Statement of

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Federal Housing Finance Agency

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

The Future of Housing Finance: A Progress Update on the GSEs

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Chairman Kanjorski, Ranking Member Garrett, and members of the Subcommittee, thank you for inviting me to speak on the conservatorships of Fannie Mae and Freddie Mac (Enterprises). Given the enormous losses at those institutions and exceptional market reliance over the past three years on all of the housing government-sponsored enterprises (GSE), there has been considerable discussion about their role, performance, and future. I appreciate the opportunity to provide you with information on the strategies that the Federal Housing Finance Agency (FHFA) is pursuing to limit the need for future capital infusions into Fannie Mae and Freddie Mac from the U.S Department of Treasury (Treasury). I hope that my comments will help to build the foundation for the upcoming Congressional consideration of the future structure of the housing finance system.

Today I will highlight:

1) the status of the conservatorships;
2) the current condition of the Enterprises;
3) projected losses by the Enterprises; and
4) considerations for the future of the housing finance system.

Conservatorship Status

The Enterprises have been operating in conservatorships for two years now, since September 2008. The statutory purpose of conservatorship is to preserve and conserve each company's assets and put them in a sound and solvent condition. The goals of conservatorship are to help restore confidence in the companies, enhance their capacity to fulfill their mission, and mitigate the systemic risk that contributed directly to instability in financial markets. The Enterprises are responsible for normal business activities and day-to-day operations, subject to FHFA supervision. FHFA exercises oversight as safety and soundness regulator, and, as conservator, holds the powers of the management, board, and shareholders of each Enterprise.

The Enterprises' substantial market presence over the last two years demonstrates that they continue to support housing finance in this country despite their financial condition. However, neither company would be capable of serving the mortgage market today without the ongoing financial support provided by the Treasury.

A principal focus of the conservatorships is to maintain the Enterprises' secondary mortgage market role until legislation produces a resolution of their future. FHFA's oversight is also directed toward minimizing losses, limiting risk exposure, and ensuring the Enterprises price their services to adequately address their costs and risk.

Minimizing Losses

FHFA recognizes that losses by the Enterprises translate into costs for the taxpayers, and we are doing everything in our power to minimize future losses. The Enterprises' single-family credit guarantee business has been the largest contributor to the charges against their capital and the corollary need to draw on the Treasury. Losses in this segment of the Enterprises' activities accounts for $166 billion of the total $226 billion in losses since year-end 2007, representing 73 percent of charges against capital over that period. The Treasury draw of $148 billion is less than the Enterprises' aggregate losses because the initial losses to the companies of $78 billion were borne by the Enterprises' shareholders.

To stem additional losses, all mitigation measures are critical. Loan modifications are often a lower-cost resolution to a delinquent mortgage than foreclosure. Similarly, providing opportunities for borrowers to refinance into a more affordable mortgage helps mitigate future credit losses. Since the Enterprises own or guarantee about half the mortgages in the country, efforts that provide stability to borrowers also serve to restore stability to housing markets, which directly benefits the Enterprises by reducing credit exposure.

The Enterprises' foreclosure prevention efforts—including loan modification and refinancing programs as well as short sales and deeds in lieu of foreclosure—also fulfill the Emergency Economic Stabilization Act of 2008 mandate that FHFA "maximize assistance to homeowners," while minimizing losses to the Enterprises. FHFA reports monthly to Congress on the full range of Enterprise foreclosure prevention activities through the *Foreclosure Prevention / Federal Property Manager's Report*, the latest edition of which can be found on the agency's website at http://www.fhfa.gov/webfiles/16687/2q10fprfinal.pdf .

Over the 12 months ending June 30, 2010, the Enterprises permanently modified more than 400,000 mortgages, including approximately 225,000 permanent Home Affordable Modification Program (HAMP) modifications, and completed over 185,000 repayment plans and more than 50,000 forbearance plans to help homeowners stay in their homes. The Enterprises have helped other homeowners avoid foreclosure by completing more than 90,000 short sales and deeds in lieu of foreclosure.

In fact, since the first full quarter of the conservatorships in October 2008, more than one million (1,013,669) homeowners have received assistance from the Enterprises in the form of loan modifications, repayment plans, forbearance plans, and other foreclosure alternatives. During this same time period, nearly six million families have been able to take advantage of refinance opportunities, lowering their interest rates or switching to safer lending products backed by the Enterprises.

Given the extent of the Enterprises' loss mitigation options for borrowers, I am very supportive of their efforts to discourage borrowers who can otherwise make their mortgage payments from walking away from their obligations. Both FHFA and the Enterprises are concerned about borrowers who have an ability to pay but who choose to default on their mortgages. So-called "strategic defaults" not only result in increased losses for taxpayers, but also have a deleterious effect on neighborhoods.

I have also been clear that the Enterprises should actively enforce lender compliance with their contractual obligations, which includes pursuing repurchases from those institutions whose loans did not meet the Enterprises' underwriting and eligibility guidelines. Lenders are obligated by the representations and warranties they made to the Enterprises to repurchase loans that did not meet contractual selling requirements.

Although the Enterprises have made progress in enforcing lenders' representation and warranty obligations, outstanding repurchase requests continue to be of concern to FHFA. During 2009, the Enterprises' lenders repurchased $8.7 billion of single-family mortgages, and slightly higher volumes are being repurchased in 2010. However, as of the end of the second quarter 2010, Fannie Mae had $4.7 billion in outstanding repurchase requests, and Freddie Mac had $6.4 billion in outstanding repurchase requests.

More than one-third of these repurchase requests have been outstanding for more than 90 days. Many of the lenders with aged, outstanding repurchase requests are among the largest financial institutions in the United States. The delays by lenders in repurchasing these loans are a significant concern to FHFA. There are ongoing discussions between the Enterprises and lenders to reach a workable solution. If these discussions do not yield reasonable outcomes soon, FHFA may look to its supervisory and conservatorship authorities provided under the statute to resolve the situation.

Separately, in July FHFA issued 64 subpoenas as part of an effort to determine whether other firms have legal responsibility for some of the Enterprises' losses on private-label mortgage-backed securities (MBS), which, to date, have been borne by the Enterprises and taxpayers. As we receive information from these parties, we will look to determine whether misrepresentations, breaches of warranties, or other acts or omissions by private-label MBS counterparties require repurchase of loans underlying the securities. Because the Enterprises themselves had difficulty obtaining the loan documents needed to perform this assessment, FHFA issued subpoenas for various loan files and transaction documents to trustees and servicers controlling or holding the documentation. FHFA will determine whether private-label MBS issuers and others are liable to the Enterprises for certain losses they have suffered on private-label MBS and, when appropriate, will seek to recover those losses.

Another key counterparty for the Enterprises is the mortgage insurance industry, which offers a critical form of credit enhancement. Similar to other mortgage market participants, mortgage insurers have sustained substantial losses. While FHFA has concerns and is carefully monitoring the situation, several of the largest mortgage insurers have raised new capital this year, one new company entered the market, and all have worked closely with their state regulators to take steps necessary to continue to pay claims. To date, mortgage insurers, with one exception, have paid all agreed-to claims owed. The only company that has not had sufficient capital to make full payments has committed to deferred payments to satisfy its obligations in the future. In contrast to the mortgage insurers, the bond insurers that wrap non-agency MBS are in very poor financial condition, and their losses may ultimately jeopardize their ability to pay future claims. Many of these companies have been subject to rating agency downgrades and state regulatory actions, and two have filed for bankruptcy.

Limiting Risk Exposure

In February, I communicated to Congress my position that, in conservatorship, the Enterprises will be limited to continuing their existing core business activities and taking actions necessary to advance the goals of conservatorship. I have not authorized any new products due to the operational challenges inherent in new product offerings and the need for the Enterprises to devote full attention to loss mitigation activities and remediation of internal weaknesses. This type of limitation on new business activities is consistent with standard regulatory practice for addressing companies that are financially troubled. This approach is even more pertinent for the Enterprises, given their uncertain future and reliance on taxpayer funds.

Rather than developing and offering new products, the Enterprises must maintain their focus on mitigating credit losses and remediating internal operational weaknesses while employing prudent underwriting standards and guaranteeing proven mortgage products. Since the end of 2008, both Fannie Mae and Freddie Mac have mostly eliminated their purchases of Alt-A and interest-only loans, two of the poorest performing mortgage products in the market. The Enterprises’ withdrawal from this business is significant because interest-only loans previously purchased by the Enterprises have serious delinquency rates of more than 18 percent, and Alt-A loans have serious delinquency rates of more than 12 percent. These products, which may be appropriate in limited circumstances, have produced substantial losses for the Enterprises.

Figure 1: Characteristics of Single-Family Mortgage Acquisitions

Percent of New Single-Family Business[1]
(Categories overlap and are not additive)

	Fannie Mae				YTD	Freddie Mac				YTD
	2006	**2007**	**2008**	**2009**	**Jun '10**	**2006**	**2007**	**2008**	**2009**	**Jun '10**
Alt-A[2]	22%	17%	3%	0%	0%	18%	22%	7%	0%	1%
Interest-Only	15%	15%	6%	1%	2%	17%	21%	6%	0%	0%
Credit Score <620	6%	6%	3%	0%	1%	5%	6%	3%	1%	1%
LTV >90 Percent	10%	16%	10%	4%	8%	6%	11%	9%	4%	9%
Average LTV	73%	75%	72%	67%	69%	73%	74%	71%	67%	70%
Average Credit Score	716	716	738	761	758	720	718	734	756	750

Notes:
[1] New business is defined as issuance of MBS plus purchases of whole loans and does not include purchases of mortgage-related securities.
[2] Refer to sources for Alt-A definitions. Freddie Mac's year-to-date figures include Alt-A purchases of $1.5 billion due to a long-term standby commitment termination and a subsequent PC issuance. There was no change to the Alt-A exposure on these mortgages as a result of these transactions.

Sources:
Enterprises' Forms 10-K, credit supplements to SEC disclosures, and management reports.

Pricing to Cover Costs

Another important element of conserving and preserving the Enterprises' assets is that they are pricing to cover their expected costs by setting guarantee fees at appropriate levels. FHFA published its latest study on the Enterprises guarantee fees in July. The report can be found on FHFA's website at http://www.fhfa.gov/webfiles/15918/GFEEJuly2010F.pdf (and more detailed information also can be found there). It is clear that the industry as a whole underpriced mortgage credit risk significantly over the past decade, when credit losses were at historic lows and house prices appreciated rapidly.

Each Enterprise initiated changes in their national guarantee fee pricing in 2008 to correct for the underpricing of credit risk in prior years and reflect the real risks of backing mortgages in an environment of house price decline. In light of increasing mortgage delinquencies and forecasts for worsening house prices, the Enterprises updated their costing models several times in 2009, as they had in 2008, to reflect changes in the market environment as well as borrower risk factors such as loan-to-value (LTV) ratios and credit scores

With the price adjustments just described, the average total guarantee fee charged by Fannie Mae and Freddie Mac on most single-family mortgages acquired on a flow basis in 2009 was sufficient to cover model lifetime estimated costs, including a return on economic capital at a rate commensurate with the interest rate on Treasury-held senior preferred stock. The exception is pricing on Home Affordable Refinance Program (HARP) loans, which falls short of covering expected costs; however, HARP loans lower

Enterprise credit risk and have improved pricing relative to the existing Enterprise loans they replace.

Condition of the Enterprises

To ensure that the public has access to accurate and up-to-date information about the Enterprises' business activities, performance, and financial condition, FHFA initiated issuance of a quarterly report, the *Conservator's Report on the Enterprises Financial Condition*. This report is available on the agency website at http://www.fhfa.gov/webfiles/16592/ConservatorsRpt82610.pdf. Publishing this quarterly report fulfills the pledge I made to this Subcommittee in late May to expand public information on Enterprise performance.

Let me highlight for you some of the findings presented in the report. First, as noted earlier, at the end of 2007, the Enterprises had $71 billion of combined capital. From the end of 2007 through the second quarter of 2010, charges against capital totaled $226 billion. Of the three business segments – Investments and Capital Markets, Single-Family Credit Guarantee, and Multifamily – the largest contributor to charges against capital to date has been the Single-Family Credit Guarantee segment, accounting for $166 billion, or 73 percent, of combined capital reductions over that period.

The losses from the single family credit guarantee business, particularly mortgages purchased by the Enterprises in 2006 and 2007 and originated in California, Arizona, Florida, and Nevada, have required the Enterprises to build their loan loss reserves. House price declines and prolonged economic weakness, especially the rise in unemployment, have led to higher credit losses overall.

During conservatorship, the Enterprises have made significant progress in improving the quality of new mortgages purchased. In addition to eliminating riskier types of products, the Enterprises have tightened their underwriting guidelines and reduced risk layering. New Enterprise mortgage guarantees have been for borrowers with higher credit scores and loans with lower LTV ratios, two factors that affect expected default rates. Due to the focus on improved purchase quality and underwriting standards, the loans that the Enterprises purchased in 2009 and 2010 have had much lower rates of delinquency in their initial months of repayment than did mortgages originated between 2006 and 2008.

The Enterprises have also suffered losses on their investments, accounting for $21 billion, or 9 percent, of charges against capital from the end of 2007 through the second quarter of 2010. These losses stemmed from impairments of private-label MBS, fair-value losses on securities, and fair-value losses on derivatives used for hedging interest rate risk.

Projected Losses

When I appeared before this Subcommittee in late May, I was asked how much more money the Enterprises may draw under the Preferred Stock Purchase Agreements (PSPAs). At that time, I said that even across most severe stress scenarios modeled by the Enterprises, combined Treasury draws appeared to be less than $400 billion. My answer at that time was based upon FHFA's review of Enterprise-generated loss projections derived from each company's own internal forecasts that relied upon each company's own assumptions and models.

To provide Congress and the public with a more defined sense of the Enterprises' future draws under the PSPAs, FHFA is in the process of working with the Enterprises to develop a sample of forward looking financial projections for public release. Similar to the Supervisory Capital Assessment Program (SCAP)[1], conducted by the federal banking agencies last year, the results of this exercise will not be forecasts or expected outcomes, but rather modeled projections in response to "what if" exercises that utilize various scenarios.

As I just noted, the Enterprises undertake various financial projection activities for their own purposes and to provide information to FHFA. While these Enterprise-generated exercises are useful, given that each Enterprise models various scenarios in a different manner, it is difficult to compare results between the Enterprises. With that in mind, one of the main goals of FHFA in presenting Enterprise financial projections to the public is to present the results in a comparable way. In my view that would be more useful than presenting independent modeling results from each company that are more difficult to interpret and compare.

Work is underway to develop projections that are comparable between the Enterprises. There are some differences between the Enterprise-generated results and the results from the FHFA-directed exercises, but consistent with my previous statements, even under severe stress scenarios, Treasury draws remain under $400 billion. In less severe stress scenarios, losses are much less than that. When this preliminary work is finalized in the coming weeks, we will make the results and the details surrounding the projections available to the public. FHFA will periodically update and refine these projections and will report such updates as part of the quarterly conservator report.

<u>Future of the Housing Finance System</u>

I would like to turn now to the future of housing finance. As I stated in my testimony in May before this Subcommittee, the 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. Legislation is needed to restructure and strengthen our nation's housing finance system and to resolve the Enterprise conservatorships.

Ensuring an orderly transition will be essential to avoid disrupting the housing finance system at this critical juncture, when markets are still very fragile. It is also important to

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[1] The Supervisory Capital Assessment Program stress tests were conducted by the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency to assess the capital adequacy of U.S. domestic bank holding companies with assets above $100 billion.

consider how the recent enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act will address certain deficiencies and make substantial changes to some long-standing policies and practices. The new law may affect the products offered to consumers and the manner in which financial institutions engage in various lending activities, as a result of new risk retention and borrower protection standards.

Currently all conventional mortgages purchased by Fannie Mae and Freddie Mac benefit from the financial support agreements with Treasury. 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. There may be other categories of borrowers for whom a direct form of government subsidy is appropriate, as determined by Congress.

It is reasonable to question whether all conventional mortgages warrant a government guarantee. Recently there has been a growing call for some form of explicit federal insurance to be a part of the housing finance system of the future. While such an outcome has certain merit and some attractive features, I believe that the potential costs and risks associated with such a framework have not yet been 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. I offer 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.

I would be remiss if I did not mention the Federal Home Loan Banks (FHLBanks), which factor into any discussion of the future role of housing GSEs. FHLBank assets have been on a decline since September 2008 and now stand at $937 billion. Over that same time period, advance activity has steadily declined. As of June of this year, advances were at $540 billion, 46 percent lower than record levels reached in October 2008. While the decline appears to be slowing, it represents a stark contrast to the 2007 response to the liquidity crisis, when the FHLBanks increased advances to members by 58 percent in 15 months. The steady decline since that time is primarily a reflection of member balance sheets, which are now characterized by strong deposit growth and tepid loan demand.

Although the credit quality of mortgages held by the FHLBanks is much better than the industry average, the FHLBanks have pulled back from mortgage purchase activity as well. As of June 2010, the FHLBanks held $66.8 billion in mortgage loans, which represents only 7 percent of their combined assets. The decline results from both the reduction in new activity and an increase in prepayments. Overall, the cutback in mortgage holding reflects an assessment by many FHLBanks that the returns associated with mortgages are insufficient to outweigh the associated funding and hedging risks.

Ten of the 12 FHLBanks reported a net profit in the second quarter of 2010, and the 12 collectively reported a net income of $326.4 million. This figure is nearly unchanged from the first quarter of 2010, as credit impairments on private-label MBS were offset by higher net interest income and lower mark-to-market losses. However, the FHLBanks have not escaped without some financial adversity associated with the deterioration of mortgage markets. As of June 30, 2010, the FHLBanks held private-label MBS equivalent to 4.9 percent of assets. To date, shortfalls of principal or interest have occurred on only 1 percent of the number of private-label MBS held by the FHLBanks. Still, collectively the System has taken $3.3 billion in credit-related impairments on these investments and recorded an additional $10.8 billion in noncredit-related, other-than-temporary-impairments.

Three of the FHLBanks that have recognized other-than-temporary-impairments on their private-label MBS investments—Pittsburgh, Seattle, and San Francisco—have filed complaints in state courts that allege fraud, misrepresentation, and violations of state and federal securities laws in connection with their purchase of certain securities. The complaints seek rescission of the purchase transactions and the defendants' repurchase of the securities for the original purchase price. The aggregate original principal amount of the securities in question is approximately $20 billion.

Before concluding, I would like to raise one more important safety and soundness matter concerning the FHLBanks. Based on recent trends, it appears that the FHLBanks will fulfill their obligation within the next 18 months or so to pay a portion of the interest on bonds issued by the Resolution Funding Corporation (REFCORP) as part of the savings and loan clean-up of 1989. Today, each FHLBank's REFCORP obligation is 20 percent of its net earnings.

In the 20 years in which the FHLBanks have had this obligation, their retained earnings, a key component of their capital structure, have been less than would otherwise have been the case. With this obligation, most or all FHLBanks have not rebuilt or maintained retained earnings adequate to the size and risks of their current business. As their safety and soundness regulator, this is of concern to FHFA. The fulfillment of the REFCORP obligation presents an opportunity to help the FHLBanks work through current financial problems and be better prepared for the future by accelerating the rate at which the FHLBanks build their retained earnings. I have asked FHFA staff to begin work on an approach that would achieve that end when the REFCORP obligations are satisfied.

I would be happy to provide additional information to the Subcommittee regarding the activities and performance of the housing GSEs and look forward to working with the Administration and Congress on legislative action to restructure the housing finance system, including an ultimate resolution of the Enterprises. I recognize you have 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.