Statement of

Edward J. DeMarco
Acting Director
Federal Housing Finance Agency

Before the House Financial Services
Subcommittee on Oversight and Investigations

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Chairman Neugebauer, Ranking Member Capuano, and members of the Subcommittee,
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, and the Federal Home Loan Banks (FHLBanks).

The main focus of my testimony will be on key topics related to FHFA's role as the Enterprises' conservator and regulator. I will update you on the financial condition of the Enterprises in conservatorship. Then I will review FHFA's approach to preparing for increased private market participation in housing finance and describe significant activities that FHFA has undertaken during the past year to further our conservatorship goals. Finally, I will report on the condition of the Federal Home Loan Banks (FHLBanks).

INTRODUCTION

I think 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 legal responsibilities FHFA operates under as conservator.

The determination to place Fannie Mae and Freddie Mac, or the Enterprises as I will refer to them, in conservatorship 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 Treasury Department, placed the Enterprises into conservatorship on September 6, 2008.

Conservatorship, along with financial support from Treasury, permitted the government to take greater management control of the Enterprises 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. The alternative, receivership, was rejected at the time, in part because such action would have placed greater limits on the timing and approach for the Congress and the incoming Administration to analyze and respond to the problems confronted by the Enterprises and the country's housing finance system. At the time, Treasury Secretary Paulson referred to conservatorship as a "time-out" to allow markets to continue to function while policymakers considered and acted on a permanent resolution. More than three years later, we are still waiting for that resolution.

As conservator, FHFA stands in the place of each company's shareholders, boards, and management, with the responsibility to "preserve and conserve the assets and property" of the companies. The statute also charges the conservator with the responsibility to place the companies in "a sound and solvent condition." At the time the conservatorships were established, FHFA was less than six weeks old as an agency, and had fewer than 400 employees. To accomplish these responsibilities, FHFA made the practical judgment that the most effective means to carry out these functions was to replace the boards and senior management, and then delegate to new boards and management day-to-day responsibility.   Since then, reconstituted boards of directors have worked with FHFA to define the operational goals in conservatorship and to support FHFA in its work to guide and oversee management in fulfilling these goals. Likewise, the new CEOs and executive officers have worked with FHFA to these same ends.

As conservator and regulator, FHFA has three principal mandates set forth in law that direct and motivate FHFA's activities and decisions involving the Enterprises.

First, as I have noted, FHFA has a statutory responsibility as conservator of the Enterprises to "take such action as may be: necessary to put the regulated entity in a sound and solvent condition; and appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity." As FHFA has stated on numerous occasions, with taxpayers providing the capital supporting the Enterprises' operations, this "preserve and conserve" mandate directs us to minimize losses on behalf of taxpayers.

Second, even though the Enterprises are in conservatorship, without further statutory changes they have the same mission and obligations as they did prior to being placed into conservatorship. FHFA has a statutory responsibility to ensure the Enterprises "operate in a safe and sound manner" and that "the operations and activities of each regulated entity foster liquid, efficient, competitive, and resilient national housing finance markets." We typically refer to this requirement as "supporting a stable and liquid mortgage market."

Third, under the Emergency Economic Stabilization Act of 2008, FHFA has a statutory responsibility to "implement a plan that seeks to maximize assistance for homeowners and use its authority to encourage the servicers of the underlying mortgages, and considering net present value to the taxpayer to take advantage of … available programs to minimize foreclosures."

These three mandates form the basis for how FHFA views its responsibilities as conservator of the Enterprises. In view of the critical and substantial resource requirements of conserving assets and restoring financial health, combined with a recognition that the Enterprises operate today only with the support of taxpayers, FHFA has focused the Enterprises on their existing core business, including minimizing credit losses. This means that FHFA is not permitting the Enterprises to offer new products or enter new lines of business. Their operations are focused on their core business activities and loss mitigation. 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.

As a final introductory comment, the Enterprises' equity holders retain an economic claim on the companies but that claim is subordinate to taxpayer claims. As a practical matter, taxpayers are not likely to be repaid in full, so Enterprise stock lower in priority is not likely to have any value. Prior to conservatorship, much executive compensation, and indeed some staff compensation, was in the form of company stock, so the value of such compensation has essentially vanished. Finally, the company leaders most responsible for the business decisions that led to the Enterprises ending up in conservatorship had either left the company before conservatorship, at the time of the conservatorship, or shortly thereafter. The boards of directors were also replaced.

Thus, the leadership working at the Enterprises today is not the same as those chiefly responsible for the business decisions that led to conservatorship and that continue to drive the financial results. Moreover, they are there to further the goals of conservatorship and ensure the country has a functioning secondary mortgage market while lawmakers deliberate the future structure for housing finance. The boards, executives, and staff have been and are working with FHFA in its efforts to minimize taxpayer losses, provide stability and liquidity to the market, and maximize assistance to homeowners to avoid foreclosure. They do so knowing that the long-term outlook is that neither Enterprise will continue to exist, at least in its current form, in the future.

THIRD QUARTER 2011 FINANCIAL PERFORMANCE AND CONDITION OF THE ENTERPRISES

Providing Liquidity to the Market

Since conservatorship, Fannie Mae and Freddie Mac have been the largest issuers of mortgage-related securities in the secondary market, guaranteeing roughly three-quarters of single-family mortgage-backed securities (MBS) issued.

Capital

Combined Treasury support as a result of financial performance in the third quarter of 2011 was $13.8 billion. The Single-Family Credit Guarantee segment continued to drive losses as credit-related expenses remained high. Additionally, the Investments segment results turned negative in the third quarter of 2011, due primarily to a significant decrease in interest rates and a widening of credit spreads on non-agency securities. This was partially offset by a two percent increase in net interest income. In addition, $4.1 billion of the $13.8 billion draw is to pay interest to the Treasury on previous draws.

Credit Quality of New Single-Family Book of Business

The quality of new business remained high in the third quarter of 2011. The percentage of new business volume with FICO scores below 620 remained below two percent and the average loan-to-value ratio (LTV) for new business was roughly 70 percent for both Enterprises, reflecting in part the high degree of refinance activity.

Loss Mitigation Activity

Since conservatorship, the Enterprises have completed two million foreclosure prevention transactions, of which one million have been permanent loan modifications and another 960,000 have been other forms of assistance that have allowed homeowners to retain homeownership. Significantly, loans modified since late 2009 continue to perform substantially better than loans modified before then. Separately, another 270,000 transactions have resulted in households leaving their homes but without going through foreclosure. Most of these actions have been short sales.

Projections of Financial Performance

To provide additional information on future Enterprise financial performance, beginning in October 2010, FHFA published financial projections of the Enterprises' financial performance across different house price scenarios. Those initial projections were updated a few weeks ago, and the projected combined cumulative Treasury draws (which includes 10 percent dividend payments to Treasury) through the end of 2014 range between $220 and $311 billion. In general, these financial projections show that under less stressful house price scenarios, the cumulative draws from Treasury would stabilize in the next year or so, with the Enterprises earning enough income to cover dividend payments to Treasury.

FHFA INITIATIVES

Recent Congressional efforts to begin serious discussion of a gradual transition to greater private capital participation in housing finance and greater distribution of risk to participants other than the government are important. FHFA has already begun taking actions in support of these objectives. Since conservatorship, underwriting standards have been strengthened and several price increases have been initiated to better align pricing with risk, and we will continue to gradually increase guarantee fee pricing to better reflect that which would be anticipated in a private, competitive market. Also, we will soon be exploring more private sector risk-sharing opportunities. Such steps are consistent with actions already taken in conservatorship and we are examining further options along these lines in support of a stable transition over time.

While debate over the future of the housing finance system progresses, FHFA has and will continue to focus on meeting the goals of the conservatorships through a series of initiatives aimed at retaining value in the business operations of Fannie Mae and Freddie Mac, maintaining their support for the housing market, and mitigating losses to taxpayers.

Recovering Certain Losses

Consistent with FHFA's mission to preserve and conserve the Enterprises' assets on behalf of taxpayers, this year we filed lawsuits against 18 financial institutions to recover certain losses suffered by Freddie Mac and Fannie Mae that we believe are the legal responsibility of others. We believe that the loans in these private-label mortgage backed securities (PLMBS) had different and more risky characteristics than the descriptions contained in the marketing and sales materials provided to the Enterprises for those securities.

Real Estate-Owned Request for Information
In August, FHFA, in conjunction with the Department of Housing and Urban Development (HUD) and the Treasury Department, issued a Request for Information (RFI) seeking input on new options for selling single-family real estate owned (REO) held by Freddie Mac, Fannie Mae, and FHA. We are looking for approaches to reduce the REO portfolios of the Enterprises in a cost-effective manner, as well as to reduce the losses on individual distressed properties. We are seeking alternatives that will maximize value to taxpayers and increase private investments in the housing market, including approaches that support rental and affordable housing needs. We are not trying to develop a single, national program for REO disposition. We are most interested in proposals tailored to the needs and economic conditions of local communities. Based on the input of RFI responders we understand the magnitude of the task at hand. FHFA is proceeding prudently, but with a sense of urgency, to lay the groundwork for the development of good initial pilot transactions.

Uniform Mortgage Data Program
In May 2010, FHFA directed the Enterprises to develop uniform standards for data reporting on mortgage loans and appraisals. This Uniform Mortgage Data Program is designed to improve the consistency, quality, and uniformity of data that are collected at the front end of the mortgage process. By identifying potential defects at the front end of the mortgage process, the Enterprises will improve the quality of mortgage purchases, which should reduce repurchase risk for originators. This initiative will be phased in over the rest of this year and next.

Loan Level Disclosures
Earlier this year, I announced that FHFA is considering ways to enhance loan-level disclosures on Enterprise MBS, both at the time of origination and throughout a security's life. I believe that improving Enterprise MBS disclosures over time will help establish consistency and quality of such data. Moreover, it will contribute to an environment in which private capital has the information needed to efficiently measure and price mortgage credit risk, thereby facilitating the shifting of this risk away from the government and back into the private sector.

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

Foreclosure Attorney Networks

In October, as an adjunct to SAI, FHFA directed Freddie Mac and Fannie Mae to change the way foreclosure attorneys are selected in an effort to produce uniform foreclosure processing standards to assist servicers, homeowners, and lenders. Under current practice, in certain states each Enterprise designates law firms eligible under the Enterprise's criteria to undertake foreclosure work and mortgage servicers then select and work with these firms. FHFA instructed Fannie Mae and Freddie Mac to transition away from current foreclosure attorney network programs and move to a system where mortgage servicers select qualified law firms that meet certain minimum, uniform criteria. These efforts will lead to greater transparency and benefit delinquent borrowers who become subject to the foreclosure process. FHFA is now working with other regulators and industry stakeholders to create uniform qualifications and oversight of foreclosure attorneys.

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

Servicing Compensation Initiative

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

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

Home Affordable Refinance Program

On October 24, 2011, we announced a series of changes to the Home Affordable Refinance Program (HARP). These changes should make HARP refinances accessible to more households with mortgages owned or guaranteed by the Enterprises. Changes to the program include: eliminating or reducing certain risk-based fees; removing the current 125 percent LTV ceiling; waiving certain representations and warranties; eliminating the need for certain property appraisals; improving the process for carrying over mortgage insurance coverage; and extending the end date for HARP to December 31, 2013.

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

It is impossible to project accurately how many homeowners will benefit from the enhancements to HARP because of unknowable factors, such as future interest rate fluctuations and the desire of borrowers to enter into a refinance transaction. Since HARP was introduced in 2009, more than 900,000 homeowners have refinanced through the HARP program. We believe the announced changes may double the number of homeowners helped through HARP.
Since industry participation in HARP is not mandatory, implementation schedules will vary as individual lenders, mortgage insurers and other market participants modify their processes.

Separately, the Enterprises have refinanced approximately nine million mortgages since 2009.

EXECUTIVE COMPENSATION

Now I will turn my attention briefly to the subject of executive compensation for Fannie Mae and Freddie Mac executives, a topic that has attracted much attention recently from the Congress, the press and the public. The House Financial Services Committee has already passed legislation that would put Enterprise executives' salaries in line with those at the Federal Financial Regulatory Agencies and put Enterprise employees on the Federal government's GS-pay scale. I testified before the Committee last year as to why I do not think that would be a good idea.

At the outset, let me state that the best way to address concerns with executive compensation is action by Congress to restructure the nation's housing finance system and dissolve the conservatorships. In the absence of that resolution, FHFA will continue to evaluate the appropriateness of executive compensation at the Enterprises given their ongoing activities.

As conservator, I need to ensure that the companies have people with the skills needed to manage the credit and interest rate risks of $5 trillion worth of mortgage assets and $1 trillion of annual new business that the American taxpayer is supporting. I have concluded that it would be irresponsible of me to risk this enormous contingent taxpayer liability with a rapid turnover of management and staff, replaced with people lacking the institutional, technical, operational, and risk management knowledge requisite to the running of corporations with thousands of employees and more than $2 trillion in financial obligations each. That conclusion is further buttressed by the realization that, from an Enterprise executive's or staff's point of view, continued employment at an Enterprise risks substantial job and career uncertainty. The public scrutiny and criticism is often harsh, and almost everyone expects the Enterprises to cease to exist, at least in their current form, in the future. At the same time, the taxpayer is backing Enterprise financial commitments that have 30-year lives, and we will need expert management of those guarantees for years to come. Given the amount of money at risk here, small mistakes can easily be amplified to losses far greater than the compensation paid to Enterprise executives.

In short, as Congress considers executive compensation at the Enterprises, the basic fact is that despite the large amounts of government support provided to the Enterprises they remain private companies with uncertain futures, not government agencies. They employ thousands of people. We cannot maintain operational effectiveness while suddenly treating them as ongoing government agencies – something they are not. Major changes to compensation, for executives or staff, cannot be done safely and soundly in a short period of time and attempting to do so would pose substantial risk to the mortgage market and a greater risk of loss to taxpayers.

FEDERAL HOME LOAN BANK SUPERVISION

While much attention remains focused on the Enterprises, we continue to fulfill FHFA's statutory mandate to oversee the FHLBanks.

Third Quarter 2011 Performance and Condition of the FHLBanks

Total assets of the FHLBanks declined by $31 billion in the third quarter of 2011 and by $100 billion during the first three quarters of the year. From a peak in 2008 of $1.4 trillion, combined assets have nearly halved to $778 billion at September 30, 2011. Advances (collateralized loans to members) are driving the decline, as balances have fallen from a 2008 high of $1.0 trillion to just $415 billion, or about the level of advances last seen in the first quarter of 2000. More recently, advances declined $13 billion in the third quarter of 2011, and $63 billion year-to-date through September. The decline, in part, reflects high levels of liquidity at member banks with a consequent decline in the demand for advances. As of September 30, 2011, advances comprised 53 percent of assets, non-MBS investments were 19 percent, agency and federal MBS were 15 percent, mortgage loans were seven percent, and PLMBS were four percent. Though PLMBS assets are relatively small, their distribution among FHLBanks is uneven, leading to pockets of concentration at some FHLBanks.

The FHLBanks principally fund themselves by issuing consolidated obligations in the capital markets. Market access remains excellent, and spreads to comparable Treasury securities are narrow. Total regulatory capital at September 30, 2011, was $55.4 billion or 6.5 percent of assets.

Net income is declining at the FHLBanks as fewer earning assets generate less net interest income, and as lower interest rates reduce the return on the FHLBanks' invested capital. Offsetting these factors is a decline in credit-related other-than-temporary impairment (OTTI) on PLMBS, though this remains a potentially volatile item, with the possibility to increase should collateral performance or the broader housing market deteriorate further. On a year-to-date basis through September 30, 2011, all FHLBanks were profitable, though some did have quarterly net losses. Combined net income was $475 million for the third quarter of 2011 and $1.1 billion year-to-date. This is down from comparable periods in 2010, when net income was $680 million in the third quarter and $1.3 billion year-to-date through September 2010. A significant factor in the lower quarterly net income was mark-to-market losses on derivatives. These derivatives are part of a prudent risk-management strategy, and the losses should reverse as the derivatives approach maturity. Credit OTTI charges were lower in 2011 relative to 2010—credit OTTI totaled $775 million in the first three quarters of 2011, down from $905 million for the same period in 2011. To date, the FHLBanks have reported a total of $4.4 billion in credit-OTTI charges on PLMBS, which amounts to about five percent of the peak balance of this asset category. PLMBS remain a supervisory concern.

Resolution Funding Corporation

In 2011, the FHLBanks satisfied their collective obligation to make payments related to the Resolution Funding Corporation, a funding mechanism used during the savings and loan crisis. Related to this accomplishment, the FHLBanks collectively entered into a Joint Capital Enhancement Agreement, which requires each FHLBank to allocate 20 percent of its net income to a restricted retained earnings account, from which it cannot pay dividends and which serves to enhance the joint-and-several liability features inherent in FHLBank consolidated obligations.

Federal Home Loan Bank of Chicago

On September 31, 2011, FHFA approved the capital plan of the FHLBank of Chicago, a requirement of the 2007 Consent Order with that FHLBank. Implementation is expected on January 1, 2012. Until then, the FHLBank of Chicago remains the only FHLBank still operating under a pre-Gramm Leach Bliley Act capital structure.

Federal Home Loan Bank of Seattle

The FHLBank of Seattle faces a declining advance franchise, a problematic PLMBS portfolio, and insufficient retained earnings. Although the FHLBank has capital equal to 6.8 percent of assets, FHFA has exercised its discretion to classify the FHLBank as "undercapitalized." The FHLBank of Seattle has operated under a Consent Order to resolve outstanding capital and supervisory matters since October 2010.

Voluntary Mergers

Earlier this week, FHFA published in the *Federal Register* a final rule outlining the regulatory process for FHLBanks to undertake voluntary mergers. This rule fulfills a mandate in the Housing and Economic Recovery Act of 2008 to "promulgate regulations establishing the condition and procedures for the consideration and approval of any voluntary merger" authorized by the Act.

Mr. Chairman, thank you again for this opportunity. I look forward to responding to the Subcommittee's questions.