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CRS Report for Congress

Fannie Mae, Freddie Mac, and SEC Registration and Disclosures

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Summary

Businesses selling securities to the public generally must register with the Securities and Exchange Commission (SEC). The government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac[1] are large public issuers but are exempt from SEC registration and reporting requirements. This privilege saves them millions of dollars each year and adds to the market perception that their securities have an "implied guarantee" from the federal government — a guarantee that is not officially extended.

The GSEs have announced that they would voluntarily register with the SEC, but it remains an issue whether voluntary disclosures will meet SEC standards for other publicly traded firms. Ending the exemption would have the effect of requiring, as a matter of law, greater public disclosure for individual securities issued by the GSEs, and would remove an informational advantage that the GSEs have over their mortgage market competitors. A staff report published in January 2003 by three federal regulators found that additional disclosures by the GSEs would be useful to, and not disruptive of, the mortgage-backed securities market. H.R. 2022 would end the GSEs' exemption. This report[2] will be updated as events warrant.

Background

SEC Registration. Businesses that sell securities — stocks or bonds — to the public are required to register with the Securities and Exchange Commission (SEC). Registration consists mainly of disclosure of information: before a public sale of securities can take place, a registration statement must be filed with the SEC and a prospectus must be made available to potential investors. These documents must contain detailed information about the business's operations, management, and financial condition and must describe the risks involved in the purchase of the offered security. The initial

[1] Fannie Mae is formally referred to in its chartering legislation as the Federal National Mortgage Association, and Freddie Mac as the Federal Home Loan Mortgage Corporation.

[2] Barbara Miles, former Specialist in Financial Institutions, contributed to this report.

disclosures are kept current through annual and quarterly reports, which are also filed with the SEC and made available to the public.

Most large U.S. corporations are registered with the SEC. Several kinds of securities, however, are exempt from registration and disclosure requirements, including U.S. government bonds, securities sold privately to a limited number of sophisticated investors, issued by certain small businesses, or sold within a single state. In addition, securities offered by two shareholder-owned, government-sponsored enterprises — Fannie Mae and Freddie Mac — are exempt. In the 108th Congress, H.R. 2022 proposes to repeal the exemption for these two GSEs.[3]

The GSEs. Fannie Mae and Freddie Mac are the dominant institutions in the secondary mortgage market. They buy residential mortgages from the original lenders and finance the purchases either by issuing debt securities — in denominations as small as $1,000 — or by repackaging the mortgages and selling them in the form of mortgage-backed securities (MBS). Investors in these types of bonds include mutual funds, major financial institutions, pension funds, insurance companies, and some individual investors in the U.S. markets, and central banks and other institutions in foreign countries. In 2001, Fannie Mae issued $249 billion in long-term debt, $1.8 trillion in short-term debt, and $528 billion in MBS. Freddie Mac issued $208 billion in long-term debt, $2 trillion in short-term debt, and $390 billion in MBS.[4]

Congress originally chartered Fannie Mae and Freddie Mac (in 1968 and 1970 respectively) to create a secondary (resale) market and thereby improve the functioning of home mortgage markets generally. To accomplish this, the GSEs were granted special privileges not available to other private-sector firms. In addition to the exemption from SEC regulation, both companies are exempt from state regulation and income taxation. Besides these direct benefits, Fannie Mae and Freddie Mac have a wide variety of privileges[5] that add up to what is termed an "implicit government guarantee." That is, participants in securities markets infer from the privileges that the Treasury would intervene rather than allow either company to fail. As a result, the GSEs are able to issue their securities at lower interest rates than other private borrowers, providing them a significant advantage over their fully private sector competitors.

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[3] There are three other GSEs. The Farm Credit System and the Federal Home Loan Bank System are cooperatively held by their institutional member-customers and do not register. Farmer Mac, which is publicly held, is required to register with the SEC. Sallie Mae has nearly completed the transition out of GSE status and now registers with the SEC as do other publicly held companies.

[4] Both corporations also issued large amounts of derivatives for risk-management purposes. Such securities, however, are not generally subject to SEC registration because they are not available to the public.

[5] These include a line of credit with the U.S. Treasury of $2.25 billion each, eligibility of securities for Federal Reserve open market purchases, eligibility for unlimited investment by depository institutions, eligibility of securities to collateralize public deposits, and use of the Federal Reserve as fiscal agent.

Removing the Exemption: Arguments Pro and Con

H.R. 2022 proposes to make Fannie Mae and Freddie Mac subject to the same disclosure and registration requirements that apply to other firms that sell securities to public investors. The immediate effects of repealing the exemption would be two: (1) the GSEs would, as a matter of law rather than on a voluntary basis, have to disclose periodically information about themselves, their operations, and their securities; and (2) the GSEs would have to pay registration fees to the SEC. These effects raise questions as to what new information would be disclosed, and whether such disclosure would better protect investors only at the cost of harming the liquidity of the mortgage market or endangering the practice of locking in interest rates for home buyers and owners. Further, would the payment of fees necessarily result in a rise in mortgage interest rates?

New Information. Supporters of removing the GSEs' exemption argue that SEC disclosure would improve the quality of information available to public investors about the GSEs and the securities they sell, bringing it up to par with other private sector corporations. The question is raised why Fannie Mae and Freddie Mac should be the only members of the Fortune 500 not to report to the SEC. The exemption contributes to the perception that in a crisis the government would treat the GSEs more like a government agency such as Ginnie Mae[6] than like a private corporation, and not allow them to fail. The GSEs have grown rapidly in recent years and have returned substantial earnings to their shareholders, and some observers believe that they are willing to take on more risk than other market participants because of the implicit government guarantee. The Bush Administration's FY2003 Budget noted that failure of a GSE could have "strong repercussions in financial markets."[7]

Defenders of the exemption argue that the GSEs voluntarily make disclosures that are comparable to (or better than) what SEC regulations would require. Fannie Mae and Freddie Mac publish annual and quarterly reports, and provide information to congressional committees and a regulatory agency, the Office of Federal Housing Enterprise Oversight (OFHEO). Further, on July 12, 2002, Fannie Mae and Freddie Mac jointly announced that they would register their own common stock with the SEC and begin filing their financial statements in accordance with SEC requirements, beginning perhaps as early as 2003. In March 2002, Fannie Mae announced that it would post data about insider transactions in its securities on its web site, continuing a trend of voluntary disclosures. In 2003, the GSEs agreed to publish more detailed information about the mortgages that back up their MBSs. Thus, opponents argue that repeal of the exemption would merely make what the GSEs are already doing (or proposing to do) a legal requirement, and would not provide significant new information to investors.

Opponents of the exemption, however, claim that SEC registration would substantially improve disclosures about individual debt securities issues and especially

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[6] The Government National Mortgage Association, "Ginnie Mae," is part of the Department of Housing and Urban Development. It guarantees securities that are backed by mortgages that are already government-backed, such as VA-guaranteed and FHA-insured loans.

[7] The FY2003 budget pointed out that from the end of FY1997 though FY2001, the GSEs' combined mortgage portfolios grew 150% and mortgage-backed securities guarantees grew 40%; their combined debt rose during the same period at an annualized rate of 25%.

about MBS issues. They point to several areas where disclosure about risk has been less detailed than it would be under the regular SEC regime. For example, the GSEs disclose information about the underlying mortgages that support mortgage-backed bonds on an aggregate basis for a number of similar issues of securities, rather than for each individual issue. The aggregating of data about such loan characteristics as initial and average time to maturity, interest rates paid by homeowners on individual loans, the initial size of loans, and the geographic locations of mortgaged properties may conceal small, but perhaps significant, variations in the pools of mortgages that back individual MBS issues.

In January 2003, the Treasury, OFHEO, and the SEC published a staff study that found that disaggregated, pool-level disclosures would be useful to investors and would not be disruptive to the MBS market. The study recommends that enhanced information be provided, if possible, through market forces and voluntary disclosure rather than government action (such as a repeal of the exemption).[8] Following publication of the study, the GSEs announced that they would voluntarily begin to provide pool-level information for their MBS issues.[9]

SEC registration is always based on disclosure of risks and characteristics related to the particular issue of securities that is being registered. If investors received more specific information about the mortgage pools behind individual MBS issues, they would presumably be able to price those issues more efficiently. Such information is routinely available at the individual loan level for non-GSE MBS issues.[10] An argument in favor of removing the exemption is that only their protected monopoly status allows the GSEs to withhold this data from the market. Some market participants believe, moreover, that the GSEs are able to profit from their information advantage by "cherry-picking," or retaining the MBS pools with the most attractive characteristics while selling those with less attractive characteristics. However, the Treasury/OFHEO/SEC report found no evidence of impropriety in portfolio selection.[11]

Liquidity and Rate Lock-in Concerns. The other side of the informational efficiency argument is that too much information could harm the liquidity of MBS issues and raise mortgage interest rates. Standardization of the risks of MBS issues has two main effects: it lowers the costs of information to investors, and it encourages investors to treat all MBS issues with the same basic characteristics (especially interest rates on the underlying mortgages) alike. Ginnie Mae securities issues deliberately suppress some information in order to get their MBSs treated in a generic fashion with trading based on

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[8] Department of the Treasury, OFHEO, and SEC. *Staff Report: Enhancing Disclosure in the Mortgage-Backed Securities Markets*. January 2003. 50 p. (Hereinafter cited as *Staff Report)*

[9] Fannie Mae, *Fannie Mae Provides Additional Information on New MBS Disclosures; Announces User Enhancements to MBS Section of Corporate Web Site,* News Release, February 4, 2003. See [http://www.fanniemae.com/newsreleases/2003/2376.jhtml]. For Freddie Mac's announcement, see [http://www.freddiemac.com/news/archives/mbs/2003/pcdisclsre_0203.html].

[10] The data are important to understanding a kind of interest-rate risk known as pre-payment risk. When interest rates fall, mortgages tend to be refinanced; this helps homeowners who get a better rate, but hurts investors who lose the investment they thought they had. The information problem occurs when mortgage characteristics (other than interest rates) that are relevant to pre-payment are not disclosed.

[11] *Staff Report,* p. 42.

the coupon rate of issues rather than characteristics of mortgages in the pool (all of which are themselves government-guaranteed). Fannie Mae and Freddie Mac are attempting to do the same thing by not revealing some of the relevant information on mortgages underlying individual MBS issues.

This strategy, while increasing liquidity (because more issues appear interchangeable), has limits. When mortgages prepay faster than expected because of undisclosed data, investors may reprice all MBS in a more generic way than is warranted. It is one thing if "standardized" mortgage pools are actually standard; it is something else if they are not. The greater the pre-payment discrepancies within the mortgage pools backing securities, the more valuable the information is, and the greater the possibility that investors, who cannot distinguish between issues, will penalize the broader market, raising mortgage interest rates across the board.[12]

Fannie Mae and Freddie Mac also argue that SEC registration will interfere with current arrangements that allow home buyers to lock in a mortgage rate at the beginning of negotiations with lenders, even though market interest rates may rise before final settlement. This is possible because mortgages are in effect pooled and securitized before they are actually signed. Investors agree to accept a certain interest rate, and this rate can be guaranteed to home buyers. If a prospectus were required for each bond issue, the GSEs argue, it would not be possible to lock in a fixed rate until settlement, and prospective home buyers would be exposed to interest rate risk. Supporters of SEC registration for the GSEs, however, point to private issuers of bonds backed by "jumbo" mortgages (which the GSE charters prevent them from buying and pooling) and say that home buyers in these markets are able to lock in pre-settlement mortgage rates. In any case, the GSEs should be able to hedge the interest rate risk by using interest rate derivatives or other risk management tools, with minimal impact on home buyers.

Impact of SEC Fees. The GSEs argue that SEC registration and reporting will impose costs that will ultimately be borne by home buyers. The GSEs' current charters effectively give them a subsidy which allows them to raise capital at a lower cost, which translates into lower mortgage rates. There are costs associated with SEC registration that the GSEs do not now bear: an added paperwork burden and a registration fee collected by the SEC.[13] However, the GSEs already bear the major costs associated with issuing securities: the compensation of Wall Street underwriters who find investors willing to buy, and the voluntarily or market-mandated disclosure of information as noted above. There is no obvious reason to assume that SEC registration will have any significant impact on transaction volume or prices in the robust secondary mortgage market. Opponents of the exemption point out that many other issuers of securities find the U.S. markets attractive places to sell debt and equity, regardless of registration costs. The possible impact on mortgage borrowers should also be insignificantly and unmeasurably

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[12] There is some evidence that this has happened. In 2001, the investment bank Bear Stearns released an analysis advising their customers that the prepayment problems of undisclosed GSE MBS were making the better-disclosed non-GSE securities more attractive. See: Bear Stearns & Co. non-agency mortgage research dated May 29, 2001.

[13] Under Section 6(b) of the Securities Act of 1933, issuers pay a fee of $92 for every million dollars in new securities sold, or just under 1/100th of 1%. The fee rate is adjusted periodically so that all SEC fees collected approximate the cost of running the agency.

small. At less than one cent per $100 of securities issuance, the fee is easily absorbed by the GSEs whose funding advantage is about 40 times larger.[14]

Recent Developments

In January 2003, Freddie Mac announced that it had concluded that certain accounting policies it had adopted were incorrect and that earnings for the past few years would have to be restated. In June, Freddie dismissed its top three executives and released more information about the accounting problem, including an estimate that reported earnings for 2000 through 2001 would be raised by $1.5-$4.5 billion. It appears that Freddie's former management — the top three executives were dismissed — sought to "smooth out" reported earnings by deferring earnings that should have been recognized under GAAP to future years. The episode raises questions about the value of "voluntary" SEC reporting: Freddie's press release of June 25, 2003 stated that past disclosure practices "did not meet standards that would have been required of Freddie Mac had it been an SEC registrant." (For more information about the accounting restatement, see CRS Report RS21567, *Accounting and Management Problems at Freddie Mac*, by Mark Jickling)

Conclusion

Fannie Mae and Freddie Mac were created with a blanket exemption from SEC disclosure requirements. Over time, market forces — the demand of bond buyers for relevant information — and pressure from Congress and the regulators have led the GSEs a long way down the path of voluntary disclosure. Each new disclosure undertaken voluntarily makes the exemption less significant, reducing the urgency of the case for requiring the GSEs to register like any other publicly traded firm. Recent accounting and management problems at Freddie Mac, however, may indicate a need for more rigorous GSE oversight. At the same time, when voluntary disclosure programs appear to have no harmful effects on secondary market liquidity, on GSE profitability, or on the costs of home ownership, justifications for retaining the exemption also lose persuasiveness.

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[14] Fannie Mae and Freddie Mac receive an estimated subsidy from their implied guarantee of about 41/100ths of 1%, and retain about 16 of that for their shareholders while passing through about 25 (a quarter of a percentage point) in the form of lower mortgage rates. See Congressional Budget Office, *Federal Subsidies and the Housing GSEs*, May, 2001.