Fannie Mae: a leader in American home finance

By Richard K. Eisenberg

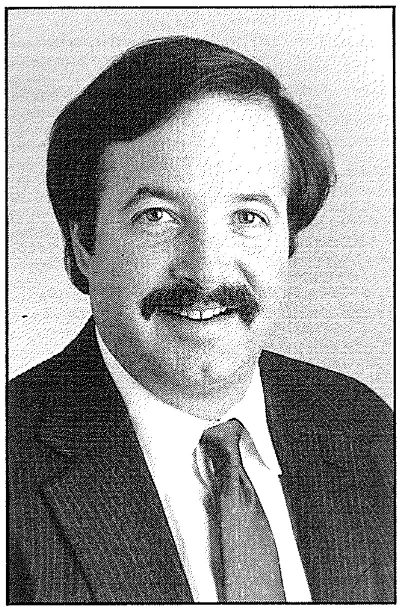
FANNIE MAE, the Federal National Mortgage Association, is a stockholder-owned, Congressionally chartered corporation that was created to provide liquidity to the housing finance market in the United States. Fannie Mae was established as an agency of the US government by directive of President Franklin D. Roosevelt in 1938. Some 30 years later the US Congress eliminated federal ownership and management of Fannie Mae, but continued to maintain government regulation and ties to the corporation.

Owned by private stockholders, Fannie Mae is a tax-paying corporation. It is one of the corporations included in the Standard and Poor's 500 Stock Price Index and is traded on the New York, Pacific and Midwest Stock Exchanges.

The Fannie Mae business

Today, Fannie Mae operates at the heart of the United States secondary mortgage market — a $1 trillion market now representing 43% of the US home mortgage debt outstanding. Fannie Mae provides liquidity to the US mortgage marketplace by purchasing home mortgages that it retains in its investment portfolio and by issuing and guaranteeing mortgage-backed securities (MBS).

For its portfolio investments, Fannie Mae purchases residential home mortgages from lending institutions, including mortgage banking companies, commercial banks and savings and loan associations. The corporation finances these purchases with funds borrowed in the capital markets — both in the United States and overseas. The corporation earns money on the difference, or the spread, between the yield on its portfolio and its cost of borrowed funds.



Fannie Mae also issues and guarantees MBS. These securities are backed by pools of residential mortgages that are originated and packaged by mortgage lending institutions. Fannie Mae establishes and monitors standards for these mortgages and for the mortgages it purchases for its own portfolio.

The corporation issues the securites, guaranteeing to the investor full and timely payment of both principal and interest. The corporation receives a guaranty fee from its MBS activities that continues for the life of the securities. In 1989, MBS fee income totalled $408 million.

The USA's housing partner

By offering debt and MBS products to a diverse group of investors, Fannie Mae expands the total amount of funds that are available to US mortgage originators and ultimately to US homebuyers and renters. Through its operations over the past 50 years, Fannie Mae has grown to be the largest investor in American home mortgages. Based on assets, it is the fifth largest corporation in the United States.

Since 1968, Fannie Mae has helped provide home financing for over nine million American families. Fannie Mae currently owns in portfolio or holds in trust for investors one out of every eight mortgages in the United States. Today, the corporation manages its $109 billion mortgage portfolio, as well as a MBS business with $246 billion in MBS outstanding.

The US mortgage market

The US residential mortgage market has grown over the past 10 years from $900 billion to $2.4 trillion of debt outstanding as of the third quarter, 1989, exceeding publicly held federal government debt of $2.1 trillion. At that time, home mortgage debt represented 25% of total private sector debt in the United States; it was almost four times the amount of business loans in the US banking system ($595 billion), more than three times the amount of consumer credit ($659 billion), and almost two times the size of the US corporate bond market ($1.2 trillion).

Fannie Mae estimates that lending institutions will originate between $350 and $400 billion of residential

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mortgages annually for the foreseeable future. If recent experience continues, more than half of those originations will be sold in the secondary market, where Fannie Mae is a major player.

Recent developments within the US savings and loan industry should present additional opportunities for the secondary market and for Fannie Mae. Stricter capital standards will apply to the thrift industry. Risk-based capital guidelines will require thrifts (and banks) to hold more capital to support assets that are deemed to be riskier by the regulations.

To meet these new capital standards, thrifts will probably consider whether to sell or securitise their mortgage assets. The corporation is well positioned to help thrifts with either strategy.

Importance of housing in the US

Owning a home of one's own continues to be one of the greatest aspirations of most Americans. In fact, 64% of American families' homes are owner-occupied.

The importance of housing in the United States is underscored by the support — both explicit and implicit — of the US government. Historically, housing has been afforded favourable tax treatment. Traditionally, real estates taxes and mortgage interest payments have been tax deductible from Federal income taxes.

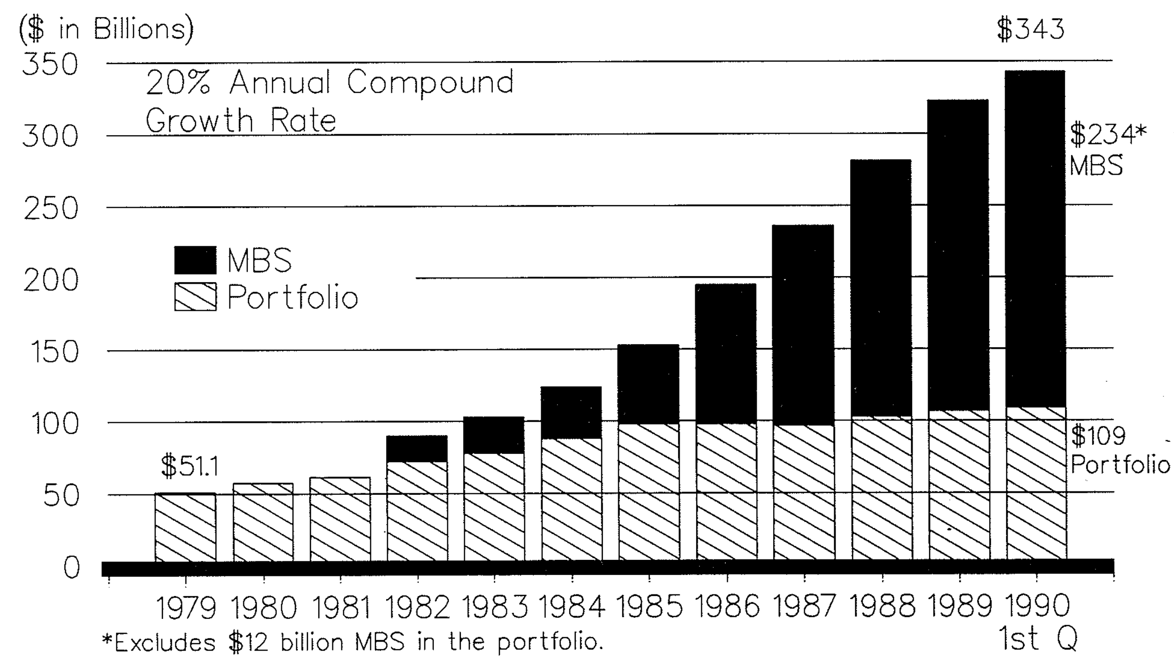
Homeowners also have enjoyed special exemptions from the payment of capital gains on home sale profits if certain criteria are met. This tax treatment has encouraged homeownership.

In addition, the US government has established and sponsored housing-related agencies that provide support through insurance and guaranty programmes, and has also created specialised entities whose sole mission is to provide funds for housing.

Fannie Mae financings

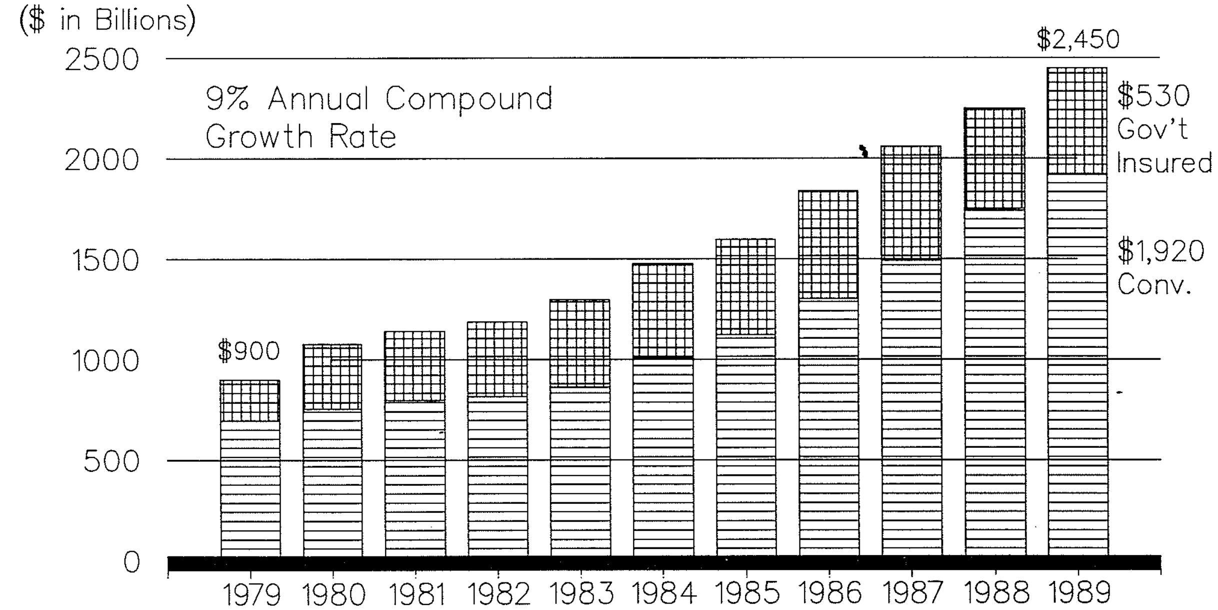
Fannie Mae primarily has funded its portfolio of mortgage assets through the sale of unsecured debt obligations (debentures and notes). During the past five years, the corporation has sold between $14 billion and $24 billion a year in debt with a term of more than 12 months. They have also sold between $22 billion and $55 billion in short-term debt annually over the same period.

Fannie Mae Mortgage Portfolio and MBS Outstanding 1979 – 1989



*Excludes $12 billion MBS in the portfolio.

Residential Mortgage Debt Outstanding 1979 – 1989



Under the Basle capital framework, US banking regulators have issued regulations that assign Fannie Mae obligations a 20% risk weight. This is the same risk weight category as obligations of supranational organisations and other government-sponsored borrowers.

Characteristics of Fannie Mae debt

The most important characteristic of Fannie Mae as a borrower has been the "agency" status conferred on it by the market. Because of this status, Fannie Mae has been able to offer in recent years its US dollar-denominated, non-redeemable, fixed rate debt, which constitutes the majority of its borrowings, at spreads ranging from 25 to 50 basis points over comparable-term US Treasury securities. During the same period, its debt generally has traded tighter to the Treasury curve than even the most highly rated corporate debt.

The corporation has, in recent years, typically sold more debt than any other corporate borrower in the world market. To accomplish this, Fannie Mae has brought its securities regularly to the market and in large size. Debt offerings are often $1 billion or more. Because of the size of the issues, the "US agency" status accorded them by the markets for many Fannie Mae domestic debt obligations have been and currently are liquid.

Investors in Fannie Mae debt

The large majority of the investors in Fannie Mae debt have been US institutions. Because many regulated and insured depository institutions are permitted to hold these securities without limit, US banks, thrifts and credit unions have been large purchasers of Fannie Mae debt. Overseas participation in its domestic debentures has represented one of the corporation's fastest growing investor segments in recent years. In 1989, international investors purchased over 20% of these debentures.

The MBS market

Unlike debt securities, the mortgage backed security is a relatively new entry to the US financial markets. The first security was issued in 1970. During the 1980s, the mortgage-backed securities market in the US grew from $100 billion outstanding at the end of 1979 to $900 billion outstanding at the end of 1989.

The growth of Fannie Mae's MBS business has paralleled this industry growth. After issuing its first MBS in 1981, Fannie Mae passed the $100 billion milestone in 1987 and just two years later total MBS issues reached over $200 billion.

Greater standardisation of the mortgage securities market has

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attracted a wide variety of investors. Money managers, thrift institutions, commercial banks, trust departments, insurance companies, pension funds, securities dealers and private investors have participated in this market. Most of Fannie Mae's MBS are issued in book-entry form and are traded actively through major Wall Street securities dealers. Total mortgage-backed securities trading volume typically exceeds $2 trillion annually.

Fannie Mae also has contributed to today's mortgaged-backed securities market by issuing such innovative products as Real Estate Mortgage Investment Conduits (REMICs) and Stripped Mortgage-Backed Securities (SMBS).

Under the Basle capital framework, US banking regulators have placed most Fannie Mae MBS in the 20% risk weight category. However, SMBS and certain residual classes of REMICs of the corporation are assigned to the 100% risk category.

Standard Fannie Mae MBS

Fannie Mae, through its guaranty, insures full and timely payment of both principal and interest to the MBS investor. Fannie Mae fixed rate MBS generally are backed by 15 to 30 year term, fixed rate single-family mortgages or multi-family mortgages. Because principal is returned throughout the life of the security, the average weighted life of these MBS is less than the original term of the mortgages.

These securities are direct pass-through securities; there is no specialised allocation of the cash flow. As of 31 December, 1989, over $216 billion in 30-year fixed rate MBS, $34 billion in intermediate term (20 years or less) fixed rate MBS, and over $2 billion in multi-family fixed rate MBS had been issued.

Fannie Mae also issues adjustable rate mortgage (ARM) MBS which are backed by mortgages with floating interest rates that reset periodically (e.g., from monthly to every five years). All the mortgage loans adjust at a spread over a specified index. The most widely used indices for Fannie Mae MBS are Cost of Funds indices. These indices are based upon the monthly weighted average cost of savings, borrowings and advances for thrift institutions.

The one year Constant Maturity Treasury index and the six month Treasury Bill index are the most common indices for Treasury-based ARM MBS.

International finance department

With the growing international presence of Fannie Mae, the corporation has now created an international finance department to serve as a focus for a wide variety of international activities. The department has responsibility for all overseas borrowings; the international marketing of the corporation's debt and MBS; and the conduct of overseas business. In the latter category, the corporation is now engaged in a variety of overseas advisory assignments for public and private mortgage finance institutions.

A look to the future

For more than 50 years, Fannie Mae has served as an important link in the American home finance market by providing mortgage lenders with access to the US capital markets.

In the future, as technology continues to develop, Fannie Mae expects to see a closer integration of world markets. As a leading participant in the US financial markets, Fannie Mae is prepared to operate successfully in a growing worldwide marketplace. ■

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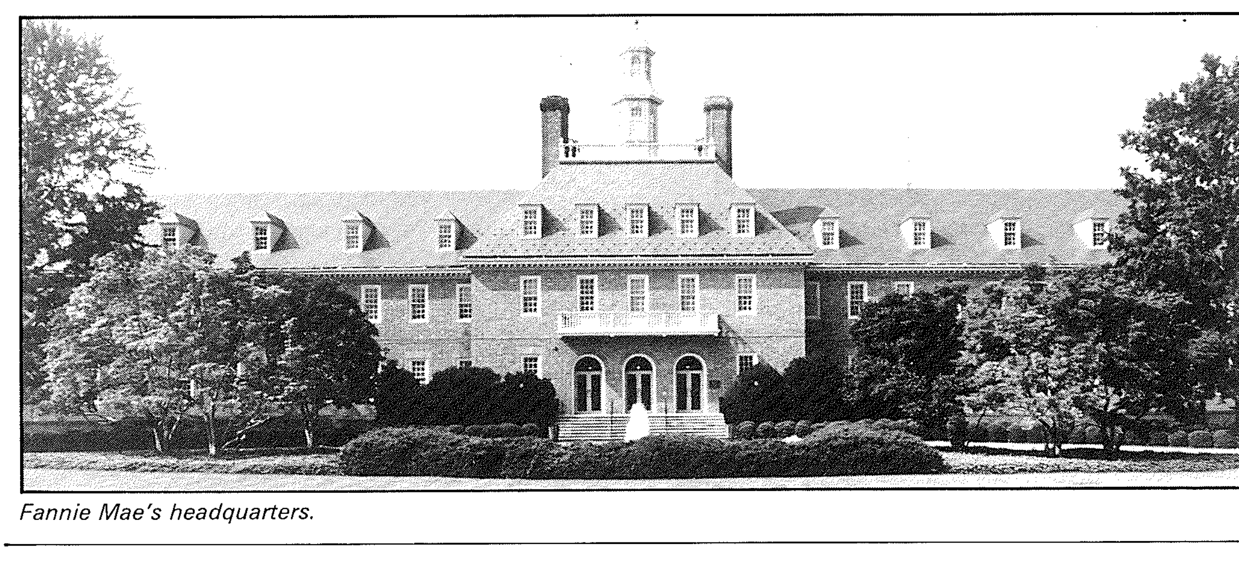

Fannie Mae's headquarters.