Statement of

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Acting Director
Federal Housing Finance Agency

Before the U.S. House of Representatives
Subcommittee on Capital Markets, Insurance, and
Government-Sponsored Enterprises

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Chairman Garrett, Ranking Member Waters and members of the Subcommittee, thank you for inviting me this morning to discuss Chairman Garrett's recent legislative proposal ("Discussion Draft") to reform the secondary mortgage market. I am pleased that the Subcommittee is beginning the serious work of considering housing finance reform options, which will lead to the ultimate resolution of Fannie Mae and Freddie Mac (the Enterprises).

This morning I will briefly review the work of the Federal Housing Finance Agency (FHFA) since I last appeared before the Subcommittee in May and then I will address housing finance reform issues, including the Chairman's proposal.

FHFA INITIATIVES

The Enterprises cannot operate indefinitely in conservatorship, and I look forward to further consideration of housing finance reform options. However, as long as FHFA remains conservator and regulator for the Enterprises, our activities will continue to be guided by the three principal statutory mandates set forth in law. Our mandates, simply stated, are: to preserve and conserve Enterprise assets and place the Enterprises in a sound and solvent condition; to support a stable and liquid mortgage market; and to maximize assistance to homeowners to minimize foreclosures. As FHFA has noted on numerous occasions, with taxpayers providing the capital supporting the Enterprises' operations the "preserve and conserve" mandate directs us to minimize losses on behalf of taxpayers.

I will very briefly highlight some of the key conservatorship activities we have taken to support one or more of our mandates since I last addressed this Subcommittee six months ago.

Lawsuits

Consistent with FHFA's mission to preserve and conserve the Enterprises' assets on behalf of the taxpayer, this year we filed lawsuits against 18 financial institutions to recover losses suffered by Freddie Mac and Fannie Mae. FHFA is seeking compensatory damages for losses the Enterprises incurred on private-label securities due to misrepresentations and other improper actions by the firms and individuals named in the suit. We believe that the loans had different and more risky characteristics than the descriptions contained in the marketing and sales materials provided to the Enterprises for those securities.

REO – RFI

In August, FHFA in conjunction with the Department of Housing and Urban Development (HUD) and the Treasury Department, issued a Request for Information (RFI) seeking input on new options for selling single family real estate owned (REO) held by Freddie Mac, Fannie Mae, and FHA. We are looking for approaches to reduce the REO portfolios of the Enterprises in a cost-effective manner, as well as to reduce the losses on individual distressed properties. We are looking for alternatives that will maximize value to taxpayers and increase private investments in the housing market, including approaches that support rental and affordable housing needs. We are not looking to develop a single, national program for REO disposition. We are most interested in proposals tailored to the needs and economic conditions of local communities. We received nearly 4,000 responses to the RFI and are reviewing the submissions.

Servicing Alignment Initiative

Our Servicing Alignment Initiative (SAI), which we announced last April, responded to concerns about how delinquent mortgages were being serviced. SAI meets the conservatorship objectives of minimizing losses and assisting homeowners with alternatives to foreclosure. FHFA instructed Freddie Mac and Fannie Mae to establish a single, consistent set of procedures for servicing Enterprise mortgages, from the time they first become delinquent. The updated framework, which went into effect on October 1, prioritizes early borrower outreach, streamlines documentation requirements, simplifies mortgage modification terms and requirements, and establishes a schedule of performance-based incentive payments and penalties aimed at ensuring that servicers review foreclosure alternatives in a timely manner. We are also working to align and improve Fannie Mae and Freddie Mac policies regarding unemployment forbearance to reflect the realities of the current job market.

Foreclosure Attorney Networks

Last month, as an adjunct to SAI, FHFA directed Freddie Mac and Fannie Mae to change the way foreclosure attorneys are selected in an effort to produce uniform foreclosure processing standards to assist servicers, homeowners, and lenders. Under current practice, in certain states each Enterprise designates law firms eligible under the Enterprise's criteria to undertake foreclosure work and mortgage servicers then select and work with these firms.

FHFA instructed Fannie Mae and Freddie Mac to transition away from current foreclosure attorney network programs and move to a system where mortgage servicers select qualified law firms that meet certain minimum, uniform criteria. These efforts will lead to greater transparency and benefit delinquent borrowers who become subject to the foreclosure process. FHFA is now working with other industry stakeholders to create uniform qualifications and oversight of foreclosure attorneys.

I am hopeful that these new directives that create uniform procedures for servicing delinquent loans and processing foreclosures will gain acceptance beyond the Enterprises and be used as "best practices" throughout the industry.

HARP

On October 24, we announced a series of changes we are making to the Home Affordable Refinance Program (HARP). These changes should make HARP refinances accessible to more households with mortgages owned or guaranteed by the Enterprises. Changes to the program include: eliminating or reducing certain risk-based fees; removing the current 125 percent LTV ceiling; waiving certain representations and warranties; eliminating the need for certain property appraisals; carrying over mortgage insurance coverage; and extending the end date for HARP until December 31, 2013.

Importantly, such refinances should also reduce the Enterprises' credit risk, and thus losses to taxpayers. HARP, even with the new enhancements, is not a mass refinancing program; it was designed to help a defined set of borrowers with Fannie Mae and Freddie Mac mortgages that are underwater or nearly underwater.

It is impossible to project accurately how many homeowners will benefit from the enhancements to HARP because of unknowable factors, such as future interest rate fluctuations. Since HARP was introduced in 2009, almost 900,000 homeowners have refinanced through the HARP program. We believe the changes announced last week may help double the number of homeowners helped through HARP.

The Enterprises plan to issue guidance with operational details about the HARP changes to mortgage lenders and servicers by November 15. Since industry participation in HARP is not mandatory, implementation schedules will vary as individual lenders, mortgage insurers and other market participants modify their processes.

Servicing Compensation Initiative

The last initiative I will discuss today, the Joint Servicing Compensation Initiative, made up of FHFA, Fannie Mae, Freddie Mac, and HUD, is one of the initiatives we have directed the Enterprises to undertake that are designed to broadly consider changes that will lead to improvements in the operations of the Enterprises and the overall mortgage market. The goals of the Joint Initiative are to improve service for borrowers, reduce financial risk to servicers, and provide flexibility for guarantors to better manage non-performing loans, while promoting continued liquidity in the To Be Announced mortgage securities market. In addition to those specific goals, the Joint Initiative seeks broader options for mortgage servicing compensation that lead to enhanced competition in mortgage servicing and origination, and that can be replicated across multiple future states of housing finance.

At the end of September, the Joint Initiative released a discussion document seeking comments on two alternative servicing compensation structures for servicing single-family mortgages. One proposal would establish a reserve account within the current servicing compensation structure. The other proposal would create a new Fee for Service compensation structure. We requested that comments be submitted by late December, after which they will be considered and evaluated by the Joint Initiative.

Let me now turn to my thoughts about reforming the housing finance system in this country, including comments on the Discussion Draft.

HOUSING FINANCE REFORM

The decision to place the Enterprises into conservatorship proved to be appropriate, accomplishing the Federal government's primary objective of supporting the ongoing availability of mortgage financing during a period of severe market contraction. The actions of placing the Enterprises into conservatorship, along with the financial support provided by the Treasury Department, were designed to maintain stability while providing policymakers time to consider the appropriate course for housing finance reform and the transition from the current Enterprise structure. Despite the benefits derived from the Treasury support for Enterprises activities, conservatorship is not a long-term solution.

We just passed the three-year anniversary of placing the Enterprises into conservatorship. We all knew it was going to be difficult to develop a housing finance reform solution, but we must move forward on this process. As the conservatorships lengthen, FHFA must not only direct the Enterprises' activities on various programs consistent with our conservatorship mandates, but must also consider how the Enterprises should be structured and make investments in business platforms and human capital in the face of an uncertain future.

In thinking about the goals of a future housing finance system, I would start by reiterating the objectives that I shared with this Subcommittee last year. Our main purpose in addressing housing finance reform should be to promote the efficient provision of credit to finance mortgages for single-family and multifamily housing. I believe that an efficient system of credit allocation should have certain core characteristics: allowing innovation, providing consumer choice, providing consumer protection, and facilitating transparency.

While these characteristics provide a set of goals for the future of the housing finance system, there are a number of specific areas related to the current activities of the Enterprises that deserve special attention, which include:

- ensuring that the mortgage market has adequate sources of liquidity;
- having the ability to avoid and if necessary absorb credit risk; and
- promoting the availability of mortgage credit.

To state the obvious, the key question in the debate on housing finance reform is the future role of the government in achieving these objectives.

We should be clear about this question at the outset. It seems safe to say that there will always be some portion of the housing or mortgage market that will be assisted by government programs, either through direct funding or through guarantees. In the future design of our housing finance system, careful consideration should be given to targeting subsidies to specific groups that lawmakers determine warrant that benefit. For example, the explicit government guarantees that the Federal Housing Administration and Veterans Administration provide reflect policymakers' judgment as to the public benefits from targeting certain borrowers with those programs. This is also the case through other programs provided by the Department of Housing and Urban Development.

Acknowledging that there will be a role for the government in the above areas, a further refinement of the key question regarding the government's role in housing finance is what type of structure is necessary to replace the activities that are currently undertaken by the Enterprises. There seems to be relatively broad agreement that the government sponsored enterprise model of the past, where private sector companies were provided certain benefits and charged with achieving certain public policy goals, did not work. That model relied on investors providing funding for housing at preferential rates based on a perception of government support, which ultimately turned out to be correct and has resulted in Enterprises' drawing $169 billion in funds from Treasury as of September 30, 2011.

Several proposals have been put forth on developing a housing finance system with some type of government guarantee. Clearly if the securities offered in a reformed housing finance market have a government guarantee, those securities will be priced favorably and have a high degree of liquidity to reflect that guarantee. However, those securities would not have the benefit of market pricing for credit risk of the underlying mortgages. In these structures, much like the banking system and deposit insurance, private sector capital through equity investment would stand in a first loss position, with a government guarantee that was funded through an insurance premium being available to cover other losses. This type of structure requires a significant amount of regulatory safety and soundness oversight to protect against the moral hazard associated with providing a government guarantee.

While such an outcome has certain merit and some attractive features, the potential costs and risks associated with such a framework should be fully explored. To put it simply, replacing the Enterprises' implicit guarantee with an explicit one does not resolve all the shortcomings and inherent conflicts in that model, and it may produce its own problems. Last year before this Subcommittee I offered three observations in that regard for your consideration.

First, the presumption behind the need for an explicit Federal guarantee is that the market either cannot evaluate and price the tail risk of mortgage default, at least at any price that most would consider reasonable, or cannot manage that amount of mortgage credit risk on its own. But we might ask whether there is reason to believe that the government will do better? If the government backstop is underpriced, taxpayers eventually may foot the bill again.

Second, if the government provides explicit credit support for the vast majority of mortgages in this country, it would likely want a say with regard to the allocation or pricing of mortgage credit for particular groups or geographic areas. The potential distortion of the pricing of credit risk from such government involvement risks further taxpayer involvement if things do not work out as hoped.

Third, regardless of any particular government allocation or pricing initiatives, explicit credit support for all but a small portion of mortgages, on top of the existing tax deductibility of mortgage interest, would further direct our nation's investment dollars toward housing. A task for lawmakers is to weigh such incentives against the alternative uses of such funds.

CHAIRMAN GARRETT'S DISCUSSION DRAFT

Another approach, as set forth in the Discussion Draft is to establish a functioning mortgage-backed securities market through replacing some of the standard-setting that the Enterprises undertake today with a regulatory regime that sets those standards. This model would not rely on a government guarantee to attract funding to the mortgage market, but rather would look to standardization and rules for enforcing contracts to provide a degree of certainty to investors.

While we have not had time to fully evaluate the Discussion Draft, the focus is on setting standards around key features that investors need to know to be willing to price credit risk in the mortgage market. These include standards associated with: underwriting; pooling and servicing; and disclosures. The model proposed in the Discussion Draft also tries to preserve some of the liquidity in today's mortgage-backed securities market by establishing buckets of securities that have similar credit characteristics and loan terms.

Clearly the framework envisioned in the Discussion Draft is much different than a framework that has a government guarantee. Investors would be required to price the credit risk of mortgages. They also would be responsible for enforcing their rights under the standard contracts developed under this framework. Those requirements are consistent with the way that a private market functions.

We look forward to further considering the framework set forth in the Discussion Draft. Some areas that deserve further consideration include the following:

- Standardization will help to develop a private mortgage-backed securities market. Are there other areas in terms of monitoring or compliance that could potentially broaden the investor base while still achieving the primary function of having private markets price credit risk?
- Preserving the availability of credit in times of stress is an important function. Is there a role for the government, perhaps through the Federal Housing Administration to take on this role if necessary?
- Preserving liquidity in the market and the financial system in this framework would be an important function. Is there a need for a backstop source of funding when financial markets become temporarily illiquid? For example, could the Treasury Department, the Federal Reserve or the Federal Home Loan Banks play a role in a market that had this type of standardized structure?

These are just some of the issues that will have to be thought through as the process moves forward on building out this framework.

The process of undertaking housing finance reform is difficult. The Discussion Draft is a thoughtful approach to a framework that does not rely on a government guarantee. The final decision that policymakers must make involves determining what structure will provide a functioning housing finance market and does not place taxpayers at risk.

CONCLUSION

Mr. Chairman, I would like to thank you for helping to move the housing finance reform discussion forward by holding this hearing. I believe that private capital markets can and should reclaim a prominent portion in providing housing finance, and your legislative proposal broadens the discussion of how we might do that.

I recognize this Subcommittee has difficult and important decisions to make in the coming months and FHFA looks forward to offering technical assistance to both the Administration and Congress in considering policy alternatives.