EDITORIAL COMMENTARY

Nothing Down

The Bush administration's wrecking-ball benevolence

By JAMES BOVARD

Updated Aug. 23, 2004 12:01 a.m. ET

ONE OF THE PROUDEST ELEMENTS of President Bush's "compassionate conservative" agenda has been government financial support to home buyers for down payments. Bush is determined to end the bias against people who want to buy a home but don't have any money. But he is exposing taxpayers to tens of billions of dollars of possible losses, luring thousands of moderate-income families into bankruptcy, and risking the destruction of entire neighborhoods.

Bush began pushing his down-payment plan in 2002. The administration's rhetoric echoed the grand works of President Lyndon Johnson's Great Society. A White House Fact Sheet issued June 17, 2002, declared that Bush's agenda "will help tear down the barriers to homeownership that stand in the way of our nation's African-American, Hispanic and other minority families. ... The single biggest barrier to homeownership is accumulating funds for a down payment."

If true, the comment shows how much times have changed. The biggest barrier to homeownership for minorities used to be racial prejudice and unequal access to credit. Now, it's just the same lack of thrift that afflicts people of all races.

Nevertheless, Congress passed Bush's American Dream Downpayment Act last fall. It authorizes federal handouts to first-time home buyers of up to $10,000 or 6% of the home's purchase price, whichever is greater, to anyone with income 20% less than their local median income. In San Francisco, where the median income is more than $113,300, a family of four with an income of up to $90,500 is eligible for this freebie.

The president is also urging Congress to permit the Federal Housing Administration to begin making zero down-payment, low-interest loans to low-income Americans. The administration forecast that zero down-payment mortgages could be given to 150,000 home buyers in the first year. Federal Housing Commissioner John Weicher said in January 2004 that "the White House doesn't think those who can afford the monthly payment but have been unable to save for a down payment should be deprived from owning a home," National Mortgage News reported. While zero-downpayment mortgages have long been considered profoundly unsafe (especially for borrowers with dubious credit history), Weicher confidently asserted: "We do not anticipate any costs to taxpayers."

Character Building

So down-payment handouts are now part of building up the American character. Bush proclaimed on June 16, 2003: "Homeownership is more than just a symbol of the American dream; it is an important part of our way of life. Core American values of individuality, thrift, responsibility, and self-reliance are embodied in homeownership."

Is individuality something that the Feds have any competence to try to mass produce?

Is thrift something which can be fertilized with billions of additional dollars of deficit spending?

Is responsibility something which can be maximized through political grandstanding?

Is self-reliance so wonderful that the government should subsidize it?

The Bush "American Dream" act and the zero down-payment plan are modeled after down-payment assistance programs that have proliferated in recent years. These programs, often engineered by nonprofit groups, routinely involve a home builder giving a "charitable contribution" to the nonprofit, which then provides the home buyer with money for the down payment. The price of the house is sometimes increased by the same amount as the builder's "gift;" in other words the builder gets a tax deduction on some of his profit.

Almost all the mortgages created with down-payment assistance end up being underwritten or guaranteed by either the Federal Housing Administration or by Ginnie Mae (the Government National Mortgage Association).

Free down payments carry catastrophic risks. The default rate on mortgages from the largest downpayment-assistance organization, Nehemiah Corp., is 25 times higher than the nationwide mortgage-delinquency rate, according to department of Housing and Urban Development Inspector General. The default rate on Nehemiah mortgages quadrupled between 1999 and 2002, reaching almost 20%. HUD currently has no idea how many of the loans that the FHA is underwriting are closed with down-payment gifts. It appears that the department does not want to know.

Destructive Creation

President Bush's policies are pouring fuel on a fire that is already ravaging many neighborhoods in the U.S. While the percentage of Americans who own homes has risen in recent years, the foreclosure rate is rising much faster, tripling since the early 1980s. The percentage of FHA single-family home loans that have defaulted rose 54% between 1999 and 2002, reaching 4.25%. Payments on roughly 12% percent of all FHA mortgages are past due.

Millions of American homeowners are at risk of sustaining collateral damage from this debacle. We should recall the role of a similar program launched in 1968 to provide federally insured mortgages to poor people. The result was a disaster and not just for the poor people who could not actually afford the mortgages they were given. Since most families in the program had almost no equity in their homes, they had nothing to lose if they ran into financial difficulty. It was often cheaper to abandon the houses than to repair them. Neighbors who were not in the program found themselves surrounded by abandoned homes, and their property values -- built over years of individual effort, thrift, responsibility, and self-reliance -- vanished.

National Journal said in 1971 that the Federal Housing Administration was "financing the collapse of large residential areas of the center cities."

The FHA continues wreaking devastation in some neighborhoods and cities across the country. A 2002 study by the National Training and Information Center found that between 1996 and 2000, 21% of FHA borrowers in low-income areas in Baltimore defaulted and 25% of FHA borrowers in low-income areas in the New York City borough of Queens defaulted.

The National Housing Institute, a non-profit research group, noted in 2002 that concentrations of FHA defaults in cities have "turned the American dream of homeownership into the neighborhood nightmare. Community organizations around the country have witnessed firsthand the devastating effects of abandoned housing and the ensuing crime, drug trafficking, prostitution, child abuse and disinvestment."

Homeownership carries far more financial rude surprises (such as the cost of major repairs) than does renting. If people get into a house they cannot financially handle and they go bankrupt, they are worse off than if they had never received down-payment assistance.

Bush administration officials stress how the new policies especially benefit minorities and often imply that the homeownership gap between races is caused by bias. But federal studies prove otherwise. A 1995 Federal Reserve Board study examined more than 200,000 mortgage loans and found that "blacks defaulted about twice as often as white borrowers." Blacks are almost twice as likely as whites to have bad credit ratings among people of the same income class, according to a 1999 survey by Freddie Mac.

Borrowing Time

These down-payment initiatives are key planks in the Bush re-election campaign. Bush will get the applause and political credit now, while the defaults from the program will not surge until sometime after November 2004.

Transferring the risk of homeownership from buyers to taxpayers does not endow virtue in America. Giving people a handout that leads them to financial ruin is wrecking-ball benevolence.

Rather than boosting the number of people dependent on government for a roof over their heads, the Bush administration should devote its energy to dismantling HUD, the fountainhead of foolish housing policies, and the biggest single blight on urban America.

JAMES BOVARD is the author of the just-published *The Bush Betrayal* (Palgrave) and *Feeling Your Pain: The Explosion and Abuse of Government Power in the Clinton-Gore Years* (Palgrave, 2000).

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Statement

Statement of FHFA Director James B. Lockhart at News Conference Announcing Conservatorship of Fannie Mae and Freddie Mac

FOR IMMEDIATE RELEASE

9/7/2008

Good Morning

Fannie Mae and Freddie Mac share the critical mission of providing stability and liquidity to the housing market. Between them, the Enterprises have $5.4 trillion of guaranteed mortgage-backed securities (MBS) and debt outstanding, which is equal to the publicly held debt of the United States. Their market share of all new mortgages reached over 80 percent earlier this year, but it is now falling. During the turmoil last year, they played a very important role in providing liquidity to the conforming mortgage market. That has required a very careful and delicate balance of mission and safety and soundness. A key component of this balance has been their ability to raise and maintain capital. Given recent market conditions, the balance has been lost. Unfortunately, as house prices, earnings and capital have continued to deteriorate, their ability to fulfill their mission has deteriorated. In particular, the capacity of their capital to absorb further losses while supporting new business activity is in doubt.

Today's action addresses safety and soundness concerns. FHFA's rating system is called GSE Enterprise Risk or G-Seer. It stands for Governance, Solvency, Earnings and Enterprise Risk which includes credit, market and operational risk. There are pervasive weaknesses across the board, which have been getting worse in this market.

Over the last three years OFHEO, and now FHFA, have worked hard to encourage the Enterprises to rectify their accounting, systems, controls and risk management issues. They have made good progress in many areas, but market conditions have overwhelmed that progress.

The result has been that they have been unable to provide needed stability to the market. They also find themselves unable to meet their affordable housing mission. Rather than letting these conditions fester and worsen and put our markets in jeopardy, FHFA, after painstaking review, has decided to take action now.

Key events over the past six months have demonstrated the increasing challenge faced by the companies in striving to balance mission and safety and soundness, and the ultimate disruption of that balance that led to today's announcements. In the first few months of this year, the secondary market showed significant deterioration, with buyers demanding much higher prices for mortgage backed securities.

In February, in recognition of the remediation progress in financial reporting, we removed the portfolio caps on each company, but they did not have the capital to use that flexibility.

In March, we announced with the Enterprises an initiative to increase mortgage market liquidity and market confidence. We reduced the OFHEO-directed capital requirements in return for their commitments to raise significant capital and to maintain overall capital levels well in excess of requirements.

In April, we released our Annual Report to Congress, identifying each company as a significant supervisory concern and noting, in particular, the deteriorating mortgage credit environment and the risks it posed to the companies.

In May OFHEO lifted its 2006 Consent Order with Fannie Mae after the company completed the terms of that order. Subsequently, Fannie Mae successfully raised $7.4 billion of new capital, but Freddie Mac never completed the capital raise promised in March.

Since then credit conditions in the mortgage market continued to deteriorate, with home prices continuing to decline and mortgage delinquency rates reaching alarming levels. FHFA intensified its reviews of each company's capital planning and capital position, their earnings forecasts and the effect of falling house prices and increasing delinquencies on the credit quality of their mortgage book.

In getting to today, the supervision team has spent countless hours reviewing with each company various forecasts, stress tests, and projections, and has evaluated the performance of their internal models in these analyses. We have had many meetings with each company's management teams, and have had frank exchanges regarding loss projections, asset valuations, and capital adequacy. More recently, we have gone the extra step of inviting the Federal Reserve and the OCC to have some of their senior mortgage credit experts join our team in these assessments.

The conclusions we reach today, while our own, have had the added benefit of their insight and perspective.

After this exhaustive review, I have determined that the companies cannot continue to operate safely and soundly and fulfill their critical public mission, without significant action to address our concerns, which are:

- the safety and soundness issues I mentioned, including current capitalization;
- current market conditions;
- the financial performance and condition of each company;
- the inability of the companies to fund themselves according to normal practices and prices; and
- the critical importance each company has in supporting the residential mortgage market in this country,

Therefore, in order to restore the balance between safety and soundness and mission, FHFA has placed Fannie Mae and Freddie Mac into conservatorship. That is a statutory process designed to stabilize a troubled institution with the objective of returning the entities to normal business operations. FHFA will act as the conservator to operate the Enterprises until they are stabilized.

The Boards of both companies consented yesterday to the conservatorship. I appreciate the cooperation we have received from the boards and the management of both Enterprises. These individuals did not create the inherent conflict and flawed business model embedded in the Enterprises' structure. I thank the CEOs for their service in these difficult times.

The goal of these actions is to help restore confidence in Fannie Mae and Freddie Mac, enhance their capacity to fulfill their mission, and mitigate the systemic risk that has contributed directly to the instability in the current market. The lack of confidence has resulted in continuing spread widening of their MBS, which means that virtually none of the large drop in interest rates over the past year has been passed on to the mortgage markets. On top of that, Freddie Mac and Fannie Mae, in order to try to build capital, have continued to raise prices and tighten credit standards.

FHFA has not undertaken this action lightly. We have consulted with the Chairman of the Board of Governors of the Federal Reserve System, Ben Bernanke, who was appointed a consultant to FHFA under the new legislation. We have also consulted with the Secretary of the Treasury, not only as an FHFA Oversight Board member, but also in his duties under the law to provide financing to the GSEs. They both concurred with me that conservatorship needed to be undertaken now.

There are several key components of this conservatorship:

First, Monday morning the businesses will open as normal, only with stronger backing for the holders of MBS, senior debt and subordinated debt.

Second, the Enterprises will be allowed to grow their guarantee MBS books without limits and continue to purchase replacement securities for their portfolios, about $20 billion per month without capital constraints.

Third, as the conservator, FHFA will assume the power of the Board and management.

Fourth, the present CEOs will be leaving, but we have asked them to stay on to help with the transition.

Fifth, I am announcing today I have selected Herb Allison to be the new CEO of Fannie Mae and David Moffett the CEO of Freddie Mac. Herb has been the Vice Chairman of Merrill Lynch and for the last eight years chairman of TIAA-CREF. David was the Vice Chairman and CFO of US Bancorp. I appreciate the willingness of these two men to take on these tough jobs during these challenging times. Their compensation will be significantly lower than the outgoing CEOs. They will be joined by equally strong non-executive chairmen.

Sixth, at this time any other management action will be very limited. In fact, the new CEOs have agreed with me that it is very important to work with the current management teams and employees to encourage them to stay and to continue to make important improvements to the Enterprises.

Seventh, in order to conserve over $2 billion in capital every year, the common stock and preferred stock dividends will be eliminated, but the common and all preferred stocks will continue to remain outstanding. Subordinated debt interest and principal payments will continue to be made.

Eighth, all political activities—including all lobbying—will be halted immediately. We will review the charitable activities.

Lastly and very importantly, there will be the financing and investing relationship with the U.S. Treasury, which Secretary Paulson will be discussing. We believe that these facilities will provide the critically needed support to Freddie Mac and Fannie Mae and importantly the liquidity of the mortgage market.

One of the three facilities he will be mentioning is a secured liquidity facility which will be not only for Fannie Mae and Freddie Mac, but also for the 12 Federal Home Loan Banks that FHFA also regulates. The Federal Home Loan Banks have performed remarkably well over the last year as they have a different business model than Fannie Mae and Freddie Mac and a different capital structure that grows as their lending activity grows. They are joint and severally liable for the Bank System's debt obligations and all but one of the 12 are profitable. Therefore, it is very unlikely that they will use the facility.

During the conservatorship period, FHFA will continue to work expeditiously on the many regulations needed to implement the new law. Some of the key regulations will be minimum capital standards, prudential safety and soundness standards and portfolio limits. It is critical to complete these regulations so that any new investor will understand the investment proposition.

This decision was a tough one for the FHFA team as they have worked so hard to help the Enterprises remain strong suppliers of support to the secondary mortgage markets. Unfortunately, the antiquated capital requirements and the turmoil in housing markets over-whelmed all the good and hard work put in by the FHFA teams and the Enterprises' managers and employees. Conservatorship will give the Enterprises the time to restore the balances between safety and soundness and provide affordable housing and stability and liquidity to the mortgage markets. I want to thank the FHFA employees for their work during this intense regulatory process. They represent the best in public service. I would also like to thank the employees of Fannie Mae and Freddie Mac for all their hard work. Working together we can finish the job of restoring confidence in the Enterprises and with the new legislation build a stronger and safer future for the mortgage markets, homeowners and renters in America.

Thank you and I will now turn it back to Secretary Paulson.

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CATO INSTITUTE

COMMENTARY

Fannie/Freddie Bailout Baloney

By Gerald P. O'Driscoll Jr.

This article appeared in the New York Post on September 9, 2008.

We can be sure that Treasury Secretary Henry Paulson only took control of Fannie Mae and Freddie Mac last weekend because he was forced to do so. But the move solves neither the housing crisis nor the root of the Fannie/Freddie problem.

At heart, Fannie and Freddie had become classic examples of "crony capitalism." The "cronies" were businessmen and politicians working together to line each other's pockets while claiming to serve the public good. The politicians created the mortgage giants, which then returned some of the profits to the pols - sometimes directly, as campaign funds; sometimes as "contributions" to favored constituents.

Because the government was universally believed to guarantee their debt, Fannie and Freddie could borrow at better rates than true private-sector firms - and accumulate far greater risks. The politicians and regulators that should've reined them in did not - because the giants bought influence, and because of their apple-pie image as "promoting homeownership."

And, because government backing let Fannie and Freddie dominate the mortgage-underwriting market, private-sector criticism was silenced. Local banks that wanted to offer mortgages dared not speak out against them. Large banks dared not complain about the giants' government-given advantage because they needed to be able to buy securities from Fannie/Freddie.

Homeowners became hostage to a system that depended on securitizing mortgages with guarantees from Fannie and Freddie. That made them part of the constituency opposed to reform.

The essential problem: Fannie and Freddie were private firms, with stockholders who garnered billions in profits over the years. Yet the government was understood to guarantee their debt. That is, it bore the risk if they failed, as they now have.

Ever since their "privatization" (Fannie in 1968 and Freddie in the 1970s), many politicians knew that the giants were operating in a financially unsafe and unsound manner - and the warning cries grew louder in recent years. Their capital was insufficient - as Paulson told us on Sunday.

Paulson had hoped to get out of office without dealing with this mess. Financial markets pressed the point, however, by bidding down Fannie and Freddie stock and driving up their borrowing costs over the summer.

By delaying action, Paulson effectively eliminated all other options (such as downsizing or privatization) except the present bailout. In July, he announced with fanfare his plan to backstop the two, getting broad authority from Congress to spend taxpayer funds and intervene in the companies. He said he never expected to fire this "bazooka" - but now he has.

If only because of the ambiguity in *who* would be backstopped - that is, which creditors would be made good; whether preferred shareholders might see their stock retain value - markets were bound to test him.

At heart, Fannie and Freddie had become classic examples of 'crony capitalism.'

Shareholders have lost virtually all their value, but that doesn't solve the problem: Doing so requires getting away from the hybrid structure of private ownership with government backing. Until the government makes it plain that it won't seek to restore the pre-crisis status quo, Fannie and Freddie are the living dead, and markets must fear their return as newly invigorated financial monsters.

Paulson admits he has punted the hard choices to the next administration and next Congress. John McCain has promised to end business as usual in Washington. He is a vocal opponent of the two firms as now structured and has said he wants them to go away. Barack Obama has rightly focused on the conflict between private ownership and government backing. Taxpayers should demand "never again" from both candidates.

Paulson has said downsizing the giants is the one thing that the next administration and Congress must do. Once downsized, we can debate whether they should be sold off in pieces to true private ownership with no government backing or made into government agencies.

At the moment, they're too big to fail but also too costly to keep.

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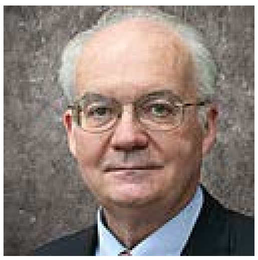

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The Failure of Fannie Mae and Freddie Mac
And the Future of Government Support for the Housing Finance System

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The Failure of Fannie Mae and Freddie Mac
And the Future of Government Support for the Housing Finance System

By Thomas H. Stanton

Thank you for the invitation to exchange views with this distinguished group of scholars and practitioners in the fields of housing, community development, and housing finance. This conference provides an excellent opportunity to place the failure of Fannie Mae and Freddie Mac into the larger context of the future of the troubled housing finance system.

In my remarks today I would like to invite discussion of three major sets of issues: (1) why Fannie Mae and Freddie Mac failed, (2) lessons we can learn from their failure, and (3) considerations regarding future government support of the residential mortgage market.

1. Why Fannie Mae and Freddie Mac Failed

On September 7, 2008, Fannie Mae and Freddie Mac voluntarily went into conservatorship. As they recognize their losses it becomes clear that taxpayer costs from the government backing of the two companies will be substantial.

The failure of Fannie Mae and Freddie Mac cannot be attributed solely to the housing credit bubble and collapse. Rather, it would appear that the collapse of the housing credit bubble was a precipitating event that (1) could have been avoided by more prudent practices by the GSEs and their management and (2) revealed shortcomings in the GSE as an institutional form.

Fannie Mae and Freddie Mac committed serious misjudgments that helped to bring about their insolvency. The most serious misjudgments involved the companies' resistance to accepting more effective supervision and capital standards. For years, starting with their successful efforts to weaken the legislation that established their regulator, the Office of Federal Housing Enterprise Oversight (OFHEO),[1] the two companies managed to fend off capital standards that would have reduced their excessive leverage and provided a cushion to absorb potential losses. In 2007 Freddie Mac concluded a stock buyback program that further weakened the company's ability to withstand a financial shock. As late as March 2008 Freddie Mac defied calls to increase its capital cushion.[2] As late as summer 2008 Fannie Mae continued to resist legislation that would give a federal regulator the discretion to set higher capital standards.[3]

[1] Among the many reports documenting the successful efforts of Fannie Mae and Freddie Mac at weakening the regulator and their capital standards, see, e.g., Carol Matlack, Getting Their Way, *National Journal*, October 27,1990, pp. 2584-2588; Jill Zuckman, "Bills To Increase GSE Oversight Move Ahead in House, Senate," *CQ Weekly*, August 3, 1991; Stephen Labaton, "Power of the Mortgage Twins: Fannie and Freddie Guard Autonomy," *New York Times*, November 12,1991, p. D1; Kenneth H. Bacon, "Privileged Position: Fannie Mae Expected to Escape Attempt at Tighter Regulation," *Wall Street Journal*, June 19,1992, p. A1.
[2] David S. Hilzenrath, "Chief Says Freddie Won't Raise Capital; Mortgage Financier Cites Responsibility to Shareholders, Won't Increase Loan Capacity," *Washington Post*, March 13, 2008, p. D4.
[3] Steven Sloan, "Fannie CEO Details Issues with GSE Bill," *American Banker*, June 5, 2008.

The companies fought for high leverage because this benefited their shareholders and managers, at least until the companies failed. Freddie Mac reported returns on equity of over 20 percent for most years since it became an investor-owned company in 1989, reaching highs of 47.2 percent in 2002 and 39.0 percent in 2000. Fannie Mae reported earnings of almost as much, reaching a high of 39.8 percent in 2001. The two companies fought higher capital requirements because more capital would have diluted those returns to shareholders.

The two companies compounded the problem of their self-inflicted structural vulnerabilities with a series of misjudgments that involved taking on excessive risk just at the point that housing prices were peaking. According to press reports, the chief executives of both Fannie Mae and Freddie Mac disregarded warnings from their risk officers and sought to catch up with the market by greatly increasing their purchases of risky loans.[4]

Freddie Mac reported in its 2007 Annual Report that,

> "The proportion of higher risk mortgage loans that were originated in the market during the last four years increased significantly. We have increased our securitization volume of non-traditional mortgage products, such as interest-only loans and loans originated with less documentation in the last two years in response to the prevalence of these products within the origination market. Total non-traditional mortgage products, including those designated as Alt-A and interest-only loans, made up approximately 30% and 24% of our single-family mortgage purchase volume in the years ended December 31, 2007 and 2006, respectively."[5]

Fannie Mae's 2007 Annual Report states:

> "We are experiencing high serious delinquency rates and credit losses across our conventional single-family mortgage credit book of business, especially for loans to borrowers with low credit scores and loans with high loan-to-value ("LTV") ratios. In addition, in 2007 we experienced particularly rapid increases in serious delinquency rates and credit losses in some higher risk loan categories, such as Alt-A loans, adjustable-rate loans, interest-only loans, negative amortization loans, loans made for the purchase of condominiums and loans with second liens. Many of these higher risk loans were originated in 2006 and the first half of 2007."[6]

Fannie Mae reported that purchases of interest-only and negative amortizing ARMs amounted to 7% of its business volume in 2007 and 12% in each of 2006 and 2005. Moreover, Alt-A mortgage loans "represented approximately 16% of our single-family business volume in 2007,

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[4] David S. Hilzenrath, "Fannie's Perilous Pursuit of Subprime Loans: As It Tried to Increase Its Business, Company Gave Risks Short Shrift, Documents Show," *Washington Post*, August 19, 2008, p. D01; Charles Duhigg, "At Freddie Mac, Chief Discarded Warning Signs," *New York Times*, August 5, 2008; Charles Duhigg, "The Reckoning: Pressured To Take More Risk, Fannie Reached Tipping Point, *New York Times*, October 5, 2008.

[5] Freddie Mac, *Annual Report*, 2007, p. 13.

[6] Fannie Mae, *Annual Report*, 2007, p. 24.

compared with approximately 22% and 16% in 2006 and 2005, respectively."[7] Both companies also invested in highly rated private-label mortgage-related securities that were backed by Alt-A or subprime mortgage loans, amounting to total holdings by the two companies of over $ 200 billion in 2007.[8]

In short, the mix of private incentives and government backing created a dynamic that led not only to the hubris that brought about the meltdown of internal controls at both Fannie Mae and Freddie Mac a few years ago,[9] but also to their insolvency in 2008.

That said, Fannie Mae and Freddie Mac did not cause the housing bubble or the proliferation of subprime and other mortgages that borrowers could not afford to repay. In analyzing the dynamics of Fannie Mae and Freddie Mac I discovered a phenomenon that can be called Stanton's Law: *risk will migrate to the place where government is least equipped to deal with it.*[10] Thus, the capital markets arbitraged across regulatory requirements and ultimately sent literally trillions of dollars of mortgages to Fannie Mae and Freddie Mac, where capital requirements were low and federal supervision was weak.

However, the capital markets also found other places where government could not manage the risk, including structured investment vehicles of commercial banks, private securitization conduits, and collateralized debt obligations that were virtually unregulated except by the vagaries of the rating agencies and exuberance of the market during the housing bubble. Huge volumes of subprime, alt-A, interest-only and other toxic mortgages went to these parts of the market. As the bubble reached its limits and began to deflate the GSEs tried to catch up and regain the market share that they had lost to the new competition.

II. Lessons From the Failure of Fannie Mae and Freddie Mac

Many other kinds of financial institution have failed in the current debacle, including commercial banks, thrift institutions, mortgage companies, insurance companies and hedge funds. Among all of these, the government-sponsored enterprise manifests specific shortcomings that call the value of this institutional form into doubt.

In making their mistakes, Fannie Mae and Freddie Mac revealed the inherent vulnerabilities of the government-sponsored enterprise (GSE) as an organizational model.[11] First, the GSE lives

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[7] *Ibid*, pp. 128-9.
[8] Fannie Mae, *Annual Report*, 2007, p. 93; Freddie Mac, *Annual Report*, 2007, p. 94.
[9] Thomas H. Stanton, "The Life Cycle of the Government-Sponsored Enterprise: Lessons for Design and Accountability," *Public Administration Review*, September/October 2007.
[10] This dynamic was first presented in my testimony before the Senate Banking Committee in a hearing on *The Safety and Soundness of Government Sponsored Enterprises*, October 31, 1989, p. 41, pointing out that increases in stringency of capital requirements and government supervision for thrift institutions after the savings and loan debacle would drive many billions of dollars of mortgages from the portfolios of savings and loan associations to Fannie Mae and Freddie Mac because their capital standards and government oversight were much weaker.
[11] A government-sponsored enterprise is a government chartered, privately owned and privately controlled institution that, while lacking an express government guarantee, benefits from the perception that the government stands behind its financial obligations. See, Ronald C. Moe *and* Thomas H. Stanton, "Government Sponsored Enterprises as Federal Instrumentalities: Reconciling Private Management with Public Accountability," *Public*

or dies according to its charter and other laws that determine the conditions under which it operates. That means that GSEs must balance their profit goals against public purposes and the interests of stakeholders that can influence their charters.

Second, the GSE combines private ownership with government backing in a way that creates a political force that can dominate virtually any safety-and-soundness framework. GSEs select their chief officers in good part based on ability to manage political risk rather than on their ability to manage two of the largest financial institutions in the world. Consider these issues in turn.

The GSE business model, involving private ownership and public purposes, is difficult if not impossible to manage.

The GSE business model, involving private ownership and public purposes, is difficult if not impossible to manage. Fannie Mae and Freddie Mac were more vulnerable than commercial banks or other federal instrumentalities to the contradictions between the requirement to serve private shareholders and the need to serve public purposes that stakeholders, including members of Congress, guarded and enforced.

It has long been recognized that GSEs are a special type of federal instrumentality, i.e., a private institution chartered under law to swerve public purposes. Other federal instrumentalities include most commercial banks and thrift institutions and other for-profit and nonprofit institutions.[12] In contrast to those other instrumentalities, the officers and directors of Fannie Mae and Freddie Mac seem to have had a much more difficult time balancing their fiduciary responsibilities to shareholders against the public purposes of their charter acts and pressure from stakeholders to carry out public purposes that may not have helped the GSEs to protect themselves as sources of long term strength to the housing market.

Perhaps most eloquent on this issue was Daniel Mudd, the former CEO of Fannie Mae, who testified in December 2008 that:

> "I would advocate moving the GSEs out of No Man's Land. Events have shown how difficult it is to balance financial, capital, market, housing, shareholder, bondholder, homeowner, private, and public interests in a crisis of these proportions. We should examine whether the economy and the markets are better served by fully private or fully public GSEs."[13]

Administration Review. July/August 1989. This definition is consistent with the definition Congress enacted in amendments to the Congressional Budget Act of 1974, codified at 2 U.S.C. Section 622 (8).

[12] See, e.g., Thomas H. Stanton, *A State of Risk: Will Government-Sponsored Enterprises be the Next Financial Crisis?*HarperCollins, 1991, Appendix A ("Laws, Cases, and other Legal Sources on Government-Sponsored Enterprises"); and Thomas H. Stanton, "Federal Supervision of Safety and Soundness of Government-Sponsored Enterprises," *The Administrative Law Journal*, Summer 1991.

[13] Daniel H. Mudd, Written Statement, Before the Committee on Oversight and Government Reform U.S. House of Representatives, December 9, 2008, available at http://oversight.house.gov/story.asp?ID=2252, accessed February 7, 2009. Richard Syron, Freddie Mac's former CEO, pointed to the same issue:

> "Freddie Mac is a shareholder-owned corporation, chartered for the public purpose of supporting America's mortgage finance markets, and operating under government mandates. We had

There were several reasons why Fannie Mae and Freddie Mac were so susceptible to being whipsawed between their fiduciary obligations to shareholders and their public purposes. A major source of mischief was the fact that the two companies were chartered by act of Congress rather than by a federal regulator. Members of Congress constantly could pressure Fannie Mae and Freddie Mac to undertake unwise lending policies, for fear that Congress otherwise might impose higher capital requirements or other restrictions that were unwelcome to shareholders. Mr. Mudd testified, for example, that he felt pressure to increase Fannie Mae's market activity even as other institutions were stepping back because of declining market conditions.

In addition, the GSEs selected a political strategy of achieving short-term goals at the potential cost of longer term achievements. Their refusal to accept bank-type capital requirements and a bank-type supervisory framework for accountability has already been mentioned. The GSEs marshaled so much political power that they simply dominated their environment and dampened feedback signals that might have helped company officials to make better decisions.[14] In return, however, the GSEs had to buy off stakeholders with large volumes of mortgage purchases that they, or at least their risk officers, knew were unwise.

Those interested in seeing some of the pressures on the companies and the nature of mistakes that the GSEs made in 2005-7, including overriding warnings from risk officers but assuming that credit risk would be appropriately managed, and seeking yield and market share despite added risk from nontraditional mortgage products, may wish to consult confidential company documents that the House Committee on Oversight and Government Reform released on December 9, 2008.[15]

In their governance shortcomings the two GSEs compounded the more general problem that the current debacle has revealed. Alan Greenspan put it best:

> "I made a mistake in presuming that the self interest of organizations, specifically banks and others, was such that they were best capable of protecting their own shareholders and the equity in the firms."[16]

> obligations to Congress and to the public to promote our chartered purposes of increasing affordability, liquidity and stability in housing finance, which included some very specific low-income housing goals. We also had obligations to our regulator to pursue our goals in a manner that was prudent and reasonable. And, at the same time, we had fiduciary obligations to our shareholders that were the same as any other publicly traded company. Freddie Mac always worked hard to balance these multiple obligations, and for decades the company was effective."

Richard F. Syron, Statement, Before the Committee on Oversight and Government Reform U.S. House of Representatives, December 9, 2008, available at http://oversight.house.gov/story.asp?ID=2252, accessed February 7, 2009.

[14] This problem is analyzed with respect to the two GSEs' failed internal controls in Thomas H. Stanton, "The Life Cycle of the Government-Sponsored Enterprise: Lessons for Design and Accountability," *Public Administration Review*, September/October 2007.

[15] Three sets of documents are available at the committee website, http://oversight.house.gov/story.asp?ID=2252, accessed February 7, 2009.

[16] Kevin G. Hall, "Greenspan takes some blame for financial meltdown," McClatchy Newspapers, October 23, 2008, http://www.mcclatchydc.com/staff/kevin_hall/v-print/story/54712.html, accessed 12-06-2008

There are huge governance implications of this statement, coming as it does from a firm believer in the efficiency of market forces. Not only GSEs, but other financial institutions sought ways to increase their leverage and reduce the quality of their supervision by government. But there was a difference. As they served the perceived interests of their shareholders, banks and other investors were filled with the irrational exuberance of the market bubble; in addition, the GSEs faced, and failed to manage, stakeholder pressure to engage in activities that they probably knew, and their risk officers did know, could inflict serious harm on the companies.

The GSE combines private ownership with government backing in a way that creates a political force that can dominate virtually any safety-and-soundness framework. The statutory framework of GSEs also creates special financial vulnerability because of the incentives that GSEs have to appoint CEOs and senior management that are politically adept and who may not necessarily be experienced at managing a major financial institution.

A GSE lives or dies according to the terms of its enabling legislation. Especially GSEs such as Fannie Mae and Freddie Mac that are directly chartered by Congress, but also GSEs such as the Federal Home Loan Bank System that are chartered by their regulator, have tended (albeit not invariably) to select CEOs and other top managers because of their ability to manage political risk rather than the risks that derive from their financial activities. This was seen in the newest GSE, Farmer Mac, which returned to the Congress several times since its original authorization in 1987 to obtain adjustments to its charter powers to allow it to offer increasingly profitable financial services. Farmer Mac has never been a strong success in public policy terms[17] and has invested heavily in assets that that have nothing to do with meeting public needs.[18]

Fannie Mae and Freddie Mac made a practice of mastering political risk, both by providing blandishments to favored members of the political establishment and other stakeholders, and by applying pressure to contain threats to what the companies considered their franchise value.[19]

[17] U.S. General Accounting Office, Farmer Mac: Revised Charter Enhances Secondary Market Activity, But Growth Depends on Various Factors, GAO/GGD-99-85, May 1999

[18] Among other investments having nothing to do with its public purpose, in September 2008 Farmer Mac held in its investment portfolio $50.0 million of Fannie Mae floating rate preferred stock and $60.0 million of Lehman Brothers senior debt securities. After taking losses on these investments the GSE was recapitalized on September 30, 2008 by issuing new stock to institutions of the Farm Credit System, another GSE, and thereby averted insolvency. See Farmer Mac, *Form 10-Q Quarterly Report for the Period Ended September 30, 2008.*

[19] This has been a long-standing policy. In 1991 Representative Jim Leach (R-IA) stated:

> "[I]t is not surprising that Fannie and Freddie are beginning to exhibit that arrogant characteristic of a duopoly, controlling 90% of the market. Such market dominance allows for heavy-handed approaches to competitors, to financial intermediaries, and to consumers. Competitors such as community based savings and loan associations and commercial banks are also users of GSE services. They are understandably apprehensive about expressing reservations about their practices in fear of retaliation. Likewise, would-be competitors such as securities firms run well known market risks if they object or attempt to compete with Fannie and Freddie. The two GSEs distribute billions of dollars of business on Wall Street and have a reputation of not cottoning to challengers of the status quo."

U.S. House of Representatives, "Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991," Report of the Committee on Banking, Finance and Urban Affairs, H.Rpt. No. 102-206, to accompany H.R. 2900, September 17, 1991, at p. 122 (Dissenting Views of Representative Jim Leach).

The GSEs are active participants in the process of influencing policymakers, and especially those who are in positions to affect their charter legislation. On April 19, 2006, Freddie Mac paid a record fine to the Federal Election Commission to settle charges that the company violated federal law by using company resources to hold some $ 1.7 million in fundraisers, many involving the then-Chairman of the House Financial Services Committee. That committee is responsible for the legislation that created both Fannie Mae and Freddie Mac and that periodically considered legislation to address shortcomings in their supervision.

Thanks to the lobbying power of Fannie Mae and Freddie Mac, the Office of Federal Housing Enterprise Oversight (OFHEO) had been created as an institution that lacked the capacity needed to do its job. OFHEO was limited by the appropriations process and had a budget that was much smaller, compared to its responsibilities, than the budgets of federal bank regulators.

Whenever OFHEO tried to do its job well, as in the 2004 Special Examination Report on Fannie Mae, it felt political pressure. Fannie Mae lobbyists generated a congressional request for the Inspector General (IG) of the Department of Housing and Urban Development (HUD) to investigate OFHEO's conduct of the special examination. Between October 2002 and June 2004, there had been three other congressional requests for IG investigations of OFHEO. Fannie Mae lobbyists also tried to use the appropriations process to force a change in the leadership of OFHEO. They convinced the relevant Senate Appropriations Subcommittee to try to withhold $10 million from OFHEO's appropriation until a new OFHEO director would be appointed.

The enactment of a stronger supervisory framework in 2008 meant that the new regulator, the Federal Housing Finance Agency (FHFA) no longer was subject to the appropriations process. However, the political strength of the GSEs was reflected in the fact that the new legislation, improving as it did on the old law, continued to deny the regulator the mandate, discretion, or authority to regulate safety and soundness that federal bank regulators have long possessed.[20]

The new law, the Housing and Economic Recovery Act of 2008 (HERA) became law less than two months before Fannie Mae and Freddie Mac failed. Ultimately the two GSEs were not well served by their tradition of selecting politically capable CEOs who could fend off the kind of supervision that a more capable regulator might have been able to provide.

Because of their government backing and low capital requirements in their charters, Fannie Mae and Freddie Mac gained immense market power. They doubled in size every five years or so until in 2008 the two companies funded over $ 5 trillion of mortgages, over 40 percent of the mortgage market.

Their market power gave them political power. Whenever someone would urge regulatory reform, such as higher capital standards to reduce the GSEs' dangerous leverage, huge numbers of constituents could be expected to flood Capitol Hill.[21] That political power in turn entrenched the GSEs' market power.

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[20] To give but one example, the new law required the new regulator to conduct an estimated 25-30 rulemakings, often with short deadlines, to implement key provisions of the act. The bank regulators have discretion in many of the areas where HERA sought to impose inflexibility upon the FHFA through required rulemakings.

[21] Observers have long noted this pattern. "Builders, real estate brokers and bankers across the country rely so heavily on Fannie Mae for mortgage funds that they live in fear of offending the firm and routinely defend it in

The experience of Fannie Mae and Freddie Mac as privately owned institutions with extensive government backing shows the shortcomings of the government-sponsored enterprise as an organizational model. However sound the accountability structure may be when the organization begins, the incentive to satisfy private owners will lead a GSE to try to weaken safety and soundness oversight and lower capital standards. Both Fannie Mae and Freddie Mac arguably had more effective accountability structures when they were chartered as GSEs than when they were supervised by OFHEO. Between 1968 and 1992, when OFHEO was established, both companies had successfully removed government controls that they considered unacceptable.

In short, the drive to satisfy shareholders is intense and easily can overwhelm considerations of what might be best for the financial system, the housing system, or American taxpayers.

III. What Should be Done With the GSEs Now?

This question must be separated into two parts, first how the government should use the two failed GSEs to support today's troubled mortgage market, and second, what should happen with the GSEs in, say five years, after the housing market has begun to recover.

A. The government should place Fannie Mae and Freddie Mac into receivership and allow them to function as wholly owned government corporations to support the mortgage market.

The government placed Fannie Mae and Freddie Mac into conservatorship rather than receivership. Unlike receivership, the voluntary acceptance of conservatorship by Fannie Mae or Freddie Mac was not subject to litigation, which could have further roiled the financial markets. Placing a failed financial institution directly into conservatorship violates the customary practice of the federal bank and thrift regulators who first place an institution into receivership, then separate the assets into a "good-bank/bad-bank" structure and send the good bank, cleaned out of troubled assets, into conservatorship or bridge-bank status. Placing an institution into receivership removes the shareholders of the defunct institution. Thus, when IndyMac failed, it was placed into receivership. The receiver then transferred the deposits and most of the assets to a newly chartered thrift, IndyMac Federal Bank. The FDIC then placed itself as conservator of the new IndyMac Federal Bank.

As past losses materialize and are recognized by Fannie Mae and Freddie Mac it has become clear that both institutions have lost their entire net worth. It is time to place both companies into receivership. Placing both companies into receivership will help to remove an inherent conflict in the government's position. Technically, conservatorship means that the government is working to restore the companies to financial health. The government has preserved the shareholders in the two companies and allowed their stock to trade freely. This is inconsistent in key aspects with the government's need to use the two companies, now that the value of shareholder

Washington." David A. Vise, "The Money Machine: How Fannie Mae Wields Power," *Washington Post*, January 16, 1995, p. A14.

holdings in the companies is zero, to support the mortgage market. Until shareholders are removed from the equation, officers and directors of the two companies will face conflict as to their fiduciary responsibilities. Do they price mortgage purchases low to support the market or do they price higher to replenish the companies' shareholder value?[22]

With shareholders still in the equation government must try to cobble unwieldy support such as using the Federal Reserve to buy mortgage-backed securities of the two companies as a way to lower mortgage rates.

If the government placed both companies into receivership, then we could use Fannie Mae and Freddie Mac as agents of reform for the mortgage market. They could fund mortgages in a manner targeted to meet pressing public purposes. They could begin to impose essential consumer protections for borrowers, such as Alex Pollock's one-page borrower disclosure form.[23] They also could begin to devise and impose requirements that primary lenders and other participants in the mortgage process have appropriate financial strength and capability and accountability before they are allowed to do business with the two companies. In short, the government could turn the collapse of Fannie Mae and Freddie Mac into an opportunity to begin to fashion important rules of conduct for those types of participants in the housing market that have served American consumers and taxpayers so poorly. The government also could use the GSEs to help shore up the Federal Housing Administration by providing technical and IT systems support.[24]

The Congress also would be well advised to place a sunset provision of perhaps five years into each company charter. As the sunset approaches, and the mortgage debacle hopefully is behind us, policymakers can decide whether further support for the mortgage market is required, and the organizational form that is most suitable.

B. Fannie Mae and Freddie Mac should not again become privately owned organizations that operate with federal backing.

For many reasons, it is important now to end the GSE status of Fannie Mae and Freddie Mac. First, the GSEs have now squandered a policy tool that government had used for decades: the perception of an implicit rather than explicit federal guarantee of their debt obligations. That means that government would need to provide some form of express guarantee if the GSEs were to be restored. Second, as has was seen in the savings and loan debacle and now with the GSEs, the government risks far too much trying to insure the liabilities of a specialized financial institution. If policymakers were to seek to support the mortgage market they should authorize government guarantees of mortgage assets or, at most, mortgage-backed securities. Third, the government should not provide special charters to a limited number of specialized institutions.

[22] The two companies themselves complain of the conflict in their roles in conservatorship. Fannie Mae Form 10Q filing for the quarterly period ended September 30, 2008, p. 7; Freddie Mac Form 10Q filing for the quarterly period ended September 30, 2008, p.5.

[23] Alex Pollock's one page mortgage form can be found at http://www.aei.org/scholars/scholarID.88/scholar.asp. It is attached below.

[24] FHA's need for enhanced capacity is discussed, e.g., in Thomas H. Stanton, "Strengthening Government's Ability to deal with the Financial Crisis," IBM Center for the Business of Government, March 2009, found at http://www.businessofgovernment.org/pdfs/StantonFinancial.pdf.

As the GSEs have shown, it is virtually impossible to protect the regulator of a few institutions from being dominated. This is especially true if the regulated institutions operate under a law such as HERA, that provides for different rules, especially for capital, but also for other aspects of safety and soundness, than apply to other institutions in the same lines of business. Fourth, proposals to craft special rules such as trying to regulate the GSEs as public utilities or by limiting them to cooperative ownership will not overcome the vulnerabilities of the GSE as an institutional form that is based on political dominance. Consider each of these issues in turn.

The implicit government guarantee of GSE obligations is no longer available as a policy tool.

In earlier years, government was careful to preserve the option that it would decline to bail out holders of GSE obligations and GSE-guaranteed mortgage-backed securities. Treasury regularly counseled that the government's involvement should be characterized as merely the "perception of an implicit guarantee" rather than as an actual implicit guarantee. These niceties began to erode with the financial rescue of the failed Farm Credit System in the mid-1980s and the government's rush to support obligations of the Funding Corporation (FICO) in 1996. With the financial rescue of Fannie Mae and Freddie Mac debtholders and MBS-holders in 2008, the perception of implicit government backing of GSEs has become an anachronism. If the Federal Home Loan Bank System continues on its current financial trajectory, that institution may add to the market's expectations that a GSE is backed by an explicit rather than implicit government guarantee.

One consequence of the destruction of the implicit guarantee is that government in the future either will be required to provide an express guarantee, backed by the full-faith and credit of the United States, or none at all. Another consequence is that, unlike the former implicit federal guarantee, explicit government guarantees are subject to scoring on the federal budget comparable to the treatment of Ginnie Mae's financial guarantees by the Office of Management and Budget. The days of the GSE as a source of an off-budget government subsidy for housing finance are coming to an end.

The government risks far too much trying to insure the liabilities of a specialized financial institution.

As periodic failures of federal guarantee programs have shown,[25] the government can and sometimes does lose the capacity to supervise use of its financial guarantee. The Federal Housing Administration's single-family mortgage insurance program currently would seem to be especially at risk, for example.[26] However, a guarantee of assets rather than liabilities has several advantages for the government and taxpayers. First, asset guarantees are subject to oversight through the federal budget and the application of credit budgeting. This allows the Office of Management and Budget to monitor the risks involved in extending the guarantee and to provide

[25] See, e.g, Leonard Downie, Jr., *Mortgage on America*, Praeger Publishers, 1974, for a discussion of the failure of HUD single-family and multifamily programs in the early 1970s.
[26] See, e.g., HUD Secretary Steve Preston, Prepared Remarks at the National Press Club, November 19, 2008; and Barry Meier, "As FHA's Role Grows, So Does the Risk of Fraud," *New York Times*, December 10, 2008., available at http://www.hud.gov/news/speeches/2008-11-19.cfm, accessed January 2, 2009.

feedback to the agency and program through the annual process of reestimating the budgetary costs. As can be seen with programs such as federal deposit insurance and guarantees of the Pension Benefit Guaranty Corporation (PBGC),[27] for example, this form of supervision and discipline is sorely lacking for federal programs that guarantee liabilities rather than financial assets.

Second, it is less difficult to monitor the risks inherent in a guarantee of assets than in a guarantee of liabilities. For a guarantee of assets, the government must monitor the quality of origination, servicing, and collections, and the credit quality of the assets themselves. By contrast, monitoring a guarantee of liabilities of a financial institution involves trying to assess the quality of the institution's management, its capitalization, its accounting practices, and many other potential sources of risk besides the quality of its assets.

Third, as was seen most clearly in the savings and loan debacle, a federal guarantee of an institution's liabilities creates a form of moral hazard that can greatly multiply the government's risk exposure, compared to the actual volume of liabilities that government believes that it is guaranteeing. By contrast, when government guarantees financial assets or even pools of financial assets, it can provide for risk sharing that, at least in principle, can reduce the government's potential losses.

For all of these reasons, if government can avoid guaranteeing the liabilities of a private institution, it should do so. In the case of providing support for the residential mortgage market, this conclusion is bolstered by the fact that federal mortgage insurance, or perhaps a federal guarantee of pools of mortgages, with appropriate risk-sharing with the loan originator, can provide needed support for the mortgage market without incurring the risks involved in trying to guarantee the liabilities of a GSE. It seems prudent that the future structure of housing finance must take account of the difficulty that both public and private sector managers can have in trying to manage a large volume of assets and mortgage-backed securities.

The government should not provide special charters to a limited number of specialized institutions.

Regulatory capture is a major problem for federal regulators of all types.[28] The problem is especially acute for a regulator of only a few institutions. Such a regulator can be expected to assume a parochial point of view compared to a regulator with responsibility for supervising a plethora of institutions with varying interests and perspectives.[29] The problem becomes

[27] The law states that liabilities of the PBGC are not backed by the United States. As with the backing of GSE obligations that the GSEs disavow in their loan documentation, no one believes this.
[28] See, e.g., Marver Bernstein, *Regulating Business by Independent Commission*, Princeton University Press, 1955.
[29] The GAO has made similar observations and earlier recommended that all of the GSEs be supervised by a single high-level regulator:

> "Because of its important responsibility to supervise the safety and soundness of all the enterprises, the members of the independent regulator's board need to have sufficient status, respect in government and business, and financial expertise. GAO proposes a three-member board composed of a full-time chairperson who acts as the chief executive officer of the regulatory staff, the Secretary of the Treasury, and the Chairman of the Federal Reserve System."

U.S. General Accounting Office, *Government-Sponsored Enterprises: a Framework for Limiting the Government's Exposure to Risks*, GAO/GGD-91-90, May 1991, p. 8. This recommendation failed to be adopted, in part because it especially acute for institutions such as GSEs that fall into a hybrid category between other organizational types. Take, for example, the issue of appropriate capital standards: should GSE capital standards be set according to bank-type standards or according to the standards that state regulators apply to private mortgage-backed securities conduits? A regulator with responsibility for supervising only the housing GSEs is likely to move towards the lower capital standards. This opens the door to regulatory arbitrage and the likelihood that the GSEs once again would resume their excessive growth, based on their regulatory advantages rather than on whether it makes sense to concentrate so much risk in a few specialized financial institutions.

The inability of the Congress to set bank-type capital standards for Fannie Mae and Freddie Mac or to create for them a supervisory framework that was at least as strong as the supervisory framework for banks stands as a warning of the political dynamics that are at play here. As specialized institutions, GSEs tend to be the province of parochial committees or subcommittees of the Congress that are attuned to the benefits of GSEs for the stakeholders whom they serve and are relatively insensitive to the need to protect ordinary taxpayers from having to pay for an expensive rescue.

The prospect of differential capital and other supervisory requirements that permit regulatory arbitrage relates to the problem of GSEs becoming not only "too big to fail," but also "too big to succeed." Along with other financial institutions, Fannie Mae and Freddie Mac have shown, at great cost to the residential mortgage market and larger financial system, that the GSEs and their politically oriented managers lack the ability to manage such large institutions. The failure of internal controls at both GSEs occurred in 2003-4, when they were smaller than they were when they failed completely several years later.

Again, if government guarantees assets rather than liabilities, support can be provided to the residential mortgage market without incurring the political and financial risks that a GSE entails.

III. Evaluating the GSE as an Organizational Form

The Government Sponsored Enterprise tends to have greater capacity and flexibility than the government agency, but is much less accountable and exhibits life cycle vulnerabilities.

Four criteria are helpful in evaluating the quality of agencies and instrumentalities of government that carry out public purposes:[30]

> *Capacity*: What is the capacity of the organization, in terms of people, administrative budget, systems, and organization, to carry out its public purposes?

could have placed congressional jurisdiction over the regulator into a broad-based committee such as the House Ways and Means Committee rather than in the hands of the GSE authorizing committees.

[30] See, e.g., Thomas H. Stanton, "The Administration of Medicare," *Washington and Lee University Law Review*, 2003; and, Thomas H. Stanton, "Moving Toward More Capable Government: A Guide to Organizational Design," Chapter 1 in Thomas H. Stanton, ed., *Meeting the Challenge of 9/11: Blueprints for Effective Government*, M.E. Sharpe Publishers, 2006.

Flexibility: What flexibility does the organization have, under the law and in practice, to carry out its public purposes?

Accountability: How well is the organization held accountable for (1) carrying out its public purposes, and (2) its stewardship of public resources?

Life Cycle: As the organization matures, what strengths and shortcomings manifest themselves?

For different organizations different measures will become more critical than others in understanding strengths and weaknesses. As a general rule, to the extent that weaknesses appear, government departments may have difficulty with the measures of capacity and flexibility, while privately owned instrumentalities may have difficulty with accountability. Numerous organizations of all types have difficulty with life-cycle, and the ability to remain active, focused and useful over many years.

Government sponsored enterprises are privately owned institutions free from the budgetary and other constraints imposed on government agencies. As such they tend to develop significant capacity and flexibility compared to government agencies that serve the same economic sector. A comparison of mortgage operations of Fannie Mae and Freddie Mac on the one hand and the Federal Housing Administration (FHA), on the other, displays this pattern.

On the other hand, the issue of accountability is salient for GSEs, and Fannie Mae and Freddie Mac in particular. As private companies operating with substantial government subsidies, GSEs often grow to dominate their markets. Market power leads to political power which in turn leads to favorable changes to the GSE's charter to help expand its market power and reduce the effectiveness of any accountability framework government may seek to apply to the GSEs.

The issue of life cycle is also important for the GSEs. The rapid growth of GSEs, combined with their dominance of accountability measures such as government oversight and capital requirements can lead to flawed business decisions.[31] The current crisis in the mortgage market raises issues of GSE accountability and life cycle with special force.

Proposals to craft special rules such as trying to regulate the GSEs as public utilities or by limiting them to cooperative ownership will not overcome the vulnerabilities of the GSE as an institutional form that is based on political dominance.

Proposals to create a different accountability framework or governance structure for Fannie Mae and Freddie Mac do not change the assessment of the GSE, even with those changes, as an organizational form. Most importantly, the issue of political dominance of the GSEs over their regulators and GSE influence over their congressional authorizing committees will not go away.

Some have suggested that Fannie Mae and Freddie Mac can be regulated as public utilities. This suggestion has several defects. The first issue relates to the purpose of utility regulation.

[31] See, e.g., Thomas H. Stanton, "The Life Cycle of the Government-Sponsored Enterprise: Lessons for Design and Accountability," *Public Administration Review*, September/October 2007.

Regulation is called for when public utilities benefit from scale economies that may give them characteristics of monopolies; price regulation by a public utility commission seeks to prevent a public utility from imposing monopoly pricing on its customers.

In other words, rather than limiting the size of a public utility, government accepts a utility's dominant market position and seeks to limit the high prices that could result. But taxpayers are far too much at risk if the GSEs grow to hold a dominant position in the mortgage market, regardless of price regulation. Given that the problem facing taxpayers in today's context is one of limiting the size of GSEs and their financial risks rather than controlling monopoly pricing, the public utility model is not relevant.

Secondly, regulated companies too often capture their regulators. Many a political scientist has written, for example, about the dominance of the Interstate Commerce Commission by the railroads that the ICC was supposed to regulate. The GSEs would simply shift the application of their political power from domination of their past regulators to the new public utility regulator.

Third, the creation of a separate utility-type regulator for the GSEs, rather than merging supervision with the responsibilities of a regulator that supervises banks and thrifts as well as GSEs, again would encourage the preferential capital and supervisory requirements that lie at the core of GSE financial vulnerability.

In short, application of a public utility model to Fannie Mae and Freddie Mac would perpetuate many of the vulnerabilities and large-scale risks of the GSE model that lie at the root of their failure in 2008.

A cooperative governance structure also fails to add quality to the GSE model. This has been seen among the GSEs in the financial failure of the Farm Credit System in the mid-1980s and the precarious financial condition of the Federal Home Loan Banks today. While the investor-owned GSE seeks to increase risk to serve its investor owners, the cooperative GSE has an incentive to increase risk to serve its owners that use its services. That was seen in the efforts of the Farm Credit System to provide credit to its cooperative borrowers below the GSE's own cost of funds. That approach could not be sustained and led to the system declaring insolvency in the mid-1980s.

IV. To Help Stabilize the Mortgage Market the Government Should Provide Support to the Residential Mortgage Market Through One or Two Wholly Owned Government Corporations. Thereafter the Government Should Largely Withdraw From Supporting the Secondary Market

As has been recommended above, the government should promptly end Fannie Mae and Freddie Mac as investor-owned companies with perceived federal backing and turn today's Fannie Mae and Freddie Mac into separate wholly owned government corporations. At some specified time, say five years from now, when the mortgage market stabilizes once again the government would wind up those corporations.

This approach deals both with the capacity and the life-cycle disadvantages that otherwise can accompany the creation of wholly owned government corporations. Having a five year sunset period would allow the wholly owned government corporations to provide support for the mortgage market at a critical time. The experience of the Resolution Trust Corporation (RTC) indicates how a temporary government corporation can develop the capacity to deal with complex financial issues. It does this by attracting high-quality talent who might not contemplate a longer term career in government. The RTC was impressive in the way that it evolved constant improvements in its approach to its mission.[32]

Even though the Congress could allow one or both of the government corporations to sunset at the end of their charter terms, this is not a foregone conclusion. The continuation of a government corporation could appeal to some policymakers because of the ability to use revenues from mortgage operations to support affordable housing, which the congressional housing subcommittees strongly favor.

Some argue that government support is needed to ensure access to the 30-year fixed-rate mortgage at all times during the credit cycle. The presence of the GSEs, with their massive federal subsidies, has distorted the market so that we have no clear idea what the private market will be able to fund by itself. One possibility would be to use a government corporation to provide government support for a 30-year fixed-rate mortgage only for selected borrowers such as first-time homebuyers.

Just as one must question whether a GSE or other private institution is properly manageable once it funds, say, a trillion dollars of mortgages, one must also question whether managers of wholly owned government corporations will be up to the task. As a matter of protecting taxpayers from excessive financial risk there should be limits on the size of both public and private institutions that provide financial support to the mortgage market. One clear lesson of the current debacle is that it is too risky to maintain immense financial institutions of any kind over the long term. This logic may lead policymakers to sunset the government corporations that have been proposed here to assist during the current period of instability. If so, the model of the wholly owned government corporation would remain available when needed to provide government support for the mortgage market in the event of any future crisis.

V. Conclusion

The government sponsored enterprise has outlived its usefulness as an instrument of government policy. While other financial institutions have also shown vulnerability, the GSE appears to be especially prone to dominating any reasonable accountability structure. GSEs are simply too powerful for their own good. Fannie Mae and Freddie Mac, now demonstrably insolvent, should be placed into receivership and turned into wholly owned government corporations that sunset after perhaps five years. As such they could support the mortgage market, not only through their access to government funding, but also by imposing rules for consumer and investor protection,

[32] See, e.g., Thomas H. Stanton, "Lessons Learned: Obtaining Value From Federal Asset Sales," *Public Budgeting & Finance*, Spring 2003.

capital requirements on mortgage market participants, and other protective measures that policymakers could apply to the rest of the housing finance system.

About the Author

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Press Center

Treasury Department Announces Further Steps to Expedite Wind Down of Fannie Mae and Freddie Mac

8/17/2012

Modifications to Preferred Stock Purchase Agreements Will Make Sure That Every Dollar of Earnings Fannie Mae and Freddie Mac Generate Will Benefit Taxpayers

Announcement Will Support the Continued Flow of Mortgage Credit during a Responsible Transition to a Reformed Housing Finance Market

WASHINGTON -- The U.S. Department of the Treasury today announced a set of modifications to the Preferred Stock Purchase Agreements (PSPAs) between the Treasury Department and the Federal Housing Finance Agency (FHFA) as conservator of Fannie Mae and Freddie Mac (the Government Sponsored Enterprises or GSEs) that will help expedite the wind down of Fannie Mae and Freddie Mac, make sure that every dollar of earnings each firm generates is used to benefit taxpayers, and support the continued flow of mortgage credit during a responsible transition to a reformed housing finance market.

"With today's announcement, we are taking the next step toward responsibly winding down Fannie Mae and Freddie Mac, while continuing to support the necessary process of repair and recovery in the housing market," said Michael Stegman, Counselor to the Secretary of the Treasury for Housing Finance Policy. "As we continue to work toward bi-partisan housing finance reform, we are committed to putting in place measures right now that support continued access to mortgage credit for American families, promote a responsible transition, and protect taxpayer interests."

The modifications to the PSPAs announced today are consistent with FHFA's strategic plan for the conservatorship of Fannie Mae and Freddie Mac that it released in February 2012. The modifications include the following key components:

Accelerated Wind Down of the Retained Mortgage Investment Portfolios at Fannie Mae and Freddie Mac

The agreements require an accelerated reduction of Fannie Mae and Freddie Mac's investment portfolios. Those portfolios will now be wound down at an annual rate of 15 percent – an increase from the 10 percent annual reduction required in the previous agreements. As a result of this change, the GSEs' investment portfolios must be reduced to the $250 billion target set in the previous agreements four years earlier than previously scheduled.

Annual Taxpayer Protection Plan

To support a thoughtfully managed wind down, the agreements require that on an annual basis, each GSE will – under the direction of their conservator, the Federal Housing Finance Agency – submit a plan to Treasury on its actions to reduce taxpayer exposure to mortgage credit risk for both its guarantee book of business and retained investment portfolio.

Full Income Sweep of All Future Fannie Mae and Freddie Mac Earnings to Benefit Taxpayers for Their Investment

The agreements will replace the 10 percent dividend payments made to Treasury on its preferred stock investments in Fannie Mae and Freddie Mac with a quarterly sweep of every dollar of profit that each firm earns going forward.

This will help achieve several important objectives, including:

- Making sure that every dollar of earnings that Fannie Mae and Freddie Mac generate will be used to benefit taxpayers for their investment in those firms.
- Ending the circular practice of the Treasury advancing funds to the GSEs simply to pay dividends back to Treasury.
- Acting upon the commitment made in the Administration's 2011 White Paper that the GSEs will be wound down and will not be allowed to retain profits, rebuild capital, and return to the market in their prior form.
- Supporting the continued flow of mortgage credit by providing borrowers, market participants, and taxpayers with additional

confidence in the ability of the GSEs to meet their commitments while operating under conservatorship.

- Providing greater market certainty regarding the financial strength of the GSEs.

For a copy of the modification agreements for the PSPAs, please visit, link and link .

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The Resolution of Systemically Important Financial Institutions: Lessons from Fannie and Freddie

By Mark A. Calabria

January 13, 2015

CATO WORKING PAPER

No. 25/CMFA No. 1

CATO INSTITUTE | Center for Monetary and Financial Alternatives

1000 Massachusetts Avenue NW, Washington DC 20001

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The Resolution of Systematically Important Financial Institutions: Lessons from Fannie and Freddie

Mark Calabria[1]

There was perhaps no issue of greater importance to the financial regulatory reforms of 2010 than the resolution, without taxpayer assistance, of large financial institutions. The rescue of firms such as AIG shocked the public conscience and provided the political force behind the passage of the Dodd-Frank Act. Such is reflected in the fact that Titles I and II of Dodd-Frank relate to the identification and resolution of large financial entities. How the tools established in Titles I and II are implemented are paramount to the success of Dodd-Frank. This paper attempts to gauge the likely success of these tools via the lens of similar tools created for the resolution of the housing government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac.

An additional purpose of this paper is to provide some additional "legislative history" to the resolution mechanisms contained in the Housing and Economic Recovery Act of 2008 (HERA), which established a resolution framework for the GSEs similar to that ultimately created in Title II of Dodd-Frank. The intent is to inform current debates over the resolution of

[1] Director of Financial Regulation Studies, the Cato Institute. The author served as senior professional staff on the United States Senate Committee on Banking, Housing and Urban Affairs from April 2003 to April 2009. In his capacity on the Banking Committee staff, he served as one of the primary drafters and negotiators of the Housing Economic and Recovery Act of 2008, as well as the Banking Committee's GSE reform bills of 2004 and 2005. It is in that capacity which the following "legislative history" is recalled. Accordingly emphasis will be on Senate proceeding. As the conservator and receiver provisions ultimately included in HERA are those devised by the Senate, omitting coverage of House proceedings does not diminish the arguments advanced here.

systemically important financial institutions by revisiting how such issues were debated and agreed upon in HERA.

Purposes of a Resolution Authority

To gauge the effectiveness of a resolution regime, it helps to have a clearly defined set of goals or purposes. In the area of bank resolution, there is considerable consensus as to those goals.[2] Many of these goals were explicated, debated, and examined by members of Congress and their staffs during the drafting of GSE reform.

Foremost among the purposes of a resolution regime, including a court-supervised bankruptcy, is to decide on the allocation of losses. In most circumstances, and definitely the case for a GSE resolution, the book value of liabilities will exceed the book value of assets. Given that book value can lag market value, the fair value of this difference can be quite substantial in a resolution. In the simplest terms, someone is not getting 100 cents on the dollar.

A resolution regime determines the process, the priorities, and even the "hair-cuts" imposed on creditors. Such a process was absent for the GSE before the passage of HERA. For instance prior to HERA, holders of agency mortgage-backed securities (MBS) had no guarantee that they would receive a higher priority in the resolution process than holders of unsecured GSE debt. In part this was due to the fact that the GSE did not organize their MBS pools as

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[2] Generally see Phoebe White and Tanju Yorulmazer, 2014 "Bank Resolution Concepts, Trade-offs, and Changes in Practices", *Economic Policy Review*, Federal Reserve Bank of New York, Volume 20, Number 2 http://www.newyorkfed.org/research/epr/2014/1403whit.html

bankruptcy-remote trusts, as had been the case with private MBS pools. Specifying a chain of priorities can give market participants greater certainty as to their potential recovery in insolvency. Doing so also assists market participants in the pricing of different tranches of debt. As the largest cost in a corporate bankruptcy is generally the operation of a creditor committee, a resolution regime that specifies creditor priorities can substantially reduce administrative costs.

A resolution regime can also explicitly favor certain creditors over others. For instance the FDIC has generally treated foreign depositors differently than U.S. domestic depositors.[3] Of course the very structure of the FDIC treats depositors as a class separate from unsecured creditors. As witnessed in a variety of instances during the recent crisis, policymakers may also choose, *ex post*, to treat certain creditors more favorably than others without any statutory authority.

Administrative resolutions are occasionally claimed to be superior to a court-supervised bankruptcy due to concerns over potential contagion or panics.[4] During the financial crisis it was often claimed that firms could not be allowed to enter bankruptcy without causing a broader panic. The failure of Lehman Brothers is pointed to as evidence of this concern. While there is little debate over the ability of bankruptcy courts to resolve financial firms and allocate losses, the question is one of speed. The FDIC, for instance, allows insured depositors, and occasionally other creditors, to be paid immediately. While this is allowable under the bankruptcy code, it is not usual practice. Title II of Dodd-Frank is essentially a mechanism for quickly resolving non-bank financials in a manner similar to that for banks, with the exception that Title II appears on

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[3] See Christopher Curtis, 2000, "The status of foreign deposits under the federal depositor-preference law," *University of Pennsylvania Journal of International Economic Law* 21, Summer, 237-271.
[4] Federal Deposit Insurance Corporation. 2011. "The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act", *FDIC Quarterly* Volume 5 #2.
https://www.fdic.gov/bank/analytical/quarterly/2011_vol52.html

its surface only to allow for liquidation. It also allows for the protection of certain creditors to forestall a panic. Accordingly, an administrative resolution regime is presented as an avenue for containing financial market contagion.

Whether an administrative resolution is quicker than a court-supervised bankruptcy is an empirical question. Both an administrative agency and court face similar tasks, such as judging the validity of claims. For most, if not all, of these tasks there is no “special sauce” that agencies have which courts lack. While the data is sparse, with important limitations, what data that does exist, suggest that FDIC receiverships are no faster than the typical Chapter 11 proceeding.[5] Both have a median time to resolution of 28 months. Since the FDIC is generally the largest creditor in the resolution of a depository, having the FDIC manage the failure of a depository may indeed offer some cost savings. In the case where the FDIC is not the largest creditor, for instance with an insurance company, it is far from obvious that the FDIC is cost effective.

A related, but separate, issue to contagion is the importance of maintaining “critical facilities.” A rationale for deposit insurance is protecting the payments system. Given the important role of certain banks in the tri-party repo market, one could also imagine assistance being provided for those entities. If the resolution process for an entity administering critical facilities is uncertain, the ability of those facilities to access credit and basic services may indeed be hindered. Thus, both the bankruptcy code and FDIC administrative proceedings allow continued operation of the troubled entities during the resolution process. The central role of the GSEs in the U.S. mortgage market also demanded that a continuing operation of core facilities be possible should a GSE become insolvent.

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[5] Mark Calabria. 2010. *Failing Banks: Bankruptcy or Receivership?* Cato-At-Liberty. http://www.cato.org/blog/failing-banks-bankruptcy-or-receivership

All of the preceding rationales for a resolution framework were debated, either at the staff or member level, during the drafting of GSE reform. The included legislative history[6] is intended to shed some light on the substance and conclusion of those debates. The following is also meant to illustrate that regulators were not simply left helpless and without appropriate "tools" by Congress.

Comparing Bank and GSE Resolution

The resolution framework for the GSEs is explicitly modeled on the Federal Deposit Insurance Act, as is the orderly resolution authority established in Title II of Dodd-Frank. There are a number of important differences between GSEs and depositories that require some modifications to the traditional FDIC approach.

There are also a number of differences in the GSEs model that make resolution relatively simpler than similarly sized bank (bear in mind that by level of assets, Freddie Mac is close in size to Citibank).[7] One difference that has vexed policymakers is the issue of cross-border resolution. Given the many foreign subsidiaries of large U.S. banks and the difference in national resolution regimes, handling the failure of a large internationally active entity remains an important public policy issue. Fortunately that is not an issue with Fannie Mae or Freddie

[6] Of course one person's faulty recollection of events, sometimes a decade previous, does not officially constitute "legislative history" in any legal sense. The recollections provided here are meant to inform on-going and future debates as to the resolution of large financial companies.

[7] For a fuller comparison, see Larry Wall, W. Scott Frame and Robert Eisenbeis. 2004. "Resolving Large Financial Intermediaries: Banks Versus Housing Enterprises," Federal Reserve Bank of Atlanta Working Paper No. 2004-23a; and David Carpenter and M. Maureen Murphy. 2008. "Financial Institution Insolvency: Federal Authority over Fannie Mae, Freddie Mac, and Depository Institutions," CRS Report for Congress. Congressional Research Service. September 10.

Mac. Neither have foreign subsidiaries. There is no need to for Washington (or New York) to coordinate with London (or elsewhere) in the resolution of a GSEs.

Relatedly, the GSEs are relatively simple organizations when compared to similarly-sized financial companies. Their legal structures are not particularly complex. Questions as to the relationship between subsidiaries and a holding company are not relevant. Questions as to the relationship between affiliates, such as those raised under Sections 23A and 23B of the Federal Reserve Act, are not relevant. GSEs engage in a relatively small number of activities and ones that are transparent and easily understood. Their core business is not a mystery. As such, a GSE is far easier to reorganize or resolve than a comparably sized bank.

The GSEs also lack debt that could be described as "demandable." Almost all their debt issuance is relatively long-term, with only about half coming due within a year. Text book style bank runs simply are not an issue with the GSEs, although roll-over risk may be a concern.[8] About half of GSE debt is in the form of MBS, which offer the security of the underlying mortgages as collateral.

Contrary to popular perceptions, the FDIC generally avoids liquidating a failed bank. The preferred strategy is to sell the bank "whole" in a "purchase and assumption" transaction to another bank. Under such circumstances, there is no liquidation. The purchasing bank takes both the assets and liabilities of the failed bank, occasionally with some assistance from the FDIC. It was recognized that such a strategy would be both politically and administratively difficult for a failed GSE. Obviously the size of either Fannie Mae or Freddie Mac would make a direct purchase unlikely. And even if such a purchase could be arranged, Congress wanted

[8] For Fannie Mae's outstanding debt, due within one year, the effective term to re-pricing generally runs between 4 and 5 months. For Fannie Mae's longer term outstanding debt, the typical effective term to re-pricing is 60 months.

ultimate say over such a transaction. Accordingly HERA explicitly relies on a "bridge bank" structure under which an insolvent GSE continues its operations and the existing charter is retained. As with the FDIC, conservatorship was not viewed as a likely option for an insolvent entity. Conservatorship was largely perceived as a "holding tank" for an illiquid GSE. Conservatorship for a GSE was envisioned to last no more than six months, after which a GSE would be expected to either leave conservatorship or enter receivership.

The Road to GSE Resolution Authority

> **Chairman Richard Shelby**: "There is a perception by some people that some of the largest banks are too big to fail.…In that context, do we need to give the new proposed GSE regulator the same type of systemic risk powers that FDIC has?
>
> **Chairman Alan Greenspan**: "I would certainly think so, sir."
>
> Hearing before the Senate Committee on Banking, Housing and Urban Affairs, February 24, 2004

On June 9, 2003, Freddie Mac dismissed its three most senior executives, including its CEO.[9] It was later revealed that Freddie Mac had been engaged in manipulating its earnings; a finding applied to Fannie Mae almost a year later. Of additional concern is that its then regulator, the Office Of Federal Housing Enterprise Oversight (OFHEO), in its annual Report to Congress, also released in June 2003, praised Freddie Mac's audit and accounting functions as

[9] http://articles.baltimoresun.com/2003-06-10/news/0306100348_1_freddie-mac-weakness-chief-financial-officer

"independent and effective," as well as claiming that Freddie Mac's internal audit function "appropriately identifies and communicates control deficiencies to management and the Board of Directors."[10] Those observations on the part of OFHEO proved stunningly wide of the mark.

Public and congressional concerns as to the potential systemic risk of the GSEs were nothing new. What gave much needed energy to the debate was the sudden loss of confidence in their accounting and also in the competence of their regulator. The events of June 2003 and subsequent congressional hearings that fall led many in Congress to believe that no one was "watching the store"—not the management, not the board, and unfortunately not the regulator. What was needed, at a minimum, was a new regulator with enhanced powers. At no time during the 2003 to 2008 congressional debates was serious consideration given to eliminating the GSEs, which was seen as politically impossible. As a participant in those debates, I can attest that just imposing "bank-like" prudential standards on the GSEs was hard enough politically. Reform was almost exclusively focused on the powers of the regulator.

During the 108th and 109th congressional sessions, Senator Richard Shelby (R-AL) chaired the Senate Banking Committee and led efforts to reform the regulatory structure of the GSEs. The author served on Chairman Shelby's staff during that time. Senator Shelby's instructions to staff were to create a GSE regulator that was as "bank-like" as possible. While the 2003 Shelby bill was based upon a bill in the House of Representatives (H.R. 2575) introduced by Representative Richard Baker (R-LA), it was felt that the receivership provisions of the Baker bill (section 134) did not sufficiently mirror the existing framework for depository institutions.

[10] OFHEO, *Report to Congress*, June 2003, pages 36-37.

The 2004 Shelby bill was considered by the Banking Committee on April 1, 2004, using Senator Hagel's bill (S. 1508) as the base text for the mark-up. Essentially the entire text of S. 1508, as introduced, was struck and replaced by a Chairman's "mark" drafted by Chairman Shelby's staff. S.1508 was reported out of Committee with receivership provisions that more closely mirrored the Federal Deposit Insurance Act. These provisions were later modified and included in the 2005 Senate consideration of GSE reform, where the base text was S.190, marked-up by the Banking Committee on July 28, 2005.

In crafting the conservator and receivership provisions that eventually comprised Section 1145 of HERA, the Committee staff, under the direction of Chairman Shelby, quite literally "marked-up" Sections 11 and 13 of the Federal Deposit Insurance Act (FDIA). Every line of those sections was examined and debated over to consider whether they would be appropriate for GSEs. The presumption was that FDIA powers would apply to a GSE resolution, unless there was a compelling reason otherwise. By that time the Committee also had little faith in the ability of the GSE regulator. It was anticipated that OFHEO or any successor organization would not implement regulations surrounding a GSE conservator or receivership before they were needed. The authorities contained in statute would have to suffice on their own. It was also intended that the existing body of law, including court decisions, surrounding the FDIC's exercise of its conservator and receivership powers be incorporated into that governing the GSEs.

It was recognized that doing so would give the new GSE regulator considerable—some would say extraordinary—power. This was intentional. By placing the GSEs within the body of law governing bank receivership the Committee intended to create additional certainty over how a GSE would be resolved in the case of insolvency. It was also the understanding and intent of the drafters that such powers would be used. The receivership provisions contained in HERA were never intended to be a "dead letter." They were meant to be used.

The Banking Committee considered the approach of placing the GSEs within the bankruptcy code. Contributing to the uncertainty of how a failed GSE would be handled is that prior to 2008, the GSEs were understood by many to be exempt from the bankruptcy code, although such is not explicit. In the absence of either explicit court or administrative powers, the failure of a GSE could well force a congressional rescue and at a minimum would entail significant uncertainty. During the Committee mark-up of S.1508 in 2004, Senator John Sununu (R-NH) offered amendments that would have allowed the regulator to file a bankruptcy petition in the case of GSE insolvency. The Sununu amendments also clarified that a GSE would not be treated as a "governmental unit" for the purposes of a bankruptcy. The Sununu amendments were withdrawn and never voted upon. The primary concern was that by including these amendments jurisdiction over the proposed legislation might be extended to the Senate Committee on the Judiciary, which has jurisdiction over the bankruptcy code. Given the existing complexity of reform, involving negotiations with another committee were viewed as an unsurmountable obstacle to reform. These provisions were not rejected because any perceived inadequacies in the bankruptcy process.

The conservator and receivership provisions in HERA were largely taken from the 2005 Shelby bill (S.190 as amended in Committee). Little debate in 2008 occurred around these provisions, despite the change in control of the Senate from Republicans to Democrats. The following are a number of specific issues debated within the Senate Banking Committee in the years leading up to the passage of HERA.

The Role of the U.S. Treasury

A crucial question during GSE reform was where to house the new regulator. The Bush administration initially proposed to model the new regulator on the Office of the Comptroller (OCC) and place it within the Department of the Treasury. A bill (H.R. 2803) was introduced in the House by Representative Ed Royce (R-CA) in July 2003 that followed this suggestion. By the time the Senate began its deliberations and in response to congressional objections, the Bush administration softened its preferences for Treasury control, only stipulating certain conditions that should apply and expressing some preference for those conditions.[11]

Regardless of the preferences of the Bush administration, momentum in Congress quickly built against a policy or supervisory role for the Treasury Department. Generally Democrats did not trust the Bush Treasury, fearing a too aggressive regulator, while Republicans feared that housing the regulator within the Treasury would "harden" the implied guarantee, as market participants might perceive such as bringing the GSEs ever closer to having their debt viewed as equivalent to treasuries.

The Treasury, or its related agencies (Office of the Comptroller of the Currency), are often given important roles in the supervision and resolution of depositories. The OCC, as the primary regulator of national banks, can appoint the FDIC as receiver of a national bank. The Treasury Department also has a critical role to play when the systemic risk exceptions to the least-cost resolution requirements of Section 13G of the Federal Deposit Insurance Act are invoked. Congress specifically and intentionally gave FHFA sole authority over a GSE conservatorship or receivership. Only FHFA can decide when a GSE enters or leaves. No other

[11] See Statement of John W. Snow, Secretary, U.S. Department of the Treasury, before the United States Senate, Committee on Banking, Housing and Urban Affairs, October 16, 2003.

entity has legal authority to appoint FHFA as conservator or receiver. Nor is there any systemic risk exception contained in HERA.

The sole authority granted to the Treasury under the GSE provisions of HERA is in the exercise of its rights as a creditor, should it provide assistance to the GSEs. While a creditor can, of course, negotiate certain provisions as a condition of providing credit, under no circumstances can those conditions supersede other provisions of law. The Treasury has no authority to assume the powers of a conservator via its rights as a creditor. The Treasury can no more, as a creditor, bind FHFA's authorities, than could a holder of bank debt bind the powers of FDIC. Moreover, FHFA, as an independent regulator, has no authority to delegate its powers as a conservator/receiver to the Treasury or any other government agency.

The role of the Treasury was viewed under HERA as that of a creditor. The Treasury was directed to consider issues of priority and protection of the taxpayer. In addition, such assistance was intended to be temporary, as is the nature of credit, rather than perpetual, as is the nature of equity. Put simply Treasury assistance to the GSEs was envisioned to take the form of a senior debt, something like debtor-in-possession financing. Such assistance was not intended to keep the GSEs out of receivership or to transfer losses from creditors to the taxpayer.

Avoiding "Takings" Claims

Ours is a Litigious Society. The design of any resolution framework must take such into consideration. Such was explicitly examined during the construction of a resolution framework for the GSEs. In order to obtain federal deposit insurance, bank owners agree to accept the terms of the bank charter and the legal framework surrounding those terms. As such, their ownership in a bank can have considerable value. That value can be lost in a resolution. In fact one of the objectives of a resolution may well be to impose losses on equity.

The FDIC has authority to invoke a receivership when a depository institution still has some positive book value. Committee staff were concerned that if FHFA could invoke a receivership while a GSE still had a positive book value, then shareholders could make a "takings" claim.[12] For this reason, a mandatory receivership is not invoked until a GSE has a book value of zero or less. Furthermore, shareholders would also receive any excess value obtained from the performance of a failed GSE's assets. HERA establishes a "good bank/bad bank" or bridge bank model to allow a failed GSE to be quickly reorganized. In such reorganization, shareholders are left with the "bad" bank, but could receive any excess value should assets end up being worth more than liabilities.

Treatment of Favored Creditors

A resolution mechanism can explicitly prefer some creditors over others, regardless of what place in line those creditors have contracted for. A variety of entities are significant holders of GSE debt. Insured depositories have large holdings of GSE debt, as do other financial market participants, such as insurance companies and pension funds. Of particular importance are the large holdings of GSE debt by foreign governments, especially foreign banks. Some of these central banks, such as the Chinese and Russian, have unique and critical relationships with the United States. These central banks are also large purchasers of U.S. Treasury debt. The Banking Committee was not unaware of these relationships. In fact concerns were repeatedly

[12] The fifth amendment's requirement that not private property not be taken by government without compensation could potentially arise when a public company is acquired by the government while there is some probably that shareholders equity still have a positive value, see generally Richard A. Epstein (1985). *Takings: Private Property and the Power of Eminent Domain*. Cambridge: Harvard University Press

voiced that if left to the Treasury, credit losses on GSE debt holders by foreign central banks would transferred to the American taxpayer. This was viewed as an unacceptable outcome. The lack of an explicit creditor preference for foreign agencies is not due to Congress having overlooked the issue, but rather to Congress having rejected such a preference.

Conservatorship versus Receivership

As a rough approximation, about 90 percent of the energy and thinking of Congress in relation to resolution were devoted to receivership as opposed to conservatorship. Similar to bank conditions under the FDIC, it was assumed that conservatorship would rarely be used and if it was used, it would be brief. As it clear under HERA, any reorganization or wind-down would occur under a receivership, which itself had explicit time limits, albeit measured in years. The receivership framework created in HERA was established both because the existing conservatorship framework was inadequate but also because conservatorship itself was believed inadequate. The limbo currently being experienced by the GSEs was never intended by Congress and is quite contrary to the framework established in HERA.

The Path Not Taken

The preceding demonstrates that most, if not all, the rationales asserted commonly for the rescue of large financial entities were contemplated and addressed in regards to the GSEs in HERA. The tools to resolve a failed GSE, without cost to the taxpayer, were created and in place by September 2008. Those tools closely mirror both the Federal Deposit Insurance Act and those created in Title II of Dodd-Frank. Yet, those tools where not used.

As the FHFA and Treasury only offer vague generalities at the commencement of the conservatorships of Fannie Mae and Freddie Mac, one can only parse their statements and actions for the actual intent. Certainly the primary objective of Treasury and FHFA was to guarantee that GSE creditors did not take losses, despite clear statutory intent otherwise. As Dodd-Frank's Title II is presented as a way to impose losses on creditors, this issue is of paramount importance if Dodd-Frank is to have any credibility.

There are at least three reasons that the Treasury and FHFA may have wanted to protect GSE creditors. The first is foreign policy concerns. Foreign governmental entities, including central banks, are large holders of GSE debt. Despite Congress having contemplated and rejected treating foreign governmental entities as favored creditors, the Treasury, in particular, may have felt that allowing a default on GSE debt would be viewed internationally as the equivalent of a default by the U.S. government. As many large holders of GSE debt were also holders of U.S. Treasury debt, that concern was likely foremost on the minds of policymakers. Although a GSE default could well have triggered a "flight to quality" driving down the yield on U.S. Treasuries.

The GSEs were not alone in receiving an implied guarantee, even if they represented an extreme version of such. As their failure came at a time of particular stress in the U.S. financial markets, Treasury officials may have felt that imposing losses on GSE creditors would have called into question any implied guarantee among other troubled institutions. If Fannie Mae and Freddie Mac were allowed to fail, then would not the same be possible for Citibank or Bank of America? If the Treasury desired to maintain an implied guarantee behind the largest banks, then protecting Fannie Mae and Freddie Mac would have been necessary.

GSE securities were also held across the U.S. financial markets. At the time of the crisis, GSE securities held by depositories was well over 150 percent of Tier 1 capital levels for the banking system as a whole. About 3 percent of insured depositories held GSE securities at levels in excess of 500 percent of their Tier 1 capital.[13] GSE securities were also broadly used as collateral in the repo market. Allowing even minor haircuts on GSE debt could have contributed to the failure of hundreds of (mostly small) banks.[14] The GSEs also held large derivative positions with a small number of commercial and investment banks. To some extent the rescue of Fannie Mae and Freddie Mac was a rescue of the banking system. While most of these holdings were known, in some cases publicly, the Treasury may have felt that allowing losses, even small ones, on such a large number of institutions would undermine confidence in U.S. financial markets.

Lessons for the Future of Too-Big-To-Fail

There are perhaps no companies considered more "too big to fail" than Fannie Mae and Freddie Mac. Recognizing the harm a disorderly failure of a GSE could cause, Congress established in law in the summer of 2008 a resolution mechanism that would allow an insolvent GSE to fail without cost to the taxpayer and in an orderly manner. Despite those tools being in place, they were not used. That failure raises the distinct possibility that even though Dodd-Frank creates similar tools for other large complex financial organizations those tools will simply be ignored. How can policymakers increase the likelihood that such tools will be used?

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[13] Federal Deposit Insurance Corporation. 2004. *An Update on Emerging Issues in Banking: Assessing the Banking Industry's Exposure to an Implicit Government Guarantee of GSEs*, Federal Deposit Insurance Corporation. https://www.fdic.gov/bank/analytical/fyi/2004/030104fyi.html

[14] Tara Rice and Jonathan Rose. 2012. "When Good Investments Go Bad: The Contraction in Community Bank Lending After the 2008 GSE Takeover" Board of Governors of the Federal Reserve System IFDP 1045.

Both Dodd-Frank and HERA leave regulators with considerable discretion. As long as regulators have such discretion, the choice of personnel also becomes one of policy. One avenue for reducing "too big to fail" is to appoint regulators individuals who place a larger weight on ending bailouts than does the public, something along the lines of Kenneth Rogoff's "conservative banker," except for rescues rather than monetary policy.[15] The appointment of Thomas Hoenig to Vice-Chairman of the FDIC can be viewed in such a light. His selection was a conscious strategy by the Senate Republican leader along these very lines.

Congress may also choose to limit the discretion of regulators. In a few instances, Dodd-Frank attempts to limit regulatory discretion, such as the Federal Reserve's use of its Section 13-3 authorities. In establishing a mandatory receivership mechanism for the GSEs, HERA also attempted to limit regulatory discretion. What HERA missed was that regulators would simply ignore those limitations. This is perhaps the hardest question in ending bailouts. Regulators rarely suffer when they violate legal restrictions on their ability to assist failing firms. For instance FDIC's broad guarantee of bank debt during the crisis lacked any basis in law, but no one at the FDIC has paid any penalty for doing so. The general public lacks any standing to sue regulators for statutory violations. Until a better solution is found, efforts must be made to change the culture of bank regulators. Instead of a "whatever it takes" mentality, regulators should be encouraged to embrace a "whatever the law directs" mentality.[16] Regulators should also not simply assume that if they lack tools which they would like to have that somehow Congress simply forgot to give them such tools. In many instances Congress did indeed debate giving regulators certain tools and then decided not to. A number of regulators have expressed

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[15] Kenneth Rogoff. 1985. "The Optimal Degree of Commitment to an Intermediate Monetary Target," *The Quarterly Journal of Economics* Vol. 100, No. 4 November, pp. 1169-1189

[16] For an up close picture of "whatever it takes" see David Wessel, *In FED We Trust: Ben Bernanke's War on the Great Panic*, Crown Business 2010.

dismay at being "second guessed" post-crisis, especially by Congress.[17] Such regulators may well keep in mind that Congress doesn't usually enjoy being "second guessed" by regulators on what powers said regulators were given.

The regulatory culture around financial rescues is also driven by how those rescues are portrayed. A number of commentators, including some regulators, have argued that if Lehman Brothers had been given assistance, much of the financial crisis would have been avoided. Doing so, however, would send a signal to market participants that regulators are comfortable with rescues. Regardless of one's views on the effectiveness of rescues, the need to avoid the appearance of "victory laps" should be obvious. A better solution would be for rescues to be accompanied by the resignation of the responsible regulators along with the responsible management (or not to engage in rescues at all).

A difficult policy question is how to handle foreign governments as creditors.[18] Congress did examine the issue of foreign governments as large holders of GSE debt. Congress made the choice not to treat such creditors as favored. But Treasury Secretary Hank Paulson apparently did not agree with Congress and during the crisis assured Chinese officials that their holdings would be protected, despite not having any legal authority to make such assurances. Given that the role of sovereign wealth funds as investors in many large U.S. financials, the significance of foreign policy considerations is not limited to Fannie Mae and Freddie Mac. Should Congress accept that the Treasury (and White House) will occasionally treat some foreign investments as "favored" despite statutory provisions otherwise? Should such creditors

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[17] See Timothy Geithner, *Stress Test: Reflections on Financial Crises*, Crown 2014.
[18] See William Patalon III, "Foreign Bondholders – and not the U.S. Mortgage Market – Drove the Fannie/Freddie Bailout," *Morning Money*, September 11, 2008. http://moneymorning.com/2008/09/11/fnm/

be given an express preference? If they were, hair-cuts would have to be imposed upon other creditors, while also forcing these favored foreign creditors to receive lower yields.

Conclusion

Dodd-Frank's efforts to create an orderly resolution framework closely mirror similar attempts at ending the "too-big-to-fail" status of the housing enterprises, Fannie Mae and Freddie Mac. Title II's orderly liquidation authority mirrors the receivership provisions created for the GSEs in HERA. These provisions were operational by September of 2008, yet were not used. Several of the reasons they were not used are applicable to Dodd-Frank's Title II, suggesting that its tools will also be ignored by policymakers and the comfortable and familiar route of taxpayer rescue will again be taken.

The neglect of HERA's tools and the likely similar neglect of Dodd-Frank's suggest a much deeper reform of our financial regulatory system is in order. The regulatory culture of "whatever it takes" must be abandoned. A respect for the rule of law and obedience to the letter of the law must be instilled in our regulatory culture. More important, the incentives facing regulators must be dramatically changed. If we hope to end "too-big-to-fail" and to curtail moral hazard more generally, significant penalties must be created for rescues as well as deviations from statute. A very difficult question is that lack of standing for any party to litigate to enforce statutory prohibitions against rescues.

Of course all of these objectives are more difficult to obtain under a regulatory environment that lacks transparency. While Dodd-Frank has made modest advances in forcing financial regulators to become more transparent, it falls short in relation to future regulatory actions. A policy audit of the Federal Reserve would be a useful starting place. Any exercise of the Federal Reserve's Section 13(-3) powers should be subjected to an immediate independent audit.

Policymakers must also review regulatory decisions that create systemic risk. For instance, despite a the lack of a explicit guarantee and statutory language to the contrary, bank regulators have treated, for regulatory purposes, the debt of Fannie Mae and Freddie Mac as "risk free." But it should be obvious that such debt is not risk free. As a Banking Committee staffer in 2004, I queried senior FDIC staff on this issue and received little more than a shrug. The fact is that a rescue of GSE creditors was made more likely because bank regulators treated it as such. Similar issues have arisen in the euro area with the regulatory treatment of sovereign debt. It is reckless enough when legislators choose to treat risky debt as risk free, it is puzzling when prudential regulators choose to do so.

My experience attempting to avoid a taxpayer assisted rescue of Fannie Mae and Freddie Mac leaves me pessimistic as to avoiding bailouts for other large financial institutions. My skepticism of Dodd-Frank's resolution powers derives from the experience of having tried such tactics for the GSEs and watching them fail. To guarantee the success of Dodd-Frank's efforts to end taxpayer-assisted rescues, we must learn from the failure of similar efforts for the GSEs.

Statement of Melvin L. Watt
Director, Federal Housing Finance Agency

Before the U.S. House of Representatives Committee on Financial Services

January 27, 2015

Chairman Hensarling, Ranking Member Waters and members of the Committee, thank you for inviting me to testify today about our work at the Federal Housing Finance Agency (FHFA) and for providing my first opportunity to return to this Committee since I left Congress.

FHFA was established by the Housing and Economic Recovery Act of 2008 (HERA) and is responsible for the effective supervision, regulation, and housing mission oversight of the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Bank System, which includes 12 Federal Home Loan Banks (FHLBanks) and the Office of Finance. FHFA's mission is to ensure that these regulated entities operate in a safe and sound manner and that they serve as a reliable source of liquidity and funding for housing finance and community investment. Since 2008, FHFA has also served as conservator of Fannie Mae and Freddie Mac (together, the Enterprises).

I am pleased to provide an overview of FHFA's statutory responsibilities and an update on the Enterprises' financial condition, FHFA's activities as regulator and conservator of the Enterprises, the FHLBanks' financial condition, and FHFA's regulatory activities as regulator of the FHLBanks.

FHFA's Statutory Responsibilities

I. FHFA's Regulatory Oversight of the Federal Home Loan Banks, Fannie Mae and Freddie Mac

The Federal Housing Enterprises Financial Safety and Soundness Act (the Safety and Soundness Act), as amended by HERA, requires FHFA to fulfill the following responsibilities in our oversight of the Federal Home Loan Bank System (FHLBank System) and the Enterprises:

(A) to oversee the prudential operations of each regulated entity; and

(B) to ensure that--

> (i) each regulated entity operates in a safe and sound manner, including maintenance of adequate capital and internal controls;
>
> (ii) the operations and activities of each regulated entity foster liquid, efficient, competitive, and resilient national housing finance markets (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities);
>
> (iii) each regulated entity complies with this chapter and the rules, regulations, guidelines, and orders issued under this chapter and the authorizing statutes;
>
> (iv) each regulated entity carries out its statutory mission only through activities that are authorized under and consistent with this chapter and the authorizing statutes; and
>
> (v) the activities of each regulated entity and the manner in which such regulated entity is operated are consistent with the public interest.

12 U.S.C. § 4513(a)(1).

II. FHFA's Role as Conservator of Fannie Mae and Freddie Mac

Congress granted the Director of FHFA the discretionary authority in HERA to appoint FHFA as conservator or receiver of Fannie Mae, Freddie Mac, or any of the Federal Home Loan Banks, upon determining that specified criteria had been met. On September 6, 2008, FHFA exercised this authority to place Fannie Mae and Freddie Mac into conservatorships. Subsequently, Fannie Mae and Freddie Mac together received $187.5 billion in taxpayer support under the Senior Preferred Stock Purchase Agreements (PSPAs) executed with the U.S. Department of the Treasury. FHFA continues to oversee these conservatorships.

As conservator of the Enterprises, FHFA is mandated to:

> (D) … take such action as may be--
>
> (i) necessary to put the regulated entity in a sound and solvent condition; and
>
> (ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity.

12 U.S.C. § 4617(b)(2)(D).

As conservator, FHFA must also fulfill the responsibilities enumerated above in 12 U.S.C. § 4513(a)(1). Additionally, FHFA has a statutory responsibility under the Emergency Economic Stabilization Act of 2008 (EESA) 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." 12 U.S.C. § 5220(b)(1).

My goal, as Director of FHFA since January 6, 2014, has been to lead FHFA in meeting the mandates assigned to it by statute until such time as Congress revises those mandates.

FHFA's Actions as Regulator and Conservator of Fannie Mae and Freddie Mac

As regulator and conservator of Fannie Mae and Freddie Mac, FHFA has taken consistent actions in the past year to ensure their safety and soundness, to ensure that they provide liquidity to the housing finance market, to preserve and conserve their assets, and to ensure that they meet their obligations to homeowners under EESA.

I. Financial Performance and Condition of Fannie Mae and Freddie Mac

Since the Enterprises were placed in conservatorship in 2008, their operations have stabilized and their financial performance has improved significantly. Fannie Mae has not made a draw under the PSPA since the fourth quarter of 2011, and Freddie Mac has not made a draw since the first quarter of 2012. Some of the improvement in the Enterprises' performance relates to one-time or transitory items, such as the reversal of each Enterprise's deferred tax asset valuation allowance, legal settlements, and the release of loan loss reserves as a result of rising house prices. Part of the improvement is also attributable to other factors, including responsible business practices, strengthened underwriting practices, rising house prices, and increased guarantee fees.

While steps taken in the conservatorships have helped stabilize the Enterprises' financial condition and the mortgage market, significant challenges remain. Serious delinquencies have declined but remain historically high compared to pre-crisis levels, and counterparty exposure remains a concern. While risks from the Enterprises' mortgage-related investment portfolios are declining as the size of their portfolios shrinks, revenues from these portfolios are also shrinking. Both Enterprises continue to work to maintain and improve the effectiveness and efficiency of their operational and information technology infrastructures. Additionally, under the terms of the PSPAs, the Enterprises do not have the ability to build capital internally while they remain in conservatorship. Attracting and retaining the best qualified workforce in this period in which the future of the Enterprises is uncertain also continues to be a challenge.

Other significant financial and performance highlights about the Enterprises include the following:

Fannie Mae

- For the first nine months of 2014, Fannie Mae reported earnings of $12.9 billion compared to net income of $77.5 billion for the first nine months of 2013, which reflected a number of one-time or transitory items. Calculations have not yet been completed for 2014 and, therefore, comparisons are being made here on the basis of three quarters.

- The cumulative amount of draws that Fannie Mae has received from the Treasury to date under its PSPA is $116.1 billion. Through September 30, 2014, Fannie Mae has paid $130.5 billion in cash dividends to Treasury on the company's senior preferred stock. Under the PSPA, dividends do not offset prior Treasury draws.

- The credit quality of new single-family acquisitions was strong through the third quarter of 2014, with a weighted average FICO score of 743 and a weighted average loan-to-value (LTV) ratio of 77 percent.

- The serious delinquency rate was 1.96 percent for Fannie Mae's total single-family book of business as of September 30, 2014. The serious delinquency rate for loans acquired between 2005 and 2008 was 8.27 percent compared to 0.34 percent for loans acquired since 2009 as of September 30, 2014. The serious delinquency rate for loans acquired prior to 2005 was 3.27 percent.

- Fannie Mae continues to reduce its retained portfolio in accordance with the PSPA. As of September 30, 2014, Fannie Mae's retained portfolio balance was $438.1 billion, which represents a decline of $52.6 billion since the beginning of the year, when the balance was $490.7 billion.

Freddie Mac

- For the first nine months of 2014, Freddie Mac reported earnings of $7.5 billion, compared to net income of $40.1 billion for the first nine months of 2013, which reflected a number of one-time or transitory items.

- The cumulative amount of draws that Freddie Mac has received from the Treasury to date under its PSPA is $71.3 billion. Through September 30, 2014, Freddie Mac has paid $88.2 billion in cash dividends to Treasury on the company's senior preferred stock. Under the PSPA, dividends do not offset prior Treasury draws.

- The credit quality of new single-family acquisitions remained high through the third quarter of 2014, with a weighted average FICO score of 744 and a weighted average LTV ratio of 77 percent.

- The serious delinquency rate was 1.96 percent for Freddie Mac's single-family book of business as of September 30, 2014. The serious delinquency rate for loans originated between 2005 and 2008 was 7.66 percent compared to 0.23 percent for loans originated since 2009 as of September 30, 2014. The serious delinquency rate for loans originated prior to 2005 was 3.12 percent.

- Freddie Mac continues to reduce its retained portfolio in accordance with the PSPA. As of September 30, 2014, Freddie Mac's retained portfolio balance was $413.6 billion, which represents a decline of $47.4 billion since the beginning of the year, when the balance was $461.0 billion.

II. FHFA's Supervisory Activities Related to the Enterprises

FHFA's supervision function evaluates the safety and soundness of the Enterprises' operations. Safety and soundness is a top priority in meeting FHFA's statutory obligations, in execution of Enterprise strategic initiatives and in all business and control functions. FHFA takes a risk-based approach to supervision, which prioritizes examination activities based on the risk a given practice poses to a regulated entity's safe and sound operation or its compliance with applicable laws and regulations. FHFA conducts on-site examinations at the regulated entities, ongoing risk analysis, and off-site review and surveillance. FHFA communicates supervisory standards to the regulated entities, establishes expectations for strong risk management, identifies risks, and requires remediation of identified deficiencies.

In 2014, FHFA issued supervisory guidance to the Enterprises on topics related to operational risk management, counterparty risk management, mortgage servicing transfers, cyber risk management, and liquidity risk management. This guidance articulates FHFA's supervisory expectations related to those matters and informs examination activities. Examples of important guidance issued during 2014 include the following:

Advisory Bulletin 2014-05, *Cyber Risk Management Guidance*, describes the characteristics of a cyber risk management program that FHFA believes will enable the regulated entities to successfully perform their responsibilities and protect their environments. FHFA's key expectations include Enterprise assessment of system vulnerabilities, effective monitoring of cyber risks, and oversight of third parties with access to Enterprise data.

Advisory Bulletin 2014-06, *Mortgage Servicing Transfers*, articulated FHFA's supervisory expectations for the Enterprises with regard to servicing transfers of mortgage loans that they hold or guarantee. Pursuant to contracts with their counterparties, the Enterprises must approve the transfer of servicing operations or servicing rights. FHFA has focused on Enterprise approval processes for these transactions due in large part to the significant recent transfers of mortgage servicing operations from federally-regulated banks to non-bank entities that are generally subject to less regulation and are more concentrated in their operations.

Advisory Bulletin 2014-07, *Oversight of Single Family Seller/Servicer Relationships*, articulated FHFA's requirement that the Enterprises assess financial, operational, and compliance risks associated with their counterparties and develop a risk management framework that can be applied throughout the Enterprise's contractual relationship with seller/servicers.

Standards set by FHFA are also reflected in guidance to our examiners, which is provided in FHFA's Examination Manual. The manual includes twenty-six modules that cover various Enterprise operations and provide background on a range of operational, credit, and market risks. The manual is a valuable tool for implementing FHFA's risk-based approach to supervision of the Enterprises and is available on FHFA's website.

FHFA maintains a team of examiners on-site at each Enterprise, and the examiners receive support from off-site analysts and subject matter experts. Examination teams perform targeted examinations of specific Enterprise operations and conduct ongoing monitoring of risk control functions and business lines. The examination work is performed in accordance with plans prepared annually for each Enterprise, taking into account factors such as analysis of existing risks, changes in business operations and strategic initiatives, and mortgage market developments. Where FHFA's Enterprise supervision team identifies deficiencies, examiners communicate expectations for remedial action. Examiner risk assessments are updated during the year to ensure that emerging risks and Enterprise business changes receive appropriate examination coverage.

Findings from targeted examinations and ongoing monitoring conducted through the course of the year are relied upon by examiners in assigning ratings to each Enterprise under the ratings system adopted by FHFA in 2013. The system, known as CAMELSO, includes separate ratings for Capital, Asset quality, Management, Earnings, Liquidity, Sensitivity to market risk, and Operations. The examination findings are also incorporated into annual Reports of Examination, which capture FHFA's view of the safety and soundness of each Enterprise's operations. Information from the Reports of Examination is included in FHFA's annual Report to Congress.

III. FHFA's Strategic Goals and Scorecard Objectives for the Conservatorships of Fannie Mae and Freddie Mac

During 2014, FHFA defined and worked to further the objectives included in the *2014 Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac* (2014 Conservatorship Strategic Plan) and the 2014 Conservatorship Scorecard.

FHFA has already published the *2015 Scorecard for Fannie Mae, Freddie Mac and Common Securitization Solutions* (2015 Conservatorship Scorecard), which details FHFA's conservatorship expectations for the Enterprises during 2015 and builds on last year's Scorecard. Both the 2014 and 2015 Conservatorship Scorecards are centered around three strategic goals.

A. MAINTAIN, in a safe and sound manner, credit availability and foreclosure prevention activities for new and refinanced mortgages to foster liquid, efficient, competitive, and resilient national housing finance markets

FHFA's first strategic goal, MAINTAIN, requires the Enterprises to support access to credit for single-family and multifamily mortgages, as well as foreclosure prevention activities. FHFA and the Enterprises have focused on a number of objectives under this strategic goal in the last year, including clarifying the Representation and Warranty Framework, providing targeted access to credit opportunities for creditworthy borrowers, working with small and rural lenders, implementing loan modification and REO strategies in hardest hit communities, and prioritizing affordable housing through multifamily loan purchases. In the 2015 Conservatorship Scorecard, FHFA also expressed an expectation that the Enterprises address other priorities, such as assessing the reliability of and the operational feasibility of using alternate or updated credit score models.

Representation and Warranty Framework

FHFA and the Enterprises made substantial progress on updating and clarifying the Representation and Warranty Framework (Framework) during 2014, and these efforts build on the agency's work over the last several years to refine the Framework. The Framework provides Fannie Mae and Freddie Mac with remedies – such as requiring a lender to repurchase a loan – when they discover that a loan purchase does not meet their underwriting guidelines. In updating and clarifying the Framework, FHFA's objectives are to continue to support safe and sound Enterprise operations, encourage lenders to reduce their credit overlays, and complement the agency's efforts to strengthen the Enterprises' quality control process.

FHFA prioritized providing greater clarity around the life-of-loan exclusions used in the Framework during 2014, and the Enterprises announced further improvements in this area on November 20, 2014. Specifically, those changes 1) limit repurchase requests under the life-of-loan exclusions to significant matters that impact the overall credit risk of the loan; 2) modify the life-of-loan exclusions for misrepresentations and data inaccuracies to incorporate a significance test; 3) clarify the requirements for requesting repurchase related to compliance with applicable laws and regulations; and 4) provide lenders a list of unacceptable mortgage products. The changes provide all parties with greater clarity about when the life-of-loan exemptions apply and when they do not. These revisions also maintain and support safe and sound Enterprise operations and are consistent with FHFA's broader efforts to ensure that the Enterprises' place more emphasis on upfront quality control reviews and other upfront risk management practices.

Earlier in 2014, FHFA and the Enterprises also announced other Framework refinements that included revising payment history requirements, providing written notification of repurchase relief to lenders, and eliminating automatic repurchases for mortgage insurance rescissions.

We also started efforts in 2014 to develop an independent dispute resolution program that could be used as a last step, in certain circumstances, to resolve disputes between lenders and the Enterprises. This would enable lenders to challenge a repurchase request by allowing them to request a neutral third party to determine whether there was a breach of the selling representations and warranties that justifies the repurchase request. Currently, FHFA and the Enterprises are engaged in outreach activities with a variety of lenders and dispute resolution providers to solicit their input on the initial design of the dispute resolution process. Under the 2015 Conservatorship Scorecard, FHFA expects the Enterprises to finalize these improvements to the Representation and Warranty Framework in 2015.

Providing Targeted Access to Credit Opportunities for Creditworthy Borrowers

On December 8, 2014, Fannie Mae and Freddie Mac announced purchase guidelines that enable creditworthy borrowers who meet stringent criteria and can afford a mortgage, but lack the resources to pay a substantial down payment plus closing costs, to get a mortgage with a three percent down payment. These purchase guidelines will provide an important – but targeted – access to credit opportunity for creditworthy individuals and families.

To appropriately manage the Enterprises' risk, the Enterprises' purchase guidelines emphasize strong underwriting standards and do not allow the kind of risk layering that occurred in the years leading up to the housing crisis. First, the purchase guidelines for these loans include compensating factors and risk mitigants – such as housing counseling, stronger credit histories, or lower debt-to-income ratios – to evaluate a borrower's creditworthiness. Second, like other loans purchased by the Enterprises, these loans must have full documentation and cannot include 40-year or interest-only terms. Third, 97 percent LTV loans must be fixed-rate and cannot have an adjustable rate. Fourth, the products will leverage the Enterprises' existing automated underwriting systems. Finally, like other loans with down payments below 20 percent, these loans require private capital credit enhancement, such as private mortgage insurance.

The Enterprises' purchase guidelines for the 97 percent LTV loan product provide a responsible approach to improving access to credit while also furthering safe and sound lending practices. The product focuses on first-time homebuyers and requires borrowers to be owner-occupants. Both Enterprises expect to purchase only a small amount of these loans each year compared to their overall loan purchase volume, and FHFA will be monitoring the ongoing performance of these loans.

Working with Small Lenders, Rural Lenders and Housing Finance Agencies
The Enterprises have also continued efforts to work with small lenders, rural lenders, and Housing Finance Agencies (HFAs) and to strengthen their understanding of how the Enterprises might be able to better serve these entities. This work is important because we know that community-based lenders and HFAs play a vital role in serving rural and underserved markets across the country.

In the first quarter of 2014, the Enterprises issued lender guidance clarifying a number of property and appraisal requirements for dwellings in small towns and rural areas. Further, as part of its ongoing effort to serve the affordable housing market and provide liquidity to small towns and rural areas, Fannie Mae revised its Selling Guide in September 2014 to allow for the delivery of Department of Housing and Urban Development (HUD)-guaranteed Section 184 mortgages and Department of Agriculture Rural Development (RD)-guaranteed Section 502 loans as standard instead of negotiated-only products. Fannie Mae also piloted expanded partnerships with county-level HFAs which go beyond its traditional state-level approach.

FHFA expects the Enterprises to continue outreach and initiatives with small lenders, rural lenders, and HFAs in 2015, including exploring the feasibility of purchasing a greater number of manufactured housing loans that are secured by real estate.

Loss Mitigation and Foreclosure Prevention Activities
Since entering conservatorship, the Enterprises have continued to focus on loss mitigation and borrower assistance activities. As of October 31, 2014, the Enterprises had conducted nearly 3.4 million foreclosure prevention actions since the start of the conservatorships in September 2008.

The 2015 Conservatorship Scorecard provides updated expectations for the Enterprises concerning their loss mitigation and foreclosure prevention activities. This includes expectations for the Enterprises to develop and execute strategies that reduce both the number of severely aged delinquent loans and the number of vacant real estate owned (REO) properties held by the Enterprises. These efforts will leverage and build on activities over the last year, including the Neighborhood Stabilization Initiative. Through this effort, FHFA has selected the City of Detroit and Cook County, IL for pilot programs. In these areas, the Enterprises have worked to improve outcomes in hardest hit markets through developing pre-foreclosure strategies, such as deeper loan modifications, and post-foreclosure strategies that address individual properties.

The 2015 Conservatorship Scorecard expectation that the Enterprises reduce the number of seriously delinquent loans they hold will also draw upon recent experience with non-performing loan (NPLs) sales. FHFA's expectation is that the sale of seriously delinquent loans through NPL sales will result in more favorable outcomes for borrowers, while also reducing losses to the Enterprises and, therefore, to taxpayers. In 2014, Freddie Mac conducted a pilot sale of loans serviced by Bank of America that were, on average, more than three years delinquent at the time of sale. In addition, FHFA is working with both Enterprises to develop additional guidelines for ongoing NPL sales by the Enterprises, with a focus on guidelines that provide more favorable outcomes for borrowers, avoid foreclosure wherever possible and require post-sale reporting to track borrower outcomes. FHFA and the Enterprises plan to release further information about these NPL sale guidelines in early 2015.

FHFA also expects the Enterprises to continue targeted outreach activities to increase consumer awareness of the Home Affordable Refinance Program (HARP). Many borrowers could benefit from the HARP program, but may not fully understand the benefits or that they qualify. In addition, FHFA expects the Enterprises to continue refining and improving other loss mitigation and foreclosure prevention strategies. In 2014, Enterprise activities in this area included expanding the Streamlined Modification program, which addresses documentation challenges associated with traditional modifications, to include deeply delinquent loans. Moving forward, FHFA will continue to review loss mitigation options to help families stay in their homes, stabilize communities, and meet our conservatorship and EESA obligations.

Multifamily

For individuals and families who rent rather than buy, continuing to support affordable rental housing is also an ongoing priority for FHFA and the Enterprises. Fannie Mae and Freddie Mac have historically played a key role in providing financing to the multifamily housing finance market throughout all market cycles and their multifamily portfolios demonstrated strong performance even through the financial crisis.

FHFA's 2015 Conservatorship Scorecard requires each Enterprise to continue multifamily purchases, but not to exceed a volume cap of $30 billion each for these purchases. This continues the approach taken in the 2014 Conservatorship Scorecard. FHFA has also continued to emphasize the Enterprises' critical role in the affordable rental housing market by allowing the Enterprises to provide financing for affordable multifamily properties beyond the volume cap. Through this approach, the focus is to support the financing of affordable housing and the housing needs of people in rural and other underserved areas, including areas that rely heavily on manufactured housing.

On multifamily purchases, we are also requiring the companies to continue to share risk with the private sector, which Freddie Mac does through a capital markets structure and Fannie Mae does through a risk sharing model. Both approaches transfer significant risk in the multifamily business to the private market.

B. REDUCE taxpayer risk through increasing the role of private capital in the mortgage market

FHFA's second strategic goal, REDUCE, is focused on ways to bring additional private capital into the system in order to reduce taxpayer risk. This strategic goal, and the related expectations in the 2015 Conservatorship Scorecard, requires the Enterprises to reduce Fannie Mae and Freddie Mac's overall risk exposure. FHFA's objectives include ongoing requirements for the Enterprises to conduct single-family credit risk transfers, reduce each Enterprises' retained portfolio, and update private mortgage insurance eligibility requirements.

Credit Risk Transfers

FHFA and the Enterprises remain focused on increasing the amount of credit risk transferred from the Enterprises. FHFA increased the targeted levels of single-family credit risk transfers in 2014 and 2015. FHFA increased the 2014 Conservatorship Scorecard target to achieve a meaningful credit risk transfer of $90 billion in unpaid principal balance (UPB), up from $30 billion in 2013. In the 2015 Conservatorship Scorecard, FHFA increased these targets to $150 billion of UPB for Fannie Mae and $120 billion of UPB for Freddie Mac, subject to market conditions. In meeting these thresholds, FHFA will continue to expect each Enterprise to execute a minimum of two different types of credit risk transfer transactions, which includes securities-based transactions and insurance transactions. Additionally, FHFA expects all activities undertaken in fulfillment of these objectives to be conducted in a manner consistent with safety and soundness.

During 2014, the Enterprises executed credit risk transfers on single-family mortgages with a combined unpaid principal balance of over $300 billion. In each transaction, the Enterprises retained a small first-loss position in the underlying loans, sold a significant portion of the risk beyond the initial loss and then retained the catastrophic risk in the event losses exceeded the private capital support. As a result, private capital is absorbing significant credit risk on much of Fannie Mae and Freddie Mac's new purchases, thereby substantially reducing risk to taxpayers from these purchases. Both Enterprises will also continue to utilize and test different risk transfer structures.

Retained Portfolio Reductions

Both Enterprises continue to reduce the size of their retained mortgage portfolios consistent with the terms of the PSPAs, which require them to reduce their portfolios to no more than $250 billion each by 2018. Both Fannie Mae and Freddie Mac have developed plans to meet this target even under adverse market conditions. As their portfolios continue to decline, they are transferring interest rate risk, credit risk on securities and liquidity risk from these portfolios to the private sector. As of September 30, 2014, Freddie Mac's portfolio stood at $414 billion, and Fannie Mae's at $438 billion.

Under the 2015 Conservatorship Scorecard, FHFA is requiring the Enterprises to implement their approved retained portfolio reduction plans in order to meet the PSPA requirements. FHFA's guidelines require the Enterprises to implement these plans even under adverse market conditions while taking into consideration the impacts to the market, borrowers, and neighborhood stability.

<u>Private Mortgage Insurer Eligibility Requirements</u>

FHFA has continued to advance efforts to strengthen Fannie Mae and Freddie Mac's counterparty requirements for private mortgage insurers. When a borrower makes a down payment of less than 20 percent, these mortgages are required by statute to have a credit enhancement – private capital standing behind the loan – in order to qualify for purchase by the Enterprises. Private mortgage insurance has always played an important role in meeting this requirement and it is critical to make sure that private mortgage insurers are able to cover claims both in good times and in bad times. To this end, in 2014 FHFA released a Request for Input on draft Private Mortgage Insurer Eligibility Requirements. Our objective is to have the Enterprises strengthen their risk management by enhancing the financial, business, and operational requirements in place for their private mortgage insurer counterparties, thereby enhancing mortgage insurers' ability to pay claims over the long-term.

FHFA is in the process of reviewing and considering the public input we received as part of our comprehensive evaluation of this issue. Consistent with our statutory mandates, our assessments and policy decisions will take into account both safety and soundness considerations and potential impacts on access to credit and housing finance market liquidity.

C. BUILD a new single-family securitization infrastructure for use by the Enterprises and adaptable for use by other participants in the secondary market in the future

FHFA's final strategic goal is to BUILD a new infrastructure for the Enterprises' securitization functions. This includes ongoing work to develop the Common Securitization Platform (CSP) infrastructure and to improve the liquidity of Enterprise securities. FHFA has established that FHFA's first objective for the CSP is to make sure that it works for the benefit of Fannie Mae and Freddie Mac. We are also requiring that the CSP leverage the systems, software and standards used in the private sector wherever possible, which will ensure that the CSP will be adaptable for use by other secondary market actors – including private-label securities issuers – in the future. In addition, FHFA has worked with the Enterprises to leverage the CSP in order to develop a Single Security, which we believe will improve liquidity in the housing finance markets. FHFA and the Enterprises have made significant progress on both the CSP and the Single Security in the past year, and we expect the Enterprises to continue moving aggressively on these multiyear initiatives in 2015.

Common Securitization Platform

The Enterprises made important progress during 2014 in establishing the organizational infrastructure for the CSP. This includes the announcement of a Chief Executive Officer for Common Securitization Solutions (CSS) – the entity that we expect to house and operate the CSP.

In addition, FHFA and the Enterprises made considerable progress on the design-and-build phase of the CSP. Each Enterprise has designated staff to work on the project at the CSS location, and this team has been developing the technology and infrastructure of the CSP platform during the last year. This includes work to incorporate the Single Security into the development of the CSP. Furthermore, Fannie Mae and Freddie Mac have reorganized their staffs with business operations and information technology experts to develop the systems and processes needed to integrate with the CSP. As this work continues, Fannie Mae and Freddie Mac staff will engage in continuous testing and will develop operating policies and procedures to ensure a smooth transition to the CSP. FHFA, Fannie Mae, and Freddie Mac are committed to achieving a seamless CSP launch, and the actions taken so far are moving us in the right direction toward this multiyear goal.

Single Security

FHFA's top priority in pursuing the Single Security is to deepen and strengthen liquidity in the housing finance markets. In today's market, the mortgage-backed securities issued by Fannie Mae and Freddie Mac trade in separate "to-be-announced" (TBA) markets. The forward-trading that takes place in TBA securities allows borrowers to lock in a mortgage rate. The TBA market also adds efficiencies to the process, which reduce transaction costs and result in lower mortgage rates for borrowers. In today's TBA market, there is a price disparity between Fannie Mae and Freddie Mac securities largely due to greater trading volumes of Fannie Mae securities. This price disparity imposes an additional cost on Freddie Mac – and therefore on taxpayers. We believe that a Single Security can further strengthen market liquidity by reducing the trading disparities between Fannie Mae and Freddie Mac securities.

FHFA issued a Request for Input on FHFA's proposed Single Security structure last year as the first step in a multiyear process. FHFA is working with the Enterprises to process the feedback we received and will move forward in a deliberative and transparent manner. FHFA will release a Progress Report on this initiative in the coming months. As part of the 2015 Conservatorship Scorecard, FHFA established the expectation that the Enterprises would finalize the Single Security structure during 2015 and would begin the process of developing a plan to implement the Single Security in the market. This remains a multiyear process, but we made significant progress during 2014.

IV. Additional Matters and Initiatives Impacting Fannie Mae and Freddie Mac

In addition to the activities outlined above, FHFA continues to work on a number of other matters and initiatives that impact Fannie Mae and Freddie Mac, several of which are highlighted below.

Guarantee Fees

One of the first decisions I made as Director of FHFA was to suspend increases in guarantee fees that had been announced by FHFA in December of 2013. Given the impact of these fees on the Enterprises, the housing finance markets, and on borrowers, I believed that it was critical to do further evaluation and to get feedback from stakeholders. After additional assessment at FHFA, we issued a Request for Input that provided further details on how the Enterprises set these fees and posed a number of questions to prompt substantive feedback about how guarantee fee levels affect various aspects of the mortgage market.

FHFA is now reviewing and considering the input we received as part of our comprehensive evaluation of this issue. Consistent with our statutory mandates, our assessments and policy decisions will take into account both safety and soundness and possible impacts on access to credit and housing finance market liquidity.

Fannie Mae and Freddie Mac Housing Goals

On August 29, 2014, FHFA issued a proposed rule to set the Enterprises' housing goals for 2015 through 2017 for both single-family and multifamily loan purchases. FHFA's proposed rule raised questions for public comment about how best to set Fannie Mae and Freddie Mac's housing goals to encourage responsible lending that is done in a safe and sound manner and that also serves the single-family and rental housing needs of lower-income families as required in HERA. FHFA is in the process of evaluating comments submitted to the agency and finalizing the rule.

Housing Trust Fund and Capital Magnet Fund

Last month, FHFA directed Fannie Mae and Freddie Mac to begin setting aside funds to be allocated to the Housing Trust Fund and the Capital Magnet Fund pursuant to HERA. The statute authorized FHFA to temporarily suspend these allocations, and FHFA informed Fannie Mae and Freddie Mac of a temporary suspension on November 13, 2008. In letters sent to the Enterprises on December 11, 2014, FHFA notified Fannie Mae and Freddie Mac of the agency's decision to reverse the temporary suspension. These letters, copies of which were provided to Members of Congress who had communicated views to FHFA about whether or not the temporary suspension should continue, established prudent safeguards in the event of adverse changes in the Enterprises' financial condition or draws under the PSPAs.

Certain Super Priority Lien Programs and Risk to the Enterprises
During 2014, FHFA has continued to monitor and assess two areas of state-level actions that threaten the legal priority of single-family loans owned or guaranteed by Fannie Mae and Freddie Mac: 1) through certain energy retrofit financing programs structured as tax assessments and 2) through granting priority rights in foreclosure proceedings for homeowner associations.

While FHFA is not opposed to energy retrofit financing programs that allow homeowners to improve energy efficiency, these programs must be structured to ensure protection of the core financing for the home and, therefore, cannot undermine the first-lien status of Fannie Mae and Freddie Mac mortgages. Concerning certain energy retrofit financing programs, such as first-lien Property Assessed Clean Energy (PACE) programs, FHFA has reiterated that Fannie Mae and Freddie Mac's policies prohibit the purchase of a mortgage on property that has a first-lien PACE loan attached to it. This restriction has two potential implications for borrowers. First, a homeowner with a first-lien PACE loan cannot refinance their existing mortgage with a Fannie Mae or Freddie Mac mortgage. Second, anyone wanting to buy a home that already has a first-lien PACE loan cannot use a Fannie Mae or Freddie Mac loan for the purchase. In addition to aggressive enforcement of these existing policies, FHFA is continuing to evaluate or explore other possible remedies and legal actions to protect the Enterprises' lien position.

Additionally, FHFA has taken legal action in some instances in which unpaid homeowners association dues may be deemed under the laws of a state to be senior to preexisting mortgage liens owned or guaranteed by Fannie Mae or Freddie Mac on a homeowner's property. As conservator, FHFA has an obligation to protect Fannie Mae's and Freddie Mac's rights, and will aggressively do so.

FHFA's Actions as Regulator of the Federal Home Loan Banks

The FHLBanks continue to play an important role in housing finance by providing a reliable funding source and other services to member institutions, including smaller institutions that would otherwise have limited access to these services. In addition, the FHLBanks have specific statutory requirements related to affordable housing and, as a result, the FHLBanks annually contribute substantially toward the development of affordable housing.

I. Financial Performance and Condition of the Federal Home Loan Banks

The financial performance and condition of the FHLBank System remain strong. Led by growth in advances, the aggregate balance sheet of the FHLBanks has increased over the past two years, but remains considerably smaller than in peak years. Advances totaled $545 billion as the end of the third quarter of 2014, up from $499 billion at year-end 2013, but down approximately 50 percent from a peak of $1.01 trillion in the third quarter of 2008. The overall decline in advance volume from the peak is a result of increased market liquidity from deposits and sluggish economic growth.

Following are highlights of the financial performance of the FHLBanks:

- The FHLBanks, in aggregate, reported net income of $1.7 billion for the first three quarters of 2014 after earning $1.8 billion in the first three quarters of 2013. All twelve FHLBanks were profitable during these quarters.
- The FHLBanks saw substantial asset growth during the first nine months of 2014, driven by advances to members. As of the end of the third quarter of 2014, aggregate FHLBank assets totaled $883 billion and $545 billion in advances – up from $835 billion and $499 billion at the end of 2013. Advances constituted 62 percent of assets at the FHLBanks in aggregate at the end of the third quarter of 2014, up from 60 percent at the end of 2013.
- Retained earnings have grown significantly in recent years and totaled $13.0 billion, or 1.5 percent of assets, as of the third quarter of 2014.
- Also at the end of the third quarter of 2014, the FHLBanks had an aggregate regulatory capital ratio of 5.6 percent – comfortably above the statutory minimum of 4.0 percent.
- All FHLBanks had net asset values (equity values) in excess of the par value of their members' stock holdings. The market value of the FHLBanks was 142 percent of the par value of capital stock as of the third quarter of 2014, the highest ratio since FHFA started tracking this metric in 2002.

II. FHFA's Supervisory and Regulatory Activities Related to the FHLBanks

FHFA conducts annual safety and soundness and affordable housing program examinations of all 12 FHLBanks and the Office of Finance based on well-defined supervisory strategies. Similar to the approach utilized in supervision of the Enterprises, FHFA uses a risk-based approach to conducting supervisory examinations of the FHLBanks, which prioritizes examination activities based on the risks given practices pose to a regulated entity's safe and sound operations or to its compliance with applicable laws and regulations. FHFA's FHLBank supervision also utilizes the CAMELSO ratings system and incorporates these ratings into each FHLBanks' Report of Examination. Information from the Reports of Examination is included in FHFA's annual Report to Congress.

Over the last few years, FHFA's supervisory work has included assessments of FHLBank mortgage purchase programs, the substantial increase in advances to a few very large member institutions, the FHLBanks' changing capital composition in light of their increasing retained earnings and reduced activity stock requirements, and their management of unsecured credit. We are also currently conducting reviews of FHLBank enterprise risk management structures and approaches to vendor management.

FHFA also provides the FHLBanks supervisory guidance in the form of Advisory Bulletins that outline the agency's regulatory expectations. In 2014, FHFA issued Advisory Bulletins 2014-02, *Operational Risk Management*, and 2014-05, *Cyber Risk Management*. Other Advisory Bulletins applicable to the FHLBanks covered areas such as model risk management, collateral valuation and management, and the classification of risky assets.

FHFA's supervision of the FHLBanks' expanding mortgage programs involves oversight of the operational issues raised by two new products – Mortgage Partner Finance (MPF) Direct and MPF Government MBS. The FHLBank of Chicago expects to begin offering these new products in early 2015, although this could change. Under MPF Direct, participating members may sell non-conforming and conforming, single-family, fixed-rate mortgage loans to the Chicago FHLBank, which would concurrently sell the loans to a third-party private investor that would accumulate the loans for securitization. The Chicago FHLBank expects, at least initially, that loans sold would be "jumbo conforming" loans capped at $729,750 for a single unit in the contiguous United States.

Under the MPF Government MBS program, the Chicago FHLBank would purchase government guaranteed or insured loans, accumulate the loans on its balance sheet as held for sale, and pool the loans in securities guaranteed by the Government National Mortgage Association (Ginnie Mae). The Chicago FHLBank would then sell the securities to other FHLBanks, members approved to participate in the mortgage programs, and external investors.

The mission focus of the FHLBank System is an important component of FHFA's regulatory activities. FHFA has undertaken three recent efforts related to the housing finance mission of the FHLBanks. First, in September 2014, FHFA released a proposed rulemaking involving membership requirements for the FHLBanks. Congress established the FHLBank System in 1932 as a government sponsored enterprise with a focus on housing finance. Over time, Congress has expanded the membership base, expanded the types of assets that are eligible collateral for advances, and made other incremental changes to the System. However, over eighty years later, the FHLBanks are still grounded in supporting housing finance.

Under the current membership rule, institutions may gain access to the benefits of FHLBank membership by meeting a one-time test showing the minimum required housing finance assets at the time of application. FHFA has proposed eliminating this one-time test and, instead, requiring that FHLBank members maintain a minimum amount of housing finance assets on an ongoing basis. In addition, FHFA has proposed defining an insurance company in such a way that captive insurers would no longer be eligible for FHLBank membership. A captive insurance company provides benefits only for its parent company, which itself is often not eligible for FHLBank membership. While captive insurers may in some cases be involved in housing finance, allowing them to have access to the FHLBank System raises a number of policy issues that are discussed in the proposed rule.

The comment period for this proposed rule ended on January 12, 2015, and we received approximately 1,300 comments. FHFA is in the process of reviewing and considering these comments. As I have consistently emphasized since becoming Director of FHFA, getting input and feedback from stakeholders is a crucial part of FHFA's policymaking process, and we will carefully consider comments made by members of this Committee as well as the public in determining our final rule.

Second, FHFA has been in continued dialogue with the FHLBanks about "core mission assets." This also relates to the fundamental issue of how the FHLBanks use the benefits of their government-sponsored status to support their housing finance and community investment mission. In partnership with the FHLBanks, I believe we are making progress in developing a framework to describe the fundamental characteristics of what a FHLBank's balance sheet should look like in order to demonstrate a satisfactory mission commitment.

FHFA's third ongoing effort related to the mission of FHLBanks is a review of FHFA's Affordable Housing Program (AHP) regulation. The AHP program provides funding for both single-family and rental affordable housing – including housing affordable to very low-income individuals and families. In 2013, the FHLBanks allocated $297 million to their AHPs for the purchase, construction, or rehabilitation of over 37,800 housing units. FHFA is committed to working with the FHLBanks to make this program more efficient by reviewing, and possibly updating, our AHP regulation.

A new area of FHFA's recent regulatory work has involved the merger of the FHLBanks of Des Moines and Seattle, which would be the first merger ever of two FHLBanks. There has been considerable change in our nation's financial system, in the membership base of the FHLBanks, and in market conditions across the various FHLBank districts since the FHLBank System was established in 1932. As a result, the FHLBanks have seen changes in advance demand and membership composition which, in turn, has affected the fundamental franchise values of some of the FHLBanks.

These changes, in part, have led the Boards of Directors of the FHLBank of Des Moines and the FHLBank of Seattle to determine that a combined entity would better serve the needs of their members. The Boards of both FHLBanks voted to approve their merger on September 25, 2014. FHFA reviewed and evaluated the merger application submitted by the FHLBanks of Des

Moines and Seattle to ensure that the merger would be accomplished in a safe and sound manner and would result in a financially strong FHLBank that supports the interests of all its members. FHFA issued an approval of the merger application on December 22, 2014, contingent upon the members of both FHLBanks ratifying the merger and meeting other specified conditions. If ratified, the merger could be finalized as early as the second quarter of 2015.

Conclusion

While I have not focused in my statement on administrative matters at FHFA, I would be remiss if I did not point out that none of the activities or initiatives described in this statement would be possible without the dedication of the staff at the Federal Housing Finance Agency. Since I became Director at FHFA last year, it has been a pleasure getting to know the very qualified staff at FHFA and working with them to reevaluate and pursue FHFA's priorities. I thank them for their service. I also want to recognize the hard work of the boards, management and staffs of Fannie Mae, Freddie Mac and the FHLBanks, who continue to restore and provide critical contributions to our nation's housing finance system.

In the coming year, FHFA will continue to work to meet the agency's statutory mandates to ensure the safe and sound operations of our regulated entities and to ensure that they provide liquidity in the national housing finance market. In addition, FHFA will continue to advance its Office of Minority and Women Inclusion responsibilities, which include furthering diversity in management, employment and business activities at FHFA, as well as at our regulated entities.

Thank you again for having me here this morning, and I look forward to answering your questions.

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Testimony

An Update from the Federal Housing Finance Agency on Oversight of Fannie Mae, Freddie Mac and the Federal Home Loan Banks

4/18/2013

Statement of Edward J. DeMarco, Acting Director
Federal Housing Finance Agency
Before the U.S. Senate Committee on Banking, Housing and Urban Affairs
April 18, 2013

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

In my testimony today I will focus mainly on FHFA's role as the conservator and regulator of Fannie Mae and Freddie Mac (together, the "Enterprises"). As this committee is well aware, the Enterprises have been in conservatorship for more than 4 ½ years. These have been the largest and most complex conservatorships in history. Throughout this time FHFA has explained its approach to the conservatorships in light of the statutory responsibilities Congress placed on the agency as conservator. I have reported to Congress numerous times regarding FHFA's actions in light of these responsibilities, recognizing that the prolonged time in conservatorship has required us to adapt to changing circumstances, while remaining consistent with the fundamental responsibilities given us as regulator and conservator. I am pleased to provide you today with an update on what we have accomplished and where we are headed.

I would first like to take a moment to thank the Chairman and Ranking Member for their introduction of an amendment to the 2014 budget resolution that would prevent any additional Enterprise guarantee fees from being used to fund other budget items. And I would like to thank all the members of the committee for supporting that amendment, which the Senate adopted by unanimous consent. I was also glad to see the introduction by Senators Corker, Warner, Vitter and Warren of S. 563, the Jumpstart GSE Reform Act. I share the views of the sponsors of S. 563 that now is the time to address reform of the housing finance system. I look forward to working with all of you as you move forward on that effort.

I will begin this prepared statement with a brief review of the goals of FHFA as Conservator. Then I will review FHFA's approach to preparing for increased private market participation in housing finance and describe the significant activities that FHFA has undertaken during the past year to further our conservatorship goals. Next I will touch on the financial condition and performance of Fannie Mae, Freddie Mac and the Federal Home Loan Banks. And finally, I will close with some thoughts on the role of government in housing finance.

Goals of Conservatorship

With the financial crisis unfolding, and after substantial consultation with the Department of the Treasury and the Federal Reserve, FHFA placed the Enterprises into conservatorship on September 6, 2008. The Housing and Economic Recovery Act of 2008 (HERA), which created FHFA, specified two conservator powers, stating that the Agency should "take such action as may be:

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

From the outset, FHFA stated that the goals of the conservatorships were to help restore confidence in the companies, enhance their capacity to fulfill their mission, and mitigate the systemic risk that contributed directly to instability in financial markets. As supervisor, we have also taken steps to strengthen risk management, internal controls, and establish proper governance over all of the Enterprise's activities.

As the private mortgage securitization market had already vanished and there were no other effective secondary market mechanisms in place, the initial phase of the conservatorships was focused on stabilizing the Enterprises' operations to ensure the continued functioning of the mortgage market during the crisis. This phase has been successful; operations of the two Enterprises have largely stabilized and the origination market and secondary market for mortgage has continued to function throughout the financial crisis.

The second phase of the conservatorships has focused on foreclosure prevention efforts, which have been critical for helping homeowners in distress and essential to meeting the conservatorship mandate to preserve and conserve the Enterprises' assets. These continuing efforts also are consistent with FHFA's statutory responsibility under the Emergency Economic Stabilization Act to provide assistance to homeowners and minimize foreclosures. Nearly 2.7 million "foreclosure prevention" actions evidence the success of that effort to date.

FHFA also clarified that the Enterprises would be limited to continuing their existing core business activities. This type of limitation on new business activities is consistent with the standard regulatory approach for addressing companies that are financially troubled. And it is even more pertinent for the Enterprises given their uncertain future and reliance on taxpayer funds. While there still is legacy credit exposure to work through, the second phase of the conservatorships put in place the loss mitigation infrastructure to help borrowers and protect taxpayers. At the same time, the Enterprises' new books of business are much stronger than their old ones.

Today we have a mortgage market that relies heavily on taxpayer support, with very little private capital standing in front of the federal government's risk exposure. There seems to be broad consensus that Fannie Mae and Freddie Mac will not return to their previous corporate forms. The Administration has made clear that its preferred course of action is to wind down the Enterprises. Of the various legislative proposals that have been introduced in Congress, none of them envisions the Enterprises exiting conservatorship in their current corporate form. In addition, recent changes to the Preferred Stock Purchase Agreements (PSPAs), replacing the 10 percent dividend with a net worth sweep, reinforce the notion that the Enterprises will not be building capital as a potential step to regaining their former corporate status. The amount of funding, essentially the Enterprises' capital base, available under the PSPAs also has become fixed as the Enterprises recently reported year-end 2012 financial results.

Against this backdrop, FHFA has moved into a third phase of Enterprise conservatorship, embodied in its Strategic Plan for the Operation of the Enterprise Conservatorships.

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

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

1. **Build.** Build a new infrastructure for the secondary mortgage market.
2. **Contract.** Gradually contract the Enterprises' dominant presence in the marketplace while simplifying and shrinking their operations.
3. **Maintain.** Maintain foreclosure prevention activities and credit availability for new and refinanced mortgages.

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

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

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

Maintain

Although it is the third strategic goal, I would like to start with Maintain. Maintaining foreclosure prevention activities and promoting market stability and liquidity so that there is credit availability for new and refinanced mortgages is an important aspect of our work as conservator. Foreclosure prevention efforts were extensive in 2012 as FHFA and the Enterprises continued to simplify, streamline, and improve existing programs. More than 540,000 foreclosure prevention actions were completed last year alone, bringing the total to nearly 2.7 million since the start of conservatorship in 2008.

Since the start of conservatorship, Fannie Mae and Freddie Mac's management teams have completed over 1.3 million permanent loan modifications, more than 665,000 repayment plans, and nearly 150,000 forbearance plans. Together they have enabled the Enterprises to help more than 2.2 million families who were having trouble paying their mortgages remain in their homes. Additionally, the Enterprises have made it possible for more than 445,000 other families to gracefully exit their home without going through a painful foreclosure process by facilitating short sales and deeds-in-lieu of foreclosure.

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

- The nearly 1.1 million HARP refinances in 2012, almost equaled the number of HARP refinances over the prior three years. An additional 97,000 HARP refinances were completed in January of this year.
- HARP refinances with greater than 105 loan-to-value ratios made up 43 percent of total HARP refinances in 2012, compared

to 15 percent in 2011. In January of this year, 47 percent of HARP refinances were for borrowers with a greater than 105 loan-to-value ratio.

- HARP refinances with greater than 125 percent loan-to-value ratios made up 21 percent of total HARP refinances in 2012 and nearly 25 percent of total refinances in January of this year.
- HARP refinances into a shorter-term mortgage made up 18 percent of total HARP refinances in 2012 for underwater borrowers, compared to 10 percent in 2011, and stand at 18 percent of total HARP refinances in January 2013.

We are very pleased with the success of HARP thus far and look forward to building on this success in 2013. We will soon be implementing a nationwide public relations campaign to educate consumers about HARP and its eligibility requirements. The goal of this campaign is to reach as many eligible homeowners as possible and educate them on HARP eligibility criteria and the value of refinancing under HARP, and motivate them to explore their options and utilize HARP before the program expires. HARP is a valuable risk reduction tool for the Enterprises, and I announced last week that we will be extending the HARP deadline by two years through December 2015. I feel confident that with the changes made to HARP in 2011, the increased consumer awareness through the HARP consumer education campaign and the extension of the HARP deadline, every eligible homeowner who wants to refinance through the HARP program will have the opportunity.

For those homeowners who are seeking a modification we also recently announced that the Enterprises will soon be offering a new, streamlined loan modification initiative to minimize Enterprise losses and help troubled homeowners avoid foreclosure and stay in their homes. Starting this July, servicers will be required to offer eligible homeowners who are at least 90 days delinquent on their mortgage an easy way to lower their monthly payments and modify their mortgage. This new option supplements our existing suite of loan modifications, including the Home Affordable Modification Program (HAMP) and the Enterprise's standard modification program.

A key element of this new program is that it is essentially automatic and seriously delinquent homeowners are eligible for the program even if they have not provided complete documentation. Since the beginning of the financial crisis a consistent hindrance to assisting troubled borrowers has involved documentation requirements. The Streamlined Modification Initiative should be especially helpful to those who are self-employed, part of a multi-generational household, or are simply overwhelmed with the document collection burden. All borrowers have to do to take advantage of the modification offer is make three on-time trial payments, after which their loan will be permanently modified. Servicers will continue to work with borrowers throughout the trial period to evaluate all their foreclosure prevention options, as documenting income and financial hardship could result in a modification with additional savings for the borrower. This program also fits within our safety and soundness goals.

This new program builds on the principles embodied in the Servicing Alignment Initiative that was launched in 2011. The Servicing Alignment Initiative was designed to establish consistent policies and processes for the servicing of delinquent loans owned or guaranteed by the Enterprises to make it easier for servicers to reach borrowers as early in the delinquency as possible. Early, effective borrower outreach and engagement is critical for successful modification solutions. We are excited about the prospects of this new program and look forward to tracking and reporting on its progress.

A priority since the onset of conservatorship and enumerated under the "maintain" goal is to continue to strengthen the credit risk management practices of the Enterprises, and provide more certainty and timely feedback to originators as they make decisions on extending credit. Pursuant to this end, last September FHFA and the Enterprises announced the start of fundamental changes to the representation and warranty framework for conventional loans sold or delivered on or after January 1, 2013. The objective of the new framework is to clarify lenders' repurchase exposure and liability and inject greater upfront monitoring by moving the focus of quality control reviews forward to the time the loan is delivered to the Enterprises instead of when it has defaulted. The priorities for 2013 are enhancing the post-delivery quality control practices and transparency associated with the new rep and warranty framework, and FHFA's onsite supervisory teams will continue to review the effectiveness of the new framework.

In addition to the efforts of FHFA, the progress that I have just discussed on foreclosure prevention, refinancing, and maintaining credit availability would not have been possible without the commitment of the boards, management, and employees of Fannie Mae and Freddie Mac. I am gratified that the leadership and staff at both companies remain committed to fixing what is broken and creatively addressing the challenging issues we face. I would add that other such examples of their commitment abound. For example, Fannie Mae undertook an important effort to develop a bulk approach to selling properties in their real estate owned portfolio, and Freddie Mac has been leading efforts to expand loan level disclosures.

Build

The first strategic goal is to build a new infrastructure for the secondary mortgage market. The Enterprises' existing proprietary infrastructures are not effective at adapting to market changes, issuing securities that attract private capital, aggregating data, or lowering barriers to market entry. These outmoded infrastructures must be maintained and updated. An investment of capital—capital that would come from taxpayers through the PSPAs—will be necessary for this effort. But to the extent possible, we should invest taxpayer dollars to this end once, not twice.

Hence, updating the Enterprises' outmoded infrastructures should provide enhanced value to the mortgage market with a common and more efficient securitization model. The ultimate goal is to develop a new securitization model that will have benefits beyond the current Enterprise business model. To achieve this, the new infrastructure must be operable across many platforms and operate in a cost effective manner so that it can be used by any issuer, servicer, agent, or other party that decides to participate.

In October 2012, FHFA issued a white paper designed to gather input from the industry and move this effort forward. The white paper discusses development of a common securitization platform, including the important issue of its scope and functionality. One approach we outlined is that the focus of the platform could be on functions that are routinely repeated across the secondary mortgage market, such as issuing securities, providing disclosures, paying investors, and disseminating data. These are all functions where standardization could have clear benefits to market participants.

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

What I have just described is the governance and ownership structure for the near-term phase of the platform. It will be initially owned and funded by Fannie Mae and Freddie Mac, and its functions are designed to operate as a replacement for some of their legacy infrastructure. However, the overarching goal is to create something of value that would be a foundational element of the mortgage market of the future. We are designing the platform to be flexible so that the long-term ownership structure can be adjusted to meet the goals and direction that policymakers may set forth for housing finance reform.

The white paper issued last October also puts forth some broad ideas on creating a model contractual framework. Similar to the securitization infrastructure effort, the focus of this effort is to identify areas where greater standardization in the contractual framework would be valuable to the mortgage market of the future.

This is an optimal time to consider how best to address contractual shortcomings identified during the past few years. A great deal of work has already been done in this area by market participants and additional input will be exceptionally valuable. As the Enterprises move forward with risk sharing transactions such as those I will describe shortly, the development of transactional documents will provide a real time test of a new standardized contractual framework for transactions where the private sector is absorbing credit risk.

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

Contract

The second strategic goal is to contract the Enterprises' dominant presence in the marketplace while simplifying and shrinking their operations, thus de-risking both Fannie Mae and Freddie Mac's activities. With an uncertain future, limited capital resources and a general desire for private capital to re-enter the market, the Enterprises' market presence should be reduced gradually over time.

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

First, the 2013 Scorecard sets a target of $30 billion of unpaid principal balance in credit risk sharing transactions in the single-family credit guarantee business for both Fannie Mae and Freddie Mac. A considerable amount of preparatory work was done in 2012 to lay the groundwork for executing on risk sharing transactions this year, and we have specified that each Enterprise must conduct multiple types of risk sharing transactions to meet the 2013 target. The Scorecard encourages the Enterprises to consider transactions involving: expanded mortgage insurance with qualified counterparties; credit-linked securities; senior/subordinated securities; and perhaps other structures. The goal for 2013 is to move forward with these transactions and to evaluate the pricing and the potential for further execution in scale. What we learn in 2013 will set the stage for the targets for 2014, and I fully expect to move from a dollar target to a percentage of business target at some point in the future.

Also, while it is not a Scorecard item, we expect to continue increasing guarantee fees in 2013, and the execution of the single-family risk sharing transactions I just described should provide valuable information as to how market participants are pricing mortgage credit risk. As we have noted before, the financial crisis demonstrated that the Enterprises had not fully priced their credit risk. In 2012, guarantee fees were increased twice, bringing the average guarantee fee on new mortgages to around 50 basis points, approximately double what guarantee fees were prior to conservatorship. A key motivation behind increasing Enterprise guarantee fees is to bring their credit risk pricing closer to what would be required by private sector providers. However, I feel it is important to note that increasing guarantee fees is part of the goal of contracting the Enterprises' dominant presence in the marketplace. It is not designed primarily to increase their revenue. The hope is that at some point the increases in guarantee fees will encourage private capital back into the market. We are not there yet, but in conversations with market participants, I think we are getting closer.

Second, we are setting a target of a 10 percent reduction in new multifamily business acquisitions from 2012 levels. We expect that this reduction will be achieved through some combination of increased pricing, more limited product offerings, and tighter overall underwriting standards. The multifamily business differs significantly from the single-family credit guarantee business. The Enterprises have a smaller share of the multifamily market and there are other providers of credit in the market. The Enterprises' market share of new multifamily originations did increase during the financial downturn, but in 2012 it returned to a more normal position.

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

Given that the multifamily market's reliance on the Enterprises has moved to a more normal range, reducing the Enterprises' footprint in this market is appropriate and aligns with the overall goal of contracting their dominant market presence.

Finally, we are setting a target of selling an additional five percent of the less liquid portion of the Enterprises' retained portfolios —primarily their retained portfolios excluding agency securities. The retained portfolios of Fannie Mae and Freddie Mac have been declining since 2009. The initial PSPAs required a 10 percent annual reduction, and the most recent changes to the PSPAs increased the annual reduction to 15 percent. The composition of the Enterprises' retained portfolios has also changed significantly since the establishment of the conservatorships. Prior to conservatorship, the retained portfolios were dominated by their own mortgage-backed securities and performing whole loans. As those securities have been paid down, and as the need to work through delinquent loans increased, the retained portfolios changed from being relatively liquid to being less liquid.

Given that natural run-off in the retained portfolios would have likely satisfied the PSPA reduction targets in the next few years, and that the Enterprises are not actively purchasing new assets for their retained portfolios, requiring them to sell from the less liquid portions of their retained portfolios should lead to an even faster reduction than is required under the PSPAs.

Additional Priorities for 2013

Let me close this review of the conservatorship strategic plan by highlighting a couple of other priorities we are working towards in 2013. One will be the near-term efforts regarding mortgage insurance. To better protect the interests of the Enterprises, we are updating mortgage insurance master policies by clarifying the role and responsibilities of insurance carriers, particularly when servicers pursue loss mitigation to help delinquent borrowers. Further, we intend to formulate new mortgage insurance eligibility standards, to ensure that all insurance carriers doing business with the Enterprises have the appropriate financial, operational, and management capacity to fulfill their obligations, particularly in the event of additional stress to the housing markets. These efforts will be an important and critical step for mortgage insurance to remain a viable risk transfer mechanism in the future.

Another policy project of note is the development of an aligned set of standards for so-called force placed, or lender-placed, insurance. The various concerns with lender-placed insurance are well-known, including the costs, limitations on coverage, and consumer protections. FHFA recently sent a Notice to the Federal Register setting forth an approach to address certain practices relating to lender-placed insurance that we consider contrary to prudent business practices, contrary to appropriate administration of Enterprise guaranteed loans, and which expose the Enterprises to potential losses and safety and soundness risks.

These practices include sales commissions received by sellers and servicers when placing coverage or maintaining placement with particular insurance providers, and remuneration received by sellers and servicers from insurance providers that cede premiums to a reinsurer that is owned by, affiliated with or controlled by the seller or servicer. After receiving input during the 60 day period provided for in the Federal Register Notice and after FHFA review, we would anticipate the Enterprises putting these change in practices into place over a several month period.

We also plan to pursue a broader approach to lender-placed insurance, bringing together both public and private sector parties to participate in a dialogue with us and with a wide range of stakeholders. Our goal is to establish a set of standards that could be adopted by a broader set of mortgage market participants, similar to what was done with the Servicing Alignment Initiative. This broadened approach will also enable greater regulatory coordination in an effort to consider the various issues associated with lender-placed insurance.

FHFA as Supervisor

While FHFA has outlined a plan for the next phase of conservatorship, we continue to fulfill our supervisory responsibilities at both the Enterprises and the Federal Home Loan Banks. Since FHFA was created in 2008, we have added more than 200 employees. Over the past two years, we have undertaken substantial restructuring, particularly with regard to our supervision program and have hired experienced examiners at the executive and staff levels. I anticipate a modest amount of additional hiring, but believe that FHFA now has the executive management team, the organizational structure, and the staff necessary to carry out our safety and soundness mission.

With respect to Fannie Mae and Freddie Mac, we have strengthened our supervision and oversight of their activities, including how they implement and comply with conservatorship and FHFA policies. FHFA has in the past year implemented several changes that will enable us to quickly and effectively respond to emerging risks and developments, and to put in place a framework for supervising the secondary housing market not only today but for the future. This includes issuing supervisory guidance, governing regulations, and establishing a new risk-based supervisory framework. FHFA's 2013 supervisory objectives include:

- Assess the risks posed by new initiatives to ensure that they are being implemented under a sound control framework. These initiatives include SAI, the common securitization platform, the contract harmonization project, multifamily bulk loan sales and REO disposition programs.
- Maintain a full understanding of the Enterprise's overall risk profile, particularly for the incremental risk created by implementing the new initiatives while maintaining and upgrading information systems and internal controls.
- Determine if the board and management are taking appropriate steps to comply with conservatorship and supervisory directives.
- Develop a formalized process for the ongoing monitoring program.
- Implement the CAMELSO rating system.

Financial Condition and Performance of the Enterprises and FHLBanks

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

Housing Market Conditions

- We are seeing signs of recovery in the housing market across a number of dimensions and, while the marketplace is by no means "normalized," conditions are promising in many ways.
- According to the latest data from the National Association of Realtors, the inventory of homes available for sale was only 1.9 million units in February. Given that the annualized rate of home sales during that month was nearly 5 million properties, this represented only about 4.7 months' worth of supply. Just a year earlier, the relative supply was a still modest 6.4 months. And

at its peak—in July 2010—the supply was 12.1 months.

- According to the FHFA index, national home prices grew 5.5 percent between the fourth quarters of 2011 and 2012. For the 12 month period ending in January, home prices rose 6.5 percent.
- Census data from December 2011 estimated the seasonally adjusted annualized rate of housing starts to be about 700,000 units. By September 2012, that rate had grown to roughly 840,000 units and, in March, the rate was estimated at 1,036,000 units. This compares to a low of about 480,000 units in April 2009, and is 71 percent of the long-run average.
    - The latest CoreLogic information, which includes data for October, indicates that shadow inventory dropped roughly 12.3 percent between October 2011 and October 2012. This decline represented a reduction in the shadow inventory pool of about 300,000 units.

Freddie Mac

- Net income for the fourth quarter of 2012 totaled $4.5 billion, and represented the fifth consecutive quarter of positive earnings. Annual net income of $11.0 billion represented a record level of earnings for Freddie Mac and compares to a net loss of $5.3 billion in 2011.
- In 2012 Freddie Mac required $19 million of funding from Treasury bringing the cumulative Treasury draw to $71.3 billion. Through December 31, 2012, Freddie Mac has paid $23.8 billion in cash dividends to Treasury on the company's senior preferred stock. Under the PSPAs, the payment of dividends cannot be used to offset prior Treasury draws. This provision has remained unchanged since the PSPAs were established. So while $23.8 billion has been paid to Treasury in dividends, Treasury still maintains a liquidation preference of $72.3 billion on its senior preferred stock. Freddie Mac has $140.5 billion remaining in available support from Treasury.
- The credit quality of new single-family acquisitions remained high in the fourth quarter of 2012, with a weighted average FICO score of 756. The average loan-to-value (LTV) ratio for new business was 75 percent. This higher LTV ratio is due to the expansion of HARP eligibility to borrowers whose mortgages have LTV ratios above 125 percent and to relief provided to lenders for borrowers with LTV ratios above 105 percent. These high LTV refinances represented 43 percent of HARP loans in 2012.

Fannie Mae

- Net income for the fourth quarter of 2012 totaled $7.6 billion, and represented the fourth consecutive quarter of positive earnings. Annual net income of $17.2 billion represented a record level of earnings for Fannie Mae and compares with a net loss of $16.9 billion for 2011.
- Fannie Mae did not require funding from Treasury in 2012. Fannie Mae's cumulative Treasury draw remains at $116.1 billion. Through 2012, Fannie Mae has paid $35.6 billion in cash dividends to Treasury on the company's senior preferred stock. Under the PSPAs, the payment of dividends cannot be used to offset prior Treasury draws. This provision has remained unchanged since the PSPAs were established. So while $36.5 billion has been paid to Treasury in dividends, Treasury still maintains a liquidation preference of $117.1 billion on its senior preferred stock. Fannie Mae has $117.6 billion remaining in available support from Treasury.
- The credit quality of new single-family acquisitions was strong in 2012, with a weighted average FICO score of 761. The average LTV for new business was 75 percent in 2012, compared with 69 percent in 2011. The year-over-year increase in average LTV ratios is due to the expansion of HARP to borrowers with high LTV mortgages.

Federal Home Loan Banks

- The FHLBanks have emerged from the financial crisis in generally good condition. They are profitable and have strengthened capital positions. The FHLBank System reported net income of $2.6 billion in 2012, the highest annual earnings since 2007.
- Retained earnings have grown significantly in recent years and totaled $10.4 billion, or 1.37 percent of assets, as of year-end 2012. Retained earnings are at their highest level ever, and will continue to grow as a result of provisions included in each FHLBank's capital plan. The FHLBank System regulatory capital ratio of 6.8 percent exceeds the regulatory requirement of 4.0 percent. The market value of the FHLBanks is 124 percent of the par value of capital stock, the highest ratio in at least 11 years.
- The aggregate balance sheet of the FHLBanks has shrunk considerably in recent years, led primarily by declining advance volumes due to market liquidity and sluggish economic growth. Advances totaled $426 billion as of year-end 2012, down 58 percent from a peak of $1.01 trillion in the third quarter of 2008.
- Viewed over the past business cycle, the FHLBanks carried out their public purpose of providing credit when needed to support the mortgage investments of their members.

Role of the Government in Housing Finance

The key question in housing finance reform is what, and how large, should the role of the federal government be? While it is ultimately up to lawmakers to provide an answer, in my opinion the main purpose in addressing housing finance reform should be to promote the efficient provision of credit to finance mortgages for single-family and multifamily housing. An efficient market system for providing mortgage credit to people that want to buy a house should have certain core characteristics: (1) it should provide consumer choice, (2) it should provide consumer protections, (3) it should allow for innovation by market participants, and (4) it should facilitate transparency.

As lawmakers consider the extent of the government's role in housing finance, it is useful to start with some basic market facts. As of the fourth quarter of 2012, there was about $9.9 trillion in single family mortgage debt outstanding. About 13 percent was guaranteed through direct government programs, roughly 52 percent was guaranteed by Fannie Mae and Freddie Mac, and the remainder not guaranteed by the Federal government.

On a flow basis, Inside Mortgage Finance reports that in the third quarter of 2012 new single family mortgage originations totaled approximately $510 billion. Of that total roughly 18 percent was guaranteed through direct government programs, 66 percent through Fannie Mae and Freddie Mac, and 16 percent not guaranteed by the Federal government.

Measured by securities issuance, the proportion supported by the government is over 90 percent.

However measured, it should be clear that today's housing finance market is dominated by government support.

The relevant question then appears to be more in the line of how we move from the housing finance market of today, where almost all new single-family mortgage originations have some type of government support, to a future market far more reliant on the private provision of mortgage credit? And in particular, of the $5 trillion portion of the mortgage market currently served by the Enterprises, what share, if any, should have government credit support in the future?

From the point of view of an economist, the answer to this question, and to the general question of how great a role the government should ultimately play in the housing finance sector, begins with consideration of a potential market failure. A market failure may lead the private market to produce less of, or more of, a particular good than would be economically optimal. Broadly speaking, in housing finance there are at least two potential market failures that are often considered; each may lead to an under-provision of mortgage credit.

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

Another potential market failure is what is often thought of as the positive externality associated with homeownership. In this view, the benefits of homeownership extend beyond the individual household to the broader aspects of society, hence if left solely to the market the number of homeowners will be less than optimal. The broader societal benefits of homeownership that are often highlighted include things such as the propensity for homeowners to engage more in civic and political action; stronger neighborhood and social ties that accompany homeownership; the opportunity to build family wealth through home equity; and the willingness of homeowners to make improvements to their property, thereby increasing the value of their home and neighborhood. A common government approach to increase market demand is to provide some type of subsidy or other assistance to encourage or facilitate such consumption. Direct subsidies to lower the cost of mortgage credit or easing the eligibility terms for a mortgage are methods of delivering subsidies through the housing finance market. Government policies beyond the housing finance market are also used to promote housing demand. Prominent among these is the mortgage interest tax deduction.

These policies demonstrate that as a nation we are committed to providing opportunities for homeownership, and there may be other social goals where it is decided that government support is warranted. The Federal Housing Administration (FHA) and other traditional government credit programs are typically used to address credit market failures or to achieve public policy goals. If policymakers begin by defining the role FHA and other government mortgage credit programs should play in the future in terms of which borrowers should have access to these programs, then it should be easier to consider the government's role, if any, in the remainder of the mortgage market.

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

However, a very important difference separates the single-family mortgage market from other consumer credit markets—the size of the overall market. As I mentioned earlier, there is currently around $9.9 trillion in single-family mortgage debt outstanding. A market of this size needs to draw on broader sources of capital to fund this level of activity. The single-family mortgage market has come to rely on the Enterprises as the mechanism for attracting capital.

With their statutory public mission of supporting a stable and liquid mortgage market, along with their low capital requirements, the Enterprises were long able to guarantee mortgage credit risk at a volume and price at which other market participants could not compete. They were also seen as having a public mission to promote the availability of mortgage credit, especially to support affordable housing.

Still, there seems to be relatively broad agreement that this government sponsored enterprise model of the past, where private sector companies were provided certain benefits and charged with achieving certain public policy goals, did not work. That model relied on investors providing funding for housing at preferential rates based on a perception of government support, which ultimately turned out to be correct and has resulted in Enterprises' drawing $187.5 billion in funds from Treasury as of December 31, 2012.

Determining how to replace this flawed model—and developing an efficient secondary market that can access capital markets in order to serve that part of the single-family mortgage market that is not covered by traditional government credit programs—is central to congressional consideration of ending the conservatorships of the Enterprises.

The options for consideration range from a market-oriented approach that would ensure broad minimum standards, to establishing a Federal backstop to provide liquidity when needed, to developing a government guarantee structure to ensure stability in the flow of mortgage credit and limit market uncertainty. These options are not novel. They are essentially the three options that the Administration set forth in its white paper more than two years ago. Let me offer some thoughts on these three options.

Standard-Setting

This approach would replace some of the standard-setting that the Enterprises undertake today with a regulatory regime or a market utility that sets those standards and that are subject to rigorous supervision. This model would not rely on a government guarantee to attract funding to the mortgage market, but would look to standardization and rules for enforcing contracts to provide a degree of certainty to investors. The focus in such an approach could be on setting standards around key features that investors need to know to be willing to price credit risk in the mortgage market. These include standards associated with underwriting, pooling and servicing, and disclosures.

Clearly, a standard-setting framework is much different than a framework that has a government guarantee. Investors would be required to price the credit risk of mortgages. They also would be responsible for enforcing their rights under the standard contracts developed under this framework. Those requirements are consistent with the way that a private market functions. Arguably, this is part of the market oversight and investor protection regime that is already established in various securities laws overseen by the Securities and Exchange Commission.

Part of the question here is, given the size of the single family mortgage, and the unique characteristics of today's agency securities market, in particular the To-Be-Announced market, would additional standard-setting measures enhance liquidity and provide further structure to the market? An important question to consider is whether there are other areas in terms of monitoring or compliance that could potentially broaden the investor base while still achieving the primary function of having private markets price credit risk?

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

Federal Backstop

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

- Preserving the availability of credit in times of stress is an important function. Is there a role for the government, perhaps through the Federal Housing Administration to take on this role if necessary? Or alternatively, with a more standardized market and infrastructure, would it be possible for an existing guarantor, like Ginnie Mae, to play such a temporary guarantee function?
- Preserving liquidity in the market and the financial system in this framework would be an important function. Is there a need for a backstop source of funding when financial markets become temporarily illiquid? For example, could the Treasury Department, the Federal Reserve or the Federal Home Loan Banks play a role in a market that had this type of standardized structure?

Government Guarantee

Finally, the third option is a secondary mortgage market operating with some type of government guarantee. This is somewhat similar to what we have today. Clearly if the securities offered in a reformed housing finance market have a government guarantee, those securities will be priced favorably and have a high degree of liquidity to reflect that guarantee. However, pricing for those securities would not provide the benefit of market pricing for credit risk of the underlying mortgages. In such a structure, private sector capital through equity investment would stand in a first loss position, with a government guarantee that was funded through an insurance premium being available to cover other losses (much like with deposit insurance in the banking system). This type of structure requires a significant amount of regulatory safety and soundness oversight to protect against the moral hazard associated with providing a government guarantee.

While such an outcome has certain merit and some attractive features, the potential costs and risks associated with this type of framework should be fully explored. Simply put, replacing the Enterprises' implicit guarantee with an explicit one does not resolve all the shortcomings and inherent conflicts in that model, and it may produce its own problems. As I have in past testimony, I offer three observations in this regard.

First, the presumption behind the need for an explicit federal guarantee is that the market cannot evaluate and price the tail risk of mortgage default, at least at any price that most would consider reasonable, or it cannot manage that amount of mortgage credit risk on its own. But we might ask whether there is reason to believe that the government will do better? If the government backstop is underpriced, taxpayers eventually may foot the bill again.

Second, if the government provides explicit credit support for the vast majority of mortgages in this country, it would likely want a say with regard to the allocation or pricing of mortgage credit for particular groups or geographic areas. The potential for government involvement to distort the pricing of credit risk may subject taxpayers to further involvement if things do not work out as planned.

Third, regardless of any particular government allocation or pricing initiatives, explicit credit support for all but a small portion of mortgages, on top of the existing tax deductibility of mortgage interest, would further direct our nation's investment dollars toward housing. It would also drive up the price of housing, other things being equal. A task for lawmakers is to weigh such incentives and outcomes against the alternative uses of such funds.

Fourth, what will be the breadth and depth of regulatory authority and how is it exercised? For example, just how much capital should be maintained by a major mortgage market enterprise.

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

Conclusion

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

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

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

Where lawmakers identify particular market failures requiring direct government involvement, there may be more targeted approaches to addressing those issues than a broad subsidy to credit. For example, if certain borrowers or communities are of concern, taxpayer support could be targeted directly to support the building or purchasing of housing rather than indirectly through credit subsidies. Individual communities have already undertaken this approach, developing their own comprehensive list of challenges and potential solutions and bringing these to all parties involved with their communities.

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

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

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