Statement of

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Before the U.S. House Committee on Financial Services
On Sustainable Housing Finance:
An Update from the Federal Housing Finance Agency on the GSE Conservatorships

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Chairman Hensarling, Ranking Member Waters and members of the Committee, I am pleased to be invited here today to discuss the Federal Housing Finance Agency's (FHFA) oversight of our regulated entities, Fannie Mae and Freddie Mac, (together the Enterprises) and the Federal Home Loan Banks (FHLBanks).

Although I will touch on the financial condition and performance of Fannie Mae, Freddie Mac and the Federal Home Loan Banks as requested, the main focus of my testimony will be on key topics related to FHFA's role as the Enterprises' conservator and regulator. I will begin with the goals of FHFA as Conservator. Then I will review FHFA's approach to preparing for increased private market participation in housing finance and describe the significant activities that FHFA has undertaken during the past year to further our conservatorship goals. Finally, I will close with some thoughts on the role of government in housing finance.

It is unprecedented that two enormous financial institutions such as these have been in conservatorship for more than four and one half years. Throughout this time, FHFA has explained its approach to the conservatorships in light of the statutory responsibilities Congress gave the agency as Conservator. I have reported to Congress numerous times regarding FHFA's actions in light of these responsibilities, recognizing that the prolonged time in conservatorship has required us to adapt to changing circumstances, while remaining consistent with the fundamental responsibilities given us. I am pleased to provide you with this report on what we have accomplished and where we are headed.

Goals of Conservatorship

As it has been some time since I appeared before this committee at a general oversight hearing, it may be useful for me to begin with a brief overview of what it means for Fannie Mae and Freddie Mac to be in conservatorship and what statutory responsibilities FHFA operates under as conservator.

The Housing and Economic Recovery Act of 2008 (HERA), which created FHFA, specified two conservator powers, stating that the Agency should "take such action as may be:

(i) necessary to put the regulated entity in a sound and solvent condition; and
(ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity."

Furthermore, HERA provides: “DISCRETIONARY APPOINTMENT. – The Agency may, at the discretion of the Director, be appointed conservator or receiver for the purpose of reorganizing, rehabilitating, or winding up the affairs of a regulated entity.”

The determination to place the Enterprises in conservatorships was made as the financial crisis of the autumn of 2008 was taking shape. At that time, the private mortgage securitization market had already vanished, house prices were declining rapidly, and the Enterprises’ eroding financial condition and inability to access capital markets threatened a collapse of the country’s housing finance system. FHFA, with financial support from and substantial consultation with the U.S. Department of the Treasury, placed the Enterprises into conservatorships on September 6, 2008.

Conservatorship, along with taxpayer support from Treasury provided through the Senior Preferred Stock Purchase Agreements (PSPAs), permitted FHFA to take greater management control of Fannie Mae and Freddie Mac and give investors in the Enterprises’ debt and mortgage-backed securities confidence that the Enterprises would have the financial capacity to honor their financial obligations. At the time, Treasury Secretary Henry Paulson referred to conservatorship as a “time-out” to allow markets to continue to function while policymakers considered and acted on a permanent resolution.

From the outset, FHFA stated that the goals of the conservatorships were 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. Today, FHFA is balancing three responsibilities: preserve and conserve assets, ensure market stability and liquidity, and prepare the Enterprises for an uncertain future.

The initial phase of the conservatorships was focused on stabilizing the Enterprises’ operations to ensure the continued functioning of the mortgage market. As operations were stabilized, I would characterize the second phase of the conservatorships as focusing on developing tools for the Enterprises to reduce losses on their legacy credit exposures. This effort was also consistent with FHFA’s statutory responsibility under the Emergency Economic Stabilization Act to provide assistance to homeowners and minimize foreclosures. FHFA also clarified that the Enterprises would be limited to continuing their existing core business activities. This type of limitation on new business activities is consistent with the standard regulatory approach for addressing companies that are financially troubled. And it is even more pertinent for the Enterprises given their uncertain future and reliance on taxpayer funds.

In short, while there still is legacy credit exposure to work through, the second phase of the conservatorships put in place the loss mitigation infrastructure to help borrowers and protect taxpayers. At the same time, the companies’ new books of business are much stronger than their old ones.

But that still leaves us with a mortgage market that is reliant on federal government support, with very little private capital standing in front of the federal government’s risk exposure. There seems to be broad consensus that Fannie Mae and Freddie Mac will not return to their previous corporate forms. The Administration has made clear that its preferred course of action is to wind down the Enterprises. Of the various legislative proposals that have been introduced in

Congress, none of them envision the Enterprises exiting conservatorship in their current corporate form. In addition, the recent changes to the PSPAs, replacing the 10 percent dividend with a net income sweep, reinforces that the Enterprises will not be building capital as a potential step to regaining their former corporate status. The amount of funding, essentially the Enterprises' capital base, available under the PSPAs also will become fixed when the Enterprises report year-end 2012 financial results.

FHFA's 2012 Strategic Plan for the Operation of the Enterprise Conservatorships

In early 2012, recognizing that the conservatorships were over three years along and not likely to end soon, FHFA developed and formally communicated to Congress a strategic plan for the companies to pursue while in conservatorship, pending legislative action. That Strategic Plan had three goals:

1. **Build.** Build a new infrastructure for the secondary mortgage market.

2. **Contract.** Gradually contract the Enterprises' dominant presence in the marketplace while simplifying and shrinking their operations.

3. **Maintain.** Maintain foreclosure prevention activities and credit availability for new and refinanced mortgages.

These goals satisfy our statutory mandate as conservator, are consistent with the Administration's call for a gradual wind down of the Enterprises, and preserve all options for Congress while establishing a stronger foundation on which Congress and market participants can build to replace the pre-conservatorship government sponsored enterprise (GSE) model.

With a focus on transitioning to a more secure, sustainable and competitive model for the secondary mortgage market, FHFA established the 2012 Conservatorship Scorecard to provide a roadmap for the Enterprises to implement the Strategic Plan. The Scorecard had four focus areas all tied to the Strategic Plan and great progress was made in all areas.

Building upon the 2012 Scorecard, earlier this month FHFA published the Conservator's Scorecard for 2013, again setting forth annual performance targets to build, contract, and maintain. I would like to walk through each of these with you now while also highlighting some of the successes of 2012.

<u>Build</u>

The first strategic goal is to build a new infrastructure for the secondary mortgage market. The basic premise behind this goal is that the Enterprises' outmoded proprietary infrastructures need to be updated and maintained, and any such update should provide enhanced value to the mortgage market with a common and more efficient model. The Enterprises' infrastructures are not the most effective when it comes to adapting to market changes, issuing securities that attract private capital, aggregating data, or lowering barriers to market entry. In short, there must be some updating and continued maintenance of the Enterprises' securitization infrastructure. This requires the investment of capital, capital that would come from taxpayers through the PSPA. We concluded that to the extent possible, we should invest taxpayer dollars to this end once, not twice.

We also have undertaken this effort with the goal that it will have benefits beyond the Enterprise business model. Therefore, this new infrastructure must be operable across many platforms, so that it can be used by any issuer, servicer, agent, or other party that decides to participate.

To move this effort forward and gather input from the industry, FHFA issued a white paper in October 2012 on the build goal, which includes the development of a common securitization platform and a model contractual framework. One of the most important issues we raised in the white paper was the scope of the securitization platform. One approach we outlined is that the focus of the platform could be on functions that are routinely repeated across the secondary mortgage market, such as issuing securities, providing disclosures, paying investors, and disseminating data. These are all functions where standardization could have clear benefits to market participants.

Earlier this month, I announced as part of the 2013 Scorecard that a new business entity will be established between Fannie Mae and Freddie Mac. We believe that setting up a new structure, separate from the two companies, is important for building a new secondary mortgage market infrastructure. This does not mean we are consolidating the companies. Our objective, as we stated last year, is for the platform to be able to function like a market utility, as opposed to rebuilding the proprietary infrastructures of Fannie Mae and Freddie Mac. To make this clear, I expect that the new venture will be headed by a CEO and Chairman of the Board that are independent from Fannie Mae and Freddie Mac. It will be physically located separate from Fannie Mae and Freddie Mac and will be overseen by FHFA. Importantly, we plan on instituting a formal structure to allow for input from industry participants.

What I have just described is the governance and ownership structure for the near-term phase of the platform. It will be initially owned and funded by Fannie Mae and Freddie Mac, and its functions are designed to operate as a replacement for some of their legacy infrastructure. However, the overarching goal is to create something of value that could either be sold or used by policy makers as a foundational element of the mortgage market of the future.

We are designing this to be flexible so that the long-term ownership structure can be adjusted to meet the goals and direction that policymakers may set forth for housing finance reform.

In the October White Paper we also put forth some broad ideas on creating a model contractual framework. Similar to the securitization infrastructure effort, the focus of this effort is to identify areas where greater standardization in the contractual framework would be valuable to the mortgage market of the future.

FHFA's alignment efforts, under which FHFA, Fannie Mae, and Freddie Mac work collectively to modify, enhance, and improve Enterprise programs and practices, will continue in 2013.

Much can be learned from these efforts, but given that the ultimate outcome of housing finance reform remains uncertain, this is an optimal time to further consider how best to address contractual shortcomings identified during the past few years. A great deal of work has already been done in this area by market participants, including the American Securitization Forum's Project Restart and additional input will be exceptionally valuable. As the Enterprises move forward with risk sharing transactions such as those I will describe shortly, the development of transactional documents will provide a real time test of a new standardized contractual framework for transactions where the private sector is absorbing credit risk.

Another aspect of the build goal is the Uniform Mortgage Data Program or UMDP. This effort may get overlooked at times, but a solid foundation of data standards is vitally important regardless of the future direction of housing finance reform. I am very encouraged by this effort as the Enterprises have worked through an industry process set up through MISMO – the Mortgage Industry Standards Maintenance Organization – to move this process forward. Considerable work has already been accomplished through the development of a Uniform Loan Delivery Dataset and a Uniform Appraisal Dataset. Work is beginning on the Uniform Mortgage Servicing Dataset. This latter effort will take time, but working through the process with a broad-based coalition of industry participants in MISMO should serve as a model for future efforts as we seek to rebuild the foundation of the mortgage market. In the end the benefits are immense. Developing standard terms, definitions, and industry standard data reporting protocols will decrease costs for originators, servicers and appraisers and reduce repurchase risk.

<u>Contract</u>

The second strategic goal is to gradually contract the Enterprises' dominant presence in the marketplace while simplifying and shrinking their operations. The basic premise behind this goal is that with an uncertain future and a general desire for private capital to re-enter the market, the Enterprises' market presence should be reduced gradually over time.

In 2012, guarantee fees were increased twice, which now brings the average guarantee fee on new mortgages to around 50 basis points, approximately double what guarantee fees were prior to conservatorship. A key motivation behind increasing Enterprise guarantee fees is to bring their credit risk pricing closer to what would be required by private sector providers. However, the increase in guarantee fees is part of the contract framework; it is not designed primarily to increase the Enterprises' revenue. The idea is that at some point the increases in guarantee fees will encourage private capital back into the market. We are not there yet, but in conversations with market participants, I think we are getting closer. We also set some goals in 2012 of executing on risk sharing transactions. While we did not execute any transactions, a considerable amount of preparatory work was done to lay the groundwork for 2013.

To move the contract goal forward, we set forth three priorities in the 2013 Scorecard.

First, in the single-family credit guarantee business we have set a target of $30 billion of unpaid principal balance in credit risk sharing transactions in 2013 for both Fannie Mae and Freddie Mac. We have specified that each Enterprise must conduct multiple types of risk sharing transactions to meet this target. For example, we expect to see transactions involving: expanded mortgage insurance; credit-linked securities; senior/subordinated securities; and perhaps other structures. The goal for 2013 is to move forward with these transactions and to evaluate the pricing and the potential for further execution in scale. What we learn in 2013 will set the stage for the targets for 2014, and I fully expect to move from a dollar target to a percentage of business target at some point in the future.

While it is not a Scorecard item, we also expect to continue increasing guarantee fees in 2013, and the execution of the single-family risk sharing transactions I just described should provide valuable information as to how market participants are pricing mortgage credit risk.

Second, the multifamily business presents a different set of issues. Unlike the single-family credit guarantee business, the Enterprises have a smaller market share and there are other providers of credit in the multifamily market. The Enterprises' market share of new multifamily originations did increase during the financial downturn, but in 2012 it returned to a more normal position.

Another difference from the single-family business is that each Enterprise's multifamily business has weathered the housing crisis and generated positive cash flow. In contrast to their common approach to their single-family businesses, Fannie Mae and Freddie Mac do not take the same approach to their multifamily businesses. Each approach also already embeds some type of risk sharing. For a significant portion of its business, Fannie Mae shares multifamily credit risk with loan originators through its delegated underwriting program. For a significant and increasing portion of its business, Freddie Mac shares multifamily credit risk with investors by issuing classes of securities backed by multifamily mortgages where the investor bears the credit risk.

Given that the multifamily market's reliance on the Enterprises has moved to a more normal range, to move forward with the contract goal we are setting a target of a 10 percent reduction in multifamily business new acquisitions from 2012 levels. We expect that this reduction will be achieved through some combination of increased pricing, more limited product offerings, and tighter overall underwriting standards.

Finally, the retained portfolios of the Enterprises have been declining since 2009. The initial PSPAs required a 10 percent annual reduction, and the most recent changes to the PSPAs increased the annual reduction to 15 percent. The composition of the Enterprises' retained portfolios has also changed significantly since the establishment of the conservatorships. Prior to conservatorship, the retained portfolios were dominated by their own mortgage-backed securities and performing whole loans. As those securities have been paid down, and as the need to work through delinquent loans increased, the retained portfolios changed from being relatively liquid to being less liquid.

To address this issue and further "de-risk" the Enterprises' retained portfolios in 2013, we are setting a target of selling five percent of the less liquid portion of their retained portfolios, in other words their retained portfolios excluding agency securities. Given that natural run-off in the retained portfolios would have likely satisfied the PSPA reduction targets in the next few years, and that the Enterprises are not actively purchasing new assets for their retained portfolios, this added requirement to sell from the less liquid portions of their retained portfolios should lead to an even faster reduction than is required under the PSPAs.

Maintain

Finally, in 2013 we seek to make further progress on the third strategic goal, maintaining foreclosure prevention activities, and promoting market stability and liquidity. Foreclosure prevention efforts were extensive in 2012 as FHFA and the Enterprises continued to simplify, streamline, and improve existing programs. As of November 31, 2012, the Enterprises put in place more than 200,000 new loan modifications.

In fact, the Enterprises have undertaken more than 2.6 million foreclosure prevention actions from the establishment of the conservatorships through November 2012. They put in place 1.3 million loan modifications. Along with other foreclosure prevention actions, such as repayment plans, the Enterprises have enabled nearly 2.2 million families having trouble paying their mortgages to remain in their homes. In this same time frame, they have also assisted more than 430,000 other families to gracefully exit their home without going through foreclosure, through short sales and deeds-in-lieu of foreclosure.

In 2012, the Enterprises implemented changes to the Home Affordable Refinance Program (HARP) that we announced late in 2011. Those changes included: expanding the program to greater than 125 loan-to-value ratio; clarifying representation and warranty exposure; and incenting shorter-term refinance opportunities through reduced pricing. The results have been impressive:

- The volume of total HARP refinances in 2012, nearly 1.1 million, nearly equaled the number of HARP refinances over the prior three years.

- HARP refinances with greater than 105 loan-to-value ratios made up 43 percent of total HARP refinances in 2012, compared to 15 percent in 2011.

- HARP refinances into a shorter-term mortgage made up 18 percent of total HARP refinances in 2012 for underwater borrowers, compared to 10 percent in 2011.

We look forward to building on those successes in 2013. We soon will be implementing a nationwide public relations campaign to educate consumers about the HARP program and the eligibility requirements.

Another "maintain" priority was initiated in September 2012 when FHFA and the Enterprises announced the start of fundamental changes to the representation and warranty framework, which is moving the process to more upfront monitoring. The goal of these changes is to improve the credit risk management practices of the Enterprises, and provide more certainty to originators as they make decisions on extending credit. The priorities for 2013 include:

- Enhancing the post-delivery quality control practices and transparency associated with the new rep and warranty framework.

- Working to complete rep and warranty demands for pre-conservatorship loan activity.

Let me close this review of the conservatorship strategic plan by highlighting a couple of other 2013 priorities. One will be the near-term efforts regarding mortgage insurance to update master policies and formulate eligibility standards. While this effort can be looked at as maintaining credit availability, it also seeks to strengthen and clarify standards to increase the reliability of this form of credit enhancement. This will be a needed step for mortgage insurance to remain a viable risk transfer mechanism in the future.

Another policy project of note is the development of an aligned set of standards for force placed, or lender-placed, insurance. The various concerns with force placed insurance are well-known, including the costs, limitations on coverage, and consumer protections. From our perspective, we could have addressed some of these concerns with a narrowly focused approach that would contain costs for Fannie Mae and Freddie Mac, such as Enterprise self-insurance or a direct procurement of insurance coverage by and for the Enterprises. However, I believe that these Enterprise-centric options would do little to address the needs of a future mortgage market without the Enterprises. Therefore, we plan to pursue a broader approach, bringing together Federal and state regulators to participate in the dialogue with us and with a wide range of stakeholders. We would like to establish a set of standards that could be adopted by a broader set of mortgage market participants, similar to what was done with the Servicing Alignment Initiative. This broadened approach will also enable greater regulatory coordination in an effort to consider the various issues associated with force placed insurance.

Financial Condition and Performance

Before turning to options for the future, I should first address current market conditions and the financial condition and performance of the Enterprises and of the FHLBanks, which are also important components of the U.S. housing finance system.

Housing Market Conditions

- We are seeing signs of recovery in the housing market across a number of dimensions and, while the marketplace is by no means “normalized,” conditions are promising in many ways.

- According to the latest data from the National Association of Realtors, the inventory of homes available for sale was only 1.7 million units in January. Given that the annualized rate of home sales during that month was nearly 5 million properties, this represented only about 4.2 months’ worth of supply. Just a year earlier, the relative supply was a still-modest 6.2 months. And at its peak—in July 2010—the supply was 12.1 months’ worth available for sale.

- According to the FHFA index, national home prices grew 5.5 percent between the fourth quarters of 2011 and 2012.

- Census data from December 2011 estimated the seasonally adjusted annualized rate of housing starts to be about 700,000 units. By September 2012, that rate had grown to roughly 840,000 units and, in January, the rate was estimated at 890,000 units. This compares to a low of about 480,000 units in April 2009, and is 61 percent of the long-run average.

- The latest CoreLogic information, which includes data for October, indicates that shadow inventory dropped roughly 12.3 percent between October 2011 and October 2012. This decline represented a reduction in the shadow inventory pool of about 300,000 units.

<u>Freddie Mac</u>

- Net income for the fourth quarter of 2012 totaled $4.5 billion, and represented the fifth consecutive quarter of positive earnings. Annual net income of $11.0 billion represented a record level of earnings for Freddie Mac and compares to a net loss of $5.3 billion in 2011.

- In 2012 Freddie Mac required $19 million of funding from Treasury bringing the cumulative Treasury draw to $71.3 billion. Through December 31, 2012, Freddie Mac has paid $23.8 billion in cash dividends to Treasury on the company's senior preferred stock. Under the PSPAs, the payment of dividends cannot be used to offset prior Treasury draws. This provision has remained unchanged since the PSPAs were established. So while $23.8 billion has been paid to Treasury in dividends, Treasury still maintains a liquidation preference of $71.3 billion on its senior preferred stock.

- The credit quality of new single-family acquisitions remained high in the fourth quarter of 2012, with a weighted average FICO score of 756. The average loan-to-value (LTV) ratio for new business was 75 percent. This higher LTV ratio is due to the expansion of HARP eligibility to borrowers whose mortgages have LTV ratios about 125 percent and to relief provided to lenders for borrowers with LTV ratios above 105 percent. These high LTV refinances represented 43 percent of HARP loans in 2012.

<u>Fannie Mae</u>

- Net income for the third quarter of 2012 totaled $1.8 billion, and represented the third consecutive quarter of positive earnings. For the first nine months of 2012, Fannie Mae reported earnings of $9.7 billion compared to a net loss of $14.4 billion for the first nine months of 2011.

- Fannie Mae did not require funding from Treasury in the first nine months of 2012. Fannie Mae's cumulative Treasury draw remains at $116.1 billion. Through September 30, 2012, Fannie Mae has paid $28.5 billion in cash dividends to Treasury on the company's senior preferred stock. Under the PSPAs, the payment of dividends cannot be used to offset prior Treasury draws. This provision has remained unchanged since the PSPAs were established. So while $28.5 billion has been paid to Treasury in dividends, Treasury still maintains a liquidation preference of $116.1 billion on its senior preferred stock.

- The credit quality of new single-family acquisitions was strong in the third quarter of 2012, with a weighted average FICO score of 761. The average LTV for new business was 77 percent. Again, this higher ratio is due to the expansion of HARP to borrowers with high LTV mortgages.

Federal Home Loan Banks

- The Federal Home Loan Banks have emerged from the financial crisis in generally good condition, profitable and with a strong capital position. The System reported net income of $2.6 billion in 2012, the highest annual earnings since 2007.

- Retained earnings have grown significantly in recent years and totaled $10.4 billion, or 1.37 percent of assets, as of year-end 2012. Retained earnings are at their highest level ever, and will continue to grow as a result of provisions included in each FHLBank's capital plan. The System regulatory capital ratio of 6.8 percent exceeds the regulatory requirement of 4.0 percent. The market value of the Federal Home Loan Banks is 124 percent of the par value of capital stock, the highest ratio in at least 11 years.

- The aggregate balance sheet of the Federal Home Loan Banks has shrunk considerably in recent years, led primarily by declining advance volumes due to market liquidity and sluggish economic growth. Advances totaled $426 billion as of year-end 2012, down 58 percent from a peak of $1.01 trillion in the third quarter of 2008.

Role of the Government in Housing Finance

In thinking about the role of the government in housing finance, I would start by reiterating the objectives that I shared in previous testimony. 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 market system for providing mortgage credit to people that want to buy a house should have certain core characteristics: allowing innovation, providing consumer choice, providing consumer protection, and facilitating transparency.

At the most fundamental level, the key question in housing finance reform is what, and how large, should be the role of the federal government?

Let me first approach this issue from a somewhat technical standpoint as an economist. A typical way that an economist would think about the government's role in the marketplace is in the context of a potential market failure. A market failure may lead the private market to produce less of, or more of, a particular good than would be economically optimal. Broadly speaking in housing finance there are at least two potential market failures that are often considered; each may lead to an under-provision of mortgage credit.

A potential market failure could arise in housing finance if market participants have undue or unnecessary concerns about the ongoing stability and liquidity of mortgage credit in a purely private market across various economic environments. If this view prevails in the housing market, less credit will be provided than would be the case in the absence of this type of uncertainty. The government response to this type of potential market failure could take a number of approaches, ranging from establishing standards and greater transparency for the market; providing liquidity or credit support under certain market conditions; to providing a government guarantee to largely eliminate uncertainty.

Another potential market failure is what is often thought of as the positive externality associated with homeownership. In this view, the benefits of homeownership extend beyond the individual household to the broader aspects of society, hence if left solely to the market the number of homeowners will be less than optimal. A common government approach to increase market demand is to provide some type of subsidy or other assistance to encourage or facilitate such consumption. Many aspects of government policy beyond the housing finance market are used to promote such an outcome in housing. Prominent among these is the mortgage interest tax deduction. Direct subsidies to lower the cost of mortgage credit or easing the eligibility terms for a mortgage are methods of delivering subsidies through the housing finance market.

With that technical background, in considering government policy as it relates to the housing finance market, it is useful to start with some basic market facts. As of the fourth quarter of 2012, there was about $9.9 trillion in single family mortgage debt outstanding. About 13 percent was guaranteed through direct government programs, roughly 52 percent was guaranteed by Fannie Mae and Freddie Mac, and the remainder not guaranteed by the Federal government. On a flow basis, *Inside Mortgage Finance* reports that in the third quarter of 2012 new single family mortgage originations totaled approximately $510 billion. Of that total roughly 18 percent was guaranteed through direct government programs, 66 percent through Fannie Mae and Freddie Mac, and 16 percent not guaranteed by the Federal government. Measured by securities issuance, the proportion supported by the government is over 90 percent. However measured, it should be clear that today’s housing finance market is dominated by government support.

While the choice obviously rests with lawmakers, the substantial and longstanding role of FHA and VA suggests there will continue to be some meaningful government role in the future housing finance market. As a nation we are committed to providing opportunities for homeownership, and there may be other social goals where it is decided that government support is warranted. The relevant question appears to be more in the line of how do we move from the housing finance market of today, where almost all new single-family mortgage originations have some type of government support, to a future market far more reliant on the private provision of mortgage credit. And in particular, of the $5 trillion portion of the mortgage market currently served by the Enterprises, what share, if any, should have government credit support in the future?

At a conceptual level, I think the place to start answering this question is to think about the role of the traditional government mortgage guarantee programs, like FHA. FHA and other traditional government credit programs are typically what are used to address credit market failures or to achieve public policy goals. If policymakers begin by defining the role FHA and other government mortgage credit programs should play in the future in terms of which borrowers would have access to these programs, then it should be easier to consider the government's role, if any, in the remainder of the mortgage market.

This is not dissimilar to the approach taken in other credit markets. Take business lending as an example. The government provides support to address potential market failures or achieve other public policy goals through the Small Business Administration and direct government credit programs. The rest of the small business loan market is generally left to the private sector, and credit for larger businesses is generally provided without direct government credit support. Other consumer credit markets, like auto loans, have little if any direct government credit involvement.

I think there is broad recognition that the single-family mortgage market has at least one important difference from other consumer credit markets – the size of the overall market – and the need to draw on broader sources of capital to fund this level of activity. The single-family mortgage market also has come to rely on the Enterprises as the mechanism to attract capital to this market.

Fannie Mae and Freddie Mac are often said to bring essential benefit to the mortgage market by ensuring the ongoing liquidity of the market. With their statutory public mission and statutory (low) capital requirements, the Enterprises were long able to guarantee mortgage credit risk at a volume and price other market participants could not. They were also seen as having a public mission to promote the availability of mortgage credit, especially to support affordable housing.

Still, there seems to be relatively broad agreement that this 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 $187.5 billion in funds from Treasury as of December 31, 2012.

Considering how to replace the government sponsored enterprise model, in particular developing an efficient secondary market that can access capital markets to serve the single family market that is not covered by traditional government credit programs is central to congressional consideration of ending the conservatorships.

The options here for the Committee's consideration range from a market-oriented approach that would ensure broad minimum standards were in place to establishing a Federal backstop to provide liquidity when needed, to developing a government guarantee structure to ensure stability in the flow of mortgage credit and limit market uncertainty. These options are not novel – they are essentially the three options that the Administration set forth in its white paper more than two years ago

Standard-Setting

A standard-setting approach would replace some of the standard-setting that the Enterprises undertake today with a regulatory regime or a market utility 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. The focus in such an approach could be 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.

Clearly a standard-setting framework 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. Arguably, this is part of the market oversight and investor protection regime that is already established in various securities laws overseen by the Securities and Exchange Commission. Part of the question here is given the size of the single family mortgage, and the unique characteristics of today's agency securities market, in particular the To-Be-Announced market, would additional standard-setting measures enhance liquidity and provide further structure to the market? An important question to consider is 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?

To establish a liquid non-government guaranteed market there would seem to be a need to have greater homogeneity in borrower characteristics. I would think such a market would broadly cover the bulk of the business that the Enterprises undertake today, but such a market might not be available to all borrowers currently served by the Enterprises. With greater transparency in requirements, it would give borrowers a clear sense of the qualification requirements. Traditional government guarantee programs would still exist to meet various policy goals. And finally, for borrower characteristics that do not fit neatly into the secondary market, we need to find a way to get insured depository institutions back into the business of funding mortgages. Understanding individual borrowers and special circumstances is at the heart of the financial intermediation function of insured depository institutions and an issue that deserves further exploration. I would also note that the Federal Home Loan Banks give depository institutions access to credit across the maturity spectrum to assist in funding such mortgages on depository institution balance sheets.

Federal Backstop

In a standard-setting approach without a government guarantee, it would be important to consider how such a market would operate in a time of stress. Having clear standards and greater transparency would certainly improve market operations, but there still could be cyclical swings that could broadly be of concern to the government. Two potential concerns are:

- 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? Or alternatively, with a more standardized market and infrastructure, would it be possible for an existing guarantor, like Ginnie Mae, to play such a temporary guarantee function?

- 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?

Government Guarantee

Finally, the third option, somewhat similar to what is in place today, is 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, pricing for those securities would not provide 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. In past testimony I have 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. It would also drive up the price of housing, other things being equal. A task for lawmakers is to weigh such incentives and outcomes against the alternative uses of such funds.

Finally, what I have just discussed relates to the single-family mortgage market. A similar type of analysis could be performed for the multifamily market.

Conclusion

Few of us could have imagined in 2008 that we would be approaching the fifth anniversary of placing Fannie Mae and Freddie Mac in conservatorships and have made little meaningful progress to bring these government conservatorships to an end. The conservatorships were never intended to be a long-term solution, rather, as I stated at the beginning of my testimony they were meant primarily as a "time out" for the rapidly eroding mortgage market – an opportunity to provide some stability while Congress and the Administration could figure out how best to address future reforms to the housing finance system.

The U.S. housing finance system cannot really get going again until we remove this cloud of uncertainty and it will take legislation to do it. Fannie Mae and Freddie Mac were chartered by Congress and by law, only Congress can abolish or modify those charters and set forth a vision for a new secondary market structure. While FHFA is doing what it can to encourage private capital back into the marketplace, so long as there are two government-supported firms occupying this space, full private sector competition will be difficult, if not impossible, to achieve.

I have been observing a developing "consensus" among private market participants that the conforming conventional mortgage market cannot operate without the American taxpayer providing the ultimate credit guarantee for *most* of the market. As I have noted, that clearly is one policy outcome, but I do not believe it is the only outcome that can give our country a strong housing finance system. I believe that our country, and its financial system, are stronger than that. I believe it is possible to rebuild a secondary mortgage market that is deep, liquid, competitive, and operates without an ongoing reliance on taxpayers or, at least, a greatly reduced reliance on taxpayers, if that is what we set our minds to accomplishing.

Where lawmakers identify particular market failures requiring direct government involvement, there may be more targeted approaches to addressing those issues than a broad subsidy to credit. For example, if certain borrowers or communities are of concern, taxpayer support could be targeted directly to support the building or purchasing of housing rather than indirectly through subsidies to borrowing money. Individual communities have already undertaken this approach.

I have said before, however, that these choices are for elected officials to make, not me. I am offering to work with this Committee, its counterpart in the Senate, and the Administration to make these policy determinations and then set about ending these conservatorships and transitioning to a future housing finance system that can serve our children, grandchildren, and beyond.

Thank you again for inviting me here today. I look forward to discussing these important matters with all of you.