Legal Opinion Letter

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DEFIANT FANNIE AND FREDDIE:
SKETCHY FINANCIAL DISCLOSURE HARMS INVESTORS AND TAXPAYERS

by
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Fannie Mae and Freddie Mac, two large government-sponsored enterprises (GSEs), have been under increased pressure to improve their financial disclosures to investors and the general public. The two GSEs dominate the housing finance marketplace, purchasing home mortgages originated by banks, thrifts, and mortgage bankers. They securitize most of the mortgages they purchase by selling to investors pieces of pools of mortgages, called mortgage-backed securities (MBS).

Fannie and Freddie recently agreed to register with the Securities and Exchange Commission (SEC), specifically so the SEC can review the financial statements Fannie and Freddie issue to their stockholders. Hopefully, ongoing SEC review of Fannie's and Freddie's financial statements will provide greater transparency for two of America's largest financial institutions.

The SEC should strive to improve the comparability of the financial statements of the two organizations, which operate in a very similar manner and yet are quite unlike the private-sector corporations they compete against. Not only will improved financial disclosure better serve Fannie's and Freddie's stockholders, but taxpayers will gain a better understanding of the financial and systemic risks posed by the $3.06 trillion of debt and MBS Fannie and Freddie had outstanding as of June 30, 2002.

Fannie and Freddie will continue, though, to be exempt from key laws administered by the SEC as well as SEC fees. Failing to bring them under the full panoply of the securities laws leaves unresolved two important issues. First, Fannie and Freddie will continue to be exempt from a requirement that companies selling securities to the general public register them with the SEC. Registration enables the SEC to review a company's prospectus and other disclosure materials to ensure that the company has provided potential investors with all the information they need in order to make an informed investment decision.

Fannie and Freddie sell relatively little stock, but they issue enormous amounts of debt and MBS. In 2001, they sold $4.25 *trillion* of short- and long-term debt plus $920 billion of MBS. At the present time, the financial disclosures related to these sales were reviewed only by Fannie's and Freddie's safety-

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and-soundness regulator, the Office of Federal Housing Enterprise Oversight (OFHEO). While well intentioned, OFHEO has neither the depth nor breadth of expertise to adequately review the financial disclosures of large, financially complex organizations such as Fannie and Freddie.

The American Enterprise Institute recently contrasted the financial disclosures Fannie provided to prospective investors in one of its MBS pools with disclosures provided to investors in a pool of home mortgages securitized by J.P. Morgan Chase. The differences were startling — Chase provided much more detailed information about the mortgages being securitized than did Fannie in a document three times as long as a comparable Fannie disclosure document (110 pages versus 32 pages). In particular, Chase provided much more insight into the likely prepayment characteristics of the mortgages in each segment or "tranche" of the mortgage pool than Fannie provided.

Although both GSEs deny it, their sketchy disclosures create an opportunity for "cherry picking." Through the act of creating MBS, Fannie and Freddie gain a much more precise understanding of the mortgage prepayment characteristics of each tranche within the pool. Tranches with better characteristics (the mortgages in them are slower to prepay) are more valuable. There is widespread belief along Wall Street that Fannie and Freddie are using their superior knowledge to purchase the more valuable tranches, thereby enhancing their profitability.

The SEC, OFHEO, and the Treasury Department have pledged to complete in early 2003 a study of mortgage securitization to determine what steps should be taken to level the playing field between Fannie and Freddie and their private-sector competitors in issuing MBS. Hopefully, any changes Congress adopts will eliminate any cherry-picking potential for any MBS issuer.

Fannie's and Freddie's continued exemption from many federal securities laws raises a second concern — they are now exempt from many types of SEC enforcement actions, particularly those intended to discourage securities fraud. Many provisions of the just-enacted Sarbanes-Oxley Act of 2002, which is intended to improve corporate accountability, likewise will not be applicable to Fannie and Freddie. Although the two companies have pledged to improve their accountability, this promise falls far short of bringing them under all the laws the SEC administers.

Reps. Christopher Shays (R-CT) and Edward Markey (D-MA) introduced legislation in 2002 (H.R. 4071) that would eliminate the statutory exemption from the securities laws that Fannie and Freddie now enjoy. The GSEs' agreement to voluntarily register with the SEC with regard to their financial disclosures has not eliminated the need for such legislative reform. Concerns Fannie and Freddie have raised that SEC registration fees would be a "tax on housing" can easily be resolved through a limit on the amount of fees any large securities issuer would pay. Although it is unlikely that the current Congress will take up the Shays-Markey bill before adjourning, the bill has garnered sufficient support and attention that its reintroduction in the next Congress is a virtual certainty.

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