



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

May 14, 1976

CONFIDENTIAL (FR)
CLASS II FOMC

TO. Federal Open Market Committee

FROM: Arthur L. Broida *ALS*

Attached is a copy of a memorandum from Messrs. Axilrod and Holmes dated May 14, 1976, entitled "System Open Market Operations in Securities of FNMA."

It is contemplated that this memorandum will be discussed by the Committee at its meeting on Tuesday.

Attachment

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date May 14, 1976

To Members of Federal Open
Market Committee

Subject: System Open Market Operations

From Messrs. Axilrod and Holmes

in Securities of FNMA

This memorandum responds to the FOMC's request that we review the desirability of continuing System open market operations in the securities of the Federal National Mortgage Association (FNMA), in light of the fact that FNMA has many of the characteristics of a private borrower and investor.

After reviewing the legislative history, the Charter Act and the operations of FNMA, and after assessing the market and other implications of withdrawing from operations in its securities, we would recommend that the Committee continue to authorize open market transactions in such securities. Withdrawal might lead to a noticeable rise in yields on FNMA securities, and would also leave the impression that the Federal Reserve is significantly reducing its activity in housing-related agency securities. However, the System's holdings of FNMA issues are large, even though the ratio of FNMA holdings to total System agency holdings has declined steadily over the past five years. It may be possible to achieve a further reduction in this ratio in the future, but any additional decline should be generally consistent with the Desk's policy of purchasing securities on a best price basis and in maintaining a portfolio with a wide maturity range.

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Initial FOMC Decision to Acquire FNMA Issues

The question of the eligibility of FNMA securities for purchase by Federal Reserve Banks was last considered by the Board and the FOMC in early 1971, just before the System began to make outright purchases of Federal agency securities. At that time the FOMC concluded that, although FNMA is a privately owned corporation with equities traded on major stock exchanges, it still qualified as a Federal Agency of the United States for purposes of Section 14(b)(2) of the Federal Reserve Act. Consequently, its debt obligations were found to be eligible for purchase by Federal Reserve Banks. (FNMA securities have been held under repurchase agreement since Congress added Section 14(b)(2) in 1966.) This determination was based on General Counsel's interpretation^{1/} that the statutory language transferring FNMA to full private ownership explicitly indicates that Congress intended for FNMA to retain its Federal Agency status. In addition, Counsel noted a number of provisions of the 1968 Housing Act which supports the view that FNMA is a Federal agency including:

- (a) Five of FNMA's fifteen directors are appointed by the President and subject to removal for cause,
- (b) FNMA is subject to "general" regulation by the Secretary of HUD, including approval of dividend payouts.
- (c) FNMA is required to obtain approval of the Secretary of Treasury prior to the issue of all securities and,

^{1/} The memo by the FOMC's General Counsel, Mr. Hackley, entitled "Eligibility of FNMA obligations for purchases in the open market" is appended to this manuscript.

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- (d) FNMA is authorized to borrow up to \$2,250 million from the Treasury.

Private Characteristics of FNMA

As is true of other government sponsored agencies, FNMA issues stock to the institutions and firms with whom it does business. Sellers of mortgages to the association are required to subscribe for common stock in amounts equal to at least one-fourth of 1 per cent of the unpaid principal of the mortgages being sold to the association--although they need not retain this stock. Servicers of home mortgages held in FNMA's portfolio are also required to purchase and hold an amount of FNMA common stock equal to from 1/4 to 1 per cent of the unpaid balance of the mortgages they are servicing. FNMA, however, is one step further advanced in private ownership than other government sponsored enterprises in that its common stock trades publicly on the New York Stock Exchange, the Midwest Stock Exchange and the Pacific Stock Exchange.^{2/} As a result many current holders of FNMA shares do not conduct business with the agency but rather hold its stock solely for investment or speculative purposes. Their primary concern is with FNMA's earnings and dividends, and the resulting secondary market prices of its shares. Also, because FNMA's earnings are determined by movements in interest rates, its stock is very sensitive to changing or differing interest rates expectations,

^{2/} FNMA publicly offered common stock to stockholders of record in November 1970. Then, in September 1971, it sold \$250 million of capital debentures convertible into FNMA stock, although because of the weakness of the stock market, only a modest amount of debentures have been converted.

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and, consequently, the price of its stock fluctuates considerably over time and trades actively.

The extent to which the difference in the ownership arrangements of FNMA sets it apart from other sponsored agencies and may influence it to act more as a private than a government corporation is difficult to judge. FNMA, for example, has grown much more rapidly since 1970, when direct Federal control was ended through a restructuring of its Board of Directors. But, in appraising the implications of this development, it is only fair to note that FNMA's asset growth rate over this period has been roughly matched by the Home Loan Bank System and by the Farm Credit System. Moreover, it can also be argued--and FNMA has done so--that FNMA's aggressive expansion of mortgage holdings has served the national interest objectives which FNMA was established to perform. Most certainly, a policy of aggressive mortgage acquisitions does not directly run counter to Congress's general charge to FNMA to serve as a secondary market outlet for residential mortgages. In rebuttal, many critics contend that a large amount of the funds supplied by FNMA would have flowed into mortgage investment without its help.

3/ FNMA was founded in 1938 but its present corporate status dates to 1968 when Congress partitioned FNMA in an act which resulted in the Government National Mortgage Association and the new, privately owned corporation which retained the name and secondary market operation of the old agency. In September 1968 FNMA retired its preferred stock which was previously held by the U.S. Treasury but, as provided for by Congress, responsibility for its own management was not assumed until after a transition period. This period terminated in May 1970 when Federal control over the Board of Directors ended through a restructured Board two-thirds of which are elected by stockholders.

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An appraisal of the dividend policy adopted by FNMA since its Board was restructured also fails to provide a clear-cut answer to this issue. FNMA's annual dividend per share has increased sharply over the past 5 years rising from 24 cents in 1970 to 77 cents in 1975. By comparison FNMA's annual dividend per share only increased from 20 cents to 24 cents in the 10-year period ending in 1970.^{4/} But, while this represents a major change in policy in keeping with its new status as a private corporation, it is again not clear that this new approach is in direct conflict with FNMA's Federal agency status. FNMA's dividend yield in 1971 was only a bit above 1 per cent, and it seems reasonable that this yield had to be increased significantly if FNMA's stock was to be at all attractive to the general investor. FNMA's dividend yield has since moved up to 5 per cent, not far different from the 3.9 per cent average dividend yield last year of Standard and Poors 425 industrial stocks. The price of FNMA's stock was as high as \$19-7/8 and as low as \$12 in 1975. The stock is currently trading near its 1976 low of \$14-3/8, apparently in anticipation that earnings will decline as interest rates rise.

^{4/} The Charter Act of 1954 restricted dividends on common stock to not more than 5 per cent of the par value. The present Act, as amended, states that dividends shall not exceed any rate which may be determined from time to time by the Secretary of Housing and Urban Development to be a fair rate of return after consideration of the current earnings and capital condition of the corporation.

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In our view, however, the most significant point regarding FNMA's organizational makeup is that, while it is privately owned and its stock is traded on exchanges, it still remains subject to the general supervision of the Secretary of HUD who can influence its operating policies and regulate its dividend payments. Moreover, it must clear its borrowings with the Treasury, and it has a backup line with the Treasury.^{5/} Given these arrangements, FNMA is regarded as a Governmental agency by the market and is perceived to act in line with Governmental policies.

Implications of System Withdrawal from Operations in FNMA Obligations

System purchases of FNMA debt obligations do not appear to have any perceptible, direct impact on the price of FNMA stock. We looked at the movement of FNMA's stock price on several occasions on the days before and after a System purchase of agency issues and could find no basis for concluding that such transactions caused the price of FNMA stock to rise. Instead, the price of FNMA stock appeared to move in accordance with the general direction of the market. Moreover, in those instances in which general market indexes remained stable following a System operation, there was a tendency--

^{5/} The legislative report accompanying the 1968 Housing Act stated, "The committee intends that the use of this backstop authority by FNMA be limited to periods of money crisis such as the 'credit crunch' of 1966 or when large groups of debentures or discount notes mature simultaneously. The existence of this backstop authority, which is similar to that of the Federal Home Loan Banks, would tend to enhance the corporation's credit standing and would constitute Government recognition of the significance of the corporation's operations to the national interest aspects of the mortgage financing industry."

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at least over the period we looked at--for FNMA's stock price to fall more often than it increased.

While System transactions currently appear to have no affect on FNMA stock prices, it seems likely that, if the System were to cease operating in FNMA debt obligations, this might cause a decline in FNMA stock prices and a rise in the market yield on its debt issues. The System's transactions in FNMA obligations would appear to reinforce FNMA's status as a Federal agency, and thus a termination of such trading might tarnish FNMA's government agency image and cause both lenders and equity investors to require some premium when making funds available to the agency.

If the System were to stop purchasing FNMA debt obligations, there may well be adverse reactions from both FNMA and the Congress. FNMA would argue that its operations have been entirely consistent with the guidelines set down by Congress in the 1968 Act authorizing its transfer to full private ownership. It seems likely that FNMA will receive wide support from the private investment community, which generally appears to regard FNMA as a Federal agency.

There is the risk also that Congress may come to believe that the System is not conforming to the intent of Congressional legislation, if the System terminates operations in FNMA securities. Moreover, it is likely that such action would be interpreted as a significant change in the System's attitude towards the residential mortgage market.

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Size of FNMA in System Portfolio

If the FOMC decides to continue trading in FNMA securities, it may nevertheless be possible to reduce the relative importance of such debt in the open market portfolio. FNMA obligations make up roughly one-third of the total of debt obligations issued by all agencies whose debt is purchased by the System. This compares with a current ratio of FNMA issues to the System's total holdings of Federal agency securities of 43 per cent, as shown in the table on the next page. System holdings of FNMA securities are relatively large in part because FNMA issues are actively traded. In addition, FNMA has a greater number of longer-term issues than the other major agencies, which contributes to balance in the maturity distribution of the System's agency holdings.

The ratio of FNMA holdings in the System's portfolio has, however, been declining steadily since the first year of System agency acquisitions. Further efforts to cut back would appear to be warranted to the extent that this can be accomplished without departing significantly from the System's policy of purchasing securities on a best price basis and without conflicting with the policy of acquiring securities within a wide maturity range.

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Holdings of Federal Agency Issues
in System Open Market Account

	1972	1973	1974	1975	1976 ^{1/}
Total Holdings Agency Securities	810	1280	2123	5190	6607
Total Holdings FNMA securities	502	771	1115	2327	2865
Per cent of FNMA to Total	62%	60%	53%	45%	43%

^{1/} All observations are as of the end of March.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 29, 1971.

To Alan R. Holmes, Manager,
System Open Market Account
From Howard H. Hackley, General Counsel,
Federal Open Market Committee

Subject: Eligibility of FNMA obligations
for purchase in the open market.

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At the April 6, 1971, meeting of the Federal Open Market Committee, reference was made to the question whether obligations of Federal National Mortgage Association (FNMA) as presently constituted may still be regarded as obligations of an "agency of the United States" within the meaning of section 14(b)(2) of the Federal Reserve Act that authorizes the Reserve Banks to buy and sell in the open market "any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, any agency of the United States."

This question has been specifically considered by the Board and answered in the affirmative.

As you know, the Board has an outstanding published interpretation (Published Interpretations, ¶ 925) that lists the principal agency obligations eligible for purchase by the Reserve Banks and therefore also eligible as collateral for Reserve Bank advances. On April 29, 1971, the Board approved recommendations submitted by its Legal Division (1) that obligations of FNMA be retained on the list, (2) that obligations of Federal Home Loan Mortgage Corporation and the United States Postal Service be added to the list, and (3) that certificates issued by the Trustees of Penn Central Transportation Company that are fully guaranteed by the Secretary of Transportation be regarded as fully guaranteed by the United States and therefore eligible as collateral for advances.

I have considered this matter independently and I agree with the conclusion reached by the Board's Legal Division that the reconstituted FNMA is an agency of the United States for purposes of section 14(b)(2) of the Federal Reserve Act.

The law does not define the phrase "agency of the United States". Whether a particular organization is such an agency must be determined in the light of evidences of Congressional intent and various characteristics of the organization in question, e.g., whether it has any claim against the Treasury Department, the nature of its management, the extent to which it is subject to Federal regulation and control, whether it is exempted from Federal, State, and local taxation, and whether its securities are exempted from Federal securities laws.

Alan R. Holmes

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When the stock of FNMA was owned by the United States, no question was raised as to whether it was an agency of the United States. Pursuant to provisions of the Housing and Urban Development Act of August 1, 1968, that stock has now been retired and all of the corporation's stock is privately owned. The 1968 statute stated that the new Government National Mortgage Association (GNMA) would "remain in the government" whereas, in contrast, it referred to the reorganized FNMA as "a government-sponsored private corporation".

When paragraph (2) of section 14(b) of the Federal Reserve Act was added in 1966, it was clearly the intent of Congress that the "principal agency issues" contemplated by the amendment were obligations of Federal Intermediate Credit Banks, Federal Home Loan Banks, Federal Land Banks, the Bank for Cooperatives, and FNMA. (See Report of Senate Banking and Currency Committee, Senate Rep. No. 1601, 89th Cong., 2d Sess. (Sept. 14, 1966), p. 8.) There is no evidence in the history of the 1968 Act that Congress intended to change the status of FNMA's obligations as "agency issues". On the contrary, the House Committee's Report stated that the reorganized corporation "would be a government-sponsored private corporation, regulated by the Secretary and would have a status analogous to that of the Federal Land Banks and the Federal Home Loan Banks." (House Rep. No. 1585, 90th Cong., 2d Sess., p. 69) The Home Loan Banks and the Federal Land Banks are, of course, privately owned; but their obligations have consistently been regarded, particularly in the light of the legislative history of the 1966 legislation, as agency issues.

The fact that the new FNMA was referred to in the 1968 Act as a "government-sponsored" private corporation indicates that it was regarded not as an ordinary private corporation but as one created for governmental purposes. The House Committee's Report stated that the reorganized FNMA would "continue to carry out the national interest."

In addition to these evidences of Congressional intent, the conclusion that FNMA is an agency of the United States is supported by provisions of the 1968 Act. The Secretary of the Treasury is authorized to purchase FNMA obligations up to an aggregate of \$2,250 million. (12 U.S.C. 1719(c)) FNMA may issue obligations only with the approval of the Secretary of the Treasury, and maturities and interest rates are subject to approval by the Secretary. (12 U.S.C. 1719(b)) FNMA is subject to "general" regulation by the Secretary of HUD. (12 U.S.C. 1723(a)(h)) It is exempted from all State and local taxation except taxes on real property. (12 U.S.C. 1723(a)(c)(2)) Its securities are exempted from SEC regulation to the same extent as securities that are direct obligations of or obligations guaranteed as to principal and interest by the United States. (12 U.S.C. 1719(d)) Five of its 15 directors are appointed by the President and all 15 are subject to removal by the President for cause. (12 U.S.C. 1723(b))

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The general counsel for FNMA, in a memorandum of November 25, 1968, expressed the view that the obligations of the reorganized corporation should continue to be regarded as "Federal agency securities". However, in a letter to HUD dated July 10, 1970, the Department of Justice expressed the opinion that the new FNMA is not an Executive Department, an Independent agency, or a Government corporation within the meaning of the conflict-of-interest provisions of 18 U.S.C. 208 and Executive Order 11222. Nevertheless, the Department of Justice's opinion related only to the status of FNMA for purposes of criminal provisions and an Executive Order relating to conflicts of interests. The opinion expressly recognized that FNMA "may for some purposes be described as a 'quasi-governmental' organization". The Department's conclusion appears to have been influenced considerably by the fact that three of the 15 directors of FNMA are required to represent non-governmental interests and that the purposes of the 1968 Act would be seriously limited if the conflict-of-interest provisions should be held applicable to them.

I assume that you are not particularly interested in the status of obligations of the new Federal Home Loan Mortgage Corporation and the new United States Postal Service, and certainly not interested in the Penn Central Trustee certificates. I might add, however, that I agree with the conclusions of the Board's Legal Division that all of these obligations are eligible for purchase in the open market. The Federal Home Loan Mortgage Corporation is managed by a board of directors that consists of the members of the Federal Home Loan Bank Board; the Corporation is exempted from all Federal, State, and local taxation except taxes on real estate; it is expressly deemed to be an agency for various provisions of the Criminal Code; and its financial transactions are subject to audit by the Government Accounting Office. The U. S. Postal Service is declared by law to be "an independent establishment of the executive branch of the Government of the United States"; the law provides that it shall be operated "as a basic and fundamental service provided to the people by the Government of the United States"; and it is managed by a Board of Governors consisting of 11 members, nine of whom are appointed by the President with the advice and consent of the Senate, the other two being the Postmaster General appointed by the Governors and the Deputy Postmaster General appointed by the Governors and the Postmaster General. The Penn Central Trustee certificates are fully guaranteed by the Secretary of Transportation and may therefore be regarded as guaranteed by the United States.