Statement by

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Chairman Hensarling, Ranking Member Waters, Members of the Committee, thank you for the opportunity to testify on impediments to private investment in the U.S. housing finance system.

In 2008, the U.S. government effectively nationalized the residential mortgage market. It placed the largest providers of funding to this market, the Federal National Mortgage Association (Fannie) and the Federal Home Loan Mortgage Corporation (Freddie) (together, the enterprises), into federal conservatorships and established an equity backstop for their solvency from the U.S. Department of the Treasury (Treasury), thereby creating an explicit government guarantee of over $5 trillion of their mortgage-backed securities (MBS) and corporate indebtedness. The Federal Housing Administration (FHA) and Department for Veterans Affairs tripled their combined footprint in the market. The largest mortgage originators and servicers in the country—the nation's largest banks—received trillions of dollars of loans from the Federal Reserve, hundreds of billions of TARP equity from Treasury, and new deposit and transaction account guarantees from the Federal Deposit Insurance Corporation (FDIC), all to ensure that they remained in business and did not engage in fire sales of, among other things, their mortgage assets. The Federal Reserve and Treasury became the largest buyers of agency debt and MBS in the world to ensure stable pricing of mortgage credit in the secondary markets.

Without the government's intervention, mortgage credit would have disappeared for almost all Americans because all of the major providers of such credit—Fannie and Freddie and the country's major banks—would have failed.

There is growing consensus across the political spectrum that continued government dominance of the mortgage market is unacceptable. In 2012, ninety percent of the $1.9 trillion of new mortgage originations were supported by the government. Through credit from a variety of "government sponsored" entities, taxpayers today bear the risk of loss on $6.5 trillion of the $10 trillion of residential home mortgages outstanding in America. The FHFA and Treasury have prevented Fannie and Freddie from building any real reserves to cover potential future losses on their guarantees of $4.5 trillion of mortgage backed securities, leaving taxpayers on the hook for mortgage losses if we experience another downturn in home prices. Access to mortgage credit for most Americans remains limited despite historic low rates, because underwriting standards have been restrictive post-crisis. Private risk-taking in the mortgage markets remains muted.

My testimony will focus on the actions that I believe this Congress and the Administration should take to restructure the government's role in the mortgage market and to accelerate the process of bringing private investors back into the fold.

During my recent tenure as the Chief Restructuring Officer at Treasury, I had primary responsibility for the oversight of the government's capital commitments to AIG, which rivaled in size the amount of capital invested to date in Fannie and Freddie. After a series of restructurings of that $182 billion commitment, we designed and implemented a recapitalization plan for AIG that involved (i) selling off almost half of its insurance businesses to generate sufficient proceeds to repay its debt to the Federal Reserve and (ii) the exchange of the Treasury Department's $50 billion of preferred stock into 92 percent of the common equity of the company. The Treasury Department then sold the common stock into the public markets in a series of secondary offerings in 2011 and 2012, fully eliminating AIG's perceived government sponsorship. In the end, taxpayers made almost $23 billion on an investment that the OMB originally projected the government would lose $50 billion.

Although housing finance reform is more complex in several respects than the AIG restructuring, I believe that a similar corporate finance solution combined with broader housing finance reform should allow Congress to:

1. End the conservatorships within three years;
2. Fully recover the taxpayers' substantial investment in Fannie and Freddie; and
3. Create conditions under which private investment capital can return to a market now almost completely dominated by the government.

State of the U.S. Mortgage Market

We have to deal with the world as we find it, not as we wish it to be. Housing is central to the health of the nation's economy and to the wealth that remains within the grasp of ordinary Americans. Therefore, it is particularly important that, in designing policy to reduce the government's now dominant role in mortgage credit formation, we do not engage in wishful thinking about the appetite of private investors for mortgage credit risk. These investors are still reeling from losses generated by the greatest house price decline in four generations.

Where are private investors and private providers of mortgage funding today, six years past the peak of the housing bubble? Nibbling at the edges.

Let's start with the banking industry. Since the crisis, the sector as a whole has reduced its exposure to the residential mortgage market by approximately $580 billion, nearly 20 percent off its peak. It is true that after four years of significantly cutting their holdings of single-family residential loans and incurring hundreds of billions of dollars of losses related to those assets, in 2012 commercial banks expanded their holdings. However, that increase was a mere 2.8 percent or approximately $59 billion in mortgage loans. Meanwhile, savings and loan institutions have continued to shrink their exposure to the mortgage market—by $103 billion in 2012. As a result, overall holdings of residential mortgages in the banking sector fell 1.7 percent last year, continuing the basic trend since the peak of the housing bubble in early 2007.

Next, let's look at the private mortgage insurers (PMIs). While it is true that some have recently been able to raise new capital in the public markets and that the aggregate amount of primary insurance in force in the sector is no longer in free fall, total capital in the sector was down from a peak of $17 billion in 2006 to roughly $5 billion at the end of 2012, which is at least $100 billion short of the capital necessary to support the $4.5 trillion in MBS guarantees of the enterprises.

Finally, there is the private-label securities (PLS) or non-government-guaranteed MBS market. Issuance of PLS reached $6 billion in 2012, and forecasts suggest that there could be $20 billion of new issuance this year, down from $740 billion in the peak year of 2006. A handful of issuers account for this greatly diminished volume, and the characteristics of the mortgages underlying the securities issued are similar. A recent issuance, Sequoia Mortgage Trust 2013-4, is representative. All loans in the pool were long-term fixed-rate mortgages, and the weighted average coupon was 3.8 percent. But the average loan size was $805,000, the weighted average combined loan-to-value ratio was 65 percent, and the weighted average original FICO (credit score) was 773. In other words, the mortgages in these pools represent the cream of the crop—not the majority of America.

Moreover, as we think about what it might take to get private investors to take mortgage credit risk in this market and to pick up more of the risk being borne by taxpayers through Fannie and Freddie, it is important to understand that newly issued PLS are structured to provide immense protection for investors. The recent Sequoia issuance included four senior tranches, three interest-only strips, and three subordinated tranches. What does that mean? If mortgages in the pool default, investors in the three subordinated tranches take losses up to the amount of their investment before investors in the senior tranches suffer any loss at all. Given that the average combined loan-to-value ratio for the underlying mortgages is 65 percent, home prices would need to decline by 35 percent before the investors in the subordinated tranches would suffer any loss at all. And then, because the subordinated tranches constitute 6.25% of the total debt secured by the mortgages in the pool, investors in the senior tranches would still be protected against loss so long as the underlying homes could be sold upon default for 61% of the value of the home at the time the mortgages were originated.

Policymakers need to avoid wishful thinking as they consider whether the sale of these new private label securities truly signal the return of private risk-taking in the mortgage market that is capable of displacing the government. First, while growing, the total volumes might represent one to two percent of aggregate demand. Second, the securities being sold are backed by mortgages that represent the cream of the crop. Finally, and most telling, the issuers of these new private label securities have had to retain the subordinated tranches in their new issues to get investors to buy the senior tranches at all. Regardless of potential risk-retention rules, private investors are not only demanding that issuers have "skin in the game" but also that the issuer's skin be in the "first loss" tranche in the new structures, and that there be a mountain of homeowner equity ahead of them as well.

Further, we must remember that during the period leading up to the crisis, the PLS market was rife with fraud, misrepresentation, fast and loose underwriting practices as well as conflicts of interests. Investors in these securities suffered badly from these practices that ultimately resulted in default rates in excess of 25% and hundreds of billions of dollars of credit losses. No one should be surprised that investors remain reluctant to take mortgage credit risk in such a tarnished market.

The slow re-opening of PLS markets gives me hope for the future, but it also leads me to be extremely skeptical that private investors will have the appetite to displace much of the credit risk that Fannie and Freddie currently underwrite in the US mortgage market any time soon. Last year there were roughly $1.9 trillion in single-family mortgage originations in the United States, of which Fannie and Freddie provided support for approximately $1.3 trillion. Going forward, estimates for normalized annual total originations are in the range from $1 trillion to $1.5 trillion. A PLS market projected to do $20 billion of issuance in 2013 clearly cannot handle anything approaching these annual volumes.

Again, as we map a way forward in housing finance reform, we must be very careful in the assumptions we make about the appetite of private investors for taking mortgage credit risk.

Impediments to Private Capital

GSE Conservatorships

The conservatorships of the enterprises are the greatest impediments to the return of private investors to the mortgage market. Private investors need to understand what the future of the enterprises looks like before committing capital to this market in size. Further, FHFA has managed Fannie and Freddie during the conservatorships in a manner that makes it difficult for others to compete. Fannie and Freddie have been operating with essentially unlimited leverage and no capital to absorb future losses. With an open line of equity from Treasury to cover any such losses, they continue to underprice the risk of loss on the mortgages they have guaranteed during the conservatorships vis-à-vis potential private competitors.

No private insurance company can compete against a government-controlled insurance business operating with no capital and no real return on capital hurdles. Moreover, if a private insurance company were as critically undercapitalized as Fannie and Freddie are today, regulators would insist that profits be retained to build capital so as to create a cushion against future potential loss—not distributed to equity holders. Yet, under last summer's amendments to Treasury's preferred stock purchase agreements, all profits are being swept out of the companies into the general fund, leaving taxpayers exposed to potential future losses on the trillions of dollars of new guarantees written since Fannie and Freddie were placed into conservatorship.

Worse, the enterprises are being used to fund government initiatives unrelated to housing. The Temporary Payroll Tax Cut Continuation Act of 2011 required the enterprises to increase the fees they charge to guarantee mortgages by 10 basis points and to pay those fees directly to the Treasury.[1] The projected $35 billion in proceeds from that increase were spent in January and February of 2012 but will not be collected in full until 2021. The CBO assumptions on which that "pay for" is based is that the enterprises' current market share will remain essentially unchanged between now and 2021. Reform is complicated enough without having to solve for this shadow tax regime. Its creation implies to private investors that the conservatorships will remain in place for at least the coming decade.

The same Act also directed the FHFA to increase guarantee fees to levels that "appropriately reflect the risk of loss, as well as the cost of capital allocated to similar assets held by other fully private regulated financial institutions." As the Chairman of this Committee has noted, that has not happened yet. At the end of 2012 the average guarantee fee charged by the enterprises on newly-originated mortgages was just over 50 basis points. That is roughly double what they charged two years ago. Yet they are still not losing market share to new entrants.

Why? So long as the status quo persists, and the enterprises remain under government control, the pricing and credit characteristics of loans that Fannie and Freddie are permitted to support are

[1] The Act also imposed the same requirement on the FHA.

subject to non-economic influences that could have a negative impact on the future returns of private investors. Private capital cannot enter a market in size when the dominant players in that market are subject to such substantial political risk.

The reason that private investors ran for the hills in 2008 is that they could not estimate their downside risk in a collapsing housing market and were unwilling to invest in mortgages at any price. Underwriting models have improved, in part because of the data we have from this most recent crisis. However, the fact that lending standards remain so tight is a signal that market participants remain unwilling to be exposed to tail risk at any price. The recent PLS issuances illustrate this point: with 35 cents of homeowner equity and 6.25 cents of issuer "skin in the game" ahead of them on every dollar of new PLS investment, investors in the senior tranches would not be exposed to loss even if home prices declined again as sharply as they did between 2006 and 2009. Investors are unprepared to take the risk of another housing downturn.

FHA Pricing

There is emerging evidence that private mortgage insurers are now competing with the FHA at the current prices it charges for its guarantee. The FHA Reform Act of 2010 removed the 0.55 percent premium cap, and allowed the Administration to raise premiums to 1.55 percent. The current FHA premium is 1.35 percent, and private mortgage insurers have expanded market share and raised nearly $3 billion of new capital in the past year. Certainty around FHA requirements—for example, whether it will compete for prime borrowers in the future—could further increase the opportunity for and role of PMI in the market. But, they will need to raise significant incremental capital to do so.

New Regulations

Regulations also impact the availability of private capital in the mortgage market. Banks face a new capital regime that makes it more expensive to hold mortgage assets, in particular non-conforming mortgages. The final "Qualified Mortgage" (QM) rule reinforces this bias. While lenders have a safe harbor for conforming mortgages for up to seven years, lenders are exposed to potential liability from violations for other mortgages. Although it has not been finalized, it is likely that the "Qualified Residential Mortgage" (QRM) rule will have a similar impact.

I caution strongly, however, against concluding that these regulations should not be implemented. On the contrary, the United States just experienced the worst financial crisis and recession in four generations. It was in no small part because of weak capital requirements and loose regulation of providers of mortgage credit. While they may not be perfect, Basel III and the Dodd-Frank Act represent significant positive steps toward a better capitalized and less "fast and loose" financial system.

That said, I do believe that regulators need to finalize the QRM rule as soon as possible and provide certainty to the market over how QM and QRM will be implemented. That is easier said than done, in part because regulators have no clearer picture of the future role of Fannie, Freddie, FHA and other government providers of mortgage credit than private investors do.

Impediments to PLS Issuance

The list of impediments to a liquid PLS market is long. I group them into four categories: disclosure, inter-creditor rights, enforcement, and servicing.

Investors in PLS were burned during the crisis in part because information about the mortgages underlying their securities was either difficult to obtain or hard to understand. Rating agencies suffered from the same problem in their diligence and analysis. Today both investors and rating agencies are reluctant to touch many kinds of PLS issuances. Moreover, many investors no longer assume that rating agencies can substitute for their own diligence.

The crisis also revealed that the current regime that defines rights between first and second lienholders is defective. Loans secured by second liens eliminated the buffer of equity that many first lienholders expected would protect them in a downturn. When home prices fell precipitously, aggregate loan balances exceeded the value of many homes and, despite their legal priority, first lienholders found themselves treated the same as or worse than second lienholders. Further, second liens have inhibited modifications and principal reductions in troubled loans, and have exposed inherent conflicts between servicers—who frequently own second liens—and investors in PLS backed by first liens.

There are a number of problems with current mortgage enforcement processes. Conflicts of interest and weak incentives in servicing can impose unnecessary costs on borrowers and reduce returns to PLS investors when a borrower defaults. Trustees are poorly compensated to enforce PLS investor rights. Investor remedies are poorly defined and vary issue to issue. Technical defects in the foreclosure process hurt borrowers and PLS investors alike. Separately, improper transfer of title for mortgages underlying PLS prevents trustees from having standing to foreclose on behalf of investors, and it allows creditors of originators and securitizers to seize the asset to satisfy their claims in bankruptcy—potentially denying the PLS investor's recovery altogether.

The mortgage servicing industry suffers from widespread conflicts of interest, a one-size-fits-all compensation regime, and the lack of uniform standards for restructuring or modifying mortgages. Many second lienholders also service first liens, and servicers frequently have economic relationships with third-parties who play a role in foreclosure processes. Servicers historically have been overpaid to service performing loans and underpaid to service non-performing loans. Although that model might have survived minor waves of defaults, it proved woefully inadequate to survive a shock of the magnitude that we just experienced.

Fortunately there seems to be consensus on many of the solutions to these problems. Some require legislative action, some regulation, others actions by industry alone. But nearly all will take a long time to be implemented, and it will take even longer for market participants to get comfortable with them.

A Way Forward

Resolving Fannie and Freddie is the most important step that Congress can take to remove investor uncertainty and encourage private investment in the US mortgage market. However, that is impossible to do without affecting the future market structure and the role of the government in it. And it is irresponsible to do so without a realistic appraisal of the ability of private investors to replace the government's role.

I propose a transition plan that we can begin implementing immediately to bring private capital into the market. The plan has four key features.

1. We must wind down the government-sponsored hedge funds that Fannie and Freddie ran, terminate the government charters that created an “implied” guarantee of their debt, and recapitalize and sell their mortgage guarantee businesses to private investors.

2. The government should provide reinsurance for qualified MBS in exchange for a fee, properly calibrated to protect taxpayers against the risk of potential loss. This is similar to the FDIC's deposit insurance and represents a dramatic shift in structure and substance from the pre-crisis model of a free implicit guarantee of undercapitalized “government-sponsored” entities.

3. Structural impediments to PLS issuance should be removed.

4. Housing affordability initiatives should be funded from a fee on all MBS issued with government reinsurance.

This plan offers several benefits.

- ***Restarts private markets***. The plan provides a smooth path to a new system in which the private sector plays the leading role, there is sufficient private capital ahead of the government reinsurance to absorb losses in most situations, and taxpayers are compensated for providing a public backstop.

- ***Ends the private-gain, public-loss GSE model***. GSE charters are terminated and taxpayer-subsidized portfolios are wound down.

- ***Repays taxpayers***. Modeled on the successful resolution of the government’s investments in AIG, the privatization allows Treasury to recoup its $122 billion of net investments in Fannie and Freddie.

- ***Protects our economy***. Privatized, adequately-capitalized mortgage guarantee businesses and government reinsurance provide a bridge to a stable mortgage system without risking a sudden reduction in mortgage credit that would depress house prices and risk another recession. And importantly, they afford policymakers the tools to reduce the Government’s credit exposure over time as private risk appetite increases.

- ***Ensures affordability***. Mortgage credit will be available during times of stress, long-term fixed-rate mortgage products will be available for most Americans, lending standards can normalize, and funding for affordability initiatives is transparent.

Ending the GSEs and Capitalizing the Private Mortgage Market

The first step is to end the GSEs and to recapitalize and privatize their mortgage guarantee businesses. The highly-levered investment portfolios each firm ran before the crisis--in effect, government-sponsored hedge funds--should continue to be wound down under federal supervision. The public charters that allowed private shareholders to benefit on the backs of taxpayers should be terminated. The private mortgage guarantee businesses should be recapitalized and sold as private "first loss" insurers, with significant capital standing in front of the government's new reinsurance. They will have no special privileges, and no implicit or explicit guarantee of their liabilities. As private companies, they will have no ability to issue government guaranteed debt to fund expansive on-balance-sheet mortgage portfolio investments as they did under the “government sponsorship” model.

Without special privileges, the firms will be forced to compete with other private companies willing to pay the government for its reinsurance, with strict regulation to ensure that community banks can originate and securitize mortgages on an even playing field with the giant banks that have come to dominate the business over the past four years under the auspices of the conservatorships. The new government reinsurer should also be directed to facilitate structured products that provide a variety of ways for private investors to shoulder more mortgage credit risk, thereby reducing the government’s footprint. To the extent that the newly privatized mortgage guarantee businesses exceed acceptable market share parameters, the new government reinsurer should impose higher capital requirements on them, just as the largest banks are to be subject to capital surcharges. And there should be no regulatory capital arbitrage permitted among providers of mortgage credit: the same capital charges should be applicable whether a mortgage is held on a bank’s balance sheet or guaranteed through “first loss” insurance.

Efforts to establish a single securitization platform that could serve as a market utility should continue, as it represents an important step towards facilitating a competitive marketplace. Such competition will spur innovation and reduce systemic risk in mortgage securitization. As the system spurs new entrants in mortgage finance, and diversified institutional sources of mortgage funding develop, we will no longer be held hostage to the fate of any one or two large institutions’ survival as the government was in the summer of 2008. Any one of them could fail—including the privatized mortgage guarantee businesses—without the threat of a housing market collapse. Shareholders will be wiped out and any mortgage guarantee infrastructure transferred to new ownership.

To build the capital required to support their becoming the “first loss” insurers of their outstanding $4.5 trillion of MBS (and thereby to protect taxpayers on the new government reinsurance), FHFA should immediately direct the enterprises to increase their fees to market levels and keep them there until a sufficient capital cushion is built. In a market structure where the government provides reinsurance to cover tail risk, higher guarantee fees will also have the collateral benefit of creating a pricing umbrella under which new private investors and insurers can compete. Treasury should suspend its profit sweep so that the mortgage guarantee businesses can retain those guarantee fees and build up capital. Building capital is the first step in getting them ready to be sold back into private hands. It is also essential to building a stable private mortgage market that can absorb most shocks without triggering government reinsurance.

Privatizing newly recapitalized and state-chartered mortgage-guarantee businesses would also enable Treasury to recover its substantial investment in the companies and begin moving toward a safer housing finance system driven by market incentives, with private capital first in line for losses. Taxpayers deserve both outcomes. Once the companies have enough capital to cover their "first loss" insurance exposure, Treasury should convert its preferred stock into a sufficient percentage of common stock to ensure that taxpayers' investments can be repaid in full. The firms could then be released from government control and Treasury's equity in the restructured entities sold to private investors over time. This is exactly what Treasury did with its 92 percent stake in AIG, with great success.

I believe that this plan will not only return all of Treasury's net investments in the enterprises, but that its adoption would also have an immediate positive impact on budget negotiations. I estimate that the plan could score between $100 and $190 billion in deficit reduction (that is, a negative subsidy) under Congressional Budget Office accounting.

Transforming the Government Guarantee

Since 2008, Treasury has backstopped the enterprises' solvency while preventing them from building any capital to support the trillions of dollars of MBS they have guaranteed during the conservatorships. I urge you to transform this convoluted guarantee of the enterprises' solvency into a secondary backstop of qualified MBS, and to charge the market an appropriate price for it.

This is a political hurdle for conservatives, who are understandably reluctant to establish yet another government credit-support program. But the guarantee of the mortgage market through Fannie and Freddie today cannot be replaced until it is acknowledged for what it is. Each day the current system remains in place the likelihood increases that the profit sweep becomes embedded in the federal budget, and that Treasury's backstop for the enterprises and the conservatorships become permanent, leaving private capital on the sidelines indefinitely.

Moreover, it is unrealistic to expect that the government will not again intervene in a future housing crisis, or that private markets alone will provide a stable source of financing for the sector in good times and bad. Previous attempts in U.S. history to rely on purely private mortgage markets resulted in spectacular crashes. We experienced it in the 1880s when originators issued debt backed by their mortgage pools, in the 1900s when New York title guarantee companies sold participation certificates backed by mortgages they had originated, and in the 1920s when single-property real estate bonds were used to finance construction projects. Poor underwriting, misaligned incentives, lax regulation, and investors' inability to judge credit quality undermined every model. And in each of these instances, investors fled the market for years after the crash and mortgage credit evaporated with disastrous effects on the economy as a whole. The flight of investors from PLS markets in the recent crisis illustrates that this propensity for wide swings in private investor appetite for risk remains equally strong today.

Therefore, I believe it is better to structure and price an explicit guarantee behind a well-regulated and properly capitalized private market *ex ante* than to bail out an undercapitalized, pro-cyclical system *ex post*, and to suffer distortions from implicit backstops and hidden subsidies along the way.

To that end, I propose establishing a Federal Mortgage Insurance Corporation (FMIC) modeled on the FDIC. The FMIC would have a limited mandate: ensuring stable credit for the housing system and protecting taxpayers against loss. To do so, it would (i) establish standards for qualifying single-family and multifamily mortgage products and practices, (ii) sell reinsurance for MBS comprised of mortgages that meet those standards, and (iii) supervise entities that purchase that reinsurance for safety, soundness, and capital adequacy. Well-capitalized private MBS insurers and issuers would be first in line to cover losses on a qualified MBS pools reinsured by the FMIC. The FMIC would guaranty incremental shortfalls in payment on the MBS (after the exhaustion of the "first loss" providers primary coverage) and enforce capital requirements for first-loss providers to ensure that they can meet their insurance obligations. Proceeds from FMIC's reinsurance fee would be placed in a reserve fund that builds over time and used only to fund operations and offset potential losses. The FMIC must also be insulated against political interference on the model of the FDIC, with a budget off limits for any purpose beyond its limited mandate.

Will the FMIC misprice its reinsurance? Yes, just as private mortgage insurers mispriced their insurance before the crisis and no doubt will again. But the FMIC can fund any shortfalls from the qualified MBS market through fees over time—not from taxpayers through a government bailout. This is exactly what the FDIC did in 2009 when it experienced a shortfall in its Deposit Insurance Fund and imposed special and pre-paid assessments on banks. Although Congress granted the FDIC authority to borrow as much as $500 billion from Treasury, the FDIC did not take $1. Further, Congress can establish a hard floor for the guarantee fee based on actuarial models that take the recent crisis into account. It can also require stress testing of the FMIC's fund and reinsurance pricing on a periodic basis.

Removing Impediments to PLS Issuance

To address deficiencies in disclosure, loan-level information should be published for all mortgages in securitized pools. This would allow investors, rating agencies, and regulators to evaluate collateral and expected economic performance at the time of underwriting and over the life of the mortgage-backed security. Freddie has already taken a significant step in this direction, publishing online loan-level information at time of issuance and on a monthly basis for all securities issued after December 1, 2005. A national electronic registry of mortgage liens and servicing relationships should be established and published. This could be done by modifying or replacing the existing Mortgage Electronic Registration System (MERS). Deal documents for MBS should be available electronically to investors, rating agencies and regulators, as should servicing performance and fees.

The FMIC should be directed to establish a new inter-creditor regime for mortgages. First lien investors should have rights to approve second liens that would lead to an unsustainable combined loan-to-value ratios. Loan-level losses should be properly allocated in the pools according to lien priority. Second lienholders should not be paid before the first lienholder without consent. And first lienholders should control the restructuring or foreclosure process.

To address deficiencies in the enforcement of investor rights under pooling and servicing agreements, the Trust Indenture Act of 1939 should be amended to apply to MBS or it should be replicated for MBS. The FMIC should be directed to work with industry to establish standard pooling agreements with model representations and warranties. The new MERS should address transfer of title defects. And a model non-judicial foreclosure law should be drafted and implemented.

The FMIC should follow in the footsteps of the FHFA to address deficiencies in servicing, in particular by establishing and enforcing rules to eliminate conflicts of interest and to ensure adequate investment by servicers in the systems and people necessary to handle the work outs of troubled mortgages. Second lienholders should be barred from servicing first liens they originate, a rule which will also serve to stimulate servicing competition. Economic relationships between servicers and third parties involved in the foreclosure process should be severed. The FMIC should be directed to work with industry to establish uniform accounting policies and procedures for loan servicing and restructuring.

Ensuring Affordability

The steps above should ensure that mortgage credit will remain available during times of stress. FMIC insurance will also ensure a deep, liquid market for qualified MBS, the benefits of which will flow to borrowers and lenders during normal times. The plan also ensures that long-term fixed-rate mortgage products will be available for most Americans. Absent some form of government reinsurance, it is likely that most mortgages will be shorter term and/or variable rate products, forcing the least sophisticated in the system—homeowners—to manage interest rate risk. Further, by providing clarity about where the housing finance system is headed and by putting private capital first in line for losses on the government-reinsured product, lending standards can begin to normalize.

However, there are tradeoffs. The affordability goals embedded in the charters of Fannie and Freddie would disappear along with their “government-sponsored” status. Although Community Reinvestment Act provisions would continue to apply to mortgage market participants, neither the privatized mortgage guarantee business nor the FMIC would have affordability goals. In their place, I propose that each new MBS sold with government reinsurance pay a fee over the life of the security to fund federal and state affordability initiatives. For example, proceeds from a fee on government-reinsured MBS could be directed to the Housing Trust Fund and Capital Magnet Fund established by the Housing and Economic Recovery Act of 2008. Those proceeds could also be allocated among state public housing agencies in order to fund affordability programs, such as the expansion of the oversubscribed Housing Choice Voucher Program.

Some suggest that this proposal risks creating a two-tier system: one for those with access to the new qualified MBS and PLS markets, and one for those without. This is one reason why it is essential that community banks have the ability to access the benefits of secondary markets in the new market structure. They are more likely than the larger banks to funnel local deposits and other funding into mortgages in their local communities. It is also why the FHA must have the ability to expand during times of crisis for non-prime borrowers and, at all times, to charge rates for its guarantee that are appropriate for its mission while protecting taxpayers.

Conclusion

Some advocate for the wind down of the guarantee businesses of Fannie and Freddie, either by stepping down loan limits or restricting their underwriting authority in some formulaic way. The theory is that private investors will fill the void in the market created by the enterprises' forced withdrawal and that the transition will be seamless.

My question to the advocates of this approach is: what if it isn't seamless and substantial demand for mortgage credit goes unmet? If policymakers get the size or pace of a forced wind down wrong, we will suffer a credit contraction, house prices will fall and the U.S. economy will once again be at risk for a recession. When I ask the proponents of wind down "what then?", the answer is that the FHFA will wind the enterprises back up. This is precisely the kind of start/stop government policymaking that prevents private investors from taking risk. Until Congress provides private investors with a credible transition plan from the government-dominated market that exists today to one with a better balance of private risk and public support, I predict that private risk taking in the mortgage markets will remain muted.

My proposal is consistent with suggestions to use structured credit vehicles to stimulate private risk taking. The difference is that my proposal does not rely on those vehicles as the exclusive way to encourage private capital into the market and to reduce the government's footprint. Creating well-capitalized "first loss" insurers from the guarantee businesses of the enterprises is consistent with trying to induce private investors to buy a "first loss" piece of Fannie and Freddie MBS. The difference is this: I believe we can accomplish the former over the next three years if we have the political will to do so, whereas it is near impossible to predict the timetable over which private investors will purchase a sufficient amount of "first loss" securities in future Fannie and Freddie MBS to protect taxpayers on their backstop of Fannie and Freddie's solvency. And, there will be no capital ahead of the government on the enterprises' current $4.5 trillion of outstanding MBS.

These paths are also not mutually exclusive. Taken together they present a safe, responsible way to return private capital to mortgage markets, to end the conservatorships, to get the taxpayers' investments in the enterprises repaid in full, and to restore balance to the housing finance system on a more certain timeline.

Thank you, again, for inviting me here today. I appreciate the opportunity to assist the committee in working through the myriad challenges inherent in comprehensive housing finance reform.

Appendix I

April 24, 2013

Housing Finance Reform – Restructuring the Government's Role

Housing Finance Reform Proposal

- **The proposal provides a transition to a stable housing finance system driven primarily by private capital**
  1. Fannie Mae and Freddie Mac are eliminated, and their mortgage guarantee businesses are recapitalized and privatized with no government support, repaying taxpayers in full for the amounts invested in them during the conservatorships
  2. The government sells reinsurance on qualified mortgage-backed securities (MBS) with private insurance companies and investors first in line for losses
  3. New protections for investors in private-label MBS are enacted and disclosures are enhanced to restore confidence in a tarnished market
  4. A fee is imposed on government-reinsured MBS to fund federal and state affordable housing initiatives

✓ **Restarts private markets**

- Provides a smooth path to a new system in which the private sector plays the leading role, there is sufficient private capital to absorb losses, and taxpayers are compensated for providing an FDIC-like backstop

✓ **Ends the private-gain, public-loss GSE model**

- GSE charters are terminated and taxpayer-subsidized portfolios are wound down

✓ **Repays taxpayers**

- Modeled on the successful AIG restructuring, recapitalization and privatization, the plan allows Treasury to recoup $122 billion of net taxpayer investments in Fannie and Freddie

✓ **Protects our economy**

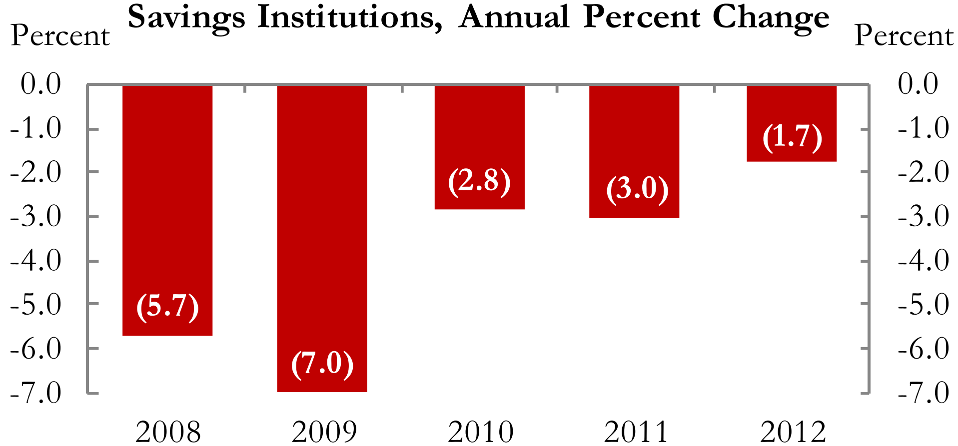
- Privatized, adequately-capitalized mortgage guarantee businesses and government reinsurance provide a bridge to a stable mortgage system without risking a sudden reduction in mortgage credit that would depress house prices and risk another recession

✓ **Ensures affordability**

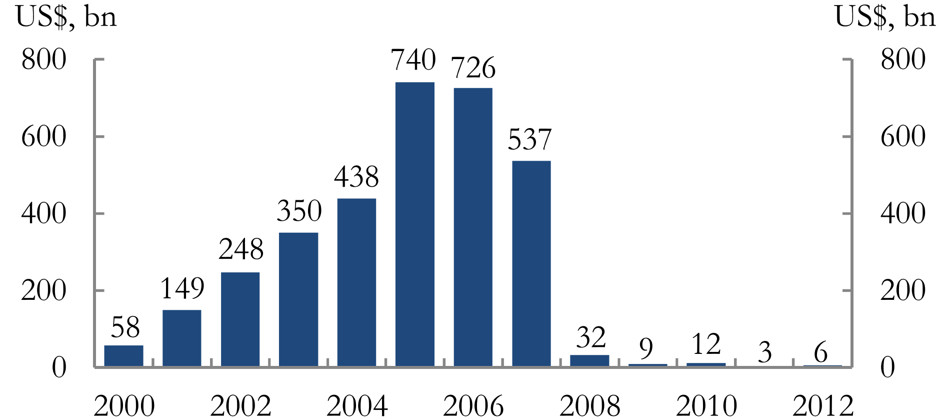
- Mortgage credit will be available during times of stress, long-term fixed-rate mortgage products will be available for most Americans, lending standards can normalize, and funding for affordability initiatives is transparent

A Transition Plan Must Be Realistic About the Availability of Private Capital

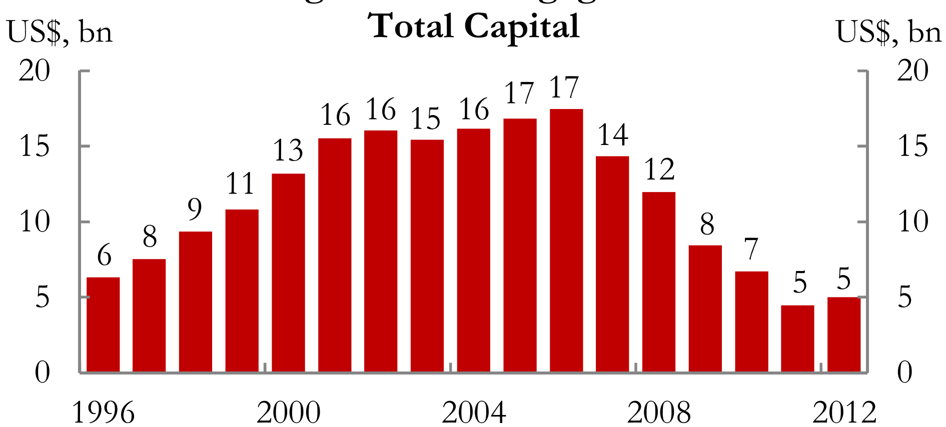
Residential Mortgages Held by Commercial Banks and Savings Institutions, Annual Percent Change



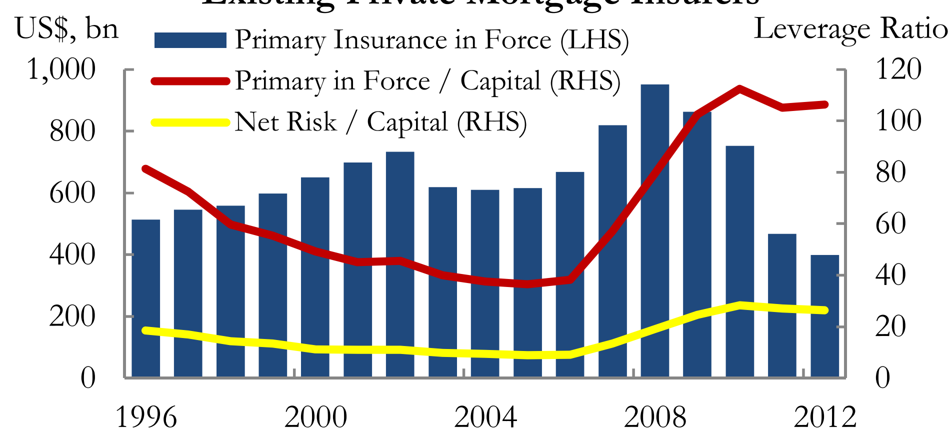
Private-Label MBS Issuance



Existing Private Mortgage Insurers Total Capital

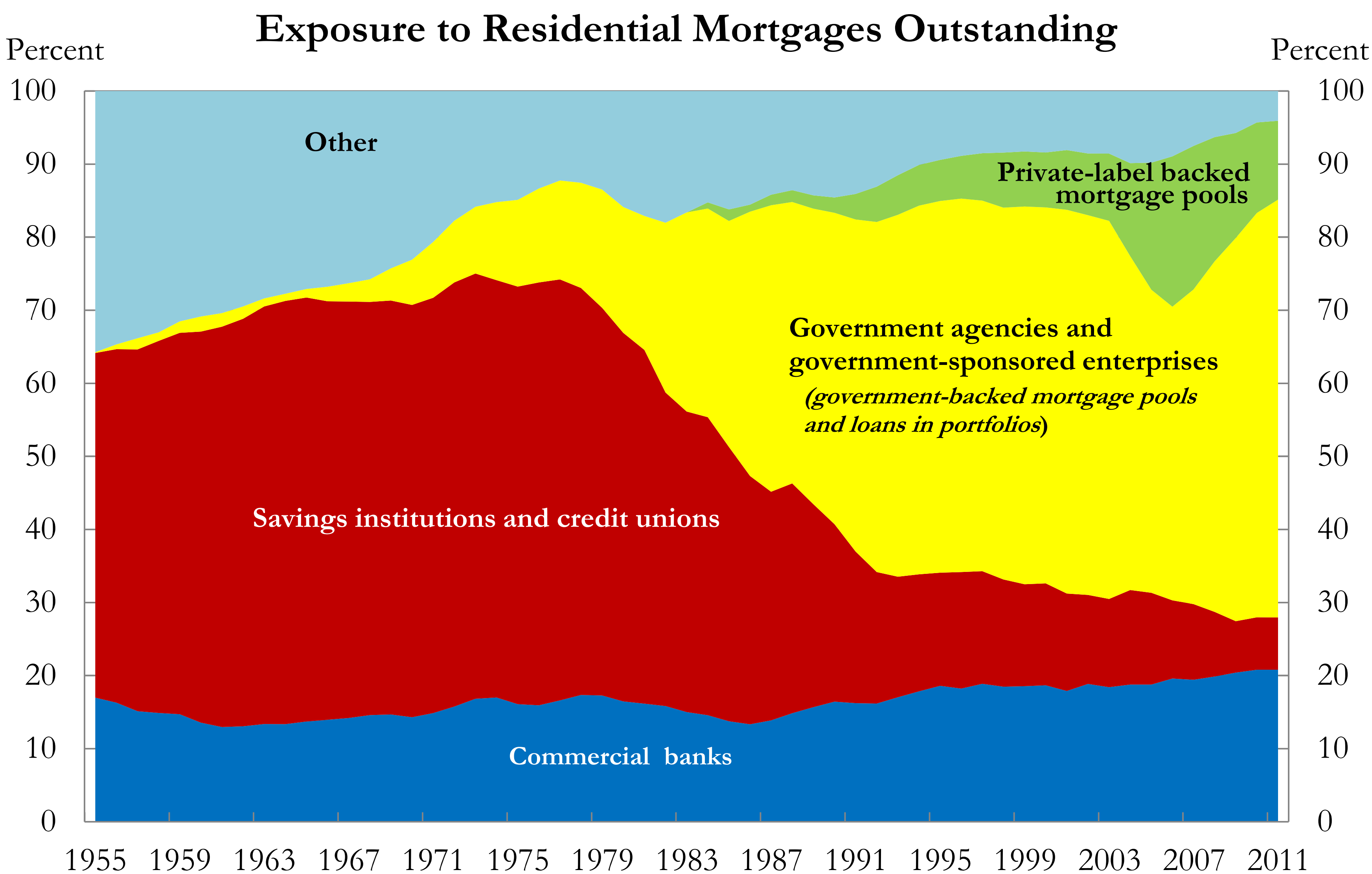


Existing Private Mortgage Insurers



Sources: Federal Reserve Board; Securities Industry and Financial Markets Association; Mortgage Insurance Companies of America; company reports; Millstein & Co. calculations.
Notes: End-of-year 2011 and 2012 estimates include Mortgage Guaranty Insurance Corp., Radian Guaranty Inc., and Genworth Mortgage Insurance Corp. Prior to 2011, estimates also include PMI Mortgage Insurance Co., United Guaranty Corp., and Republic Mortgage Insurance Co.

A Transition Plan Must Be Realistic About the Availability of Private Capital



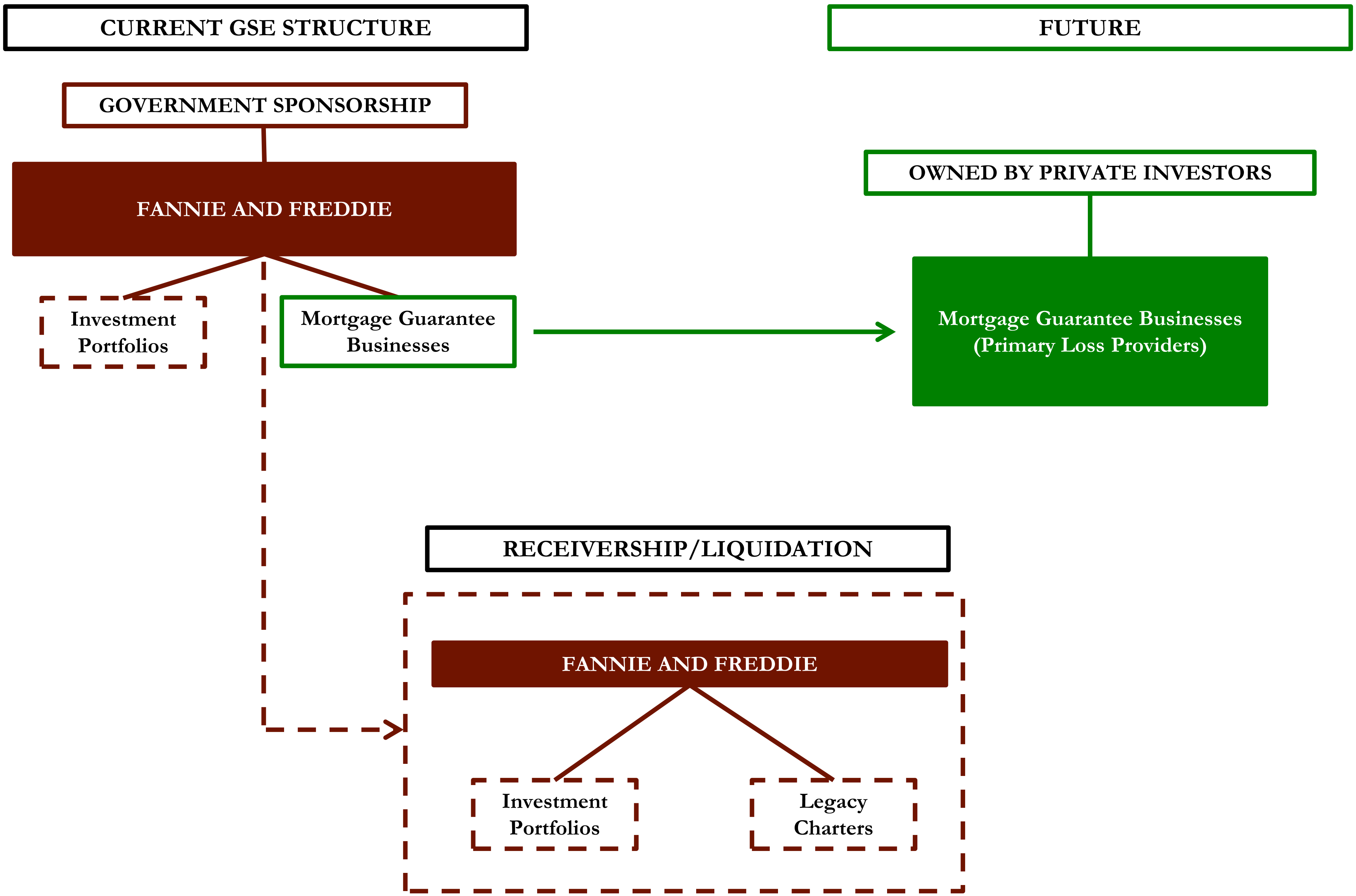
Source: Federal Reserve Board.

Notes: Other includes life insurance companies, finance companies, real estate investment companies, private pension funds, state and local government retirement funds, households and nonprofit institutions, and non-financial corporate and non-corporate businesses.

Where Does Capital Come From? Recapitalization to Privatization

1. **Use Fannie and Freddie earnings under conservatorship to build capital to protect taxpayers on guarantee businesses**
   - Raise the guarantee fees that they charge on MBS, which will have the collateral benefit of attracting private competition
   - Turn off the dividend on Treasury's Senior Preferred Stock
     - The current dividend requires the entities to remit any earnings to Treasury, which (i) leaves no capital in the institutions to absorb future losses, (ii) perpetuates the conservatorships, and (iii) enshrines Treasury's guarantee and effective nationalization of Fannie and Freddie and the secondary mortgage market
2. **Continue wind down of legacy investment portfolios and indebtedness**
3. **Contribute enterprise infrastructure to a new securitization utility for qualified MBS**
4. **Once the guarantee businesses have adequate capital, charter them as state corporations**
   - No special privileges
   - Along with other adequately-capitalized private MBS insurers, they can apply for a license from a new government reinsurer
5. **Recover taxpayers investments**
   - As Treasury did with AIG, Treasury converts its preferred stock to a substantial majority of the restructured companies' common stock and divests its stake over time in the public equity markets
6. **Repeal GSE charters and complete wind down of legacy investment portfolios and indebtedness**

Where Does Capital Come From? Recapitalization to Privatization



Recapitalization to Privatization – Supporting Detail

- **If policymakers implement this plan, Treasury could recoup $150 billion from selling its stake in the reorganized and privatized first-loss providers into the market over time**
  - Assumes privatized mortgage guarantee businesses charge 75 basis points (bps) to guarantee MBS, 10 bps go to the FMIC for reinsurance, and normalized expenses are 6 bps (net 59 bps of guarantee income)
  - Assumes guarantee books decline 10 percent
- **That would be $28 billion more than Treasury's current net investments in the companies**
- **Projected proceeds from the sale of Treasury's stake would be scored as deficit reducing immediately**
- **Fannie and Freddie are already demonstrating significant earnings potential**

HYPOTHETICAL FUTURE LOSS PROVIDER ANALYSIS			
$ in billions	NewCo 1	NewCo 2	Total
Size of Guarantee Book	$2,542	$1,558	$4,100
Net Guarantee Income, % of Book	0.59%	0.59%	0.59%
Guarantee Income	**$15**	**$9**	**$24**
Size of Liquidity Book	$75	$75	$150
Fee Income	**$0**	**$0**	**$1**
Size of Multifamily Book	$225	$160	$385
Investment Income, % of Book	0.60%	0.60%	0.60%
Multifamily Income	**$1**	**$1**	**$2**
Normalized Provision Rate	(0.05%)	(0.05%)	(0.05%)
Normalized Provisions	**($1)**	**($1)**	**($2)**
Taxes - 30% assumed rate	(5)	(3)	(8)
Net Income	**$11**	**$7**	**$18**
Assumed Valuation Multiple	10.0x	10.0x	10.0x
Implied Market Capitalization	**$108**	**$68**	**$176**
Treasury Ownership	85.0%	85.0%	85.0%
Treasury Share	**$92**	**$58**	**$150**
% of Net Investment as of Q1 2013	*114%*	*139%*	*123%*

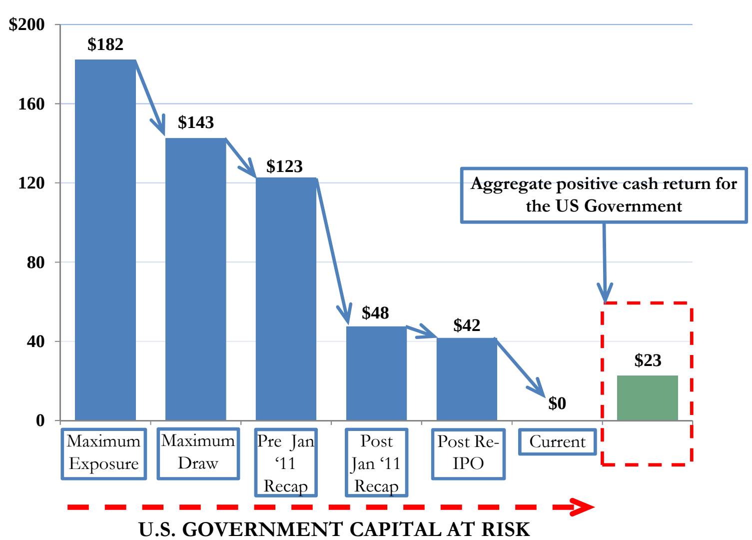
  - FHFA projects more than $60 billion of additional repayments to Treasury from net income through 2015 (exclusive of potential deferred tax asset write-ups and reserve releases)
- **Retained earnings would allow the companies to build substantial private capital ahead of FMIC reinsurance**
  - The restructured businesses could build to Tier 1 Capital levels that comply with Basel III standards imposed on banks
- **Private shareholders provide initial capital base into which Treasury can dispose of its common equity stake over time**
  - UST successfully used this approach to sell its common equity in AIG at a profit for taxpayers

AIG Case Study

At the height of the financial crisis in the Fall of 2008, the Federal Reserve Bank of New York ("FRBNY") and U.S. Department of the Treasury ("UST") provided massive credit and capital support to AIG in order to prevent the destabilization of the global financial system that would have resulted from AIG's collapse

Sep. 2008	Nov. 2008	Mar. 2009	Nov. 2010	Jan. 2011
FRBNY initially provides an $85 billion, high interest rate credit facility to AIG, which requires several restructurings in order to effectively support the company, the financial system and protect committed taxpayer capital	UST invests $40 billion of TARP funds in cumulative preferred stock in the company and the FBRNY established Maiden Lane II and III in order to buy troubled assets from the insurer at discounted prices	Cumulative preferred stock converted to non-cumulative preferred, to maintain necessary credit ratings for the core insurance operations and avoid a potentially disastrous liquidation process	Sale of the two largest non-core assets completed, with the sale of ALICO to MetLife and the IPO of AIA on the Hong Kong Stock Exchange, which raises a combined $36 billion in proceeds	Completion of a comprehensive recapitalization of AIG, including the repayment of all FRBNY obligations and **the conversion of UST preferred stock to 92% of AIG common stock**

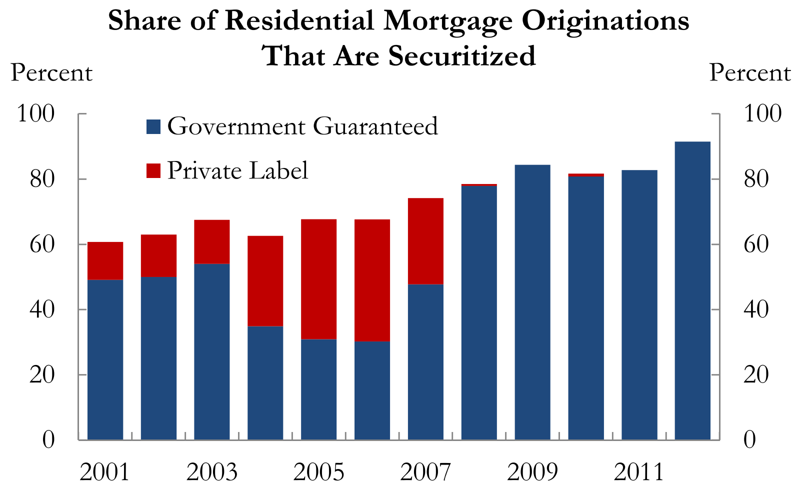
Government Exit Path

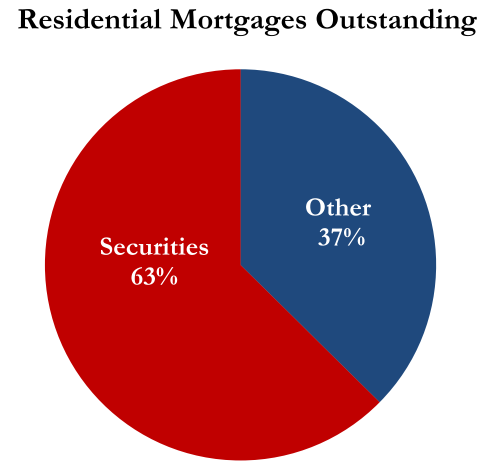


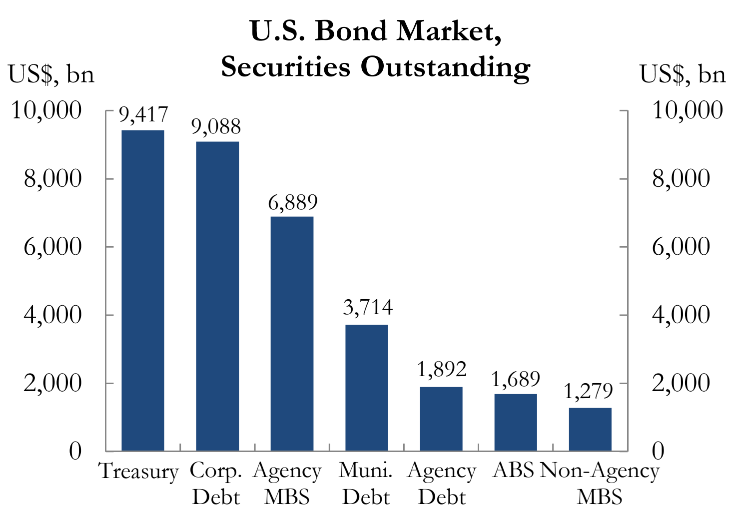
Recovery for Taxpayers Post Recap

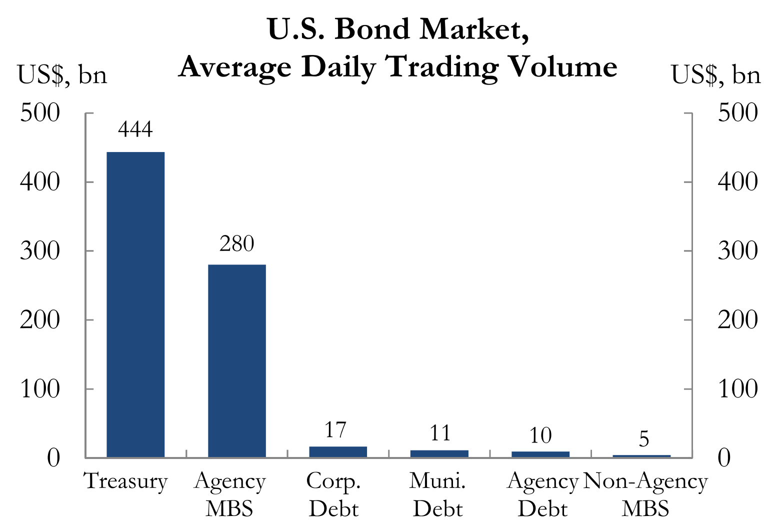
- **UST's $20 billion of preferred equity interests were completely repaid.**
- **UST sold its common ownership stake in AIG in six public offerings that generated $52 billion in proceeds for taxpayers**
- **At the height of the financial crisis, loss estimates on the government's investments in AIG were as much as $36 billion at the Congressional Budget Office (CBO) and $50 billion from the Office of Management and Budget (OMB)**
- **However, UST realized a significant profit on its original invested capital**
- **Including $19 billion of interest and dividends received, the U.S. government as a whole recovered the entire capital outlay, plus nearly $23 billion of cash profit**

The Government Cannot Abandon Housing Finance Without Putting the Depth and Liquidity of Housing Finance Markets At Risk









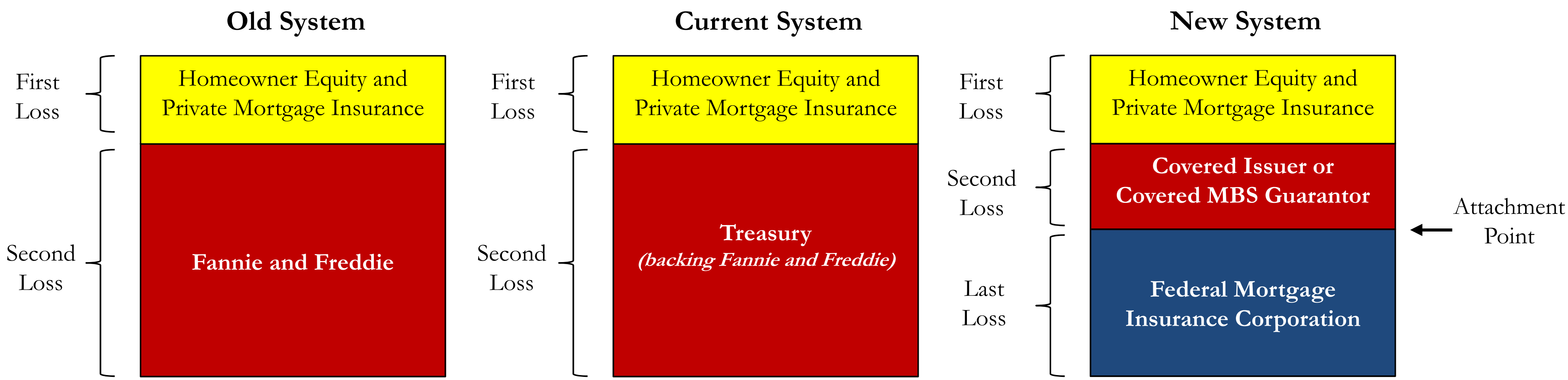
Sources: Inside Mortgage Finance; Securities Industry and Financial Markets Association; Federal Reserve Bank of New York.

Notes: One-to-four family mortgages. Securitized origination estimate for 2012 reflects annualized data. Treasury, agency and corporate debt estimates exclude issues of one year or less. MBS includes both residential MBS and commercial MBS. Outstanding bond estimates based on data through December 31, 2012. Trading volume estimates for 2012.

How is the New Government Guarantee Delivered?

- **A Federal Mortgage Reinsurance Corporation (FMIC) sells reinsurance on qualified mortgage-backed securities**
  - Homeowners and private mortgage insurers remain first in line for losses
  - Properly-capitalized issuers and MBS guarantors are second in line for losses on pools of covered mortgages up to an attachment point set by the FMIC
  - The FMIC is last in line for losses and will make up shortfalls in payments to MBS investors

Loss Sharing



Old System

- Fannie and Freddie guaranteed conforming mortgages
- The government implicitly guaranteed Fannie and Freddie
- The government did not charge for that implicit guarantee and did not have a mechanism to absorb losses if it was triggered
- **There was little private capital protecting taxpayers**

Current System

- Fannie and Freddie continue to guarantee conforming mortgages
- Treasury provides an explicit backstop for Fannie and Freddie
- Dividends from Treasury's investments go to the general fund, leaving taxpayers exposed to future losses at the enterprises
- **There is no private capital protecting taxpayers**

New System

- A private covered issuer or covered MBS guarantor is required to absorb losses up to an attachment point
- The FMIC provides explicit reinsurance on the covered MBS
- The FMIC charges a fee for its reinsurance and, like the FDIC, places proceeds in a strategic reserve fund
- **There is substantial private capital protecting taxpayers**

The Federal Mortgage Insurance Corporation (FMIC)

- **Establish the FMIC within the FHFA with a limited mandate**
  - Ensure stable credit for the housing system and protect taxpayers against loss
- **Three functions to accomplish mandate**
  1. Establish standards for qualifying mortgage products and practices
  2. Sell reinsurance for MBS comprised of mortgages that meet conservative underwriting and disclosure standards
  3. Supervise participating MBS securitizers and new private MBS insurers for safety, soundness, and capital adequacy
- **Independent agency with strong firewalls against political interference**
  - It must be insulated against political interference on the model of the Federal Deposit Insurance Corporation (FDIC), with a budget off limits for any purpose beyond its limited mandate and funded through fees set at arms length
- **Securitizers and private MBS insurers are first in line to cover losses and forced to hold capital adequate for their risks**
  - Capital standards must be consistent for all first-loss providers – no room for regulatory arbitrage
- **The FMIC would charge a fee to guaranty incremental shortfalls**
- **Similar to FDIC Deposit Insurance Fund, fees collected by the FMIC would be placed in a reserve fund that builds over time and only used to absorb losses**
- **The FMIC can decrease its role in the market over time by lowering the attachment point for its reinsurance**
- **Successful precedent**
  - FDIC, Terrorism Risk Insurance Act, Florida Hurricane Catastrophe Fund, Japanese Earthquake Reinsurance Co.

Transition Timeline

- Pass legislation for FMIC and broader housing finance reform
- Convert outstanding Treasury Preferred to new non-cumulative preferred stock to rebuild capital and pave the way to total taxpayer repayment

- Stand up FMIC and begin offering reinsurance on qualified MBS for a fee
- Fannie and Freddie build capital to pay back taxpayers
- Implement broader legislation

- Raise g-fees
- Wind-down portfolios

2013 | 2014-2015 | 2016 | 2017-2020 | 2021+

- Terminate conservatorships
- Convert all preferred stock to common stock at a valuation that provides Treasury full recovery of net cash investment
- In concert with the conversion, conduct an equity rights offering to public investors in order to accelerate Treasury repayment
- Impose go-forward regulatory regime under FMIC

- Divest remaining Treasury common stock position in the public equity markets over time

- FMIC supervises licensed first loss providers

Remove Obstacles to Private-Label MBS Markets

Disclosure

- Loan-level information should be published for mortgages in all securitized pools
- A new Mortgage Electronic Registration System (MERS) should be established
- Deal documents for all MBS should be disclosed
- Servicing would also be improved from additional disclosure, including performance and servicing fees

Enforcement

- The Trust Indenture Act should be amended to apply to MBS or it should be replicated for MBS
- The FMIC should work with industry to establish standard pooling agreements with model representations and warranties as a non-waivable minimum
- The new MERS should address transfer of title defects
- A model non-judicial foreclosure law should be drafted and implemented

Inter-Creditor Rights

- The FMIC should establish a new inter-creditor regime for mortgages
- First lien investors should have rights to approve second liens that would lead to an unsustainable combined LTV
- Second lien holders should not be paid before the first lien holder without consent
- First lien holder should control the restructuring or foreclosure process
- Loan-level losses must be properly allocated in the pools, and junior lien holders should be impaired first

Servicing

- The FMIC should establish and enforce rules to eliminate conflicts of interest in servicing and to improve processes for restructuring mortgages
- Bar second lien holders from servicing first liens, which would also stimulate servicing competition
- Sever servicer relationships that undermine investor rights, increase transaction costs, and hurt borrowers
- Modify servicer compensation
- Establish uniform accounting policies and procedures for loan servicing and restructuring

Note

We may purchase and sell securities, derivatives and other instruments issued by one or more entities which are the subject of this report and may currently or in the future provide advisory, investment banking and other securities related services to such entities and to investors in the securities issued by such entities.

- *Millstein & Co., LLC*