsistent with its charter mission. However, FCA also stated that the debt issuance strategy associated with the investments is intended to be temporary and to develop over a reasonable period of time. Therefore, according to FCA, its position could change if over time evidence does not show that such investments play a role in helping Farmer Mac achieve its mission.

HUD Approved Fannie Mae's Proposed Mortgage Protection Plan Under Its New Mortgage Program Authority

The enterprises may at times propose new mortgage programs that contain nonmortgage investment components. In addition to its general regulatory authority, HUD also has regulatory authority to approve new mortgage programs proposed by the housing enterprises. HUD used this authority to review Fannie Mae's proposed mortgage protection plan (MPP),[21] which it approved on June 23, 1997. On that date, OFHEO's acting director provided the Secretary of HUD a letter with his determination that MPP would not create a "risk of significant deterioration of the financial condition" of Fannie Mae; this determination is required for the Secretary of HUD's approval. Under the proposed program, Fannie Mae would purchase a cash value life insurance policy—essentially a nonmortgage investment[22]—on a first-time homebuyer after the selected borrower's residential mortgage was purchased by Fannie Mae and the borrower agreed to accept such coverage. The policy would protect Fannie Mae and the homebuyer against the risk that the mortgage would not be paid due to the borrower's death. The policy also would offer limited protection against default and foreclosure due to disability and job loss. Due in part to potential tax benefits available under current tax law when HUD approved MPP, and in part to Fannie Mae's relatively low cost of capital, Fannie Mae expected that MPP would be profitable. Since HUD's approval, however, a new tax bill was signed into law that, according to Treasury, substantially reduced the tax benefits that were available to Fannie Mae under the MPP. Fannie Mae officials told us that Fannie Mae has decided not to go forward with the program.

[21]Fannie Mae disagreed with HUD's characterization of MPP as a new mortgage program. Fannie Mae argued that MPP was a logical extension of its existing mortgage products.

[22]Cash value life insurance is a nonmortgage investment because Fannie Mae would pay premiums to a life insurance company and would receive a tax-deferred or tax-exempt return, part of which would be guaranteed and part of which might not be guaranteed, based in part on the yields on the assets held by the life insurance company. Unless Fannie Mae contractually specified that its premiums be invested solely in mortgages, the premiums it paid to the life insurance company generally would be invested in a wide range of securities.

In commenting on a draft of this report, HUD stated that it did not possess detailed knowledge of the intricacies of the life insurance industry at the time MPP was submitted for review. We did not see evidence that HUD provided Fannie Mae's MPP proposal to anyone with experience in evaluating cash value life insurance. HUD determined that although it would have been helpful, detailed industry expertise was not necessary to HUD's review and understanding of MPP's potential benefits to borrowers and its related costs. A Treasury attorney with expertise in life insurance provided basic information about life insurance products to HUD. However, according to HUD officials, HUD determined that providing information on MPP to Treasury was not necessary as it had obtained sufficient information and analysis to complete its work. In its written response to us, Treasury said: "Since HUD has the statutory responsibility to rule on Fannie Mae's request to undertake the MPP, and since HUD did not ask for the Treasury's assistance in making its determination regarding the MPP, the Treasury did not seek to obtain additional information from Fannie Mae."

HUD's new mortgage program review authority states that the Secretary can disapprove a new mortgage program if he finds that the program is not in the public interest. HUD did not include tax revenue losses in its analysis for the public interest determination. In commenting on a draft of this report, HUD stated its belief that tax issues were within the scope of the MPP review but that in making its public interest determination, HUD would find it difficult to conclude that a practice that is permissible under current tax law was nevertheless against the public interest. Consequently, in its legal analysis, HUD took the position that as long as the MPP program is permissible under the current laws, MPP should not be regarded as against the public interest solely on the basis of a potential adverse impact on federal revenues or the concomitant favorable impact on Fannie Mae's tax position.

Because tax consequences were a major factor in Fannie Mae's MPP proposal, we asked Treasury whether it was concerned that HUD's public interest determination left out tax policy considerations. Treasury's written response stated: "The Treasury defers to HUD's interpretation of its statutory authority and responsibilities." The response also stated:

"The Treasury has long been concerned about the revenue loss from the favorable tax treatment of cash value life insurance with business policyholders or beneficiaries, and the MPP highlighted these concerns. However, this tax policy concern was not limited to the

MPP. In August, Congress passed and the President signed a tax bill that dealt with some of the principal tax policy concerns associated with the MPP."

The Relationship of the Enterprises' Nonmortgage Investments to Earnings and Mission

Nonmortgage investments constituted 10 to 15 percent of on-balance sheet assets at the housing enterprises at June 30, 1997, and most of these investments are short term (i.e., maturities of less than 5 years). Freddie Mac, however, created an investment fund in 1997 authorized to contain up to $10 billion in nonmortgage investments with maturities of over 5 years. Farmer Mac embarked on a debt issuance strategy in 1997 in which the debt largely finances nonagricultural-mortgage investments; such investments grew during the first half of 1997 to about 66 percent of Farmer Mac's assets. The housing enterprises stated that they hold nonmortgage investments primarily for cash management purposes and to employ capital not currently needed to fund mortgages. Farmer Mac officials stated that Farmer Mac makes nonagricultural-mortgage investments primarily to invest funds from debt issuance that exceed purchases of agricultural mortgages.

Overview of Enterprise Nonmortgage Investments

Nonmortgage 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 perspective. For example, nonmortgage investments were about 2.6 percent of Freddie Mac's and about 6.3 percent of Fannie Mae's total mortgage servicing portfolio. Nonmortgage investments were more than double Freddie Mac's capital and more than four times Fannie Mae's capital. At Farmer Mac, nonagricultural-mortgage investments were about one-fourth of on-balance sheet assets and over three times capital.

As shown in table 1, over 65 percent of Freddie Mac's nonmortgage 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 nonmortgage investments by contractual maturity.[23] About

[23]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 nonmortgage 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.

78 percent of Freddie Mac's nonmortgage 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. According to housing enterprise officials, all of their nonmortgage investments were investment-grade.[24] According to the data provided on sales of holdings, neither housing enterprise appears to have actively engaged in frequent selling of its nonmortgage investments.

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

Dollars in millions

	Freddie Mac	Fannie Mae	Farmer Mac
Total assets	$173,866	$351,041	$603
Stockholders' equity	6,731	12,773	47
Mortgage servicing portfolio	610,820	835,225	643
Nonmortgage investments[a]			
—Cash and equivalents	9,141	850	69
—Term federal funds and eurodollar deposits	1,330	21,734	—
—Asset-backed securities	2,086	12,792	—
—Mortgage-backed securities[a]	—	—	79
—State/municipal bonds	2,009	[b]	—
—Commercial paper	[b]	6,192	—
—Corporate debt	819	[b]	—
—Agency debt	—	—	2
—Auction rate preferred stock	392	[b]	—
—Other	243	11,239	5
—Accrued interest receivable	64	[b]	—
Total nonmortgage investments	$16,084	$52,807	$155

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. Housing enterprise repurchase agreements were excluded from nonmortgage investments based on our understanding that such agreements are mortgage related. Freddie Mac mortgage-related securities held for trading were also excluded. Definitions used by the enterprises for classifying individual data elements, such as cash equivalents and term federal funds, may not be strictly comparable.

[a]For purposes of this report, Farmer Mac nonmortgage investments denote nonagricultural-mortgage investments and include residential MBS.

[b]These data elements are not individually reported.

Source: 1996 annual reports of Freddie Mac, Fannie Mae, and Farmer Mac; and information supplied by OFHEO and Fannie Mae.

Between the end of 1996 and the end of the second quarter of 1997 (June 30, 1997), the two housing enterprises' total assets grew (see table

[24]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 normally means bonds that have a credit rating of BBB or above.

2). Freddie Mac's assets grew about 5.8 percent, and Fannie Mae's assets grew about 4.3 percent. Both enterprises' nonmortgage investments remained relatively stable at about 10 percent of assets for Freddie Mac and at about 15 percent of assets for Fannie Mae.

Farmer Mac's assets more than doubled from $603 million at year-end 1996 to about $1.4 billion at June 30, 1997; its nonagricultural-mortgage investments grew about sixfold—from $155 million to $931 million—and accounted for virtually the entire increase in total assets. At June 30, 1997, these investments totaled about 66 percent of its total on-balance sheet assets.

Table 2: Enterprise Assets at June 30, 1997

Dollars in millions

Assets	Freddie Mac	Fannie Mae	Farmer Mac
Total assets	$184,003	$365,997	$1,408
Total nonmortgage investments	18,325	53,960	931
Nonmortgage investments as a percentage of total assets	9.96	14.74	66.12

Source: Second quarter financial statements and information supplied by Fannie Mae.

The housing enterprises undertake nonmortgage long-term investments, and Farmer Mac undertakes nonagricultural-mortgage long-term investments. These longer term investments (i.e., more than 5 years) include fixed-rate debt and variable-rate asset-backed securities (ABS).[25] The three enterprises fund these investments by issuing debt and undertaking different strategies, which are incorporated in their investment policies, to limit interest rate risks.[26] Generally, the housing enterprises (1) match fund their fixed-rate nonmortgage investments—they issue debt of the same maturity as the investment; and (2) fund their variable-rate ABS with either short-term debt with the maturity of that debt matching the reset provision (i.e., the time period between the dates when the interest rate adjusts) in the ABS or with variable-rate debt. Enterprise officials told us that to the extent interest rate risks still exist after they use the above-mentioned practices, they use hedging strategies to lessen or eliminate such risks.

[25]Farmer Mac's longer term nonagricultural-mortgage investments included residential MBS.

[26]A risk that a financial institution faces is the risk that the interest rates will change in ways that reduce the value of the institution's portfolio.

Housing Enterprises Say That They Hold Nonmortgage Investments for Cash Management and to Make Capital Available to Help Fund Mortgage Purchases

Freddie Mac officials told us that the primary purposes for holding nonmortgage 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 nonmortgage investments, as of December 31, 1996, had stated maturities exceeding 5 years. However, according to Freddie Mac officials, these investments with longer stated maturities included asset-backed securities that are expected to be paid off, and thereby terminate, prior to their stated maturity dates.

In March 1997, Freddie Mac created a nonmortgage investment fund to hold securities with maturities exceeding 5 years to be generally funded by matched maturity noncallable debt. 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 the amount of its other nonmortgage 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 nonmortgage 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, capital to help support mortgage purchases could be made available by selling the nonmortgage assets, which would be quicker than raising additional capital.
- Longer maturity nonmortgage investments do not exhibit the prepayment risks (i.e., the risk that borrowers would pay off their mortgages early, thus terminating payment streams) associated with mortgages.
- Match funding these investments (i.e., issuing debt with the same maturity of the investment) would allow Freddie Mac to access the noncallable bond market without generating interest rate risk.
- The longer-term nonmortgage 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 nonmortgage investments are for cash management, as an investment vehicle to employ capital[27] not currently needed to fund mortgages that is

[27]Here, as earlier in this report, an investment vehicle, which could make capital available is defined as an investment vehicle to employ capital.

intrinsically appropriate for a financial corporation of its size, and to maintain a capital cushion in excess of minimum capital requirements. 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 nonmortgage 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 and, thus, is important to its overall safety and soundness.

Farmer Mac Makes Nonagricultural-Mortgage Investments Primarily to Invest Funds From Debt Issuance That Exceed Its Purchases of Agricultural Mortgages

In February 1997 Farmer Mac's board changed its investment policies in order to increase Farmer Mac's presence in the capital markets, particularly the debt markets, to help attract investors to its securities and thereby reduce its borrowing and securitization costs. The board and management believe that increasing Farmer Mac's presence in the debt markets will improve the pricing of its agricultural mortgage-backed securities and thereby enhance the attractiveness of the products it offers through its programs for the benefit of agricultural lenders and borrowers. Farmer Mac officials said that although the ultimate objective of Farmer Mac's increased debt issuance strategy is to invest the proceeds in loans qualifying for inclusion in its securitization and guarantee programs, during the initial period in which Farmer Mac is increasing its debt issuances it will be investing those proceeds in interest-earning nonagricultural-mortgage investment assets. In commenting on a draft of this report, Farmer Mac proposed that 2 to 3 years could serve as a reasonable time frame within which the anticipated increased market interest in its AMBS will occur.

FCA and OSMO officials said that Farmer Mac's rationale for its debt issuance strategy for enhancing the secondary market in AMBS is plausible at this point in time. However, FCA and OSMO officials noted that the extensive nonagricultural-mortgage asset holdings are supposed to be temporary until Farmer Mac's debt and AMBS costs decline to levels comparable to those for the housing enterprises. Should Farmer Mac's strategy prove unsuccessful, then FCA and OSMO may revisit the appropriateness of the existing Farmer Mac nonagricultural-mortgage investment portfolio policy and practices. In the interim, FCA, through OSMO, is monitoring the Farmer Mac strategy. FCA and OSMO officials said they have set no time frame for assessing the success of the debt issuance strategy.

Nonmortgage Investments Differ in the Degree to Which They Generate Arbitrage Profits and Relate to Mission

Enterprise officers and board members have incentives to increase shareholder value, just as the officers and board members of private corporations do. However, unlike private corporations, the enterprises also have public missions stated in their charters. Thus, these enterprise incentives can create tensions between increasing shareholder value and fulfilling the public mission. In addition, the enterprises have opportunities to generate arbitrage profits that can increase shareholder value and that are not available to private corporations. 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 nonmortgage investments.[28] Under this definition, at least some enterprise nonmortgage investments generate arbitrage profits. In addition to generating arbitrage profits, nonmortgage investments can contribute to achieving the enterprises' missions, although shorter maturity nonmortgage investments more clearly relate to mission than do longer maturity nonmortgage investments. Because the enterprises can generate arbitrage profits and because of the tension between shareholder interests and mission achievement, it is important for the mission regulators, HUD and FCA, to ensure that the missions of these enterprises as stated in their respective charter acts are accomplished.

Enterprise Officers and Board Members Have Incentives to Increase Shareholder Value

According to enterprise officials, the competitiveness of today's marketplace literally demands that the enterprises recruit and maintain the caliber of executive officers and board members that will help ensure that their corporations remain among the top-performing organizations. Such action includes the construction of compensation packages that will attract top performers and that contain incentives that will promote the achievement of corporate objectives in addition to satisfying shareholder interests. To ensure that they are in line with current trends, the enterprises have used consulting firms to review and compare the pay structure of their officers and board members with the pay structure of comparable positions in similar private sector financial institutions and other enterprises. Our review of published literature and other information

[28]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 the 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."

on executive and board compensation the enterprises and OFHEO provided us suggests that in today's world, more companies are including stock-based compensation for their directors and officers to help create an economic alignment of director and shareholder interests. Like their competitors, the enterprises award stock-based compensation to their board members and senior officers with the intention of helping them to focus on the long-term success of their corporations.

In establishing statutory authority, Congress set the tone for the governance structure of all three enterprises—Freddie Mac, Fannie Mae, and Farmer Mac. Each of these shareholder-owned corporations, which also have a public mission, is governed by a board consisting of shareholder-elected directors and appointed directors. Statutory authority provides that the total number of directors elected by shareholders include 13 at Freddie Mac, 13 at Fannie Mae, and 10 at Farmer Mac; each of the enterprises must have 5 directors appointed by the president. According to enterprise officials, the directors have the same or similar duties and obligations as directors of other private corporations, including fiduciary responsibilities to shareholders and the establishment of general operation policies that govern the companies. All directors, whether elected or appointed, share the same duties and obligations, which are primarily carried out through participation in and preparation for board and committee meetings. All directors of the housing enterprises serve 1-year terms unless reelected or reappointed. Appointed directors of Farmer Mac serve at the pleasure of the president, the elected directors serve 1-year terms.

In keeping with statutory requirements, the housing enterprises' compensation structure is built upon a philosophy of comparability[29] (i.e., compensation is reasonable and comparable to that of similar businesses) and pay for performance, which includes the achievement of individual as well as corporate-level objectives. All three enterprises have committees that set policy and make recommendations concerning compensation. Annual evaluations allow for salary adjustments based on merit performance and the need to maintain market competitiveness. Board members of all three enterprises receive cash compensation in the form of an annual retainer and stipulated fees for attending board and committee meetings. In addition to the cash, board members receive long-term compensation in the form of stock and stock options (see table 3). Similarly, in addition to their base salaries, senior managers of the

[29]Through its authority to prohibit excessive compensation at the housing enterprises, OFHEO is responsible for monitoring compensation to ensure that this philosophy of reasonable and comparable compensation is carried out.

enterprises receive bonuses (which are to recognize their individual contributions to the success of corporate goals), as well as stock and stock options designed to ensure sustained corporate success. (See app. II for more detailed information on the enterprises' compensation structures.)

Table 3: Compensation Structure for Enterprise Board Members

	Board members[a]		Cash compensation		Long-term compensation	
Enterprises	**Elected**	**Appointed**	**Retainer**	**Fees**	**Stock**	**Stock options**
Freddie Mac	13	5	yes	yes	yes	yes
Fannie Mae	13	5	yes	yes	yes	yes
Farmer Mac	10	5	yes	yes	no	yes

[a]Freddie Mac and Fannie Mae have three and two employee directors, respectively. These directors are compensated in their positions as executive officers. All of Farmer Mac's board members are outside directors.

Source: Developed from information provided by the enterprises.

Tension Between Increasing Shareholder Value and Achieving Mission

Private corporations without government sponsorship provide incentives to their senior management and board members to take actions that will increase profits and shareholder value. The enterprises have instituted compensation packages that conform closely to those of private corporations, including financial institutions, with which they compete for individuals with specific skills. These compensation packages include stock-based compensation strategies that have the intent of aligning the economic interests of managers and directors with shareholder interests.[30] The compensation packages that board members at the enterprises receive do not differ according to whether the board member is shareholder elected, presidentially appointed, or chosen by another method. The enterprises told us that the orientation and training activities they provide new board members do not differ according to how the board member is selected. The enterprises also told us that board members are instructed to advocate corporate activities that enhance shareholder value while supporting the enterprise's charter purposes. From our analysis, it appears to us that compensation incentives available to enterprise senior management and board members, including stock-based compensation,

[30]Fannie Mae officials emphasized the inclusion of public purpose goals in the compensation of some senior management officials. For example, they told us that Fannie Mae's chief executive officer's compensation is based, in part, on Fannie Mae's progress in meeting its $1 trillion commitment for mortgage purchases serving low-income and underserved borrowers. Freddie Mac officials also indicated that compensation of some senior managers is partially tied to achievement of mission requirements.

reinforce the tension between increasing shareholder value and achieving mission. At a minimum, stock-based compensation can affect how broadly board members and senior managers interpret whether the corporate activities they advocate contribute to fulfillment of mission.

Freddie Mac officials disagreed with our view that a tension exists between increasing shareholder value and achieving mission. They told us that the two goals were compatible and codependent. They stated that Congress wanted a private company to fill a public purpose. With this role, they noted that if one were to ignore the entity of the shareholder, the public mission cannot be fulfilled. We note that short of ignoring the interests of the shareholder, a tension exists. It is this tension that hightlights the importance of mission oversight. Without effective mission oversight, the incentives to use the benefits of government sponsorship to increase shareholder value could, over time, erode the public mission. If this were to occur, long term nonmortgage investments could become an increasing part of the housing enterprises' portfolios and Farmer Mac's temporary approach could become a permanent strategy even it it does not enhance Farmer Mac's ability to purchase agricultural mortgages.

Arbitrage Can Arise If Securities Have Different Yields by Virtue of Differences in Government Provided Benefits

In a previous report about the housing enterprises, we concluded that the greatest benefit to the enterprises 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.[31] In that report, we indicated that the funding advantage could be in the range of 30 to 106 basis points. This range took into account the long-term nature of residential mortgage investments, and it assumed that the housing enterprises would receive a credit rating between a high of AAA and a low of A if their government sponsorship were eliminated. Findings from our analysis of housing enterprise financial data are consistent with this estimated funding advantage range and with a credit rating between AA and A.[32] Appendix I contains a more detailed discussion of our analysis.

[31]Housing Enterprises: Potential Impacts of Severing Government Sponsorship (GAO/GGD-96-120, May 13, 1996).

[32]An AA rating is higher, signifying less credit risk, than an A rating; an AA rated corporation has lower debt costs than an A rated corporation. Therefore, the yield difference (i.e., the funding advantage) measure between an AA corporation and the housing enterprises is smaller than between an A corporation and the housing enterprises. Likewise, an AAA rated corporation has lower debt costs than an AA rated corporation.

In the previous report about the housing enterprises,[33] we indicated that government sponsorship of the housing enterprises lowered interest rates on single-family, fixed-rate, conforming mortgages. Although the benefits of government sponsorship reduce certain mortgage interest rates, there is no similar effect on the yields of nonmortgage investments, because the enterprises are not a significant source of funding outside the residential mortgage market. Thus, there is an additional incentive for the enterprises to issue debt, whose yield is lower by virtue of government sponsorship, to invest in nonmortgage investments, whose market yields will be relatively higher because they are not affected by government sponsorship.

Farmer Mac is a government-sponsored enterprise that also benefits from the market perception of an implied guarantee on enterprise obligations. It is, however, a much smaller and less established corporation than either of the housing enterprises. As a result, it is difficult to estimate Farmer Mac's funding advantage. For example, we do not know whether it could remain in business without government sponsorship or what its credit rating would be if it became a going concern as a private corporation without government sponsorship. If its credit rating without government sponsorship would be less than A, its funding advantage from government sponsorship could be greater than the advantage for the housing enterprises. However, Farmer Mac's securities may be currently perceived by market participants as more risky than housing enterprise securities. Farmer Mac documents provided to us in July 1997 indicated that yields on Farmer Mac debt had been between 1 and 10 basis points higher than yields on equivalent housing enterprise debt prior to Farmer Mac's new debt issuance strategy, and these yield differences had not yet been eliminated by Farmer Mac's debt issuance strategy.[34]

Of the specific nonmortgage investments made by the enterprises, public information is available on one investment that generated arbitrage profits; this investment was in Phillip Morris bonds purchased by Freddie Mac. 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. The yield difference was slightly over 60 basis points. Freddie Mac officials told us that its nonmortgage investment fund holding securities with maturities exceeding 5 years is authorized to contain up to

[33]GAO/GGD-96-120, May 13, 1996.

[34]In response to our inquiry, Farmer Mac's Wall Street traders, at Farmer Mac's direction, prepared estimates of yield spreads between Farmer Mac and housing enterprise debt. The estimated yield spreads generally were between 1 and 10 basis points.

$10 billion.[35] Applying, as an example, an interest rate differential of 60 basis points, a $10 billion fund could generate as much as $60 million annually in arbitrage profits. If a similar 60-basis-point differential were applied to Farmer Mac nonagricultural-mortgage investments with maturities exceeding 5 years, arbitrage profits would represent about $3.2 million.[36]

We did not make an overall estimate of arbitrage profits, in part because of difficulties in estimating the funding advantage. For the housing enterprises, we have good estimates for the funding advantage on longer term investments in fixed-rate debt that are match funded. These enterprises hold nonmortgage investments in variable-rate ABS with stated maturities of over 5 years. The enterprises told us that many of these securities have expected maturities of less than 5 years due to borrower prepayments, and we do not have good estimates for the funding advantage on these investments. We also do not have good estimates for the funding advantage on short-term investments. From our review of variable-rate ABS and short-term investments made by the housing enterprises, however, it appears that the funding advantage associated with government sponsorship is lower for these investments than for longer term, fixed-rate nonmortgage investments.

Shorter Term Investments Relate to the Housing Enterprises' Missions

The public purposes of the housing enterprises, as specified in their respective federal charters, include providing stability in the secondary market for residential mortgages and responding appropriately to the private capital market. Enterprise purchases of residential mortgages directly contribute to mission achievement. As a general matter, the housing enterprises said they also take actions they think position them to serve their respective markets under different financial market conditions as well as different conditions affecting the residential mortgage market. The housing enterprises state that their nonmortgage investment holdings allow them to respond appropriately to capital markets and fund residential mortgages during different market conditions. They also emphasize that the yields on their nonmortgage investments are lower than the yields on their mortgage investments.

Our analysis of the housing enterprises' nonmortgage investments indicated that overall, the yields on such investments are lower than on

[35]Freddie Mac officials told us that its forecasted level for year-end 1997 holdings in the fund is $2 billion.

[36]As of June 30, 1997, Farmer Mac held $536 million in longer term, variable-rate, nonagricultural-mortgage investments.

their mortgage investments. For example, in 1996 Freddie Mac's average interest rate on cash and nonmortgage investments was 5.55 percent, and on mortgages it was 7.46 percent. The respective interest rates for Fannie Mae in 1996 were 5.68 percent on nonmortgage investments and cash equivalents and 7.71 percent on mortgages. The general preponderance of short-term investments in the enterprises' nonmortgage investments accounts for the lower overall yield on these investments compared to mortgage investments. Our analysis of these short-term nonmortgage investments, such as term federal funds, indicates that they have a clear relationship to mission in enhancing liquidity, thereby allowing the enterprises to fund residential mortgages during different market conditions. In addition, even though they might also generate arbitrage profits, they are not the primary vehicle through which the housing enterprises would attempt to generate arbitrage profits. Likewise, since the yields from these investments are low relative to long-term nonmortgage investments, it is not likely that the volume of short-term nonmortgage investments would be substantially affected by the tension between increasing shareholder value and achieving mission, because these investments have lower yields than mortgage investments.

Long-Term, Fixed-Rate Nonmortgage Investments by the Housing Enterprises Generate Arbitrage Profits, and Their Relationship to Mission Is Less Clear

Freddie Mac officials indicated that nonmortgage investments are an integral tool for carrying out its housing finance mission and are held for three principal reasons: (1) cash management purposes; (2) as an investment vehicle that could make capital available (i.e., to employ capital) to help fund future anticipated demand to fund residential mortgages; and (3) as an investment vehicle to employ capital for future unexpected demand to fund residential mortgages. Freddie Mac created a fund in March 1997, which it calls its core fund, to invest in securities with maturities exceeding 5 years to be funded by matched maturity noncallable debt. The main stated purpose for the core fund is to have capital employed in case it becomes necessary to fund unexpected mortgage demand. Although Freddie Mac does not expect to liquidate core fund investments, Freddie Mac officials told us that liquidation could occur to fund purchases of residential mortgages if a decline in interest rates triggered a substantial increase in mortgage prepayments or if a major mortgage dealer or investor failed. The officials also said that raising capital to fund unexpected mortgage demand could take up to 4 months, and therefore it was important to have capital employed in investments that could quickly be liquidated in case such funds became necessary.

Our analysis focused on alternative mechanisms available to Freddie Mac for funding unexpected mortgage demand. We asked Freddie Mac officials if they were able to supply the necessary liquidity in 1993, when declining mortgage interest rates caused the highest level of mortgage prepayments in history, by using financing techniques that did not rely on liquidation of long-term investments. The officials told us that the enterprises were able to serve the market by funding purchases of residential mortgages, but this particular experience was not a guarantee for the future. It is worth noting that mortgage prepayments reduce the level of the enterprises' outstanding MBS held by investors; therefore, investment funds to fund newly refinanced mortgages are made available from investors who purchase housing enterprise MBS. Thus, in this situation MBS issuance could provide necessary liquidity without reliance on liquidation of core fund investments.

We agree that the potential failure of a major mortgage dealer or investor could bring about a need for additional liquidity in the mortgage market. However, Freddie Mac has a number of vehicles to provide liquidity, such as use of proceeds from maturing short-term nonmortgage investments to purchase residential mortgages, which in turn can be funded by issuance of MBS. Freddie Mac could also issue MBS backed by on-balance sheet holdings of residential mortgages, thereby reducing required capital to support its mortgage servicing portfolio. Such an action would make a capital cushion available to support funding of the unexpected mortgage demand, because the enterprises do not have to hold as much capital to finance off-balance sheet compared to on-balance sheet mortgage assets.[37]

Fannie Mae officials indicated that nonmortgage investments are held for three principal reasons: (1) cash management purposes, (2) as an investment vehicle to employ capital that is intrinsically appropriate for a financial corporation of its size, and (3) to maintain a capital cushion in excess of minimum capital requirements. Fannie Mae's nonmortgage investments with maturities exceeding 5 years are mostly asset-backed securities (ABS) with variable interest rates. The market value of the longer term ABS does not fluctuate as much as the market value of long-term fixed-rate securities, because most of the ABS have variable interest rates.[38]

[37]Currently, the housing enterprises are subject to minimum capital standards that are computed on the basis of capital ratios. The two capital ratios relevant to this discussion are (1) 2.50 percent of aggregate on-balance sheet assets and (2) 0.45 percent of the unpaid principal balance of outstanding MBS.

[38]The market value of the longer term ABS, however, may fluctuate more than the market value of short-term nonmortgage investments.

Therefore, at times Fannie Mae has sold ABS to finance mortgage purchases. This activity is consistent with how Fannie Mae employs its short-term nonmortgage investments. In addition, according to our review of variable-rate ABS investments by all three enterprises, it appears that the funding advantage associated with government sponsorship is lower for these instruments compared to long-term, fixed-rate nonmortgage investments. Nonetheless, some arbitrage profits are generated from these investments. Therefore, the ABS investments appear to have characteristics that differ somewhat from other nonmortgage investments in two dimensions. First, they appear to be somewhat related to mission, because they are more liquid than fixed-rate long-term investments but less liquid than short-term nonmortgage investments. However, fluctuations in the market value of ABS, in relation to short-term nonmortgage investments, can reduce their effectiveness in providing liquidity. Second, they appear to generate arbitrage profits, although at a lower level than other fixed-rate long-term nonmortgage investments.

Arbitrage Profits Could Represent a Potential Source of Funds for Targeted Housing Mortgage Programs

In addition to the contribution to mission goals and the generation of arbitrage profits already presented, there is an additional potential mission-related rationale for holding nonmortgage investments where the investment merely provides a potential source of resources that can be used to fund targeted housing mortgage programs.

Such a rationale appears to be consistent with one offered by HUD in its analysis of the housing enterprises' retained mortgage portfolios. HUD's report on privatization[39] concluded: "Full privatization would reduce the GSEs' portfolio operations. This would not have a major impact on the mortgage market because the MBS market is now well-developed and is an effective mechanism for allocating interest rate risk." HUD also concluded, however: "Most GSE earnings come from their portfolio operations. Without the cushion of a highly profitable portfolio, the fully privatized GSEs would reduce their funding of the more risky affordable loans, unless these loans started carrying much higher interest rates."[40]

[39]HUD, Privatization of Fannie Mae and Freddie Mac: Desirability and Feasibility (July 1996), page 15.

[40]Ibid. p. 105.

Farmer Mac's Nonagricultural-Mortgage Investments Generate Arbitrage Profits: Relationship to Mission Is Uncertain

Farmer Mac's first year with positive net income was 1996. Net income has grown during the first two quarters of 1997 as Farmer Mac initiated its debt issuance strategy. Currently, over half of its on-balance sheet asset holdings are in investments other than agricultural mortgages. Government sponsorship of Farmer Mac lowers its debt costs, generating arbitrage profits from such investments. In its semiannual report to the House and Senate Agriculture Committees transmitted in April 1997, FCA notes that Farmer Mac can operate at a profit even if its core business does not expand, as long as it can borrow funds at lower rates than it can earn on investments. Farmer Mac's strategy appears to be unique, not at all similar to the strategies followed by the housing enterprises over the course of their development, which makes it more difficult to determine whether the debt issuance policy will help Farmer Mac achieve its mission.

It appeared to us that Farmer Mac's debt issuance strategy would logically operate by allowing Farmer Mac to profitably price agricultural mortgage purchases so that originators would expect higher returns by selling rather than retaining mortgages in their own portfolios. For example, if the debt issuance strategy lowered funding costs for Farmer Mac on its AMBS, Farmer Mac might be able to pay mortgage originators higher prices for agricultural mortgages and remain profitable. Farmer Mac officials also told us that their investments in agricultural mortgages have higher returns than those for its nonagricultural-mortgage investments. Based on this observation by the Farmer Mac officials, it appeared to us that Farmer Mac may be able to pay mortgage originators higher prices than it currently does for agricultural mortgages and remain profitable in this mission-related segment of its business. We asked the Farmer Mac officials why Farmer Mac does not, therefore, price its agricultural mortgage purchases more favorably for mortgage originators to help this mission-related business expand. Farmer Mac officials stressed other strategies it is pursuing, such as outreach efforts with agricultural mortgage originators. We are uncertain as to whether Farmer Mac's debt issuance strategy will contribute to mission achievement, because Farmer Mac's debt issuance strategy intends to lower funding costs to purchase agricultural mortgages and issue AMBS. Farmer Mac might become better able to spend funds to recruit mortgage originators and pay mortgage originators higher prices for agricultural mortgages while remaining profitable in its mission-related business if its AMBS costs declined. However, Farmer Mac already appears to have the ability to spend more funds for such purposes than it does currently.

Conclusions

Our analysis indicates that in establishing GSEs, Congress has followed the rationale of focusing GSE activity on specific sectors of the economy. Freddie Mac, Fannie Mae, and Farmer Mac have federal charters that specify the purposes of each enterprise and provide the enterprises with broad authorities as private corporations to manage their day-to-day business operations, including their investment policies.

The enterprises' charters also direct them to fulfill specific public missions. The enterprises have mission regulators with general regulatory authorities that are charged with ensuring that the missions of these enterprises are being fulfilled. We agree with a recent HUD evaluation that it could use its general regulatory authority to potentially limit nonmortgage investments. HUD has begun a rulemaking effort intended to develop regulations governing nonmortgage investments by the housing enterprises to help ensure that such investments are related in some fashion to mission achievement. We agree that this effort can help HUD develop criteria to determine the extent to which various nonmortgage investments are mission related. Although FCA could use its general regulatory authority over nonagricultural-mortgage investments by Farmer Mac to help ensure that such investments are related in some fashion to Farmer Mac's mission achievement, it has not established a procedure for doing so. To date, neither HUD nor FCA has developed specific criteria to determine whether enterprise nonmortgage investments are consistent with mission achievement.

The enterprises have investment policies that specify permissible credit ratings, maturities, and concentration limits and describe the relationship of investments to earnings and to achievement of mission. The enterprises have incentives as private corporations to increase shareholder value; these incentives create a tension with achievement of the missions stated in the federal charters of the enterprises. It is this tension that hightlights the importance of mission oversight. Without effective mission oversight, the incentives to use the benefits of government sponsorship to increase shareholder value could, over time, erode the public mission. If this were to occur, long term nonmortgage investments could become an increasing part of the housing enterprises' portfolios and Farmer Mac's temporary approach could become a permanent strategy even if it does not enhance Farmer Mac's ability to purchase agricultural mortgages.

Government sponsorship of the enterprises lowers their debt costs, and they can therefore generate arbitrage profits (i.e., profits resulting from their funding advantage) by investing in nonmortgage assets. The various nonmortgage investments appear to fall along a continuum representing the degree to which they relate to the housing enterprises' missions. On one end are short-term nonmortgage investments, such as term federal funds, which facilitate liquidity although they might also generate arbitrage profits. On the other end are longer term investments that generate arbitrage profits, but they are less clearly related to the enterprises' missions in facilitating liquidity in the secondary market, because fluctuations in their market value reduce their usefulness in responding to changes in capital and mortgage products.

At this time, it is not clear whether Farmer Mac's debt issuance strategy will eventually help it expand purchases of agricultural mortgages in fulfillment of its mission. Given the uncertainty of when, or if, the Farmer Mac strategy will be successful, FCA has the responsibility to monitor Farmer Mac's strategy to help ensure that the nonagricultural-mortgage investments, which are a primary source of its earnings, are related in some fashion to Farmer Mac's mission achievement. Farmer Mac's strategy appears to be unique, not at all similar to the strategies followed by the housing enterprises over the course of their development. In presenting this strategy, Farmer Mac officials told us that the strategy's contribution to mission achievement should develop over a reasonable period of time.

Recommendations

To provide more focused oversight of the housing enterprises' nonmortgage investments, we recommend that the Secretary of HUD promptly implement HUD's stated intention to develop criteria through appropriate rulemaking processes to help ensure that the housing enterprises' nonmortgage investments are consistent with the purposes expressed in their charter acts. We also recommend that the Chairman of the FCA Board direct OSMO to develop the requisite criteria and report periodically, such as through its semiannual reports to the House and Senate Agriculture Committees, on the relationship of Farmer Mac's debt issuance strategy to the achievement of Farmer Mac's mission.

Matters for Congressional Consideration

To help ensure that the enterprises' nonmortgage investments appropriately support their public missions, the appropriate congressional committees may wish to monitor HUD and FCA actions to establish criteria and procedures for carrying out their general regulatory authorities. Such oversight is important to help ensure that corporate incentives to increase shareholder value do not erode the enterprises' public mission. If adequate progress is not made in a timely way, Congress may wish to consider providing further guidance to the regulatory agencies.

Agency Comments and Our Evaluation

We received comments on a draft of this report from each of the three enterprises, HUD, OFHEO, FCA, and Treasury (see apps. III through IX). Appendixes III, IV, V, VI, and VIII also contain additional responses to specific comments by Freddie Mac, Fannie Mae, Farmer Mac, HUD, and FCA. Farmer Mac, OFHEO, FCA, and Treasury provided technical comments that were incorporated in the report where appropriate.

The three enterprises agreed with our finding that the enterprises have broad investment authority and noted our acknowledgement that the safety and soundness regulators have determined that the enterprises' nonmortgage investment portfolios do not raise safety and soundness concerns. However, the enterprises raised a number of concerns and disagreed with some of our major findings pertaining to the relationship of nonmortgage investments to mission achievement, arbitrage profits, and the tension between increasing shareholder value and achieving mission. Based on Freddie Mac's disagreement with our findings, it did not concur with our recommendation to HUD. Although Farmer Mac disagreed with some of these findings, it agreed with our recommendation to FCA. HUD, OFHEO, FCA, and Treasury also provided comments, some of which focused on the three major issues raised by the enterprises.

Relationship of Nonmortgage Investments to Mission

Concerning the relationship of nonmortgage investments to mission achievement, Freddie Mac said (see app. III) that our draft report made the erroneous assertion that long-term nonmortgage investments are fairly illiquid, and this assertion provided the basis for our questioning the role of nonmortgage investments in mission achievement. As shown in appendix IV, Fannie Mae raised the concern that we had a "brief and somewhat unclear presentation of how Fannie Mae views the role of nonmortgage investments in capital management."

In response to Freddie Mac's comments, we clarified our discussion of the role of the various nonmortgage investments in facilitating liquidity in the secondary market for residential mortgages. Many of the housing enterprises' intermediate and longer term nonmortgage investments have broad and deep markets that make them readily marketable or liquid in the sense that they can be sold without substantial loss in market value. However, longer term investments are less liquid than shorter term investments in the sense that their market values are subject to larger fluctuations with changes in interest rates. These fluctuations can reduce their usefulness in responding to changes in capital and mortgage markets and facilitating liquidity in the residential mortgage market at a particular point in time, because their market values can be less than their original values when liquidation may be warranted. Therefore, we did not change our conclusion that the relationship between longer term nonmortgage investments and mission achievement is less clear than that for short-term nonmortgage investments.

In response to Fannie Mae's comments, we supplemented our discussion of Fannie Mae's primary purposes for holding nonmortgage investments to include maintaining a capital cushion in excess of minimum capital requirements. We note, however, that this purpose overlaps with the other purposes we cite in our report—cash management and providing a capital cushion to respond to capital markets and fund residential mortgages (thus facilitating liquidity). Beyond these purposes, Fannie Mae appears to emphasize the role of nonmortgage investments in Fannie Mae's earnings and capital management as well as attention to safety and soundness concerns. This emphasis is consistent with Fannie Mae's purposes for its investment portfolio as stated in its annual report,[41] which are to contribute to corporate profitability, serve as a source of liquidity, and provide a return on the excess capital of the corporation. This argument by Fannie Mae, however, does not demonstrate a relationship between nonmortgage investments and mission achievement beyond the relationship already established in our report.

Concerning the relationship of nonmortgage investments to mission achievement and regulatory oversight, HUD said (see app. VI) that our report fairly characterizes the issues, constraints, and ambiguities involved in overseeing the housing enterprises' nonmortgage investment activities. HUD agreed with, and said it has begun to implement, our recommendation to the Secretary of HUD. OFHEO (see app. VII) stated that it is appropriate for Congress to monitor nonmortgage investments at the enterprises and that Congress may wish to provide more specific guidance to the regulatory agencies regarding the appropriate range of investment activities.

Farmer Mac (see app. V) agreed with our finding that FCA has the responsibility to monitor Farmer Mac's strategy to help ensure that the nonagricultural-mortgage investments are related in some fashion to

[41]1996 Fannie Mae Annual Report, page 30.

Farmer Mac's mission achievement and our recommendation to the Chairman of the FCA Board containing an FCA reporting requirement. However, Farmer Mac took issue with our finding that its debt issuance strategy and related investment activities may not be mission related. In particular, Farmer Mac stated that we implied that its debt issuance strategy will not work because we stated that the strategy is unique. Farmer Mac also stated that this strategy, by lowering funding costs, can make funds available to recruit new mortgage originators. In addition, Farmer Mac provided a detailed description of its debt issuance policy, how it is expected to lower funding costs, and how the corporation sees the policy as linked to achievement of its mission.

In response to Farmer Mac's comments, we made revisions to clarify Farmer Mac's position on its debt issuance strategy to include the potential for making more funds available to recruit new mortgage originators. We also added clarifying language to indicate that our characterization of Farmer Mac's debt issuance strategy as unique was included as one of several reasons why it is hard to determine whether the debt issuance policy will be effective in helping Farmer Mac achieve its mission.[42]

FCA said (see app. VIII) that our draft report contains a fair representation of Farmer Mac's investment activity and FCA's views with respect to that activity. FCA appears to show some support for our recommendation to the Chairman of the FCA Board to report on the relationship of Farmer Mac's debt issuance strategy to the achievement of Farmer Mac's mission. However, it is not clear whether this willingness to report is limited to reporting on safety and soundness matters or includes issues of mission regulation. In addition, FCA said that it does not currently have any activities under way that are expected to culminate in regulation of the investment portfolio. In response to FCA's comments, we revised our recommendation to the Chairman of the FCA Board to state that requisite criteria should be developed to assess and report on the relationship of Farmer Mac's debt issuance strategy to the achievement of Farmer Mac's mission.

Treasury said (see app. IX) that we identified some of the important policy issues raised by the investment practices of the enterprises. Treasury stated that it agrees with our recommendation that the enterprises'

[42]Here we note that in Farmer Mac's third quarter 1997 SEC filing, Farmer Mac reported: "Loan volume has not been increasing as rapidly as management anticipated following the enactment of its revised legislative authorities due, in part, to the longer than expected lead-time between marketing initiatives and the realization of results."

mission regulators should use their general regulatory authority to limit the enterprises' nonmortgage investment activity. We note, however, that our recommendation calls for the mission regulators to develop criteria to help ensure that nonmortgage investments are consistent with the purposes expressed in the enterprises' charter acts.

Arbitrage Profits

The second issue relates to our position that the purchase of nonmortgage investments generates arbitrage profits. In commenting on our draft report, Freddie Mac took issue with our definition of arbitrage and asserted that we created a new definition of arbitrage to be responsive to the requester's instructions that we report on the extent to which the enterprises have undertaken nonmortgage investments for arbitrage profits. Freddie Mac also asserted that under our definition, any profitable investment Freddie Mac makes would be considered arbitrage, and therefore we have a circular argument. Freddie Mac states the general definition of arbitrage used by financial analysts that is also stated in our report. This general definition, however, does not consider differences in government-provided benefits among debt issuers. Therefore, we adopted a definition of arbitrage that is similar to the definition of an arbitrage bond defined in a section of the U.S. tax code. The definition is in reference to state and local governments whose funding costs are lowered by virtue of the federal income tax exemption for interest on state and local bonds; this definition explicitly accounts for differences in government-provided benefits. Freddie Mac's assertion that anything profitable would be arbitrage according to our definition is not correct. We note that in an integrated national financial market there would be little if any opportunity for profit from borrowing and lending for the same time period with no risk if no funding advantage were present. Under our definition of arbitrage, arbitrage profit is the amount of profit on nonmortgage investments associated with the funding advantage from government sponsorship and not the profit resulting from either risk-taking or good business judgement.

Treasury agreed with our conclusion that the enterprises' long term nonmortgage investments generate arbitrage profits and that some of the enterprises' short-term investments may also generate arbitrage profits.

Tension Between Increasing Shareholder Value and Achieving Mission

All three enterprises took issue with our conclusion that a tension exists between increasing shareholder value and achieving mission. Freddie Mac said our draft report suggests that there is an inherent conflict between private ownership and Freddie Mac's public mission, which is at odds with legislative intent and Freddie Mac's demonstrated record of achievement. Fannie Mae said that although we provided a good review of the policies underpinning its executive compensation policy, our "tension" construct implies a conflict that is theoretical at best. Fannie Mae offered a construct where senior management is required to achieve multiple objectives. Fannie Mae adds: "What is unique to the enterprises is that our mission is elevated by the Charter and enforced through oversight, regulation and potential legal sanction. The seriousness of our mission obligations are very clearly understood by managers, Directors and shareholders alike." Farmer Mac believes that there is a convergence of, rather than a tension between, the interests of Farmer Mac's shareholders and mission achievement through expanded volume, because of Farmer Mac's early stage of development.

In our report, our finding of a tension between increasing shareholder value and mission fulfillment points to the role of mission regulation in helping to ensure that the purposes of the charter acts are achieved. We recognize that Congress granted the housing enterprises federal charters to direct them to bring private sector operating efficiencies to fulfill a public purpose in the secondary mortgage market. Congress also granted regulatory authorities to OFHEO to help ensure that the housing enterprises operate in a safe and sound manner and to HUD to ensure that the purposes of the respective charter acts are accomplished. Therefore, it appears that Congress intended regulatory oversight to address situations in which the private and public interests may not be aligned. Government sponsorship of the housing enterprises has created a mechanism for the government-provided benefits to be passed through, at least in part, in the form of lower mortgage interest rates. Because this mechanism is not present for nonmortgage investments, at least some of these investments could be more profitable on a risk-adjusted basis than mortgage investments. To the extent that profits from some nonmortgage investments are less clearly related to mission, reasonable questions can be raised about whether government benefits are supporting shareholder interests at the expense of the public mission. Fannie Mae's view explicitly acknowledges charter restrictions, regulatory oversight, and multiple corporate goals. Therefore, it is difficult to distinguish its view from ours, except that Fannie Mae appears to believe that the mission has been integrated into its corporate culture. Rather than relying solely on corporate culture, however, Congress established HUD as a regulator to ensure that mission objectives are achieved. Farmer Mac's debt issuance strategy has expanded the volume of nonagricultural-mortgage investments. Although it is clear that these investments are profitable and affect executive compensation, it is not yet clear whether they contribute to mission achievement.

As arranged with your office, unless you publicly announce the contents of this letter report earlier, we plan no further distribution until 14 days after its issue date. At that time, we will send copies to HUD; OFHEO; FCA; Treasury; the enterprises; the Ranking Minority Member of your Committee; the Chairman and Ranking Minority Member of the 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.

Major contributors to this report are listed in appendix X. Please contact me or Bill Shear, Assistant Director, at (202) 512-8678 if you or your staff have any questions.

Sincerely yours,

Thomas J. McCool
Director, Financial Institutions
and Markets Issues

Contents

Abbreviations

ABS	asset-backed securities
AMBS	agricultural mortgage-backed securities
FCA	Farm Credit Administration
GSE	government-sponsored enterprise
HUD	Department of Housing and Urban Development
MBS	mortgage-backed securities
MPP	mortgage protection plan
OFHEO	Office of Federal Housing Enterprise Oversight
OSMO	Office of Secondary Market Oversight
SEC	Securities and Exchange Commission
S&P	Standard and Poor's

Measuring Arbitrage Profits

We are defining the term arbitrage to mean using the funding advantage from government sponsorship to raise funds for making nonmortgage investments. In a previous report about the housing enterprises, 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.[43] In that report, we indicated that the funding advantage could be in the range of 30 to 106 basis points. This range accounted for the long-term nature of residential mortgage investments, and it assumed that the housing enterprises would receive a credit rating between a high of AAA and a low of A if their government sponsorship were eliminated.

Our definition of arbitrage does not require the enterprise to match fund its nonmortgage investments. However, our measurement of the yield differences used to estimate arbitrage profits is based on a comparison of debt securities with similar maturity and risk. Under this method, if the debt securities being compared had different maturities, the yield difference (i.e., yield spread) would reflect both the impact of government sponsorship and the difference in interest rate risk between the debt securities. Alternatively, if the debt securities being compared had similar maturities and risks but differed by virtue of government sponsorship, the yield difference would reflect the impact of government sponsorship. For this reason, matched maturity debt provides the best measure of arbitrage, even though arbitrage is also present when nonmortgage investments are funded by enterprise debt with different maturities and risks.

In addition to relying on yield differences between enterprise nonmortgage investments in corporate bonds and matched maturity enterprise debt used to finance such investments as a measure of arbitrage, another possible approach to measuring arbitrage is to use statistical techniques to adjust yield differences between corporate and enterprise debt for differences in maturity and risk. Such an approach was used in a study commissioned by the Department of Housing and Urban Development to evaluate the implications of severing government sponsorship of the housing enterprises on the enterprises' debt costs.[44] The study included analysis of yield differences between housing enterprise debt and debt issued by different groups of corporations (i.e., the benchmark groups) with A, AA, and AAA credit ratings. The benchmark groups were chosen

[43] GAO/GGD-96-120, May 13, 1996.

[44] Brent W. Ambrose and Arthur 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. 169-204.

on the assumption that the housing enterprises would have credit ratings in this range if their federal charters were revoked. The analysis was complex, because bond characteristics differ between bonds issued by the enterprises and other issuers. Ambrose and Warga recognized how difficult their research task was and qualified their results on the basis of the statistical complexities.

We relied on the Ambrose and Warga study results for the period 1991 through 1994, in part, in making our estimate that the housing enterprises' funding advantage from government sponsorship could be in the range of 30 to 106 basis points. Due to the statistical complexities of their analysis, we concluded that their estimates lacked precision. Therefore, we used this broad range for the funding advantage on debt.

Recently, the Standard and Poor's (S&P) credit rating agency rated each housing 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.

The housing enterprises fund their nonmortgage investments with noncallable debt. Generally, the Ambrose and Warga yield spread estimates were smaller for noncallable than for callable debt. On the basis of the S&P credit ratings and the way the enterprises fund their nonmortgage investments, we have concluded that the Ambrose and Warga estimated yield spreads based on the A and AA credit ratings for issuance of noncallable debt are most relevant for measuring arbitrage profits. For the 1991 through 1994 period, the range of estimated yield spreads on noncallable debt between the AA-rated companies and the housing enterprises was 39 to 46 basis points; when the A-rated companies were used as the benchmark, the range was 65 to 72 basis points. We continue to support the Ambrose and Warga estimates and our estimated range of 30 to 106 basis points for the funding advantage; findings from our analysis of housing enterprise financial data are consistent with these estimates.

As indicated in the body of this report, we could not estimate the funding advantage resulting from government sponsorship for Farmer Mac.

However, we indicated qualitatively how Farmer Mac's funding advantage could compare to the funding advantage of the housing enterprises.

Compensation Structure for Board Members and Senior Managers

The enterprises' management and boards of directors have implemented compensation policies designed to attract and retain individuals from various disciplines who have the talent and motivation needed to accomplish the corporations' objectives. The enterprises seek to closely link pay with performance and provide compensation that is reasonable and comparable with compensation for employment in other similar businesses involving similar duties and responsibilities.[45] Through committees, the enterprises' boards of directors develop policies and administer compensation programs that are meant to conform to the congressional mandate.

Freddie Mac's overall compensation package consists of both direct compensation (i.e., cash and stock incentives) and noncash employee benefit programs. A base salary, an annual cash bonus, and long-term stock incentives are included in the direct compensation package. Base salaries are determined primarily by position and individual skills and are targeted to match the median (i.e., 50th percentile) level of the market as determined by data obtained from comparator groups (e.g., companies identified as being in a similar line of business) and market surveys. Annual cash bonuses, which function as short-term incentives, are based on a combination of individual and corporate performance and increase as a percentage of base salary at successively higher levels of responsibility and accountability. Long-term stock incentives are awarded to officers and director-level employees (i.e., employees who report directly to officers or are senior-level technical and professional employees, but not members of Freddie Mac's Board of Directors). For officers, long-term stock incentives are awarded as a percentage of base salary and increase as a percentage of base salary at successively higher levels of responsibility. The director-level employee is awarded long-term stock incentives as a percentage of the director-level salary grade midpoint. Freddie Mac's long-term stock incentives include restricted stock, which is awarded to the corporation's executive officers, and stock options. Examples of noncash employee benefits offered to all regular employees include an individually structured benefits package (i.e., health care, life insurance, etc.); a pension plan; and an employee stock purchase plan.

Fannie Mae's compensation package consists of a base salary, employee benefits, annual incentives, and long-term incentives. The salary is based on individual skills, experience, performance, etc; benefits include such

[45]For the housing GSEs, these considerations are set forth at 12 U.S.C. §§ 1452 (c), (h)(2) (Freddie Mac), 12 U.S.C. §§ 1723a (d)(2), (3)(B) (Fannie Mae). There are no similar statutory provisions covering compensation at Farmer Mac, but Farmer Mac officials told us that such factors are included in determining officer and director compensation levels.

provisions as insurance coverage, vacation pay, sick leave, and retirement. Annual incentives reward employees for reaching specific objectives or completing projects that enhance the corporation's success for that year, and long-term incentives generally reward executives for shareholder gains and the achievement of specific corporate objectives.

Today, Farmer Mac's salaries and other compensation components are based on surveys of pay structures at other enterprises and other financial institutions; however, this was not always the case. Although its salary compensation policies were generally competitive, Farmer Mac officials told us that other aspects of its compensation were not. In 1995, assisted by a compensation consultant, Farmer Mac recognized the need to revise its compensation policies to emphasize the creation of a greater management equity stake in Farmer Mac's future. Consequently, the consultant helped Farmer Mac to establish a baseline compensation package for its staff that now includes an annual salary, annual bonus to award current-year contributions to Farmer Mac's success, and long-term compensation (stocks and options) to ensure that directors and senior managers hold an equity interest in the corporation to provide the incentive to ensure the long-term survival of Farmer Mac. Officers and employees are also provided certain benefits, such as health and life insurance and a pension plan.

As of December 31, 1996, Farmer Mac had 21 employees. The proportion of Farmer Mac's total compensation package representing incentive compensation for the 1995-96 plan year was 26 percent for the Chief Executive Officer and ranged between 13 percent and 19 percent for other senior management personnel. As recommended by a consultant, a portion of incentive compensation ranging from 67 percent to 88 percent represented stock grants and stock option awards. Incentive compensation was linked to the evaluation of each individual's performance, based on standards that included professional competence, motivation, and effectiveness, as well as the individual's contribution to the implementation of strategies designed to achieve the objectives set forth in Farmer Mac's business plan for the 1995-96 plan year.

The purpose of Farmer Mac's stock option plans is to encourage stock ownership by directors, officers, and other key employees to provide an incentive for such individuals to expand and improve the business of the corporation and to assist Farmer Mac in attracting and retaining key personnel. As with the other enterprises, the use of stock options is an attempt to align the long-term interests of employees more closely with those of Farmer Mac's stockholders by providing employees with the opportunity to acquire an equity interest in Farmer Mac.

Comments From Freddie Mac

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

Leland C. Brendsel
Chairman and
Chief Executive Officer
(703) 903-3000

8200 Jones Branch Drive
McLean, VA 22102-3107

Freddie Mac

January 12, 1998

Mr. Thomas J. McCool
Director, Financial Institutions and Market Issues
General Accounting Office
441 G Street, N. W.
Washington, D.C. 20548

Re: Draft GAO Report on GSE Nonmortgage Investments

Dear Mr. McCool:

Thank you for the opportunity to comment on the General Accounting Office (GAO) draft report on the nonmortgage investment activities of certain government-sponsored enterprises ("GSEs").

Freddie Mac agrees with a majority of the substantive findings made in the draft report, particularly:

- Freddie Mac is authorized to make nonmortgage investments under our charter.
- The Office of Federal Housing Enterprise Oversight has concluded that Freddie Mac's nonmortgage investment activities are conducted safely and soundly.
- Freddie Mac's nonmortgage assets are not actively traded.
- Freddie Mac's nonmortgage investment activities are a small aspect of our mortgage related activities. At December 31, 1996, Freddie Mac's total nonmortgage investments were only 2.6 percent of our total mortgage portfolio.[1]

See comment 1.

[1] GAO also calculates nonmortgage assets as a percentage of "on-balance-sheet" assets. This exaggerates the size of nonmortgage investments in relation to Freddie Mac's total mortgage-related activities, since all of the passthrough mortgage securities that Freddie Mac issues are accounted for as "off-balance-sheet" holdings. As the draft report states elsewhere: "The housing enterprises accomplish [their] mission by purchasing residential mortgages from lenders. The housing enterprises retain some of the mortgages they purchase in their own portfolios, but the majority are pooled into mortgage-backed securities (MBS) that are sold to investors in the secondary mortgage market. As of December 1996, Freddie Mac has about $554 billion in MBS obligations and $156 billion in debt obligations outstanding." Draft Report at 3. Although Freddie Mac's mortgage

Now on p. 2.

Mr. Thomas J. McCool
General Accounting Office
January 12, 1998
Page 2

- Nonmortgage assets enable Freddie Mac to fulfill our public mission by enhancing liquidity, thereby allowing us to fund residential mortgages during different market conditions.

While the draft report concludes that substantially all of Freddie Mac's nonmortgage investments support our public mission, the draft report questions whether fixed-rate nonmortgage investments having maturities greater than five years are related to fulfillment of Freddie Mac's statutory purposes. The draft report makes three principal erroneous assertions that provide the basis for questioning longer-term nonmortgage investments.

See pp. 5, 31, and 32.

First, the draft report states that long-term nonmortgage assets are "fairly illiquid." In Freddie Mac's experience, this is an incorrect assertion, and the draft report provides no evidence to support it. Freddie Mac's longer-term nonmortgage investments are highly liquid. Therefore, consistent with the draft report's own reasoning, these longer-term securities support Freddie Mac's fulfillment of its statutory purposes.

See p. 35.

Second, the draft report departs from well-established definitions of the term "arbitrage" in order to characterize any profitable nonmortgage investment activities as "arbitrage" activities. The draft report's apparent premise is that Freddie Mac's nonmortgage activities should be conducted in a more costly – less profitable – manner, solely to avoid so-called "arbitrage" profits.

See pp. 36-37.

Third, the draft report asserts that there is a "tension" between Freddie Mac's private-sector structure and the accomplishment of our public purposes. This assertion is fundamentally at odds with the congressional premise upon which Freddie Mac and Fannie Mae were created – that there is a synergy between private-sector discipline and the efficient achievement of our public mission. Freddie Mac and Fannie Mae have a strong record of attracting and harnessing private capital to fulfill their public purpose of providing a stable and reliable supply of low-cost mortgage credit nationwide.

Nonmortgage investments are a small but essential part of how Freddie Mac fulfills our statutory purposes. Because Freddie Mac's nonmortgage investments are authorized, necessary to fulfill statutory purposes and managed in a safe and sound manner, the draft report's recommendations are unwarranted and suggest precisely the

---

participation certificates (PCs) and other passthrough mortgage securities represent the largest part of our mortgage related activities, they are not part of "on-balance sheet assets," and thus are excluded from GAO's calculations.

Mr. Thomas J. McCool
General Accounting Office
January 12, 1998
Page 3

type of micromanagement of GSE activities that Congress has consistently admonished federal regulatory agencies to avoid.

We welcome the opportunity to provide our comments in more detail below.

Freddie Mac's Longer-Term Nonmortgage Assets Are Highly Liquid and Directly Related to Fulfillment of Our Statutory Purposes

See pp. 5, 31 and 32.

In assessing the relationship between nonmortgage investments and Freddie Mac's statutory purposes, the draft report focuses on the liquidity of these assets, since "liquidity allows the housing enterprises to fund residential mortgages during different market conditions."[2] In this regard, the draft report states:

> In our analysis, we found that the various nonmortgage investments fall along a continuum representing the degree to which they provide readily available liquidity and thus are more clearly related to the enterprises' missions. On the one end are short-term nonmortgage investments, such as federal funds which are liquid. . . On the other end are fairly illiquid long-term investments . . . whose relationship to mission is less clear.[3]

The draft report concludes that short-term assets (defined as those assets having maturities of five years or less) "have a clear relationship to mission in enhancing liquidity, thereby allowing the enterprises to fund residential mortgages during different market conditions."[4]

Using this analysis, substantially all of Freddie Mac's nonmortgage investments are directly related to the fulfillment of our public mission. As the draft report notes, about 78 percent of Freddie Mac's nonmortgage investments had maturities under one year, and about 93 percent had maturities under five years.[5] In fact, fixed-rate nonmortgage investments with maturities greater than five years total less than two-tenths of 1 percent of Freddie Mac's mortgage portfolio.

Now on p. 5, fn. 7.

[2] Draft Report at 8.

Now on p. 5.

[3] Draft Report at 8.

Now on p. 26.

[4] Draft Report at 46.

Now on pp. 15 and 16.

[5] Draft Report at 26-27.

Mr. Thomas J. McCool
General Accounting Office
January 12, 1998
Page 4

Nonetheless, we strongly disagree with the draft report's conclusion that "the relationship between longer term nonmortgage investments and the enterprises' mission goals is not always clear, because long term investments are not as liquid as short term investments."[6]

Although the draft report appropriately states that "a market is more liquid if investors can buy and sell large amounts of holdings without affecting the prices of traded securities,"[7] the draft report's suggestion that an asset's longer maturity renders it illiquid is simply wrong.

For example, long-term, 30-year Treasury bonds are among the most liquid securities in the world – a ready market for these instruments exists 24 hours a day, and investors can liquidate these instruments for a price reflecting the value of the asset and obtain cash proceeds on a "same-day" settlement basis. In contrast, 30-day Federal fund deposits – which the draft report uses as an example of short-term, "liquid" investments – actually are less liquid than 30-year Treasury bonds, for the simple reason that no secondary market exists in which 30-day Federal fund deposits are traded. Similarly, due to the secondary mortgage market developed by Freddie Mac, long-term 30-year fixed-rate residential mortgages are highly liquid, yet short-term, one-year small business loans are generally illiquid.

The draft report contains no evidence or analysis to support the finding that Freddie Mac's longer-term nonmortgage assets are "fairly illiquid." In fact, the majority of Freddie Mac's longer-term nonmortgage assets are medium-term corporate notes issued by leading corporations, commercial banks, insurance companies and securities dealers. These securities are all investment-grade bonds, and are traded continuously by a multitude of dealers and investors in deep and well-established markets. According to statistics published by the Bond Market Association (formerly the Public Securities Association), the U.S. corporate bond market had outstanding debt of $2.1 trillion at the close of third quarter 1997.

Freddie Mac's longer-term nonmortgage investments are highly liquid, and numerous offers for purchase are readily available on any day in which trading markets are open. In other words, in the event of a disruption in the secondary mortgage market, Freddie Mac could generate funds for mortgage purchases by liquidating its fixed-rate, longer-term nonmortgage assets with a single phone call, and receive cash proceeds on such sale within a few hours on the same day.

---

[6] Draft Report at 8.

[7] Draft Report at n. 7.

Mr. Thomas J. McCool
General Accounting Office
January 12, 1998
Page 5

Any asset's liquidity will vary with the full range of events that can affect the market in which such assets are traded. Assets that are highly liquid can become less so when markets are disrupted. It is precisely for this reason that Freddie Mac employs a variety of strategies to assure the overall liquidity necessary to fulfill our public mission under adverse market conditions. In this context, long-term, fixed-rate nonmortgage investments are a small but essential part of our strategy for deploying capital that directly relates to fulfillment of our statutory purposes. The longer-term fixed-rate nonmortgage investments that Freddie Mac holds could provide an important source of funding to the secondary mortgage market in financial circumstances where other funding sources have been disrupted. In such a case, Freddie Mac's ability to sell nonmortgage investments and purchase mortgages could prove crucial to keeping the cost of conforming mortgages from rising precipitously.

As the draft report notes, Freddie Mac has well developed global debt and mortgage-backed securities markets. However, these markets are not immune from disruption. Longer-term nonmortgage investments, such as corporate medium-term notes, allow Freddie Mac to have funds available to provide liquidity to the mortgage market by purchasing mortgages at times when selling Freddie Mac debt or mortgage-backed securities to fund such purchases might add to the instability of mortgage investments as a whole.[8] Consequently, these longer-term nonmortgage investments clearly support Freddie Mac's public mission.

Freddie Mac Purchases of Nonmortgage Investments Are Not "Arbitrage" Activities

See p. 35.

The draft report departs from established definitions of "arbitrage" and relies instead on a newly created, circular definition that suggests that any nonmortgage investment that yields a profit entails arbitrage. Such a definition is inappropriate because it obscures the question of the substantive purposes for which these investments are made.

The generally accepted definition of arbitrage is "[t]he simultaneous purchase and sale of the same, or essentially similar, security in two different markets

See comment 2.

Now on p. 27.

[8] For example, should secondary market investors begin to sell large amounts of long-term mortgage-backed securities, the "spreads" on these securities against Treasury bond benchmarks would widen (meaning the value of the MBS relative to Treasury securities would drop, perhaps significantly). In this environment, Freddie Mac could only make matters worse by issuing new mortgage-backed securities into a deteriorating market. The draft report nonetheless suggests that, in a market disruption which calls for additional liquidity, Freddie Mac should issue additional mortgage-backed securities. [draft report at 48] Such action could be directly contrary to Freddie Mac's statutory purpose to provide stability and liquidity to the market on a continuous basis.

Mr. Thomas J. McCool
General Accounting Office
January 12, 1998
Page 6

for advantageously different prices."[9] This reflects not only generally accepted financial analysis, but the definition used by government agencies that interpret the term for regulatory purposes. For example, the Securities and Exchange Commission defines the term as follows:

> The term "bona fide arbitrage" generally describes an activity undertaken by market professionals in which essentially contemporaneous purchases and sales are effected in order to "lock in" a gross profit or spread resulting from a current differential in pricing. For example, an arbitrageur may effect an offsetting purchase and sale of the ***same security*** in different markets on the basis of an existing price differential between those markets, or may effect offsetting transactions in the same market in a security and another security convertible into the first.[10]

Similarly, the Internal Revenue Service defines arbitrage operations as:

> transactions involving the purchase and sale of property entered into for the purpose of profiting from a current difference between the price of the property purchased and the price of the property sold. Assets acquired for arbitrage operations include only stocks and securities and rights to acquire stocks and securities. The property purchased may be either ***identical*** to the property sold or, if not so identical, such that its acquisition will entitle the taxpayer to acquire property which is so identical. Thus, the purchase of bonds or preferred stock convertible, at the holder's option, into common stock and the short sale of the common stock which may be acquired therefor, or the purchase of stock rights and the short sale of the stock to be acquired on the exercise of such rights, may qualify as arbitrage operations.[11]

Had the draft report used any of these accepted definitions, the draft report would have concluded that Freddie Mac does *not* engage in arbitrage activities. Unlike arbitrage activities, Freddie Mac's nonmortgage investments are funded by its own debt; require

---

Now on p. 20.

[9] W. Sharpe, G. Alexander and J. Bailey, *Investments* (5th ed.), at 1001. Indeed, the draft report agrees that this is the commonly accepted definition, stating: "Financial analysts generally define arbitrage as profiting from differences in price when the same security is traded in two or more markets." Draft report at 35.

[10] SEC Release No. 34-15533, 1979 SEC LEXIS 2244 (January 29, 1979)(emphasis added).

[11] 26 C.F.R. § 1.1233-1(f)(3) (1997)(emphasis added).

Mr. Thomas J. McCool
General Accounting Office
January 12, 1998
Page 7

the management of interest rate, credit and other risks; and directly serve Freddie Mac's statutory purposes.

Instead, the draft report creates a definition that ensures that Freddie Mac's nonmortgage investment activities are characterized as "arbitrage." Thus, as the draft report states:

> In this draft report, we are defining the term 'arbitrage' to mean using the funding advantage from government sponsorship to raise funds for making nonmortgage investments.[12]

This newly created definition is clearly responsive to the requester's instructions that the GAO report on:

> the extent to which the enterprises have undertaken nonmortgage investments for arbitrage profits – using the funding advantage from government sponsorship to purchase nonmortgage investments that generate profits.[13]

Under this definition, any profitable investment Freddie Mac makes is considered arbitrage, and the draft report completes the circle by concluding: "it is clear that nonmortgage investments generate arbitrage profits."[14]

In the draft report's discussion of so-called "arbitrage profits," the most serious flaw is the implication that Freddie Mac should avoid investments in longer-term nonmortgage investments because they provide liquidity at a lower cost than alternative nonmortgage investments. Enhancing efficiency by minimizing costs is what every well-managed financial enterprise should strive to do, and, in Freddie Mac's case, is a key element in how we bring benefits to the nation's homebuyers. Yet this fundamental tenet of good business practice has been stood upon its head by

See comment 3.
Now on pp. 5 and 20.

[12] Draft Report at 8. The draft report attempts to lend credibility to its failure to apply standard definitions of arbitrage by referring to an Internal Revenue Code definition drawn from the municipal bond arena. In the municipal bond context, however, Congress disapproved what it viewed as the inappropriate conversion of federal Treasury securities into municipal bonds, the proceeds of which were never applied for any legitimate governmental purposes. Freddie Mac's nonmortgage investments, in contrast, directly serve our statutory purposes of providing liquidity and stability to the mortgage market.

Now on p. 1.

[13] Draft Report at 2.

Now on p. 5.

[14] Draft Report at 8.

Mr. Thomas J. McCool
General Accounting Office
January 12, 1998
Page 8

the draft report's erroneous assertion that the achievement of profitability and public mission are inherently inconsistent.[15]

See p. 36.

Serving Public Mission and Serving Shareholders Go Hand in Hand

The draft report asserts that there is a "tension" between private ownership and the fulfillment of a public purpose. In this regard, the draft report states:

> Enterprise officers and board members have incentives to increase shareholder value, just as do officers and board members of private corporations. However, unlike private corporations, the enterprises also have public missions stated in their charters. Thus, these enterprise incentives can create tensions between increasing shareholder value and fulfilling the public mission.[16]

The draft report suggests that there is an inherent conflict between private ownership and Freddie Mac's public mission. The draft report provides no support for its opinion other than the finding that Freddie Mac's compensation practices comply with statutory requirements.[17]

See comment 4.

Now on pp. 42 and 43.

[15] In addition to disagreeing with the fundamental basis for the draft report's finding of so-called "arbitrage," we disagree with a number of the assumptions that the draft report uses. The draft report repeats a finding in an earlier 1996 GAO report that Freddie Mac's funding advantage "could" range from 30 to 106 basis points. As noted in the draft report's appendix, the GAO chose to report this "broad range" because these estimates "lacked precision," and we continue to disagree with these estimates. Draft Report at 60. Freddie Mac has previously provided an analysis detailing the methodological flaws underlying the erroneous estimates in the 1996 GAO report. Freddie Mac's analysis of this issue is contained in *Financing America's Housing; The Vital Role of Freddie Mac* (1996) at 33, n. 21. See also, Miller, Tollison and Higgins, *A Critical Review of the Ambrose and Warga Privatization Study.* We will not repeat this analysis here. We also note that the data upon which the draft report's estimates rely are from the period 1991 to 1994. A longer time series that includes more recent data is likely to represent a wider range of market conditions. For example, spreads between five-year bullet debt (averaged for A-rated and AA-rated debt) and comparable Freddie Mac and Fannie Mae debt averaged only 36 basis points from September 1992 to November 1997. *Lehman Brothers Relative Value Database.*

See comment 5.

Now on pp. 24 and 25.

Freddie Mac also disagrees with the draft report's estimates of potential arbitrage profits based on an assumed portfolio that is nearly 17 times larger than Freddie Mac's current longer-term nonmortgage investments. Draft Report at 44. Freddie Mac estimates that its profits on longer-term nonmortgage investments in 1997 will represent a mere fraction of the contribution to earnings hypothesized in the draft report. The draft report also exaggerates the extent to which arbitrage profits could contribute to Freddie Mac's earnings by comparing pre-tax profits on its projected portfolio of investments to Freddie Mac's actual 1996 after-tax net income, an "apples and oranges" comparison.

Now on p. 20.

[16] Draft Report at 35.

Now on pp. 22 and 23.

[17] Draft Report at 38.

Mr. Thomas J. McCool
General Accounting Office
January 12, 1998
Page 9

In contrast to the draft report's point of view, Congress clearly recognizes a synergy – not a conflict – between Freddie Mac's private ownership and public purpose. For example a 1992 Senate report states that:

> Congress created the enterprises under private ownership and management to bring the entrepreneurial skills and judgments of the private sector to bear on accomplishment of public purposes relating to housing.[18]

Similarly, a former Chairman of the Senate Banking Committee observed:

> These GSEs have become the most successful Government housing programs in modern times because they have harnessed private capital and private sector ingenuity in order to fulfill a public purpose. . . . They have accomplished their task while exercising prudent management and building a strong financial condition.[19]

Fulfilling our mission and creating shareholder value are fundamentally linked and mutually fortifying – we cannot achieve one without the other. Freddie Mac's success in meeting the needs of investors, lenders, and ultimately homeowners and renters generates a return that enables us to attract and retain shareholder capital, ensuring that funds are continuously available to finance housing. Over the years, Freddie Mac has attracted hundreds of billions of dollars of capital into the mortgage finance system, increasing the supply of mortgage credit and driving down mortgage rates for borrowers.

Freddie Mac has a 27-year record of profitably fulfilling our public mission, bringing enormous benefits to homebuyers, the housing finance system and the general public. Today, the United States enjoys the most advanced mortgage delivery system in the world, in large part because of Freddie Mac's and Fannie Mae's innovations, efficiencies, deep investor bases and ability to provide a reliable supply of low-cost mortgage credit to potential homebuyers nationwide.

For example:

---

[18] S. Rep. No. 282, 102nd Cong., 2d. Sess. at 25 (1992)

[19] Statement of Senator Jake Garn (R-UT), 138 Cong. Rec. S 8611 (June 23, 1992)

Mr. Thomas J. McCool
General Accounting Office
January 12, 1998
Page 10

- Each year, as a result of Freddie Mac's and Fannie Mae's activities, American homebuyers save about one-half of a percentage point in mortgage interest; these savings amount to $10 billion annually.
- In the early 1980s, mortgage rates ranged between two and three percentage points above the comparable Treasury rates. With Freddie Mac's creation and development of multiclass mortgage securities (CMOs), continued refinement of uniform documentation and underwriting standards and electronic trading of mortgage securities, the spread has declined to less than two percentage points and has ranged between one and one-and-one-half percentage points throughout the 1990s.
- Prior to the creation of Freddie Mac and Fannie Mae, regional mortgage rate disparities were widespread. Thanks to the GSEs, mortgage money is available at all times, at about the same cost, throughout the nation.
- Freddie Mac serves a wide variety of borrowers of all incomes and in all neighborhoods. Over 40 percent of our mortgage purchases in 1996 financed housing for families at or below the area median income.
- Sources of mortgage funds have broadened dramatically, as Freddie Mac has attracted a new, more diverse base of investors to the mortgage market.

Freddie Mac's and Fannie Mae's long-standing record of fulfilling their public mission while simultaneously meeting the interests of shareholders has also been recognized by Congress. In 1991, the ranking Republican member of the House Banking Committee stated:

> [T]he housing related GSEs continue to fulfill their public mission in an exemplary manner. Without the link between housing markets and capital markets which has been forged by these GSEs, there would be far fewer homeowners in the United States today. The GSEs have been a true success story in providing liquidity, efficiency and access to the housing finance system for low, moderate, and middle-income Americans at no cost to the federal government.[20]

More recently, the Chairman of the Senate Banking Committee concluded that:

> Freddie Mac steadfastly continues to fulfill its important mission to make a reality of the American dream of decent, safe and affordable housing. Since its creation, Freddie Mac has assisted 16 million hard working American families by financing one out of every six homes in the United States. This is a tremendous accomplishment which

[20] Statement of Rep. Chalmers Wylie (R-OH), 137 Cong. Rec. E 2354 (June 25, 1991).

Mr. Thomas J. McCool
General Accounting Office
January 12, 1998
Page 11

> deserves our commendation. . . .Freddie Mac is working to enhance the existing mortgage finance delivery system through efforts to ensure fair lending, revitalize neighborhoods and expand affordable housing opportunities. These efforts should enable Freddie Mac to continue to serve Americans for generations to come.[21]

The GAO may perceive a tension between Freddie Mac's private ownership and the fulfillment of our public purpose, but that perception is at odds with Congressional findings, legislative intent and Freddie Mac's demonstrated record of achievement.

Freddie Mac's Nonmortgage Investments Directly Support Fulfillment of Our Statutory Purposes

Freddie Mac is proud of the role that we play in the world's greatest housing finance system. Through our continuous innovation and financial discipline, we have helped millions of American families achieve the dream of homeownership. Nonmortgage investments are a small but essential part of how Freddie Mac fulfills our statutory purposes.

See pp. 5, 31, and 32.

See pp. 36 and 37.

While the draft report concludes that these investment activities are authorized under our charter, conducted safely and soundly and largely related to our public mission, the draft report's statements regarding longer-term, fixed-rate nonmortgage investments miss the mark. The finding that Freddie Mac's longer-term nonmortgage related activities are "fairly illiquid" is clearly wrong. These assets are liquid and, by purchasing them, Freddie Mac increases our ability to provide liquidity to the mortgage market in the future. The draft report's other assertion of a tension between private ownership and public mission is also wrong. Accordingly, the draft report's recommendation that additional oversight of Freddie Mac's nonmortgage investment activities is "needed" is unwarranted.

Thank you for the opportunity to comment on this draft report. We would be happy to meet with you to discuss our concerns or answer any questions you may have.

Sincerely,

Leland C Brendsel

Leland C. Brendsel

[21] Statement of Senator Alfonse D'Amato (R-NY), 141 Cong. Rec. S 12420 (August 11, 1995).

The following comments represent our response to specific comments made on a draft of this report on January 12, 1998, by the Chairman and Chief Executive Officer of Freddie Mac.

GAO Comments

1. Freddie Mac said that we calculate nonmortgage assets as a percentage of on-balance sheet assets and that this exaggerates the size of nonmortgage investments in relation to Freddie Mac's total mortgage-related activities. We calculate nonmortgage investments as a percentage of (1) on-balance sheet assets; (2) total mortgage servicing portfolio; and (3) capital (i.e., corporate equity). The second measure captures Freddie Mac's total mortgage-related activities. The second measure is relevant if the sole purpose of the nonmortgage investments is, by definition, to support the total mortgage servicing portfolio. However, we provide the first and third measures because of their relevance in cases where the relationship of nonmortgage investments to mission is not clear. For example, both measures are relevant for comparisons among different corporations competing in the financial services industry.

2. Freddie Mac stated that its debt and MBS markets are not immune from disruption and states the example, ". . . should secondary market investors begin to sell large amounts of long-term mortgage-backed securities, the 'spreads' on these securities against Treasury bond benchmarks would widen (. . . perhaps significantly)." Freddie Mac added that it could only make matters worse in this environment by issuing new MBS. Freddie Mac does not specify the economic conditions that would cause investors to sell large amounts of MBS so that the value of MBS relative to Treasury securities would fall, while at the same time there would be such an unexpected surge in mortgage demand that would require liquidation of core fund investments. During the course of our assignment, we asked Freddie Mac to provide analyses indicating the economic conditions that would require sales of nonmortgage investments from the core portfolio to purchase mortgages. With respect to the examples Freddie Mac provided, in our report we analyzed alternative mechanisms available to Freddie Mac for funding unexpected mortgage demand. These alternatives have been successfully employed by the housing enterprises in the past to meet their charter responsibilities. (See pp. 26-27.)

3. Freddie Mac takes issue with our definition of arbitrage, which is similiar to the definition of an arbitrage bond in the U.S. tax code. It said: "In the municipal bond context, however, Congress disapproved what it viewed as the inappropriate conversion of federal Treasury securities into

municipal bonds, the proceeds of which were never applied for any legitimate governmental purposes. Freddie Mac's nonmortgage investments, in contrast, directly serve our statutory purposes of providing liquidity and stability to the mortgage market." Here, we again note that the relationship between the various nonmortgage investments and mission achievement is less clear for the longer term than the shorter term nonmortgage investments. Therefore, we have concluded that the analogy to municipal bonds in defining arbitrage is appropriate.

4. Freddie Mac disagrees with our use of the range of 30 to 106 basis points to represent the housing enterprises' funding advantage on debt. Freddie Mac's comments and our response appear in the previous GAO report establishing this range.[46] In its comment letter in this report, it cited its analysis of the yield spread on 5-year bullet debt between housing enterprise debt and debt of A and AA rated companies to illustrate Freddie Mac's disagreement with our range. Freddie Mac also noted that the data upon which this range was established are from the 1991 to 1994 time period. We first became aware of the Freddie Mac analysis when it was submitted for the record at congressional hearings on July 31, 1996, after we completed our previous (i.e., privatization) study identifying the 30- to 106-basis-point range. Although we have not thoroughly analyzed the methodology (including its emphasis on 5-year debt rather than debt issues with longer maturities) or data relied upon in the Freddie Mac analysis, we note that the findings on yield spreads from the Freddie Mac analysis are in the vicinity of the bottom of our range (see reference to the 36-basis-point average cited by Freddie Mac). In addition, our findings from our analysis of housing enterprise financial data during this assignment are consistent with the estimated funding advantage range we established in our previous report and rely upon in this report. The housing enterprise financial data and the Standard and Poor's credit ratings we relied upon for our analysis during the course of this assignment are more recent than the data relied upon in the Freddie Mac analysis.

5. Freddie Mac disagreed with our "draft report's estimates of potential arbitrage profits based on an assumed portfolio that is nearly 17 times larger than Freddie Mac's current longer-term nonmortgage investments." We provide this estimate as an example of how much a $10 billion fund, the authorized level for Freddie Mac's core fund, can generate in arbitrage profits. We also make reference to the $2 billion forecasted level for year-end 1997 holdings in the core fund.

[46]GAO/GGD-96-120, May 13, 1996, pages 49-53.

Comments From Fannie Mae

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

FannieMae

Annette Fribourg
Vice President
Regulatory Activities

3900 Wisconsin Avenue, NW
Washington, DC 20016-2892
phone 202 752 6675

January 12, 1998

Mr. Thomas J. McCool
Director
Financial Institutions and Markets Issues
General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Mr. McCool:

The following are Fannie Mae's official comments on the draft letter report "GAO/GGD-98-XX Enterprise Nonmortgage Investments." The topic is highly complex with significant implications for liquidity, capital management, mission fulfillment -- in effect, overall operations of the enterprises. The draft affirms key points that should advance understanding of the vital role non-mortgage investments play in the effective accomplishment of the Fannie Mae mission.

The draft points out that the enterprises have broad authority to maintain non-mortgage investments. It indicates that such investments "should not be unrelated to the special purposes for which the enterprises were created." On this point, the draft recognizes that such investments play an important role in providing liquidity, and that the liquidity function is a clear example of how investments serve our public mission.

Indeed, liquidity is essential to Fannie Mae's ability to preserve smooth operations regardless of sudden changes or disruptions in the market. Liquid investments give us ready access to funds when conditions may not otherwise allow us to access the market at the moment, in the volume or with the maturities we need. This flexibility is essential to our ability to perform our mission and carry out our Charter Act obligations.

Importantly too, the draft states clearly that the investment portfolio has not posed a safety and soundness concern. GAO draws this conclusion on the basis of OFHEO's risk assessments, as supported by their own overview of the composition of the portfolio. Indeed, Fannie Mae manages non-mortgage investments under Board-approved guidelines that impose strict credit, maturity and position limitations and an explicit goal of zero credit loss. We actively review these investments as a part of our management and oversight of overall portfolio investments. The Fannie Mae Treasurer reports weekly to management, and senior management reports quarterly to the Executive Office on the full range of portfolio investments. In addition, the Assets & Liabilities Committee of the Board of Directors reviews the composition and performance of our liquid investments at least annually.

Mr. Thomas J. McCool
January 12, 1998
Page 2

See pp. 32 and 33.

However, we have concerns about several parts. The most critical of these is the report's brief and somewhat unclear presentation of how Fannie Mae views the role of non-mortgage investments in capital management. Our liquid investment portfolio serves as a vehicle for maintaining a significant risk-based capital cushion. This is a paramount purpose of these investments, tied inextricably to safety and soundness -- and our Charter obligations. This relationship to our Charter and its implications for safety and soundness are pivotal considerations for any regulatory review of this area. Neither this function of the non-mortgage portfolio, nor its implications, are adequately captured in the draft.

As a part of Fannie Mae's approach to capital management, our policy is to maintain a capital cushion in excess of minimum capital requirements. In anticipation of the promulgation of final risk-based capital standards, the corporation believes it is prudent business management and sound mission planning to ensure that it has more than enough capital to meet whatever the final risk-based standards may be. After the regulations are promulgated, Fannie Mae intends to maintain a cushion above the risk-based standard, to ensure that we can meet the quarterly adjustments in the risk-based requirements without having to raise additional capital. Our goal is to avoid any shortfalls in capital that might force the corporation to have to raise additional capital unexpectedly in a changing economic environment.

Fannie Mae's liquid investment portfolio is primarily an investment vehicle for this excess capital. Rather than let the capital be unproductive, the corporation invests it in safe, liquid assets. This approach is consistent with the approach of other financial institutions. With respect to Fannie Mae, in its 1996 Risk Examination Report, OFHEO concluded that Fannie Mae's Treasury management activities, which include the liquid investment portfolio, support the capital deployment needs of the corporation.

See comment 1.

The capital account management purposes of the liquidity portfolio also serve to put into proper context our longer-term non-mortgage investments. GAO allows that these investments may relate to mission, but considers the merits of shorter-term investments to be more apparent. As GAO notes, Fannie Mae has relatively few longer-term investments. Nonetheless, we wish to point out that, at least with regard to the specific non-mortgage investments Fannie Mae maintains and the purposes for which we maintain them, the distinctions GAO makes are not germane. Specifically, the investments Fannie Mae selects pursuant to Board approved guidelines serve the same capital management purpose for which we maintain the portfolio as our shorter-term investments. Though the yield on the longer-term investments is somewhat greater than on shorter-term investments, it is still less than that of mortgage investments; at the same time longer-term investments offer opportunity for diversification within the non-mortgage investment pool.

Mr. Thomas J. McCool
January 12, 1998
Page 3

The corporation's capital management strategy ensures that Fannie Mae is always positioned to fulfill its mission of serving the demands of a dynamic housing market. To do otherwise would expose the corporation to the serious risk of capital shortfall in times of critical need, reduce our ability to meet our public mission and affect our ability to maintain a safe and sound operation. We urge GAO to expand its review and discussion of the vital capital management function of the liquidity portfolio and the implications for safety and soundness. We encourage GAO to consider -- and caution against -- the potential for perverse regulatory incentives toward decapitalization.

See pp. 36 and 37.

A second issue relates to the use of stock and other incentives in Director and senior management compensation. The draft provides a good review of the policies underpinning our executive compensation philosophy, including comparability and performance. Indeed, comparability is specifically embraced in the 1992 Act as a standard for OFHEO review of executive compensation. Similarly, the Act mandates pay for performance, specifying that "a significant portion of potential compensation of all executive officers...shall be based on the performance of the corporation." GAO agrees that our policies are "fairly typical" of major corporations and financial institutions.

However, within this discussion, GAO sees a "tension" between mission fulfillment and increasing shareholder value. This construct implies a conflict that is theoretical at most. A more useful construct is that senior management is required to manage and achieve multiple objectives. Shareholder interests are not in competition with these objectives. Rather, Fannie Mae management's perspective is that the successful fulfillment of <u>all</u> of these objectives is the most effective strategy for promoting long-term shareholder value.

Managing goals other than profit maximization is hardly unique in corporate America. Managers and Directors typically manage goals that do not translate directly, or even at all, into higher profitability or share price. What <u>is</u> unique to the enterprises is that our mission is elevated by the Charter and enforced through oversight, regulation and potential legal sanction. The seriousness of our mission obligations are very clearly understood by managers, Directors and shareholders alike.

Mr. Thomas J. McCool
January 12, 1998
Page 4

On the positive side of the incentive spectrum, performance compensation provides strong affirmative reinforcement for meeting our mission obligations. Housing impact, franchise, risk management and delivery of value to our customers are four of Fannie Mae's corporate strategic goals. The others are work force development and financial performance. All of these objectives are approved by the Board of Directors, and form the basis upon which executive and senior management compensation is determined. Office of the Chairman compensation, as well as stock incentives to all of senior management, is tied directly to the performance of the corporation in meeting each of the corporation's objectives. The Trillion Dollar Initiative and the corporation's record in exceeding its regulatory housing goals demonstrate the rigor of these internal objectives and the effectiveness of the incentives in serving mission.

See comment 2.

GAO's draft acknowledges that pay for performance includes the achievement of individual as well as corporate objectives, but it should make clear and give weight to the fact that both individual and corporate goals, as determined by the Board, include specific and measurable objectives that relate to fulfillment of mission. Regardless of whether GAO sees tension or a more compatible series of multiple goals, the degree to which the corporation incents and holds management accountable for meeting mission obligations should be amplified in the report.

As a related matter, GAO was asked to examine whether stock incentives might somehow induce managers and Directors to increase non-mortgage investments. Issues of corporate duty and obligation aside, the question assumes that non-mortgage investments are a profit center. Appropriately GAO makes clear that this is not the case, as non-mortgage investments overall have lower yields than mortgage investments.

A broader review demonstrates still more clearly what in fact guides our non-mortgage investments, and we encourage GAO to expand its review beyond simply alternative investments. Indeed, another option available to management is to return surplus capital to shareholders in the form of increased dividends or share buy backs. The immediate increase in shareholder return undoubtedly would be rewarding to shareholders. The very existence of the liquid investment portfolio reflects management's decision not to maximize shareholder return, and instead to retain surplus capital as part of its strategy of prudent capital management. If the non-mortgage portfolio shows anything about shareholder return versus other corporate objectives, it is that Fannie Mae considers the fulfillment of its multiple corporate objectives -- in this case risk management through maintenance of a capital cushion, as opposed to near-term financial performance -- as the best way of promoting long-term value.

Mr. Thomas J. McCool
January 12, 1998
Page 5

Finally, we wish to provide some miscellaneous corrections and edits. The draft shows Fannie Mae's non-mortgage investments at June 30, 1997, as $59,282 million -- over 16 percent of total assets. The correct figure for non-mortgage investments is $53,960 million at June 30, 1997 -- 14.7 percent of total assets. GAO apparently used the figure from the "Investments" category of Fannie Mae's financial reports (Investor/Analyst Report). However, the Investor/Analyst Report includes MBS repurchase agreements, which should be subtracted in order to calculate a "non-mortgage" figure. (By contrast, the GAO draft correctly shows Fannie Mae non-mortgage investments as of December 31, 1996 to be $52,807 million. In this case, GAO did not use the financial reports "Investments" figure.)

Now on p. 2.

Page 3 of the draft states that Fannie Mae and Freddie Mac accomplish their mission "by purchasing residential mortgages from lenders. The housing enterprises retain some of the mortgages they purchase in their own portfolios, but a majority of the mortgages are pooled into mortgage-backed securities (MBS) that are sold to investors in the secondary market." The wording suggests that the enterprises give all lenders cash in exchange for mortgages, that we subsequently decide which loans to pool into MBS, and that it is Fannie and Freddie who sell these MBS to investors.

In fact it is the lender who decides whether to sell loans for cash or "swap" loans for MBS. In a swap, the lender receives the MBS rather than cash for the loans. The lender then may retain or sell the MBS. If the lender retains the MBS, the securities are not sold in the secondary market at all. If the lender sells the MBS, it is the lender, not Fannie or Freddie, who sells the MBS in the market. Fannie Mae and Freddie Mac receive a guaranty fee; it is the lender who receives the price of the securities in the market.

Now on p. 10.

On page 17 the draft refers to Fannie Mae's position that HUD lacks authority to regulate the liquid investment portfolio prospectively as Fannie Mae's "belief." This characterization understates the position. More precisely, our comments reflect the corporation's legal opinion, as supported by an opinion letter from legal counsel.

Now on p. 16.

Table 1 on page 28 shows Fannie Mae's mortgage servicing portfolio at year-end 1996 as $834,039 million; the actual figure was $835,225 million.

We appreciate the opportunity to respond to the GAO draft, and would be pleased to discuss these issues further.

Sincerely,

Kenneth Leibowitz

The following comments represent our response to specific comments made on a draft of this report on January 12, 1998, by the Vice President for Regulatory Activities at Fannie Mae.

GAO Comments

1. Fannie Mae stated that the yield on the longer term investments is less than that of mortgage investments. This simple yield comparison does not take into account the risks, in particular interest rate and prepayment risks, that accompany residential mortgage investments. Our report states that government sponsorship of the housing enterprises lowers yields on single-family, fixed-rate, conforming mortgages. This mechanism is not present for nonmortgage investments. Therefore, we conclude that on a risk-adjusted basis, some nonmortgage investments are more profitable than mortgage investments.

2. Fannie Mae said that we should amplify “the degree to which the corporation incents and holds management accountable for meeting mission obligations.” We did not review contracts of individual managers and members of Fannie Mae’s Board. Because of the proprietary nature of the information, we could not have provided concrete examples to make such an amplification.

Comments From Farmer Mac

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

FARMER MAC
Financing Rural America

Federal Agricultural Mortgage Corporation
919 Eighteenth Street N.W. ■ Washington, D.C. 20006
202-872-7700 ■ FAX 202-872-7713
800-879-FARM ■ www.farmermac.com

January 12, 1998

Mr. Thomas J. McCool
Director, Financial Institutions
and Markets Issues
United States General Accounting Office
441 G Street, NW
Washington, D.C. 20548

Re: GAO Draft Report:
"Government Sponsored Enterprises –
Federal Oversight Needed for Nonmortgage Investments"

Dear Mr. McCool:

Thank you for providing us this opportunity to comment on the draft of the above-referenced General Accounting Office Report (the "Report"). We appreciate the cooperation afforded us by the GAO staff who worked on the Report. While we are submitting these comments, we were generally comfortable with the data collection process and discussions held between the GAO staff and Farmer Mac in connection with GAO's preparation of the Report.

The Report states that it has been prepared in response to a request by Congressman James A. Leach, Chairman of the House Committee on Banking and Financial Services, for GAO to gather and analyze information on nonmortgage investment activities at three government-sponsored enterprises (Fannie Mae; Freddie Mac; and Farmer Mac, referred to hereinafter as "GSEs"). Chairman Leach's request asked GAO to examine: (1) the GSEs' legal authority for making nonmortgage investments and federal regulatory oversight of that activity; (2) the relationship between nonmortgage investment policies and practices and the missions of the GSEs; and (3) the extent to which the enterprises have undertaken nonmortgage investments for arbitrage profits. We have organized our comments to follow the format of the Report.

Results in Brief

The Report finds that the respective statutory charters of the GSEs provide each of them with broad investment authority, and that the respective regulators have determined they are acting within their authority and "that the enterprises' nonmortgage investment portfolios do not raise safety and soundness concerns." In general, we are pleased to note that the results and

Mr. Thomas J. McCool
January 12, 1998
Page 2

conclusions of the Report do not find serious problems or faults with the investment practices of the GSEs. Our own analysis of Farmer Mac's legal authority for investment activity is consistent with the Report and the stated position of the Farm Credit Administration (FCA).

The Report concludes that all investment activity generates "arbitrage profits" (as defined by GAO in the Report), but suggests that this would only be objectionable if the investment activity were unrelated to mission. The Report concludes that short-term and long-term variable rate investments (which includes all of Farmer Mac's investments) appear to be related to mission, but states that the relationship is not always clear in the case of long-term fixed-rate investments. The Report makes these distinctions depending on "the degree to which [GSE investments] provide readily available liquidity." While recognizing that short-term investments are clearly related to mission, the Report states that the "relationship between longer term nonmortgage investments [specifically fixed-rate investments] and the enterprises' mission goals is not always clear, because long term investments are not as liquid as short term investments."

See comment 1.

As is discussed below at greater length, Farmer Mac's investments include long-term variable-rate mortgage-backed securities (Farmer Mac has no long-term fixed-rate investments), but we believe several observations on long-term issuance and investment are in order. There appear to be two weak points in the premises of the Report as to the relevance of liquidity for the GSEs. First, long-term investments with short-term interest rate resets are generally considered to have short-term liquidity. Second, in corporate money management, liquidity considerations are not restricted to the short end of the yield curve; financial corporations like the GSEs need the ability to generate funds in the intermediate- and long-term maturity ranges as well, since they deal in mortgages in all those maturity ranges. They need to be able to issue debt securities efficiently in those maturity ranges as a funding mechanism for assets of like duration, and they need to hold investment securities in those maturity ranges at times, as a funding alternative to debt issuance. The GSEs were created by Congress to be self-sustaining, for-profit corporations with public purpose missions, and they function in the same sophisticated financial world in which other, comparable financial institutions follow strategies identical to those of the GSEs. Nowhere in the Report is it suggested to the contrary; rather, it is suggested (and, we respectfully submit, incorrectly) that the GSEs' missions somehow constrain them from proceeding to exercise what is recognized as sound business judgment in the private sector. In stockholder litigation, would a court of law excuse a GSE from its general legal obligation to exercise prudent "business judgment" on the grounds of its limited mission? We think not.

We now focus our comments more specifically on the portions of the Report addressing Farmer Mac in respect of Chairman Leach's second and third queries.

Mr. Thomas J. McCool
January 12, 1998
Page 3

Relationship of Investment Policies to Mission

In general, the Report accurately reflects information we presented to GAO as to the extent and nature of Farmer Mac's investment activities.[1] The Report characterizes certain categories of investments made by the GSEs as consistent with the establishment of liquidity and therefore mission-related. Although all of Farmer Mac's investments fit within those categories, the Report seeks to differentiate Farmer Mac's investment strategy from those of the other GSEs, asserting that "[a]s far as we know, Farmer Mac's strategy is unique. . ." (pages 51 and 54). From this, the Report implies broadly that Farmer Mac's debt issuance strategy and related investment activities may not be mission-related. For the reasons set forth below, we strongly disagree with those implications.

Now on pp. 29 and 31.

Farmer Mac's debt issuance strategy and related investment activities were described to GAO as addressing its legitimate corporate financial concerns for liquidity of various types. In that regard, Farmer Mac's needs were described as follows.

A. Ready access to the capital markets as an issuer of competitively priced debt at all maturity ranges along the yield curve. Farmer Mac needs short-term debt: (i) to fund its Farmer Mac I mortgage pipeline and warehousing operations; and (ii) for anticipated and current purchases of Farmer Mac I and Farmer Mac II short-term adjustable rate mortgages (ARMs). Farmer Mac also needs short-term debt to fund short-term investments and intermediate- to long-term investments that reset to short-term rates. Farmer Mac needs intermediate- and long-term debt to fund its purchases of Farmer Mac II intermediate- and long-term loans. In addition, Farmer Mac issues intermediate- and long-term debt that it swaps into short-term rates to finance short-term ARMs and investments. This latter strategy is a common practice among financial corporations (including the other GSEs) and permits the Corporation to have a presence at a wider range of maturities on the yield curve and to offset risk as to future funding availability in those maturity sectors.

In order to achieve competitive pricing of its debt securities, Farmer Mac must issue them in transactions that are large enough to be comparable to other GSE transactions. As the Report notes, on December 31, 1996, Fannie Mae and Freddie Mac had outstanding debt securities of $331 billion and $156 billion, respectively. Though not noted in the Report, Farmer Mac informed GAO that its investment bankers had advised it that a minimum presence of at least $1.5 billion in the capital markets would be necessary to begin to close the gap between the yields on Farmer Mac debt securities and those of the other GSEs.

See p. 25, fn. 36.

[1] GAO has advised that an inaccurate reference in footnote 38 on page 44 of the Report, that Farmer Mac's $536 million in long-term investments were fixed-rate securities, was inadvertent and will be revised to state that these investments were all variable-rate.

Mr. Thomas J. McCool
January 12, 1998
Page 4

B. Investments in marketable securities that are readily saleable close to "par" as an alternative source of funding, and carried during the intervening time at a positive spread relative to the cost of the debt that supports their purchase. As Farmer Mac moves from investing the proceeds of its debt issuances in non-program assets to investing in program assets, it is important that the non-program assets it acquires have short-term maturities, to permit space on the balance sheet for program assets, or have short-term rate resets, to return them to par value for resale purposes. In addition, it is important that Farmer Mac have an inventory of saleable non-program (if not program) assets that may be liquidated readily, as an alternative to debt issuance, at times when issuance is inefficient because of wide agency spreads or a need to adjust the balance of the portfolio for asset and liability management purposes.

C. Improved pricing of agricultural mortgage-backed securities (AMBS) guaranteed by Farmer Mac, in order to increase the competitiveness of the rates on agricultural mortgages eligible for purchase and securitization by the Corporation. At year-end 1996, Farmer Mac's cash window program had been in operation only about six months, its outstanding guaranteed loan-backed securities were just over $400 million with new issuances of about $20 million anticipated every sixty days, and its outstanding volume of debt securities in the capital markets was less than $500 million. By all accounts, Farmer Mac was a very small issuer in the agency market, its investor base was limited, and its securities priced less favorably than comparable securities issued by the other GSEs, largely due to a market liquidity penalty attributable to low volume. Farmer Mac was advised by its investment bankers that it would have to increase its market presence to make further headway in improving its pricing and expanding its investor base – but that, in the absence of near-term AMBS volume, its debt securi1ties could be a surrogate for AMBS, in light of the bond-like characteristics of Farmer Mac AMBS (semi-annual payments, low prepayment speeds due to historically slower prepayments on agricultural mortgages, and yield maintenance prepayment adjustments). Although the other GSEs do not need to use this strategy, their experience provides empirical evidence that it will work: spreads on the mortgage-backed securities of other GSEs tend to track the spreads on their debt.

Based upon those needs, in early 1997 Farmer Mac management recommended and its board adopted an expanded debt issuance strategy that would permit the Corporation to maintain a higher level of debt outstanding, made possible by the $32 million increase in equity from the December 1996 public offering of Class C Common Stock. At its February 1997 meeting, the Farmer Mac board, in consultation with its investment bankers, evaluated the Corporation's situation in the capital markets as it related to business prospects and concluded that increased presence in the debt markets would lead to tighter spreads on Farmer Mac debt and mortgage-backed securities. Recognizing that tighter spreads would improve business prospects, the Farmer Mac board exercised its business judgment and adopted the debt issuance strategy reviewed by GAO in the Report. The new strategy authorized the issuance of debt securities to a

Mr. Thomas J. McCool
January 12, 1998
Page 5

new ceiling of $2 billion and authorized investment of up to $1.5 billion of funds raised through debt offerings.

Several factors drove the board's decision: (a) to make competitive mortgage products available to lenders in the Farmer Mac programs, the pricing of Farmer Mac securities had to be moved closer to parity with comparable securities issued by the other GSEs; (b) to improve the pricing of Farmer Mac securities available to the capital markets, it was necessary to increase market liquidity through volume; (c) to achieve greater name-recognition in the capital markets, Farmer Mac securities issuance volume had to be increased; (d) to obtain wider acceptance of Farmer Mac securities, its name had to be included on the "permissible investment" lists of institutional investors -- once achieved for debt, this would apply equally to AMBS; (e) to prompt "reverse inquiries" by investors, those who purchase one security from an issuer will make inquiry for a different security when the need arises if there is an established pattern of dealing; and (f) the opportunity to establish pricing norms for Farmer Mac AMBS by issuing debt securities as a surrogate.

At the time, Farmer Mac management further recommended to the board that the Corporation adopt a three-phase strategy, directly linking the generation and investment of debt proceeds to the achievement of Farmer Mac's mission under its charter.

- In the first phase, Farmer Mac's volume of debt securities would be substantially increased, within the limits of the board's policy, and the proceeds deployed into investment assets conforming to conservative investment guidelines for safety and soundness. As of June 30, 1997 Farmer Mac's average net return on investments was only 23 basis points, consistent with the conservative nature of the investments. FCA reviewed Farmer Mac's investment guidelines and portfolio in connection with its 1997 annual examination of the Corporation and determined that the overall quality and administration of the investment portfolio was adequate.

- In the second phase, the deployment of the funds would be shifted from investment assets to the purchase of agricultural mortgages and mortgage-backed securities guaranteed by Farmer Mac as needed to facilitate expanding program volume. This should be the result of an increased volume of agricultural mortgage purchases as Farmer Mac's participating lender network expands, with no impact on debt levels.

- In the third phase, as Farmer Mac's on-balance sheet assets utilize its capital at almost four times the rate of off-balance sheet obligations,[2] on-balance sheet assets would be decreased to free up capital needed to support the expanding volume of off-balance sheet guaranteed AMBS sold to investors.

[2] Statutory minimum capital for Farmer Mac is 75 basis points for off-balance sheet obligations and 275 basis points for on-balance sheet assets.

Mr. Thomas J. McCool
January 12, 1998
Page 6

See comment 2.

Farmer Mac's board did not establish a timeframe for the full implementation of the three phases of the debt issuance strategy, but anticipated that this would occur over a reasonable period of time, as indicated in the Report. Recognizing the enormity of the task facing Farmer Mac, i.e., to double or triple its guaranteed mortgage-backed securities volume, we submit that a reasonable timeframe for reaching the third phase of the board's strategy could be two to three years following adoption of the strategy. Farmer Mac will be subject to monitoring and oversight by the FCA during such a period, and will be obligated to meet minimum statutory and regulatory capital requirements assuring its safe and sound operation. Although the Report appears in several places to question whether Farmer Mac's debt issuance strategy is working, we note that the increased volume of Farmer Mac securities available to investors has already produced positive results in the form of some improvement in pricing and a significant expansion of Farmer Mac's investor base. The ultimate effectiveness of the board's strategy is tied to success in bringing active new lenders into the program and increasing mortgage activity as a result. This will take some time. We submit that there is simply no basis at this time to draw negative implications about the validity of Farmer Mac's strategy relative to the achievement of Farmer Mac's mission.

What made the description of Farmer Mac's strategy unfamiliar to GAO was that this Corporation, as the newest and smallest GSE, is concerned not only with the liquidity of its investments, but also with the market liquidity of its debt securities and mortgage-backed securities. While this distinction was wholly consistent with the novelty and low profile of Farmer Mac's presence in the capital markets relative to the other GSEs, it became a focal point of GAO's inquiries. Whereas the other GSEs were allowed a period to experiment and develop their operations without regulatory oversight, Farmer Mac has been subjected to close regulatory oversight since its inception. Farmer Mac's response has been to study and evaluate those strategies of the other GSEs that proved successful over time and to attempt to follow them in its own operations in a compressed time. For example, Farmer Mac's "unique" equity structure was designed to lay the foundation for evolution over time from "franchise" stock ownership to "investment" stock ownership, along the paths followed by Sallie Mae and Freddie Mac. Likewise, Farmer Mac's "Linked Portfolio Strategy" was modeled after Fannie Mae's successful matched-book funding of mortgage securities in its own portfolio and Farmer Mac's current mortgage-backed securities structure closely resembles that of Fannie Mae's Delegated Underwriting and Servicing (DUS) securities. The nineteenth century British scientist Thomas Henry Huxley observed that "[i]f I have seen farther than other men, it is because I stood upon the shoulders of those who came before me." Similarly, from time to time Farmer Mac has attempted to stand upon the shoulders of the other GSEs and has adopted strategies that would permit it to develop in parallel and equally successful ways, to serve its agricultural constituency as well as Fannie Mae and Freddie Mac have served their residential homeowner constituencies.

Moreover, Farmer Mac's original statute was seriously deficient from an operating standpoint, compared to those of the other GSEs, and this resulted in a number of years of

Mr. Thomas J. McCool
January 12, 1998
Page 7

unprofitable operation before corrective legislation was enacted in 1996. Farmer Mac had only operated under the revised legislation for about one year when this GAO study was begun, yet it is being evaluated side-by-side with the well-established and very mature residential mortgage GSEs. Farmer Mac continues to evolve from a start-up operation toward a more established entity, but that process is not finished. To complete the process, the Farmer Mac board will need to continue to use its business judgment to adopt strategies, such as its debt issuance strategy, that it believes will contribute to the success of the Corporation and facilitate achievement of its Congressional mission in a safe and sound but highly effective manner.

Now on p. 29.

See comment 3.

The Report states (pages 51-52) that Farmer Mac has not yet passed the benefit of the improvement in securities pricing through to participating lenders to encourage increased mortgage sales volume and that the failure to do so "appears to us [GAO] to contradict, at least in part, the logic behind Farmer Mac's debt issuance strategy, which intends to lower the funding costs to purchase agricultural mortgages and issue AMBS." There is no contradiction here, in that the agricultural mortgage origination market is currently very inefficient, resulting in artificially high mortgage rates and limited selection of competitive mortgage products for farmers. In the Farmer Mac program alone, lenders have been adding an average of 45 basis points of excess servicing to Farmer Mac's net yield rates. Without competitive pressure on agricultural lenders to make more favorable rates available to borrowers, we believe that a 5 or 10 basis point tightening by Farmer Mac (reflecting the improved securities pricing) would have little or no effect on mortgage volume. Instead, Farmer Mac is directing these funds toward expanded efforts to recruit new mortgage originators into the program, particularly those who more aggressively offer and price Farmer Mac products to borrowers. As competition among lenders in this market increases with securitization volume, lenders will reduce excess servicing. Farmer Mac will then be able to reduce program net yields (resulting from tighter spreads on its AMBS) that lenders will more likely pass back to borrowers in the form of better rates. At the current time, the key to increasing Farmer Mac's volume is not to enhance lender profitability, but to recruit more competitive lenders who will use mortgage securitization to compete vigorously for agricultural mortgage loans.

Now on p. 31.

See comment 4.

The Report (pages 54-55) states that "FCA has the responsibility to monitor Farmer Mac's strategy to help ensure that the nonagricultural mortgage investments . . . are related in some fashion to Farmer Mac's mission achievement" and "the Chairman of the FCA Board [should] direct OSMO to report periodically, such as through its semiannual reports to the House and Senate Agriculture Committees, on the relationship of Farmer Mac's debt issuance strategy to the achievement of Farmer Mac's mission." We agree and are pleased to note that the FCA already monitors Farmer Mac's investment activity and has throughout Farmer Mac's entire existence. Farmer Mac files quarterly call reports with FCA which contain, among other information, investment and debt issuance information facilitating FCA's oversight. In addition, FCA conducts an annual examination of Farmer Mac during which extensive review is made by FCA examiners of Farmer Mac's business activity from the standpoint of assuring safety and soundness as well as compliance with statutory requirements and consistency with the

Mr. Thomas J. McCool
January 12, 1998
Page 8

Now on p. 4.

achievement of Farmer Mac's mission. As noted on page 6 of the Report, "[i]n October 1997, FCA indicated that at present, it does not have concerns that Farmer Mac's nonmortgage investment activity is inconsistent with its charter mission, but FCA also stated that the debt issuance strategy associated with the investments is intended to develop over a reasonable period of time." As previously discussed herein, we agree that the implementation of the board's strategy will develop over a reasonable period of time and we will continue to cooperate with the FCA to facilitate its oversight as this occurs.

<u>GSE Profits from Investment Activities</u>

Now on p. 5.

See p. 31.

See comment 5.

As we have attempted to explain in connection with the relationship of Farmer Mac's investment income to its mission, "arbitrage" profit is certainly not the driving consideration in the Corporation's debt issuance and investment activities. The Report (page 8, last two lines of text) states that arbitrage profits from investments "presently are the principal income source at Farmer Mac." Based on materials presented to GAO auditors, for the quarter ended June 30, 1997, Farmer Mac's net income from non-program investments represented about 38 percent of total net income. Accepting a common dictionary definition of "principal" (meaning a matter or thing of primary importance), the statement incorrectly characterizes the portion of Farmer Mac's income attributable to investments. Farmer Mac's income from program operations represented about 62 percent of net income and was the principal source of income. Program assets and activities continue to generate a greater proportion of Farmer Mac's total net income than nonmortgage (non-program) investments.[3]

Now on pp. 20-22.

Now on pp. 45-47.

In addition, the Report discusses (pages 34-40) "compensation incentives" available to GSE senior management and board members which, in GAO's view, "reinforce the tension between increasing shareholder value and achieving mission." The compensation of Farmer Mac's management and board, like that at the other GSEs, is based on outside consultants' evaluations of comparable positions in related industries. Farmer Mac deliberately lags the other GSEs for total cash compensation of persons in similar positions, due to the continuing start-up status of its development. Compensation policies for Farmer Mac management have been designed to facilitate the hiring and retention of bright, experienced and highly competent individuals, subject to practical limitations imposed by the Corporation's small size and limited income. (See also, the further discussion of Farmer Mac's compensation policies in Appendix II of the Report, page 62, which is consistent with our discussion in this paragraph.)

Contrary to the suggestion in the Report, we submit that because of Farmer Mac's early stage of development there is a convergence of, rather than a tension or conflict between, the interests of Farmer Mac's shareholders and the need to make progress in achieving its mission

Now on p. 31.

[3] On page 54, the Report similarly states that investment income generates a "majority" of Farmer Mac's earnings. That statement is also incorrect, as net investment income did not represent a majority of Farmer Mac's earnings.

GAO note: We did not reproduce the appendix

Mr. Thomas J. McCool
January 12, 1998
Page 9

through expanded volume. In the long run, shareholders will not be assuaged by increased investment activity if there are shortfalls relative to volume expectations. Investment income at Farmer Mac contributes to the Corporation's profitability and thus to shareholder value, as it does at the other GSEs, but management's incentive to increase investment income as a substitute for program volume has been expressly limited by board policy. Specifically, for management performance and compensation considerations, any income from investments that exceeds income from mortgage securitization activity cannot be considered in evaluating management performance or fixing annual incentive compensation levels.

The balance of our comments are more technical in nature, and have accordingly been included as an appendix hereto intended to be an integral part of this letter. We request that GAO give due consideration to the comments, clarifications and corrections presented herein (including the appendix) in preparing the final Report. In that regard, we would particularly ask that GAO expressly recognize that Farmer Mac's business strategies involving debt issuance or investments are integrally related to the achievement of its mission, and that no basis has been brought forth to support any contrary implication.

We trust that this letter will permit GAO to clarify better in the final Report the purposes and goals of Farmer Mac's current business strategies relating to debt issuance and investments. Farmer Mac's board and management are committed to the successful implementation of the agricultural secondary market and the full achievement of the Corporation's Congressional mission, and are pleased to have been given this opportunity to share our thoughts on these important matters.

Very truly yours,

Henry D. Edelman
President and CEO

The following comments represent our response to specific comments made on a draft of this report on January 12, 1998, by the President and Chief Executive Office of Farmer Mac.

GAO Comments

1. Farmer Mac stated that long-term investments with short-term interest rate resets are generally considered to have short-term liquidity. We have concluded from our analysis that Farmer Mac's longer term, variable-rate, nonagricultural-mortgage investments are subject to greater market value fluctuations with changes in interest rates than short-term investments. As a result, they are less useful in facilitating liquidity in the agricultural mortgage market than short-term investments.

2. Farmer Mac suggested that a reasonable time frame for reaching the final stage of its debt issuance strategy could be 2 to 3 years following adoption of the strategy. As far as we know, this is the first time a time frame has been suggested as a reasonable period of time for the debt issuance policy to contribute to mission.

3. Farmer Mac took issue with our observation that Farmer Mac's debt issuance strategy, which intends to lower the funding costs to purchase agricultural mortgages and issue AMBS, appears to us to contradict, at least in part, our observation that Farmer Mac has not offered higher prices for agricultural mortgages. Farmer Mac states that the agricultural mortgage origination market is currently very inefficient, and therefore Farmer Mac is directing funds made available by the debt issuance strategy toward expanded efforts to recruit new mortgage originators. We revised our discussion (see page 29) and, rather than referring to a possible contradiction, we now directly relate these observations to the uncertainty associated with the effectiveness of Farmer Mac's debt issuance strategy on mission achievement.

4. Farmer Mac said that it agrees with our recommendation to the FCA Board to report on the relationship of Farmer Mac's debt issuance strategy to the achievement of Farmer Mac's mission. Its letter added that FCA already monitors Farmer Mac's investment activity. We note, as indicated in our report, that FCA's monitoring of Farmer Mac's investment activity has focused on matters of safety and soundness. Our recommendation is specific to FCA's mission oversight responsibilities.

5. Farmer Mac said that for the quarter ended June 30, 1997, Farmer Mac's net income from nonprogram investments represented about 38 percent of

total net income. In response, we made revisions (see pp. 5 and 31) and now state that nonagricultural-mortgage investments are a primary source of income rather than the principal source or majority of income.

Comments From the Department of Housing and Urban Development

Note: GAO's comment supplementing those in the report text appears at the end of this appendix.

U. S. Department of Housing and Urban Development
Washington, D.C. 20410-8000

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

Mr. Thomas J. McCool
Director, Financial Institutions
and Markets Issues
General Accounting Office
441 G Street, NW
Washington, DC 20548

JAN 16 1998

Dear Mr. McCool:

We appreciate the opportunity to provide comments on the General Accounting Office's draft report entitled "Government Sponsored Enterprises: Federal Oversight Needed for Nonmortgage Investments" (the "Report"). As detailed below, HUD has already begun to carry out the single recommendation in the Report to HUD that it initiate the rulemaking process to help ensure that the nonmortgage investments of Fannie Mae and Freddie Mac (the "Government Sponsored Enterprises" or "GSEs") are consistent with the purposes in their Charter Acts. This response is to update the General Accounting Office ("GAO") on HUD's efforts respecting regulation of the GSEs' nonmortgage investments and to provide comments to clarify certain points in the Report regarding the Department's review of Fannie Mae's Mortgage Protection Plan ("MPP") and the scope of HUD's regulatory activities.

Regulation of Nonmortgage Investments

In HUD's opinion, the Report fairly characterizes the issues, constraints, and ambiguities involved in overseeing the nonmortgage investment activities of Fannie Mae and Freddie Mac. The Report concludes that GAO agrees with HUD that its general regulatory authority could be used to potentially limit the GSEs' nonmortgage investments. The Report recommends that to provide more focused oversight of the housing enterprises, the Secretary "promptly implement HUD's stated intention to develop criteria through appropriate rulemaking processes to help ensure that the housing enterprises' nonmortgage investments are consistent with the purposes expressed in their charter acts."

HUD agrees with and is implementing GAO's recommendation. When the Department learned of significant GSE nonmortgage investment activities in 1997, the Department promptly requested a report on the matter. Since that time, HUD has requested and received reports from both Fannie Mae and Freddie Mac on their nonmortgage investment policies, procedures and holdings and will require reports on a regular basis in the future. In addition, on December 30, 1997, HUD published in the Federal Register an Advance Notice of Proposed Rulemaking ("ANPR") (62 CFR 68060-68061). Through the ANPR, which is attached to this response, HUD is seeking comments on possible regulations regarding the GSEs' nonmortgage investments.

Mortgage Protection Plan

See comment 1.

Now on p. 14.

The Report discusses Fannie Mae's proposed MPP which was submitted to HUD for review and approval under HUD's statutory authority to review new GSE programs. Under MPP, Fannie Mae proposed to purchase cash value life insurance policies on first-time hombuyers, policies which GAO characterizes as essentially nonmortgage investments. In its discussion of the program, the Report includes statements which may create a misimpression regarding the quality of HUD's review, the rationale for not providing data to Treasury, and the scope of HUD's public interest review authority. In order to clarify the first two points, HUD suggests that the following language be substituted for the first three sentences of the first full paragraph on page 23 of the Report as it better captures HUD's perspective with regard to its review of MPP:

See p. 14.

> HUD officials told us that HUD did not possess detailed knowledge of the intricacies of the life insurance industry at the time MPP was submitted for review. HUD officials determined, however, that while detailed industry expertise would have been helpful, it was not necessary to HUD's review and understanding of MPP's potential benefits to borrowers and its related costs. A Treasury attorney with expertise in life insurance provided basic information about life insurance products to HUD; however, according to HUD officials, the Department determined that it was unnecessary to provide MPP materials to Treasury as it had obtained sufficient information and analysis to complete its work.

HUD's review of MPP was performed in accordance with Section 1321 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (FHEFSSA), was completed within the 45-day statutory period, and demonstrated necessary expertise to evaluate MPP's characteristics and potential impact in the marketplace. HUD carried out a thorough and competent review of MPP using its own staff and outside resources, as appropriate. The review of MPP was conducted by an multi-disciplined team consisting of attorneys, economists, fair lending specialists, financial and program analysts, and mortgage insurance experts. During the course of its review, HUD staff worked closely with the Office of Federal Housing Enterprise Oversight (OFHEO) and consulted with an attorney from the Treasury who had extensive, relevant expertise in the tax implications of life insurance endowment contracts. HUD analyzed all relevant aspects of MPP, including its life, disability and unemployment insurance components, the expected value of the program, its financial costs and benefits, and the relevant tax issues. HUD evaluated MPP's effect on expanding homeownership and on the mortgage

2

and insurance markets, as well as the fair lending implications of the program. HUD's review did not require knowledge of the intricacies of the insurance industry, but did require that HUD staff understand the program benefits to borrowers and its related costs. As a result of its review and in accordance with FHEFFSA, HUD found that MPP was legally authorized and not against the public interest. HUD furnished GAO a copy of its complete analysis of MPP on September 11, 1997.

See pp. 14 and 15.

The Report also indicates that HUD determined not to share the contents of the MPP proposal with Treasury, citing a potential conflict of interest as the Department's rationale for that determination. However, such a concern about a conflict of interest did not cause HUD to withhold Fannie Mae's submission on MPP from Treasury. HUD determined that it was unnecessary to furnish MPP materials to the Treasury attorney with whom HUD consulted during its review. HUD had obtained sufficient information and analysis to complete its review. Moreover, HUD understood that Treasury, the agency primarily responsible for tax policy, was separately assessing the tax implications of MPP and that it would have access to sufficient materials for that purpose.

Now on p. 14.

With regard to the third point, the scope of HUD's public interest review authority, the Report states that "HUD officials told us that tax costs were not included in its analysis for the public interest determination, because they concluded that the statutory language did not grant HUD the authority to consider broader tax policy issues" (page 24). HUD's new program review authority requires that HUD determine whether a new program is authorized under a GSE's charter and whether it is not outside of the public interest. HUD believes that tax issues are within the scope of this review. However, HUD staff advised GAO that in making its public interest determination, the Department would find it difficult to conclude that a practice which is permissible under current tax law was nevertheless against the public interest. Consequently, in this case, HUD determined, as noted in the Report, that..."[a]s long as the program [was] permissible under current tax laws, MPP should not be regarded as against the public interest based solely on potential adverse impact on federal revenues or the concomitant favorable impact on Fannie Mae's tax position" (page 24).

Now on p. 14.

<u>HUD's General Oversight of Fannie Mae and Freddie Mac</u>

Now on p. 11.

GAO's Report states that the Department has focused on numeric goals and fair lending issues (page 19). While the Department has and must expend considerable resources to carry out these responsibilities, it has also devoted significant resources to a variety of other significant regulatory activities respecting the GSEs. Immediately following passage of FHEFSSA, the Department dedicated itself to the development and publication on December 1, 1995, of the final rule implementing the statute. The rule covers data collection, information dissemination, new program and reporting, as well as housing goal and fair lending provisions. Since the rule was published, HUD has been fully implementing these regulations and the statute including carrying out regulatory

3

activities in all areas. By way of examples, HUD has conducted three new program reviews including MPP, HUD has devoted resources to validating the loan level data and reviewing reports from the GSEs, the Department has established and maintained a GSE public use data base to assure public access to data to evaluate the GSEs' mortgage purchase activities, and HUD staff reviewed various affordable housing policy issues for the purpose of evaluating their impact on HUD's regulation. Additionally, HUD's research and analysis of the GSEs' mortgage activities has resulted in several publications including a report to Congress on the desirability and feasibility of privatizing the GSEs and a series of working papers. HUD is providing complete details to GAO on all of its regulatory activities as part of GAO's current review of HUD's regulation of the GSEs.

Editorial Note

Now on p. 11.

At the bottom of page 19, the phrase "request for nonmortgage activity" should read "request for a report on nonmortgage investment activity".

We hope that these comments have been helpful to your Report. If we can provide further information, please do not hesitate to call my office.

Sincerely,

Nicolas P. Retsinas

Nicolas P. Retsinas
Assistant Secretary for Housing-
Federal Housing Commissioner

GAO note:
We did not
reproduce the
enclosure.

Enclosure

4

The following comment represents our response to a specific comment made on a draft of this report on January 16, 1998, by the Assistant Secretary for Housing-Federal Housing Commissioner at HUD.

GAO Comment

1. HUD took exception to our characterization of the expertise issue in HUD's approval of MPP. In particular, HUD's comment letter stated that some statements in our draft report appear to be based on misunderstandings of statements made by HUD staff. HUD stated that HUD did not possess detailed knowledge of the intricacies of the life insurance industry at the time MPP was submitted for review. However, HUD also stated that it concluded it was unnecessary to provide MPP materials to Treasury because HUD had obtained sufficient information and analysis to complete its work. HUD said that this conclusion, rather than a HUD determination that it could not share the contents of the MPP proposal due to a potential conflict of interest within Treasury, formed the basis for not providing MPP materials to Treasury. We made revisions to our report (see pages 13-15) and state HUD's position as described in its comment letter.

Comments From the Office of Federal Housing Enterprise Oversight

OFHEO

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

1700 G STREET NW WASHINGTON DC 20552 (202) 414-3800

January 7, 1998

Via Transmittal

Mr. Thomas J. McCool
Director, Financial Institutions and Markets Issues
General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Mr. McCool:

We appreciate the opportunity to provide formal comments on your draft report entitled GOVERNMENT SPONSORED ENTERPRISES: Federal Oversight Needed for Nonmortgage Investments. The study of the GSEs' nonmortgage investments is timely and it raises important public policy issues.

The report correctly characterizes OFHEO's role with respect to nonmortgage investments made by Fannie Mae and Freddie Mac. OFHEO is responsible for ensuring the financial safety and soundness of these two Enterprises, including their nonmortgage investment activities.

The report also correctly characterizes OFHEO's conclusions regarding the safety and soundness of nonmortgage investments at Fannie Mae and Freddie Mac. During our 1996 examinations of risk management, we reviewed both Enterprises' portfolios and their management of the risks associated with their nonmortgage investments. As a result of the examinations, we concluded that these portfolios posed no safety and soundness concerns at either Enterprise. Subsequent to the 1996 review, both Enterprises amended their purchase policies regarding liquid investments. The amendments have increased the Enterprises' flexibility to invest in nonmortgage instruments, but have not resulted in increased overall risk profiles for nonmortgage investment portfolios. For OFHEO's comprehensive annual examinations in 1998, nonmortgage investments at Fannie Mae and Freddie Mac have been identified as a specific area for a follow-up evaluation.

Mr. Thomas J. McCool
January 7, 1998
Page 2

OFHEO agrees with GAO that is appropriate for the Congress to continue to monitor nonmortgage investments at the Enterprises. Furthermore, as the chartering authority for the Enterprises, the Congress may wish to provide more specific guidance to the regulatory agencies regarding the appropriate range of investment activities.

Sincerely,

Mark Kinsey

Mark Kinsey
Acting Director

Comments From the Farm Credit Administration

Note: GAO's comment supplementing those in the report text appears at the end of this appendix.

Farm Credit Administration

1501 Farm Credit Drive
McLean, Virginia 22102-5090
(703) 883-4000

January 6, 1998

Mr. Thomas J. McCool
Director, Financial Institutions
and Markets Issues
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. McCool:

The Farm Credit Administration (FCA or Agency) appreciates the opportunity to comment on the draft report entitled "Government-Sponsored Enterprises: Federal Oversight Needed for Nonmortgage Investments." Overall, the report is a fair representation of the investment activity of the Federal Agricultural Mortgage Corporation (Farmer Mac) and the FCA's views with respect to that activity.

Now on pp. 9-13. See comment 1.

However, the discussion beginning on page 15 and ending on page 21 indicates a misunderstanding of the past and current thinking and position of the Agency. The FCA believes that its authority to supervise and regulate the safety and soundness of Farmer Mac's activities, including investments, is clear. To that end, the Agency has analyzed the Farmer Mac investment policy and the application of that policy and concluded that no safety and soundness concerns exist. FCA continues to monitor the investment activity closely and would be willing to include relevant information in its Semiannual Report to the Congress.

See pp. 9 and 30.

The FCA also believes that it has sufficient authority to regulate the investment portfolio should the size of the portfolio prove to be excessive in relation to Farmer Mac's financial operating needs or otherwise be inappropriate to the statutory purpose of Farmer Mac. As the report correctly states, FCA believes that the logic supporting Farmer Mac's current investment practices is plausible and that some time is required to prove or disprove the appropriateness of Farmer Mac's position. The FCA does not currently have any activities underway which are expected to culminate in regulation of the size or content of the investment portfolio of Farmer Mac. We would, however, consider promptly all available options including regulations if Farmer Mac exceeded its authority in this area.

We hope these comments are helpful in the General Accounting Office's development of its final report.

Sincerely,

Marsha Pyle Martin
Chairman and Chief Executive Officer

The following comment represents our response to a specific comment made on a draft of this report on January 6, 1998, by the Chairman and Chief Executive Officer of the FCA Board.

GAO Comment

1. FCA stated that discussion on pages 9 through 13 of our draft report indicated a misunderstanding of its past and current thinking and position, namely that FCA has clear safety and soundness authority and has concluded that no safety and soundness concerns exist at Farmer Mac. These FCA positions had been expressed in a previous section of the draft report dealing with safety and soundness oversight. The section FCA discusses relates to FCA's general regulatory authority. In response to FCA's comment, we added some clarifying language to our discussion on FCA's general regulatory authority.

Comments From the Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

UNDER SECRETARY

January 22, 1998

Mr. Thomas J. McCool
Director, Financial Institutions and
Markets Issues
U.S. General Accounting Office
441 G St., N.W.
Washington, D.C. 20548

Dear Mr. McCool:

Thank you for the opportunity to comment on the GAO's draft report, *Government-Sponsored Enterprises: Federal Oversight Needed for Nonmortgage Investments.* The GAO has identified some of the important policy issues raised by the investment practices of the three GSEs it studied.

Because government sponsorship enables the GSEs to borrow in public markets at rates lower than those applicable to private debt instruments, the potential exists for GSEs to realize arbitrage profits for their shareholders through their investment practices. We believe that the issuance of debt securities by a GSE for the purpose of generating such arbitrage is not consistent with the intent of Congress in conferring agency status on such debt. Accordingly, we believe that a GSEs' investments should be limited in kind and amount to those necessary for and related to the fulfillment of its primary mission.

The benefits of government sponsorship give the GSEs continuous access to liquidity. Consequently, GSEs have less need to maintain significant balance sheet liquidity than would a similar firm operating without those benefits. The frequency and volume of GSE security issuance testify to GSEs' ready access to capital market financing and to capital market investors' broad acceptance of their securities. Yet, as the GAO reports, the GSEs nonetheless maintain substantial nonmortgage investments.

We therefore agree with the GAO's conclusion that these GSEs' long term nonmortgage investments generate arbitrage profits without furthering the GSEs' missions. The GAO also correctly notes that some short-term investments, although possibly facilitating the GSEs' core business activities, may also generate arbitrage profits. Because investments in mortgage-related securities were beyond the scope of the GAO's report, it did not have occasion to consider the extent to which the GSEs' investments in such securities raise similar issues.

We also agree with the GAO's recommendation that GSE program regulators use their general regulatory authority to limit GSE nonmortgage investment activity. We believe that such regulations should limit a GSE's investments to those necessary and appropriate for normal business operations, such as cash management. In exercising its regulatory authority, each GSE

2

regulator should remain mindful of the ready access to capital markets inherent in the GSEs' charters. Regulators should also give careful scrutiny and analysis to claims that a particular investment is mission-related. All investments should be scrutinized in light of the specific public purpose -- and expressly approved lines of business -- for which Congress has established each GSE. We note that the Department of Housing and Urban Development recently published an advanced notice of proposed rulemaking that should help establish regulatory guidance for Fannie Mae and Freddie Mac.

Thank you again for the opportunity to comment on your draft report.

Sincerely,

John D. Hawke, Jr.
Under Secretary for Domestic Finance

Major Contributors to This Report

General Government Division

William B. Shear, Assistant Director
Marion L. Pitts, Evaluator-in-Charge
James R. Black, Senior Evaluator
Edward S. Wroblewski, Senior Evaluator

Office of the General Counsel

Paul G. Thompson, Senior Attorney

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. VISA and MasterCard credit cards are accepted, also. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

U.S. General Accounting Office
P.O. Box 37050
Washington, DC 20013

or visit:

Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC

Orders may also be placed by calling (202) 512-6000 or by using fax number (202) 512-6061, or TDD (202) 512-2537.

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (202) 512-6000 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

For information on how to access GAO reports on the INTERNET, send an e-mail message with "info" in the body to:

info@www.gao.gov

or visit GAO's World Wide Web Home Page at:

http://www.gao.gov

PRINTED ON RECYCLED PAPER