Statement of

James B. Lockhart III, Director

Federal Housing Finance Agency

Before the House Financial Services Committee

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

"The Present Condition and Future Status of Fannie Mae and Freddie Mac"

June 3, 2009

Statement of James B. Lockhart III
Director, Federal Housing Finance Agency
Before the Financial Services Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises
June 3, 2009

Chairman Kanjorski, Ranking Member Garrett, and the Members of the House Financial Services Committee, thank you for inviting me to speak to you today. In my testimony today I'd like to first provide a summary of the current status of the housing government-sponsored enterprises (GSEs) as reported in the Federal Housing Finance Agency's (FHFA's) first *Annual Report to Congress*. Then, I will provide my perspective on the future of those entities and federal involvement in the housing finance system. With $11.9 trillion in outstanding mortgage debt, housing finance is extremely important to the U.S economy, as we have seen in the present crisis.

As the conservator, FHFA's most important goal is to preserve the assets of Fannie Mae and Freddie Mac over the conservatorship period. That is our statutory responsibility. As the regulator, FHFA's mission is to ensure the Enterprises provide liquidity, stability, and affordability to the mortgage market in a safe and sound manner. That also is our statutory responsibility and is the public purpose Congress gave to the Enterprises.

The Enterprises own or guarantee 56% of the single family mortgages in this country or $5.4 trillion. Obviously, given that massive exposure, the best way to preserve their assets and fulfill their mission is to stabilize the mortgage market and strengthen their safety and soundness to serve the mortgage market better. Working with the Federal Reserve, the Bush and Obama Administrations, and other regulators, that has been our top priority since the conservatorship began in September and will continue to be so. Mortgage modifications and refinancing homeowners into safer mortgages are an important element of stabilization of the housing market and U.S. economy. The form in which Fannie Mae and Freddie Mac exit from the conservatorships once the housing market is stabilized should be addressed by Congress and the Administration. This hearing is a first step in the process, and I thank you for having it.

Part I—Current Situation of the Housing GSEs and FHFA

The Current Condition of Fannie Mae and Freddie Mac

As you are well aware, FHFA continues to classify Fannie Mae and Freddie Mac (the Enterprises) as "critical supervisory concerns." After many years of debate, substantial deterioration in housing and financial markets and in the outlook and financial status of the Enterprises in the second half of 2007 and in 2008 helped lead to the enactment of the Housing and Economic Recovery Act of 2008 (HERA) last July. The enhanced regulatory authorities provided by that legislation came too late to allow FHFA to prevent excessive leveraging and to address serious safety and soundness issues at Fannie Mae and Freddie Mac. As there were significant risks that the Enterprises would be unable to fulfill their missions, FHFA placed each Enterprise into conservatorship last September.

Critically, the Treasury Department exercised the authorities Congress had provided in HERA to support the housing GSEs. In conjunction with the conservatorships of Fannie Mae and Freddie Mac, the Treasury Department established three facilities to support the ongoing business operations of the Enterprises and to provide confidence to investors in the housing GSEs' debt and guaranteed mortgage-backed securities (MBS). Those facilities include the Senior Preferred Stock Purchase Agreements with Fannie Mae and Freddie Mac, the GSE MBS Purchase Program, and the GSE Credit Facility. In November, the Federal Reserve committed to supporting the housing GSEs and the mortgage market through purchases of their direct obligations and MBS, as well as MBS guaranteed by Ginnie Mae, as part of its open market operations. In total as of May 29, 2009, the Federal Reserve has purchased over $507 billion in MBS and $81 billion in direct obligations. The Treasury Department has purchased $167 billion through its GSE MBS Purchase Program. In addition, under the senior preferred stock purchase agreements with each Enterprise, the Treasury Department will have provided Freddie Mac $50.7 billion and Fannie Mae with $34.2 billion when the first quarter 2009 losses are funded **(Slide 1, see attached)**.

As reflected in the Enterprises' first quarter financial results reported in May, credit-related expenses continue to increase. First quarter net losses were $23.2 billion at Fannie Mae and $9.9 billion at Freddie Mac. The provision for credit losses—to build loan loss reserves—remains a primary driver of net losses at both Enterprises. Loan loss reserves at both Enterprises increased substantially in the first quarter to reflect higher expectations of credit losses from increasing mortgage delinquencies. Loan loss reserves increased by 70 percent at Fannie Mae to $42 billion and by 50 percent at Freddie Mac to $23 billion.

Also driving first quarter losses were other-than-temporary-impairments (OTTI) of private-label mortgage-backed securities (PLS). Those impairments accounted for $6 billion of Fannie Mae losses and $7 billion of Freddie Mac's. Losses on loans purchased out of trusts for loan modifications had a notably smaller effect on earnings, accounting for approximately $2 billion of each Enterprise's losses.

The short term outlook for the Enterprises' financial results is poor. Credit-related expenses and mark-to-market losses are influenced by market conditions that are expected to remain difficult during 2009. Continued poor financial performance will result in additional requests for preferred stock investment from the Treasury Department in 2009. However, both Enterprises have stress tested their capital shortfalls and expect the Treasury Department's commitment to fund up to $200 billion in capital for each Enterprise to be sufficient.

The combined financial support of the Treasury Department and the Federal Reserve have ensured that the markets for housing GSE debt and MBS remain liquid and that the Enterprises have both significant liquidity and access to capital. In particular, the Senior Preferred Stock Purchase Agreements have given investors confidence that there is an effective guarantee of GSE obligations, as any negative equity balance at either Enterprise will be offset by the Treasury Department's investment. This support will

continue indefinitely into the future subject to the commitment limit of $200 billion per Enterprise.

Because of this support, both Enterprises have been able to maintain an ongoing, significant presence in the secondary mortgage market. Their combined share of mortgages originated in the first quarter of 2009 was 73 percent, unchanged from 2008 and up from 54 percent in 2007 and 37 percent in 2006 **(Slide 2)**.

While the Enterprises have continued to support the secondary mortgage market, new senior management teams have worked with FHFA to establish and implement comprehensive remediation programs to address the financial and operational deficiencies identified by FHFA's regulatory examinations and by internal and external audit activities. The Enterprises have made progress, but they face numerous, significant challenges to their operations, including:

- remediating the operational, financial, and risk management weaknesses that led to conservatorship;
- building and retaining staff and infrastructure;
- modeling credit risk in this uncertain environment;
- mitigating credit losses, including through loan modifications;
- pricing mortgage products given market uncertainties, modeling difficulties, and the uncertainties of operating in conservatorship;
- buying / guaranteeing mortgages with loan-to-value (LTV) ratios greater than 80 percent due to declining house prices when there are constraints on the availability of private mortgage insurance; and
- providing for mission and public policy objectives of housing market stability, mortgage availability, and mortgage affordability.

In the current mortgage crisis, the Enterprises have focused on mortgage availability, mortgage affordability, and foreclosure mitigation. In November, they announced a streamlined mortgage modification program. Loan modifications undertaken for their own books of business are critical for limiting their own credit losses and stabilizing the mortgage market. First quarter results on significant foreclosure prevention activity related to the 30.4 million Enterprise residential mortgages outstanding show that completed foreclosure prevention actions increased by 38 percent from the third quarter of 2008, the last quarter prior to putting the Enterprises into conservatorship. Repayment plans grew 15 percent. Loan modifications increased by 176 percent from the third quarter of 2008 and accounted for 48 percent of all foreclosure prevention actions in the first quarter of 2009. Seventy-one percent of loan modifications completed in the first quarter involved both interest rate reductions and term extensions. Completed alternatives to foreclosure—short sales and deeds in lieu—accounted for 10 percent of all completed foreclosure prevention actions. Those activities brought year-to-date home retention actions to a total of nearly 77,213 and foreclosure alternative actions to just nearly 9,000.

The Enterprises temporarily suspended all foreclosure sales on owner-occupied properties during the period from November 26, 2008 through January 31, 2009 and during the last two weeks of February and the first week of March. The suspension led to a substantial reduction in completed foreclosure sales in December 2008 and January

2009. However, when the moratorium on foreclosures was lifted during the first half of February, completed foreclosure sales surged to 28,897 for that month from 3,222 in January. The moratorium ended on March 6, 2009. Total foreclosure sales for the first quarter amounted to 41,264, down 13 percent from 47,497 in the third quarter of 2008.

The credit performance of all types of single-family mortgages owned or guaranteed by the Enterprises has continued to deteriorate, as approximately 41,000 more loans became delinquent 60 days or more in February, bringing the total of such mortgages to 1.1 million. One in 10 nonprime Enterprise-owned or -guaranteed loans was delinquent 60 days or more at the end of February, compared with two in 100 prime loans. Non-prime loans (those to borrowers with credit scores below 660) were 16 percent of the total 30.2 million Enterprise-owned or -guaranteed loans.

As of March 31, 2009, seriously delinquent loans accounted for 2.3 percent of single-family mortgages owned or guaranteed for Freddie Mac and 3.2 percent for Fannie Mae. While those are historically high levels, they compare favorably to industry averages of 4.7 percent for all prime loans, 7.2 percent for all single-family mortgages, 24.9 percent for all subprime mortgages, and 36.5 percent for subprime adjustable rate mortgages **(Slide 3)**.

The Enterprises and FHFA worked closely with the White House, the Treasury Department, and HUD to develop the Administration's Making Home Affordable program. Fannie Mae is working with mortgage servicers to implement the Home Affordable Modifications program, which is designed to help prevent foreclosures for homeowners willing and able to make affordable mortgage payments. Freddie Mac's role is to oversee the servicer compliance with program terms and conditions. The modification program is especially challenging as a key target is the loans backing PLS. Those loans represent only 15 percent of mortgages but 50 percent of serious delinquencies (loans 90 days or more past due). In contrast at yearend 2008, the loans the Enterprises held or guaranteed represented 56 percent of the U.S. single family mortgages outstanding, but only 20 percent of serious delinquencies.

The reported activity above does not yet reflect the Making Home Affordable modification plan (MHA). Servicers and the Enterprises have been working hard to increase efforts. In addition, the MHA plan offers the promise of greater impact because the government is offering incentives to offset the servicer costs, has created much more flexibility to lower payments to an affordable level (interest rates may be lowered to 2%), and is willing to compensate investors for a portion of the loss realized with modifications. The impact of MHA on the data will be delayed for two reasons. First, servicers have been required to register as an MHA participant, contractually agree to program terms and conditions, and operationally implement the MHA programs. Second, borrowers are required to submit the required documentation, be approved for a modification, and successfully perform under a three-month trial modification plan before their loans can be formally modified. Therefore, FHFA expects to see the results of current activities ramp up in late summer.

Both Enterprises also have undertaken the Home Affordable Refinance initiative to enable homeowners who are current on their Enterprise-owned or -guaranteed mortgages to refinance at a lower rate. Under that initiative, mortgages with current LTV ratios of up to 105 percent are eligible for refinancing, since the Enterprises already hold the credit risk and lower payments will reduce that risk. This program should assist millions of homeowners who otherwise would have difficulty refinancing due to declining house prices and lack of private mortgage insurance.

Both the Making Home Affordable and the Home Affordable Refinance programs have been launched and will be an important part of the Enterprises' business—and mission—activities this year. The goals of Enterprise participation in the Making Home Affordable programs are to stabilize housing markets while improving the credit position of their books of business. Given the Enterprises' substantial market position—they own or guarantee $5.4 trillion in mortgages—activities that promote responsible homeownership, reduce preventable foreclosures, and stabilize house prices should help reduce their future credit losses.

Those changes in the mission activities of the Enterprises come in the wake of their inability to meet most of the affordable housing goals and home purchase subgoals for 2008 established by the Department of Housing and Urban Development (HUD). In addition, FHFA suspended Enterprise contributions to the Housing Trust Fund in light of Enterprise losses and their draws on the Treasury Department's Senior Preferred Stock Purchase facility.

Fannie Mae failed to meet all but one of its 2008 affordable housing goals and home purchase subgoals. Freddie Mac missed all of the 2008 goals and home purchase subgoals. Both Enterprises met their multifamily subgoals. As permitted by Congress, FHFA is reconsidering the appropriateness of the goal levels for 2009 based on the current state of the mortgage market. Going forward, affordable housing goals should be in line with and responsive to actual market conditions and should promote sustainable mortgage options for low- and moderate-income families and neighborhoods. There is evidence that Enterprise efforts to meet previous housing goals, especially through the purchase of PLS, purchases of Alternative-A (Alt-A) mortgages, and overall loosening of underwriting guidelines, contributed to the unsustainable buildup of credit risk that led to the conservatorships.

The Current Condition of the Federal Home Loan Banks

When financial markets seized up in 2007 and 2008, the Federal Home Loan Banks (FHLBanks) played a critical role in providing liquidity to their members. FHLB advances, which are loans secured by eligible collateral, grew to more than $1 trillion by September 30, 2008, the height of financial market distress. Since then, advances have declined by roughly 25 percent to $759 billion as of May 15.

Despite stress in financial markets and among member financial institutions, investments in the FHLBank System have remained sound as a result of its capital structure and requirements and the FHLBanks' joint and several liability for their consolidated

obligations. The capital structures of the FHLBanks ensures that each member's capital investment in each FHLBank of which it is a member generally increases with its advances outstanding at that FHLBank. In addition, even though several FHLBank members, including some large ones, were either troubled or actually failed in 2008, the advance business suffered no credit losses.

That said, FHFA has safety and soundness concerns about certain FHLBanks. Those concerns are largely centered on actual and potential losses associated with PLS. As of the end of the first quarter of 2009, PLS losses recognized by the System amounted to $6.6 billion at the eight FHLBanks that held such investments and had filed their first quarter financial statements by May 29, 2009.[1] Of that amount, only $618 million has flowed through the income statement or accounting transition adjustments to retained earnings as other-than-temporary impairments (OTTI), due to the fact that the FHLBanks are early adopters of the Financial Accounting Standards Board's (FASB's) new accounting rules. The remaining $6 billion has been booked as Accumulated Other Comprehensive Income, which is part of GAAP Shareholders' Equity but not of regulatory capital. That amount exceeds the total retained earnings of the FHLBanks.

The credit quality of the FHLBanks' investments in PLS has proven to be much worse than the initial triple-A credit ratings of those securities would have suggested. By the end of 2008, six FHLBanks had voluntarily or by regulatory requirement ceased paying dividends and repurchasing member stock in order to conserve capital. With ongoing uncertainty surrounding the true economic value of PLS, those investments will continue to raise safety and soundness concerns.

HERA Implementation and Conservatorship

HERA Implementation

We believe we have accomplished a lot in the short time since FHFA was created in July 2008 by the enactment of the Housing and Economic Recovery Act (HERA)**:**

- We are working effectively with the Enterprises as their conservator, even as we continue to oversee them as their regulator.
- We have worked to establish an infrastructure for FHFA, including systems, procedures, and policies that serve as the foundation for accomplishing the mission of the agency. We are combining the personnel and financial systems of three separate organizations and this presents challenges that we are meeting.
- FHFA appointed new boards of directors for the Enterprises and implemented the HERA-required changes for the FHLBanks' boards of directors.
- We have been working with the 12 FHLBanks regarding valuing their PLS and their early adoption of the Financial Accounting Standards Board's new OTTI standard.
- We have smoothly transitioned to a new Administration and a new Federal Housing Finance Oversight Board, which I chair. The other members are the Secretaries of

[1] As of that date, the FHLBanks of Pittsburgh and Topeka were still computing other-than-temporary impairments.

Treasury and HUD, and the Chairman of the Securities and Exchange Commission (SEC).

- We are working with the Obama Administration, the Enterprises, other regulators, and the private sector in developing and implementing the new housing program, the Homeowner Affordability and Stability Program, to address this challenging housing market. Our work there has been particularly focused on foreclosure prevention and keeping people in their homes whenever possible.
- FHFA has a seat at the critical tables—the Financial Stability Oversight Board, which oversees the Troubled Asset Relief Program (TARP) and the President's Working Group on Financial Markets, which is responsible for responding to the crisis in financial markets. We have also consulted with the Chairman of the Federal Reserve as required by HERA. However, FHFA is not a liaison member of the Federal Financial Institutions Examination Council (FFIEC), which I believe would be very helpful in coordinating supervision of the mortgage segment of financial markets.
- The HUD team that oversaw the Enterprises' mission has joined us, and we have been developing new housing goals for Fannie Mae and Freddie Mac and, similarly, an affordable housing program rule for the FHLBanks, both of which are critical parts of our agency's mission.
- In accordance with Section ll0 of the Emergency Economic Stabilization Act of 2008 (EESA), FHFA has produced the *Federal Property Management Report* for Congress.
- We are finalizing our first strategic plan.
- We are developing and issuing the many regulations, guidances, and reports required by HERA to ensure a stable and effective secondary mortgage market. One of these requirements is an annual *Report to Congress*, which we recently completed. FHFA has a number of regulations to promulgate. I am pleased to report that all rules required under HERA with a fixed date have been published on time and those remaining are on track to be published in line with the statute.

Conservatorship Operations

As conservator, FHFA is responsible for the overall management of the institutions and has delegated certain operational and other duties to the Enterprises' directors and officers as deemed appropriate. The Enterprises consult with and obtain approval of the Conservator before taking action on transactions involving capital; creation of any subsidiaries or affiliates; certain hiring, termination, and compensation decisions related to executive vice presidents and above; retention and termination of external auditors; and certain other actions that either involve transactions greater than $50 million, relate specifically to the conservatorship, or are likely to cause significant reputation risk.

Both Enterprises continue to carry on their daily business activities under the conservator's oversight, and all existing contracts of the Enterprises remain in effect, with the exception of lobbying contracts, which the conservator disaffirmed. All lobbying and political contributions by the Enterprises were immediately ordered stopped with the conservatorships. The Director also eliminated dividends on all common and preferred stock.

As conservator, FHFA changed some Enterprise management and governance practices. FHFA appointed new CEOs, nonexecutive chairmen, and Boards of Directors to both Enterprises. FHFA also worked with both Enterprises to establish a new Board committee structure, including key changes in charters and responsibilities. FHFA has worked with Fannie Mae on replacing its CEO, and continues to work with Freddie Mac in its search for a replacement CEO, CFO and the hiring of a COO. FHFA continues to work with the Enterprises and executive leaders at both Enterprises to retain key staff.

FHFA also has redirected certain decisions and refocused the Enterprises on strategic and mission-related goals. For example, FHFA issued a statement supporting the continuation of multi-family activities, reversed a planned increase in certain fees, and continue to review pricing and credit changes to ensure that changes are consistent with market conditions and support mission-related activities. Other activities have included the public release of 2007 and 2008 charitable giving, implementing internal controls around charitable giving, improving accounting consistency between the Enterprises, and working with Treasury to support initial and subsequent capital draws. FHFA encouraged Fannie Mae and Freddie Mac to lead foreclosure prevention initiatives and collaborate with the new Administration and other industry participants to address the economic crisis and keep people in their homes.

Late last August as we were planning the establishment of Enterprise conservatorships, we quickly identified retention of human capital as one of our most important challenges. With $1.9 trillion in assets and more than $3.7 trillion in guarantees, the Enterprises are two of the largest financial institutions in the world. Managing such a large and complex set of financial assets and guarantees requires skilled and experienced staff in a wide range of corporate activities, including financial asset and property management, operations, technology, and modeling, among others.

Even more important, the dependence of the mortgage markets and the American economy on the Enterprises in the continuing crisis had greatly accentuated the importance of maintaining their critical mission. Keeping the Enterprises operating at full speed was possible only if we retained the Fannie Mae and Freddie Mac teams. They are an important part of the solution, not the problems of the past.

Their conservatorships, new CEOs and the possibility of major changes in the structure of the Enterprises created considerable uncertainty for their employees. At the same time, we knew one of our first announcements would be that bonuses would not be paid to senior executives based on 2008 performance. Furthermore, the collapse in value of the Enterprises' stock had destroyed years of savings for many employees, and future vesting of previous stock grants no longer provided any retention incentives.

We hired a firm with expert compensation advisers to help us develop, in consultation with the Treasury Department, a program to keep key staff without rewarding poor performance. We felt it was extremely important to have a broad-based plan. The final retention programs, designed to incorporate market practices for troubled companies, included a total of 4,057 Freddie Mac employees, and 3,545 Fannie Mae employees. Payments were scheduled from late 2008 through early 2010. The total dollars paid and

scheduled to be paid over that period equal 12 percent of 2008 salaries and employee benefits at Freddie Mac and 11 percent at Fannie Mae, or an average of $24,000 per recipient at Freddie Mac and $32,000 at Fannie Mae.

For the 2009 performance year, Freddie Mac has established short-term and longer-term incentive award plans for employees at the Vice-President level and below. The amount of money in the short-term bonus pool will depend on the Enterprise's achievement of a variety of important goals primarily relating to mission, risk management, accounting, internal controls, business infrastructure, financial performance, and foreclosure prevention. A longer-term incentive plan will payout over two years, depending on Enterprise performance in addressing FHFA examination findings and other infrastructure issues. Non-salary compensation plans have yet to be completed for senior Freddie Mac executives or for Fannie Mae employees, generally.

Other Current Concerns
At this juncture we see several other issues that we would like to call to your attention. The first relates to FHFA's Office of Inspector General (OIG), which HERA established. The Inspector General (IG) is a Presidentially-appointed and Senate-confirmed position. The Inspector General Act of 1978 requires that such offices be funded each year through the annual appropriations process, while HERA authorized FHFA to assess the regulated entities to finance its activities. No appropriation has been provided for FHFA's IG for fiscal year 2009, since, when Congress considered related funding issues, the IG had not been nominated or confirmed. I fully support the establishment of an OIG for the agency and encourage the Administration to move forward to fill this position. I also support Congress providing the IG with the necessary resources, through the annual appropriations process, to establish an appropriately staffed, high-quality office.

The vulnerability of the private mortgage insurance industry is also a concern. As you know, Fannie Mae and Freddie Mac have relied on the mortgage insurers because the Enterprises' charters bar them from buying or guaranteeing loans with loan-to-value (LTV) ratios above 80 percent where the mortgages lack credit enhancement. The Enterprises' substantial counterparty credit risk exposure to private mortgage insurers totaled $184 billion at year-end 2008 and accounted for 85 percent of those insurers' risk-in-force at that time. Currently, delinquency rates are increasing significantly for all mortgage insurers, their capital positions are eroding, and their credit ratings are falling. Many insurers are operating in a capital preservation mode in an attempt to avoid breaching risk-to-capital levels, which would require their regulators to put them in run-off, ending their ability to take on new business. Thus, the underwriting standards of the private mortgage insurers have become tighter and new business written fell approximately 65 percent in the first quarter of 2009 from the year-earlier period. Mortgage insurers' actions, although understandable given losses incurred and weak market conditions, cloud the long-term outlook for the industry and have limited the Enterprises ability to write higher LTV loans. I believe that a financially sound mortgage insurance industry is critical to the recovery of housing markets. FHFA has discussed with the Treasury Department ways to bring new capital to these institutions.

The staffs at FHFA and the housing GSEs have been working hard to restore or maintain the institutions' safety and soundness. For Fannie Mae and Freddie Mac, however, the consequences of the size and credit characteristics of their mortgage books of business create substantial uncertainty as to the form of the ultimate resolution of the conservatorships. In the next section of my testimony, I will speak to the future of the Enterprises and the federal role in the housing finance system.

Part II—Future of the Enterprises

Before we talk about the future of Fannie Mae and Freddie Mac, I will summarize what went wrong in housing and mortgage markets, identify lessons learned, and raise three basic questions that policy makers face at this juncture. Then I will offer my own thoughts on the potential roles for the federal government in the housing finance market, some principles that I think should guide policy choices, and the viability of alternative institutional structures.

To place this discussion in context, let me define the purpose of the secondary mortgage market. Simply put, it connects global investors to local lenders and borrowers. While the average mortgage in the United States is about $200,000, the entire U.S. mortgage market is an $11.9 trillion market. The secondary mortgage market provides a critical link between global capital market investors who deal in millions and billions of dollars, and local institutions that provide the personal service to individual borrowers seeking loans of thousands of dollars. Traditionally, Fannie Mae and Freddie Mac have provided standardization of forms and data, combined with sound underwriting, to give global investors confidence to invest in pools of mortgages in the form of mortgage-backed securities and debt issued by the Enterprises. The secondary market helps to lower borrowing costs for homebuyers, in part because large institutional investors may be better able to fund mortgages and to manage and hedge certain mortgage risks than primary market lenders.

What Went Wrong

A number of things went wrong in U.S. housing and mortgage markets in first decade of this century. Part of what happened was beyond the housing sector. The "dot com" bust at the beginning of the decade resulted in a shift of some investor funds out of the stock market and into real estate, among other investments. The 1997 tax changes that made capital gains from owner-occupied housing essentially tax free for most homeowners spurred that shift. In response to the recession of 2001 and the September 11th attacks, the Federal Reserve lowered the federal funds rate and committed to maintaining low rates for an extended period to combat fears of deflation. The low interest rates decreased monthly payments and enabled home buyers to bid more, putting upward pressure on home prices. Investors worldwide, in turn, were seeking higher returns without adequate consideration of the associated risks. Risk was mispriced in many markets, but especially in the mortgage market.

At the same time, private sector innovations stimulated rapid growth in mortgage lending. Those innovations included the development of alternative mortgages aimed at people

who did not wish to provide standard documentation, who had blemished credit records, who could not make substantial down payments, or who wanted lower (initial) monthly payments. Such loans included low- and no-documentation mortgages, low- or no-down payment loans, piggy-back mortgages that eliminated the need for private mortgage insurance, interest-only loans, and payment-option mortgages. Many of these loans allowed more households to qualify for higher balance loans but were often relatively complex and posed risks that borrowers might have failed to understand. The rapid growth in the availability of alternative mortgages added to upward pressure on home prices that, as the boom proceeded, ultimately increased the credit risk of a broad range of outstanding mortgages.

Because many of these alternative mortgages were not eligible for purchase and securitization by the Enterprises, they would not have increased rapidly without another innovation—the development of PLS. By the mid-1990s, private firms were issuing their own MBS backed by nonconforming, mostly jumbo, mortgages. Unlike Enterprise and Ginnie Mae MBS, such securities were issued without the benefit of either an explicit or implicit federal guarantee of the timely payment of principal and interest. Instead, credit protection was achieved through dividing the securities into many pieces (or tranches) that differed in their priority to receive payments of principal and interest from the underlying mortgages. Private securitizers and their investors sought to increase profitability and hedge their risk through the use of complex structured financing and derivatives. Such instruments included credit default swaps (CDS), which act much like insurance against default, and collateralized debt obligations (CDOs and CDOs-squared), which were thought to reduce credit risk through diversification. As many market participants have now learned, however, the models and data used by credit rating agencies and investors, including the housing GSEs, to assess the risks of the new mortgages and securities based on them proved to be seriously flawed and inadequate.

The mortgage lending boom made possible by those innovations caused the dollar amount of single-family mortgages outstanding to grow at an unprecedented pace. At year-end 2000, $5.1 trillion single-family mortgages were outstanding. By the end of 2008, that total had more than doubled to over $11 trillion single-family mortgages. Between 2001 and 2007, the average growth rate in mortgages outstanding was 12 percent per year, which greatly exceeded overall growth in household income. Much of this increase was from non-traditional and, to a lesser extent, jumbo non-conforming mortgages.

Most non-traditional and jumbo mortgages were financed through the sale of PLS. Issuance of PLS surged beginning in 2004, when 46 percent of all single-family MBS issued were PLS. The PLS share peaked at 56 percent in 2006, but fell to 4 percent in 2008 **(Slide 4)**.

Private-label securitization competed to some degree with Fannie Mae and Freddie Mac. PLS as the Enterprises also integrated local lenders into national and international capital markets to reduce reliance on local deposit funding of mortgages. The rise of PLS, however, created a sort of competition in laxity by offering consumers mortgage credit on looser terms than the Enterprises traditionally offered. Ultimately, the Enterprises eroded

their own credit standards in an effort to keep pace with the rapid growth of subprime and other non-traditional mortgages funded with PLS.

By 2004, the Enterprises found their share of total single-family mortgage originations eroding as the prevalence of alternative mortgages grew and issuance of PLS ballooned. At the same time, demand for Enterprise MBS by foreign and other investors reduced profit margins for the Enterprises' own retained portfolios. To maintain profitability of the retained portfolios and to meet HUD-designated affordable housing goals, each Enterprise increased purchases of PLS backed by alternative mortgages and of high-risk whole loans. Freddie Mac purchased more PLS, and Fannie Mae purchased more whole loans. This weakening of their traditional underwriting standards has been a key driver of their recent, massive credit losses.

The credit performance of those goal-rich investments, however, has been far worse than anticipated and has accounted for a large share of total Enterprise losses. For example, during 2008 Freddie Mac recorded realized and unrealized losses related its investments in PLS of $53 billion, compared to the provision for credit losses on the entire single family book of $16 billion.

Purchases of PLS ultimately proved disastrous for the Enterprises. Credit and market-value losses would have been even larger had the Office of Federal Housing Enterprise Oversight (OFHEO), one of FHFA's predecessor agencies, not increased the Enterprises' capital requirement by 30 percent and capped their asset portfolios because of accounting and control problems. Those losses have largely validated previously expressed concerns about the weaknesses of the GSE model as implemented for the Enterprises. That model created private, for-profit corporations with special privileges that protected them from market discipline and led them to manage political risk more aggressively than economic and financial risks. The model resulted in large, systemically important institutions with excessive leverage, which by statute could exceed 100 to 1.

Lessons Learned

A time of crisis is also a time of learning, and we are learning or relearning many important lessons from this crisis. Some of the more important lessons have to do with the behavior of private firms and markets and their potential impact on the stability of the financial system. We should not lose sight of the fact that the marketplace continues to generate tremendous wealth and other benefits for this country and its citizens. But poorly regulated innovations in products, risk management, and underwriting standards can undermine the safety and soundness of financial institutions and overall financial stability by increasing leverage and capital arbitrage and by allowing unrecognized risks to accumulate.

The risk that a market innovation will have adverse systemic effects increases as it becomes difficult for all parties to understand and analyze. The complexity of many alternative mortgages certainly confused many borrowers, and the complexities of many PLS and derivatives created from them appear to have confused and confounded analysts, ratings agencies, and professional investment managers. The PLS and related derivatives

were often quite opaque, and the lack of adequate information confounded analysis of their risks. Protecting borrowers from predatory lending and protecting the liquidity of the secondary markets both require greater simplicity of securitized mortgages. Thus, we have learned that securitization does not inherently overcome poor underwriting and credit practices.

Another set of important lessons has to do with how we regulate financial firms and what we can hope to achieve through that regulation. It is now clear that regulation failed to contain excessive risk-taking in housing finance. That failure can be linked partly to structural weaknesses such as the limits to the regulatory authority of OFHEO, which were belatedly addressed in HERA. But many regulators also believed that damage from subprime mortgage excesses would be limited and would not affect their own regulated institutions to any great degree. Those beliefs reflected a focus on compliance with capital adequacy requirements that relied heavily on ratings from nationally recognized statistical ratings organizations (NRSROs), a failure to recognize the extent of off-balance-sheet risks, and a failure to recognize the extent of capital arbitrage. All those factors helped to magnify leverage and undermined capital adequacy. In 2006 and 2007, bank and thrift regulators did adopt guidance on nontraditional and subprime mortgages. OFHEO made the Enterprises comply with that guidance for the mortgages they bought and guaranteed as well as for the underlying mortgages in the PLS that they purchased.

Regulators and financial institutions also have learned that capital can disappear rapidly when asset markets become illiquid. The rapid disappearance of capital makes the combination of capital adequacy triggers and prompt corrective action embodied in regulation of banks and the Enterprises inadequate to protect taxpayers from the costs of resolving systemically important financial institutions when they founder. To protect taxpayers and the financial system, regulators and financial firms must prepare explicitly and in detail for widespread solvency and liquidity problems if they hope to address problems early and avoid full-blown crises. Preparation should include developing detailed plans for the orderly resolution of large, complex institutions to increase their incentives to limit risk of failure and the risk they pose systemically. Pre-existing and pre-funded mechanisms for the orderly resolution of large, complex financial institutions would also mitigate the need for taxpayer-funded rescues of such firms.

Key Questions Related to the Future of Housing Finance

Given what went wrong in housing and mortgage markets, I think the following are key questions that policy makers both in Congress and the executive branch must confront:

1. How can mortgage lending, including mortgage securitization, be changed to better serve our society? What is the role of regulation in achieving that goal?
2. How can financial institutions involved in mortgage lending and their supervision be reformed in order to protect overall financial stability better?
3. Beyond prudential regulation and supervision, does the government need to perform directly any specific functions in the secondary mortgage market? If so, how could the government best perform any such functions?

The answers to these questions have important implications for the future of housing finance and the potential structures and functions of the Enterprises.

Thoughts About the Future of the Enterprises

To begin contemplating the future of the Enterprises, we need to consider the potential functions in the secondary mortgage market that might best be accomplished by an institution or institutions with links to the federal government. We have learned that poor underwriting and credit practices cannot be overcome by securitization. It can be argued that three specific roles remain for the government or a special government-linked entity. Ultimately, the roles chosen for any government-linked entities going forward will have implications for their range of activities and institutional structure.

Potential Roles

The first potential role would be that of liquidity provider of last resort for the secondary market for MBS and possibly other asset-backed securities. In the past few decades, Fannie Mae and Freddie Mac have largely and profitably undertaken that role for their own MBS. However, they were unable to do so in the current crisis because of the magnitude of the disruption and their own weakened financial conditions. Consequently, during the current crisis, the Federal Reserve and the Treasury stepped in to do so. For the foreseeable future, the Enterprises' ability to perform this function will be limited by their financial weaknesses and the limits on their portfolios imposed by the Senior Preferred Stock Purchase Agreements with the Treasury Department.

The second potential role would be that of a guarantor or catastrophic risk insurer of the credit risk of conventional MBS. As we have seen, a catastrophic event in the housing sector—a severe house price decline, for example—can result in widespread financial losses and lead to a financial crisis. We have also seen that private firms are limited in their ability to insure against such catastrophic events. On the other hand, I know from my own experience at OFHEO, Social Security, the Pension Benefit Guaranty Corporation (PBGC), and now FHFA, that government insurance comes with significant risks of moral hazard and perverse incentives. However, a key advantage of a well-managed insurance program is that money is charged in the form of premiums in good times to offset losses during future bad times.

A final potential role of a government-linked entity is to alter the allocation of resources by providing subsidies or using other means to attempt to increase the supply or reduce the cost of mortgage credit to targeted borrowers. Such a role has been central to all the housing GSEs and has had mixed results as recent events have shown.

Principles for the Future

If policy makers decided to use the Enterprises in some reconstituted form or another institution or institutions with links to the federal government to perform any of those functions, issues about appropriate legal and ownership structures would arise. Before considering those questions, in my view it would make sense, first, to establish some very basic principles to guide our evaluation of those options and the choices among them.

Before laying out those principles, I'd like to reiterate that this is not just about Fannie Mae and Freddie Mac. As the key questions I posed above suggest, very important decisions have to be made about the future of the mortgage market and the appropriate role of the secondary mortgage market, including the roles of government regulation and programs, before we get to the future of the Enterprises themselves.

The first principle is that the Enterprises or any successors should have a well-defined and internally consistent mission. Their activities should be well-tailored to achieving that mission. Current law states that the Enterprises should promote the stability and liquidity of the secondary mortgage market and support financing for housing that is affordable. That raises various questions: Specifically, how should the Enterprises or successor institutions promote market stability and liquidity? Should their business volumes be strongly countercyclical? How much risk should they bear to promote affordable mortgage lending? Should they focus their activities on supporting long-term, fixed-rate mortgage lending and on loans with simple, easy-to-understand terms?

The second principle is that there should be a clear demarcation of the respective roles of the federal government and the private sector in the secondary mortgage market, and any federal risk-bearing should be provided explicitly and at actuarial cost. The old hybrid model of private, for-profit ownership underwritten by an implicit government guarantee allowed the Enterprises to become so leveraged that they posed a large systemic risk to the U.S. economy. The questions now are: What roles are best played by the federal government? What roles are best played by private firms? How can we best harness the strengths of market capitalism, while reducing the risks and avoiding unintended consequences? Should the existing books of business be split from new business on emergence from conservatorship, using a bridge bank structure, as provided for in HERA? How can we prevent undue political influence that may increase risks to the taxpayers?

The third principle is to base any organization (including any government corporation or entity) that provides credit guarantees or mortgage insurance on sound insurance principles: sound management, strong underwriting, strong capital positions, risk-based pricing, and flexibility to react to changes in the market. This raises several implicit questions: Do the Enterprises' retained mortgage portfolios compound their overall risks? Should the Enterprises or successor institutions be solely insurers of mortgage credit risk? Since private institutions cannot always reserve adequately for the bad times during the good times, should they pay the government an explicit, risk-based fee for the catastrophic risk the federal government will bear? Such coverage could take the form of reinsurance of private mortgage insurance or MBS guarantees. If so, what agency should manage that reinsurance program, and how should its coverage be structured relative to credit enhancements provided by the private sector?

The fourth principle is to create a regulatory and governance structure that ensures risk-taking is prudent. From nearly the first day of my job three years ago, I pointed out the folly of allowing the Enterprises to have such large portfolios and legally leverage their mortgage credit by well over 100 to 1, as did the Bush Administration well before I accepted the position. Congress provided a stronger regulatory structure for the housing

GSEs as part of HERA. That act afforded FHFA greater flexibility to establish capital and other prudential standards for the housing GSEs, and we are in the process of examining options to strengthen minimum and risk-based capital requirements and to make them more countercyclical. Beyond prudential regulation, the internal governance—board composition, management structure, compensation, and incentives—should be examined and strengthened.

The fifth principle is that housing finance should be subject to supervision that seeks to contain both the riskiness of individual institutions and the systemic risks associated with housing finance. The latter type of supervision would include policies and countercyclical capital regulations that counter the private sector's tendency to generate lending booms and busts. Our recent experiences have driven home how important safe and sound practices in housing finance are to the stability of the financial system and the U.S. economy. Going forward, we should seek to monitor, understand, and prevent or contain the buildup of excessive risk caused by imprudent practices related to housing finance.

Potential GSE Structures
With those principles in mind, we can consider issues related to the structure of the Enterprises or successor institutions such as their ownership structure, range of activities, regulatory environment, and housing policy mission.

With respect to ownership structure, there are three basic options for the future of Fannie Mae and Freddie Mac: government agency, GSE, or fully private firms. Each of these options has several variants, and each variant in turn will have its own advantages and disadvantages. The first option would be the equivalent of nationalizing the Enterprises. One variation of that idea would be to merge them with either FHA or Ginnie Mae. I am opposed to nationalization because government insurance programs are particularly high risk and rife with moral hazard. The FHA model is being tested right now. The present mortgage market difficulties do not provide a sound rationale for permanently nationalizing the $11.9 trillion mortgage market.

The second alternative would be to keep the Enterprises as GSEs, building upon HERA. There are several variations on that theme. They could continue with Treasury net worth protection or government reinsurance for catastrophic risk. Such reinsurance offers three primary advantages over a direct government insurance program. First, it does not put the government in a first loss position, reducing the moral hazard concerns. Second, since financial crises often drive down the cost of federal borrowing, the government has a natural hedge against such risk that the private sector lacks. Finally, some have argued that the government cannot avoid being in the position of a catastrophic reinsurer and is better off acknowledging and pricing those services. The current agreements with Treasury call for a sharp reduction of the Enterprises' retained portfolios, which will reduce their ability to take risks, but may hinder their ability to provide a liquidity backstop for the MBS market. As former Treasury Secretary Paulson suggested in January, a public utility model could be established. A cooperative ownership model similar to that of the FHLBanks has also been suggested. Extreme care would have to be

taken to prevent the inherent conflict always present in the GSE model—the tension between private profits, in part from publicly bestowed benefits, and public purposes.

A third option is to establish purely private-sector firms to supply liquidity to mortgage markets with or without government catastrophic insurance or reinsurance. Private firms could offer the benefits of greater competition such as improved operational efficiency and increased benefits to consumers. However, to maintain the level of liquidity the MBS market has enjoyed under Fannie Mae and Freddie Mac, a high degree of standardization and quality control across firms would be necessary. This approach raises transitional issues and would need to incorporate the principles set forth earlier. Whatever option is chosen, the country's financial system will continue to require a vibrant secondary mortgage market, including the functions currently performed by the Enterprises.

With respect to the future regulatory environment of the Enterprises or any private successor firms, the key issues involve choices regarding both safety and soundness and mission regulation. Recent experience has taught us that traditional prudential supervision may be insufficient to prevent the buildup of risks that threaten overall financial stability. FHFA therefore supports a shift to broaden supervisory activities to include the monitoring of systemic risk and the development of regulatory policies that focus on systemic stability. Such policies, often termed "macroprudential," include efforts to dampen credit cycles by making capital and other regulatory requirements more countercyclical.

FHFA is currently working on a new approach to mission regulation that is more sensitive to market conditions and better promotes sustainable mortgage options for low- and moderate-income households. We believe that the Enterprises' approach to meeting the HUD-designated housing goals was ultimately destabilizing. In this context, we urge Congress to consider how best to provide subsidies for lending to targeted borrowers. We believe that the approach taken to funding the FHLBanks' affordable housing mission, which is essentially a flat tax that finances direct subsidies to targeted borrowers and developments, is more consistent with safety and soundness than is the percent-of-business approach taken with Fannie Mae and Freddie Mac. In either case, some conflicts between safety and soundness and mission will arise and require tough decisions.

Regardless of the choices Congress and the Administration make about the future of the Enterprises, a number of cross-cutting issues will have to be addressed. Three such issues come to mind. First, should our approach to competition among secondary market institutions be different from elsewhere in the economy? Second, should secondary market institutions be specialized by sector or diversified across sectors? Third, how will the choices affect the future of the private mortgage insurance industry, FHA, and Ginnie Mae?

I'd like to close with a few personal thoughts. My career has included work with several private-sector insurance companies and several government insurance programs. My observation is that government insurance programs are high risk and invite the private sector to shift risk to the government. Among other issues, it is often difficult in a political environment to calculate or charge an actuarially fair price, resist pressure to

broaden the mission, and prevent inadequately compensated increases in federal risk-bearing. Nonetheless, government has an important role to play in providing certain types of insurance, especially reinsurance against catastrophic risks. One possibility to improve financial stability going forward would be for the government to provide catastrophic reinsurance in the secondary mortgage market funded by premiums paid by participating companies.

Finally, the regulators need to take a more unified and cohesive approach to supervising mortgage products, markets, and institutions. A near term step would be for FHFA to have fuller participation in Federal Financial Institutions Examination Council (FFIEC). In particular, designating FHFA as a liaison member to the FFIEC would facilitate sharing of information with FFIEC members. Because of the importance of mortgage holdings for banks, FHFA should be part of the FFIEC in terms of sharing information and providing input. FHFA would learn of new initiatives that would affect the Enterprises and be better positioned to offer supervisory assistance to other regulators in fields where it has expertise. As a liaison member, FHFA would not vote on any FFIEC matters.

Conclusion

The Enterprises and the FHLBanks are playing a vital role in helping to stabilize housing and the economy today. Fannie Mae's and Freddie Mac's participation and leading role in the Making Home Affordable Program is extremely important in helping to stabilize the mortgage market and their own books, which encompass 56 percent of single-family mortgages in this country. As markets and the Enterprises stabilize, there will be the need to address the complex issues I have outlined in this testimony. It is important to get the restructuring right for the U.S. economy and all present and future American homeowners and renters. Hopefully, I have helped to clarify the range of issues and choices confronting you. I will be happy to answer any questions.

Treasury and Fed Support Is Strong

(in Billions)

	Available	Used	
Treasury:			
Senior Preferred	$400	$85	
Enterprise MBS	no limit	167	*
GSE Liquidity Facility	no limit	0	
Federal Reserve:			
Enterprise Credit Facility	no limit	$0	
Agency MBS	$1,250	$507	
GSE Debt	200	81	
Total:	**$2,017+**	**$840**	

data as of 5/29/09

** included in available*

Enterprise Share of Mortgage Originations

Originations (Billions)

$4.5
$4.0
$3.5
$3.0
$2.5
$2.0
$1.5
$1.0
$0.5
$0.0

Fannie Mae/Freddie Mac Combined Share

80%
70%
60%
50%
40%
30%
20%
10%
0%

72.6%

1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 1Q 2009

Fannie/ Freddie New Business
Other
Fannie/Freddie Share

Sources: Inside Mortgage Finance, Enterprise Monthly Volume Summaries.

Serious Delinquencies Continue to Rise

Single-Family Mortgages

Legend:
- Subprime ARMs Seriously Delinquent
- Subprime Loans Seriously Delinquent
- All Loans Seriously Delinquent
- Prime Loans Seriously Delinquent
- Fannie Mae Delinquencies
- Freddie Mac Delinquencies

Serious Delinquency Rate (%)

0 5 10 15 20 25 30 35 40

1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009

36.5%
24.9%
7.2%
4.7%
3.2%
2.3%

Sources: Inside Mortgage Finance, Enterprise Monthly Volume Summaries.

Private-Label Issuance Grew and Declined Rapidly

MBS Issuance by Issuer, in Trillions
2000 - 2008

Source: *Inside Mortgage Finance* Publications.