

FANNIE MAE'S SUBORDINATED DEBT PROGRAM

**Noel Fahey
Fannie Mae**

April 27, 2001

TABLE OF CONTENTS

I. Introduction and Summary	3
II. The Case for Mandatory Subordinated Debt	6
III. The Fannie Mae Subordinated Debt Program	10
IV. Fannie Mae's Subordinated Debt Program Meets all Effectiveness Tests	13

I. Introduction and Summary

Members of the Shadow Financial Regulatory Committee (SFRC) have long advocated a central role for subordinated debt in imposing market discipline on banking institutions. This advocacy goes back at least fifteen years.¹

More recently, the committee itself has gone on record as endorsing subordinated debt as a significant, if not *the most* significant, element in bank capital requirements.² In fact, in Statement No. 169, SFRC said that a requiring banks to issue subordinated debt was “a better approach” to bank capital regulation than the proposed New Basel Accord published by the Basel Committee on Banking Supervision on January 16, 2001:

- “The SD requirement is simple and straightforward to implement, compared to the highly complex system proposed by the Basel Committee.
- The SD requirement avoids the long delays associated with protracted investigation and study that are inherent in the latest Basel proposal.
- A related advantage is the SD requirement does not require three more years for national regulators to implement.
- Because it relies on market discipline, an SD requirement, by its nature, adapts to ongoing market developments. In contrast, the lengthy development process entailed in revising the Basel framework underscores how difficult it is for regulators to keep up with constant changes in the markets.
- Market measures of risk are neither arbitrary, nor susceptible to manipulation by banks or regulators, and holders of bank debt have strong pecuniary incentives not to forbear.
- An SD requirement combined with appropriate disclosure avoids the problem of establishing hard rules for measuring subjective or

¹ “Holders of subordinated debt are a particularly attractive source of market discipline because, as distinct from depositors, debtholders cannot withdraw their funds on demand when bad news surfaces. As distinct from stockholders, they do not share in the increased profits that may arise from increased risk-taking; therefore, they have every incentive to prefer safe, conservatively managed banks.” *Perspectives on Safe and Sound Banking*, G. Benston, R. A. Eisenbeis, E. Kane and G. C. Kaufman, MIT Press, Cambridge, MA **1986**, at 179.

² *Reforming Bank Capital Regulation: A Proposal by the U.S. Shadow Financial Regulatory Committee*, (Statement No. 160, March 2, 2000), The AEI Press, Washington DC, 2000; *Statement of the Shadow Financial Regulatory Committee on Requiring Large Banks to Issue Subordinated Debt* (Statement No. 168, February 26, 2001); *Statement of the Shadow Financial Regulatory Committee on the Basel Committee’s Revised Capital Accord Proposal* (Statement No. 169, February 26, 2001); *Improving the Basle Committee’s New Capital Adequacy Framework*, Joint Statement by a sub-group of the Shadow Financial Regulatory Committees of Europe, Japan, and the U.S., New York, June 14, 1999.

hard-to-quantify risks that are evaluated in the markets on a case by case basis.”³

In a voluntary agreement entered into with Congressman Richard Baker, Chairman of the House Subcommittee on Capital Markets, on October 19, 2000, Fannie Mae and Freddie Mac committed themselves to a subordinated debt program. By making its commitment, Fannie Mae pledged to undertake a subordinated debt program on a schedule that can be publicly monitored.

This paper reviews the standards that the SFRC has set for an effective sub debt program and shows how the program initiated by Fannie Mae stacks up against those standards.

The major question that observers will ask with regard to the program is whether the markets will regard the debt as truly subordinated or whether it will be regarded as undistinguishable from our senior debt.

We designed our subordinated debt program to put purchasers on notice that it is different from our senior debt. For instance, the subordinated notes have a trigger mechanism whereby, under certain well-defined conditions of economic distress, interest payments on the notes would be deferred for up to five years or for the remaining maturity of any particular issue, whichever is shorter.

In rating the debt, Standard & Poor’s and Moody’s looked to the underlying strength of the company rather than to any implied government backing. For instance, in commenting on its rating, S&P stated:

“Although Fannie Mae and Freddie Mac are government-sponsored enterprises (GSEs), their subordinated debt is rated from a financial, not a political, perspective, since the potential for payment default is present. ***Accordingly, Standard & Poor’s assesses the GSEs’ financial ability to make repayment using the same analytical factors that it uses for other financial institutions.***”⁴

A consensus of market analysts agreed that our sub debt would carry a higher interest rate than our senior debt and that is what has happened. In 46 trading days following its inauguration on January 25, the subordinated debt traded at an average spread of 22.4 basis points over the company’s senior debt, a higher spread than we see in the case of some large bank holding companies.

By its commitment, Fannie Mae, along with Freddie Mac, becomes the first financial company in the country to do what the SFRC has been advocating for all large financial institutions. In reviewing a study by the Treasury Department and the Federal Reserve on the advisability of mandatory subordinated debt requirements, the SFRC stated that:

³ Shadow Financial Regulatory Committee, Statement 169, at 5.

⁴ *Commentary: Subordinated Debt Ratings Reflect Unsupported Creditworthiness of Fannie Mae and Freddie Mac*, Standard & Poor’s, March 26, 2001 (emphasis added).

“the logic of the Federal Reserve/Treasury report points strongly toward one conclusion. If information about how a mandatory subordinated debt requirement would work is desired, there is only one way to find out: test such a requirement now. No further research, without a real world trial, will resolve the alleged uncertainties of the effectiveness of a mandate.”⁵

That is exactly what Fannie Mae is doing: putting a subordinated debt program into real-world operation.

This paper:

1. Reviews the outline and benefits of a mandatory subordinated debt program;
2. Summarizes the Fannie Mae subordinated debt program;
3. And, most importantly, presents evidence that the markets should, and do, regard Fannie Mae’s subordinated debt as truly subordinated.

⁵ Shadow Financial Regulatory Committee, *Requiring Large Banks To Issue Subordinated Debt*, Statement No. 168, February 26, 2001.

II. The Case for Mandatory Subordinated Debt

While details differ, mandatory subordinated debt programs suggested for large banks often require that subordinated debt:⁶

1. Indeed be mandatory; i.e., that large banks be required to issue a certain amount of subordinated debt on a regular basis;
2. Indeed be subordinated; i.e., that it not be collateralized and that it be junior to other claims on the firm besides equity or other debt/equity instruments that by their stated terms are either junior or equal to the subordinated debt;
3. Have a certain minimum maturity—such as one year or five years;
4. Be issued on a staggered schedule so that a bank would be required to come to market with some frequency (e.g., semi-annually); and
5. Be sold to investors on an arms-length basis without mutual trading by related (or colluding) institutions or parties.

Economic theory suggests that such a mandatory sub debt program would promote safety and soundness in the banking system. Thus, for instance, a joint study by the Federal Reserve Board and the Treasury Department required by the Gramm-Leach-Bliley Act of 1999 (GLBA) gave five postulated benefits emanating from a mandatory subordinated debt program culled from the literature of the previous two decades:⁷

“Direct market discipline

[This] would be achieved if an institution’s expected cost of issuing subordinated debt became more directly related to purchasers’ perceptions of the riskiness of that institution. The anticipation of higher funding costs from increased risk would provide an incentive for the issuing organization to refrain from taking excessive risk.

Indirect market discipline

...Improved indirect market discipline would be exerted if a rise in secondary market subordinated debt yields were interpreted by investors and others as a signal of increased risk, leading them to demand higher

⁶ In mandating a Federal Reserve/Treasury Department study of the advisability of a mandated subordinated debt requirement for large banks, GLBA defined subordinated debt for the purposes of the study as: (1) having original weighted average maturity of not less than five years; (2) subordinate with regard to payment of principal and interest to all other indebtedness of the bank; (3) not supported by any credit enhancement; and (4) not held by an affiliate or an affiliated-related party of the bank. P.Law 106-102 Sec. 108(c).

⁷ *The Feasibility and Desirability of Mandatory Subordinated Debt*, Board of Governors of the Federal Reserve System and United States Department of the Treasury, December 2000.

returns on other liabilities or to otherwise limit their exposure to the bank or other type of depository institution. Depository institution supervisors could also exert indirect discipline if they took the increase in secondary market yields as a signal of potentially increased institution risk and took actions to address that possibility.

Improved transparency and disclosure

...In order to price risk accurately, purchasers of subordinated debt need a clear picture of a depository institution's overall riskiness. If such a picture is not forthcoming from the issuing institution, purchasers may require higher yields than would otherwise be the case or perhaps not even be willing to buy an institution's subordinated debt at any price.

Increasing the size of the financial cushion provided to the federal deposit insurer

When an institution fails, subordinated debt holders receive their funds only after the deposit insurer has been fully compensated. Thus, increased issuance of subordinated debt could increase the deposit insurer's financial cushion.

Reduce the tendency for depository institution supervisors to forbear their resolution of a troubled institution

Because subordinated debt holders receive their funds after the deposit insurer in a depository institution failure, they may have an incentive to encourage supervisors to take prompt corrective actions against a troubled depository institution.”⁸

Many financial regulators support subordinated debt as an important way to crystallize the views of thousands of market participants into a clear signal—the relative yield on a company's sub debt—of the market's view of a company's risk position and potential for loss. Below are a few recent quotes from bank regulators on the value of sub debt:

- **Federal Reserve Chairman Alan Greenspan:** “The great advantages of... subordinated debentures is that it is something of the nature... of a canary in a mine, that if... the credit capacity of these institutions seems to be eroding at the edges, it is very much more likely to show up in the prices of liabilities which are not insured and have no collateral behind them.”⁹
- **Federal Reserve Governor Laurence Meyer:** “If the train crashes, then the subordinated debt holders sit not in the caboose but in the cab of the

⁸ *Id.* at v-vi.

⁹ Testimony on Nomination to Fourth Term as Chairman Before the Senate Committee on Banking, Housing, and Urban Affairs, Alan Greenspan, Jan. 26, 2000.

engine. They are thus quite sensitive to the speed of the train and the quality of the tracks.”¹⁰

- **Atlanta Federal Reserve Bank:** “Because holders of these instruments are the least likely to be bailed out if a bank fails, they are the most likely to demand disclosure of a bank’s condition. Subordinated debt holders receive, at most, the promised principal and interest payments and so do not share in the profits that may be associated with risk taking; they merely suffer the losses. Such downside risk gives subordinated debt holders the incentive to monitor a bank’s risk and demand a higher interest rate to compensate for higher risk. This type of direct market discipline punishes banks for taking on inappropriate risk.”¹¹

Thus, subordinated debt can play a similar, or even superior, role to equity in imposing market discipline and protecting the taxpayer. Indeed, in Statement No. 160, the SFRC makes the case for the superiority of subordinated debt relative to equity:

“The Basel standards reflect the suspicion about subordinated debt that regulators and policymakers in the member countries, including the United States, have displayed for many years. That suspicion presumably reflects the fact that debt requires the payment of interest—a contractual obligation—while equity entails no such requirement. Similarly, debt principal (unlike equity capital) itself must be paid back. For those and possibly other reasons, the Basel standards assign a junior role to subordinated debt by relegating it to a second tier of capital. Even then, banks need not issue subordinated debt but instead are merely allowed to count it toward only the total capital requirement.

The suspicions about subordinated debt are ill-founded. If anything, from the perspective of both banks and regulators, subordinated debt does at least as good a job as equity of protecting depositors and the deposit insurance fund, as well as of providing incentives for banks to avoid taking excessive risks. In fact, subordinated debt offers advantages to regulators that are superior to common equity, in three principal respects.

First, the presence of subordinated debt reduces banks’ incentives to take on inappropriate risks because, for solvent banks, the incentives of the subordinated debt holders and the deposit insurance agency are aligned...

Second, increases in the interest yield on existing traded debt provide a warning from investors of the risks banks are taking. The ease or

¹⁰ Remarks Before the National Bureau of Economic Research Conference, Laurence H. Meyer, October 31, 2000.

¹¹ *Subordinated Debt Can Help Regulators Monitor Bank Risk*, 13 Financial Update 1 (Federal Reserve Bank of Atlanta, Jan-Mar 2000) available at http://www.frbatlanta.org/publica/finan_update/v13n1/index.html

difficulties faced by banks in issuing new subordinated debt also provide signals about their risk profiles...

Third, bankers would have greater incentives to disclose relevant information on their risks so as to reduce the interest expense of subordinated debt. That cost would be lower, in part, because disclosure by banks would save research and analysis expenses for subordinated-debenture holders. Banks that take lower risks would benefit from effectively informing potential holders of their debentures about the favorable situation. Banks with less-favorable risk situations nevertheless would have to disclose information; if they did not, potential debenture holders would have reason to draw adverse inferences. Furthermore, once the decision has been made to disclose information about some aspect of bank performance, similar information generally will not be withheld at subsequent reporting intervals, since any interruption likely would be interpreted as an attempt to conceal a deteriorating situation.”¹²

Given the market discipline and other benefits from a subordinated debt program, Fannie Mae has committed to issue subordinated debt on a regular schedule. Along with Freddie Mac, therefore, we become the first financial institution to institute a program similar to that advocated for years by economists, members of the SFRC prominent among them.

¹² *Reforming Bank Capital Regulation: A Proposal by the U.S. Shadow Financial Regulatory Committee*, Statement No. 160, March 2, 2000, The AEI Press, Washington DC, 2000, at 35-7.

III. The Fannie Mae Subordinated Debt Program

On January 23, 2001, Fannie Mae announced its inaugural issue of Subordinated Benchmark Notes that initiated the subordinated debt program the company committed to on October 19, 2000.

As shown in Exhibit 1, the first issue was in the amount of \$1.5 billion maturing in ten years. At a yield of 6.29%, the subordinated notes were priced at 22 basis points above our senior debt with a similar maturity.

Exhibit 1: Fannie Mae Inaugural Subordinated Benchmark Notes

Pricing Date	January 25, 2001
Settlement Date	February 1, 2001
Maturity Date	February 1, 2011
Original Term	10 years
Amount	\$1.5 Billion
Payment Dates	Each February 1st and August 1st: beginning August 1, 2001
Price	99.684
Interest Rate	6.25%
Yield	6.29%
Spread	+98 basis points to 5.750% U.S. Treasury Note due August '10 +22 basis points to 6.625% FNM Benchmark Note due 11/15/10
Credit Rating:	Moody's Aa2 Standard & Poor's AA-(Fannie Mae Senior Debt Credit Rating: Aaa/AAA)
Listing	Luxembourg Stock Exchange
Lead Managers	Goldman Sachs, Morgan Stanley, Salomon Smith Barney
Co-Managers	Bear Stearns, Blaylock, CSFB, JP Morgan, Lehman Bros., Merrill Lynch

Under our subordinated debt program:

1. There will be quarterly issuance during the first year of the program, and at least semi-annual issuance thereafter;
2. We will issue an estimated \$12-\$15 billion in subordinated notes over a three-year phase-in period, a sufficient amount, that is, so that core capital plus subordinated debt plus unallocated loss reserves will equal at least 4% of on-balance-sheet assets plus 0.45% of MBS outstanding—MBS that are guaranteed but not owned by Fannie Mae. Subordinated debt will not count as regulatory capital but instead will act as a risk-absorbing layer behind capital;
3. The minimum initial new issue sizes will be \$1 billion, and through reopenings it is possible that we will grow outstanding issues to \$1.5 billion or larger;
4. The average maturity of outstanding subordinated debt securities will be at least five years following the phase-in period;

5. Each issue will at all times be publicly rated by Moody's Investor Service and Standard and Poor's. The first issue of subordinated debt was rated Aa2 by Moody's and AA- by Standard and Poor's.
6. Subordinated notes will be unsecured and subordinated, and rank junior in priority of payments to all our senior liabilities—all current and future liabilities of the company other than those that by their terms expressly rank them as equal with, or junior to, the subordinated notes. Fannie Mae cannot make any payments of principal or interest on the subordinated notes if the company defaults on any senior liabilities.
7. Subordinated notes will not be convertible to equity even when deferral of interest payments is triggered.¹³
8. The subordinated notes have a trigger mechanism whereby, under certain defined conditions of economic distress, interest payments on the notes would be deferred for up to five years or for the remaining maturity of any particular issue, whichever is shorter.

In particular, interest deferral would be triggered if:

- i) Our core capital falls below 125% of critical capital levels; or
- ii) (a) Our core capital falls below minimum capital levels, **and**, (b) pursuant to the company's request, the Secretary of the Treasury exercises his or her discretionary authority to purchase the company's obligations under Section 304(c) of the company's Charter Act.

In the event of interest deferral being triggered, it would simultaneously be triggered for all outstanding subordinated notes. In addition, dividend payments on outstanding equity and preferred stock would be suspended.

Once interest deferral is triggered, no interest payments will be made until the requirement for interest deferral ceases. Upon the earliest of (i) the requirement for interest deferral ceasing, (ii) the given issue maturing, or (iii) the maximum five year period of deferral for the given issue having elapsed, all missed interest will

¹³ "We have deliberately chosen not to [allow conversion to equity] because we want to ensure that a holder of subordinated debt has the same interest as the U.S. taxpayer. Subordinated debt that converts to equity gives the holder an interest in the company doing whatever it can to make that subordinated debt principal pay off, even if the risk the company takes are very high. Equity holders, if a company is in trouble, basically want the company to go for broke, shoot for the moon, on the hope they will get paid off. Debt holders want exactly the opposite. So subordinated debt holders in that circumstance if the debt is not converted to equity have exactly the same interest as the Congress and the U.S. taxpayer, and that is what we wanted to create." Timothy Howard, Executive Vice President and Chief Financial Officer, Fannie Mae, in answer to a question from Rep. Bachus, *Hearing on Compliance with Voluntary Commitments*, House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, March 27, 2001.

be due and payable along with interest on the missed payments compounded at the coupon rate of the particular issue.

The securities will not contain any provision to allow holders to accelerate the maturity of the securities if Fannie Mae does not pay after a five-year deferral. Therefore, holders will have the right only to institute a judicial proceeding to collect amounts then due and unpaid—i.e., the accrued interest and compounded interest thereon. Holders would then need to institute additional judicial proceedings for future payments of interest and principal that become due and unpaid.

IV. Fannie Mae's Subordinated Debt Program Meets all Effectiveness Tests

The major aim of a subordinated debt program is to enhance market discipline. There are at least three requirements that are necessary in order for subordinated debt to fulfill that role:

1. There must be a certain element of either compulsion or pre-commitment in the program so that the issuing entity is required to access the market regularly;
2. The debt instruments should have provisions that would alert purchasers to the fact that they are more risky than other more senior instruments; and
3. Investors in a company's subordinated debt need to be able to judge the condition of the issuing company so as to form a judgment as to the amount of risk they are subject to. The issuing company, in other words, must be transparent.¹⁴

In designing our subordinated debt program, we took explicit account of these requirements to maximize its market-discipline-enhancing potential.

Mandatory vs. Voluntary Issuance

SFRC Position: "Large banks not only should be allowed to meet a specified proportion of their capital requirements with new issues of subordinated debentures, but should be required to do so...[I]t is desirable to go beyond a permissive approach toward subordinated debt as a component of bank capital by requiring that a minimum proportion of capital take the form of subordinated debt."¹⁵

In Statement No. 168, the committee applauded the joint report of the Treasury and the Federal Reserve for its empirical findings that "support the Committee's position that some form of mandatory subordinated requirement be adopted."¹⁶ However, the statement goes on to express disappointment that:

¹⁴ The SFRC also recommends that the sub debt (1) must be subordinated to all other liabilities, and that it not be collateralized nor convertible to equity; (2) have a minimum remaining maturity; (3) be sold in large denominations, such as \$100,000, so as not to be confused with insured deposits; (4) should have covenants that allow the issuing bank to withhold principal and interest payments if it is capital deficient; and (5) be sold at arm's length. (Cf., Shadow Financial Regulatory Committee, *supra* note 12, at 37-38). Fannie Mae's sub debt program meets all of these criteria except for the large denomination one—the minimum denomination for our sub debt notes is \$1,000. However, the reason for that requirement, to avoid confusion with insured deposits, is irrelevant in the case of Fannie Mae since we don't have retail operations or offer insured deposits. Indeed, 99% of the purchasers of the first issue of the notes were institutions (as shown in Exhibit 3 on page 20 *infra*) and the average ticket size was approximately \$5.333 million.

¹⁵ Shadow Financial Regulatory Committee, *supra* note 12, at 4 and 42 (emphasis in original).

¹⁶ Shadow Financial Regulatory Committee, *supra* note 5, at 1.

“Nonetheless, the Report declines to endorse a mandatory system because of ‘uncertainty’ about its practicality and potential impact, suggesting instead that more data be gathered. But as other Federal Reserve research has shown, although large depository organizations now voluntarily issue subordinated debt, they have a demonstrated reluctance to do so when encountering financial difficulties. Yet this is precisely the point in time when such debt should be issued. Knowing that they must always confront the marketplace—in good times and in bad—banks would be more prudent in their activities. Furthermore, the inability of a bank to sell its debt when required, or to do so only at interest rates substantially higher than the rates on high quality corporate securities of comparable maturity, provides a strong market signal to regulators to take appropriate action under the ‘prompt corrective action’ provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Accordingly, without mandating some subordinated debt issuance, there is no way for regulators to obtain the information that the Federal Reserve and Treasury ostensibly are seeking: namely, the effectiveness of subordinated debt in encouraging the markets and regulators to discipline banking organizations.”

As shown in Table 5 (page 23) of the Treasury/Federal Reserve report, all but four or five of the 50 largest U.S. bank holding companies had subordinated debt outstanding on December 31, 1999.¹⁷ Thus, the issuance, *per se*, of sub debt is anything but an unusual practice.

However, as the SFRC pointedly notes, a bank that issues sub debt on a voluntary, irregular schedule can quietly refrain from doing so when facing financial difficulty and its decision of omission is likely to go unnoticed.¹⁸ Thus, it is of the essence for an effective program that a bank be mandated, or at least publicly committed, to issue sub debt regularly so that if it fails to issue as scheduled, the decision is likely to be, in and of itself, pregnant with information for the markets and for regulators. In that case, evidence of absence is not absence of evidence as it would be with an intermittent voluntary scheme.

¹⁷ Four BHCs had zero sub debt outstanding while State Street Corporation had a minimal amount—0.01% of risk-weighted assets.

¹⁸ Note that GLBA has an embryonic mandatory sub debt requirement for some large banks. Specifically, if a national bank, that is among the 50 largest FDIC-insured banks, wants to establish a “financial subsidiary,” it must have at least one issue of long-term subordinated debt outstanding rated A or better (for banks 51 to 100 the requirement can be met with rated sub debt or some other showing considered by the regulator to be an equivalent standard). A financial subsidiary may engage in some activities not allowed a national bank but would not be granted the insurance underwriting, real estate development or investment, or merchant banking powers allowed the new Financial Holding Companies authorized by GLBA. P.Law 106-102 Sec. 121. In this instance, subordinated debt is merely the vehicle through which the bank can fulfill a requirement to maintain a rating of a certain level from a “nationally recognized statistical rating organization.” If the rating slips below the prescribed level, the bank is prohibited from investing any further amounts of funds in financial subsidiaries until it gets itself back into compliance. Thus, the focus is on the bank getting a rating rather than on a subordinated debt program.

It is true that, *de jure*, Fannie Mae's subordinated debt program is also a voluntary one. There is no requirement in statute or in regulation for the company to issue sub debt regularly.

But what is of the essence here is commitment not compulsion. All that is necessary is for a financial institution to commit to a definite and reliable schedule for issuing sub debt so that interested parties, the market and regulators particularly, can take note if it fails to live up to its commitment.

On October 19, 2000, our chairman, Franklin Raines, in the company of leading members of Congress, including Reps. Richard Baker and Paul Kanjorski (chairman and ranking member, respectively, of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises), committed the company to a subordinated debt program. Fannie Mae has since publicly pledged itself to an issue schedule of once a quarter during 2001 and at least semi-annually thereafter.¹⁹

Chairman Baker has already held a hearing (on March 27) to monitor progress in implementing the commitments made on October 19. Furthermore, OFHEO has notified the company that it intends to monitor compliance with the commitments on an ongoing basis as part of its regular examination function.

Thus, as intended, Fannie Mae's public statements and pledges have been taken as an easily monitored commitment by the company to reliably issue subordinated debt. Along with Freddie Mac, we are thereby unique among U.S. financial institutions in meeting one of the *sine qua nons* set down by the SFRC for an effective subordinated debt program. The SFRC concluded its Statement No. 168 on requiring large banks to issue subordinated debt by observing that:

“the logic of the Federal Reserve/Treasury report points strongly toward one conclusion. If information about how a mandatory subordinated debt requirement would work is desired, there is only one way to find out: test such a requirement now. No further research, without a real world trial, will resolve the alleged uncertainties of the effectiveness of a mandate.”

In our subordinated debt initiative, we are conducting a real world trial and, indeed, much more than a trial. It is a full-fledged program. When it is phased in, Fannie Mae expects to have the substantial total of \$12 to \$15 billion in subordinated debt outstanding. We invite the SFRC, in the company of other interested parties, to see how the committee's long-advocated proposal actually works out.

¹⁹ Cf., for instance, press release of January 23 at <http://www.fanniemae.com/news/pressreleases/1110.html>.

The SFRC recommends that large banks be required to issue subordinated debt equal to at least 2% of assets. Our program is likely to be closer to the 1.5%-of-assets level, as was noted by SalomonSmithBarney.²⁰

There is nothing magical about 2% as the level for an effective subordinated debt program. According to two researchers from the Office of the Comptroller of the Currency:

“The Shadow Financial Regulatory Committee (SFRC) recommends 2 percent as the minimum ratio of subordinated debt to assets. Part of the appeal of 2 percent is that it is close to the average amount of subordinated debt outstanding that large banks and large bank holding companies have already issued voluntarily. The question arises whether a mandate for subordinated debt should call for a greater or lesser amount.

An advantage of 2 percent is that at larger banks this amount should be sufficient to maintain adequate market depth and liquidity in the secondary market. Ensuring adequate liquidity in the subordinated debt market is particularly important if subordinated debt prices are used as regulatory triggers. Greater liquidity and smoother trading will generally enhance the quality and clarity of price signals and thus help avoid false alarms because of poor signals.

In certain circumstances, rule-makers might be able to require less subordinated debt without diminishing the quality of the signal. If banks provided market participants with more and better information about their assets, for example, the improved quality of the signals from the subordinated debt market could allow the system to work well with a 1 percent requirement.”²¹

Thus, a major reason for a 2% requirement is to ensure that the amount of debt outstanding is adequate to constitute a market with sufficient liquidity so that the prices of the instrument give reliable information as to the market’s perception of risk. Each issue of our subordinated debt will be sufficiently large to fulfill this requirement.²² Lack of liquidity has been cited as a reason for some banks not to issue sub debt. Their reasoning is that poor liquidity will invalidate any credit signal being derived from the

²⁰ *Introducing U.S. Agency Subordinated Debt, Bond Focus, U.S. Agency, SalomonSmithBarney, December 27, 2000, at 2.*

²¹ *Analysis of Proposals for a Minimum Subordinated Debt Requirement, William W. Lang and Douglas Robertson, Economic and Policy Analysis Working Paper 2000-4, Office of the Comptroller of the Currency, March 2000, at 23-4.*

²² “Fannie Mae expects to issue quarterly during 2001, the first year of the program, and at least semi-annually thereafter, with a minimum new issue size of \$1 billion. From time to time in order to enhance liquidity, Fannie Mae may also reopen an existing Subordinated Benchmark Notes issue. Fannie Mae currently expects that individual issues size could ultimately be \$1.5 billion or larger.” *fundingnotes*, Fannie Mae, January 2001, at 3 (available at http://www.fanniemae.com/markets/debt/fundingnotes/pdf/fundingnotes_1_01.pdf).

sub debt. “Secondary market prices for all but the most liquid bonds are apt to be ‘indicative prices,’ set by individual dealers for purposes of marking positions to market rather than firm bids and offers.”²³ Our commitment to the sub debt market was to issue large-sized bonds frequently. This commitment to maximize liquidity was established specifically to address this concern.

The Risk Perception of the Market

SFRC Position: “[T]he terms of the debt should include a covenant that permits the issuing bank, at the direction of its supervisor, to withhold payment of interest and principal if the issuing bank's capital should fall below a specified percentage of assets...The greater risk of subordinated debt motivates more monitoring effort on the part of subordinated debt holders, and because subordinated debt buffers the risk of other debts, its existence will concentrate monitoring efforts in the hands of subordinated debt holders.”²⁴

The central question that observers, members of the SFRC among them, ask with regard to our subordinated debt program is whether the market will regard it differently from our senior debt or whether, in the alternative, it will look upon our subordinated debt as no different from our senior debt.

As will be detailed below, we have taken great pains to deliberately design our subordinated debt program to dispel the latter perception. Before turning to that issue, however, one should consider the same question in relation to large banks.

As summarized earlier in this paper, the SFRC, as a body over the last two years and in positions taken by individual members over a much longer period, has strongly advocated a central role for mandatory subordinated debt programs in promoting market discipline at large banks.

As shown in Exhibit 2, we are not the largest financial institution in the country. Citigroup and JP Morgan Chase have larger balance sheets than ours and Bank of America’s is just slightly smaller.²⁵

Exhibit 2: Total Assets of Selected Financial Institutions

Institution	Total Assets (12-31-00, \$B.)
Citigroup	\$902
JP Morgan Chase	\$715
Fannie Mae	\$675
Bank of America	\$642

Source: Annual Reports

If the Committee were to find that our sub debt program was not effective in promoting market discipline and in furnishing signals about

²³ *Market Discipline and Mortgage Debt: A Review of some Salient Issues*, Robert R. Bliss, Economic Perspectives, Federal Reserve Bank of Chicago, Vol. XXV, Issue 1 (First Quarter 2001), at 33.

²⁴ Shadow Financial Regulatory Committee, *supra* note 12, at 38 and 46.

²⁵ Fannie Mae also has a large off-balance sheet credit exposure in the form of \$707 billion in MBS outstanding but not owned by the company. But large banks also have large off-balance-sheet exposures. For instance, according to the FDIC, at the end of last year, the seven largest participants in bank derivative activity had derivatives with a notional amount of \$38.5 trillion, 96% of all derivatives in the banking industry. *FDIC Quarterly Banking Profile*, Fourth Quarter 2000, at 27.

the health and risk-posture of the company while at the same time promoting subordinated debt as a major part of the bank regulatory structure, the inescapable conclusion would be that the SFRC and the market believe that the government would treat an ailing Fannie Mae in a fundamentally different manner than, say, an ailing Citigroup or JP Morgan Chase. In essence, it would require a belief that the government would regard Fannie Mae as too big to fail while not having a similar concern about the impact of a failure of equally big (or bigger) banks.

One reason supporting such a position might be FDICIA. It requires the FDIC to use those resolution methods that produced the least cost to the insurance fund and it prohibits the protection of uninsured depositors and creditors when such action would increase costs to the fund. As a result, it is argued that “FDICIA increases the likelihood that large banks will be resolved with losses to uninsured depositors [and creditors]”²⁶ and that this increases market discipline at large banks. Indeed, some studies have suggested that interest rates on uninsured bank liabilities have become more risk-sensitive since the passage of FDICIA.²⁷

However, FDICIA has an exception to the least-cost rule. If the resolution of a bank failure should entail systemic risk, FDICIA’s rules may be waived.²⁸

Furthermore, the FDICIA provisions have yet to be tested in the real world.²⁹ The test for how well FDICIA works will come the next time there is a truly big bank failure.^{30,31}

²⁶ *History of the Eighties—Lessons for the Future*, Federal Deposit Insurance Corporation, Volume I, at 76.

²⁷ See review in *Using Subordinated Debt as an Instrument of Market Discipline*, Study Group on Subordinated Notes and Debentures, Staff Study 172, Federal Reserve System, December 1999, at 14.

²⁸ Such a waiver requires concurrence by two-thirds of the Federal Reserve Board, two-thirds of the FDIC Board, and the Secretary of Treasury in consultation with the President that conformance with least-cost resolution would “have serious adverse effects on economic conditions or financial activity” before the FDIC is allowed to “take other action or provide assistance as necessary to avoid or mitigate such effects.” In addition, if the systemic risk exception is used, any insurance fund losses arising from such exceptional actions must be recovered through special assessments on all depository institutions that are members of the relevant federal deposit insurance fund.

²⁹ FDICIA “took significant steps toward dealing with TBTF, but since then no very large bank has failed, so the law’s effect on how regulators would respond to such a failure has not yet been tested.” FDIC, *id.*, at 236.

³⁰ “FDICIA substantially increased the likelihood that uninsured depositors and other creditors would suffer losses when their bank fails. The fix was incomplete, however, because regulators can provide full protection when they determine that a failing bank is too-big-to-fail (TBTF)—that is, its failure could significantly impair the rest of the industry and the overall economy. The Secretary of the Treasury must consult with the president in making this determination. In addition, two-thirds of the governors of the Federal Reserve System and two-thirds of the directors of the FDIC must approve the extraordinary coverage.

While these limitations appear to constrain bailouts, they are not prohibitive. *Indeed, Congress appears to have codified, but not necessarily altered, the informal rescue process that was previously in place.* Consider the 1984 testimony of the Comptroller of the Currency on the decision to bail out Continental Illinois:

We debated at some length how to handle the Continental situation. ... Participating in those debates were the directors of the FDIC, the Chairman of the Federal Reserve Board, and the Secretary of the Treasury. In our collective judgment, had Continental failed and

“[D]espite the positive impact of FDICIA in reducing implicit government subsidies, it is likely that bank creditors, particularly creditors of very large banks, still believe there is a substantial probability that the fear of systemic problems will lead the U.S. government to protect them.”^{32,33}

To repeat, therefore, in order for the SFRC to enthusiastically endorse a putative subordinated debt requirement for banks while dismissing our in-place program, the committee must hold that the markets believe that the government would stand behind Fannie Mae’s subordinated debt and not do likewise for a large bank. In reality, of course, the government would probably tend to treat Fannie Mae and the largest banks somewhat the same—and in the constructive ambiguity that the government tends to use in these matters, it is not clear what that treatment might be.

However, as far as our subordinated debt is concerned, Fannie Mae has structured the instrument so as to convince the market participants that there is additional risk in our subordinated debt relative to senior debt—and, as will be seen, all indications are that we have been successful in that effort.

The structure of our subordinated debt is such that, in the unlikely event that Fannie Mae experienced serious problems so that our capital was reduced sufficiently, holders of our subordinated debt are *guaranteed* to suffer discomfiture through the deferral of interest

been treated in a way in which depositors and creditors were not made whole, we could very well have seen a national, if not an international, financial crisis the dimensions of which were difficult to imagine. None of us wanted to find out.”

Fixing FDICIA: A Plan to Address the Too-Big-To-Fail Problem, Ron J. Feldman and Arthur J. Rolnick, Federal Reserve Bank of Minneapolis Annual Report, 1997 (emphasis added).

³¹ Ironically, the 1993-enacted *national depositor preference* (see footnote 39 *infra*) which aimed to reduce costs to the FDIC by giving domestic deposits (insured and uninsured), and derivatively the FDIC, preference over foreign depositors and other unsecured claimants could cause a “greater probability of a systemic-risk determination in the case of a bank with sizable foreign operations.” *The Consequences of National Depositor Preference*, James A. Marino and Rosalind L. Bennett, FDIC Banking Review, Vol. 12, No. 2 (1999), at 37. “[T]he FDIC can impose losses on foreign depositors. But...if the FDIC attempts to impose such losses, it may lose control of the resolution process. If a country attempts to protect its depositors, it may decide to dispose—under its own laws—of the assets and liabilities of the domestic branches of a failed foreign bank (in this case the foreign bank would be a U.S. bank)...In this way, domestic depositor preference complicates the resolution of a large bank with a substantial presence abroad.” *Id.*, at 35.

³² Lang and Robertson, *supra* note 21, at 8.

³³ The Federal Reserve Bank of New York’s involvement in the rescue of Long-Term Capital Management in 1998 did not increase confidence that FDICIA’s provisions would be followed when a crisis was thought to loom. As SFRC member George Kaufman noted: “the 1998 involvement of the Federal Reserve in Long-Term Capital Management’s (LTCM’s) financial problems troubles me greatly. Although informed parties can and do differ on the broader consequences of possibly forcing a more rapid liquidation of LTCM’s complex and far-reaching derivative positions, particularly in a period of already substantial uncertainty in the financial markets, it is difficult for me to believe that the world would have ended if the Fed had stayed on the sidelines a while longer. In addition, the Fed’s involvement gave rise to widespread accusations of crony capitalism in the United States and intensified the doubts of many that, despite FDICIA’s strong language for banks, when push comes to shove, U.S. regulators will be unable to resist TBTF. And LTCM was not even a bank!” *How Real Is the Risk of a Massive Banking Collapse?* George G. Kaufman, *Regulation*, Volume 23, No. 1 (2000), at 29.

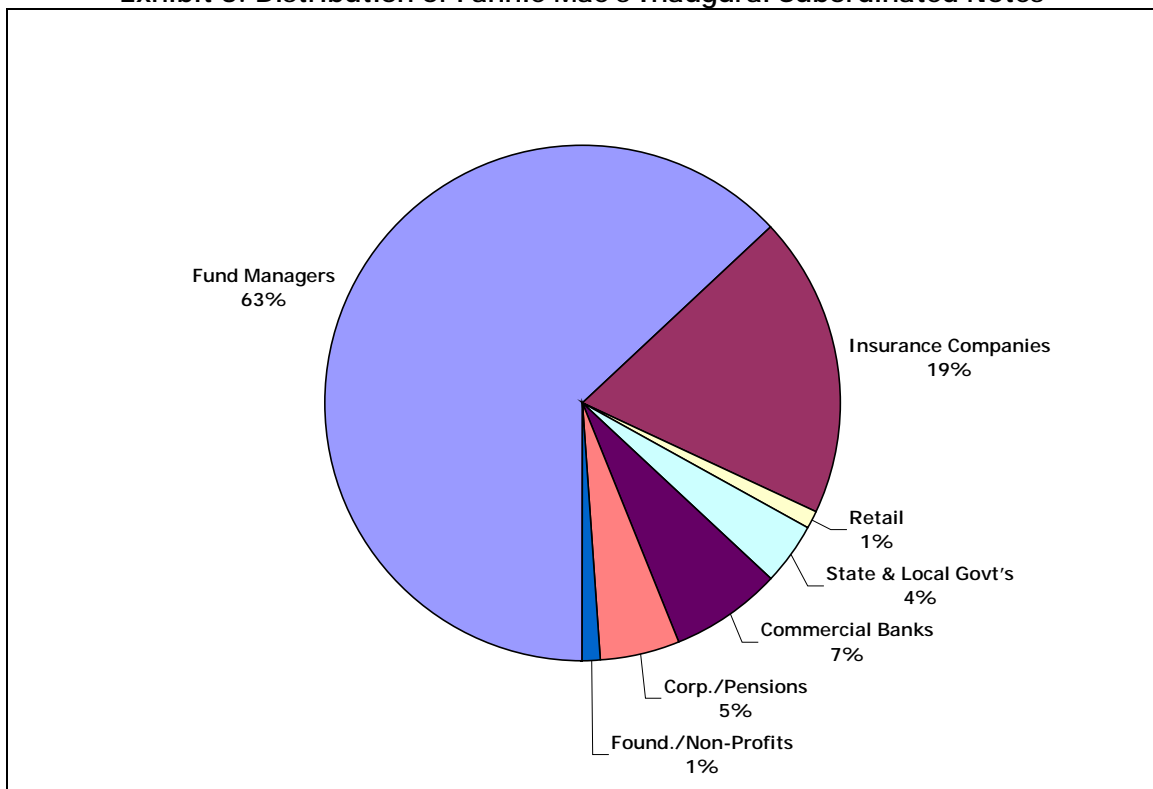
provision—and, as Goldman, Sachs & Co. points out (see page 22 *infra*), interest deferral would likely have more serious consequences for our sub debt holders than a mere delay in receiving interest payments.

There are no *ifs*, *ands*, or *buts* about it. The mechanism for triggering deferral of interest payments is self-executing if either of the two triggers is encountered. This distinguishes our subordinated notes from other more traditional bank-issued subordinated debt. These triggers (as defined on page 11 *supra*) result in interest deferral under the defined conditions for up to five years, though not exceeding the maturity of the issue. Other financial institutions who have issued securities with a deferral provision typically do not specify exactly what has to happen for the deferral to be triggered, whereas investors in our subordinated notes will know exactly how close a deferral is to being triggered by monitoring our capital levels. If the triggers are met, the deferral of interest for holders of Fannie Mae subordinated notes is automatic. Additionally, the triggers do not depend on intervention by the regulator so that supervisory forbearance does not enter the picture.

And, of course, should the company ever experience extreme difficulties, holders of our subordinated debt securities would stand in line behind senior debt creditors and MBS investors before they can recover their principal.

Investors in our subordinated debt have been overwhelmingly institutional. As shown in Exhibit 3, fund managers purchased 63% of the issue and fully 99% went to institutions of various sorts.

Exhibit 3: Distribution of Fannie Mae's Inaugural Subordinated Notes



With this sort of a market for the instrument, it is inconceivable that buyers wouldn't monitor developments very carefully and demand an appropriate risk-adjusted return if Fannie Mae was getting anywhere near the trigger point for interest deferral. And this, of course, is the sort of market signal that proponents of a mandatory subordinated debt requirement expect, and want, to see.

For these reasons, a consensus of market analysts agree that Fannie Mae subordinated debt would be regarded by the market as different from our senior debt and would trade at a discount to it.

For instance, Goldman, Sachs identified three factors that would impact the return on our subordinated relative to our senior debt:³⁴

1. **Liquidity:** "We expect lower liquidity in the subordinated debt market than we see in Benchmark and Reference Notes. Investors will demand more yield for the reduced liquidity of this market."
2. **Credit Risk:** "The biggest factor that will probably drive the valuation of subordinated debt relative to Benchmark and Reference Notes is the additional credit risk that holders of subordinated debt will face. In the unlikely event of default, holders of Benchmark and Reference Notes, the senior debt holders, will have their claims on the firm satisfied before the subordinated debt holders. In default, subordinated debt holders will receive any proceeds that arise from liquidation of the firm after the senior debt holders, but before common and preferred shareholders...Therefore, investors will require a yield premium for subordinated issues."
3. **Interest Deferral Feature:** "The agencies will defer interest rate payments for up to five years under certain conditions of financial distress. Since this rearrangement of cash flows will reduce reinvestment income and cause the duration of the security to increase, investors will require additional yield for this feature."

For 10-year issues, Goldman, Sachs estimated that the premium of our subordinated over our senior debt would range between 15 and 26 basis points (Exhibit 4).

**Exhibit 4: Estimated Yield Premiums for
10-Year Subordinated Agency Debt**

All values expressed in basis points (bp)		
Source of Premium	Low	High
Liquidity	3	7
Credit Risk	10	15
Interest Deferral	2	4
Total	15	26

Source: Goldman, Sachs & Co.

³⁴ *Agency Subordinated Debt*, Goldman, Sachs & Co., January 5, 2001

The company said that: “In addition to this estimated yield premium between the two classes of debt, we also think the market will charge a small premium on the 10-year issue, raising that senior-subordinated spread to perhaps 20-30 bp.”³⁵

Note that interest deferral would cause only an estimated 2 to 4 basis points of the total premium. However, Goldman, Sachs warned that while “we believe that the interest deferral feature represents a relatively small component of the value of subordinated debt—and that liquidity and credit risk are the dominant factors in pricing the debt”:

“It is important for investors to note, however, that *any announcement of interest rate deferral would be negative for subordinated debt holders and would raise the cost of funds for the agencies*. In the event of interest deferral, the market would be likely to revise upward the probability of default on the subordinated debt and/or revise downward its expected recovery value. Spreads on the securities would widen significantly, and liquidity would diminish. In our analysis, this is captured under the valuation of subordination, because we assume debt holders ultimately will receive deferred interest (with or without reinvestment accrual) unless there is a default. Investors should recognize that while today’s expected value of the interest deferral feature is relatively small, the cost of interest deferral, if it occurred, would be significant. Furthermore, it is possible that deferred interest payments will never be made to investors.”³⁶

Though the Goldman, Sachs estimates were made several weeks before the first issue of our subordinated debt hit the market, its estimate of a 20 to 30 basis point premium was remarkably accurate. Thus, the prices at which the notes have traded indicate that the market is behaving consistent with the analysis.

The subordinated notes were initially priced at 98 basis points over the 10-year U.S. Treasury and 22 basis points over the November 2010 Fannie Mae Benchmark Note.

Approximately \$250 million traded during the course of the day at spreads as tight as 17 basis points to our 10-year senior note before closing the day at 19 basis points (Exhibit 5 and Exhibit 6).³⁷ Since issuance, the subordinated debt has traded in large blocks, with pricing ranging from 18.5 to 28 basis points higher in yield than the company’s senior debt. In the two-plus months in which it has been traded, the average spread has been 22.4 basis points.

³⁵ *Id.*, at 11.

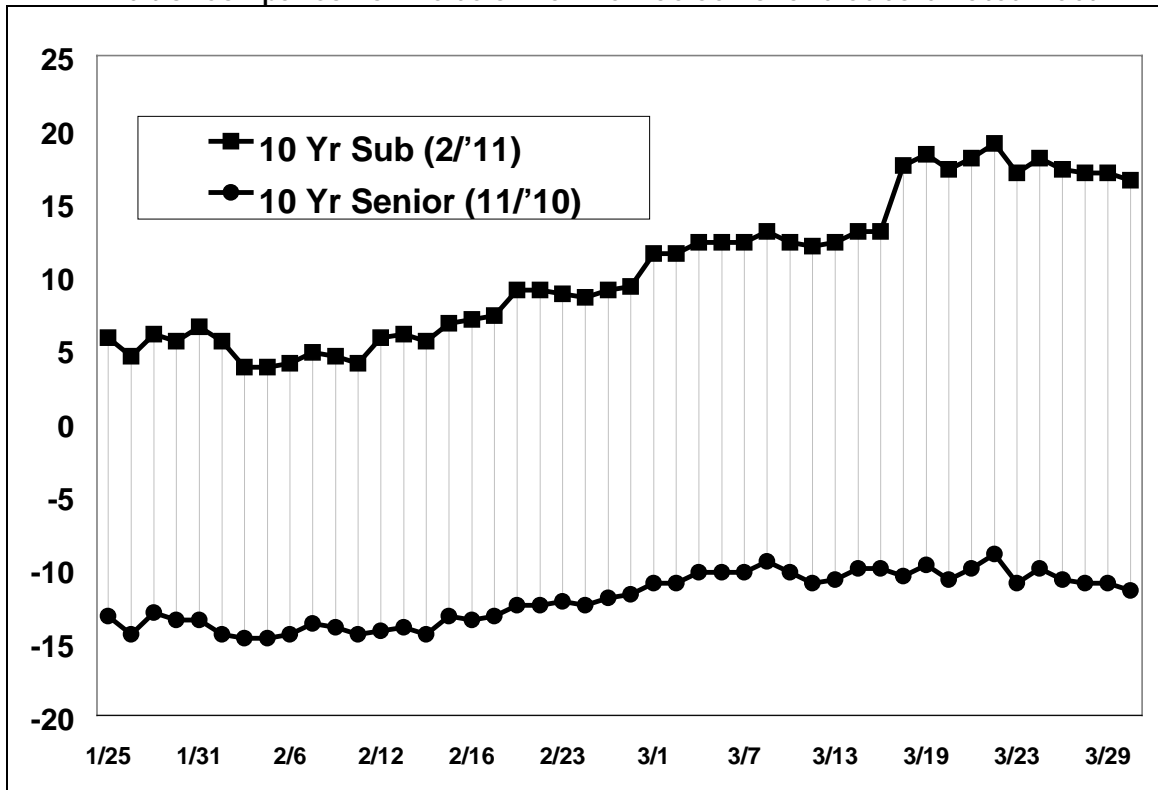
³⁶ *Id.*, at 9 (emphasis in original).

³⁷ Our spreads in Exhibit 5 are measured off the swap rather than the U.S. Treasury curve. Since the swap curve is more densely populated, it provides a more accurate basis for comparison of our senior versus sub differentials when compared to the senior/sub relationships for large commercial banks, as examined below.

Exhibit 5: Comparison of Yields on Fannie Mae Senior and Subordinated Debt

Date	Spread of Swaps to Treasuries	Spread of Fannie Mae Securities to the Swap Curve			Date	Spread of Swaps to Treasuries	Spread of Fannie Mae Securities to the Swap Curve		
		10 Year Senior (11/2010)	10 Year Subordinated (2/2011)	Difference			10 Year Senior (11/2010)	10 Year Subordinated (2/2011)	Difference
1/25	88.25	(13.25)	5.75	19.0	2/28	89.25	(11.75)	9.25	21.0
1/26	87.50	(14.50)	4.50	19.0	3/1	89.00	(11.00)	11.50	22.5
1/29	86.00	(13.00)	6.00	19.0	3/2	91.00	(11.00)	11.50	22.5
1/30	83.50	(13.50)	5.50	19.0	3/5	90.25	(10.25)	12.25	22.5
1/31	80.50	(13.50)	6.50	20.0	3/6	91.25	(10.25)	12.25	22.5
2/1	80.00	(14.50)	5.50	20.0	3/7	91.75	(10.25)	12.25	22.5
2/2	83.75	(14.75)	3.75	18.5	3/8	91.50	(9.50)	13.00	22.5
2/5	85.75	(14.75)	3.75	18.5	3/9	94.75	(10.25)	12.25	22.5
2/6	86.00	(14.50)	4.00	18.5	3/12	96.50	(11.00)	12.00	23.0
2/7	82.75	(13.75)	4.75	18.5	3/13	98.25	(10.75)	12.25	23.0
2/8	93.50	(14.00)	4.50	18.5	3/14	98.00	(10.00)	13.00	23.0
2/9	93.50	(14.50)	4.00	18.5	3/15	96.50	(10.00)	13.00	23.0
2/12	92.25	(14.25)	5.75	20.0	3/16	95.50	(10.50)	17.50	28.0
2/13	93.50	(14.00)	6.00	20.0	3/19	95.25	(9.75)	18.25	28.0
2/14	96.50	(14.50)	5.50	20.0	3/20	93.75	(10.75)	17.25	28.0
2/15	96.75	(13.25)	6.75	20.0	3/21	91.00	(10.00)	18.00	28.0
2/16	95.00	(13.50)	7.00	20.5	3/22	91.50	(9.00)	19.00	28.0
2/20	93.75	(13.25)	7.25	20.5	3/23	92.50	(11.00)	17.00	28.0
2/21	92.50	(12.50)	9.00	21.5	3/26	93.00	(10.00)	18.00	28.0
2/22	94.50	(12.50)	9.00	21.5	3/27	94.25	(10.75)	17.25	28.0
2/23	96.25	(12.25)	8.75	21.0	3/28	95.00	(11.00)	17.00	28.0
2/26	96.00	(12.50)	8.50	21.0	3/29	95.00	(11.00)	17.00	28.0
2/27	92.50	(12.00)	9.00	21.0	3/30	93.50	(11.50)	16.50	28.0
Average							(12.00)	10.40	22.4

Exhibit 6: Comparison of Yields on Fannie Mae Senior and Subordinated Debt



In terms of spread, it is useful to compare our subordinated debt to that of the largest bank holding companies. It is difficult to find such companies with subordinated debt of comparable maturity to a senior issue and comparable at the same time to our initial ten-year offering.

However, two of the largest BHCs, Citigroup and Bank of America Corp., have subordinated debt outstanding that meet these conditions. In February and March of this year, they traded at spreads of 1.5 to 21 basis points to the BHC's senior debt, lower spreads than those between our subordinated and senior debt (Exhibit 7 and Exhibit 8). Thus, the average spread for Citigroup was 21 basis points and that for BofA was 14 basis points compared to 23.1 basis points for Fannie Mae.³⁸

One explanation for this is that, unlike our senior debt, bank senior debt stands in line behind a large number of senior claimants (depositors and the FDIC).³⁹ Many people have speculated that senior debt at large banks could be helped by an application of a too-big-to-fail doctrine. Nonetheless, that application is uncertain.

Bank sub debt is thus junior to a class of debt that is already quite junior within the bank liability structure. Hence the market spread between senior and subordinated debt, and the derived signal, will be somewhat muted.

In contrast, our senior debt is *the* senior claimant on payments from an organization whose balance sheet is made up of residential mortgage collateral and is thus inherently more stable than a bank's. There is no significant class of claimants standing between the senior debt holder and the assets. For this reason, the spreads of senior debt to Treasuries or to swaps should be relatively narrow and stable, while the spread to sub debt should be wider and should provide a more accurate market credit signal.

³⁸ The 22.4 basis point spread mentioned on page 22 was for 46 trading days between January 25 and March 30. Data for Citigroup and Bank of America were only available on a weekly basis. Thus, the average given in comparison here for Fannie Mae of 23.1 basis points is for nine trading days, each one week apart, between February 2 and March 30.

³⁹ In 1993, in the *Omnibus Budget Reconciliation Act*, Congress adopted "national depositor preference" whereby claims on bank receiverships were subjected to the following preferences: (1) administrative expenses of the receiver; (2) secured claims (including Federal Reserve discount-window borrowings and Federal Home Loan Bank advances); (3) domestic insured and uninsured deposits; (4) foreign deposits and other general creditor claims; (5) subordinated debt; and (6) shareholders. Since the FDIC pays off the insured depositors, it stands in their stead in the seniority of claimants. The legislation thereby aimed to lower FDIC costs by shifting some of the losses to foreign depositors and other unsecured creditors. It is still an open question whether depositor preference will be beneficial to the FDIC in practice since, when a bank is troubled, uninsured and unsecured claimants have an added incentive to protect themselves from loss by withdrawing their funds or requiring collateral. Additionally, foreign governments could take pre-emptive defensive steps against the foreign branches of international U.S. banks. All of this could actually *increase* FDIC losses. "As a consequence, the FDIC could become more vulnerable than before. Ironically, this important piece of banking legislation was enacted as part of a nonbanking bill without much publicity and only minimal analysis." *FDICIA after Five Years: A Review and Evaluation*, George J. Benston and George G. Kaufman, June 1997, at 27-28. "The main impetus behind passage was that it allowed Congress to project cost savings to the FDIC and use these projected savings to offset part of the projected U.S. budget deficit." Marino and Bennett, *supra* note 31, at 23.

Exhibit 7: Spreads between Senior and Subordinated Debt—Citigroup vs. Fannie Mae

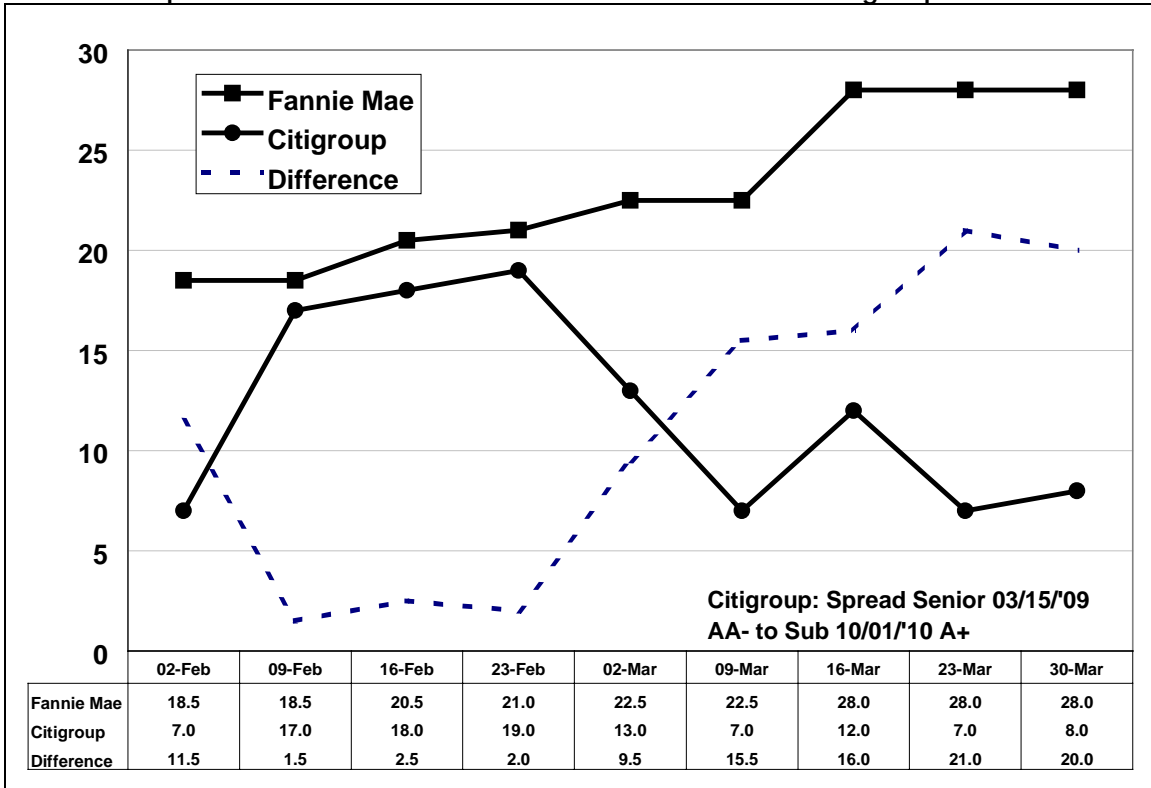
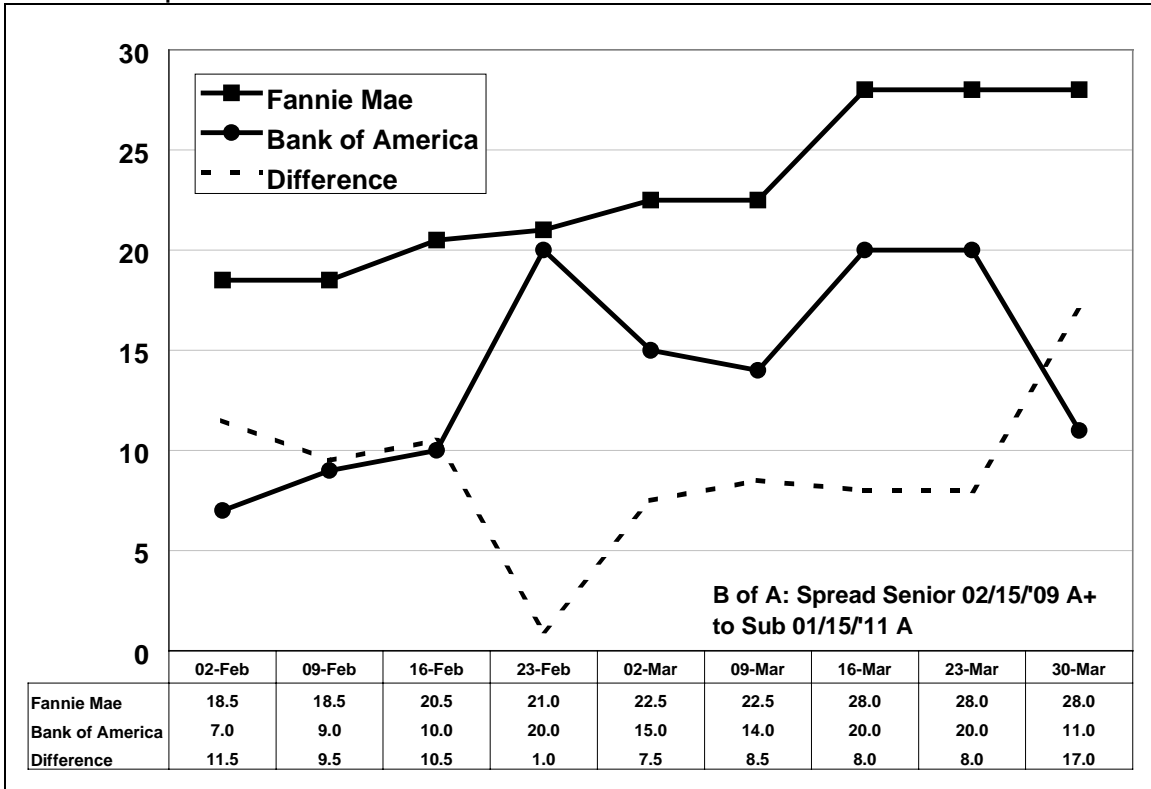


Exhibit 8: Spread between Senior & Subordinated Debt—Bank of America vs. Fannie Mae



In short, therefore, the market is taking into account, at least to the same extent as for large BHCs, the fact that our subordinated debt is junior to our senior debt and carries more risk because of features such as the deferral of interest provisions and the payment priority in the event of a Fannie Mae default.⁴⁰ In doing so, the market is following, and ratifying, the lead of the rating agencies when they assigned ratings to the subordinated notes:

“Unlike Standard & Poor’s triple-‘A’ rating on the senior obligations of Fannie Mae, which incorporates implied government support, the rating on the subordinated debt assumes that the government would not intervene to prevent payment default on the instrument.”⁴¹

“Although Fannie Mae and Freddie Mac are government-sponsored enterprises (GSEs), their subordinated debt is rated from a financial, not a political, perspective, since the potential for payment default is present. *Accordingly, Standard & Poor’s assesses the GSEs’ financial ability to make repayment using the same analytical factors that it uses for other financial institutions.*”⁴²

All this evidence from the marketplace shows that our subordinated debt program is as robust as any that could be applied to large banks and that the SFRC, supportive as it is for subordinated debt programs for banks, should welcome its proposals being put to the test in the real world by as large a company as we are.

So far, our subordinated debt has performed as theory would have it. There is no reason that it shouldn’t similarly perform if Fannie Mae ran into financial difficulty although, of course, this is a part of the real world test that we have absolutely no intention of undertaking.

As Morgan Stanley wrote in January,

“Spreads between the Subordinated Benchmark Notes and its senior Benchmark Notes will provide a real time indicator of investors’ perceptions of the adequacy of Fannie Mae’s capital relative to the risks it faces. Going forward Fannie Mae will have an additional yardstick with which to gauge the success of its capital policies. In striving to keep these spreads stable, Fannie Mae will have an incentive to communicate more extensively about the risks it faces and how it manages its capital in relation to these risks. This increased transparency to which Fannie Mae is

⁴⁰ “[I]nvestors should note that there is at least one key difference between the subordinated securities [of other companies] and the subordinated debt we expect the agencies to issue: Subordinated debt issued by Freddie Mac and Fannie Mae will contain an interest deferral feature, while conventional subordinated debt issues of the other corporate issuers do not.” Goldman, Sachs & Co., *supra* note 34, at 10.

⁴¹ *Rating Assigned to Fannie Mae Subordinated Benchmark Notes*, Standard and Poor’s *CreditWire*, January 24, 2001.

⁴² *Commentary: Subordinated Debt Ratings Reflect Unsupported Creditworthiness of Fannie Mae and Freddie Mac*, Standard & Poor’s, March 26, 2001 (emphasis added).

already committed will enable investors to better assess Fannie Mae's risk and the adequacy of its capital."⁴³

Moody's summarized the beneficial results from subordinated debt, emphasizing the difference between it and Fannie Mae's and Freddie Mac's senior securities:

"The subordinated debt issued by Freddie Mac and Fannie Mae will, in combination with common and preferred equity, improve senior debtholders' position in the highly unlikely event of a liquidation or similar event. This should help to alleviate concerns about the systemic risks from GSE failure and help to provide an early warning signal to the marketplace in times of stress...The GSEs' proposed subordinated debt also would not benefit from the same degree of implied support that senior enjoys and could face mandatory interest payment suspension."⁴⁴

With the unique features of our subordinated debt and the liquid market that Fannie Mae expects to develop, the company has created a new class of fixed-income assets for investors. The planned, regular, and large-size issuances of subordinated debt also validate the idea of a dynamic and active subordinate debt market as a means of market discipline. We expect that the market will use its collective expertise in measuring our risk profile, capital adequacy and financial health each time we bring new issues of subordinated notes to market, as well as in ongoing trading in the secondary market. In doing so, our subordinated debt will truly be chairman Greenspan's "canary in a coal mine" that establishes Fannie Mae at the forefront of financial institutions globally in adhering to the highest standards of market discipline.

Transparency

SFRC Position: "[A] subordinated-debt requirement would provide stronger incentives for banks to disclose more information than they currently do about their portfolio risks in a timely manner to the public—and in particular to the holders of subordinated debt."⁴⁵

An important condition for a well-functioning subordinated debt program is that the purchasers of that debt need to be able to judge the financial health of the issuer. After all, the information content from the market signal will not be of much use to anyone if market participants are either uninformed or, even worse, misinformed, as to the risk to which they are exposed.

Fannie Mae is among the most transparent financial institutions in the country because we are subject to continuous examination and to scrutiny from many quarters and because of the relative simplicity and straightforwardness of our operations.

⁴³ *Product Note on Fannie Mae Subordinated Benchmark Notes*, Morgan Stanley, Jan. 2, 2001.

⁴⁴ *New Freddie Mac and Fannie Mae "Open Book" Policy: A Positive Credit Development*, Moody's Investor Services Special Comment, Oct. 2000, at 4.

⁴⁵ Shadow Financial Regulatory Committee, *supra* note 12, at 5.

In 1992, Congress established OFHEO as Fannie Mae's and Freddie Mac's first "safety and soundness" regulator. OFHEO's sole task is to oversee just two companies, each headquartered within a few miles of the OFHEO offices and each engaged in a very similar narrow line of business. Two-thirds of the examination staff hired by OFHEO have prior experience, averaging sixteen years, with banking regulators such as the Office of the Comptroller of the Currency and the Federal Reserve System. Others have experience in the financial services industry as bankers or mortgage bankers.

The number of examiners assigned to Fannie Mae is on a par with the number that would examine the very largest commercial banks. However, such banks tend to have multiple lines of complex businesses all over the world.⁴⁶ In contrast, Fannie Mae examiners are watching a single, relatively simple line of business in just one country.

In addition, large banks engage in a broad array of lending activities, ranging from mortgages, auto loans, credit cards, and commercial lending, to far riskier and more obscure activities. In fact, in the post Gramm-Leach-Bliley Act world, these institutions have a whole range of new business activities available to them, including merchant banking, real estate development, and insurance underwriting.

Many bank assets are not standardized and do not have a readily available market. Indeed, one of the skills that bankers are said to provide the economy, and for which they are compensated, is their ability to judge the risk in idiosyncratic credits. Thus, many bank assets are difficult to value since there is not a readily observable price for them and little standardized information as to how they might be expected to perform. This is one of the reasons why banking industry regulators have had a difficult time figuring out how to develop stress test regimes or other similar modeling techniques for even the most sophisticated banks.⁴⁷

⁴⁶ "Adding to the supervisor's problems is the increasing scale, scope, span of operation, and general complexity of the largest banks operating in the United States...as we call them at the Fed, large, complex banking organizations (LCBOs). These entities are becoming increasingly difficult to supervise and evaluate because of their complexity and opaqueness....The challenge of supervising global financial institutions is the challenge of the decade for supervisors. Large banking organizations are likely to become increasingly complicated and wide ranging, and the banking supervisory agencies will have to adjust to that." Remarks by Federal Reserve Governor Laurence H. Meyer at the Federal Financial Institutions Examination Council, International Banking Conference, Arlington, Virginia, May 31, 2000, available at <http://www.federalreserve.gov/boarddocs/speeches/2000/20000531.htm>.

⁴⁷ "[C]redit risk modelling [sic] may indeed prove to result in better internal risk management, and may have the potential to be used in the supervisory oversight of banking organizations. However, before a portfolio modelling approach could be used in the formal process of setting regulatory capital requirements for credit risk, regulators would have to be confident not only that models are being used to actively managed risk, but also that they are conceptually sound, empirically validated, and produce capital requirements that are comparable across institutions. At this time, significant hurdles, principally concerning data availability and model validation, still need to be cleared before these objectives can be met, and the Committee sees difficulties in overcoming these hurdles in the timescale envisaged for amending the Capital Accord." Basle Committee on Banking Supervision, *Credit Risk Modelling: Current Practices and Applications*, at 1 (Apr. 1999). In documents released on January 16, 2001, proposing a new Basel Capital Accord, the Committee did not believe that bank modeling techniques had advanced sufficiently to be used by banks to set their own capital standards. "As currently configured, the IRB

In contrast, conforming mortgages are typically executed on standardized documents using consistent underwriting practices (so that, even if the lender doesn't plan on immediate sale or securitization, the option for a later sale to Fannie Mae or Freddie Mac would be preserved). In addition, the mortgage market, at \$5.62 trillion as of December 2000, represents the largest single credit market in the world with voluminous trading every day of the year in both whole loans and mortgage-backed securities.

In addition to our continual on-site examination, Fannie Mae, along with Freddie Mac, is one of the most closely scrutinized financial institutions in the country:

- Our annual examination report is made public, presented to Congress and posted on the Internet at www.ofheo.gov for all the world to see. The examination reports of other federally regulated financial institutions are kept secret;
- We are required to provide reports on activities, financial condition, and business practices (including employee compensation and benefits) to Congress, HUD and OFHEO;
- We are subject to audit by the U.S. General Accounting Office;
- We have been studied by the General Accounting Office, the Congressional Budget Office, the U.S. Treasury Department, and the U.S. Department of Housing and Urban Development; and
- We have been the subject of oversight hearings by congressional committees.

Finally, Fannie Mae has committed to increase its transparency even further with additional disclosures relative to interest rate, credit and liquidity risk and on its ability to meet capital requirements based on a stress test.

In commenting favorably on the cutting-edge nature of the Fannie Mae/Freddie Mac initiative, Moody's noted that these commitments will create a new standard for financial institution regulation:

These financial and disclosure commitments by Fannie Mae and Freddie Mac are new standards not only for them, but also for the global financial market. These GSEs' proposals rely extensively on recommendations by the Basel Committee on Banking Supervision for bank disclosure, even taking such disclosure a step further than the recommendations in some instances. Despite their non-bank status and special ties with the U.S.

[Internal Ratings-Based] approach allows banks to use many of their own internal risk assessments in the derivation of regulatory capital requirements. It stops short, however, of permitting banks to calculate their capital requirements on the basis of their own or vendor portfolio credit risk models. ... Even the advanced IRB methodology will not allow for bank-specific adjustments to measures of credit risk to reflect risk correlation between different borrowers (in effect, this is the complexity boundary beyond which the IRB approach as currently configured will not pass)." Basle Committee on Banking Supervision, *The Internal Ratings-Based Approach* (Jan. 2001), at 2.

government, Fannie Mae and Freddie Mac agree that similar risk management disciplines apply to both banks and GSEs—and perhaps, by implication, nonbank financial institutions in general. The leadership shown by Freddie Mac and Fannie Mae could prove difficult for other firms to ignore, and could usher in a wave of enhanced financial risk disclosure. This may prove to be one of the more important ramifications of the GSEs' initiative.⁴⁸

Thus, Fannie Mae and Freddie Mac meet the transparency requirement for a well-functioning subordinated debt program more than any other large financial company in the country.

In summary, therefore, this paper shows, as the market itself is showing, that our subordinated debt program meets all the requirements that one would require in order for it to have the effects that economists, such as the members of the SFRC, expect from a mandatory subordinated debt regime.

⁴⁸ Moody's Investors Service, *supra* note 44, at 3.