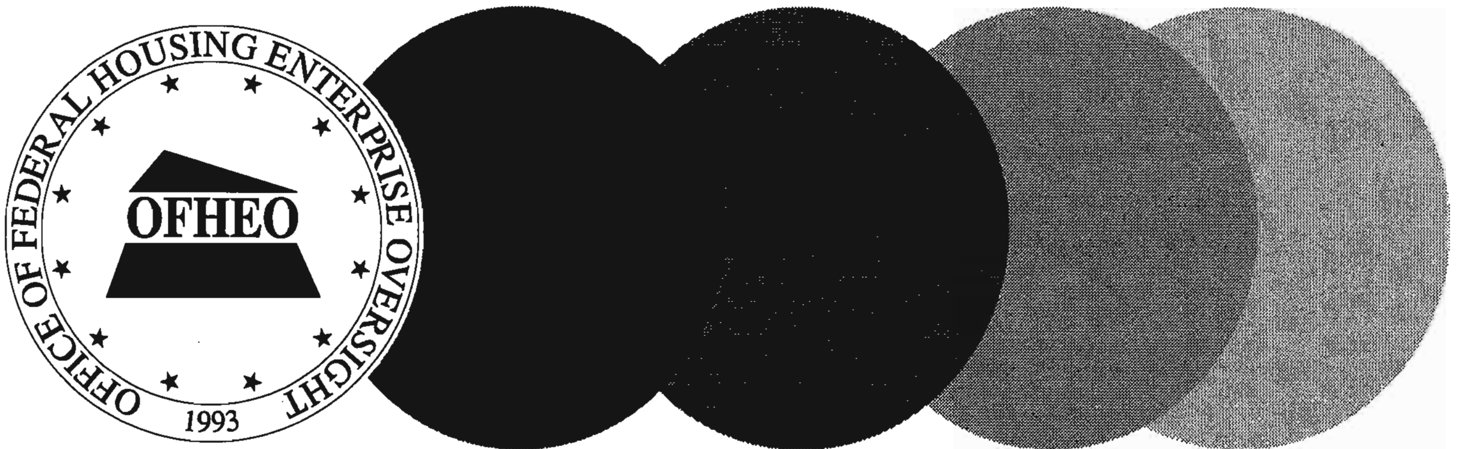
Office of Federal Housing Enterprise Oversight

Annual Report to Congress 1995



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
1700 G STREET NW WASHINGTON DC 20552 (202) 414-3800

June 15, 1995

Honorable Alfonse D'Amato
Chairman
Committee on Banking,
Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510-6075

Dear Mr. Chairman:

I am pleased to transmit the second Annual Report to Congress of the Office of Federal Housing Enterprise Oversight (OFHEO). This report has been prepared to meet the statutory requirements in section 1319B of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Title XIII of Pub. L. No. 102-550).

The statute requires the OFHEO Director to submit to the Committee on Banking and Financial Services of the House of Representatives, and the Committee on Banking, Housing, and Urban Affairs of the Senate, an annual report not later than June 15 that shall include:

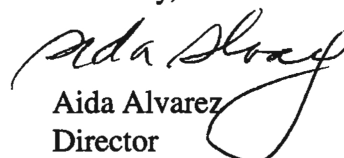
(1) A description of the actions taken, and being undertaken, by the Director to carry out the title;

(2) A description of the financial safety and soundness of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), including the results and conclusions of their annual examinations; and

(3) Any recommendations for legislation to enhance the financial safety and soundness of the Enterprises.

OFHEO was established on June 1, 1993. This second annual report includes an analysis of the financial condition of the Enterprises, as well as a description of economic conditions in the secondary mortgage market. It also describes the efforts of the Office in the area of examinations and the unprecedented work the Office is doing relative to the risk-based capital stress test required by the enabling statute. The views in this report are those of the Director and do not necessarily represent those of the President or the Secretary of Housing and Urban Development.

Sincerely,



Aida Alvarez
Director

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
1700 G STREET NW WASHINGTON DC 20552 (202) 414-3800

June 15, 1995

Honorable Paul Sarbanes
Ranking Minority Member
Committee on Banking,
Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510-6075

Dear Senator Sarbanes:

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Sincerely,

Aida Alvarez
Director

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
1700 G STREET NW WASHINGTON DC 20552 (202) 414-3800

June 15, 1995

Honorable Jim Leach
Chairman
Committee on Banking
and Financial Services
House of Representatives
Washington, D.C. 20515-6050

Dear Mr. Chairman:

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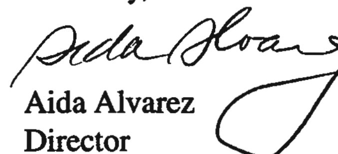

Aida Alvarez
Director

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
1700 G STREET NW WASHINGTON DC 20552 (202) 414-3800

June 15, 1995

Honorable Henry B. Gonzalez
Ranking Minority Member
Committee on Banking
and Financial Services
House of Representatives
Washington, D.C. 20515-6050

Dear Congressman Gonzalez:

I am pleased to transmit the second Annual Report to Congress of the Office of Federal Housing Enterprise Oversight (OFHEO). This report has been prepared to meet the statutory requirements in section 1319B of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Title XIII of Pub. L. No. 102-550).

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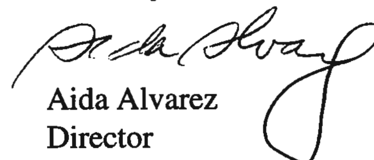


Aida Alvarez
Director

Message from the Director

"OFHEO protects the interests of the American taxpayer and contributes to the strength and vitality of the nation's housing finance system through independent, fair and effective financial regulation of Fannie Mae and Freddie Mac...."

This excerpt from OFHEO's Mission Statement sums up the scope and responsibility of the regulatory responsibilities assigned to OFHEO by Congress. I am pleased, in this second Annual Report to Congress, to note considerable progress toward meeting these goals.

OFHEO's Mission Statement also represents a commitment by this Office to carry out its duties professionally, promptly, and in a cost-effective manner, while remaining ever vigilant. I note with pleasure that this regulatory approach is also consistent with the principles of "reinvented government" articulated by the Administration.

This Annual Report details OFHEO's accomplishments for the 12 months ending June 15, 1995. It also describes and analyzes a number of important mortgage and financial market trends and developments that impact the operations of Fannie Mae and Freddie Mac. Three such areas are given special attention: advances in automated underwriting of mortgage loans; the use of financial derivatives by the Enterprises; and new goals proposed by HUD for purchases of mortgages by Fannie Mae and Freddie Mac to benefit low-income and moderate-income families and other specific groups.

(continued)

The General Accounting Office noted the following after completing its first study of OFHEO's operations:

"OFHEO has made considerable progress toward setting up its key management systems since its first Director was sworn in on June 1, 1993. As of the end of February 1995, much of OFHEO's administrative structure was in place.... OFHEO has also initiated its major mission-related programs — examining the enterprises and assessing their capital adequacy...."

OFHEO's notable accomplishments and activities include:

- *Conducting quarterly capital classifications of the Enterprises. OFHEO has classified Fannie Mae and Freddie Mac as "adequately capitalized" for eight successive quarters ending March 31, 1995.*

- *Completing on-site examinations of the use of derivative contracts by Fannie Mae and Freddie Mac, as well as examinations to provide an understanding of the Enterprises' organizational structures. Developing plans for future examinations of risk management and specific functional business areas.*

- *Analyzing and making recommendations on Special Reports from each Enterprise dealing with their approaches to disclosure and investor suitability in the issuance of derivative securities, principally structured notes and REMICs.*

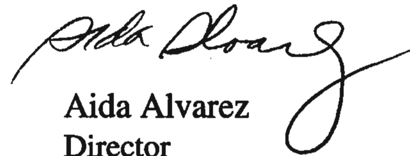
- *Publishing a proposed regulation covering minimum capital levels for the Enterprises.*

- *Making notable progress toward the introduction of a risk-based capital stress test, including continued development of a financial*

(continued)

model to simulate the business performance of the Enterprises under economically stressful conditions. Issuing an Advance Notice of Proposed Rulemaking asking for comment on OFHEO's approach to the risk-based rule.

In building a new regulatory office, OFHEO has been fortunate in attracting a team of talented, hard-working professionals. Many others have assisted OFHEO as well. The ongoing support of Secretary Henry G. Cisneros, as well as that of HUD's Assistant Secretaries and senior staff, has been essential to OFHEO's development. The advice and wisdom of Members of Congress, their senior staffs, and my fellow financial regulators has been indispensable. These contributions continue to serve OFHEO in its dedication to upholding the interests of the American taxpayer.



Aida Alvarez
Director

The Office of Federal Housing Enterprise Oversight

The Office of Federal Housing Enterprise Oversight (OFHEO) was created by Congress in the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Title XIII of Pub. L. No. 102-550). OFHEO was established on June 1, 1993, when Aida Alvarez was sworn in as OFHEO's first Director. OFHEO's Director is appointed by the President for a five-year term.

OFHEO's congressionally mandated mission is to ensure the capital adequacy and the financial safety and soundness of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Fannie Mae and Freddie Mac are government-sponsored enterprises (GSEs) that operate as shareholder-owned, publicly traded corporations. They were chartered by Congress for the purpose of providing a reliable source of funds for mortgage lending through their secondary market operations.

OFHEO's primary constituent is the American taxpayer. The Office was established to protect taxpayers against potential future losses in connection with obligations of the two GSEs. In carrying out its mission, Congress gave OFHEO the authority of an independent federal financial regulator. OFHEO conducts ongoing safety and soundness examinations of Fannie Mae and Freddie Mac, as well as quarterly tests to ensure that the two GSEs are adequately capitalized. The Director also has other responsibilities set forth in the Act.

OFHEO is an independent regulatory office within the Department of Housing and Urban Development (HUD). OFHEO's budget is funded by assessments on Fannie Mae and Freddie Mac; the operations of the Office represent no cost to the taxpayer.

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Current Issues

The housing finance industry is undergoing profound changes as it reacts to important technological trends and financial market developments. In its role as the safety and soundness regulator for the two largest mortgage finance institutions, OFHEO has been particularly mindful of events in three areas: advances in automated mortgage underwriting; use of financial derivatives; and new goals for purchases by Fannie Mae and Freddie Mac of mortgages that benefit specific groups.

Advances in technology will change the way mortgage loans are made as well as the roles of the Enterprises and other participants in the mortgage process. OFHEO will be closely following developments in this area to evaluate the effect of the Enterprises' new systems on their safety and soundness from three perspectives: the impacts of the systems on loan quality; the business risks associated with the provision of automation products and services; and any potential risks to the Enterprises stemming from the transforming effects that automation may have on industry structure.

The growth in the use of derivatives has been one of the most important developments in financial markets in recent years. The Enterprises have been both significant users of interest rate swaps and major issuers of derivative securities, such as REMICs (Real Estate Mortgage Investment Conduits) and structured notes. Last year, OFHEO examined how well Fannie Mae and Freddie Mac were addressing the risks involved in their use of derivative contracts.

The risks to the Enterprises associated with derivative securities are more indirect. OFHEO is particularly interested in the risk that widely reported investor losses on some of these securities, and the accompanying adverse publicity, pose to the reputations of the Enterprises as well as possible detrimental effects on the market for all government-sponsored enterprise securities. OFHEO has identified possible improvements in the availability of information to investors and urges prompt implementation of sales practice rules.

Establishment of goals for the Enterprises' purchases of mortgage loans for affordable housing has already shifted some of the focus of their purchase programs. Future increases in the goals, as proposed, would reinforce this trend. Efforts to meet the goals may tend to involve the Enterprises more heavily in relatively high-risk loan categories. Thus, OFHEO will examine the procedures the Enterprises use to limit risks and will evaluate the likely performance of the loans in order to ensure that the Enterprises set aside adequate capital.

The first section of this Annual Report to Congress explains how the Enterprises both influence and react to events in these three areas. It also describes OFHEO's regulatory role in these areas.

Enterprises Introduce Automated Underwriting Systems

In 1994 and early 1995, Fannie Mae and Freddie Mac introduced automated mortgage loan underwriting systems and other related technologies that will likely have significant effects on the housing finance system. OFHEO will be studying the impact of these initiatives on the Enterprises' safety and soundness. OFHEO is evaluating their potential impact on the credit quality of loans purchased by the Enterprises; the potential business risks associated with the provision of technology products and services; and the potential effects on Fannie Mae and Freddie Mac of changes in industry structure stemming from automation of the mortgage origination process.

The technology initiatives of Fannie Mae and Freddie Mac are similar to those that mortgage

lenders and others in the industry are developing and beginning to use to lower the costs of originating single-family loans. The entry of Fannie Mae and Freddie Mac into these market segments will accelerate the trend toward automation of the origination process and may increase the savings to homebuyers from automation. Overall, the Enterprises' initiatives will alter the relationship between the primary and secondary markets and affect the roles of mortgage lenders and companies that supply information used in mortgage underwriting.

Mortgage Loan Types

FHA/VA: Loans that are insured by the Federal Housing Administration or guaranteed by the Department of Veterans Affairs.

Conventional: Loans that are neither insured nor guaranteed by the FHA or VA.

Conforming: Loans that are eligible to be purchased by Fannie Mae and Freddie Mac. In addition to meeting the Enterprises' underwriting guidelines, the loans cannot exceed a dollar limit linked to a house price index published by the Federal Housing Finance Board (FHFB). Although the index declined marginally in 1994, the maximum loan amount for single-family mortgages remained unchanged at $203,150.

Nonconforming: Loans that cannot be purchased by Fannie Mae or Freddie Mac. Generally, such loans are "jumbos," that is, the loan amount exceeds the dollar limit set for the Enterprises. Data from an FHFB survey indicate that jumbos account for slightly less than 20 percent of the dollar volume of new conventional single-family loans.

Fannie Mae and Freddie Mac are developing and marketing their automated underwriting systems and related technologies in an effort to maintain or increase their market share, improve the credit quality of the single-family loans they buy, and profit from the sale of new services. Lenders can use the Enterprises' systems to achieve savings in origination costs, but the magnitude of the potential savings is uncertain.

The Mortgage Origination Process Is Increasingly Automated

The introduction of automated underwriting systems and electronic mortgage information networks by Fannie Mae and Freddie Mac will accelerate a broad trend toward automation of the mortgage origination process.

Traditionally, this process has consisted of several distinct steps, all of which lenders have performed: marketing to prospective sources of loan applications ("sourcing"); prequalifying prospective borrowers and taking their applications; collecting and verifying data on applicants' income, employment, and assets; ordering property appraisals and mortgage credit reports; underwriting loan applications; and processing loans that have been approved.

The origination process has been laborious, paper-intensive, and time-consuming. Without automation, prospective borrowers fill out loan applications by hand or typewriter. Lenders use the U.S. mail to request and receive credit and appraisal reports and approvals of mortgage insurance coverage. Each firm involved creates separate records, and all documents are prepared manually. A human underwriter personally reviews the hard copies of the documents in an applicant's file to make a lending decision. If an application is approved, the documents necessary to close the loan also are prepared manually and transmitted by mail.

In the last fifteen years, lenders, credit bureaus, mortgage credit reporting agencies, mortgage insurers, and other firms involved in the origination process have begun to exploit new computer and telecommunications technologies. Virtually all firms in the industry have computerized their records. Many lenders have installed systems that automate and speed up many steps in the origination process. Software packages are available that analyze and prequalify prospective borrowers, match them to available loan programs, order credit bureau reports, track the status of loan applications, produce all necessary documents, and perform other functions.

Some lenders and originators are using laptop computers to facilitate "point-of-sale" lending. Originators working in the field can obtain data on loan products and rates, conduct borrower affordability analyses, submit applications to lenders electroni-

cally, lock in rates, and obtain updates on the status of applications. Some institutions are formalizing arrangements with real estate brokerage firms and home builders in order to use these technologies to maximize the number of loans they originate.

In addition, some of the largest and most sophisticated lenders and service providers are using electronic data interchange (EDI), rather than the mail or telephone facsimile, to transmit data and request and receive credit reports, appraisals, and mortgage insurance decisions. Rather than creating a separate link to each firm with which they do business, some of those companies are also hooking up to networks that give them access through EDI to many potential business partners.

The trend toward automation has recently extended to the underwriting segment of the origination process. Traditionally, all mortgage underwriting decisions were made by human underwriters. Since the late 1980s, many of the largest mortgage lenders and insurers have developed automated underwriting systems for their internal use. Mortgage lenders can choose among several commercially available automated underwriting systems. Such systems have the potential to reduce credit risk by evaluating loan applications more consistently, improving the data used in underwriting, and making it easier to adjust underwriting standards when necessary.

The Enterprises' Initiatives

Each Enterprise rolled out its automated underwriting system to the commercial market in early 1995. Freddie Mac started pilot testing its system, *Loan Prospector*, in March 1994, and made the system commercially available in January 1995. Fannie Mae began pilot testing its system, *Desktop Underwriter*, in October 1994, and released the commercial version in April 1995. In the same period, Fannie Mae also pilot tested and released *Desktop Originator*, a set of automated tools designed to help lenders and originators streamline the origination process.

Each Enterprise also recently started pilot testing an electronic mortgage information network that will allow lenders to electronically exchange data and conduct business with credit reporting firms, mortgage insurers, appraisal firms, title insurance companies, and other firms in the industry. Fannie Mae began testing its network, *MORNET EDI*, in December 1994, and Freddie Mac started testing its network, *GoldWorks*, in January 1995.

There are important differences between the current versions of the Enterprises' automated underwriting systems, but those differences may diminish over time. Freddie Mac's *Loan Prospector* uses a scoring methodology in place of the current approach of relying on a set of underwriting guidelines. Under the new methodology, statistical models use data from a prospective borrower's loan application and credit report to estimate a score that indicates the risk of the loan relative to the risk of other loans. In contrast, Fannie Mae's *Desktop Underwriter* automates the application of its current underwriting guidelines, providing accurate and consistent evaluation of loan applications according to those rules.

A scoring methodology can take more account of compensating factors that have the potential to reduce credit risks. This may make it possible to approve more loan applications. OFHEO intends to monitor closely Freddie Mac's experience with its scoring methodology as a tool for evaluating credit risk.

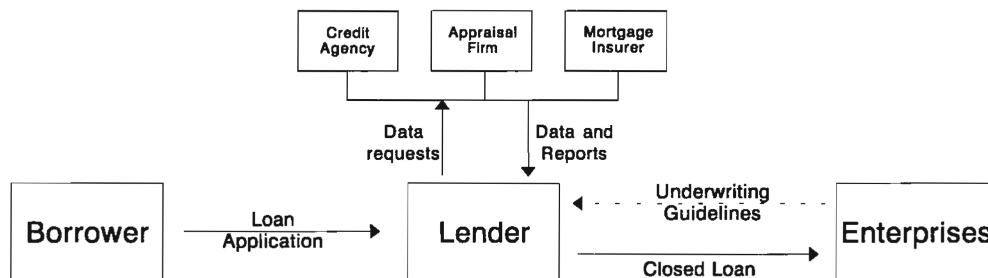
Another difference between the systems is that Freddie Mac's *Loan Prospector* gives lenders the option of delegating the valuation of the property to the Enterprise. In many cases *Loan Prospector* will substitute an automated statistical valuation for a traditional appraisal. Fannie Mae is researching ways to develop an automated appraisal component for *Desktop Underwriter*. Fannie Mae is also developing a title insurance feature for *MORNET EDI* that would allow lenders to order title insurance policies electronically. All of the technology initiatives of each Enterprise are in a relatively early stage of development, and refinements and additional features are likely to be added over time.

Automated Underwriting Adds a New Dimension to the Enterprises' Roles

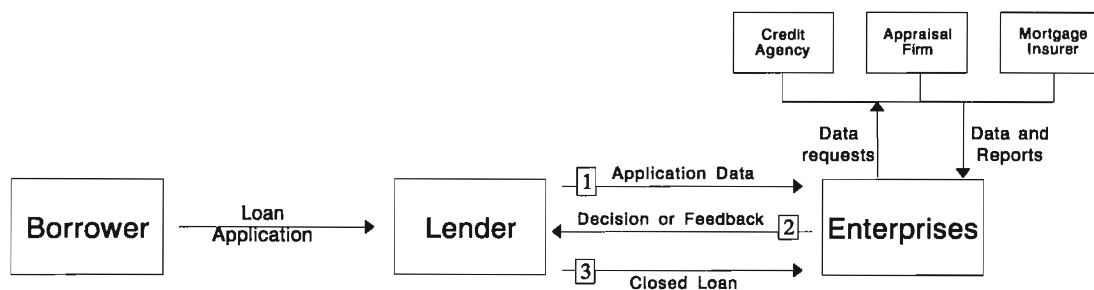
The automated underwriting systems of Fannie

The Effect of Automated Underwriting on the Enterprises' Role in the Loan Origination Process

Traditional Role of the Enterprises in Underwriting a Loan



Alternative Enterprise Role Using Automated Underwriting



Note: Lender has the option to do business directly with appraisal firms and mortgage insurers.

Source: OFHEO

figure 1

Mae and Freddie Mac add a new dimension to their roles in the housing finance system. As shown in **figure 1**, the Enterprises' traditional role has been to provide guidelines that shape the underwriting decisions made by lenders. Fannie Mae and Freddie Mac also have done post-purchase reviews of samples of the single-family loans they purchase. Lenders have purchased reports directly from credit bureaus, mortgage credit reporting agencies, and appraisal firms, and have requested approval of mortgage insurance coverage directly from mortgage insurers.

The Enterprises' automated underwriting systems alter these arrangements in three fundamental ways. First, each system directly evaluates a loan application, tells the lender whether the respective Enterprise would purchase the loan and, if not, provides feedback on the application's weaknesses. Thus, when a lender submits a loan application to Freddie Mac's *Loan Prospector* or Fannie Mae's *Desktop Underwriter*, the underwriting step of the origination process shifts to the Enterprise. If the system approves the loan for purchase by the Enterprise, the loan's underwriting is complete.

Second, the Enterprises' systems are capable of obtaining directly the information needed to underwrite a mortgage loan: a credit report on the borrower, an appraisal of the property, verification of mortgage insurance coverage, and possibly verification of the applicant's income, employment, and assets. At present, both systems automatically order credit reports, shifting that step in the origination process from lenders to Fannie Mae or Freddie Mac.

Each system also gives lenders the option of shifting other steps to the respective Enterprise. At the lender's option, Freddie Mac's *Loan Prospector* will directly order an appraisal or less expensive property valuation. A future upgrade of Fannie Mae's

Desktop Underwriter is expected to give lenders the option of ordering a property valuation. Freddie Mac's system also gives the lender the option to obtain a mortgage insurance commitment from a mortgage insurer at the time that a loan is approved for purchase by the Enterprise. Fannie Mae's system does not yet allow lenders to communicate with mortgage insurers, although the Enterprise is developing such a capability for its system.

Third, each Enterprise will have complete data on all loan applications approved for purchase by its system. This will allow Fannie Mae and Freddie Mac to review loans approved by the systems only to verify data on the borrower and property. Thus, each Enterprise will be able to devote its resources to more detailed reviews of loans processed outside of its automated underwriting system.

The Enterprises' Initiatives Reshape the Housing Finance System

The Enterprises' technology initiatives will likely have significant effects on the housing finance system. Automated underwriting systems and mortgage information networks allow Fannie Mae and Freddie Mac to centralize the acquisition of the information required to underwrite loans. The initial version of each Enterprise's system did this for credit reports. The modification of Freddie Mac's *Loan Prospector* released in May 1995 did it for appraisals. A future modification of Fannie Mae's *Desktop Underwriter* is likely to do it for appraisals. Down the road, the Enterprises could establish direct links to many employers and financial institutions to verify incomes and bank account balances after receiving proper borrower authorizations. The search for additional savings in origination costs will probably lead to the creation of national, centralized databases.

The electronic mortgage information networks of Fannie Mae and Freddie Mac will also provide lenders easier and more direct access to information about mortgage insurers, title insurers, and other firms that provide services used in originating mortgage loans. The effects of all of these changes in information flows should be increased efficiency and lower transaction costs throughout the origination process.

More broadly, the automation initiatives of Fannie Mae and Freddie Mac are likely to alter the relationship between the primary and the secondary markets for single-family conforming loans. Lenders will continue to originate all mortgages, but may perform fewer of the steps in the origination process. Fannie Mae and Freddie Mac will directly underwrite many conforming loans and, increasingly, will collect much of the information used in the underwriting process. The property valuation component of Freddie Mac's *Loan Prospector* suggests that, wherever possible, the Enterprises will use alternative sources of information to underwrite a loan if savings in time and money can be achieved without compromising credit quality.

Some mortgage lenders that already have their own automated underwriting systems may continue to use them, but many lenders may limit their operations to sourcing loans, submitting applications to the Enterprises for underwriting, reviewing referred applications, and then processing approved loans. As more of the steps in the origination process are automated and conducted electronically, some lender functions may be greatly simplified. Other developments may have the same effect. The Enterprises will soon give lenders the ability to sell loans at the point they are closed, thereby eliminating the need to manage the interest rate risk associated with loans before selling them (i.e. pipeline hedging).

Automated Underwriting Will Lower the Costs of Originating Mortgage Loans

The automated underwriting systems of Fannie Mae and Freddie Mac will enable lenders to reduce the time they take to approve loan applications. The savings that lenders can achieve will likely increase over time as the systems become able to retrieve more of the data necessary to evaluate applications—credit reports and property values first, and possibly later verifications of employment, income, and bank account balances. Another factor is the extent to which the Enterprises' networks enable lenders to conduct electronically other transactions, such as ordering title searches and requesting title and insurance policies. The savings in time achieved by specific lenders will depend on their previous investment in similar technology

and how they take advantage of the Enterprises' systems to re-engineer their approach to originating loans.

The dollar costs of originating single-family mortgages will also go down. The savings will be greatest on applications for low-risk loans, which need little human review. Lenders will achieve savings on applications for riskier but still potentially investment-grade loans as well, because the systems will give human underwriters a concise summary of the weaknesses of referred applications. Not all of the savings in lenders' origination costs will flow through to borrowers, but the primary market is generally quite competitive, so borrowers should benefit to a considerable degree.

Fannie Mae and Freddie Mac have stated that lenders that use their automated underwriting systems may initially achieve savings of about $300 on many applications. The Enterprises have suggested that lenders could ultimately achieve overall savings in origination costs of as much as $1,000 per application by taking full advantage of the Enterprises' automated underwriting systems and electronic mortgage information networks. Achieving savings of that magnitude could require the automation of virtually all of the steps of the origination process and the creation of national databases of title information, appraisals or sales prices, and other information.

Finally, if the Enterprises' automated underwriting systems improve the credit quality of the single-family loans purchased, the average default rate may be lowered. Fannie Mae and Freddie Mac could pass some of the savings in credit losses through to lenders in the form of lower guarantee fees, which would be likely to result in slightly lower mortgage rates.

Automated Underwriting Is Potentially Profitable for the Enterprises

Fannie Mae and Freddie Mac are developing their automated underwriting systems and mortgage information networks to increase their profitability. Each Enterprise's profits will be affected by the additional fee income it earns from leasing its system, any savings in its operating costs, any reduction in its credit losses through improvements in underwriting, and any increase in its share of the secondary market for single-family conforming mortgages.

Each Enterprise has an incentive to be the first to install its system with lenders, especially those that have a history of producing a large volume of high-quality loans. Lenders that are satisfied with one Enterprise's system may not install the other's and may shift their business toward the former Enterprise.

Demand for each system will depend on the rate at which it approves applications, the cost savings that lenders achieve, and how quickly lenders decide to re-engineer their origination process. It may take several years before the systems are widely used.

Each Enterprise will earn a per loan underwriting fee on each application that a lender runs through its automated underwriting system. Freddie Mac has stated that it will initially charge lenders that use *Loan Prospector* a basic per loan underwriting fee of $100 (fees for credit reports and property valuations will be assessed separately). Fannie Mae has stated that it will negotiate fees on a lender-by-lender basis, which may result in an effective per loan underwriting fee that is similar to Freddie Mac's. Each Enterprise will also charge fees for the use of its mortgage information network. Fannie Mae will charge a small subscription fee and a per loan processing fee for its origination system, *Desktop Originator.*

The Enterprises' Automated Underwriting Systems May Affect Fair Lending

Even if lenders adopted the Enterprises' systems to evaluate all applications for conforming loans, the overall effect on the relative availability of mortgage credit to minorities would be uncertain. Automated systems evaluate loan applications without regard to such factors as race, national origin, ethnic group, or gender. To the extent that the Enterprises' systems yield definitive judgments or provide objective feedback about applications, they should reduce any disparate treatment of members of minority groups who apply for conforming mortgage loans. This outcome is clearly a plus.

More objective evaluation of applications may not raise the rates at which members of minority groups apply for loans. Many observers believe that pro-

spective minority borrowers have been less likely to apply for mortgages because they believe that they will be turned down. Increasing application rates from minority groups is an important goal that requires vigorous outreach and marketing efforts by lenders and others in the industry.

It is anticipated that the Enterprises' automated underwriting systems will refer a large share of applications to human underwriters. Applicants with unusual credit histories or lower cash reserves are likely to be referred more frequently and charged somewhat higher origination fees. Members of minority groups may be disproportionately affected. Scrutiny and analysis of these potential effects will be necessary as the systems are implemented.

Automated Underwriting May Influence the Enterprises' Safety and Soundness

A major reason that Fannie Mae and Freddie Mac are developing automated underwriting systems is to improve the credit quality of the single-family mortgages that they buy. If the systems perform well, they could improve credit quality by making underwriting more consistent, improving the data used in underwriting, and making it easier to improve underwriting in the future. Better credit quality could translate into less overall risk.

At the same time, the significant change in credit risk management practices involved in the Enterprises' systems poses management and operations risks and requires good analysis and planning. Fannie Mae and Freddie Mac must manage these risks well in order to gain the consistent improvements in credit quality and fee income that they are seeking.

In addition, the roll-out of the Enterprises' automated underwriting systems initiated a period of heightened competition between them for high-quality single-family conforming mortgages. There are important differences between the systems. If features of either Enterprise's system perform well, it may gain an edge in this competition, at least until the other system incorporates similar capabilities.

Finally, the development and marketing of automated underwriting systems and related technology initiatives entail both potential returns and potential risks. The Enterprises' position in the secondary market for conforming loans, their strategic business relationships, and electronic links with lenders give them significant advantages. Nonetheless, technology products pose additional management and operations risks that must be monitored and managed in order to maintain overall financial safety and soundness.

Derivatives

The rapid growth of derivatives, and their potential implications for users, issuers, investors, dealers, and for the behavior of financial markets, has been a source of both enthusiasm and concern in recent years. Last year, some of these concerns were highlighted by reports of large losses among a number of users and investors and, in a few cases, spectacular failures. Derivatives have become a principal focus of financial regulators and likely will continue to be so for several years to come.

Fannie Mae and Freddie Mac participate in derivative-related financial markets by:

- Entering into over-the-counter derivative contracts, mostly interest rate swaps.
- Issuing debt securities that contain embedded options, or pay interest based on the behavior of indexes or other assets.
- Issuing mortgage derivative securities: REMICs and interest-only or principal-only strips.
- Investing in derivative mortgage securities.

Fannie Mae and Freddie Mac operate as users, issuers, and investors in derivatives, rather than as traders or dealers. By engaging in these activities, the Enterprises reduce their borrowing costs, limit their exposure to interest rate risk, and receive fee income. Shareholders benefit from higher profits, homeowners benefit from lower mortgage costs, and investors benefit from broadened investment opportunities that may help investors reduce a variety of financial market risks and improve investment yields.

At the same time, derivatives also present a need for effective management oversight and internal controls by the Enterprises and by investors. Derivatives also present important regulatory challenges. For OFHEO, this means evaluating credit risks and the effectiveness of hedges and management controls when the Enterprises are users or investors. It also means seeking to promote market practices that encourage proper use by investors of securities containing derivatives, particularly REMICs and structured notes, when the Enterprises are issuers.

Derivative Contracts Help Reduce Borrowing Costs and Manage Risk

The Enterprises' use of over-the-counter derivative contracts has soared in recent years **(see figure 2).** The notional amount of Fannie Mae's outstanding contracts jumped last year by three-fourths to nearly $90 billion. Freddie Mac's rose by half to $31 billion.

Derivatives

Derivatives are financial instruments whose values are based on, or derived from, the value of indexes or assets. While the term originally denoted financial contracts, such as futures, forwards, puts, calls, and swaps, in recent years its usage has been expanded to encompass derivative securities such as structured notes and REMICs.

Notional amount is the number that is the basis for determining payments that counterparties make under the terms of a derivative contract. Payments are computed by multiplying the notional amount by rates, prices, or index values specified in the contract.

Swaps are contracts between two parties to exchange, usually on a net basis, payment flows linked to different underlying assets or indexes. In a simple interest rate swap, one party agrees to pay a fixed rate of interest on a notional amount, while the other party pays a floating rate, based on an index of short-term interest rates.

Structured notes are debt securities with characteristics of derivatives as defined above. Examples include floating rate securities, range bonds, inverse floaters, and dual index notes.

Mortgage derivatives are multi-class mortgage-backed securities and are created by redistributing the cashflows from a pool of mortgages or MBS (see box on p. 10).

A majority of these contracts are interest rate swaps that permit the Enterprises to convert short-term or floating rate debt into synthetic long-term debt at lower cost than if they issued such debt directly. The Enterprises are able to reduce their borrowing costs on these types of synthetic structures in part because rates on short-term Enterprise debt are only slightly higher than similar term Treasury debt. Enterprise spreads to Treasuries rise as maturities lengthen.

Similarly, other contracts convert structured notes, with their embedded options and often complicated indexed payments, into synthetic debt structures, also at lower cost. Cancellation (or call) features in the swaps allow the Enterprises to create the equivalent of callable debt that largely offsets the effects of interest rate changes on the value of their mortgage assets. The Enterprises use additional types of contracts, such as interest rate caps and floors, as so-called "macro-hedges" to directly manage the overall interest rate risk of their portfolios.

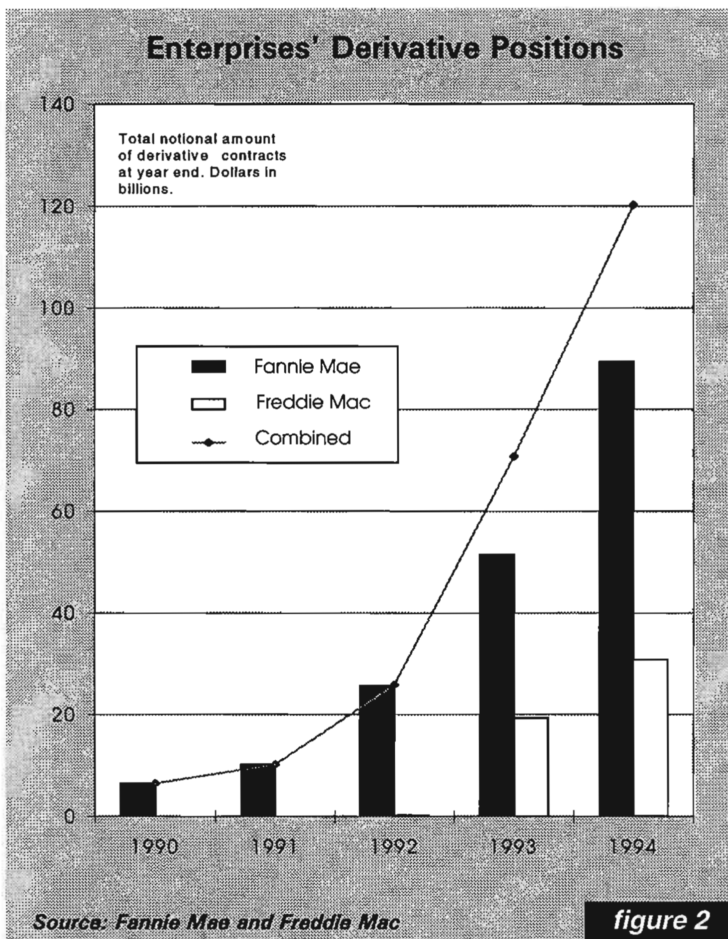


figure 2

Derivative contracts also pose some credit risk, but it is very small relative to the credit risk the Enterprises face with regard to mortgages they hold or guarantee. If a counterparty defaults, an Enterprise could lose money if the present value of payments it expects to receive from the counterparty exceeds the present value of any payments the Enterprise expects to make. The net present value of payments, or replacement cost, of contracts with positive net values amounted to roughly $3 billion at Fannie Mae and $1 billion at Freddie Mac at year-end 1994. (These amounts reflect reductions in exposures as a result of netting agreements with counterparties.) The Enterprises limit their risk by selecting highly-rated counterparties and requiring collateral sufficient to cover a large portion of their potential loss.

OFHEO's minimum capital standard requires the Enterprises to hold capital against credit exposures resulting from these derivative contracts. In this regard, the standard is essentially the same as the standard for banks and thrifts.

To determine if the Enterprises are properly evaluating, managing, and limiting the risks associated with these contracts, OFHEO conducted an examination of their derivative contract activities last year. The results and conclusions of those examinations are described later in this report **(see pages 30-31)**.

Derivative Features Contained in Enterprise Debt Issues Also Help Manage Risk

The Enterprises issue a wide range of debt securities with option features, or that pay interest rates that are tied to the values of other assets or indexes. Because Fannie Mae's retained mortgage portfolio is more than four times as large as Freddie Mac's, it is by far the larger issuer in all major categories.

Some types of these securities are simple and familiar. A callable security, one that can be redeemed at the option of the issuer, contains an embedded derivative. Homeowners issue such debt when they take out a mortgage, and they

Mortgage-Backed Securities

Mortgage-backed securities (MBS) are securities representing an undivided interest in a pool of loans secured by mortgages. This broad category includes single-class and multi-class securities.

Single-class mortgage-backed securities are interests in a pool of mortgages sold to investors. Monthly mortgage payments are collected and distributed to securities holders. The monthly payments of interest and principal are passed through to the investors, thus such securities are often referred to as "pass-throughs."

Multi-class mortgage-backed securities are repackaged forms of pass-throughs. These instruments reorganize the principal and interest cashflows from groups of single-class MBS. Multi-class mortgage-backed securities pay investors in different tranches according to different formulas. REMICs (Real Estate Mortgage Investment Conduits) are a common type of multi-class security differentiated by its tax status.

Strips (often referred to as IOs and POs) are types of multi-class mortgage-backed securities that divide the cashflows from pools of mortgages into interest and principal payments. IOs are "interest-only" and POs are "principal-only" securities.

exercise their option if they prepay the loan. Uncertainty about the timing and volume of prepayments makes it difficult for mortgage holders to match the maturities of their liabilities to those of their mortgages. Fannie Mae and Freddie Mac address this problem in part by issuing a large volume of callable debt. At year-end, the Enterprises had $110 billion of these securities outstanding.

These instruments give the Enterprises the ability to pay off debt if interest rates decline and many mortgages they hold prepay, or to keep the debt if interest rates rise and few mortgages prepay. Similar debt has been regularly issued by non-financial corporations for decades, so it generally presents no novel or unusual risks to investors. Roughly one-eighth of the Enterprises' callable issues are somewhat more complicated because their interest rates increase at specified dates if these "step-up" notes are not called. For most investors, they are less risky than standard callable issues.

Structured Notes Lower Enterprise Costs But Some Are Potentially Risky to Investors

There is no universally accepted definition of structured notes. One definition is very broad: debt securities with embedded options or whose values are based on the values of indexes or other assets. Although simple callable securities contain embedded options, most market participants do not describe such securities as structured notes. An alternative definition of structured notes is debt securities designed to meet investors' preferences, paired with swap agreements converting the notes into synthetic liabilities meeting issuers' needs at lower cost than if they were issued directly. In some cases, this definition applies to step-up notes, whose interest rates increase at specified dates if they are not called. Sometimes the Enterprises find the interest rate risk profiles of step-ups to be consistent with their overall risk management strategies and do not enter into simultaneous swaps.

The bulk of structured notes, approximately $20 billion at year-end, are simple floating-rate instruments tied to a short-term market interest rate or index. These, too, are familiar to investors, have been issued by many institutions for more than a decade, and present no unusual risks. A smaller group of these notes, a bit more than half as large, pay interest according to more complicated formulas. Of this small group, a few may present significant risks to investors if not purchased to hedge specific offsetting risks.

Many of the more exotic notes, which are also issued by Federal Home Loan Banks and others, declined sharply in value last year as interest rates rose. Some investors lost sizable amounts. In perhaps the most notable case, structured notes contributed to the bankruptcy of Orange County, Calif. late last year. These notes were not a primary cause of the county's problems, which stemmed more funda-

mentally from excessive leverage and a lack of responsible oversight of the county's investment policies. Structured notes issued by Fannie Mae did account for a small share (less than 5 percent) of the total losses. The illiquidity of these securities complicated an accurate evaluation and unwinding of Orange County's leveraged positions. Potential purchasers were concerned about the uncertain value of the notes and the cost of hedging their market risk. Fannie Mae, which issued the notes, had no concerns about resale value. It repurchased roughly $600 million of its notes from Orange County at a price that fairly reflected its cost of closing out its related swaps and issuing new debt.

Multi-Class Structures Redistribute and Concentrate Mortgage-Backed Securities' Risk

The Enterprises are the largest issuers of mortgage derivatives. Multi-class mortgage-backed securities (MBS), such as REMICs and strips, rechannel the interest and principal streams associated with pools of mortgages or MBS to meet investor preferences. The interest rate risk of the underlying mortgages or MBS is reallocated as well as the cashflows. Risk is reduced for investors in certain classes of securities (*e.g.*, so-called "Planned Amortization Class" bonds) with their more certain maturities while it is concentrated in other classes that are sold to investors most willing to accept them, in many cases because they tend to offset risk entailed in other assets and liabilities of these investors.

Through 1994, the Enterprises had issued $1.1 trillion of multi-class securities, of which well over half remained outstanding at year-end. Over the past decade, these instruments have generated large fees for the Enterprises and have helped broaden the demand for mortgage debt and lower mortgage rates for homeowners. However, some REMIC tranches and interest-only or principal-only strips can be highly volatile. When interest rates increased last year, some of these securities declined rapidly in value. Many investors underestimated both the speed with which mortgage prepayments slowed in response to higher mortgage rates and the resulting increase in effective maturities of their holdings. Market liquidity deteriorated, and investors who desired to sell some of their holdings to readjust their portfolio maturity structures found it very difficult to do so. A number of large losses were reported.

Structured Notes and Mortgage Derivatives Raise Questions of Investor Suitability

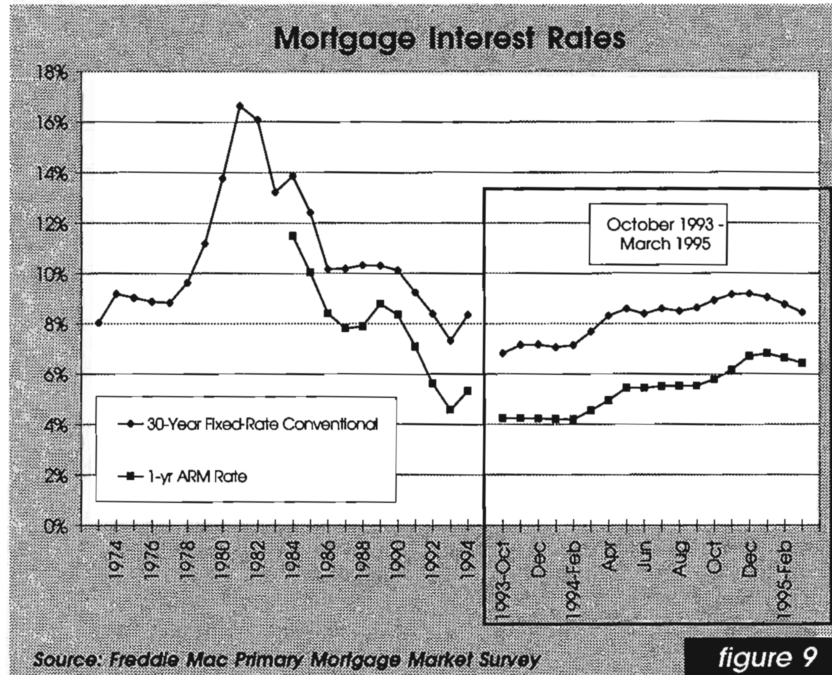
Most structured notes and mortgage derivatives present no unusual risks to investors and generally have smaller price fluctuations than 30-year Treasury bonds. The more volatile derivative securities can be safe and risk-reducing in some portfolios and dangerous and highly speculative in others. A considerable portion of the losses in derivative securities reported last year appear to reflect a lack of investor understanding of the risks involved.

In December 1994, OFHEO asked each of the Enterprises for more information about the marketing of their securities. The Office subsequently discussed issues related to the Enterprises' derivative securities with other market participants and regulators. OFHEO concluded that while disclosure of potential risks to investors was generally adequate, enforceable sales practice rules for dealers and a number of other informational and structural market changes might reduce the number of investor casualties **(see Appendix: "Derivative Securities Activities of Fannie Mae and Freddie Mac").**

REMIC Investments Grow Rapidly

The Enterprises' other focus of derivative securities activity is investment in their own REMICs. Prior to last year, both institutions held only marginal amounts of multi-class MBS. By year-end Fannie Mae held $12 billion and Freddie Mac $5 billion of such securities, which, while substantial, is less than 10 percent of mortgage assets in both cases. Purchases of these securities substituted for whole loans, which were less available in the secondary market last year. The effect of these assets on the Enterprises' overall risk cannot be fully evaluated except by modelling all of their assets and liabilities. OFHEO is developing the capacity to project the cashflows associated with individual securities or groups of them and expects to utilize that technology in the development of the stress test that will be part of its risk-based capital regulation.

2.6 percent a year earlier, and 2.3 percent in 1992 **(see figure 8).** Home price performance was uneven regionally. There were relatively large gains in the nation's midsection, but depreciation in the Atlantic and Pacific coastal regions. There were significant price decreases in several California metropolitan areas, especially in and around Los Angeles, a reflection of continued economic weakness in that state.



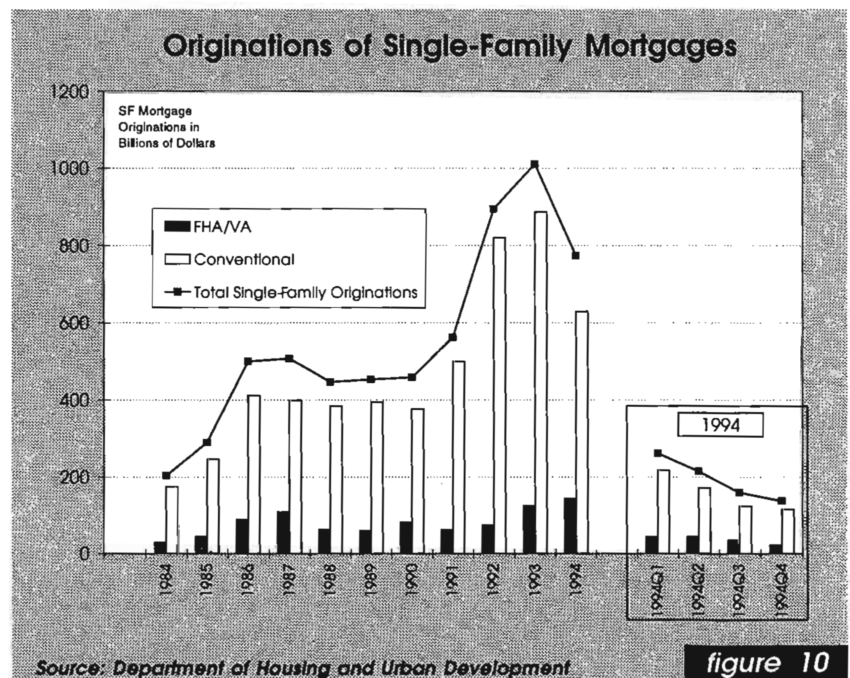
Source: Freddie Mac Primary Mortgage Market Survey

figure 9

The Federal Reserve's Open Market Committee responded to the unexpected strength of the economy by tightening monetary policy, despite continued moderate increases in the Consumer Price Index of less than 3 percent for the year. Beginning in February 1994, the Federal Reserve raised short-term interest rates in steps by a total of 300 basis points. Yields on longer-term Treasury securities, which had reached their cyclical low in October 1993, rose throughout the year. Mortgage rates followed the rising trend. According to Freddie Mac's Primary Mortgage Market Survey (PMMS), lenders' commitment rates on 30-year fixed-rate mortgages (FRMs) reached their cyclical low of 6.8 percent in October 1993 **(see figure 9).** By the end of 1994, rates on those mortgages had climbed by about 2 1/2 percentage points. In the first quarter of 1995, the yield increases seemed to be having some effect in slowing the economy (including housing activity), and long-term interest rates eased somewhat. Long-term mortgage yields declined 3/4 of a percentage point, but remained above 1993 levels.

Higher Interest Rates Reduced Mortgage Originations and Changed Their Composition

After a booming year for mortgage originations in 1993, rising interest rates caused a sharp drop in primary market activity in 1994. Originations of conventional single-family loans fell steadily throughout the year, reversing the increases in the previous two years by the fourth quarter **(see figure 10).** Preliminary data for the first quarter of 1995 indicates a further sizable reduction. The overall decline was a consequence of higher mortgage rates, which made refinancing unattractive for existing single-family borrowers. Although higher rates reduced the affordability of home ownership, rising incomes led to an increase in loans for home purchases. Strength among first-time homebuyers boosted demand for government-insured mortgages. Originations of such loans increased 17 percent to $141 billion, and further limited the volume of new conventional loans (those not insured by the Federal Housing Adminis-



Source: Department of Housing and Urban Development

figure 10

tration or the Department of Veterans Affairs). Multifamily loan originations were roughly unchanged at $31 billion.

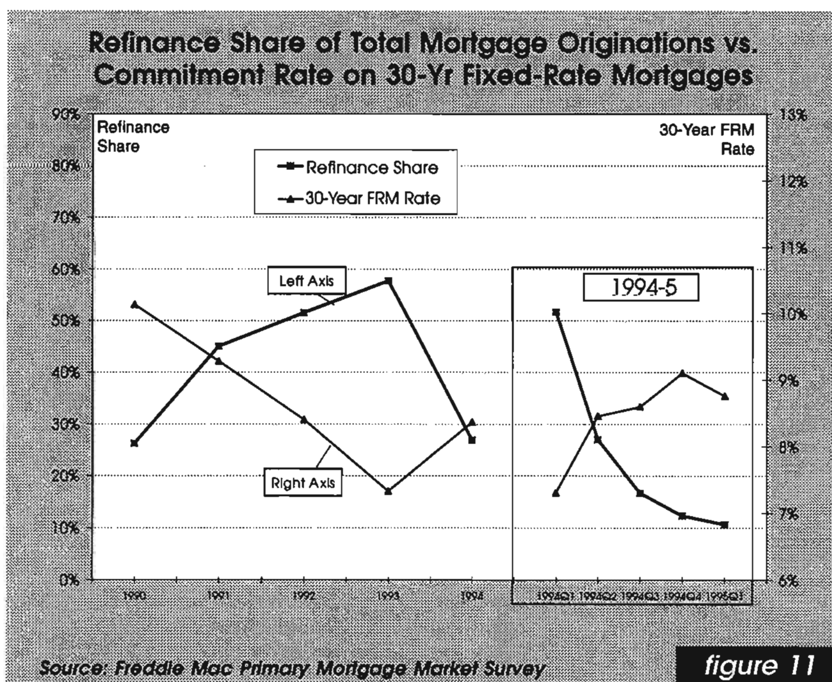


figure 11

According to Freddie Mac's PMMS, the refinance share of conventional single-family originations declined from a cyclical high of 58 percent in 1993 to 12 percent in early 1995 **(see figure 11).** This fall-off in refinance loans, which often have low loan-to-value ratios, increased the share of high LTV loans. The Federal Housing Finance Board's Mortgage Interest Rate Survey (MIRS) indicates that the proportion of conventional single-family loans with LTV ratios greater than 90 percent increased from 19 percent in December 1993 to 28 percent in December 1994. The average LTV ratio of such loans rose from 77 percent to 81 percent during the year. LTVs have risen continuously over the last five years, so the increase in 1994 also reinforced a long-term trend **(see figure 12).**

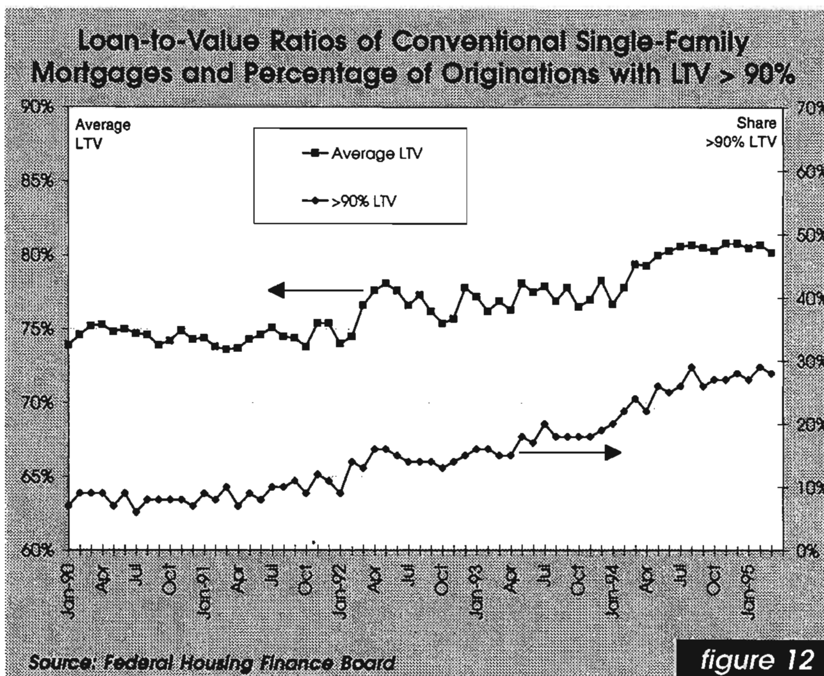


figure 12

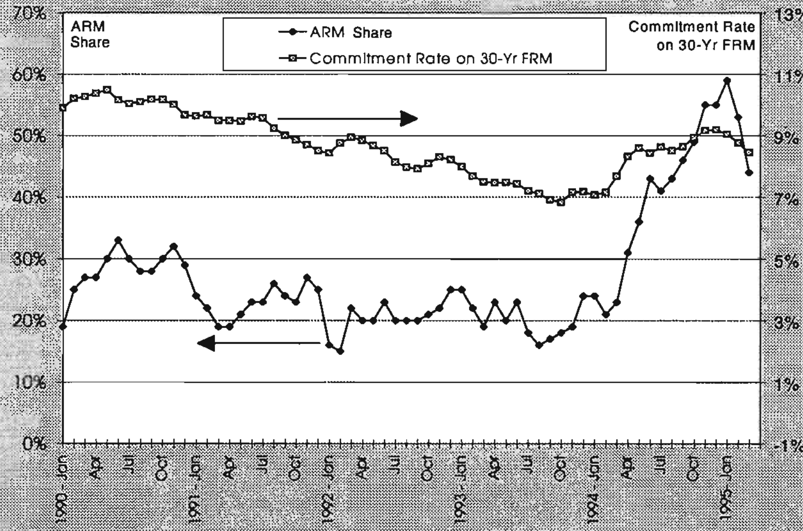
Higher interest rates also led a larger proportion of borrowers to take out adjustable-rate mortgages (ARMs). The ARM share of new conventional single-family loans more than tripled from a low of 16 percent in August 1993 to 59 percent last January **(see figure 13).** With the decline in long-term yields in 1995, the ARM share has retraced some of its earlier rise. Many ARMs were priced with a first-year discount, as usual, but lenders offered an increasing number with fixed rates for the first few years.

The market share of mortgage companies in total single-family mortgage originations, which has risen sharply in recent years, increased slightly further to 53 percent in 1994 **(see figure 14).** Commercial banks increased their market share marginally to 27 percent, while the market share of thrift institutions continued its decline, falling to less than 20 percent from more than 50 percent a decade earlier. Some of the shift over time from thrift institutions to mortgage banks may reflect the increased use of mortgage bank subsidiaries by thrifts. Mortgage banks not connected to thrifts generally sell most of their new mortgages to the Enterprises. In the multifamily market, commercial banks continued to increase their market share, which rose to more than 70 percent of 1994 originations.

Secondary Market and Mortgage Securities Activities of Fannie Mae and Freddie Mac

Enterprise Mortgage Purchases Fell Sharply

The drop in originations of conventional single-family mortgages, and the rise in the share of ARMs in 1994, produced a large decline in the volume of single-family loans purchased by Fannie Mae and Freddie Mac **(see figure 15).** Freddie Mac's single-family purchases declined 46 percent, and Fannie Mae's dropped 39 percent. The Enterprises' single-family purchases declined most dramatically in the second half of 1994, as primary market originations contracted. In the first quarter of 1995, the Enterprises' combined single-family purchases were one-fourth of their level a year earlier. These fall-offs were considerably larger than declines in single-family originations in the same period, so the Enterprises' market share declined **(see figure 16).** The rapid increase in the ARM share of originations was a major factor in reducing the Enterprises' overall share. Many lenders are more willing to hold ARMs in their portfolios because they entail less interest rate risk than FRMs when funded with short-term liabilities.

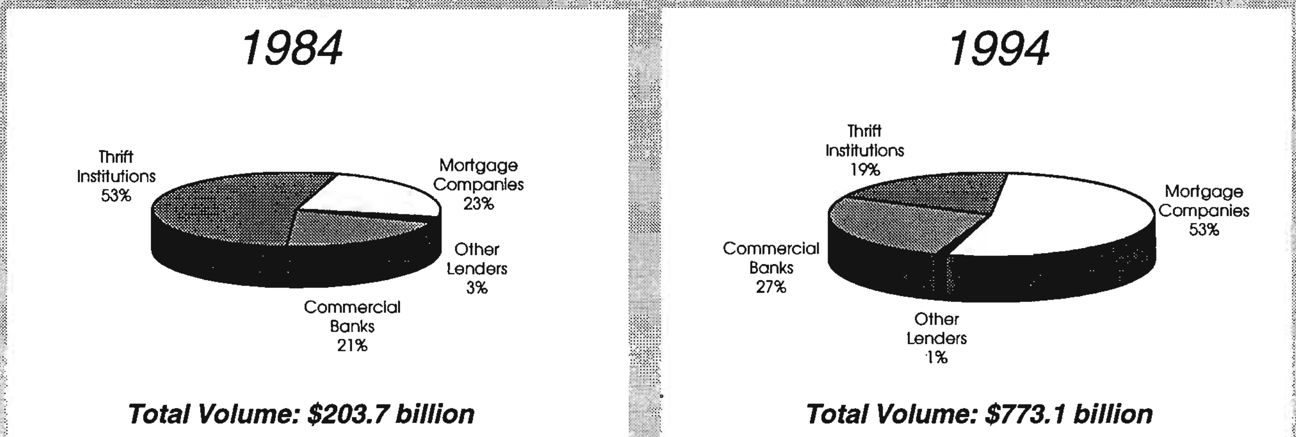


Source: Federal Housing Finance Board and Freddie Mac

figure 13

Credit Risk of Mortgage Purchases Increased Cyclically

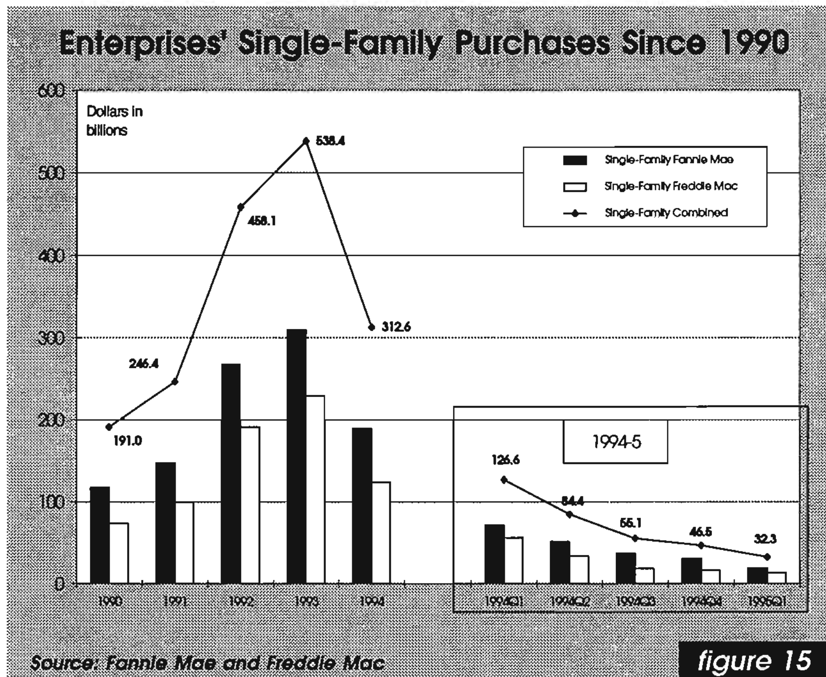
The characteristics of single-family mortgages purchased by Fannie Mae and Freddie Mac also changed significantly in 1994, again following trends in the primary market caused largely by rising interest rates. Each of the changes, which are discussed separately below, increased the credit risk posed by each Enterprise's 1994 loan purchases relative to those of 1993 and 1992, when a different interest rate environment prevailed.



Source: Department of Housing and Urban Development

figure 14

The proportion of single-family mortgages purchased by the Enterprises that were loans made to refinance existing mortgages dropped significantly last year. The refinance share of loans purchased by Freddie Mac fell from 72 percent in 1993 to 55 percent in 1994, while Fannie Mae's refinance share declined from 64 percent to 49 percent. These shares will likely drop further in 1995 if the refinance share of originations remains low.

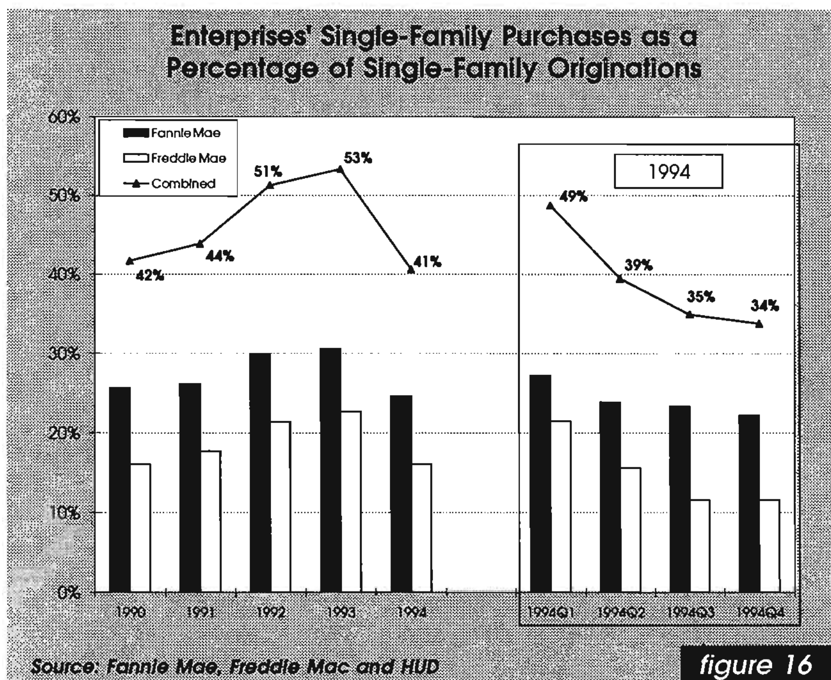


Source: Fannie Mae and Freddie Mac

figure 15

Mortgages that refinance existing loans (without increasing the principal amount appreciably) tend to have lower LTV ratios than loans to purchase homes, because LTV ratios on seasoned loans decline as property values rise and unpaid balances amortize. They are, therefore, less likely to default.

The LTV ratios of single-family mortgages purchased by the Enterprises increased, reflecting not only the sharp drop in the volume of refinance loans, but also a trend in recent years toward higher LTV ratios of purchase mortgages.



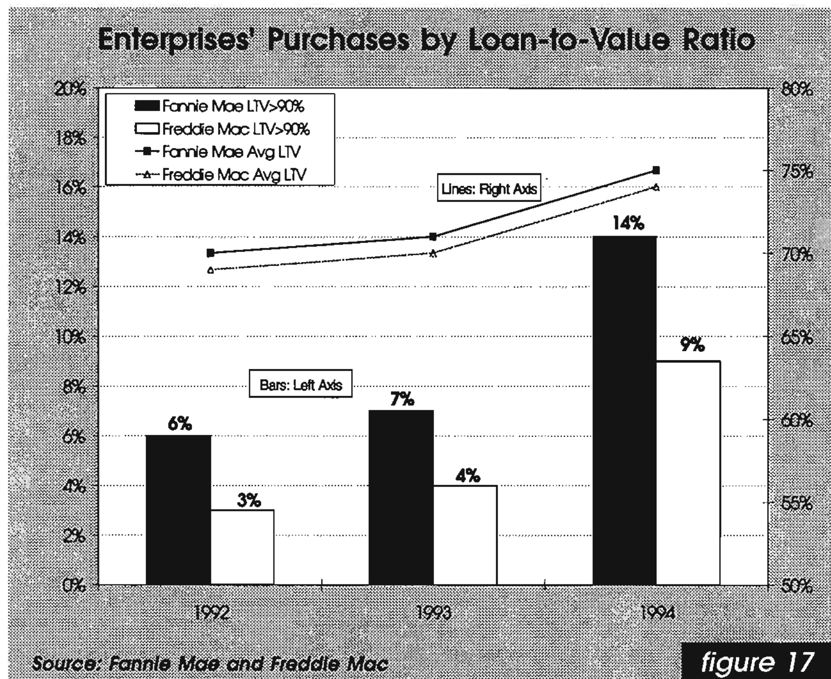
Source: Fannie Mae, Freddie Mac and HUD

figure 16

As shown in **figure 17**, the average LTV ratio of Fannie Mae's single-family purchases increased from 70 percent in 1992 to 75 percent in 1994. The proportion of loans purchased by that Enterprise with LTV ratios greater than 90 percent more than doubled to 14 percent. The LTV ratios of Freddie Mac's purchases have changed similarly. The average ratio of Freddie Mac's single-family purchases increased 5 percentage points to 74 percent, and the proportion of purchases with LTV ratios greater than 90 percent jumped to 9 percent.

The proportion of single-family FRMs purchased by the Enterprises that had intermediate-term maturities (generally 15 years) declined, as rising interest rates and the lack of refinancing opportunities reduced borrowers' interest in shorter-term loans in 1994. Intermediate-term FRMs as a share of total purchases at Fannie Mae and Freddie Mac dropped by roughly a third to 21 percent and 26 percent, respectively, in 1994. Intermediate-term loans pose a lower risk of default than 30-year FRMs due in part to the faster buildup of borrower equity inherent in the shorter life of the loans.

Adjustable-rate mortgages comprised a larger portion of each Enterprise's single-family purchases,



Source: Fannie Mae and Freddie Mac

figure 17

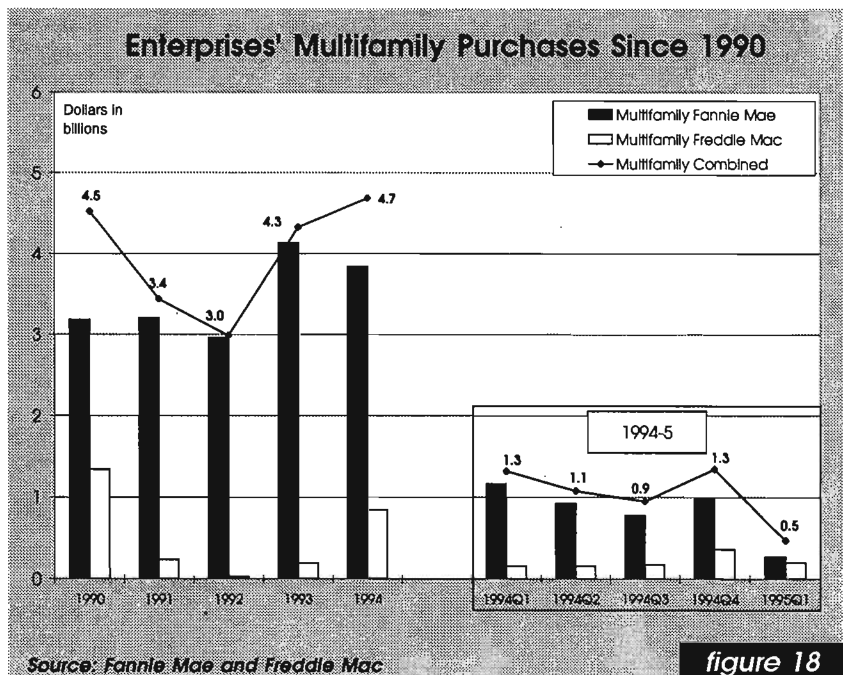
as borrowers preferred the lower initial rates on ARMs. The proportion of single-family ARMs purchased by Fannie Mae increased from 5 percent in 1993 to 9 percent in 1994. The ARM share of Freddie Mac's purchases rose from 9 percent to 14 percent. The mortgage coupon rate of an ARM is tied to a current short-term or intermediate-term interest rate index, and borrowers' payments rise and fall, within limits, with changes in market yields. Therefore, ARMs pose greater credit risk (although less potential interest rate risk) to the Enterprises than FRMs of the same maturity.

Purchases of Multifamily Loans Have Been Stable

Consistent with the stability in originations of multifamily mortgages in 1994, and the importance of those mortgages in fulfilling HUD's affordable housing goals, the Enterprises' aggregate purchases of multifamily loans did not decline and, in fact, increased modestly. Fannie Mae's purchases were little changed in 1994 at roughly $4 billion, while Freddie Mac purchased $846 million in multifamily loans with a surge in the fourth quarter of 1994 **(see figure 18)**. The increase for Freddie Mac reflected its reentry into the multifamily market in late 1993 after a virtual absence of nearly three years due to serious losses in multifamily loans. Multifamily loans are generally riskier than single-family loans. The borrowers are not homeowners; they are businesses, whose default rates are subject to cyclical swings in occupancy rates, to public policy changes, and to management problems. Furthermore, multifamily loans are heterogeneous and, therefore, more difficult to underwrite.

Volumes of Single-Class MBS Issues Diminished and REMIC Volumes Plummeted

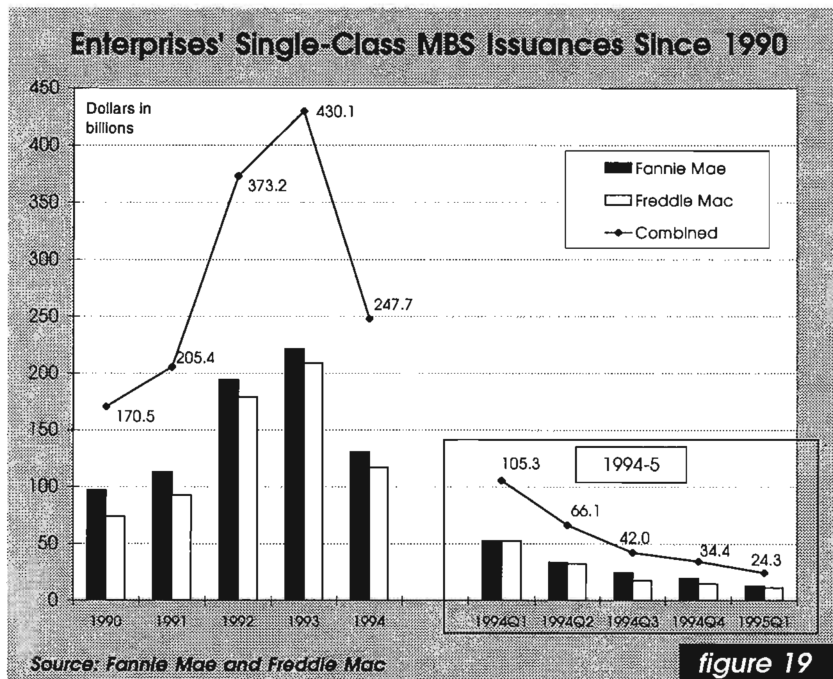
Consistent with declines in origination and purchase volumes in 1994, securitization by both Enterprises fell sharply from 1993 levels **(see figure 19)**. Freddie Mac's issuance of mortgage-backed securities fell 44 percent, while Fannie Mae's fell 41 percent. The Enterprises' activity declined sharply in the second half of 1994 and continued falling in early 1995. Despite the reduction in new offerings, however, investor holdings of MBS issued by Fannie Mae and Freddie Mac rose modestly during the year to $486 billion and $461 billion, respectively, because of the steep drop in repayments associated with the end of the refinancing boom.



Source: Fannie Mae and Freddie Mac

figure 18

The market for new REMIC and stripped MBS offerings collapsed in 1994 and early 1995. Last year, combined multi-class issuance by Fannie



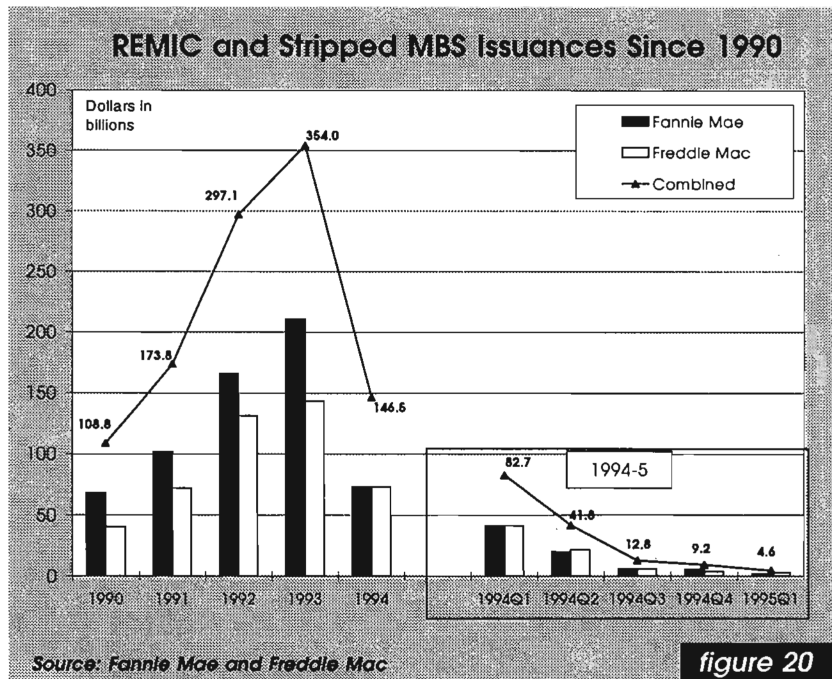
Source: Fannie Mae and Freddie Mac

figure 19

Mae and Freddie Mac plummeted 59 percent from 1993, to the lowest level since 1990 **(see figure 20)**. Volume declined most dramatically after mid-1994. In the first quarter of 1995, REMIC and stripped MBS issuance came to a virtual halt, 94 percent below its quarterly average rate in 1992 and 1993. The Enterprises faced new competition last year from Ginnie Mae, which started its own REMIC program. Ginnie Mae's REMIC issuances have been low due to unfavorable market conditions.

Both demand and supply factors contributed to the drop-off in REMIC issuance. The increases in mortgage rates and greater interest rate volatility extended the durations of REMIC securities, increased their perceived riskiness, and made them less attractive to investors. A flatter yield curve, which developed last year as long-term yields rose less than short-term yields, also reduced the profitability to dealers of converting newly issued mortgage-backed securities into REMICs. A steep yield curve allows dealers to sell low-yielding short-term tranches created from high-yielding single-class mortgage securities.

The rise in rates also caused mortgage prepayments to decline to an unexpected degree, which caused some investors in certain complex REMIC classes to suffer large losses after the Fed began raising rates. Increased risk and extended durations led many investors to try to sell simultaneously when there were few buyers. Market prices and liquidity both suffered. In the second half of the year, the supply of collateral available for placement in REMICs decreased as the volume of mortgage originations and new mortgage-backed securities issues by the Enterprises declined.



Source: Fannie Mae and Freddie Mac

figure 20

Profits Are High But Are Rising Less Rapidly

Despite the rise in mortgage interest rates and the reduction in the volume of loans that they purchased, Fannie Mae and Freddie Mac posted record profits in 1994. Combined, the Enterprises generated more than $3 billion in net income for 1994. For the year as a whole, each Enterprise's net income grew at only slightly lower rates in 1994 than in 1993. Fannie Mae's earnings increased 14 percent, while Freddie Mac's rose 25 percent **(see tables 1 and 2 for selected financial highlights).** Higher interest rates slowed the rate of growth of profits on a quarterly basis as low origination volumes in the primary market reduced growth opportunities. Profits in the first quarter of 1995 were 8 percent and 10 percent higher than in the previous year's first quarter for Fannie Mae and Freddie Mac, respectively.

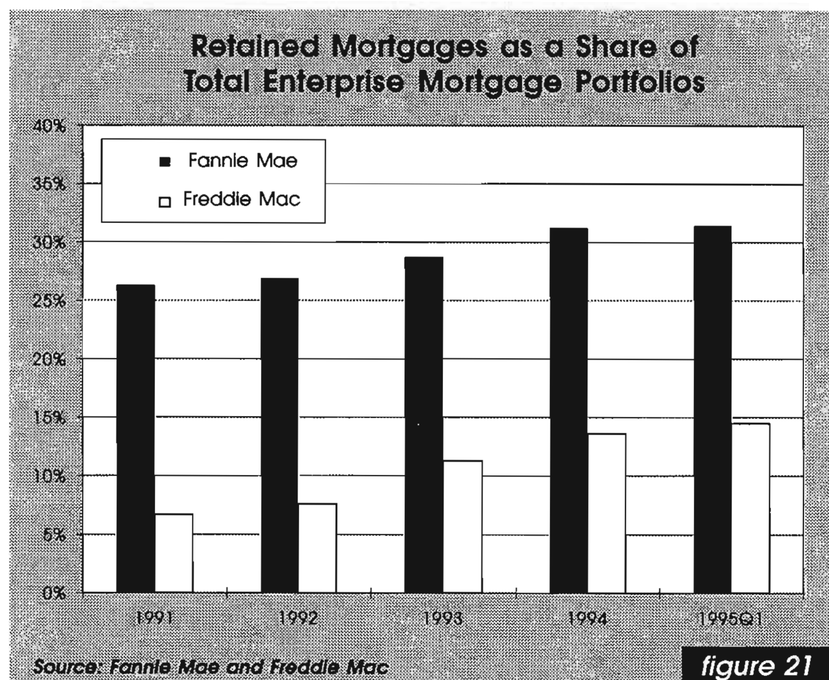


figure 21

Guarantee fees, which are received over the life of mortgages in MBS pools, increased moderately last year at both Enterprises, reflecting the continued growth in outstanding MBS. These gains were largely offset, however, by sharp declines in REMIC and related securities fees, which predominantly are received at the time of issuance. Earnings growth at both institutions continued to be supported by increasing the proportion of mortgages retained on their balance sheets rather than securitized **(see figure 21)**. Retained mortgages are generally more profitable to the Enterprises, but expose them to more interest rate risk to the extent they are not fully hedged.

Record profits enabled the Enterprises to earn returns on equity in excess of those earned by most depository institutions and financial services firms in 1994. Return on average common equity in 1994 for Fannie Mae and Freddie Mac was 24 percent and 23 percent, respectively. By comparison, the average returns on equity of the commercial banks and savings institutions insured by the Federal Deposit Insurance Corporation were 14 percent and 8 percent, respectively. Both Enterprises have earned returns of more than 20 percent in each year since 1986.

In general, a corporation can use profits to increase its capital position or make distributions to shareholders. In 1994, Fannie Mae and Freddie Mac used their record profits to significantly increase both capital and dividend payments. Fannie Mae increased its shareholder equity by 18 percent to $9.5 billion and its dividend payments by 30 percent to $504 million. The proportion of the Enterprise's profits paid out to stockholders in common stock dividends has nearly doubled since 1990. Last year, Freddie Mac increased its equity capital by 16 percent to $5.2 billion and the sum of its common and preferred dividends by 20 percent to $253 million. The proportion of profits paid out in common stock dividends by Freddie Mac has remained fairly steady in recent years.

Both Enterprises Meet Their Minimum Capital Requirements

One commonly used measure of the Enterprises' capital positions is shareholder equity as a percentage of total assets and MBS. In the five years ending in 1994, Fannie Mae increased its ratio by one-third to 1.26 percent. Freddie Mac's ratio grew by

one-half to 0.91 percent **(see figure 22)**. Although the changes in this simple capital ratio indicate that each Enterprise has significantly improved its capital position, the data must be interpreted with caution. Because the ratio equates less risky securitized mortgage assets with mortgage assets on the balance sheet, it is inappropriate to compare the Enterprises based on it alone. Further, the ratio does not account for changes in each Enterprise's exposure to credit risk and interest rate risk or in the income it will earn in the future from MBS guarantee fees. For these reasons, this simple capital ratio does not accurately measure the capital adequacy of the Enterprises.

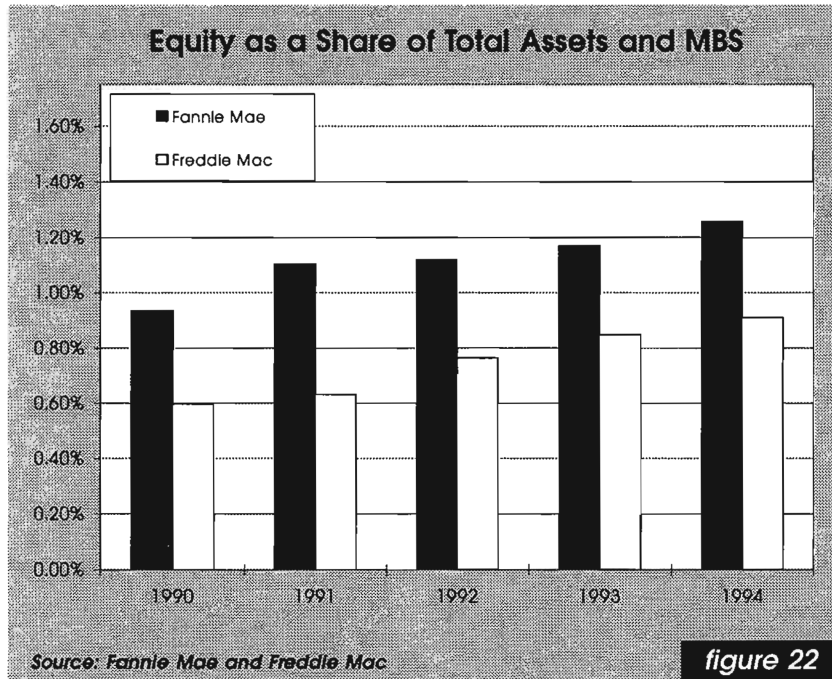


figure 22

Increases in the capital positions of Fannie Mae and Freddie Mac were sufficient for the Enterprises to meet their minimum capital requirements in 1994. The permanent requirements were established by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, and became effective June 30, 1994, after a transitional period with a lower standard. They require each Enterprise to maintain stockholders' equity equal to 2.50 percent of on-balance-sheet assets and 0.45 percent of most off-balance-sheet obligations. Both Enterprises appeared to manage their liquid assets in 1994 to closely match their permanent minimum capital requirements. At the end of 1994, Fannie Mae exceeded its permanent minimum capital requirement of $9.4 billion by $126 million. Freddie Mac exceeded its requirement of $4.9 billion by $285 million.

While the statutory minimum requirement is a much cruder standard than the risk-based capital measure currently being developed by OFHEO, it does take into account the potentially large differences in risk between on-balance-sheet mortgages and those that are securitized. **Figure 23** illustrates the relationship between the equity capital of each Enterprise and the current minimum standard at year-end for the past six years. Both Enterprises fell far short of this measure five years ago, but have consistently met the standard since the legislation providing for it was enacted in 1992.

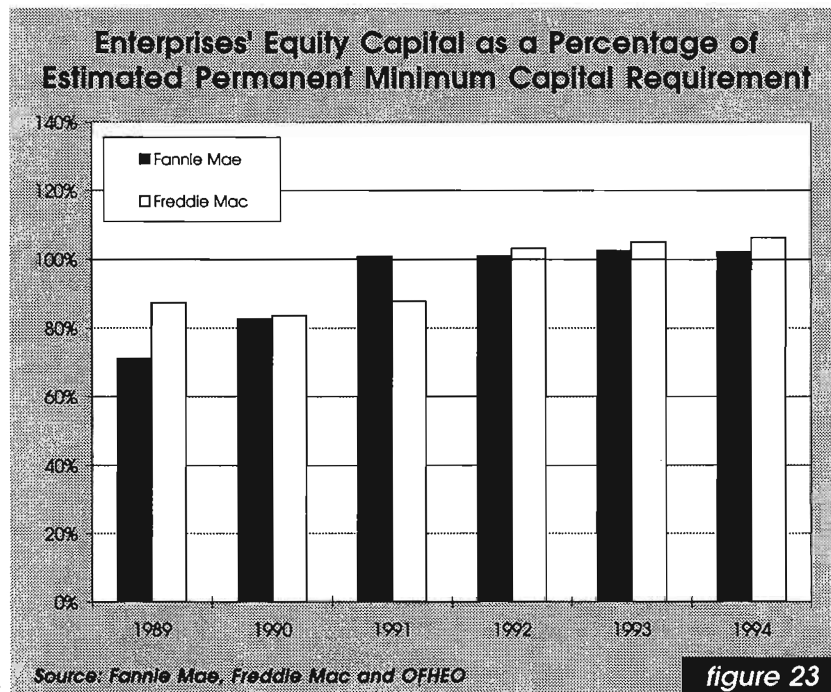


figure 23

TABLE 1

SELECTED FINANCIAL HIGHLIGHTS

FANNIE MAE

(DOLLARS IN BILLIONS)

	1995Q1	1994	1993	1992
EARNINGS PERFORMANCE:				
Earnings	$ 2.22*	$ 2.13	$ 1.87	$ 1.62
Return on Equity	22.9%	24.3%	25.3%	26.5%
Return on Assets	0.81%	1.00%	1.30%	1.00%
Dividend Payout Ratio	34%	31%	27%	23%
BALANCE SHEET POSITION:				
Total Assets	$ 274.7	$ 272.5	$ 217.0	$ 181.0
Outstanding Debt	$ 258.6	$ 257.2	$ 201.1	$ 166.3
Mortgages:				
Retained Mortgage Portfolio	$ 222.8	$ 220.8	$ 190.2	$ 156.3
Mortgage-Backed Securities	$ 486.9	$ 486.3	$ 471.3	$ 424.4
Retained Mortgages as % of Total Portfolio and MBS	31.4%	31.2%	28.8%	26.9%
Capital:				
Equity/Assets & MBS	1.30%	1.26%	1.17%	1.12%
Equity & Reserves/ Assets & MBS	1.41%	1.37%	1.29%	1.25%

Source: Fannie Mae

*Annual Rate

TABLE 2

SELECTED FINANCIAL HIGHLIGHTS

FREDDIE MAC

(DOLLARS IN BILLIONS)

	1995Q1	1994	1993	1992
EARNINGS PERFORMANCE:				
Earnings	$ 1.03*	$ 0.98	$ 0.79	$ 0.62
Return on Common Equity	21.9%	23.2%	22.2%	21.2%
Return on Assets	0.91%	0.96%	0.99%	1.11%
Dividend Payout Ratio	27%	26%	27%	27%
BALANCE SHEET POSITION:				
Total Assets	$ 113.6	$ 106.2	$ 83.9	$ 59.5
Outstanding Debt	$ 100.4	$ 92.1	$ 48.5	$ 28.2
Mortgages:				
Retained Mortgage Portfolio	$ 77.6	$ 72.6	$ 55.9	$ 33.6
Mortgage-Backed Securities	$ 458.8	$ 460.7	$ 439.0	$ 407.5
Retained Mortgages as % of Total Portfolio and MBS	14.5%	13.6%	11.3%	7.6%
Capital:				
Equity/Assets & MBS	0.93%	0.91%	0.85%	0.76%
Equity & Reserves/ Assets & MBS	1.06%	1.04%	0.99%	0.93%

Source: Freddie Mac

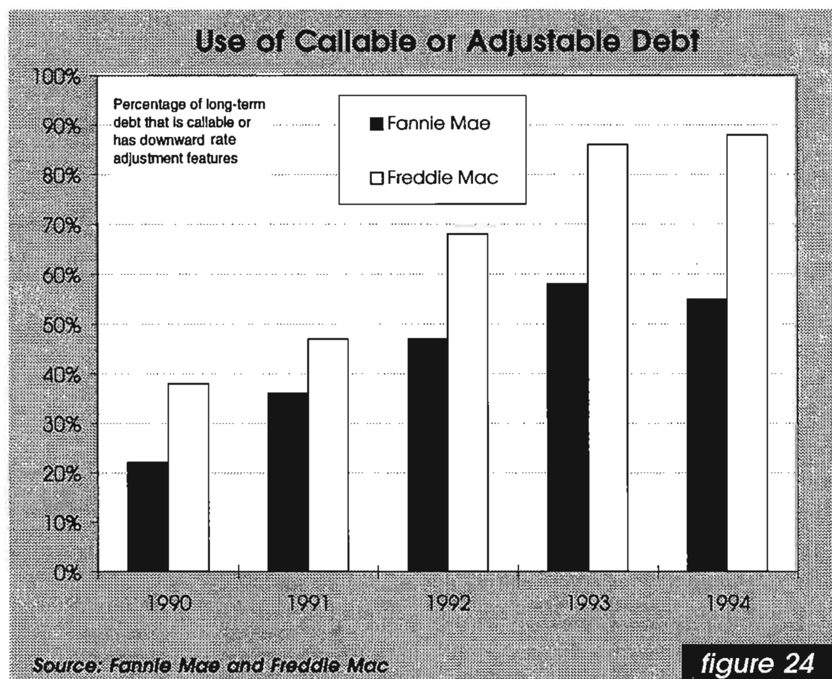
*Annual Rate

On-Balance-Sheet Assets Continue to Surge

Freddie Mac's on-balance-sheet assets increased 27 percent and Fannie Mae's increased 26 percent in 1994. The growth in Fannie Mae's assets enabled the Enterprise to become the largest corporation in the United States in 1994, measured in terms of total on-balance-sheet assets. At year-end 1994, Fannie Mae had total assets of $272 billion. The next largest firm, Citicorp, had total assets of $250 billion at year-end 1994. Freddie Mac's year-end 1994 assets totaled $106 billion, making it the nation's 17th largest firm in terms of assets (*Forbes*, April 24, 1995).

In earlier years, growth of on-balance-sheet mortgage assets at both Enterprises occurred primarily through purchases of whole mortgage loans. In 1993, for example, 89 percent of the growth in Fannie Mae's mortgage assets was due to whole loan purchases. In 1994, however, only a small percentage of the growth in either Enterprise's assets was due to purchases of whole loans. Both Enterprises relied heavily on purchases of single-class MBS and REMICs, and non-mortgage investments. Such assets accounted for nearly two-thirds of the $31 billion increase in Fannie Mae's earning assets. In Freddie Mac's case, securities purchases exceeded the overall growth in its mortgage assets, as some whole loans were liquidated and not replaced. The shift away from whole loan purchases largely reflects the diminished availability of opportunities for whole loan portfolio purchases and attractive opportunities in some sectors of the mortgage securities market.

If current market conditions continue, Fannie Mae and Freddie Mac will be less able in 1995 to bolster their profits by rapidly growing their on-balance-sheet assets. Spreads between the yields on FRMs and callable debt, which are indicative of the net interest margins that the Enterprises can earn by placing incremental mortgage acquisitions in portfolio, have narrowed significantly since interest rates reached their cyclical low in October 1993. As rates rose, borrowers shifted to ARMs, and the Enterprises continued to buy FRM loans and MBS for their portfolios. These factors limited the availability of new FRM debt. The spreads between the yields on whole FRMs and on Treasuries narrowed, and those spreads remain low by historical standards. At the same time, the greater interest rate volatility in early 1994 raised the cost of callable debt, on which the Enterprises have relied heavily in recent years to hedge the interest rate risk of their retained portfolio, relative to non-callable debt. Those spreads have not returned to earlier levels. If the spreads between fixed-rate mortgages and callable debt remain narrow in 1995 and the Enterprises do not increase appreciably the interest rate risk posed by their portfolios, the profitability of future additions to retained portfolios may be less than it has been in recent years.



Source: Fannie Mae and Freddie Mac

figure 24

Callable Long-Term Debt Helps Limit Interest Rate Risk

The sharp growth in retained assets of Fannie Mae and Freddie Mac in 1994, while raising each Enterprise's earnings potential, also increased the potential exposure to interest rate risk. The Enterprises manage interest rate risk exposure associated with their on-balance-sheet assets by issuing callable long-term debt, or by entering into derivative contracts that effectively create long-term debt that is callable or has downward interest rate adjustment features. These are essentially equivalent ways of protecting against declines in net interest income due to prepayment of mortgages held in portfolio when mortgage rates fall. Freddie Mac in-

creased its callable debt outstanding by 59 percent to $35 billion in 1994. Debt issued by Freddie Mac that is callable, or that has downward rate adjustment features, rose slightly to 88 percent of all effective long-term debt at year-end 1994 **(see figure 24).** Fannie Mae increased its callable debt by 13 percent to $74 billion in 1994. The proportion of Fannie Mae's effective long-term debt that is callable, or equivalent to callable debt, declined slightly to 55 percent.

Long-term debt, whether callable or not, provides protection against interest rate increases. Last year, as interest rates rose, the likelihood of prepayments on the Enterprises' current holdings of mortgages declined, lengthening the expected life of those assets. Freddie Mac issued long-term debt during the year sufficient to raise the ratio of effective long-term debt to mortgage assets from 56 percent to 72 percent. Fannie Mae's ratio held steady at 85 percent, but the average maturity of its long-term debt was extended slightly.

The adequacy of any given percentage of callable debt or ratio of long-term debt to mortgage assets depends on a variety of factors, principally the characteristics of mortgages held and the effective maturities of outstanding liabilities. OFHEO will be able to evaluate each Enterprise's interest rate risk exposure more accurately following full development of its financial simulation model. The model will be used to evaluate the effect of stressful conditions in connection with future risk-based capital regulations, and also will permit examination of a wide variety of alternative interest rate environments.

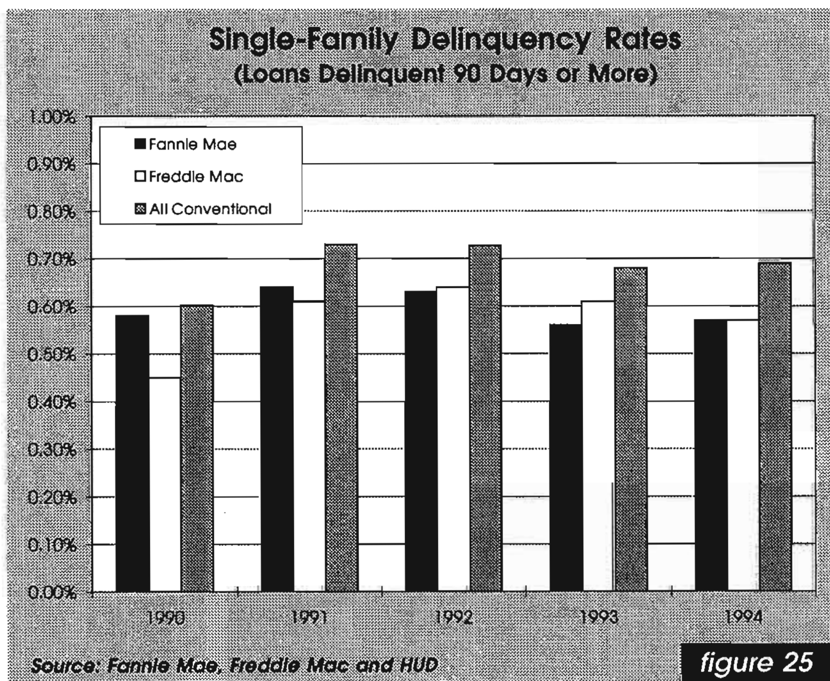


figure 25

Credit Quality Indicators Remain Healthy

The credit performance of the mortgages financed by Fannie Mae and Freddie Mac continued to be good in 1994. Mortgages generally are at greatest risk of loss during their third, fourth and fifth years, so any effect of the risk characteristics of loans purchased during the past two years would not be immediately apparent in loan quality indicators. Last year, improving general economic conditions reduced the delinquency rate of single-family mortgages (based on the number of mortgages delinquent 90 days or more) in most regions of the country, but these gains were offset by a higher delinquency rate in the West, which continues to experience weak economic conditions, particularly in California. Freddie Mac's single-family delinquency rate decreased from 0.61 percent to 0.57 percent, while Fannie Mae's, at 0.57 percent, was essentially unchanged from a year earlier. Rates for both firms were significantly below those for all conventional loans **(see figure 25).**

Improvements in the multifamily market, and in general economic conditions, reduced the delinquency rate of multifamily mortgages (based on the unpaid principal balance of mortgages delinquent 60 days or more). Fannie Mae's multifamily delinquency rate dropped from 2.3 percent to 1.2 percent. Freddie Mac's delinquency rate, which still reflects underwriting problems in the 1980s, decreased less than Fannie Mae's to 3.3 percent **(see figure 26).**

Charge-offs rose at both Enterprises last year, owing largely to increased losses in California,

where both companies have more than 20 percent of their credit exposure. California's economy was weak, and losses associated with the Northridge earthquake were significant. Subsequently, Freddie Mac acted to curtail future earthquake losses by requiring earthquake insurance on condominium loans in high-risk seismic areas in California. Total credit losses, including charge-offs and expenses related to real estate owned by the Enterprises, were less than one-tenth of one percent of mortgages owned or guaranteed at both institutions.

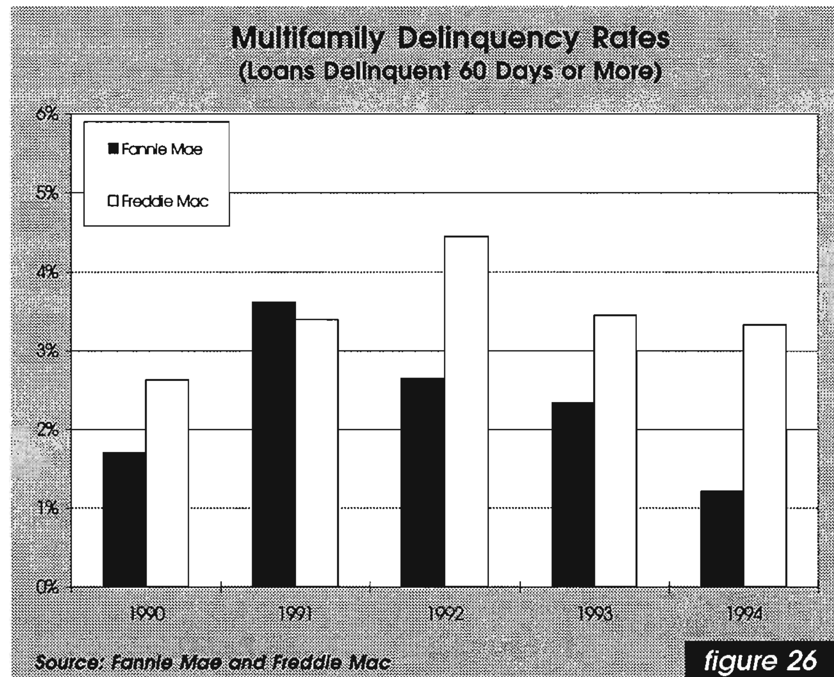


figure 26

The rise in loan-to-value ratios for loans purchased in recent years appears to have had only limited effects thus far on the distribution of LTV ratios for the Enterprises' entire books of business. But in response to concerns about the credit implications of the longer-term trend toward high LTV mortgages in new single-family loan purchases, Fannie Mae and Freddie Mac, in the fall of 1994,adjusted the amounts of private mortgage insurance (MI) coverage that they require on loans with high LTV ratios. The charter acts of the Enterprises require mortgage insurance coverage for mortgages purchased with LTV ratios at origination of more than 80 percent. This coverage reduces the Enterprises' expected credit losses. The longer the loan maturity and the higher the LTV ratios of loans, the more coverage the Enterprises require.

Both Fannie Mae and Freddie Mac raised the MI coverage they require on single-family, 30-year loans with LTV ratios of 85 percent or more. This allowed the Enterprises to reduce the credit risk inherent in the increase in the LTV ratios of 30-year conventional loans. At the same time, both Enterprises also reduced the required coverage on 15-year and 20-year mortgages with LTV ratios of 80 percent to 90 percent to better reflect the relative safety of these loans. The faster amortization of 15-year and 20-year loans allows for more rapid buildup of borrower equity in the home, which in turn leads to lower default rates and losses.

OFHEO's Regulatory Activities

In its second full year of operations, OFHEO moved expeditiously to fulfill its congressionally mandated mission. The Office conducted its first examinations of Fannie Mae and Freddie Mac, performed quarterly capital classifications of the Enterprises based on minimum capital standards, and made substantial progress toward development of a stress test that will be used to set risk-based capital requirements. A description of these and other activities, including research and projects to support these functions, are outlined in this section.

Examination of Fannie Mae and Freddie Mac

Authority

OFHEO's statute requires the Office to conduct annual, on-site examinations to determine the financial safety and soundness of Fannie Mae and Freddie Mac. The Act specifies that "the results and conclusions of the annual examinations" shall be submitted as part of the Annual Report to Congress.

Examination Approach

The purpose of examining Fannie Mae and Freddie Mac is to verify that their current condition is safe and sound, and that they are being managed and operated prudently. Recent regulatory experience has shown that the quality of a regulator's safety and soundness decisions, and the effectiveness of oversight activities, depend upon the examiner's first-hand knowledge of operations and management of the institution being examined.

Oversight of government-sponsored enterprises involves evaluation of management and operating systems, including the processes used by a GSE to identify and control exposure to risk. OFHEO is continuing to review and refine its examination and supervisory processes.

The examination starts with a big-picture approach. The scope is expanded when anomalies are found. The examination in a specific functional area of the Enterprise starts with a *Level I* review. Examiners in this phase evaluate senior management and its planning strategy, analyze internal and external audits, and verify records and control systems. *Level II* is broadened to include testing, statistical sampling, and additional analysis. *Level III* includes detailed review of an entire area by an examining team.

At the end of each examination, exit conferences are held to advise management of OFHEO's results and conclusions. In the case of the first examination described below, OFHEO's Director and the director of OFHEO's Office of Examination and Oversight met with the boards of directors of Fannie Mae and Freddie Mac to summarize the examination findings. Detailed presentations of the conclusions and recommendations were also made to the audit committees of each board.

In 1994 and the first quarter of 1995, OFHEO conducted its first on-site examinations of Fannie Mae and Freddie Mac. During this period, OFHEO staff conducted separate, simultaneous examinations at each Enterprise in two subject areas.

OFHEO 1994-95 Examinations

The initial examinations covered the use of derivative contracts by the Enterprises. The examinations were ordered by the OFHEO Director in light of congressional and regulatory concern over the rapid growth of the use of derivatives. OFHEO's objective was to determine

the business purposes of these derivatives and to verify that these purposes were consistent with safety and soundness principles.

The second set of examinations covered issues of corporate governance. These examinations had three objectives: to assess the strength of corporate governance, to enhance OFHEO's institutional knowledge of the Enterprises, and to establish priorities for future examinations.

Overall, OFHEO's initial examinations of Fannie Mae and Freddie Mac revealed no significant concerns involving financial safety and soundness. OFHEO made recommendations to the Enterprises in each of the examination reports.

The Enterprises responded promptly to OFHEO's recommendations. The actions taken or planned by each Enterprise were deemed by OFHEO to be responsive to the recommendations of OFHEO's examination staff. The next examination will focus on risk management, which assesses the adequacy of management processes to identify, measure, monitor, and control the risk exposure of the Enterprises.

Examination of Derivative Contracts

In the spring of 1994, OFHEO's Office of Examination and Oversight began examinations of the use of derivative contracts by Fannie Mae and Freddie Mac. The examinations focused on the business purposes, oversight, and risk management of the Enterprises' derivative contracts.

During its examinations, OFHEO staff analyzed derivative contracts and strategies utilized by the Enterprises, interviewed directors and executive managers, and reviewed risk management processes and systems.

Derivative contracts are an integral component of financial management at each Enterprise. The aggregate notional amount of these contracts at the Enterprises increased to $120 billion at year-end 1994, up from $4.9 billion on Dec. 31, 1989 **(see figure 2, p. 9)**. These notional amounts serve as a basis for the payments required under the contracts and indicate the level of activity, but do not measure risk exposure.

Fannie Mae and Freddie Mac use derivative contracts — primarily callable and non-callable fixed-pay swaps, basis swaps, and interest rate caps and floors — to reduce funding costs, manage interest rate risk exposure, enhance short-term investment yields, and facilitate other transactions with dealers. In addition, Fannie Mae uses foreign currency swaps to hedge its exposure to the risk of currency fluctuations on non-dollar denominated debt issues.

In its derivative contracts examinations, OFHEO evaluated the Enterprises relative to recommendations published by the Group of Thirty and the Basle Committee on Banking Supervision. The examinations also utilized related materials from the American Institute of Certified Public Accountants, banking regulators, and the General Accounting Office. Taken together, these recommendations and materials comprise OFHEO's "best practices" standard for derivatives activities. Within this framework, the examinations:

- Determined the business purposes of derivative contracts used by the Enterprises, and verified that those business purposes were consistent with principles of safety and soundness;

- Assessed oversight of derivatives activities, including the role of the board of directors, the adoption of a derivatives policy, and the responsibilities of senior management; and

- Evaluated the adequacy of risk management relating to derivatives activities, including market risk, credit risk, operations risk, liquidity risk, and legal risk.

Results and Conclusions

Examinations of Fannie Mae and Freddie Mac concluded that the use of derivative contracts by the Enterprises do not pose significant safety and soundness concerns.

The growth and composition of derivative contract portfolios reflect Fannie Mae's and Freddie Mac's responses to opportunities and risks associated with changing market conditions. At both Enterprises, derivative contracts are used to reduce funding costs **(see discussion on pp. 8-11)**. The examinations found that as users of derivatives, the Enterprises employ derivative contracts for sound business purposes that are not speculative.

Effective oversight is critical in ensuring that derivatives activities are conducted in a safe and sound manner. An effective oversight framework includes these elements: strategic policy guidance from the board of directors, delegations of authority and monitoring by the board, clearly articulated policies and procedures from senior management, and active supervision of derivatives activities by senior management.

Risk management of derivatives activities requires effective processes and systems to ensure that risks are identified, measured, and controlled by senior management. Operational policies and procedures, management information systems, and internal controls are essential elements of such risk management.

Fannie Mae

The notional amount of Fannie Mae's derivative contracts portfolio rose to $89.4 billion at year-end 1994, up from $51.5 billion a year earlier, for a 74 percent increase. This substantial growth primarily reflects the increasing use of these contracts, in conjunction with short-term and structured debt instruments, as a cost-effective alternative to more traditional long-term and intermediate-term debt in funding Fannie Mae's rapidly growing retained mortgage portfolio. The examination determined that Fannie Mae employs derivative contracts to achieve sound business purposes.

OFHEO concluded that senior management involvement was active and effective. While OFHEO recognized that recent initiatives by the Board had improved its role in oversight, OFHEO recommended that the Board of Directors further expand its role. OFHEO also recommended that institutional policies on derivatives be more clearly established and internal reporting be expanded to meet fully the guidelines proposed by the Group of Thirty.

The examination found that risk exposure on current positions was minimal and that risk management practices overall at Fannie Mae were effective. OFHEO supports efforts underway to establish aggregate credit limits for all counterparties to avoid concentrations of credit. Subsequent actions taken by Fannie Mae fully complied with the recommendations of the examination.

Freddie Mac

At Freddie Mac, the notional amount of derivative contracts increased to $30.8 billion at year-end 1994, up from $19.3 billion a year earlier, for a 60 percent increase. As was the case for Fannie Mae, this substantial growth primarily reflects the increasing use of these contracts, in conjunction with short-term or structured debt instruments as a cost-effective alternative to more traditional long-term and intermediate-term debt in funding Freddie Mac's rapidly growing mortgage portfolio. The examination determined that Freddie Mac employs derivative contracts to achieve sound business purposes.

The examination found that involvement of the Board of Directors and senior management was active and effective. OFHEO determined that institutional policies were generally adequate but needed to be updated and expanded. OFHEO also recommended more comprehensive internal reporting.

OFHEO concluded that risk exposure on current positions was minimal, but recommended that exposure limits for counterparties be established, that efforts to develop in-house capacity to measure current credit exposure be continued, and that certain internal control procedures be strengthened.

At Freddie Mac, the responses to the examination recommendations fully satisfied OFHEO's standards for "best practices."

Examination of Corporate Governance

OFHEO conducted corporate governance examinations of Fannie Mae and Freddie Mac that concluded in March 1995. The objective of each was to assess the strength of corporate governance (i.e., to determine the capacity of the Boards and executive management to manage risk, to make sound business decisions, and to assure continuity of operations). Corporate governance specifically entails the review of oversight, planning, policies and procedures, management reporting, and audit

and risk assessment. The examinations were also designed to enhance OFHEO's institutional knowledge of the Enterprises and to establish priorities for future examinations.

Results and Conclusions

Examinations of Fannie Mae and Freddie Mac concluded that corporate governance at the Enterprises is sound.

Fannie Mae

In this first, broad-based examination of Fannie Mae, OFHEO gained insight into the evolution of management and corporate practices used in governing operations. Discussions and document reviews revealed that, in a general sense, the mid- and late 1980s focused on building technical competencies of a new management team following several years of net losses in the early 1980s. During this rebuilding period, new senior management was recruited with emphasis on technical knowledge and the ability to return Fannie Mae to profitability. The early 1990s have been a period of establishing breadth and depth of management capability at the highest level.

Fannie Mae focuses on fulfilling its public mission through six clearly defined corporate goals while simultaneously strengthening the management of risk. Corporate activity is organized along three primary business lines: Financial Guarantee, Portfolio Management, and Financial Information Services. The business lines are further divided into business segments.

The corporate culture reflects a highly organized and performance-driven institution, with emphasis on risk control, communication, and accountability. The performance of the corporation is a critical element in determining compensation of executive managers.

Overall, OFHEO's examiners found and concluded that corporate governance at Fannie Mae is sound. The Board and executive management have established an organizational framework and corporate structure sufficient to manage risk, to make sound business decisions, and to reasonably assure continuity of operations. Oversight by the Board and management helps the Enterprise pursue its goals and objectives while creating an environment for prudent risk management. Planning, monitoring, and communicating frequently enable senior management to make timely and informed decisions. Finally, the policy and procedural framework, in concert with reporting and auditing, helps support a goal-oriented corporate culture.

No safety and soundness concerns were identified during this examination. Nonetheless, OFHEO recommended that the Board review and strengthen the existing policy framework.

Freddie Mac

The passage of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 changed the corporate governance structure of Freddie Mac. Since 1989, Freddie Mac has been working to re-engineer its management structure to increase its role as a customer-focused business. Freddie Mac changed its organizational structure during 1993 from the traditional hierarchical structure to one that focuses on five business areas (Sellers, Servicers, Dealer Services, Multifamily, and Portfolio), and seven support divisions (Risk Management, Finance, Information Systems and Services, Legal, Corporate Relations, Human Resources, and Internal Audit).

Freddie Mac's Board and executive management have fostered the development of a control-oriented corporate culture with a documented philosophy that is predominantly concerned with minimizing risk. This is characterized by several factors: high priority status for internal audit and control systems, maintenance of comprehensive policies and procedures, implementation of a highly-structured management reporting and formalized communications process, design of an evaluation system based on well-defined performance objectives, and the Enterprise's record of meeting its strategic and operational plan objectives.

While no safety and soundness concerns were identified during this examination, OFHEO recommended that the Board and executive management complete the management succession plan. To assure continuity of operations, it is important that Freddie Mac identify and train a core group of individuals to succeed to senior levels of management should vacancies arise.

Capital Classification of Fannie Mae and Freddie Mac

Under the Act OFHEO must determine, not less than quarterly, the Enterprises' capital adequacy. Eventually, to be classified as "adequately capitalized," the Enterprises will have to hold sufficient capital to meet both a minimum and a risk-based standard. However, until one year after OFHEO issues a final risk-based capital rule, only the minimum capital standard is applicable. At every quarter end since the Office was established, beginning with June 30, 1993, OFHEO has determined minimum capital levels for both Enterprises and classified them as "adequately capitalized."

Minimum Capital

Minimum capital levels are designed to provide protection against broad categories of business risk. They are established on the basis of ratios outlined in the Act. The ratios are: 1) 2.50 percent of aggregate on-balance-sheet assets; 2) 0.45 percent of the unpaid principal balance of outstanding mortgage-backed securities (MBS) and substantially equivalent instruments; and 3) 0.45 percent of other off-balance-sheet obligations, except as adjusted by the Director to reflect the differences between the credit risk of these obligations and the credit risk of MBS.

To expedite the capital classification process, OFHEO initially adopted and has applied interim procedures for computing the Enterprises' minimum capital levels. The Director determined the need to adjust the statutory ratios in only one category of off-balance-sheet obligations — interest rate and foreign exchange rate contracts. OFHEO has computed the portion of the minimum capital level attributable to such contracts by applying the capital adequacy guidelines for federal depository institutions. In the fall of 1994, federal regulators adopted revisions to the guidelines that OFHEO incorporated in its interim procedures beginning with computations at year-end 1994.

In June 1995, OFHEO issued a proposed rule that, when finalized, will formalize how minimum capital requirements will be calculated in the future.

Risk-Based Capital

OFHEO's second capital adequacy standard is risk-based. This measure determines the amount of capital that an Enterprise must hold to survive a dramatic shift in interest rates accompanied by 10 years of adverse credit conditions.

OFHEO's risk-based capital levels will be based on a stress test now under development. In February 1995, OFHEO published an Advance Notice of Proposed Rulemaking (ANPR) soliciting public comment on a range of issues and approaches associated with creating the stress test.

In constructing the stress test, OFHEO is guided by parameters specified in the Act. OFHEO intends to establish effective risk-based capital standards that are consistent with prudent business practices and strategies.

The Act establishes broad outlines of a stress test involving adverse credit and interest rate conditions. The credit scenario is based on the highest rates of mortgage default and loss severity experienced over a two-or-more year period in an area containing at least 5 percent of the U.S. population. The test projects conditions consistent with this experience on the Enterprises' business nationally over 10 years. Adverse interest rates are defined as rate shifts, up or down, of as much as 600 basis points. OFHEO must determine which interest rate swing, when coupled with the stressful credit conditions, would require the highest amount of capital. This amount, plus an additional 30 percent to cover management and operations risk, constitutes the risk-based capital level required by the Act for each Enterprise.

OFHEO Regulations

Risk-Based Capital:
Advance Notice of Proposed Rulemaking (ANPR)

On Feb. 8, 1995, OFHEO issued an Advance Notice of Proposed Rulemaking (60 Fed. Reg. 7468) titled "Risk-Based Capital." This is the first step in an administrative process leading to a final rule establishing the mechanism for setting risk-based capital levels for Fannie Mae and Freddie Mac. OFHEO expects to complete work on a proposed rule on risk-based capital, providing a discussion of ANPR comments and a detailed description of an initial stress test prototype, in late 1995 or early 1996.

OFHEO solicited public comment through the ANPR during a 120-day period on a variety of technical and policy issues, and on a range of approaches, related to modelling credit and interest rate risk of the Enterprises.

Subjects covered in the ANPR include:

- Definition of a "credit stress benchmark"—the historical time period and region associated with the most severe mortgage credit conditions.

- Impact of borrower equity on mortgage defaults, losses, and prepayments.

- Interaction of mortgage defaults and prepayments and the analysis of other factors affecting defaults, losses, and prepayments.

- Using house price indexes to track borrower equity over time.

- Consideration of default and loss characteristics for a wide range of mortgage types, including the risks of multifamily mortgages.

- Effect of high inflation rates on mortgage losses.

- Treatment of third party credit exposures.

- Determination of interest rates not specifically prescribed in the Act.

- Management of liabilities and derivative contracts.

- Fulfillment of commitments by the Enterprises to purchase mortgages or issue new MBS.

- Management decisions about dividends and operating expenses during the stress test.

Minimum Capital:
Proposed Rule

On June 8, 1995, OFHEO issued a proposed rule titled "Minimum Capital" (60 Fed. Reg. 30201). This rule defines terms and sets the methodology for computing minimum capital levels for Fannie Mae and Freddie Mac. It explains that minimum capital levels are computed largely on the basis of statutorily established ratios applied to certain on-balance-sheet and off-balance-sheet items. The proposed rule establishes procedures for filing quarterly minimum capital reports by Fannie Mae and Freddie Mac. It also spells out how OFHEO determines the capital classifications of the Enterprises each quarter.

Freedom of Information:
Proposed Rule

On May 11, 1995, OFHEO issued a proposed rule (60 Fed. Reg. 25162) titled "Releasing Information." The proposed rule spells out the ground rules relating to public access to information generated and maintained by OFHEO. It also implements the Freedom of Information Act (FOIA) as it relates to OFHEO.

The proposed rule establishes procedures by which the public may inspect OFHEO records, request and obtain copies of materials, and appeal denials of such requests. The rule includes a fee schedule for processing documents requested under FOIA, as well as procedures for determining when fees should be reduced or waived.

The proposed rule implements Executive Order 12600 by providing pre-disclosure notification for confidential commercial or financial information. It sets forth procedures with respect to testimony concerning official matters and the production of official OFHEO documents in legal proceedings ir which OFHEO is a named party.

Establishment of Chapter; Organization and Function, and Seal: Final Rule

On Dec. 5, 1994, OFHEO issued a final rule (59 Fed. Reg. 62303) titled "Establishment of Chapter; Organization and Function, and Seal." This rule creates a new chapter in the Code of Federal Regulations for publication of OFHEO's rules, regulations, and policy statements. It adopts regulations describing the organization and mission of OFHEO, the duties and functions of the Director and Deputy Director, and the organization of OFHEO's various offices. It advises the public of OFHEO's location and business hours.

Executive Compensation

Authority

OFHEO's statute provides authority for the Director to prohibit Fannie Mae and Freddie Mac "from providing compensation to any executive officer of the enterprise that is not reasonable and comparable with compensation for employment in other similar businesses (including other publicly held financial institutions or major financial services companies) involving similar duties and responsibilities" (Sec. 1318(a)). The Act defines "executive officer" as "the chairman of the board of directors, chief executive officer, chief financial officer, president, vice chairman, any executive vice president, and any senior vice president in charge of a principal business unit, division, or function." (Sec. 1303(7)).

The Act also prohibits the Enterprises from entering into severance agreements or contracts for executive officers without advance approval of the OFHEO Director. Approval of such agreements or contracts and their associated benefits hinges on demonstrated comparability to agreements with executives in similar businesses.

OFHEO Activities

OFHEO has taken several steps associated with the Director's executive compensation responsibilities. The Office is reviewing compensation practices and policies of Fannie Mae and Freddie Mac and has begun gathering information on compensation practices and policies of businesses similar to the Enterprises.

The Director has approved three severance packages submitted by the Enterprises. Until OFHEO completes its review of executive compensation issues, approval of individual severance packages does not set precedent on particular issues.

OFHEO Research and Analysis

Background

OFHEO's research activities are critical to establishing risk-based capital standards and analyzing issues related to the operations of the Enterprises. During 1994 and early 1995, OFHEO assembled the infrastructure required for its research and analysis efforts and began work on a number of projects.

OFHEO's current work in this area falls into two principal categories — development of the risk-based capital stress test and development of a financial simulation model. Consistent with the intent of Congress, OFHEO has supplemented its staff with experts and contractors to expedite stress test and financial simulation model development.

OFHEO distinguishes between the stress test and the financial simulation model. The stress test establishes the nature of the economic conditions to which the Enterprises will be subject during a hypothetical 10-year stress period, the anticipated performance of their assets under stress, and the anticipated management response to those conditions. The financial simulation model is OFHEO's tool for simulating these conditions and their consequences. The stress test involves interpretation of the Act and other

judgments by OFHEO and is being developed pursuant to a public rulemaking process. The financial simulation model is a straightforward but simplified representation of the actual cashflow and accounting operations of the Enterprises. In addition to implementing the stress test, this model will be augmented over time to support a broad array of research and analytical tasks.

Stress Test Related Research

OFHEO made significant progress over the past year toward development of the risk-based capital stress test. As a foundation for its work, staff reviewed historical and current Enterprise data on assets, liabilities, and derivatives. The Office also developed the capability to access and jointly process data for both Enterprises. These efforts have benefited from ongoing dialogue with the Enterprises and a number of mortgage finance industry organizations, including credit rating agencies, private mortgage insurers, thrift institutions, mortgage bankers, and securities firms.

Credit Stress Benchmark

In developing the stress test, OFHEO is required to identify the region and time period associated with the highest default and loss severity rates, and then simulate these stressful conditions nationwide. OFHEO terms this time period and region the "credit stress benchmark." OFHEO's work on identifying this stress benchmark has focused on defaults, because that is where data is most complete. Using a combined proprietary dataset from both Enterprises, OFHEO has selected appropriate loans to be used in the benchmark analysis, developed computer programs to determine default rates, and produced reports and tables of the results reflecting various definitions of a credit stress benchmark. The Office is following the same approach using loss severity data.

Yield Curve Model

The Act requires that the simulated stressful credit conditions described above be combined with one of two interest rate scenarios that results in the highest capital requirement. In one scenario, the 10-year Treasury rate rises 75 percent or 600 basis points, whichever is less; in the other, the 10-year rate falls 50 percent or 600 basis points, whichever is less. Other market yields must be simulated relative to the 10-year rate in a manner reasonably related to historical experience.

To carry out this requirement, OFHEO has designed and completed work on a yield curve model to allow exploration of various approaches consistent with the Act. The model generates consistent spot and implied forward interest rates for any yield curve. It also replicates historical Treasury yield curves, simulates Treasury yield curves that relate to historical curves in a variety of ways, and permits the simulation of other security yields and rate indexes corresponding to these curves.

House Price Indexes and Simulation Models

Changes in home prices, and the corresponding changes in mortgage loan-to-value ratios, are important factors affecting mortgage defaults and loss severity. House price indexes are used to capture changes in borrower equity over time. These indexes may also be used to establish the relationship between home equity, defaults, losses, and prepayments.

The statute requires that OFHEO reflect these factors by establishing the current loan-to-value ratios of Enterprise mortgages outstanding at the start of the stress test. For this purpose, the Act specifies use of the Department of Commerce's Constant Quality Home Price Index (CQHPI), or any index of similar quality, authority, and public availability used by the federal government.

As an alternative to CQHPI, OFHEO plans to produce and publish weighted repeat sales (WRS) house price indexes that track changes in values for given properties based on multiple mortgage transactions involving either of the Enterprises. OFHEO intends to produce indexes for the nine Census Bureau divisions, and for as many states and Metropolitan Statistical Areas for which there are sufficient data to produce a statistically valid index.

Joint Models of Default and Prepayment

OFHEO has made significant progress on two approaches to estimating statistical models of default and prepayment for potential application in the stress test. One approach is based on a loan-level model for the conditional probability of default or prepayment over the life of a mortgage. Data on individual mortgage originations and historical val-

ues for house prices and interest rates are used to model statistical relationships between loan performance and changes in the key determinants of default and prepayment, such as borrower equity and interest rates. The second approach uses aggregate data to estimate the probability of default as a function of the number of loans with marginal or negative equity, and the probability of prepayment as a function of the number of loans with positive equity.

Loss Severity

Loss severity refers to the actual dollars lost on a defaulted loan; it allows credit risk to be quantified in dollar terms. Severity is the extent to which the costs associated with default, foreclosure, and disposition exceed the revenues associated with these processes.

Many factors influencing loss severity, such as loan-to-value ratios and interest rates, are similar to those affecting default. Other factors, such as state foreclosure laws and the time from foreclosure to property disposition, influence severity without significantly influencing default. OFHEO has focused on analyzing the historical severity experience in different regions to determine the factors that should be used to simulate loss severity in the stress test.

To gather data and evaluate alternatives, OFHEO reviewed foreclosure processes and loss mitigation efforts at Fannie Mae and Freddie Mac. The Enterprises have supplied proprietary data on the historical severity experience of their mortgages. If Enterprise data are detailed enough to support an analysis of the components of loss severity, OFHEO may be able to separately consider foreclosure costs, disposition costs, carrying costs, sales prices, and other revenues. Alternatively, OFHEO may generate an overall estimate of loss severity without specifying the individual contributions of these components.

Multifamily Credit Risk

The Act requires the stress test to reflect differing risk characteristics of various mortgage types. One dramatic distinction is between single-family and multifamily loans. Single-family houses serve as home, capital investment, and tax shelter for their occupants while multifamily buildings serve primarily as income-producing businesses. Multifamily loans are less homogenous and subject to more diverse risks than single-family mortgages.

In the past year, OFHEO has met with leaders in the multifamily mortgage finance industry, including the Enterprises, credit rating agencies, seller/servicers for the Enterprises, mortgage bankers, the Federal Housing Administration, investment advisors, academicians, and trade groups. The Office has obtained access to, and initiated analysis of, the Enterprises' multifamily databases. OFHEO has also gathered data on the multifamily mortgage market from HUD.

Commitments

In developing the stress test, the Act directs OFHEO to assume that the Enterprises fulfill all outstanding commitments to purchase mortgages or to issue securities. OFHEO must determine how to translate these commitment contracts into portfolio assets and associated funding, and into MBS, so that their credit and interest rate risk may be factored into the stress test.

OFHEO has extensively reviewed commitment and mortgage delivery processes with the Enterprises. The Office has obtained proprietary data on different categories of commitments held by the Enterprises, historical rates of mortgage delivery against these commitments, and the time distribution of mortgage delivery. Using these data, OFHEO is developing algorithms for generating the appropriate mix and time pattern of new, delivered mortgages from the commitments outstanding at the start of the stress test.

Development of Financial Simulation Model

The financial simulation model is a series of interlocking computer programs and models that will simulate in great detail the Enterprises' businesses over time. It is one of OFHEO's principal financial analysis and research tools. Its first application will be to simulate the performance of the Enterprises under the conditions of the stress test. Later it will be expanded to consider other scenarios relevant to evaluating the financial safety and soundness of the Enterprises.

A conceptual design of the financial simulation model, as well as its process and information flows, is complete. The design is based on a modular structure that stores intermediate results that can subsequently be fed into later stages of the model.

This approach has certain advantages. Various model stages and modules can be enhanced and improved without having to break apart the entire model. Because intermediate results are stored, relationships between the variables can be analyzed independently.

Cashflow Generators

OFHEO is developing the capacity to calculate cashflows for a variety of mortgage types, MBS, other fixed-income securities, and derivative contracts. Thus, OFHEO will be able to model varying rates of mortgage prepayments and defaults and simulate the effect of varying interest rates on all financial instruments.

Fixed Income and Derivative Analytics

OFHEO is developing the capacity to model and conduct detailed analysis of the Enterprises' more complex fixed-income securities, including REMICs and derivative contracts. This capacity includes the ability to reverse engineer complex financial structures to generate their cashflows. OFHEO will be able to model new instruments as they are introduced.

Accounting Software

OFHEO is developing a chart of accounts for the financial simulation model that will serve as the basis for translating asset and liability cashflows into accounting events. OFHEO is using this chart of accounts to develop accounting software to calculate changes in the capital of the Enterprises during the stress period. The Office is working with the Enterprises to understand the internal processes for reconciling financial data contained in their core data systems with financial statements prepared according to Generally Accepted Accounting Principles (GAAP). The ability to replicate these processes is essential to ensure the integrity of the stress test.

Flood Insurance and Fair Lending Task Forces

OFHEO is a member of two government task forces — the Flood Insurance Interagency Task Force and the Interagency Task Force on Fair Lending. These task forces were conceived to formulate policy and monitor activity in flood insurance and fair lending, two areas that impact the operations of Fannie Mae and Freddie Mac.

The 10-member **Flood Insurance Interagency Task Force** was created by the National Flood Insurance Reform Act of 1994. The act is aimed at preventing lenders from making loans on properties located in Special Flood Hazard Areas unless buildings on those proprieties have flood insurance coverage. The law is an outgrowth of losses sustained during both Hurricane Andrew of 1992 and the 1993 Mississippi River floods.

The task force has a two-year life, ending in March 1997. Its duties include: recommending standard flood insurance enforcement procedures to Fannie Mae and Freddie Mac and to concerned federal agencies, reporting to Congress on how federal agencies and the secondary mortgage market can aid compliance with the law, reporting to Congress on possible model flood insurance compliance programs, recommending enforcement and compliance procedures, and studying the structure of fees charged by lenders to determine if properties are located in flood areas. OFHEO's primary task force responsibility is ensuring that the Enterprises are in compliance with provisions of the Flood Disaster Protection Act of 1973.

The **Interagency Task Force on Fair Lending** was created to establish uniform policy against discriminatory lending. Its members, in addition to OFHEO, include HUD, the Department of Justice, the Federal Housing Finance Board, the Federal Trade Commission, and regulators of the bank, thrift, and credit union industries. OFHEO has enforcement authority concerning fair lending violations by the Enterprises.

On April 15, 1994, the task force published a "Policy Statement on Discrimination in Lending" (59 Fed. Reg. 18266). The statement describes the guidelines

used to identify violations of federal credit and housing law. Based on public comments to this policy statement, OFHEO is helping clarify policy issues and is assisting in drafting question-and-answer responses for future publication.

Developing a New Federal Regulatory Office

In less than two years of existence, OFHEO has made great strides toward becoming a fully operational regulator. The Office has completed eight quarterly capital classifications that determined Fannie Mae and Freddie Mac to be adequately capitalized at the end of the relevant quarter. OFHEO has also made substantial progress in developing the stress test that will serve as the basis for the risk-based capital requirements described in this report.

In building and operating a new federal agency, OFHEO is committed to principles of "reinventing government," that is, finding ways to make government more efficient and more effective. In OFHEO's examination efforts, for example, this translates into devising a process and procedures to examine two large, sophisticated financial entities that have never been examined before using small teams of examiners. OFHEO's "top-down" strategy begins by evaluating senior management practices and business plans, moves to a statistical sampling and analysis of the system, and undertakes a more focused review only if concerns arise.

In administration, the reinvention approach has resulted in OFHEO exploring a variety of cost-effective solutions. In the area of personnel systems and financial and accounting management, OFHEO is weighing the options of continuing its administrative relationship with HUD, contracting these functions to another federal agency in a "cross-servicing" arrangement, or creating and maintaining an in-house system.

In the past year, OFHEO developed and implemented an employee evaluation system, PEMS (Performance Evaluation Management System). PEMS allows OFHEO to tie individual performance with agency goals, encourage feedback to employees throughout the year, reward high-quality performance, and foster professional development. After orientation and training, OFHEO began its first PEMS cycle on April 15, 1995.

GAO Recognizes Significant Accomplishments

In May 1995, the U.S. General Accounting Office (GAO) concluded its first audit of OFHEO operations. The review, titled "Government-Sponsored Enterprises: Development of the Federal Housing Enterprise Financial Regulator," covered a 21-month period, from June 1, 1993, when the Director was sworn in and OFHEO was formally established, through February 1995.

The GAO report concluded: "During its first 18 months, OFHEO has accomplished a great deal. The Director has filled all senior management staff and most key professional, technical, and analytic staff positions. OFHEO's human resource, accounting, and financial systems are approaching full implementation. OFHEO has established its central mission-related functions — examinations and capital adequacy — and met most of the act's requirements in these areas. Where OFHEO was unable to meet legislated deadlines, we believe it has taken reasonable steps to address its shortcomings."

In the examinations area, GAO reported that OFHEO has built the framework for its examinations function and established a two-year examination work plan. GAO acknowledged progress in developing a risk-based capital test, including design of the financial simulation model that serves as the platform for the test. OFHEO has hired most of the essential staff in the risk-based capital area; completed the design, purchase, and installation of computer hardware and software; and begun developing computer programs and databases.

GAO noted that OFHEO had not completed the final regulations for the risk-based test by Dec. 1, 1994, as specified in the Act. "Otherwise, OFHEO has generally met its legislated reporting requirements," GAO said. "Perhaps most importantly, it made the required quar-

terly reports of the enterprises' capital classifications." OFHEO has made quarterly capital classifications of Fannie Mae and Freddie Mac for the eight quarters ending March 31, 1995.

In the accounting and administrative area, GAO noted that OFHEO has used HUD's accounting and financial systems, and some personnel services, since the Office's inception. Though this relationship has not been problem-free, it has improved over time as HUD developed an understanding of OFHEO's statutorily independent status. GAO noted that OFHEO is using its independent contracting authority in the administrative area and is exploring "cross-servicing" arrangements with other agencies to provide administrative and financial management services.

OFHEO Funded By the Enterprises

OFHEO is financed entirely by Fannie Mae and Freddie Mac; the Office represents no direct cost to the taxpayer. Operating revenues are appropriated by Congress, but the actual funds come from annual assessments of the Enterprises, collected semi-annually and prorated in proportion to their total assets and mortgage-backed securities. OFHEO is recommending a legislative change in the timing of the assessments to better coordinate with the appropriations process. The practice of regulated financial institutions underwriting their regulator's budget is an established one, but OFHEO is one of only a few such agencies whose budget is determined through the congressional appropriations process.

FY 1995 Resources Support Developmental and Regulatory Efforts

OFHEO's FY 1995 budget is $15.5 million. This figure supports the development of the risk-based capital stress test, an examinations program that includes a comprehensive corporate examination, rulemaking activities, and strengthening of Office infrastructure. It also supports a staff increase to 65 full-time equivalent employees (FTEs) by the end of the fiscal year.

Creating a Diverse Workforce

OFHEO's recruiting and hiring policy reflects a commitment to professional excellence, integrity, and diversity. On May 1, 1995, 58 percent of OFHEO's permanent staff were women or minorities. Fifty-six percent of senior management staff were women or minorities.

Fewer Financial Resources Needed in FY 1996

OFHEO's budget request for FY 1996 is $14.9 million, a 4 percent decrease from the enacted budget of a year earlier. The lower figure reflects the funding requirements of an office that has evolved from startup to a fully operating state. There are four additional FTEs in FY 96, but fewer developmental projects. The FY 96 budget provides for specialized support for continued analysis of the evolving mortgage marketplace and development of the stress test. It also allows OFHEO to increase its examination staff to a level sufficient to achieve the knowledge and understanding of the Enterprises required to carry out OFHEO's comprehensive safety and soundness examination program.

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Fannie Mae
Financial Data
Table 1

($ in millions)	Balance Sheet/MBS				
	Total Assets	Retained Mortgage Portfolio Outstanding /1	Debt Outstanding	Total MBS Outstanding 2/	Multi-class MBS Outstanding 3/
1Q95	274,717	222,768	258,653	486,921	373,705
4Q94	272,508	220,815	257,230	486,345	378,733
3Q94	254,805	214,283	239,320	485,463	381,853
2Q94	243,173	207,287	227,897	482,052	386,868
1Q94	231,908	197,085	216,430	481,949	388,140
Annual Data					
1994	272,508	220,815	257,230	486,345	378,733
1993	216,979	190,169	201,112	471,306	381,865
1992	180,978	156,260	166,300	424,444	312,369
1991	147,072	126,679	133,937	355,284	224,806
1990	133,113	114,066	123,403	288,075	127,278
1989	124,315	107,981	116,064	216,512	64,826
1988	112,258	100,099	105,459	170,097	26,660
1987	103,459	93,665	97,057	135,734	11,359
1986	99,621	94,123	93,563	95,568	0
1985	99,076	94,609	93,985	54,582	0
1984	87,798	84,135	83,719	35,738	0
1983	78,383	75,247	74,594	25,121	0
1982	72,981	69,356	69,614	14,450	0
1981	61,578	59,629	58,551	717	0
1980	57,879	55,589	54,880	0	0
1979*	51,300	49,777	48,424	0	0
1978*	43,506	42,103	40,985	0	0
1977*	33,980	33,252	31,890	0	0
1976*	32,393	31,775	30,565	0	0
1975*	31,596	30,820	29,963	0	0
1974*	26,671	28,666	28,168	0	0
1973*	24,318	23,589	23,003	0	0
1972*	20,346	19,652	19,239	0	0
1971*	18,591	17,886	17,672	0	0

Source: Fannie Mae
*Note: Figures are not restated for 12/87 FAS 91 change.
1/Gross Retained Portfolio net of unamortized purchases, premiums, discounts, and fees.
2/Excludes MBS held in Portfolio.
3/Includes Multi-class MBS held in Portfolio.

Fannie Mae
Financial Data
Table 2

($ in millions)	Capital			Earnings			
	Stockholders' Equity	Equity / (Assets + MBS) (%)	(Equity + Loss Reserves) / (Assets + MBS) (%)	Net Income	Net Interest Margin (%)	Average Guarantee Fee Rate (%)	Return on Average Equity (%)
1Q95	9,906	1.30	1.41	555	1.15	0.220	22.9
4Q94	9,541	1.26	1.37	553	1.17	0.222	23.7
3Q94	9,186	1.24	1.35	543	1.25	0.225	24.2
2Q94	8,827	1.22	1.33	526	1.29	0.226	24.4
1Q94	8,477	1.19	1.30	511	1.26	0.226	24.8
Annual Data							
1994	9,541	1.26	1.37	2,132	1.24	0.225	24.3
1993	8,052	1.17	1.29	1,873	1.38	0.213	25.3
1992	6,774	1.12	1.25	1,623	1.37	0.212	26.5
1991	5,547	1.10	1.24	1,363	1.42	0.210	27.7
1990	3,941	0.94	1.06	1,173	1.39	0.211	33.7
1989	2,991	0.88	1.01	807	1.16	0.213	31.1
1988	2,260	0.80	0.94	507	0.89	0.216	25.2
1987	1,811	0.76	0.90	376	1.00	0.224	23.5
1986	1,182	0.61	0.74	105	0.40	0.238	9.5
1985	1,009	0.66	0.76	(7)	0.15	0.256	(0.7)
1984	918	0.74	0.85	(71)	(0.11)	0.262	(7.4)
1983	1,000	0.97	1.10	49	(0.01)	0.263	5.1
1982	953	1.09	1.25	(192)	(0.72)	0.272	(18.9)
1981	1,080	1.73	1.90	(206)	(0.74)	0.250	(17.2)
1980*	1,457	2.49	2.73	14	0.04	Not Applicable Before 1981	0.9
1979*	1,501	2.93	3.17	162	0.70		11.3
1978*	1,362	3.13	3.36	209	0.98		16.5
1977*	1,173	3.45	3.66	165	0.95		15.3
1976*	983	3.03	3.19	127	0.82		13.8
1975*	861	2.73	2.84	115	0.73		14.1
1974*	772	2.60	2.69	107	0.70		14.7
1973*	680	2.80	2.87	126	0.98		20.3
1972*	559	2.75	2.78	96	0.84		18.8
1971*	460	2.47	2.49	61	0.40		14.4

*Note: Figures are not restated for 12/87 FAS 91 change.

Fannie Mae
Financial Data
Table 3

($ in millions)	Mortgage Asset Quality				Business Activity: Purchases		
	Single-Family Delinquency Rate (%)	Multifamily Delinquency Rate (%)	Charge-Offs / (Portfolio + MBS) (%)	REO / (Portfolio + MBS) (%)	Single-Family Purchases	Multifamily Purchases	Total Purchases
1Q95	0.57	1.20	0.05	0.09	19,147	269	19,416
4Q94	0.57	1.21	0.05	0.09	30,552	984	31,536
3Q94	0.56	1.21	0.05	0.10	36,832	776	37,608
2Q94	0.57	1.77	0.06	0.09	50,977	919	51,896
1Q94	0.56	2.57	0.06	0.10	70,810	1,161	71,971
Annual Data							
1994	0.57	1.21	0.06	0.10	189,171	3,840	193,011
1993	0.56	2.34	0.04	0.10	309,346	4,135	313,481
1992	0.63	2.65	0.04	0.09	266,986	2,956	269,942
1991	0.64	3.62	0.04	0.07	146,901	3,204	150,105
1990	0.58	1.70	0.06	0.09	117,473	3,181	120,654
1989	0.69	3.20	0.07	0.14	87,446	4,836	92,282
1988	0.88	6.60	0.11	0.15	73,808	4,180	77,988
1987	1.12	Not Available Before 1988	0.11	0.18	82,277	1,483	83,760
1986#	1.38		0.12	0.22	89,515	1,877	91,392
1985#	1.48		0.13	0.32	43,959	1,200	45,159
1984#	1.65		0.09	0.33	29,161	1,106	30,267
1983#	1.49		0.05	0.35	30,757	140	30,897
1982#	1.41		0.01	0.20	29,077	9	29,086
1981#	0.96		0.01	0.13	6,828	2	6,830
1980#	0.90		0.01	0.09	8,074	27	8,101
1979*	0.56		0.02	0.11	10,798	9	10,807
1978*	0.55		0.02	0.18	12,302	3	12,305
1977*	0.46		0.02	0.26	4,650	134	4,784
1976*	1.58		0.03	0.27	3,337	295	3,632
1975*	0.56		0.03	0.51	3,646	674	4,320
1974*	0.51		0.02	0.52	4,746	2,273	7,019
1973*	Not Available Before 1974		0.00	0.61	4,170	2,082	6,252
1972*			0.02	0.98	2,596	1,268	3,864
1971*			0.01	0.59	2,742	1,298	4,040

*Note: Asset Quality figures are not restated for 12/87 FAS 91 change.
Note: Charge-off ratio has not been restated for change in Loss Accounting methodology.

($ in millions)	Business Activity: MBS			
	Single-Family MBS Issued	Multifamily MBS Issued	Total MBS Issued	Multi-class MBS Issued
1Q95	12,885	185	13,070	1,253
4Q94	18,763	822	19,585	5,573
3Q94	24,252	385	24,637	6,615
2Q94	33,083	512	33,595	19,986
1Q94	52,287	518	52,805	41,191
Annual Data				
1994	128,385	2,237	130,622	73,365
1993	220,485	959	221,444	210,630
1992	193,187	850	194,037	170,205
1991	111,488	1,415	112,903	112,808
1990	96,006	689	96,695	68,291
1989	66,489	3,275	69,764	41,715
1988	51,120	3,758	54,878	16,755
1987	62,067	1,162	63,229	9,917
1986	60,017	549	60,566	2,400
1985	23,142	507	23,649	0
1984	13,087	459	13,546	0
1983	13,214	126	13,340	0
1982	13,970	0	13,970	0
1981	717	0	717	0
1980	0	0	0	0

Freddie Mac
Financial Data
Table 5

($ in millions)	Balance Sheet / MBS				
	Total Assets	Retained Mortgage Portfolio Outstanding 1/	Debt Outstanding 2/	Total MBS Outstanding	Multi-class MBS Outstanding
1Q95	113,625	77,615	100,439	458,753	260,461
4Q94	106,199	72,585	92,053	460,656	263,662
3Q94	97,707	66,541	82,484	463,672	266,524
2Q94	89,696	62,439	71,893	465,330	269,825
1Q94	85,286	58,914	61,476	457,577	267,450
Annual Data					
1994	106,199	72,585	92,053	460,656	263,662
1993	83,880	55,938	48,510	439,029	264,122
1992	59,502	33,629	28,173	407,514	217,030
1991	46,860	26,667	28,300	359,163	142,960
1990	40,579	21,520	28,375	316,359	83,437
1989	35,462	21,448	24,102	272,870	47,573
1988	34,352	16,918	24,846	226,406	10,877
1987	25,674	12,354	17,461	212,635	0
1986	23,229	13,093	13,378	169,186	0
1985	16,299	13,547	11,754	99,908	0
1984	13,175	10,018	10,186	70,025	0
1983	8,954	7,485	6,782	57,720	0
1982	6,029	4,679	4,521	42,952	0
1981	6,326	5,178	5,480	19,897	0
1980	5,478	5,006	4,686	16,962	0
1979	4,648	4,003	3,981	15,316	0
1978	3,697	3,038	3,066	12,017	0
1977	3,501	3,204	3,110	6,765	0
1976	4,832	4,175	3,351	2,765	0
1975	5,899	4,878	4,050	1,643	0
1974	4,901	4,469	3,989	780	0
1973	2,873	2,521	2,696	791	0
1972	1,778	1,726	1,639	444	0
1971	1,038	935	915	64	0

Source: Freddie Mac
1/Gross Retained Portfolio net of unamortized Purchase Premiums, Discounts and Fees. 1Q95 includes adoption of SFAS 114. Prior periods not restated.
2/ Does not include subordinated borrowing.

Freddie Mac Financial Data Table 6

($ in millions)	Capital			Earnings			
	Stockholders' Equity	Equity / (Assets + MBS) (%)	(Equity + Loss Reserves) / (Assets + MBS) (%)	Net Income	Net Interest Margin (%) 1/ 2/	Average Guarantee Fee Rate (%) 2/	Return on Average Common Equity (%)
1Q95	5,351	0.93	1.06	258	1.19	0.240	21.9
4Q94	5,162	0.91	1.04	252	1.16	0.241	22.2
3Q94	4,979	0.89	1.02	249	1.23	0.243	23.0
2Q94	4,805	0.87	1.00	249	1.24	0.239	24.1
1Q94	4,606	0.85	0.99	233	1.20	0.242	23.6
Annual Data							
1994	5,162	0.91	1.04	983	1.21	0.241	23.2
1993	4,437	0.85	0.99	786	1.01	0.238	22.2
1992	3,570	0.76	0.93	622	1.17	0.241	21.2
1991	2,566	0.63	0.81	555	1.66	0.237	23.6
1990	2,136	0.60	0.77	414	1.76	0.224	20.5
1989	1,916	0.62	0.77	437	1.62	0.234	25.0
1988	1,584	0.61	0.76	381	1.95	0.215	27.6
1987	1,182	0.50	0.64	301	1.50	0.242	28.2
1986	953	0.50	0.64	247	1.66	0.224	28.5
1985	779	0.67	0.86	208	2.31	0.221	30.0
1984	606	0.73	0.95	144	2.08	0.247	52.0
1983	421	0.63	0.85	160	1.83	0.262	44.5
1982	296	0.60	0.84	60	0.53	0.245	21.9
1981	250	0.95	1.30	31	0.63	0.195	13.1
1980	221	0.98	1.31	34	1.17	0.143	14.7
1979	238	1.19	1.49	36	1.45	0.132	16.2
1978	202	1.29	1.56	25	1.11	0.149	13.4
1977	177	1.72	2.02	21	0.77	0.189	12.4
1976	156	2.05	2.34	14	0.34	0.136	9.5
1975	142	1.88	2.24	16	0.58	0.248	11.6
1974	126	2.22	2.52	5	1.09	0.255	4.0
1973	121	3.30	3.71	12	1.35	0.324	9.9
1972	110	4.95	5.18	4	Not Available Before 1973	0.394	3.5
1971	107	9.71	Not available	6		Not Available	5.5

1/ 1993 and 1992 are pro forma to reflect the change in the reporting of uncollectable interest on single-family mortgages implemented in 1994.
2/ Average balances used in pre-1987 calculations are based on the simple average of the year-end balance of the reported period and the prior year-end balances. 1987-1994 calculations use daily average balances.

Freddie Mac
Financial Data
Table 7

($ in millions)	Mortgage Asset Quality				Business Activity: Purchases		
	Single-Family Delinquency Rate (%) 1/	Multifamily Delinquency Rate (%) 2/	Charge-Offs / (Portfolio + MBS) (%)	REO / (Portfolio + MBS) (%) 3/	Single-Family Purchases	Multifamily Purchases	Total Purchases
1Q95	0.57	4.98	0.05	0.18	13,199	201	13,400
4Q94	0.57	3.33	0.05	0.20	15,902	361	16,263
3Q94	0.57	4.06	0.05	0.21	18,282	172	18,454
2Q94	0.61	3.94	0.04	0.19	33,402	157	33,559
1Q94	0.61	4.68	0.04	0.20	55,813	157	55,970
Annual Data							
1994	0.57	3.33	0.05	0.20	123,399	847	124,246
1993	0.61	3.45	0.05	0.20	229,515	191	229,706
1992	0.64	4.45	0.06	0.17	191,099	27	191,126
1991	0.61	3.40	0.08	0.14	99,729	236	99,965
1990	0.45	2.63	0.08	0.12	74,180	1,338	75,518
1989	0.38	2.53	0.06	0.09	76,765	1,824	78,589
1988	0.36	2.24	0.06	0.09	42,884	1,191	44,075
1987	0.36	1.49	0.06	0.08	74,824	2,016	76,840
1986	0.42	1.07	0.04	0.07	99,936	3,538	103,474
1985	0.42	0.63	0.04	0.10	42,110	1,902	44,012
1984	0.46	0.42	0.02	0.15	Not Available Before 1985	Not Available Before 1985	21,885
1983	0.47	0.58	0.02	0.13			22,952
1982	0.54	1.04	0.01	0.12			23,671
1981	0.61	Not Available Before 1982	0.00	0.07			3,744
1980	0.44		0.04	0.04			3,690
1979	0.31		0.02	0.02			5,716
1978	0.21		0.00	0.02			6,524
1977	Not Available Before 1978		0.00	0.03			4,124
1976			0.03	0.04			1,129
1975			0.05	0.03			1,716
1974			0.70	0.02			2,185
1973			0.36	0.00			1,334
1972			Not Available Before 1973	Not Available Before 1973			1,265
1971							778

1/ Pre-1982 delinquencies apply to the retained and sold mortgage portfolio.
2/ 1988-1994 Multifamily delinquencies based on Unpaid Principal Balance. 1982-1987 Multifamily delinquencies based on loans delinquent 60 days or more.
3/ 1Q95 includes adoption of SFAS 114. Prior periods not restated.

($ in millions)	**Business Activity: MBS**			
	Single-Family MBS Issued	Multifamily MBS Issued	Total MBS Issued	Multi-class MBS Issued
1Q95	11,185	29	11,214	2,956
4Q94	14,600	173	14,773	3,658
3Q94	17,379	0	17,379	6,174
2Q94	32,464	36	32,500	21,773
1Q94	52,458	0	52,458	41,526
	Annual Data			
1994	116,901	209	117,110	73,131
1993	208,724	0	208,724	143,336
1992	179,202	5	179,207	131,284
1991	92,479	0	92,479	72,032
1990	71,998	1,817	73,815	40,479
1989	72,931	587	73,518	39,754
1988	39,490	287	39,777	12,985
1987	72,866	2,152	75,018	0
1986	96,798	3,400	100,198	0
1985	37,583	1,245	38,828	0
1984	Not Available Before 1986	Not Available Before 1986	18,684	0
1983			19,691	0
1982			24,169	0
1981			3,529	0
1980			2,526	0
1979			4,546	0
1978			6,412	0
1977			4,657	0
1976			1,360	0
1975			950	0
1974			46	0
1973			323	0
1972			494	0
1971			65	0

Aggregate Enterprise
Financial Data
Table 9

($ in millions)	Balance Sheet / MBS				
	Total Assets	Retained Mortgage Portfolio Outstanding	Debt Outstanding	Total MBS Outstanding	Multi-class MBS Outstanding
1Q95	388,342	300,383	359,092	945,674	634,166
4Q94	378,707	293,400	349,283	947,001	642,395
3Q94	352,512	280,824	321,804	949,135	648,377
2Q94	332,869	269,726	299,790	947,382	656,693
1Q94	317,194	255,999	277,906	939,526	655,590
Annual Data					
1994	378,707	293,400	349,283	947,001	642,395
1993	300,859	246,107	249,622	910,335	645,987
1992	240,480	189,889	194,473	831,958	529,399
1991	193,932	153,346	162,237	714,447	367,766
1990	173,692	135,586	151,778	604,434	210,715
1989	159,777	129,429	140,166	489,382	112,399
1988	146,610	117,017	130,305	396,503	37,537
1987	129,133	106,019	114,518	348,369	11,359
1986	122,850	107,216	106,941	264,754	0
1985	115,375	108,156	105,739	154,490	0
1984	100,973	94,153	93,905	105,763	0
1983	87,337	82,732	81,376	82,841	0
1982	79,010	74,035	74,135	57,402	0
1981	67,904	64,807	64,031	20,614	0
1980	63,357	60,595	59,566	16,962	0
1979	55,948	53,780	52,405	15,316	0
1978	47,203	45,141	44,051	12,017	0
1977	37,481	36,456	35,000	6,765	0
1976	37,225	35,950	33,916	2,765	0
1975	37,495	35,698	34,013	1,643	0
1974	31,572	33,135	32,157	780	0
1973	27,191	26,110	25,699	791	0
1972	22,124	21,378	20,878	444	0
1971	19,629	18,821	18,587	64	0

Aggregate Enterprise
Financial Data
Table 10

($ in millions)	Business Activity: MBS			Earnings
	Stockholders' Equity	Equity / (Assets + MBS) (%)	(Equity + Loss Reserves) / (Assets + MBS) (%)	Net Income
1Q95	15,257	1.14	1.26	813
4Q94	14,703	1.11	1.23	805
3Q94	14,165	1.09	1.21	792
2Q94	13,632	1.06	1.19	775
1Q94	13,083	1.04	1.17	744
Annual Data				
1994	14,703	1.11	1.23	3,115
1993	12,489	1.03	1.16	2,659
1992	10,344	0.96	1.11	2,245
1991	8,113	0.89	1.05	1,918
1990	6,077	0.78	0.93	1,587
1989	4,907	0.76	0.90	1,244
1988	3,844	0.71	0.85	888
1987	2,993	0.63	0.77	677
1986	2,135	0.55	0.69	352
1985	1,788	0.66	0.80	201
1984	1,524	0.74	0.89	73
1983	1,421	0.84	1.00	209
1982	1,249	0.92	1.10	(132)
1981	1,330	1.50	1.72	(175)
1980	1,678	2.09	2.33	48
1979	1,739	2.44	2.70	198
1978	1,564	2.64	2.88	234
1977	1,350	3.05	3.28	186
1976	1,139	2.85	3.03	141
1975	1,003	2.56	2.72	131
1974	898	2.78	2.66	112
1973	801	2.86	2.98	138
1972	669	2.96	3.02	100
1971	567	2.88	Not Available	67

($ in millions)	Business Activity: Purchases			Business Activity: MBS			
	Single-Family Purchases	Multifamily Purchases	Total Purchases	Single-Family MBS Issued	Multifamily MBS Issued	Total MBS Issued	Multi-class MBS Issued
1Q95	32,346	470	32,816	24,070	214	24,284	4,209
4Q94	46,454	1,345	47,799	33,363	995	34,358	9,231
3Q94	55,114	948	56,062	41,631	385	42,016	12,789
2Q94	84,379	1,076	85,455	65,547	548	66,095	41,759
1Q94	126,623	1,318	127,941	104,745	518	105,263	82,717
Annual Data							
1994	312,570	4,687	317,257	245,286	2,446	247,732	146,496
1993	538,861	4,326	543,187	429,209	959	430,168	353,966
1992	458,085	2,983	461,068	372,389	855	373,244	301,489
1991	246,630	3,440	250,070	203,967	1,415	205,382	184,840
1990	191,653	4,519	196,172	168,004	2,506	170,510	108,770
1989	164,211	6,660	170,871	139,420	3,862	143,282	81,469
1988	116,692	5,371	122,063	90,610	4,045	94,655	29,740
1987	157,101	3,499	160,600	134,933	3,314	138,247	9,917
1986	189,451	5,415	194,866	156,815	3,949	160,764	2,400
1985	86,069	3,102	89,171	60,725	1,752	62,477	0
1984	29,161	1,106	52,152	13,087	459	32,230	0
1983	30,757	140	53,849	13,214	126	33,031	0
1982	29,077	9	52,757	13,970	0	38,139	0
1981	6,828	2	10,574	717	0	4,246	0
1980	8,074	27	11,791	0	0	2,526	0
1979	10,798	9	16,523	0	0	4,546	0
1978	12,302	3	18,829	0	0	6,412	0
1977	4,650	134	8,908	0	0	4,657	0
1976	3,337	295	4,761	0	0	1,360	0
1975	3,646	674	6,036	0	0	950	0
1974	4,746	2,273	9,204	0	0	46	0
1973	4,170	2,082	7,586	0	0	323	0
1972	2,596	1,268	5,129	0	0	494	0
1971	2,742			0	0	65	0

Mortgage Interest Rates

	Average Commitment Rates on Loans		Effective Rates on Closed Loans	
	Conventional		*Conventional*	
	30-Yr Fixed Rate (%)	One-Year ARMs(%)	Fixed Rate (%)	Adjustable Rate (%)
1Q95	8.8	6.7	9.1	7.2
4Q94	9.1	6.2	8.9	6.8
3Q94	8.6	5.5	8.6	6.6
2Q94	8.4	5.3	8.2	6.1
1Q94	7.3	4.3	7.3	5.5
Annual Data				
1994	8.4	5.3	8.2	6.4
1993	7.3	4.6	7.5	5.7
1992	8.4	5.6	8.5	6.6
1991	9.3	7.1	9.7	8.3
1990	10.1	8.4	10.4	9.2
1989	10.3	8.8	10.5	9.4
1988	10.3	7.9	10.4	8.5
1987	10.2	7.8	9.9	8.5
1986	10.2	8.4	10.5	9.4
1985	12.4	10.0	12.4	10.9
1984	13.9	11.5	13.2	12.1
1983	13.2	Not Available Before1984	13.0	12.3
1982	16.1		15.2	15.4
1981	16.6		Not Available Before1982	Not Applicable Before1982
1980	13.8			
1979	11.2			
1978	9.6			
1977	8.8			
1976	8.9			
1975	9.0			
1974	9.2			
1973	8.0			
1972	7.4			

Average Commitment Rate Source: Freddie Mac
Effective Rates Source: Federal Housing Finance Board

Housing Market Activity

(Quarterly Data at Annual Rates)

	Housing Starts (Units in Thousands)			Home Sales (Units in Thousands)	
	Single-Family Housing Starts	Multifamily Housing Starts	Total Housing Starts	New Single-Family Home Sales	Existing Single-Family Home Sales
1Q95	1,068	238	1,305	592	3,550
4Q94	1,238	265	1,503	662	3,873
3Q94	1,247	223	1,470	665	3,930
2Q94	1,220	220	1,440	664	4,063
1Q94	1,202	171	1,373	687	4,053
Annual Data					
1994	1,231	222	1,453	670	3,967
1993	1,155	133	1,288	666	3,802
1992	1,061	139	1,200	610	3,520
1991	876	138	1,014	509	3,220
1990	932	260	1,193	534	3,211
1989	1,059	318	1,376	650	3,346
1988	1,140	348	1,488	676	3,594
1987	1,212	409	1,621	671	3,526
1986	1,263	542	1,805	750	3,565
1985	1,166	576	1,742	688	3,214
1984	1,206	544	1,750	639	2,868
1983	1,181	522	1,703	623	2,719
1982	743	320	1,062	412	1,990
1981	796	288	1,084	436	2,419
1980	962	331	1,292	545	2,973
1979	1,316	429	1,745	709	3,827
1978	1,558	462	2,020	817	3,986
1977	1,573	414	1,987	819	3,650
1976	1,248	289	1,538	646	3,064
1975	956	204	1,160	549	2,476
1974	956	382	1,338	519	2,272
1973	1,250	795	2,045	634	2,334
1972	1,451	906	2,357	718	2,252
1971	1,271	781	2,052	656	2,018

Components may not add to totals due to rounding.
Housing Starts Source: Bureau of the Census, Department of Commerce

Weighted Repeat Sales House Price Index

1987=100 Yearly Index	USA	New England	Mid-Atlantic	South Atlantic	East North Central	West North Central	East South Central	West South Central	Mountain	Pacific
Quarterly Data (Percentage Change at Annual Rate)										
1Q95	0.6	(4.8)	0.0	2.4	1.6	2.1	(1.5)	0.7	10.8	(1.6)
4Q94	0.9	(1.2)	(5.2)	1.8	2.1	5.0	4.0	1.5	4.9	(3.6)
3Q94	3.7	(2.7)	(0.3)	2.7	9.4	7.0	7.0	3.0	9.5	(3.3)
2Q94	5.3	(2.3)	0.3	0.9	10.0	13.8	8.5	6.2	20.0	0.0
1Q94	4.1	0.0	0.3	3.4	7.8	7.7	5.6	4.7	11.7	(0.5)
Annual Data (4Q to 4Q Percentage Change)										
1994	3.5	(1.6)	(1.3)	2.2	7.3	8.3	6.3	3.9	11.4	(1.9)
1993	2.6	0.8	1.8	2.7	3.5	3.9	4.3	4.6	8.7	(1.7)
1992	2.3	(0.9)	2.0	2.1	4.3	3.3	3.6	3.3	5.5	(1.1)
1991	3.2	(2.0)	1.8	3.6	4.8	4.3	4.6	3.2	5.1	1.9
1990	1.2	(7.0)	(2.0)	0.4	4.1	1.0	0.4	1.0	3.2	3.0
1989	6.5	1.6	2.6	5.5	6.6	3.4	3.7	2.1	1.8	19.6
1988	6.5	4.5	6.4	8.2	6.3	2.6	2.4	(2.7)	0.6	17.5
1987	6.7	12.3	16.8	8.2	8.5	3.1	5.2	(7.0)	(2.2)	10.6
1986	7.8	21.2	17.5	7.6	7.5	4.4	6.5	0.9	3.0	8.2
1985	6.4	25.0	15.4	6.2	5.4	4.6	4.3	(0.1)	4.7	6.9
1984	4.5	18.0	13.9	6.1	3.9	3.1	2.0	(1.8)	1.9	3.7
1983	3.4	16.5	10.4	3.9	0.1	5.8	9.3	2.7	(4.3)	0.9
1982	3.4	5.0	3.8	3.6	1.7	1.8	3.9	6.0	8.3	1.0
1981	3.0	6.8	1.3	4.6	(0.1)	(2.9)	1.1	6.5	5.4	6.1
1980	6.0	2.2	6.7	8.5	0.5	4.9	(0.3)	8.1	9.9	12.3
1979	11.3	13.2	9.8	12.4	8.3	9.2	10.7	14.1	7.8	17.6
1978	15.4	18.7	12.5	10.8	17.9	15.5	11.4	17.9	22.0	15.9
1977	15.3	9.9	7.1	11.3	14.6	16.8	10.4	18.9	18.9	26.5
1976	8.0	3.8	5.8	5.5	8.3	5.4	7.1	5.0	7.8	22.4

Source: Fannie Mae & Freddie Mac

Regional Divisions
New England: CT, MA, ME, NH, RI, VT
Mid-Atlantic: NJ, NY, PA
So. Atlantic: DC, DE, FL, GA, MD, NC, SC, VA, WV
E.S. Central: AL, KY, MS, TN
W.S. Central: AR, LA, OK, TX
W.N. Central: IA, KS, MN, MO, ND, NE, SD
E.N. Central: IL, IN, MI, OH, WI
Mountain: AZ, CO, ID, MT, NH, NV, UT, WY
Pacific: AK, CA, HI, OR, WA

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APPENDIX

Derivative Securities Activities of Fannie Mae and Freddie Mac:
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DERIVATIVE SECURITIES ACTIVITIES OF FANNIE MAE AND FREDDIE MAC: DISCLOSURE AND INVESTOR SUITABILITY

VIEWS AND CONCERNS OF THE OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

May 1, 1995

In late December 1994, the Office of Federal Housing Enterprise Oversight (OFHEO) requested that Fannie Mae and Freddie Mac (the Enterprises) report on their approaches to disclosure and investor suitability in connection with their issuance of derivative securities (structured notes and Real Estate Mortgage Investment Conduits or REMICs). OFHEO's particular interest covers the risk that widely reported investor losses on some of these securities, and the accompanying adverse publicity, pose to the reputations of the Enterprises, and possible detrimental effects on the market for all government-sponsored enterprise securities. Congress has charged OFHEO with ensuring the financial safety and soundness of the Enterprises, and OFHEO's concerns arise from this responsibility.

Based on a review of these reports, supplementary materials and supporting research, OFHEO has (1) developed its own perspective on the market risk of derivative securities; (2) identified issues relating to available information about and investment analysis of these securities; and (3) developed suggestions for improving the derivative securities market generally and the structured notes market specifically.

Derivative Securities Market Risk

Overall, the development of derivative securities appears to have improved the efficiency of U.S. capital markets. Mortgage derivative structures, which allocate different portions of the interest rate risk of an underlying mortgage pool to different classes of securities (and investors), have greatly broadened the mortgage-backed securities market. Structured notes, some with complex risk characteristics, have permitted the Enterprises to reduce their funding costs while satisfying specific investment needs generated in the marketplace.

The risks of derivative securities are not unique. All fixed income securities are subject to interest rate risk, the principal risk associated with derivative securities. In fact, many mortgage derivative securities and structured notes entail far less interest rate risk than a 30-year Treasury bond. Furthermore, the risk characteristics of an individual security have no necessary relationship to the risk profile of an investor's portfolio. In many cases highly volatile securities may function to reduce significantly the overall risk of a portfolio.

Derivative securities as a whole are not inherently risky. The highly publicized losses involving derivative securities that have occurred since the birth of OFHEO (almost two years ago) have often resulted from speculative investment strategies or investors' lack of understanding of the risks of their investments. The latter principally seems to reflect insufficient expertise or analytical tools on the part of investors and, in some cases, inadequate dealer judgments about investor suitability, rather than a lack of adequate disclosure on the part of securities issuers.

Information and Investment Analysis Issues

The public debate over derivatives and structured notes has obscured many distinctions relating to the information and the analytic tools necessary for an investor to make an informed purchase. For fixed income securities generally, information available and analyses possible differ between the primary and secondary markets; in both the primary and secondary markets, information available and analyses possible differ between mortgage derivatives and structured notes.

Both REMICs and structured notes are designed and marketed before the disclosure document is even prepared. Thus, while the public debate has focused on the adequacy of disclosure, investors make their purchase decisions without benefit of all the caveats and analyses that might be included in a formal disclosure document. They base their purchase decisions on faxed "term sheets" describing the salient features of an offering, and other information conveyed over the telephone by dealers.

Legally, salespeople are permitted to provide no information that is not included in the disclosure document; investors who, upon reading the document (it must be delivered prior to settlement of the sale), feel they were misled may cancel their orders.

Some debate has centered on differences between disclosure for mortgage derivatives and structured notes. Many disclosure documents for structured notes do not contain the sensitivity and scenario analyses that issuers almost always include for mortgage derivatives. Such analyses are particularly important for mortgage derivatives because the performance of these instruments is a function of the complex interaction of interest rates and mortgage prepayments. On the other hand, the performance of structured notes is usually a function of market rates only, and generally can be evaluated more easily by an investor.

Disclosure documents provide information current when securities are issued; with the passage of time the value of such documents declines and their potential to mislead increases. Issuers have no responsibility to publish subsequent disclosure documents for securities as their interest rate sensitivities change over time. Investors considering the purchase of securities in the secondary market, therefore, generally rely on data available through information sources, such as Bloomberg or Dow Jones, together with analytical tools they purchase, develop internally, subscribe to, or access through market information sources.

The mortgage derivatives market is over ten years old; the structured note market is relatively new. Mortgage derivatives are heavily traded, and the information sources and analytical tools necessary to support the secondary market are well developed. Structured notes, on the other hand, were originally intended to be placed permanently with investors, and issuers and information sources have not yet fully responded to the needs of the secondary market. In particular, the analytical tools that information sources provide for mortgage derivatives are not available for structured notes. While investors can analyze most structured notes using popular spreadsheet software, the tools comparable to those available for mortgage derivatives would be helpful for more complex structured note issues.

Suggestions

Both Enterprises report substantial efforts to disclose the risk of their securities, and to ensure the delivery of that disclosure to initial investors by securities dealers, consistent with SEC requirements for corporate issuers. Within the present regulatory framework for our capital markets, issuers have very little ability directly to discourage inappropriate investments. Since issuers are unfamiliar with investor portfolios and risk profiles, they are in no position to assess the suitability of derivative or other securities for investor portfolios.

The Securities and Exchange Commission (SEC), the National Association of Securities Dealers (NASD) and the bank regulatory agencies have authority over dealer sales practices. We support the prompt adoption by the NASD and bank regulatory agencies of suitability and sales practice rules for the government securities market, as provided for in the 1993 amendments to the Government Securities Act of 1986. In view of the shortcomings reflected by widely reported losses, we also believe the oversight of the investment policies of some mutual funds and state and local government entities could be improved.

One area where new regulation or self-regulation might be helpful is the certification of the competence of managers of investment portfolios. A certifying authority might examine managers and, through varying levels of certification, qualify their abilities to evaluate securities of varying complexity. Such a certification program would provide both the owners of invested funds and dealers selling securities with greater confidence about the competence of portfolio managers.

In addition we have identified the following steps consistent with evolving industry practice that may reduce (not eliminate) the risk of inappropriate sales of structured notes, increase available information about outstanding issues, and increase secondary market liquidity.

- Disclosure documents could include explicit statements that securities are inappropriate investments for investors with insufficient knowledge and experience. (Freddie Mac currently includes language to this effect in its debt offering materials. Fannie Mae includes similar language in its disclosure for its Global Debt Facility, but not, at present, for its Medium Term Notes, the vehicle for its structured note issues.) Upon implementation of a certification program for investment portfolio managers, disclosure documents could specify a minimum certification level appropriate for a given security.

- For more complex instruments, disclosure documents could include analysis of how securities would have behaved under historic market conditions, or might behave across a range of hypothetical market scenarios. (In some instances Fannie Mae has provided such historical information; Freddie Mac believes it has not issued structures of sufficient complexity to warrant the inclusion of such analysis.)

- Issuers could cooperate with secondary market information sources such as Bloomberg to provide more complete, current and timely information on outstanding issues, and to help such sources develop applications to facilitate analysis and "stress testing" of securities by potential investors.

- To reduce further the likelihood of retail distribution, issuers could independently value proposed transactions, to estimate dealer compensation from swaps linked to structured note issues,

since such incremental compensation might be used to augment published sales commissions on the notes, inducing salespeople to offer the securities to retail investors. (Fannie Mae independently values proposed transactions, but focuses on its own business interests, confident that its securities are not marketed to individual investors. Freddie Mac does no such valuation.)

- Issuers could evaluate the feasibility of requiring dealers to post bid prices for outstanding issues (perhaps regardless of original underwriter) and facilitate this requirement by being prepared to buy back securities from dealers or exchange them for more liquid securities (at no loss to the issuer), as does the World Bank. Such evaluations might take into account that: (1) dealers are increasingly making secondary markets in Enterprise structured notes on their own initiative; (2) Freddie Mac reports that it has expressed to inquiring dealers a willingness to buy back structured notes at market levels; and (3) the World Bank's securities exchange program rarely has been used, but it is relatively new.

- Issuers and regulators could encourage the development and broader application of measures of the interest rate risk of individual securities, such as the Federal Financial Institutions Examination Council high risk securities test and Fitch Investors Service' CMO market risk ratings (both of these measures presently apply only to REMICs). Such measures cannot and should not substitute for analysis of securities in a portfolio context, but potentially they do flag, for investors, dealers and regulators, securities that are risky on a stand-alone basis.

OFHEO believes that these steps could improve confidence in the markets for the Enterprises' securities, and have a positive effect on the Enterprises' financial safety and soundness. In light of continuing concern over publicized instances of losses on mortgage derivative and structured note investments, OFHEO will continue to observe developments in these markets and make recommendations as appropriate.

SUMMARY OF FANNIE MAE AND FREDDIE MAC SPECIAL REPORTS ON DISCLOSURE AND INVESTOR SUITABILITY

Disclosure

The Enterprises' offering materials disclose the terms of their securities, including the formulas and methods for tabulating payments, and the related risk of interest rate movements. They claim to do so in a manner consistent with SEC requirements, although the Enterprises currently are not subject to SEC registration. For REMICs, where risk is a complex function of interest rate and prepayment patterns, offering materials include sensitivity analyses showing security performance across a wide range of economic scenarios. For some more complex structured note issues, Fannie Mae has included in its offering materials sensitivity analyses, based on historical rate patterns. Freddie Mac has not included such sensitivity analyses, but believes it has issued notes with fairly simple structures. All offering materials clearly state that Enterprise securities are not backed by the full faith and credit of the United States Government. Disclosure documents typically include language stating that dealers are not allowed to make any statements to investors that are not included in the offering materials.

Delivery of Disclosure Materials

Both Enterprises subscribe to voluntary guidelines that closely track SEC requirements for the timely delivery of offering materials to investors in primary market transactions. Members of the Enterprises' dealer groups sign agreements to adhere to the guidelines and, when selling Enterprise securities to non-dealer group members, to obtain from the latter signed agreements to adhere to the guidelines. Pursuant to their dealer agreements, the Enterprises annually audit, or instead, require certification of compliance by dealer group members. Sanctions for non-compliance can range from reprimands to expulsion from the dealer group.

Secondary Market Information

Offering materials provide information that is current at the time of the initial distribution of a new issue of securities. In the secondary market, investors require continuously updated information about the issuers' financial condition and, in the case of REMICs, mortgage prepayments. With respect to their financial conditions, the Enterprises make available annual information statements and quarterly supplements that are equivalent to the SEC-required Forms 10-K and 10-Q. The Enterprises' monthly pool factor data, which allow investors to analyze prepayments, are widely available.

Investor Suitability

The Enterprises emphasize that they believe suitability determinations are the responsibility of dealers. Fannie Mae states that determining investor suitability is beyond its expertise, and that requiring such determinations would imply a fundamental shift in how the current regulatory framework assigns responsibility for investor suitability. Freddie Mac outlines certain steps it takes to help assure its securities do not find their way into the retail market, including the requirement of higher minimum denominations for more complex structured note issues and the review of fee

valuation of proposed structured note issues focuses primarily on Fannie Mae's business needs. Both Enterprises require dealers to report on the placement of their securities by investor type, not the identities of specific investors.

Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Title XIII of Public Law 102-550)

Section 1313. DUTY AND AUTHORITY OF DIRECTOR.

(A) DUTY. - The duty of the Director shall be to ensure that the enterprises are adequately capitalized and operating safely, in accordance with this title.

(b) AUTHORITY EXCLUSIVE OF SECRETARY.- The Director is authorized, without the review or approval of the Secretary, to make such determinations, take such actions, and perform such functions as the Director determines necessary regarding -

(1) the issuance of regulations to carry out this part, subtitle B, and subtitle C (including the establishment of capital standards pursuant to subtitle B);
(2) examinations of the enterprises under section 1317;
(3) determining the capital levels of the enterprises and classification of the enterprises within capital classifications established under subtitle B;
(4) decisions to appoint conservators for the enterprises;
(5) administrative and enforcement actions under subtitle B, actions taken under subtitle C with respect to enforcement of subtitle B, and other matters relating to safety and soundness;
(6) approval of payments of capital distributions by the enterprises under section 303(c)(2) of the Federal National Mortgage Association Charter Act and section 303(b)(2) of the Federal Home Loan Mortgage Corporation Act;
(7) requiring the enterprises to submit reports under section 1314 of this title, section 309(k) of the Federal National Mortgage Association Charter Act, and section 307(c) of the Federal Home Loan Mortgage Corporation Act;
(8) prohibiting the payment of excessive compensation by the enterprises to any executive officer of the enterprises under section 1318;
(9) the management of the Office, including the establishment and implementation of annual budgets, the hiring of, and compensation levels for, personnel of the Office, and annual assessments for the costs of the Office;
(10) conducting research and financial analysis;
(11) the submission of reports required by the Director under this title.

(c) AUTHORITY SUBJECT TO APPROVAL OF SECRETARY.- Any determinations, actions, and functions of the Director not referred to in subsection (b) shall be subject to the review and approval of the Secretary.

(d) DELEGATION OF AUTHORITY.- The Director may delegate to officers and employees of the Office any of the functions, powers, and duties of the Director, as the Director considers appropriate.

(e) INDEPENDENCE IN PROVIDING INFORMATION TO CONGRESS.- The Director shall not be required to obtain the prior approval, comment, or review of any officer or agency of the United States before submitting to the Congress, or any committee or subcommittee thereof, any reports, recommendations, testimony, or comments if such submissions include a statement indicating that the views expressed therein are those of the Director and do not necessarily represent the views of the Secretary or the President.

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

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