

**THE FUTURE OF THE MORTGAGE MARKET AND
THE HOUSING ENTERPRISES**

HEARING
BEFORE THE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
ONE HUNDRED ELEVENTH CONGRESS
FIRST SESSION
ON
EXAMINING WHETHER RESPONSIBLE HOMEOWNERS WILL HAVE AC-
CESS TO THE LOANS THEY WILL NEED TO REALIZE THE AMERICAN
DREAM OF HOME OWNERSHIP

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OCTOBER 8, 2009
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Printed for the use of the Committee on Banking, Housing, and Urban Affairs



Available at: <http://www.access.gpo.gov/congress/senate/senate05sh.html>

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U.S. GOVERNMENT PRINTING OFFICE

56-337 PDF

WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
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THURSDAY, OCTOBER 8, 2009

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 9:36 a.m. in room SD-538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order. Let me welcome our guest witnesses this morning, as well as my colleagues. The title of this morning's hearing is "The Future of the Mortgage Market and the Housing Enterprises," and this is a subject matter on which there has been a tremendous amount of Committee interest and others over time. And we have had—Richard, I counted up last night. I think we have had just this year alone 70 hearings.

Senator SHELBY. I believe it.

Chairman DODD. I looked at the number, just on the various subject matters. Most of it has been focused on reg reform issues, and almost everything—

Senator SHELBY. I do not know of any other committee—

Chairman DODD. That had this many.

Senator SHELBY. Because we both serve on other committees. We would not have any sleep, would we?

Chairman DODD. It has been a lot. I know yesterday Jack Reed had a hearing as well. Judd, I think you participated in that hearing that Jack had.

So we have covered a lot of ground, and there are so many things, we could be just having—we could literally have a hearing a day on the subject matters that the Committee has jurisdiction over. And this is a subject matter Bob Corker, others, obviously Richard—we all have a great interest in this issue of the Government-sponsored enterprises and where we are, where we are going, what is the future of all of this. And so it is an important subject matter, and, therefore, I am glad we have some time this morning to spend on this.

Let me share a few opening comments. I will turn to the former Chairman, Senator Shelby, for his opening thoughts and comments on it, and then we will get right to our witnesses, unless any of the Members feel compelled that they want to share a thought or two on all of this.

Well, today we meet to discuss the Government-sponsored enterprises—Fannie Mae and Freddie Mac—and the role they will play as we seek to restore normalcy to the mortgage market. But let us not forget what we are really talking about here. We are talking about whether responsible homeowners will have the access to home loans they need to realize the American dream of home ownership.

Last year, when the mortgage market collapsed, the Director of the Federal Housing Finance Authority put Fannie Mae and Freddie Mac into conservatorship. At the same time, Secretary Paulson exercised the authority he was given by last year's bipartisan Housing and Economic Recovery Act to provide back-up funding for the two companies, ensuring that they would continue financing mortgages during the housing crisis.

Today we are going to consider where we need to go from here. Now is the time to look forward as well as looking back, but with so much damage done by this financial crisis, the role of the GSEs in that crisis is still hotly debated, as we all know.

Let me just say Fannie and Freddie were neither the villains that caused the crisis, in my view, as some claim, nor the victims of that crisis, as others would make them out to be. They did not create the subprime and exotic loan market, but they did chase it into the general—to generate profits, rather. And like many of the supposedly private financial institutions that ended up becoming equivalent to GSEs, Fannie and Freddie enriched their shareholders and management while the public took the losses.

We cannot let that happen again, in my view, and as we look forward, we must start by setting benchmarks to determine whether the mortgage market is healthy so that American families can once again begin to build wealth—not the kind of wealth that buys mansions and yachts, but the kind of wealth that sends a child to college or ensured an affordable retirement.

First, the mortgage market must remain liquid and stable, especially in times of stress. Otherwise, rates are driven up, prices are driven down, and the American family loses.

Second, we must encourage product standardization such as widespread availability of that unique American opportunity, the 30-year fixed-rate mortgage, without prepayment penalties. This helps both borrowers and lenders.

Third, mortgage credit must remain consistently available and affordable. Home ownership remains part of the American dream, as we all know. That dream should be accessible to as many people as possible and sustainable for as many people as possible as well.

Today the market is meeting these tests, but only through massive Government intervention. The Federal Reserve, for example, has committed to pumping more than \$1 trillion into the mortgage market. That cannot go on, as we all know. Therefore, it is time to begin the conversation about how we can re-create a functional market that stands on its own two feet and to decide what role, if any, the GSEs or their successors should play.

I want to start that conversation by posing a number of questions. Can the market function with no Government involvement? Should, on the other hand, the Government completely and explicitly take over the job previously done by Fannie and Freddie? Do

we want a model where there is some private capital at risk but only under strict Government control, such as a utility? Hank Paulson and others have raised this possibility or idea.

There are other important questions. The answers, in my view, are critical to ensuring that American dream that we all embrace, and I look forward to considering these questions with our distinguished panel today that we are fortunate to have with us.

Before turning to Senator Shelby, I want to quickly add that I am hopeful that the higher GSE and FHA loan limits, which were first established in HERA, will be extended again in the HUD appropriations bill currently being negotiated. These higher loan limits are helping many borrowers in States like mine and others, frankly, where it is critical, to purchase homes or refinance their mortgages. And I think we need to keep this support in place. It is a controversial item, but I wanted to mention that as a side item here this morning as well.

With that, let me turn to my good friend and colleague from Alabama, Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

As we consider the future of the GSEs, I believe we would be wise to remember the disastrous consequences that poorly regulated GSEs can have on our financial markets. Just 1 year ago, Fannie Mae and Freddie Mac were placed into conservatorship when they could not cover billions of dollars in losses.

Despite repeated warnings by me and other Members of this Committee about the risk that GSEs presented, they were allowed to accumulate more than \$5 trillion—\$5 trillion—in financial obligations with only minimal amounts of capital. The Congressional Budget Office now estimates—and this is probably conservative—that resolving the GSEs will cost American taxpayers \$389 billion, perhaps more. We must ensure that this never happens again, but the question is: Will we?

This hearing, therefore, comes at an opportune time as this Committee is considering financial regulatory reform. There is no doubt that the failure of Fannie and Freddie was a significant actor in the financial crisis because their activities touched nearly every aspect of our financial system. In addition, their debt is among the most widely held in the world. They are also major counterparties to our most prominent financial institutions. Accordingly, regulatory reform, I believe, must involve the GSEs.

But the Administration made no effort to include the GSEs in its financial regulatory reform proposal. Instead, the Administration has said that it will not propose how to deal with the GSEs until next year. Why? I believe that this is a grave mistake that will make it more difficult to reform our financial system that will potentially expose taxpayers again to even greater losses.

I believe what we need is a clear path that addresses both the GSEs' ongoing financial difficulties and the role that the GSEs should play in our economy in the future. I fear that the longer we wait, the more it is going to cost the American taxpayer. Certainly the question of what to do with GSEs is very difficult and complex. Yet it is a question that we ignore at our peril.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Do either of my two colleagues here have any comments at all?

STATEMENT OF SENATOR JUDD GREGG

Senator GREGG. Well, Mr. Chairman, I know you want to get to the witnesses, but I do not think the moment should pass when we are taking up this issue to not acknowledge the fact of the extraordinary work that you two did last summer—the summer before last, to basically address this issue. The chaos which would have occurred would have even been more severe if you two had not joined and pulled together a very aggressive resolution of the Fannie Mae/Freddie Mac issue and led the Congress in this area. So I just wanted to acknowledge that.

Chairman DODD. I thank you, Senator, very much for those comments. Let me just say—I know people hear me say these things, but it is a tremendous pleasure working with Richard Shelby, and this Committee has been tremendous. We have got a lot of work in front of us, but I am more than confident we are going to do well at it as we move forward.

I want to introduce our panel, not only Mr. DeMarco but let me introduce the second panel as well so we can just move through and so we have a sense of everyone.

Edward DeMarco, Acting Director of the Federal Housing Finance Agency, has served with the FHFA, the successor of the Office of Federal Housing Enterprise Oversight, since 2006 when he came on as Chief Operating Officer and Deputy Director. Previously he served in various capacities with the Social Security Administration and the Department of the Treasury. Mr. DeMarco, we thank you very much for joining us.

Let me briefly introduce the second panel quickly as well.

Mr. William Shear is the Director of Financial Markets and Community Investment at the U.S. Government Accountability Office. In this capacity, Mr. Shear has conducted important research on the Government-sponsored enterprises, including a recent report published in 2009, and we all look forward to hearing about that in your testimony.

Peter Wallison is the Arthur F. Burns Fellow in Financial Policy Studies at the American Enterprise Institute. He serves as cochair of the Pew Financial Reform Task Force and has held a number of Government positions, including General Counsel at the United States Treasury. He is the author of numerous books and articles about the housing enterprises, and we welcome you as well to our Committee.

Dr. Susan Wachter is a professor of real estate and finance at the Wharton School. Dr. Wachter is the former Assistant Secretary at the Department of Housing and Urban Development for Policy Development and Research and has served on numerous review and research boards in the public and private sectors.

And, last, Mr. Andrew Jakabovics—did I pronounce that correctly?

Mr. JAKABOVICS. Close enough.

Chairman DODD. Close enough? Thank you very much. Andrew, welcome. Mr. Jakabovics is the Associate Director for Housing and

Economics at the Center for American Progress Action Fund, and prior to this, he served as the research chief of staff for the MIT Center for the Real Estate Housing Supportability Initiative.

So we have a very distinguished group of witnesses to hear from this morning as well, and I am very honored that all of you agreed to appear before us this morning to talk about this important subject matter.

With that, Mr. DeMarco, we welcome you and I am going to just ask all of you—I am going to take all of your full statements, by the way. I presume they are probably fuller statements than what you are prepared to give publicly in the statement, and any supporting documents and information you think would contribute to our knowledge of this issue is welcomed as well. And so if you would try and keep your remarks in that 5- to 7-minute range, I would appreciate it so we can get to questions.

Welcome.

**STATEMENT OF EDWARD J. DEMARCO, ACTING DIRECTOR,
FEDERAL HOUSING FINANCE AGENCY**

Mr. DEMARCO. Good morning, Chairman Dodd, Ranking Member Shelby, Committee Members. Thank you for the opportunity to be here today. My written statement details FHFA's key activities and accomplishments, the challenges facing the housing GSEs, and their response to those challenges. I will summarize now the GSEs' financial condition and key challenges, and I will close with some thoughts about the future of our housing finance system.

I will begin with the current financial condition of Fannie Mae and Freddie Mac, or as I will refer to them, "the enterprises." In the first 2 years of this housing crisis, combined losses at the enterprises totaled \$165 billion. Their financial performance continues to be dominated by credit-related expenses and losses stemming principally from purchases and guarantees of mortgages originated in 2006 and 2007.

Since the establishment of the conservatorships, the combined losses at the enterprises depleted all their capital and required them to draw \$96 billion from the Treasury under the Senior Preferred Stock Purchase Agreements. With continuing uncertainty regarding economic conditions, employment, house prices, and mortgage delinquency rates, the short-term outlook for the enterprises remains troubled and likely will require additional draws.

The Treasury and the Federal Reserve have made sizable purchases of housing GSE securities to instill confidence in their securities, provide stability to mortgage markets, and lower mortgage rates. This combined support exceeds \$1 trillion and has allowed the enterprises to continue providing liquidity to the mortgage markets.

The enterprises face four key challenges. First is staffing. Both enterprises have filled vacancies at the executive management level. However, several key vacancies remain below that level. Moreover, uncertainties about the future of the enterprises make staff retention a key concern. As we see improvements in the economy, opportunities for employees and officers to seek other employment will increase, adding to the current retention challenge.

Second is credit risk. The credit risk in their mortgage books remains a supervisory concern. While a few positive signs of housing recovery have emerged, we recognize the risk associated with the increasing number of seriously delinquent loans and the uncertain path of the market's recovery. In addition, the multifamily market is experiencing declining property values and record vacancy rates.

Market risk. The enterprises' investments in mortgage assets expose them to market risk that is challenging to manage in today's environment.

And, finally, operational risk. The systems and models upon which the companies have relied in the past have been greatly stressed in this market, and the new management teams are working on appropriate remediation. The implementation of the new consolidation accounting standard, which will require the enterprises to bring off-balance-sheet mortgage-backed securities onto their balance sheets in January, is a substantial operational challenge.

Turning to the home loan banks, Federal home loan banks have not been immune from mortgage-related losses. Most notable is the deterioration in the value of private label mortgage-backed securities held by many Federal home loan banks.

In the first 6 months of this year, the home loan banks collectively saw impairment charges of \$8 billion in the private label MBS portfolio. However, a change in accounting rules resulted in only \$1 billion of that being charged against income.

Net income for the first half of 2009 was \$1.4 billion, compared to \$1.2 billion for all of last year. This improvement reflects in part these new accounting rules.

The home loan banks have two key challenges of note: First is working through the issues associated with their private label MBS, and the other is the failure or consolidation of system members has shifted business volumes among the banks and increased concentration of ownership by, and advances to, a few large institutions.

Mr. Chairman, you asked me to address the future of the housing finance system. The mortgage market in this country is a \$12 trillion market, yet this massive size is attained through millions of individual transactions that have an average size of about \$200,000. In its broadest terms, then, the housing finance system connects \$12 trillion on the one hand to these \$200,000 transactions on the other. It connects capital markets to local mortgage lending transactions.

Going forward, we might begin with the following simple goal: to promote the efficient provision of credit to finance mortgages. An efficient system would have characteristics such as allowing for innovation, providing consumer choice, providing consumer protection, and facilitating transparency in the marketplace. While these characteristics provide a broad framework, policymakers must determine the Government's role in the following areas: ensuring adequate liquidity, absorbing credit risk, and affordable housing.

Now, ensuring liquidity in this context addresses periodic disruptions in credit markets that cause investors to temporarily exit from holding or purchasing mortgages. During such episodes, do we need to ensure there is a balance sheet of last resort?

Second, markets have relied upon an implicit Government guarantee of enterprise securities. Going forward, though, what level of Government credit support is needed to have an efficient mortgage market? One approach is having the Government take a limited catastrophic credit insurance position backing certain mortgage assets. Another approach could be a combination of enhanced private sector market discipline and regulatory oversight.

Third, the Government has long promoted credit availability for low- and moderate-income homeowners and renters. The subsidies granted the enterprises were exchanged for requirements, including housing goals, to ensure the enterprises did not ignore these segments of the market. Going forward, though, policymakers may consider alternative approaches to targeting such subsidies.

Finally, we should remember the benefits of our current system. Notable are the standardization of conventional mortgages and a highly liquid forward market for mortgage-backed securities that allows mortgage applicants to lock in interest rates. We should strive to maintain those benefits as we plan for the future.

I think we are in the early stages of an important national discussion, one that the Administration has committed to addressing in the coming months. I also believe that private capital, properly regulated, has a critical role to play in the housing finance system. But we need clear rules of the road for private risk capital to fully return to this market. As for the enterprises and the home loan banks, they each may well have important roles to play in this future system. But the place to begin the discussion is outside the existing framework of institutional arrangements.

Thank you for the opportunity to be here today, and I would be pleased to answer questions.

Chairman DODD. Thank you very much, Mr. DeMarco, and let me begin.

First, let me begin with something we do not do often enough and, that is, to thank you and your staff and other personnel at the Federal Housing Finance Agency. These are the most difficult economic circumstances that any of us have had to grapple with in our tenure here in the U.S. Congress. There have been other periods of downturn, but nothing like what we have been through. You have got to go back to the period of our parents or grandparents to encounter a time that has been as difficult. So I want to begin by thanking you and the staff. You have had the equivalent of sort of an economic gun at your head and have performed very, very well, in my view, and we thank you.

Mr. DEMARCO. Thank you very much, Mr. Chairman. On behalf of the very hard-working staff at FHFA, I really appreciate that.

Chairman DODD. They do not get recognized and these alphabet letters, most people do not understand there are people behind those letters that show up every day and do a tremendous job on their behalf.

Let me begin by—there is one of our witnesses in the second panel is going to testify, and let me quote part of that testimony to you. The witness says that, “Perhaps the biggest question policymakers face is whether U.S. housing finance can attract sufficient capital to meet its needs without a significant Government role,

particularly in the wake of massive failures in the private securitization market.”

What is your answer to this question? Will the United States be able to attract the capital necessary to meet our housing needs without a role of the Federal Government?

Mr. DEMARCO. Mr. Chairman, as I said at the close of my statement, I actually think that private risk capital can and should return in a more fulsome fashion to the U.S. housing finance system.

In terms of the role of the Government as a credit backstop, there are multiple dimensions to that. Clearly, the Government is playing a direct guarantee role through the FHA, through the VA, through rural housing. So there already are various mechanisms in which the Government is providing direct credit guarantee to certain targeted mortgage activity. The question becomes really, with the conventional mortgage market, what sort of role the Government ought to play going forward there. There are various options, but I think this actually is a bit of the rub in terms of what should be done.

I would say that the system that we have had has attracted a great deal of global capital investment, but it appears to have done so with this much discussed perception of an implied Government guarantee. And so I would hope, however policymakers end up deciding on this question of the Government’s role in providing or not providing credit support to a broad swatch of the mortgage market, that we not leave this hanging uncertainty because this has the tendency to privatize the gains and put the losses on taxpayers.

So I would hope for something that is either clear about what the limit of Government support is, if there is going to be some, or clarity in the fact that we are looking to private financial institutions to be well capitalized and for private market discipline to be the controlling influence on mortgage credit risk.

Chairman DODD. I do not begin with the presumption that we ought to. In fact, I begin with the presumption that I would like to figure out how we could do it without doing that. It seems to me that ought to be the charge. Tell me how we can achieve this without that role. The question I have is, in a sense: Is that a realistic conclusion? I mean, looking down the road, can it be done that way? Otherwise, we are trying to—whether or not we deal with this in the reg reform proposal or whether or not we deal with it after the fact, we are going to have to deal with issue, and sooner rather than later. And the question is: What do we do? We would all kind of like to know the answer to the question as we proceed.

As policy setters, I begin, as I say, with the presumption I would like to figure out a way we could do it without that.

Mr. DEMARCO. Right.

Chairman DODD. But if I am being unrealistic about that and am going to destroy a great wealth creator, job creator, all of the other things that we associate with home ownership, I would like to get some sense of whether or not that is realistic.

Mr. DEMARCO. Certainly. Mr. Chairman, I believe that we, in fact, can develop structures and a framework by which this can be managed in the private sector. So if the question is can it be done, my response is, yes, sir, I believe it can be done. I think that it requires structures in which there is competition in the marketplace,

that there is freedom of entry and exit for market participants who would be engaging in secondary mortgage market activity. There ought to be suitable regulatory oversight of those functions, as there is for most aspects of our financial system. But I think that with clarity in the rules of the road, that will happen.

In any event, this is one aspect of a larger issue, Mr. Chairman, about returning to a more traditional set of underwriting so, in fact, we are being more honest with ourselves about the risk of mortgages and the differential in risk from one mortgage to another.

And so I think that, in fact, if we have appropriate transparency in the marketplace so that investors know, if we distribute risk appropriately so that there is good credit risk management, global capital market investors will want to purchase mortgages. They are not going to know about the individual credit characteristics of any individual mortgage of \$200,000 if they are investing in securities in the millions. Private mortgage insurance is one aspect today of where there is other private capital at risk assessing that very issue of what is the credit risk of this mortgage.

And so I think that our financial system can build upon what we have today so that that credit risk can be, in fact, managed and capitalized in the private sector. That is a workable model.

Chairman DODD. Let me ask you, the Case-Shiller Index has shown that housing prices in most large American cities have stabilized or turned around. At least that is according to the Case-Shiller Index. Your own house price index shows some gains at FHFA for the first time in many months.

On the other hand, we have millions of mortgages that are in delinquency and heading to foreclosure. I saw a number the other day, and I do not—I always see numbers on a TV screen, but it talked about even an 18-percent increase this year over last year in the number of foreclosures in the country. Now, probably more of that is associated at this juncture with the unemployment rates maybe than subprimes, since we seem to have run through that a little bit. But, nonetheless, those numbers seem pretty high.

I would like to ask what your expectations are regarding housing prices and what impact that will have on the performance of the enterprises, in your view.

Mr. DEMARCO. Mr. Chairman, I do not have a forecast for national house prices. I will affirm what you said, that FHFA's own house price index, which is based upon repeat mortgage transactions of mortgages that flow through Fannie Mae and Freddie Mac, has been pretty stable this year. In fact, it is up very slightly for the year. So that is one indicator that on a nationwide basis there may be some bottoming out of house prices.

The Case-Shiller number is more recent—it is the first time in 3 years Case-Shiller has shown an uptick in house prices.

These are, in fact, positive signs that perhaps were in some sense bumping along the bottom. But if you had not, I would have very much added I am concerned about the continued increase in serious delinquency rates in mortgages around the country, including in, you know, what have been considered to be prime mortgages that Fannie Mae and Freddie Mac have purchased and guarantee.

It is troubling to me to see that the serious delinquency rates are continuing to rise, and the employment situation is one factor that is certainly affecting that. But I think that that is a very clear reason why it is too early to declare victory.

Chairman DODD. Let me just ask a couple of quick ones here as well. You have pointed out that the enterprises are playing a central role in carrying out the Administration's foreclosure prevention plan in your testimony. Why did you turn to the enterprises to perform this function, number one? And to date, the loan modification effort has focused largely on payment modifications. We have been through a lot here, Senator Shelby and Members of the Committee, in trying to fashion a way that would help out. And I think all of us wished it would have worked better than it has.

I for one believe that principal reduction probably would have done more than interest rate reduction. That was a view taken by some, but we have not embraced that view nationally.

Is there any more that Fannie and Freddie can do to encourage principal forgiveness? Is this the kind of thing you are prepared to explore, or has it been rejected?

Mr. DEMARCO. To start with the first part of that question, Mr. Chairman, before the Obama administration took office, late last year FHFA, in conjunction with Treasury and with HOPE Now, a group of some of the largest mortgage lenders and servicers in the country, developed a streamlined modification plan.

What we, collectively, the GSEs and many of these mortgage servicers with their own mortgage books, as well as mortgages that were in private label securities, faced was this incredible increase in delinquent mortgages and the challenge of how to mitigate the losses from those mortgages.

And so what we first tried to do last fall with the streamlined modification program was to come up with a national program that servicers could implement regardless of whose mortgage it was, so there would be a consistent framework for engaging in a massive-scale loan modification program. That was set, what could be done voluntarily at that time, at a payment rate of about 38 percent of a homeowner's monthly income.

When the Obama administration came into office, they looked at the very early results from the streamlined program with us, with the GSEs, and with industry, and we all collectively concluded that more needed to be done here. And so the Obama administration did lead an effort to develop the Making Home Affordable program.

The reason for the enterprises' involvement in this is twofold: One, the enterprises currently own or guarantee in rough order about half the mortgages in this country. So anything that brings liquidity and stability to the general mortgage market goes directly to the financial benefit of Fannie Mae and Freddie Mac in terms of stabilizing their credit exposure.

The second thing is Fannie and Freddie, with all these mortgages, their mortgages are actually serviced by several thousand servicers around the country. Most of the servicing is being done in these same large servicing shops that do private label securities.

So to engage in a large-scale national loan modification effort, it really made a lot of sense for there to be one program that servicers had to learn the rules and had to implement, regardless

of whether it was a Fannie Mae loan, a Freddie Mac loan, or a loan on some other balance sheet.

And so the reason that the enterprises do this is they have the direct commercial relationships with these servicers, and it allowed for this consistency, which was good for the servicers, good for the borrowers—they get treated equitably that way—and certainly facilitated loss mitigation for Fannie and Freddie.

Chairman DODD. Thank you very much.

Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Mr. DeMarco, on June 18th, the day after the Administration released its regulatory reform plan, Secretary Geithner said to this Committee, and I quote, “We wanted to make sure we were focusing on those problems that were central causes of this crisis.” Those are his words.

While I agree that we should address the problems that were the central causes of this crisis, I am at a loss as to why the Administration does not or did not consider the GSEs to be a central cause meriting immediate consideration in regulatory reform. Maybe it is something we have got to do; the Administration did not understand or maybe looked the other way.

Do you know why the Administration determined that Fannie and Freddie were not central causes of the crisis when everybody else knows better?

Mr. DEMARCO. Senator Shelby, I am sorry, I cannot speak for the Administration’s view on this or why they did or did not—

Senator SHELBY. But you are part of the Administration.

Mr. DEMARCO. Well, I am running an independent Federal regulatory agency, so in that sense, I really do not think I am—

Senator SHELBY. You cannot speak on that subject.

Mr. DEMARCO. I cannot speak on that subject for Secretary Geithner, no.

Senator SHELBY. Do you have an opinion, if we do our job well, if we do—and I hope we will—on reforming financial services regulation, can we do that job really without addressing the Fannie and Freddie problem? And if so, I wish you would tell us all, both sides of the aisle, because that would be an interesting statement.

Mr. DEMARCO. Senator, there is no question that the U.S. Congress needs to deal with Fannie and Freddie and more largely, as I have tried to set out in my testimony, with the housing finance system. And I think that that needs to be done. I do not mean to be trite in saying this, Senator, but I think it needs to be done expeditiously, but not hastily.

Senator SHELBY. I agree we should not hastily do anything, especially regulatory reform.

Mr. DeMarco, the General Accounting Office found, and I will quote, that “The enterprises”—meaning GSEs, Fannie and Freddie—“structures undermine market discipline and provided them with incentives to engage in potentially profitable business practices that were risky and not necessarily supportive of their public missions.”

Do you disagree with that statement?

Mr. DEMARCO. Senator, I think it is quite clear that the GSE structure had flaws in it, and that has been widely discussed and

reported. GAO has been reporting on that for many years. I know the Treasury Department in multiple Administrations has reported on that.

The structure in which Fannie and Freddie were allowed to operate under for many years really did allow for excessive leverage and risk taking and sending mixed signals to the marketplace about just what the Government's stand with respect to them was. And it is something that I think we all ought to regret was not addressed earlier.

I would also acknowledge the Congress' enactment of HERA in 2008 that finally, after many years, created a single housing GSE regulator and gave that regulator—

Senator SHELBY. It helped some, did it not?

Mr. DEMARCO. It helped some, but, frankly, Senator it would have certainly been helpful to have had that earlier.

Senator SHELBY. You referenced that—but I will bring it up again—while the conservatorship itself would reduce incentives to some degree—and we brought that up in the legislation there—what other steps has your agency taken to bring Fannie and Freddie practices in line with sound lending standards?

Mr. DEMARCO. Senator, I think that clearly we are limiting, and they are themselves limiting, their mortgage activity to a more prudent approach to the credit quality of borrowers and the realistic pricing of credit risk. That itself is subject to some criticism, but I think that, in fact, we have for a long time underpriced mortgage credit risk, and there is an ongoing return to a more sensible price—

Senator SHELBY. We have underpriced it at our own peril, have we not?

Mr. DEMARCO. Yes, sir.

Senator SHELBY. What measures would you suggest through your agency be adopted to ensure in the future that GSEs—Freddie and Fannie—do not return to such bad practices that they have had in the past after they emerge, assuming they do—I hope they do and are privatized—from conservatorship?

Mr. DEMARCO. Well, Senator, it would certainly be my expectation that you have two institutions that have tremendous expertise, personnel and otherwise, in servicing the U.S. mortgage market. And so I do envision that there is some post-conservatorship realm for them. But there is a certain difficulty in answering that question because one does not know what the model is that this post-conservatorship world is operating in.

So I think that the sort of questions that I set forth in—

Senator SHELBY. Do you envision a hybrid model like a GSE or a totally private Fannie and Freddie or something like that?

Mr. DEMARCO. Senator I know the GAO will testify in the next panel, they have set out several broad ways this can be done, of which privatization is one. Something that moves it more into the Government is another.

As I have already said, in my view, whichever way we go here, I would urge that we avoid the key pitfalls of the current arrangement where there is this uncertainty or this implied Government backing, and a set of exclusive charters that are given a set of sub-

sidies operating in this rather unique fashion. That model does not work. And so I think those are the things we need to fix.

Senator SHELBY. I know I am over my time, but basically what lessons have we learned? And that is important. Have we learned anything from the debacle that went through Fannie and Freddie? You testified, Mr. DeMarco, and I will quote your words, "To properly consider the future of the housing GSEs, one should first consider the goals policymakers have for the U.S. housing finance system, and specifically the secondary market." I agree with that.

And as you consider this, what lessons do you see from our past experiences related to Fannie and Freddie that should help us shape, all of us, policymakers, those goals in the future? And do you believe that the GSEs' housing goals may have contributed to the buildup and subsequent fall of these institutions?

Mr. DEMARCO. Senator Shelby, I will try to hit on all the different things that were in that question.

I think in terms of the lessons learned, I have already talked about the model here. I think that we had a system driven by statute where we ended up with different regulatory capital requirements for a mortgage, depending upon where that mortgage was held or how it was being financed. I think there needs to be far greater regulatory harmony there.

I would extend that point to also say that, as a general proposition, I think that, in whatever financial regulatory reform we end up with, there will be multiple agencies of Government with responsibility for some aspect of housing finance. And I think creating mechanisms whereby those various agencies are themselves in some coordination with each other so that, as a Government, we are taking a more consistent approach of analyzing what is going on in the mortgage market, how are consumers being protected, and are we creating sort of regulatory arbitrages someplace in the market, that we ought to have mechanisms that address that in whatever regulatory reform we end up with.

Senator SHELBY. Mr. Chairman, you have been very generous with me on the time, but if I could follow up on this. As we get into regulatory reform, we are talking about and a lot of the regulators are talking about more capital for banks, for financial institutions. Yet if we deal with the GSEs in the future, they are going to have to have a lot of capital considering the risks out there in the marketplace. How do we do that?

Mr. DEMARCO. Well—

Senator SHELBY. Because you cannot—I do not believe you can have one institution or two institutions this big with very thin capital, because you are waiting for the time bomb to go off.

Mr. DEMARCO. Well, absolutely, Senator. And I think that OFHEO for many years testified to that very point, as have other Government agencies that have studied this risk. So, think about where we were statutorily. Since 1992, the requirement was that Fannie and Freddie hold 45 basis points of capital for the credit risk of mortgages that were in mortgage-backed securities. That creates leverage—

Senator SHELBY. Now, just tell the audience—and you are talking to the American people here.

Mr. DEMARCO. Sure.

Senator SHELBY. —what 45 basis points is. It is not even a half of a percent, right?

Mr. DEMARCO. That is correct, Senator.

Senator SHELBY. Fifty would be—

Mr. DEMARCO. Would be half a percent.

Senator SHELBY. That would be the most thinly capitalized financial institution in the world, would it not?

Mr. DEMARCO. That is remarkably thin, Senator.

Senator SHELBY. Would it be the most thinly capitalized financial institution you ever heard of?

Mr. DEMARCO. I am guessing so.

Senator SHELBY. Thank you, Mr. Chairman.

Mr. DEMARCO. But, I mean, Congress did address this last year.

Senator SHELBY. I know that.

Mr. DEMARCO. But, unfortunately, it was just 6 weeks before we were faced with the necessity to put them in conservatorship.

Senator SHELBY. Thank you.

Chairman DODD. Thank you very much.

Senator Reed.

Senator REED. Thank you, Mr. Chairman.

Can you give me an idea of the balance sheets today of the two GSEs in terms of the category of assets they have, direct mortgages, guarantees, mortgage-backed securities? Not with numbers, but just a rough approximation.

Mr. DEMARCO. Sure. Just roughly speaking, about \$750 billion in mortgages on their balance sheet.

Senator REED. And these are individual mortgages that they are holding?

Mr. DEMARCO. Mortgages and mortgage-backed securities.

Senator REED. And what is the breakdown between the mortgage-backed securities and—

Mr. DEMARCO. It differs between the two companies, Senator. I can give you the precise figures. But Freddie Mac tends to hold more mortgage-backed securities. And then they each have on the order of a couple trillion dollars in mortgage-backed securities that are outstanding.

Senator REED. And some of these mortgage-backed securities were essentially—as I understand the process, they would put the mortgage-backed securities together themselves. They would buy the loans and then—is that correct?

Mr. DEMARCO. There are a couple different ways in which the transactions actually take place. But in simple terms, Senator, yes. There is a pool of individual mortgages that are collected and put in trust, and then there is a security issued that is backed by the mortgages in that trust.

What Fannie Mae and Freddie Mac provide the holder of that security is a corporate guarantee that if the borrower, if any of the borrowers fail to make payment on any of the underlying loans, that as a company they will make sure that the payment of principal and interest is made to the holder of the mortgage-backed security.

Senator REED. But then they would go in and buy in the market mortgage-backed securities that were put together by other entities. Is that correct?

Mr. DEMARCO. They did do that, Senator, yes.

Senator REED. And to what extent do you think the due diligence was done and underwriting was done on those purchases by Fannie and Freddie?

Mr. DEMARCO. Well, certainly in hindsight, Senator, not enough. I think that, like other market participants, there was a reliance upon the tranching that was done in these private label securities whereby there were subordinate pieces or tranches in the security class that were to absorb the initial losses that might take place on individual mortgages. And so the rating agencies were used to identify how much of that needed to be done in order for the most senior class to be rated AAA. And so not just Fannie and Freddie, but the home loan banks as well, all the housing GSEs were engaged in purchasing these private-label mortgage-backed securities, almost all purchasing the AAA-rated pieces of it.

But as we have seen during this crisis, many of those, if not most of those, AAA-rated securities have, in fact, been downgraded.

Senator REED. I understand also that they were given credit by the regulators for their affordable housing goals with the purchase of much of these market private label securities.

Mr. DEMARCO. That is correct, Senator.

Senator REED. Was there any way that they assured themselves that these loans were actually, you know, providing affordable housing for—in fact, I would assume that the package of loans in the overall pool ranged from upper-income people buying second homes all the way down to someone buying a first home.

Mr. DEMARCO. Well, Senator, the pools themselves or the pieces of it that they purchased had to, of course, be structured to satisfy the requirements of their charter. So the loans could not exceed a certain size. And, in fact, there is a review done—the Department of Housing and Urban Development was the agency responsible for this until last year when FHFA was created. But HUD did go in and review what the enterprises reported in terms of what were the actual underlying mortgages and did they satisfy the requirements of various housing goals.

And so, for example, a private label mortgage-backed security backed by subprime loans might, in fact, be fairly goals rich, and that, in fact, is one of the ways in which the enterprises satisfied their housing goals. For other types of private label securities backed by Alt-A loans where there was, say, limited or no income documentation, in fact, those loans would not qualify for at least some of the goals because without income documentation, there was no way to verify whether they met the income requirements of those goals. So there was no goals credit given in that area.

Senator REED. So you are confident that HUD actually went in and credited those—looked at the mortgages underlying these securities, gave credit where credit was due?

Mr. DEMARCO. Well Senator, I was not at HUD. The HUD staff that have come over to FHFA have told me that there was a review process to look at what were the mortgages that were being stated as backing these goals.

Senator REED. Thank you very much.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator, very much.

Senator Johanns.

Senator JOHANNNS. Mr. Chairman, thank you.

Mr. DeMarco, thank you for being here. Do not take offense at this, but I have listened to all of this and the challenges you are facing, and I wonder what makes you tick. Why would you take a job like this?

[Laughter.]

Senator JOHANNNS. It is a temptation to revisit the past, and I think that is important. But in my questions I would like to focus on kind of a way forward and where do we go from here, because this is important and I am one of those people that believe unless we get some stability in the housing market, it is going to be hard to build an economy that works.

In getting my head around this—and I would like your reaction to this—it seems to me that we are kind of dealing with two things in a global sort of ways, maybe a 50,000-foot way. And the first thing is that we have got this book of business that you have got to deal with, and it just sounds overwhelmingly horrible, to be very blunt about it. You have said, you know, we are about into this, from the standpoint of the Federal Reserve, to the tune of about \$1 trillion plus. You anticipate additional draws will have to be made. Unemployment is rising, so that is now impacting foreclosures. It is not just the subprime phenomenon. It is almost like a snowball coming down the hill. So we have got that book of business and how to deal with that.

Then we have got the issue of the way forward. What do we do? What is the right model in terms of looking at the Government's role in the housing industry in the future?

First of all, is that a fair way of looking at it, number one? And, number two, give me some thoughts on an idea that, relative to that book of business, somehow some way we just have to deal with that, bite the bullet, find the best way to get out of that, deal with foreclosures, *et cetera*. Is that a resolution trust authority? Talk me through that a little bit, if you would.

Mr. DEMARCO. OK. I think as a general framework, Senator, that is about right, and I think it fairly accurately depicts what not just our agency but others that are involved in the current housing crisis are, in fact, doing.

The effort certainly since the creation of the conservatorships to now has really been focused on bringing as much liquidity and stability back to the mortgage market as we can and working through those books of business where all these losses are embedded. You mentioned about taking this job. I think the thing that motivates our agency, our staff, is motivating a lot of what is going on at Fannie and Freddie right now and the folks that are working there. There is an opportunity to try to help as many people in troubled mortgages as we can. It is good for those people, it is good for their neighborhoods, and it is good business sense to do everything we can to prevent avoidable foreclosures. And so the efforts that have been taken under the loan modification program is a key aspect of bringing stability to the mortgage market.

Another part of it that has not been discussed yet at this hearing is mortgage refinance activity, and there have been a number of things done in that way, and that also is good. It is good for indi-

vidual households. It allows households to strengthen their own balance sheet by being able to refinance into a lower-rate mortgage. That makes them more committed to their neighborhood, their home, and that helps stem future delinquencies and foreclosures. And it improves, frankly, the credit quality of the mortgage guarantee book that Fannie and Freddie are running.

So I think that the effort today is focused where it needs to be. This is a huge, huge problem, and it affects many, many people. And so it has been a huge undertaking to address it. And it cannot be fixed overnight, but I do, in fact, think that the conservatorships have accomplished their basic goal of getting the enterprises so that they can remain active in the marketplace, so we can have some restoration of liquidity and stability.

Clearly, the support provided by the Treasury and the Federal Reserve have been essential to that. While we work through this remaining book of business and, frankly, the larger macroeconomic issues in the country, it is also the time to be considering the future of the housing finance system and what sort of institutional arrangements and regulatory oversight is going to be most effective and efficient in ensuring going forward that we have robust, liquid, and stable capital market financing of these trillions of dollars' worth of mortgage credit across the country.

Senator JOHANNIS. You know, I do not know—my time is up already, but I do not know how we accomplish all of this, and that is what we are trying to figure out through this hearing process. But just in terms of an ongoing relationship with this Committee and maybe even individual Senators, it would be very, very helpful to me to kind of understand how the current mess is being cleaned up and the progress there and whether there is something missing in your authority or whatever that would be helpful on that.

Second, any advice you can give on the way-forward piece of this problem, what role should Government have in the future and how should that be executed.

But then I am going to add a third piece that is really important to me, and if you could just give us a quick observation on that. Fannie and Freddie are out there still doing business. Are they further compounding the problem? Or is it a new world for them? In other words, help assure me that a year from now somebody will not be in here saying, "Oh, man, all of that work we did since January of 2009 has just created a further mess." Assure me that that is not happening, if you can.

Mr. DEMARCO. Certainly, Senator. First, thank you for the offer. I would be most pleased, as would my staff, to follow up directly with you and with all the Members of this Committee on an ongoing basis. As I said earlier, this really is the start of a national discussion here, and we would be most pleased to make ourselves available to talk individually about how we are progressing in that way.

With respect to the assurance that you are seeking, Senator, I can assure you that as conservator of each of these companies, we are very focused on ensuring that we are, in fact, conserving the assets of the companies and that the companies' continued participation in the marketplace is done in a way in which it serves its core mission of ensuring liquidity and stability to the mortgage

market. And so everything that they are doing going forward is prudent, sound, safe and sound business that is adding to the stability of the market and not bringing additional risk to it. And that is very much our focus.

And I would like to say that we have got new boards of directors at each of these companies, new executive management teams, and I do appreciate the effort that they have been bringing to this effort. They see the companies' role in the same fashion, and that is why I think we have had a good, cooperative effort on the Making Home Affordable program, because they realize it is good for borrowers, it is good for communities, and it is good business sense all the way around. And so that is going to help us get through this housing recovery.

Senator JOHANNNS. Great. Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator, very much.

Senator JOHNSON.

Senator JOHNSON. Excuse me for having gone to the Energy Committee to participate in the markup.

Mr. DeMarco, how have private label securities affected the stability of the GSEs?

Mr. DEMARCO. Senator, the private-label security investments that the housing GSEs have made have been damaging to their financial condition. They have all—both Fannie and Freddie as well as the home loan banks that had sizable private-label security investments—suffered impairments from those investments, and those impairments have certainly had a negative effect on their balance sheets.

With respect to Fannie and Freddie, a tremendous amount of those securities, I think on the order of 90 percent—have been downgraded. And so this has not been a pretty financial picture for the housing GSEs.

Senator JOHNSON. Your statement includes two sentences about market risk. Can you elaborate on your strategies available to mitigate market risk and how they would impact liquidity in the mortgage market?

Mr. DEMARCO. Certainly, Senator. The combination of the volatility and severe episodes of illiquidity that we have had in financial markets—and not just in terms of debt markets but with derivatives as well—have made it an increasing challenge to finance and retain a portfolio of mortgages. There is added complication for the enterprises in conservatorship.

On the one hand, there is something very positive, and that is the Treasury Department's Senior Preferred Stock Purchase Agreement with each company that established a very sizable taxpayer backstop to the companies, and that continues on with new debt issues that the companies have.

At the same time, the market is quite cognizant of what is going on with the enterprises, that they are in conservatorship, that there is public discussion, which is quite necessary that we are having today, about the future of the enterprises. And that goes to concerns or questions in the marketplace about how much longer will they be around or issuing debt in the form and fashion in which they have. And so those sorts of uncertainties add some

unique challenges to the market risk activities that the enterprises' folks have.

Senator JOHNSON. In a relatively stable mortgage market like South Dakota, there are families underwater. What steps are being taken to assist those families, particularly in rural areas?

Mr. DEMARCO. Senator, I would immediately note two things. One is the refinance program I alluded to a few minutes ago. You know, with mortgage rates being down around 5 percent, or perhaps even lower, it is a terrific opportunity for households to strengthen their balance sheet and be able to take advantage of that by refinancing the mortgage.

But there are many homeowners that took out very prudent, sensible loans. They might have had 20 percent down and not even needed mortgage insurance when they first got their mortgage. But they happen to live in a community in which over the last 2 years there has been a tremendous decline in house prices. And so for them to be able to refinance their mortgage, they, in fact, might be underwater today.

So one of the things we did with this refinance program is we allowed for mortgages that are owned or guaranteed by Fannie Mae or Freddie Mac, for those loans to be able to be refinanced even if the current loan-to-value ratio on that property is up to 125 percent. And so that gives these borrowers that are underwater an opportunity to, in fact, take advantage of these low rates.

The reason we did that is that this credit risk is already on the books of Fannie and Freddie. They already own the mortgage, so they already own that credit risk. So if there is something that can be done to make that a more creditworthy mortgage, that is good for the borrower, and it is good business for the credit risk exposure that the enterprises have to that. So that is one thing that has been done to help underwater borrowers.

You asked particularly about rural housing, Senator. One of the things that Congress did last year in enacting HERA is it made a number of changes to the housing goals for Fannie and Freddie going forward that our agency is supposed to implement beginning next year. And one of those is a duty-to-serve requirement for the enterprises, and Congress said that we want to see—in addition to the housing goals, we want to have expressed in regulation a duty-to-serve responsibility for Fannie and Freddie to serve manufactured housing, certain targeted multifamily housing, and rural housing.

So, Senator, what we have done in the path of implementing congressional intent here is this summer, earlier this year, we issued an Advanced Notice of Proposed Rulemaking to get broad public comment on how to go about developing this duty-to-serve requirement. My team literally has gone out and hit the road to see what is actually going on across the country in these areas. So we have gone out and visited manufactured housing parks. We have gone out and visited with participants in the manufactured housing industry. We have done likewise with respect to rural housing and have been meeting with advocates for and folks with direct knowledge of what is going on in rural housing markets in this country. And we are trying to gather that information so that as we develop our proposed rule later this year, we will be informed by what we

learn from market participants so that we can implement congressional intent with respect to these duty-to-serve requirements.

Senator JOHNSON. Thank you, Mr. DeMarco. My time has expired.

Chairman DODD. Thank you, Senator, very much.

Senator Gregg.

Senator GREGG. Mr. Chairman, I—

Chairman DODD. I am sorry? We try to do it first to arrive and—

Senator GREGG. Yes, but yesterday Senator Corker was nice enough to yield to me after he had left and come back, so I would yield to Senator Bunning or Senator Corker.

Chairman DODD. I am not going to intervene here.

[Laughter.]

Senator GREGG. No, no. I am yielding to you guys. You stuck around. I will go after the—

Chairman DODD. Senator Bunning actually was next.

Senator BUNNING. Thank you, Senator Gregg.

Chairman DODD. Senator Bunning, you are on.

Senator BUNNING. Thank you. Thank you, Mr. Chairman.

It has been over a year since the creation of your agency, yet you still do not have an Inspector General. Why is that critical job still vacant? And when will it be filled?

Mr. DEMARCO. Senator, when Congress enacted HERA, it did establish—it did state in that law that there shall be established an Office of Inspector General at FHFA. As the Acting Director of FHFA, I would like to be very clear, I want an Inspector General. I would like it, and I would like it now, because I believe, Senator, that Inspectors General can be very important elements of the functioning of a Federal regulatory agency.

But, Senator, the answer to your question of why we do not have one is that there is a requirement in the statute that the Inspector General be Presidentially appointed and Senate confirmed. So this position is awaiting a Presidential nomination for the IG.

Senator BUNNING. Well, I understand that, but you as the acting head of it, you could at least make a suggestion to the Administration that this is a critical position that needs to be filled. It would really help your relationship with the Congress of the United States, I can tell you, and with this Committee if that position were filled.

Mr. DEMARCO. Senator, I have had that communication with the Administration multiple times.

Senator BUNNING. Others have asked questions about Freddie and Fannie. This one I do not believe has been asked. How many more dollars, how much more money are we going to have to put in Freddie and Fannie?

Mr. DEMARCO. I do not know the answer to that question, Senator, but I can tell you that from the time we created the conservatorships, FHFA has been regularly evaluating that question and working with both the Treasury Department and the Federal Reserve to undertake various stress test approaches to analyze under various scenarios what might be needed. And so this has been an ongoing effort, and it is an effort that continues today to assess where the losses are heading and what future draws might

look like. But it depends upon so many variables about the future, not just of house prices but of the economy.

Senator BUNNING. Do you think there is any chance of us getting taxpayers' money back?

Mr. DEMARCO. To date, Senator, there has been about \$96 billion drawn from the Treasury under the Senior Preferred Stock Purchase Agreement. I do not envision any near-term way in their current form for that money to be paid back.

Senator BUNNING. Thank you. I agree with that.

Do you know how much profit mortgage banks are making off new Government-guaranteed loans right now?

Mr. DEMARCO. I am sorry, Senator. Would you repeat that?

Senator BUNNING. Do you know how much profit mortgage banks are making off new Government loans right now?

Mr. DEMARCO. No, sir, I do not.

Senator BUNNING. You do not have any idea?

Mr. DEMARCO. What mortgage bankers are making? No, sir.

Senator BUNNING. Mortgage banks.

Mr. DEMARCO. No, sir.

Senator BUNNING. OK. According to what I have been told by people in the industry, recent profit margins are 2.5 to 3 percent per loan. Not that long ago, profits were more like 1 percent per loan. Does that seem fair to you that originators are making that much money when all the risk is being taken by the taxpayers? What are you going to do to bring those unfair profits back down to a more reasonable risk to the originators?

Mr. DEMARCO. Senator, I do not have oversight over mortgage originators, so I believe that that would be a question for other regulatory agencies. I am certainly concerned about what is going on with Fannie Mae and Freddie Mac and their earnings—

Senator BUNNING. But you do have regulatory power over the agencies.

Mr. DEMARCO. Yes, sir.

Senator BUNNING. That is the basic question.

Mr. DEMARCO. So with respect to Fannie Mae and Freddie Mac, I am concerned about the money they are still losing, Senator.

Senator BUNNING. Me, too, since it is my money.

Mr. DEMARCO. All of us, sir, as taxpayers.

Senator BUNNING. Yes, everybody. I mean "us."

Mr. DEMARCO. Yes, I understand that.

Senator BUNNING. "My" being plural.

Mr. DEMARCO. We are very cognizant of that at FHFA, Senator. Senator BUNNING. Is it true that refinanced loans that you were speaking about have better than a 50-percent failure rate?

Mr. DEMARCO. Refinanced loans? No, sir.

Senator BUNNING. Is that right? Would you like to—

Mr. DEMARCO. The default rate of a mortgage that has been refinanced?

Senator BUNNING. Yes.

Mr. DEMARCO. No, sir.

Senator BUNNING. Do you have a figure?

Mr. DEMARCO. Senator, are you actually asking me about loan modifications as opposed to refinanced? To me, there is a very important difference here. A modified loan is one where the lender

has redone the terms of the mortgage because the borrower is failing to make payment. A refinanced mortgage is a different animal.

Senator BUNNING. OK. Let us take the first type.

Mr. DEMARCO. OK. So on loan modifications, Senator, it had been common practice, before we really got into the depths of this housing crisis, that when an individual borrower got into trouble, they would certainly have the opportunity to work with their lender. There were times in which the loans would be modified, the payment would be modified to help keep the borrower from defaulting.

But the way that was done, Senator, is that the majority of time that resulted actually in an increased payment to the borrower. And so the performance rate or, if you will, the redefault rate on modified loans had been quite high.

The approach that is being taken now is much, much different than the way loan modifications were made even a year ago. A year ago, a year and a half ago, there were very few modified loans that resulted in a material decline in mortgage payments. Today the loan modifications that Fannie Mae and Freddie Mac are doing, over 80 percent of them are resulting in a decline in the borrower's payment, and over 50 percent of them are resulting in a decline of more than 20 percent.

Now, because this activity—

Senator BUNNING. You are not answering my question.

Mr. DEMARCO. Well, because—

Senator BUNNING. You are evading my question.

Mr. DEMARCO. No, Senator, I am trying to give you an honest answer that says that, in fact, loan modifications that were done 18 months ago did have high default rates, and I would not transfer that experience, that data point as a presumption of what we are going to see about loan modifications that are being done today, because those modifications are fundamentally different from the perspective of the borrower.

Senator BUNNING. Well, but aren't the fees that have been added to those loans, the loan level price adjustments, making those loans more expensive?

Mr. DEMARCO. Senator, the loan level price adjustments are things that are affecting new loans, so that might be an issue—

Senator BUNNING. That is why I asked the question.

Mr. DEMARCO. —with the refinance, but that is not an issue with the modified mortgages.

Senator BUNNING. Then you did not answer the percentage for me.

Mr. DEMARCO. Senator, I can go back, and I would be glad to try to get a percentage for you on redefault rates for refinanced loans. And I would do that for the modified as well.

Senator BUNNING. I would appreciate that, if you would give it to the Committee.

Mr. DEMARCO. Yes, Senator, I would be happy to do that.

Response: I am pleased to provide responses to questions you asked me during the October 8, 2009, Committee on Banking, Housing, and Urban Affairs hearing on the future of the mortgage market and the housing enterprises. Your questions focused on redefault rates for refinanced and modified mortgages.

Redevelopment Rate for Refinanced Loans

Fannie Mae and Freddie Mac eligibility requirements do not allow for loans that are significantly delinquent or in default to be refinanced. Loans in that condition would be more appropriate for modification. The most significant benefit of the Home Affordable Refinance Program (HARP) and other refinance programs is a reduced payment, which increases affordability for the borrower, leading to fewer defaults. Most of the borrowers refinancing their mortgages are reducing their interest rates, reducing their housing payments, and potentially substituting a new fixed rate mortgage for their original adjustable-rate mortgage. All of these changes increase their probability of successful long-term home ownership.

The Federal Housing Finance Agency (FHFA) reports on the performance of refinanced loans in its monthly *Refinance Report*, based on Enterprise data. The Enterprises have begun tracking the performance of loans refinanced under HARP, but it will be several months before they have sufficient information to establish a valid default rate. As of September 30, 2009, of the 116,677 loans with loan-to-value ratios over 80 percent to 125 percent that have been refinanced under HARP over the last 9 months, only one loan is categorized as more than 90 days delinquent. For refinance loans originated in the first and second quarters of 2008 and purchased by the Enterprises, (the most recent period with enough data to establish a redefault rate), the early payment default rate for refinance loans is approximately half the early payment default rate of purchase loans. Based on the early default data and the design of the program, FHFA does not expect a high default rate for refinanced loans.

Redevelopment Rate for Modified Loans

The Home Affordable Modification Program (HAMP) was established in March 2009, with the first trial modifications under HAMP in place in May 2009. HAMP requires a 3 month trial period where homeowners can adjust to the modified payment before the modification is final. The first trial modifications just completed their trial period in August 2009. There has not yet been enough time to establish a valid redefault rate for this program.

As I mentioned in my testimony, redefault rates for modified loans have been an area of concern for policymakers focused on keeping homeowners in their homes. Modified loans are more at risk for redefault than refinanced loans because the borrower was experiencing financial hardship. However, FHFA expects lower redefault rates for loans modified under HAMP than older modification programs developed by individual servicers for one key reason: HAMP loan modifications generally result in lower monthly payments for homeowners. Prior modification programs focused on "catching up" the loan and, with fees rolled in, often resulted in higher monthly payments. This is a significant difference, making the HAMP loans more sustainable over the long term.

FHFA's most recent monthly *Foreclosure Prevention Report* demonstrates this difference. In the first quarter of 2008, 82 percent of modified loans resulted in an increase in the monthly payment made by the homeowner. In the second quarter of 2009, after HAMP was established, only 12 percent of modifications resulted in an increased payment. Although not all borrowers qualify for HAMP modifications, some homeowners seeking a modification may still qualify for the older programs.

FHFA will continue to publish and share with Congress information on the performance of both refinanced and modified loans through the agency's *Foreclosure Prevention Reports* and *Refinance Reports*, available on the FHFA Web site, www.fhfa.gov. These reports are submitted to the Committee monthly as part of FHFA's Federal Property Manager Report.

Senator BUNNING. Thank you.

Senator JOHNSON [presiding]. Senator Reed.

Senator REED. I have already gone.

Senator JOHNSON. Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair, and thank you for your testimony. In your written testimony, you note that important features of the mortgage system include innovation and consumer choice but also consumer protection. There is sometimes some tension between those goals.

I was wondering if you would elaborate on your perspectives, if you will, how two of the features of mortgage practices that developed might have impacted this overall puzzle, those being prepay-

ment penalties and steering payments. If you could kind of give us some sense of how those practices reverberated through the markets.

Mr. DEMARCO. Senator, steering payments? I want to make sure I understand what you are meaning by that.

Senator MERKLEY. Yield spread premiums.

Mr. DEMARCO. Oh, I am sorry. Yes. So on the issue of consumer protection, prepayment penalties, it seems as though prepayment penalties on subprime mortgages have been one of the very detrimental features of those mortgages for borrowers. That is an issue. I would say that the enterprises have little or no mortgage activity that involves prepayment penalties.

I would not be quite so blanket as to say that there is not opportunity for where some of the various features in subprime loans, in fact, could not be sensible for a particular borrower in a particular circumstance and with the financial sophistication to know what it is that they are undertaking. But what we saw is that when some rather tailored mortgage products with certain features that might make sense to a sophisticated borrower with a particular situation got generalized in mortgage lending, and then offered to and encouraged for borrowers that were not the strongest credits or did not have the characteristics for which those specialized features were originally developed that has been a cause of a great deal of the problem here. A lot of that has taken place sort of outside of the normal regulated mortgage lending channels, but, nonetheless, I think we all share a concern that this activity really went too far and needed an appropriate response.

With respect to yield spread premiums, Senator, this is something that has been the object of a great deal of debate and discussion at HUD and the Fed and other regulatory agencies with responsibilities in this area, and I think that it is really kind of unfortunate we cannot get to having that resolved once and for all.

Senator MERKLEY. Well, that was not exactly an answer on yield spread premiums on either the role they played or your opinion on them.

Mr. DEMARCO. I do not have information specific to the role yield spread premiums played on mortgage defaults.

Senator MERKLEY. Well, let me enlighten you a little bit then. Ordinary families went to their mortgage brokers. They saw on their spread sheets that they were paying their broker a certain amount of money. What they did not know is that their broker was being paid a separate fee off the books to steer them into a subprime. So if you have a broker system where the brokers who are presenting themselves as the financial adviser to the American consumer on the most important transaction that an American family faces are actually being paid separately with an undisclosed conflict of interest payment to put people into something that is not in their best interests, not only does that result in tons of people being steered into subprime loans, but it also means that any sort of good advice that the customer is paying for, they are not getting because they are being outbid on the back side. That had a huge impact on the multiplication of the subprime switch. Fannie and Freddie then began to purchase.

So when I go through this, it puzzles me that you would not have any insight or thought on the role that this played, because it was a massive part of the increase in subprime lending.

Mr. DEMARCO. Senator, fair enough. I think it perhaps was a misunderstanding of the question, because, in fact, yield spread premiums are an issue there, but they are also an aspect of normal or more prime transactions as well. And it has been a focus of a great deal of regulatory discussion.

So I think, Senator, that what I would say is that yield spread premiums, prepayment penalties, and a whole array of characteristics of what was going on in the subprime market are characteristics that need to be either removed from the marketplace or restored to the limited usage where, as a tailored aspect of a mortgage product, it makes sense for that borrower.

But, clearly, Senator, I share with you the concern that we had a lot of activity here steering borrowers into mortgages that perhaps either were not suited for them or they were, in fact, qualified for something else, of which yield spread premiums may well be part of that explanation. But I would not go so far as to say that was the only thing that was going on here. But I do share your concern with this.

Senator MERKLEY. Thank you.

Senator JOHNSON. Senator Gregg.

Senator GREGG. I think Senator Corker is next.

Senator JOHNSON. Senator Corker.

Senator CORKER. Thank you, Senator Gregg and Mr. Chairman, and, Ed, for your testimony. You know, I know we need to focus on the future. I want to make just one statement before we do.

When you listen and you watch what has occurred with Fannie and Freddie and the GSEs, you really could not make up a scenario that is as strange and has such a competing undoable goal. So, you know, to have an entity that has under 45 basis points in capital, had a Government guarantee, that was actually keeping mortgages in order to juice up its profits, and then we had target groups that the Government was telling had to be lent to, really an odd model that hopefully is going away very quickly, and certainly numbers of things happened during this last crisis that would be hard to make up, again.

So hopefully as we do regulation we will make sure that this is something that we deal with, that this is not left to the side.

Mr. Chairman, I want to say I think we have a tremendous opportunity to do the right thing having this gentleman at the helm. This is a person that, you know, does not have a fiefdom he is trying to protect. The fact is he stated here that these GSEs should not exist, that the private sector can deal with this issue perfectly adequately. And so I hope this Committee will move ahead with whatever regulation is necessary to do away with the GSEs, move it to the private sector, and ensure that that is part of our regulation.

Let me just ask you, how do we do that? I read the GAO report—which, by the way, I thought they did a very good job. I know they are coming up on the next panel. We talked about some good bank/bad bank. You know, it seems to me that they exist as basically

entities that are going to continue to lose money and there is no reason to really separate those.

Walk me through how we go from having this mortgage portfolio and the insurance, how we move from there to moving this to the private sector. And what are some of the pitfalls that might exist along the way? But thank you again for your service and for your testimony. Again, I think we are very fortunate to have someone like you in this position.

Mr. DEMARCO. Thank you, Senator. That is very kind. I hope I do not now disappoint you with this answer, but I do not have a fully developed model for how one does this, but I think I can at least help move it along the way.

One of the things is that if Congress does decide on a model going forward that really relies on private capital and market discipline to be the core functioning of our housing finance system for conventional—that is, non-Government-guaranteed—mortgages, the transition point that is done with Fannie and Freddie is going to have to be very clear to market participants about what is old and what is new. Because we have clearly told the market that activity that is going on now is backed by this Senior Preferred Stock Purchase Agreement of the Treasury Department, and so there is an important responsibility that we have made to make sure that we carry that through.

So there are different ways of actually doing that separation, but I think being crystal clear about what that separation looks like is an essential element to the transition that you are talking about. So an investor knows if they are purchasing something from an old Fannie, old Freddie that has this Government support to it, they know what that is and what that means separate from any going-forward entity that comes out of a post-conservatorship realm for the enterprises and that the Government is stating its intention that this is a fully private activity or it is private with this amount of support from the Government.

There are models out there. I think that as we have done in other times, looked to the FDIC, which has certainly over its history come up with various approaches to doing these sorts of splits between institutions. That is one place that I would look to for lessons on how actually one can go about structuring these kinds of splits. But, honestly, Senator, beyond that I am sorry to say that I have not thought through a whole lot of the mechanics of this. I think I am a little too focused on working with what we have got right now.

Senator CORKER. So let me ask you, what—so you cannot walk through the transition at the present. I hope you will help us walk through that in our next meeting.

Mr. DEMARCO. I would be glad to. Sure.

Senator CORKER. What is it that a private entity that said, hey, look, you know, these entities are going to sunset. We know the oldco still has its various Government guarantees in place. But what would a newco private entity—what are some of the components that they would have to think about to, in essence, take up the vacuum that the oldco was going to leave on a go-forward basis?

Mr. DEMARCO. So I think to get into details of where I think we would need to go is we actually come up with a future system.

One of the benefits of the current system is the standardization of mortgage products. So if we create some new companies and we get rid of the barriers to entry and exit so that they are a non-Fannie or a non-Freddie entity that might come into existence that also wants to participate in this mortgage market, how do we go about appropriate standardization of mortgages and mortgage documents so that no matter which company we are talking about, we can continue to have the benefit of that standardization to lower the costs to consumers and to provide greater transparency to investors?

I think that we are going to need to think through how exactly we make sure that happens with non-GSE entities that are providing a mortgage securitization activity. It certainly can be done, but, again, it is one of these things where all I can do for you this morning, Senator, is note that these are some of the issues I think we need to make sure we have answered. And I am sure that there are answers there. I just do not have them this morning.

Senator CORKER. Mr. Chairman, thank you for the time, and, Mr. DeMarco, for your service and testimony. I would like to say that I would like—our office would very much like to be involved in a step-by-step process with you as to how we unwind oldco and move this function over the private sector. This is really not that—housing loans are not that complicated. And, in essence, by virtue of creating the huge entities that we have, we really have taken away from community banks an opportunity that exists for them to actually be able to make money on something that is less complex than commercial loans and other kinds of things where they are getting ready to take a bath.

So I look forward to working with you, and I thank the Chairman for having this Committee meeting.

Senator JOHNSON. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. Thank you, Director.

Let me ask you, in your testimony you have presented challenges that your agency faces in regulating and monitoring the progress of the GSEs. But the one thing I have heard time and time again from critics is that Fannie and Freddie were the catalysts of the mortgage collapse and not the unregulated mortgage actors.

Is it fair to say that your own agency's data indicates that Fannie and Freddie only held a small share of subprime mortgages and never originated a single subprime mortgage? Which is inconsistent with the explanation of what some people are alleging the crisis is all about.

Mr. DEMARCO. Senator, all the housing GSEs—Fannie, Freddie, and the home loan banks—were clearly important investors in subprime private label mortgage-backed securities, so they clearly provided support to that market through their purchases of it.

I think each enterprise had various programs in which they purchased mortgages directly that one would say would have some of the characteristics or features of subprime mortgages. So I think that—

Senator MENENDEZ. How big a share of them would they be?

Mr. DEMARCO. Well, Senator, for their direct purchase, I do not have those numbers directly.

Senator MENENDEZ. If you could get that for the Committee, I would like to see it, because my understanding is that they held a rather small share of those subprime mortgages. I would like to be able to quantify it.

Mr. DEMARCO. Senator, we will get something for you.

Response: I am pleased to provide responses to questions you asked me during October 8, 2009, Banking, Housing, and Urban Affairs Committee hearing on the future of the mortgage market and the housing enterprises. Your questions focused on historical information on the participation by Fannie Mae and Freddie Mac in the market for subprime single-family mortgages.

There is no common industry definition of a subprime mortgage, so it is not possible to indicate the volume of subprime loans acquired by the Enterprises. However, most industry participants would consider a mortgage made to a borrower whose credit score is below 620 to be a subprime loan. Both Freddie Mac and Fannie Mae have reported that, as of September 30, 2009, loans to borrowers with credit scores below 620 comprised 4 percent of the unpaid balance of their respective portfolios of conventional single-family mortgages. From 2002 through 2008, each Enterprise's acquisitions of such loans accounted for 3–6 percent per year of their total single-family acquisitions.

During the mortgage lending boom of the middle years of this decade private-label mortgage-related securities often were backed by pools of mortgages that issuers designated as subprime loans. The table below provides information on issuance and Enterprise purchases of such securities in 2002 through 2008. The data on securities issuance were obtained from Inside Mortgage Finance Publications. The data on each Enterprise's purchases in each year and combined Enterprise purchases in 2006 through 2008 were obtained from the Enterprises and published in FHFA's 2008 *Report to Congress*. The data on combined Enterprise purchases for 2003 through 2005 were obtained from Inside Mortgage Finance Publications and previously reported in annual research reports published by the Office of Federal Housing Enterprise Oversight, one of FHFA's predecessor agencies.

Table: Issuance and Enterprise Purchases of Private-Label Mortgage-Related Securities Backed by Subprime Mortgages, 2002–2008
(dollars in millions, unpaid principal balance)

Year	Issuance of Subprime Private-Label MBS	Fannie Mae		Freddie Mac		Combined	
		Purchases	Share*	Purchases	Share*	Purchases	Share*
2002	\$122,680.9	\$5,143.9	4.2%	n.a.	n.a.	n.a.	n.a.
2003	194,958.5	25,768.6	13.2%	n.a.	n.a.	\$81,000.0	41.5%
2004	362,549.3	67,003.6	18.5%	n.a.	n.a.	176,000.0	48.5%
2005	465,036.3	24,468.8	5.3%	n.a.	n.a.	169,000.0	36.3%
2006	448,599.6	35,606.1	7.9%	\$74,761.0	16.7%	110,367.1	24.6%
2007	201,546.7	15,970.5	7.9%	43,667.0	21.7%	59,637.5	29.6%
2008	2,261.4	637.4	28.2%	106.0	4.7%	743.4	32.9%

n.a. = not available.

Sources: Fannie Mae, Freddie Mac, Inside Mortgage Finance Publications.

* Reported "share" is Enterprise purchases of subprime private-label MBS in each year expressed as a percentage of total subprime MBS issued during the year. It cannot be assumed that the subprime private-label MBS purchased by an Enterprise in a given year were issued in that year.

Mr. DEMARCO. I think there has always been in this arena a difficult definitional question of what constitutes a subprime mortgage. The most traditional approach to this has been to look at the lending channel through which the mortgage was actually originated. But, in fact, there can be mortgages that were originated through other channels. As I said, I used the term they had some of the characteristics—

Senator MENENDEZ. Well, you cannot have a universe of people saying that Fannie and Freddie are the cause of the crisis because they were the entities that created the mortgage collapse and be-

cause they got largely involved in subprime mortgages and not be able to quantify it. You know, so we have to have some sense of being able to quantify it.

Mr. DEMARCO. So we will be glad to do that, Senator.

One other thing I would point out, just because I think it is germane to what you are asking me—and we will provide the actual data to you, but I will just try to describe it—is to look at the shifting share of secondary market activity with mortgages over the course of this decade. You know, in the early part of this decade, you see a real trend downward in Fannie and Freddie's share of mortgage securitization activity, because there was an increasing share of mortgage securitization activity taking place through the private label, private conduit system, and that is where most of the subprime and the Alt-A and the other nontraditional mortgage activity was taking place.

So there was a clear shift of market share away from the enterprises and their normal underwriting through these other channels. That has clearly and sharply reversed itself in the last 2 years, such that today Fannie and Freddie are providing the financing or mortgage guarantee on three out of every four mortgages that are made in this country. But we will make—

Senator MENENDEZ. But those are not subprime mortgages.

Mr. DEMARCO. Those are not subprime mortgages, Senator.

Senator MENENDEZ. OK. Just so we have the record clear. Which of the policy options in the GAO report do you believe are worthy of support in terms of the future of the GSEs? And are any of the GAO options particularly troublesome to you?

Mr. DEMARCO. Senator, I think GAO has done a very fair job of presenting to the Committee three broad ways in which policymakers and which the U.S. Congress can decide to go with respect to not just Fannie and Freddie, but really in terms of the secondary mortgage market and housing finance. This can come more into the Government with a more direct Government role. You can use the GSE model or various alterations to or enhancements to the GSE model. Or you can move to something that is more fully private.

I would offer two things about that. I do not have a particular preference or recommendation to offer the Committee. But I think that there are hybrids among each of these three classes that GAO lays out. In my testimony, I tried to identify three areas where I felt in particular policymakers needed to think about what role they thought the Government ought to have. That has to do with ensuring liquidity, credit backstop, and affordable housing. But I think any of that can be worked into any of these three models. Those issues can be addressed.

The one thing that I would caution against, as I have earlier this morning, is this notion of trying to have it both ways with an implicit guarantee where we say we want market discipline, but, in fact, the Government is still standing behind it there, because I think that creates a very difficult position for the taxpayer.

If we want the Government to be providing credit support, I think we ought to do it in a more sort of direct fashion and say this is what we are doing, this is how we are limiting it, this is how we are pricing for it, and so forth.

Senator MENENDEZ. All right. Thank you.

Senator JOHNSON. Senator Vitter.

Senator VITTER. I think Senator Gregg may have been in line.

Senator JOHNSON. Senator Gregg.

Senator GREGG. Thank you.

The way I look at this is it is sort of an inverted pyramid, and you have got all this structure and everything like that. But at the bottom of the pyramid is the person who borrowed money on a house, and until you can get that done correctly, until the underwriting of that loan is done correctly, you are really not going to solve the problem.

So the Congress has set up a lot of incentives to lend to that person even though the person may not be able to afford the house. The guarantees are out there that say, well, maybe the person cannot afford the house, but we are going to guarantee the loan, anyway.

All of these create incentives for bad underwriting. Is there some way to create some incentives for good underwriting? Should we require recourse loan? Should we require a percentage of—that there be 10, 15, 20 percent that cannot be loaned to, such as they do in Australia? Should we have covered bonds? Should we require covered bonds?

Is there something at that entry point in this process that we can do that does not undermine the public policy, which is that we want everybody in America to own a house? I mean, the two conflict, right? Do you have any thoughts on that?

Mr. DEMARCO. A couple, Senator. First, I believe in diversification and diversity. I think that is one of the things that impresses me in the work I do. Look at mortgage lending, and on the one hand, there is a tremendous benefit that American households get from standardization of mortgage products. On the other hand, the American household is a very diverse entity. It is different ages, different structures, different income patterns, and so forth.

And so I would hope that whatever system we come up with, I would actually not look for one answer, but, in fact, a market system that is as robust as this country is which would allow for—covered bonds might be an approach. There may be—recourse lending is an approach. I would note that the Federal home loan bank system, which we have not talked about, for a number of years have had a mortgage purchase program. It is actually shrinking a lot right now, but one mark of that program was, in fact, the initial credit risk on the mortgage actually went back to the original lender. And the mortgages in that portfolio have performed better than sort of the average in the country these past several years.

But I would look to more than one solution to this, because I think that that we have got households in different situations that have different needs. And the richness that I think having multiple sort of conduits, if you will, between capital markets and these individual lending transactions allows for diversification of credit risk and allows for greater opportunity for individual households.

Senator GREGG. OK. Accepting that—and I do accept that as a very reasoned approach to this—you still have the problem that we have created these massive incentives in our system to undermine good underwriting. I mean, basically our guarantees undermine

good underwriting. This idea that the originator is just out there for a fee really undermines good underwriting.

So what do you do to put back in the structure that does some discipline on the underwriting side?

Mr. DEMARCO. Senator, I think that is a very fair question, and it is one we all have to grapple with. If I could in some sense add to it with some additional information, we sent up to the Congress a couple months ago a study that we were required to do on guarantee fees by the enterprises, and one of the striking things about that study is what it reflects about the cross-subsidization of mortgage credit risk that was going on with the GSEs' credit book. And so you have borrowers that are in 15-year mortgages that are, in fact, effectively paying more relative to their risk than someone in a 30-year mortgage. You have someone that is a high credit quality borrower relatively speaking paying more than a less creditworthy borrower.

Now, the model that was put out there that we have operated under accepted and in some ways encouraged this sort of thing. And yet when you do that, it does not create the best incentives for people to have the most sound approach to taking credit.

So I think, in fact, there are good incentives to have credit risk properly priced to borrowers, and this gets directly at your question, I think, about underwriting.

But while I would acknowledge and share your view that this is something that needs to be addressed, I think that I do not have a particular answer. I think the answer does lie somewhere in the decisions that policymakers make about what kind of role they want for the Government in the future operation of the housing finance system.

Senator GREGG. Well, clearly, that is the problem. I was sort of hoping you had a solution for it.

Thank you.

Senator JOHNSON. Senator Vitter.

Senator VITTER. Thank you very much, Mr. Chairman, and thank you, Mr. DeMarco. And this sort of goes to Senator Menendez's lines of questions.

On June 30th of this year, at a Banking Committee hearing Secretary Geithner agreed that "Fannie and Freddie were a core part of what went wrong in our system." A core part. Would you agree with that?

Mr. DEMARCO. Clearly, Senator, the failure of these two companies, the need to put them into Government conservatorship, and the amount of taxpayer money that has been injected into them to assure that they can continue to keep a secondary market operating is a sign that their failure was a central part, a key part of the broader financial crisis that this country has been facing.

Senator VITTER. Well, I know you are not responsible for any of these broad regulatory reform proposals, but given that, don't you think it is odd that Fannie and Freddie reform is nowhere on radar, basically no part of those broad proposals? I am not saying they should be the only part or they are the only problem, but isn't it logical for them to be a big part of that discussion?

Mr. DEMARCO. I clearly think, Senator, that the Administration and the Congress need to deal directly with the issues of Fannie

and Freddie, their current status, and do that in the context of the broader housing finance system.

With respect to regulatory reform, I may have said it earlier this morning, but in any event, no matter what sort of path reform takes and what sort of system or set of entities that exists when Congress is done, whatever that looks like, it strikes me as though there is still going to be multiple Government agencies with key responsibilities for some aspect of our housing finance system. And so I think that it would be a prudent and wise thing to have arrangements whereby whatever that collection of agencies is—and not just regulatory agencies but places like HUD and the Veterans Administration and so forth—that there be sort of a systematic way for agencies with some responsibility for aspects of our housing finance system to themselves be coordinated and be sharing views on what is going on in the mortgage market, risks that are out there, whether they have to do with financial risks to investors or consumer protection issues where borrowers are at risk.

So wherever that reform discussion goes, I hope that given the huge size of the mortgage market as a particular credit market and how important it is to so many households around the country—and I would say not just homeowners. This is very important to renters as well. So this covers all the American. I think that we ought to be making sure we consider how we are addressing that kind of coordination.

Senator VITTER. Right. Apart from Freddie and Fannie as institutions, it seems to me that the sort of perverse incentives in terms of safety and soundness that Senator Gregg was describing was clearly part of the problem as well. Is that fair to say?

Mr. DEMARCO. Sure.

Senator VITTER. And, again, maybe I am missing something, but it seems to me there is little to nothing addressing that in these broad regulatory reform proposals. I know those proposals are not from you. They are not your responsibility. I am just asking for a reaction to that.

Mr. DEMARCO. Well, the Administration has put forward a regulatory reform proposal and has pledged to have its ideas on the future of the housing GSEs early next year. So that really is for the Administration to answer in terms of their thought process on this. I am sure that they see the connections that are here. But Secretary Geithner and the rest of the Administration—I am not going to speak for them in terms of the timing or staging of how they develop this.

I will say that this is a challenging—not as a challenging issue, but there has been so much effort focused on trying to get stability into the mortgage market right now and to assess kind of where we are to give that a little time to figure out where they want to go is, I suspect, part of what may be going on.

Senator VITTER. Well, this is just a statement on my part. It seems to me we are delving into regulatory reform and, in doing so, in terms of the big proposals put forward, there are a lot of things being proposed which, as I see it, have little to nothing to do with what went wrong, and there are whole gaps in the proposals, including Fannie and Freddie, where a lot of what went

wrong is not addressed, is not being changed in any way, including the perverse incentive Senator Gregg was talking about.

So I hope as the Committee works hopefully in a bipartisan way on this, we sort of use as a starting point what the real problems were that developed over the last several years.

Mr. DEMARCO. Senator, if I may, just a couple of things from the standpoint of my agency.

First we are working on developing and implementing the authorities that were given to our agency last year in HERA, so that is a step along the way. And I would just like to offer to you, as I have offered to all the Members of the Committee, we would be glad to continue to meet with you all individually and collectively to have discussions along this way, as we are working and having discussions with the Administration.

I mean, I do know the Administration cares deeply about wanting to tackle this and are working on that, and we are having discussions with them as well along the lines of the things that I presented in my testimony this morning. But I think at least we all can enter this sharing a sense that this is a challenging but important issue for the country and we all want to see it done right. And we are prepared to work with you, Senator.

Senator VITTER. Great. Well, I thought the Administration was virtually always for comprehensive reform. I guess that breaks down when it comes to Fannie and Freddie in terms of doing it together with these other pieces.

A final quick line of—one question. The CBO estimates that the conservatorship will cost taxpayers \$389 billion. Would you roughly agree with that figure as of now?

Mr. DEMARCO. Senator, I cannot comment on that. It was actually just this morning that someone on my staff alerted me that CBO had come up with some new numbers, and I have not had any opportunity to look at them or assess what that is supposed to reflect.

Senator VITTER. Whatever those numbers are, they clearly are going to be very significant. What is the taxpayer exit strategy from that type of liability?

Mr. DEMARCO. Well, Senator, I think that is what we are working on and what we are talking about right now. The immediate strategy is to bring as much liquidity and stability to the mortgage market today as we can, to try to prevent as many avoidable foreclosures as we can, because those foreclosures are only going to add to the tab. And so I think that is where our immediate efforts are, to bring liquidity back to the market and to try to stem this rising tide of foreclosures so that we can keep individual homeowners committed to their home, in their house, stabilize neighborhoods, and start to see a curtailment in the credit losses that are widespread in our housing finance system right now. So that is where the immediate focus is.

Senator VITTER. But beyond that, shouldn't there be a strategy for exiting out of that type of liability for the taxpayer in the future?

Mr. DEMARCO. Yes, Senator, there should, and I think that is very much what we are talking about when we are talking about the future of the housing finance system and the post-conservator-

ship framework for Fannie and Freddie. How do we exit and how do we then create a structure that is more robust so that we do not end up in this kind of a situation again. I would agree entirely. And that is what I hope my agency has been able to contribute in some way to that this morning, and we very much look forward to continuing the dialogue so that we can achieve just that, Senator.

Senator VITTER. Great. Thank you.

Senator JOHNSON. Thank you, Mr. DeMarco, for your public service. I appreciate your thoughtful testimony and welcome Members to submit additional questions for the record. You may be excused.

Mr. DEMARCO. Thank you very much, Mr. Chairman.

Senator JOHNSON. The second panel will take its place.

[Pause.]

Senator JOHNSON. Mr. Shear, will you proceed?

STATEMENT OF WILLIAM B. SHEAR, DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, GOVERNMENT ACCOUNTABILITY OFFICE

Mr. SHEAR. Mr. Chairman, Members of the Committee, I am pleased to be here this morning to discuss the results of our recently issued report on options for restructuring Fannie Mae and Freddie Mac. This report provides information on the roles, benefits, and risks associated with the enterprises' activities over time. Our intent is to help inform forthcoming deliberation on their future structures.

Here I will discuss our first three objectives: first, to summarize the enterprises' performance in achieving key housing mission objectives; second, to identify various options for revising the enterprises' long-term structures; and, third, to analyze these options in terms of their potential capacity to achieve key housing mission and safety and soundness objectives.

With respect to key housing mission objectives to support the secondary mortgage market, the enterprises' contributions include the establishment of standardized underwriting practices for conventional mortgages that in turn helped to develop a liquid MBS market. However, it is not clear to what extent the enterprises have been able to support a stable and liquid secondary mortgage market during periods of economic stress, nor whether enterprise efforts to facilitate mortgage credit opportunities for targeted groups have materially benefited such groups.

Over the years, we have been particularly concerned with how the enterprises' structures as for-profit corporations with Government sponsorship undermined market discipline and provided incentives to engage in potentially profitable but risky business practices that did not necessarily support their public missions. Given this concern, we have consistently called for establishing a single regulator for the housing GSEs with all the regulatory oversight and enforcement powers necessary to address unsafe and unsound practices, assess the extent to which the GSEs' activities benefit home buyers and mortgage markets, and otherwise ensure that the GSEs comply with their public missions.

Given the mixed records of the enterprises, researchers and others believe a range of options for the enterprises' structure could better achieve housing objectives, help ensure safe and sound oper-

ations, and minimize risks to financial stability. Basically, these options generally fall along a continuum, with some overlap among key features and include, first, establishing a Government corporation or agency; second, reconstituting the enterprises as for-profit GSEs in some form; and third, privatizing or terminating them.

Here I would like to draw attention to the section beginning on page 9 of my statement, particularly to Table 2 on pages 10, 11, and 12, where tradeoffs are summarized.

Let me highlight one challenge associated with each proposed reform option. If a Government corporation or agency is adopted, it could face greater challenges than private sector entities in obtaining the human and technological resources needed to manage complex processes, or it might lack the operational flexibility to do so.

With reconstituted GSEs, the incentive concern I raised would be reestablished, which in turn could lead to even greater moral hazard and safety and soundness concerns and increase systemic risk. While we recognize that FHFA is in a better position to effectively regulate the enterprises than its predecessors were, its role in this function has not been tested.

And with respect to privatization, privatization could lead to a situation where the resulting mortgage finance entities are considered too big to fail.

Finally, regardless of any enterprise structural reforms that are adopted, we urge Congress to continue to actively monitor the progress of such implementation and to be prepared to make legislative adjustments to ensure that any changes are as effective as possible. And we stand ready to assist this Committee and the Congress in its oversight capacity and in evaluating the progress that is being made in implementing any changes.

It is a pleasure to be here. I would be pleased to answer any questions.

Senator JOHNSON. Mr. Wallison.

STATEMENT OF PETER J. WALLISON, ARTHUR F. BURNS FELLOW IN FINANCIAL POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE

Mr. WALLISON. Thank you, Senator. Fannie and Freddie are now central to the housing finance system in the United States. This is especially true since the advent of the financial crisis. Because of the collapse of the securitization market, other sources of financing—jumbo loans, available through banks or private label securitization—are very expensive, and that is holding down recovery in markets that Fannie and Freddie cannot access.

For this reason, any reforms that make private credit sources more expensive will create pressure for Fannie and Freddie, as GSEs—or as Government agencies, if that is what ultimately happens to them—to remain in existence and eventually to take over the entire housing finance market. I believe that the ultimate solution to the housing finance question is a private one. However, there is a very difficult transition problem here.

Realistically, for a long while, Fannie and Freddie will continue to exist, and any comprehensive financial reform adopted now must take into account how a private housing finance system will be able to develop as long as Fannie and Freddie continue to operate.

As GAO suggests, there are really only three likely outcomes for Fannie and Freddie: nationalization, privatization, or a return to GSE status. I discuss these issues, the pros and cons—mostly cons, I might say, about nationalization and GSE status—in my prepared testimony. However, GAO did not consider how current regulatory reform proposals will affect how Fannie and Freddie, while they exist, will compete with and impede the development of the private sector financial system.

As an example, the Administration has proposed that both originating lenders and securitization sponsors retain some interest in securitized mortgages. Banks will also be required to hold more capital. These proposals may improve mortgage underwriting and financial soundness. But they will also increase the cost of private credit, especially for securitized mortgages.

As long as Fannie and Freddie exist in the conservatorship, they will not be subject to the new capital and securitization rules. Accordingly, there will be a very large gap in cost between mortgages securitized by these Government agencies and mortgages securitized in the private sector.

The housing market will be seriously bifurcated in this case, and pressure will develop for Fannie and Freddie to securitize all mortgages, including jumbo mortgages. The same thing will certainly be true if Fannie and Freddie are ultimately nationalized.

Similarly, if Fannie and Freddie are allowed to survive as GSEs, they will be subject—or they may be subject, or not, to new securitization rules and capital requirements. If so, if they are subject to those requirements, we will have authorized them again to hold a portfolio of interests in mortgages, this time the retained interests in securitizations. And that in turn will require them to borrow more with the Government's backing and to hold substantial capital in order to protect the taxpayers against losses.

If they will not be subject to the new securitization rules and capital requirements—and that will be true as long as they are in the conservatorship—the bifurcation of markets problem will arise again, and again there will be pressure to let them securitize mortgages of any size. If this happens, they will likely assume the credit risk of virtually the entire mortgage system.

Then there is the question of whether the GSEs or a Government agency will have an affordable housing mission. Their former regulator noted that, in retrospect, their affordable housing goals caused them to do things they should not have done. When Fannie and Freddie were taken over, they held or had guaranteed \$1.6 trillion of subprime and Alt-A mortgages, about 85 percent of which met the goals set by HUD. These loans are now defaulting at unprecedented rates and will probably cost the taxpayers somewhere between \$200 and \$400 billion.

There is little doubt that Fannie and Freddie bought and guaranteed these mortgages and mortgage-backed securities because of HUD's affordable housing regulations and because of demands that, as GSEs, they had to "lead the market" in increasing home ownership. These weak loans were a major part of the housing bubble, the mortgage meltdown, and ultimately the financial crisis.

The problems associated with nationalization or renewed GSE status suggest to me that the best long-term solution is privatiza-

tion. This means that if the securitization system is improved and investor confidence returns to the securitization market, Fannie and Freddie should be privatized. I do not believe that a Government-backed structure and a private system can coexist. The Government system, as Fannie and Freddie have shown, will always drive out private competitors because of its financing advantages. Accordingly, if the Committee wants to retain any role for private sector financing in the housing system, it will have to consider the future of Fannie Mae and Freddie Mac and how they will eventually be privatized.

Thank you.

Senator JOHNSON. Thank you.

Dr. Wachter.

**STATEMENT OF SUSAN M. WACHTER, RICHARD B. WORLEY
PROFESSOR OF FINANCIAL MANAGEMENT, WHARTON
SCHOOL OF BUSINESS, UNIVERSITY OF PENNSYLVANIA**

Ms. WACHTER. Thank you, Mr. Chairman and Members of the Committee. I appreciate the invitation to testify at today's hearing on the "Future of the Mortgage Market and the Housing Enterprises." It is my honor to be here.

Historically, home ownership for Americans has served as bedrock of social prosperity. As we consider the future of the mortgage market, we need to step back and understand the sources of the global financial debacle. This is essential as we evaluate the broad options before us of nationalization, privatization, and a public/private system.

While Federal support of the mortgage system is now necessary, nationalization I do not believe is a long-run solution as it ultimately expands taxpayer exposure, while privatization without a stabilizing public role also leads to the inevitable socialization of risk, as this crisis has demonstrated.

This crisis resulted from the explosion of risky mortgages, made in the USA, the result of a lethal race to the bottom for short-term profits, enabled by regulatory failure. This explosion can be traced to the issuance of private label securities. These private label securities were neither standardized nor transparent; they were not traded, and, therefore, they were not subject or accountable to private sector forces of market discipline. The common-sense-defying loans they funded, including interest only, negative amortization, zero equity, and teaser rate ARMs, were not designed to be affordable when full rates came into effect; and these loans drove housing markets to an episode of irrational exuberance of historic proportions that have brought down the entire financial system.

As these loans were pushed into the market, overall household debt to GDP rose, with the increase coming from mortgage debt and these risky loans.

As nonstandard mortgages proliferated, the market share of traditional mortgages declined. From 2000 to their peak in 2006, non-traditional mortgages grew in origination market share from 10 percent in 2000 to almost 50 percent at their height in 2006. In particular, the housing enterprises' share of the market dropped, as did the market share of the long-term standard fully amortized

fixed-rate mortgage that they fund, which I note protects borrowers against interest rate risk, a risk which is likely to be rising.

The fundamental problem in the proliferation of these non-standard loans was the lack of accountability to the long-run risks they generated. Due to the illiquidity of markets, private label mortgage-backed securities did not trade. Because they did not trade, this meant that market discipline could not prevail. They continued to be supplied, eroding mortgage lending standards and artificially pushing up housing prices.

Before private label securities, securitization did work well, supporting sustainable home ownership. Historically, the GSEs were regulated to support sound underwriting. Contrary to popular misconception, they were not allowed to securitize subprime or Alt-A mortgages. After they started losing market share to private label securities, however, shareholder and other pressures led them to purchase private label securities backed by nonstandard mortgages for their portfolio. To be clear, they did not create the risky mortgage-backed securities that caused the crisis, but they did become a burden to the taxpayer because they were allowed to purchase them for their portfolio after private institutions had manufactured them. My fellow panel member Peter Wallison elsewhere has documented how several GSE observers suggested Congress put limits on the portfolios, but to no avail.

To ensure the safety and long-term sustainability of a reenvisioned mortgage finance system, we should pursue policies that embody three principles.

First, policies and procedures are needed to identify and prevent out-of-control housing asset bubbles and systemic risk. Loan-to-value ratios, in particular, must be maintained over time.

Second, borrowers must have effective, informed choice: safe mortgages should be the presumed mortgage vehicle for borrowing. The standard mortgage must be a safe mortgage, and mortgage regulation should favor safe products. Consumer choice is inconsistent with heterogeneous nonstandard options that cannot be compared by the consumer.

Third, we need a structure that promotes and provides safe and standard mortgages through liquidity and standardization. Effective borrower choice is impacted by the structure of the system. Standard mortgages should be the cost-efficient mortgage. Liquidity in funding sources can assure this.

Securitization should be the way to bring liquidity and cost efficiency to bear on the provision of safe, transparent, and standard 30-year fixed-rate mortgages which banks cannot fund. This can assure effective choice and support for a mortgage system that once again becomes the bulwark of sustainable home ownership in the U.S.

Thank you for the opportunity to be here today, and I will be pleased to answer questions.

Senator JOHNSON. Thank you.

Mr. Jakabovics.

**STATEMENT OF ANDREW JAKABOVICS, ASSOCIATE DIRECTOR
FOR HOUSING AND ECONOMICS, CENTER FOR AMERICAN
PROGRESS ACTION FUND**

Mr. JAKABOVICS. Thank you, Mr. Chairman and other Members of the Committee, for giving me the opportunity to share a series of principles that describes the essential functions of the housing finance system that it must serve, and several of which were touched upon by Chairman Dodd in his opening remarks.

I also want to take this opportunity to touch upon important lessons to be learned from the subprime crisis in an effort to prevent us from drawing the wrong lessons from it. In short, the systemic failures we have seen stemmed from the proliferation of poorly underwritten mortgages channeled through the so-called “shadow banking system” of unregulated private label securities.

Any discussion of the housing finance system’s future should start from a clear sense of what we expect the system as a whole to accomplish. But if the Committee restricts its analysis of the past and prescriptions for the future simply to the GSEs, it will miss the most significant points of origin of the current crisis, leading possibly to a system that is inadequate to support the essential role of housing finance in our economy. The real question for the Committee’s consideration should be what the goals of the system are and what combination of public, private, and hybrid arrangements, if any, will deliver those objectives.

I want to note that the core principles that I will lay out are the result of collaborative efforts and discussions of a group of experts and stakeholders in mortgage finance convened by the Center for American Progress that have been meeting for more than a year, which we call our “Mortgage Finance Working Group.” And while we have benefited tremendously from those members’ insights and expertise, my remarks this morning should not be construed as their personal or institutional endorsement of my testimony, and any errors, of course, are my own.

I point you to my written testimony where I go into the principles in greater detail, but the key principles to consider are access to credit and liquidity, countercyclicality, risk management and oversight, standardization, transparency, and accountability, systemic stability, and consumer protection.

The first concern of policymakers in contemplating any redesign in the U.S. mortgage finance system must be ensuring sufficient credit liquidity at all times to meet the Nation’s housing needs. In thinking about liquidity, two important aspects must be considered: first, the need for consistent credit liquidity through booms and busts; and, second, the need for broad availability of credit across places and housing types, including multifamily housing, which is not easily securitized or underwritten as single-family mortgages are, and in which the GSEs have played a critical role, particularly in times of stress.

Reform efforts must consider the importance of ensuring sufficient credit liquidity during down times and who might provide that liquidity. Private mortgage securitization certainly played a procyclical role during the bubble years, but institutions with the capacity and responsibility for countercyclical activity are a requirement for a well-functioning system. This countercyclical role

is one that will require some measure of Government backing as the private sector has proven itself unable or unwilling to independently provide sufficient and necessary capital during periods of retrenchment.

Consumers, including in underserved communities, must continue to be able to receive access to credit on terms that reflect their actual not perceived credit risk and not on predatory terms. We should be careful to ensure that tightened underwriting standards are based on criteria empirically tied to credit risk while remaining sensitive to the true costs of providing that credit.

Level playing fields are necessary, particularly when it comes to affordable credit provision. Safe, affordable, and well-underwritten loans must compete against unregulated exotic mortgage products priced without regard to underlying asset value or risk marketed by brokers with misaligned incentives, and the results have been disastrous, both for homeowners and the larger economy. Parallel systems must not again emerge that put soundly underwritten loans in competition with unregulated and nontransparent products.

Susan Wachter has already mentioned the importance of consumer protection in a well-designed system and standardization closely linked to it, so I refer you to my written testimony for those points.

But exotic products should have a higher not lower obligation for transparency and consumer protection, both at the point of origination as well as securitization.

Finally, there are principles of risk management and systemic stability to consider. It is clear that the unregulated private securitization markets caused this crisis through poor underwriting and misaligned incentives that ultimately because toxic MBS whose losses infected seemingly invincible institutions. And so we believe that any efforts to reform the housing finance system that focus exclusively on the GSEs or maintain unregulated private securitization markets are destined for failure. We must ensure a level playing field.

All modern banking systems have a prudential oversight regime, but when regulators fail to use their authorities or loopholes are created that allow certain products and market participants to avoid oversight, the stability of the entire system is threatened. The problem of regulators being philosophically opposed to regulation was an even more critical failing in light of the problem of misaligned incentives throughout the system. Put simply, virtually none of the participants in the private mortgage securitization process had the incentive to originate and sell loans that were viable over the long term.

The unregulated private MBS market, free from any direct safety and soundness supervisory oversight, was held as a paradigm for efficient markets, with the result that the regulatory playing field was tilted to the advantage of private securitization, with the lack of regulation allowing the shadow banking system to enjoy cost advantages over other sources of housing finance, allowing it to dominate the marketplace and bring it to the point of collapse.

A reformed system must ensure that all market participants play by the same rules. My written testimony offers a suggestion for

how this may be accomplished, but the key take-away from this hearing should be the principles I laid out as a metric for evaluating any proposals.

I urge the Committee to ask of any proposal coming forth: Will institutions of any size in any market have access to capital and liquidity in all markets at all times? How well will it do in ensuring a steady supply of 30-year fixed-rate mortgages, in ensuring a steady supply of financing for affordable housing, specifically multifamily? Will it support and speed innovation, encourage transparency? Will all communities, especially those devastated by this particular crisis, have access to credit on fair and nondiscriminatory terms? And, finally, how can we transition to a new system without disruption?

I thank you for your time and look forward to taking your questions.

Senator JOHNSON. Thank you. Mr. Shear, how would each option that you suggest affect borrowing costs? Could there be a geographical disparity in unavailability or cost under any of these proposals?

Mr. SHEAR. You raise a very good question, because historically when the GSEs were established, we had large regional disparities in mortgage rates because of the nature of unit banking and other aspects of our financial services industry.

The GSE structure addressed that, and now we have more of a financial system where you have very large, diverse, nationwide types of financial service firms. So the return with either privatization or a Government corporation or with reconstituted GSEs, a return to regional disparities in interest rates that are not related to risk, we think would be unlikely to occur.

In terms of just affordability, part of the question—I will pose it in terms of just going back even a decade ago when we were addressing the privatization question. Government support for Fannie Mae and Freddie Mac did cause mortgage interest rates to be slightly lower on conforming conventional mortgages than other mortgages, such as jumbo mortgages. But what we pointed out, there were benefits to borrowers and there were risks to other entities, including the Federal taxpayer.

We still have that dichotomy today. Part of the question for this Committee and the Congress is what you want to achieve, how much risk you are willing to take to achieve a certain outcome.

So I think that answer is consistent with what we were saying a decade ago.

Senator JOHNSON. Thank you.

Mr. Jakabovics, in the *Chicago Sun Times* article this summer, you noted that at the end of last year, half of all seriously delinquent mortgages were improperly issued mortgage-backed securities, despite being only 15 percent of the outstanding mortgages. By way of comparison, Fannie Mae and Freddie Mac had a combined 56-percent market share, but only 20 percent of the delinquencies.

Are there tools at the Administration's disposal to address this disparity in refinanced or modified mortgages held in private label securities?

Mr. JAKABOVICS. I think that there are two aspects to that, and one is focusing, I think, on the efforts that this Committee in particular led to establish the Hope for Homeowners program and other modification efforts, where working with the owners of—or the servicers of mortgages both controlled by Fannie Mae and Freddie Mac as well as those serviced on behalf of private entities, an effort to bring those mortgages more in line with payment standards that the existing borrowers can make or to refinance borrowers out of loans that are unsustainable or underwater into a mortgage—refinance into a mortgage that is, in fact, sustainable because they are originated based on the current value of the property. A lot of the problems that we have seen have been a function of the fact that house price declines have been severe, and so borrowers who may otherwise be creditworthy lack the ability to refinance into safer loan products.

Senator JOHNSON. Dr. Wachter, would the market be able to maintain the 30-year fixed-rate mortgage without the enterprises?

Ms. WACHTER. There are very few countries in the world that have access to 30-year fixed-rate mortgages without prepayment penalties. The only other two that have systems that do provide it, Germany and Denmark, have a securitization system which is heavily regulated by their governments. And, in fact, only Denmark has a system where you have a prepayable mortgage, and their system has regulations over time which maintain underwriting and which maintain standardization of the mortgage system.

So much of the world has a banking system supported adjustable—and they support adjustable-rate mortgages. Our trading partners—U.K., Australia—all have adjustable-rate mortgages. And while adjustable-rate mortgages are, in fact, useful mortgages for some people, they do expose borrowers to interest rate risk and, indeed, the entire economy to interest rate risk, which I am at this moment very concerned about going forward.

So your question is: Can you have a 30-year fixed-rate mortgage without GSEs? GSEs are a particular securitization entity which achieves standardization. In that respect, I believe the answer is if the entities that replace GSEs or carry on the mission of GSEs are similar to the GSEs in offering standardized mortgage-backed securities as well as standardized 30-year fixed-rate mortgages, the answer is yes.

If indeed we have securitization which requires banks to keep securities on their portfolios, that is a risk to the banks, to the banking payment mechanism, and to the stability of the overall economy, and that I do not believe is consistent with the long-term provision of the 30-year fixed-rate mortgage.

Senator JOHNSON. Thank you.

Mr. Wallison, you have been a strong supporter of privatizing the enterprises. Could you discuss the transparency available to investors in the private label MBS?

Mr. WALLISON. Yes, Senator. In a private label structure, the investors should get quite a lot of information if they ask for it. There is no reason why the transparency of a private label system should not be as complete as the transparency that occurs in any securities market—particularly in our securities markets—as overseen by

the SEC. So I do not see any inconsistency between a private label system in terms of its transparency and a system that uses a Government structure for doing securitizations. The difference turns out to be that in the Government system, I believe, whether it is through a nationalized structure or a GSE-type structure, a lot of risk will be taken by the Government, which, as we have seen through Fannie Mae and Freddie Mac, ultimately comes back to the taxpayers.

So to have a realistic kind of system, one that is practical and one that is not ultimately causing losses to the taxpayers, I think we must go with a private system of some kind. Securitization might not be the only system we might have, but it should be a private system.

Senator JOHNSON. Thank you. I have been handed a note. The leadership has called a 12:15 vote. Keep that in mind.

Senator BUNNING.

Senator BUNNING. Thank you, Chairman.

Mr. WALLISON, you have made a very clear point on the GSEs, and you have outlined three different alternatives. How do we get the GSEs out of business? How? I mean, we are in to them, according to the prior panel, about \$97 billion. At least that is the preferred stock that we own. Now, how do we get them out and get into a private sector situation?

Mr. WALLISON. Well, there are really two questions, I think, in what you have asked. One is what we do with the GSEs in terms of the losses they already have embedded in their portfolios or in their—

Senator BUNNING. Do we have to eat them?

Mr. WALLISON. Oh, yes, the taxpayers are going to have to eat those losses, and it is just a question of whether we use a good bank/bad bank kind of structure—move all those things over to a bad bank—and then have the Treasury pay off the creditors who would be holding the bag there. But it is clear that the U.S. Government has always been willing to and had to stand behind the GSEs, and so the taxpayers are going to have to take losses.

This is very regrettable. Many people tried to change this, but it never happened.

On the—

Senator BUNNING. I just want you to realize that we are at \$12 trillion and counting.

Mr. WALLISON. Yes, understood.

Senator BUNNING. \$12 trillion and counting. Now we are going to be asked to increase the debt ceiling very shortly. There comes a time when my 40 grandkids are going to get tired of paying for our excesses. Even though it is a laudable goal that everybody own a house, certain people just cannot afford to own a house.

Mr. WALLISON. Yes, and, Senator, that is another problem with a Government-run system. It is subject to political manipulation. That is one of the reasons why we had affordable housing requirements and other requirements which have caused the tremendous losses that Fannie and Freddie will be suffering.

Senator BUNNING. There is no question that the Congress pushed Freddie and Fannie to make these loans.

Mr. WALLISON. No question in my mind.

Senator BUNNING. I mean, it was clear.

Mr. WALLISON. It was actually through the Department of Housing and Urban Development, which had affordable housing guidelines. Those began in the mid-1990s and were gradually ratcheted up over time so that by 2005—and we are talking about two Administrations here, the Clinton administration and the Bush administration—the affordable housing requirements required that 55 percent of loans the GSEs bought had to be affordable housing loans. Within the 55 percent, had to be to low-income people, not just people who were at or below median income.

So it became very difficult for Fannie and Freddie to find those loans unless they gave up on downpayments and they gave up on blemished credit and they reduced their underwriting standards, which they did. Now—

Ms. WACHTER. Senator, when you are complete—I do not want to interrupt, but when you complete, this is not the problem. This was not the cause of our crisis.

Mr. WALLISON. If I can—

Ms. WACHTER. I apologize.

Mr. WALLISON. But let me just finish my point, because there was a second part of your question, and that is, what do we do now with Fannie and Freddie? How do we turn them into privatized entities?

Senator BUNNING. How do we get out?

Mr. WALLISON. I do think there is a relatively simple way to do that, and that is to gradually lower the conforming loan limit over time. Once the securitized market returns and investors are confident again about what a AAA security might mean, then it is possible to reduce the conforming loan limit. And as you do that, the private sector will move into that market and begin to take up more and more of it. And, finally, the GSEs will be reduced to zero, and the private market will take it over.

So I think that is a simple way to accomplish privatization.

Senator BUNNING. Dr. Susan, you brought up the Danish system. Can that ever work in the United States? I mean, I did not know that a lot of people knew about that, but my staff did.

Ms. WACHTER. Yes, I do believe a version of the Denmark system could work in the United States. I think we have some misunderstandings of the Denmark system. Actually, the Danish system is very much supported by regulation, with standards that are maintained over time.

Senator BUNNING. Absolutely.

Ms. WACHTER. And with securitization that does not allow non-standard private label mortgage-backed securities to—

Senator BUNNING. But it also allows you to go and preclude and buy—if the bond goes down, you can go into the market and buy at a discount and reduce your rate.

Ms. WACHTER. Senator, you are absolutely right. What is required in the Danish system is prepayment options and prepayment optionality on both sides of the deal. So unlike our private label securitization, which were not subject to requiring prepayment options, the Danish systems require prepayment options and optionality on both sides.

Senator BUNNING. But let me just bring up the fact that in 1994 we gave the Federal Reserve the responsibility to regulate all mortgages, both by banks and by mortgage brokers. And it was 14 years before they wrote a regulation. Now, I mean, it was the second year of Ben Bernanke's tenure as Chairman of the Federal Reserve.

Now, you stated from 2000 to 2006 all these different types of sophisticated mortgages came in, and there were no regulations against them. My question is: Should there have been? Should there have been regulations to prevent these sophisticated interest-only type things and putting people into houses that they should not be put in?

Ms. WACHTER. Absolutely, Senator. Absolutely, the answer is yes. Ned Gramlich pushed for this. It did not happen. But it is a difficulty. There is actually a significant difficulty that I think we all must face, which is the following: Do we preclude anybody from ever using one of these niche products? Or do we allow them to be niche products? And I do think that is the difficulty we must face, that the standard mortgage should be a safe mortgage. For sophisticated borrowers with special needs, we can do something differently.

So how do we get there? We can get there by having a playing field that is supportive of the standard mortgage, a playing field where the standard mortgage is funded liquidly so that the standard mortgage is the cost-efficient mortgage. And that comes through standardization.

My concern about the private sector is that private sector entities do not automatically standardize the products they offer. Quite to the contrary. Private sector entities will want to differentiate their product not only from their competitors, but even within their own entities. So we will get—

Senator BUNNING. Well, but if they are going to bust the bank, if they are going to blow the housing and the market right out of sight, then we as regulators or as policymakers have got to prevent that.

Ms. WACHTER. Absolutely, but the way to prevent it cannot simply be to preclude these mortgages altogether, I believe, in the United States because, in fact, they are—some will want them, and appropriately so. Therefore, there needs to be as a cost advantage standardization for what we regard as the safe mortgage, which fortunately for the U.S. historically has been the 30-year fixed-rate mortgage.

Senator BUNNING. Thank you very much. My time has expired.

Senator JOHNSON. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and I thank each of you for your testimony. I wish there were more people here to hear it. I think it was all very good.

To GAO, Mr. Shear, I want to say especially the analysis you gave was very good, and I guess at the end of the day, regardless of where the costs are, there is a cost associated with loaning money out to people. And so, you know, one of the things that is fascinating about all this is that aside from the fact that an entity, maybe a Government entity, can have a tax advantage, there are still going to be costs. And so if you take risk, somebody at some point is going to bear the cost of that risk. And so the question I

guess one would have to start with—or the assumption is that that is a fact. And, second, is there a reason for us in this country to assume risk at the Government level as it relates to residential mortgages?

Mr. SHEAR. First, thank you for the compliment for the work that we do. We have some great people at GAO.

In terms of the question you ask, it is a great question because it is a question of what the priorities are of this Committee, of the Congress, and as a Nation of what we think is the appropriate Federal role to achieve certain mission requirements. We, meaning those of us from GAO, are not here to make those value judgments. But I think referring to our work and when we discuss these different options and the continuum of them, what we are trying to point out is: What are some of the safety and soundness concerns? What are some of the concerns in terms of reaching out?

And when you look at this as a whole, some of the issues that have come up at this hearing, such as regulatory arbitrage or when you have capital requirements that are lower for some pipelines compared with others, there will be a tendency for risk to move to where it is in a sense taxed or where the regulatory requirements are the least. And this is, I think, part of the challenge of what we are dealing with here.

So one of the things that I would hope would come out our work is that we have to be careful of what we ask for, because none of this comes free.

Senator CORKER. And I think that is a point that, as we move through this reg reform process, we need to understand that somebody at the end of the day is going to pay for the cost. And if the risk is high, the cost is probably going to be absorbed down the road by someone else.

Dr. Wachter, I would assume, based on your comments—and I thought they were very good—that you would also agree that if we are going to deal with regulatory reform, certainly we need to deal with the issues we have talked about in this panel meeting and to leave out—as you mentioned, I mean, the GSEs in many ways moved toward things—under two Administrations, I might add, and I think a lot of folks on the other side of the aisle are defensive sometimes about the GSEs. But, in fact, the Bush administration pushed the GSEs to purchase subprime mortgages to meet quota requirements. They did. And as you mentioned, that was not necessarily the problem because it was originating of those loans that I think you are alluding to as being the problem in the first place, creating loans that really did not meet appropriately the needs of the people they were being loaned to.

But I guess you would agree that if we are going to do regulatory reform, this area that we are talking about today needs to be a big part of that.

Ms. WACHTER. My understanding is that that is just what these discussions are about, and I am very pleased to have been invited to be part of them. I do think we have to build the understanding of the deeply interrelated parts of the systems as we move forward. There is no way that we are going to be able to move to a new system in the short run. We are reliant now on Federal support for the system, and I believe we will be for some time to come, which

is unfortunate. But, on the other hand, there is time to do this right, and we must do it right.

Senator CORKER. There is time to do it right, but it is all very related to each other, isn't it? I mean, it would be difficult to do regulation to try to deal with the systemic risk we just had and not deal with this area simultaneously. Would you not agree? Because it is so synchronized.

Ms. WACHTER. Well, I personally do believe that there are components that are commonsensical and obvious that we can begin to put into place as we deal with the entire system, yes.

Senator CORKER. Since Mr. Wallison and I tend to agree so much, I am not going to ask him many questions. I am just going to get him to come back to our office as we work this through. But is there a reason that we should have loans to home buyers that are nonrecourse? Dr. Wachter? I came up here just a fairly sophisticated—fairly sophisticated—business person and borrowed lots of money on a recourse basis and nonrecourse. Every home mortgage I have ever had, I guess because, you know, was recourse, and I actually was stunned to realize that there are so many mortgages in this country that are nonrecourse—almost all now. And I do not know what the Danish system is like, but should we have loans in the first place that are nonrecourse to residential buyers?

Ms. WACHTER. An important question, Senator, and, by the way, thank you so much for your kind comments about my testimony.

The recourse, it is true that in Denmark those loans are recourse loans. In the United States, this is a State-by-State determination. Many States have recourse. Many States do not.

The difficulty is that even with recourse loans, it is difficult in actuality to get recourse. You would then have to go through bankruptcy, so it is a complicated situation. Legal recourse and actually effective recourse are two separate issues.

Senator CORKER. But along with recourse, it does make some degree of difference when the borrower asks for the loan, does it not? I mean, there is just a different sense of obligation when it is a recourse loan.

Mr. JAKABOVICS. If I may actually touch upon that, in California, for example, there is recourse, but you only have access to the recourse if you go through judicial foreclosure. Most servicers in California do not avail themselves of judicial foreclosure because they find they would rather simply get the property in whatever condition they can faster, and then get themselves out of the loan. And so while they have the opportunity for recourse, in almost all instances they do not choose to pursue it.

So I think that sort of focusing specifically on whether a particular loan might be recourse or nonrecourse, again, setting aside the fact that there is, in fact, great variation in State laws, lenders and servicers seem not to have availed themselves of recourse because, in fact, at the end of the day when most borrowers find themselves in default and there is insufficient amount of value in the property itself, the borrower is usually not in the position to make up the difference as well. And so the availability of recourse at the end of the day has little material impact.

Senator CORKER. Let me get back to the cost issue, and by the way, if anybody needs to leave, I promise you I will not do anything mischievous if you need to go.

Senator JOHNSON. One more question.

Senator CORKER. OK. Since there is a cost with everything—I mean, you cannot create a fixed-rate loan and there not be a cost associated with that. There is a cost.

So back to Dr. Wachter. Should there not be—why isn't there a prepayment penalty? If somebody is going to give you a fixed-rate loan for 30 years and you pay it off in advance of 30 years, there is a loss that that organization has in making that loan and tying those funds up. Why isn't there a prepayment penalty? I think that is a perfectly ridiculous notion that there is not prepayment penalties associated with paying a loan off early. Why would that be a good public policy because it artificially lowers rates?

Ms. WACHTER. You are absolutely right that one could do this. One can have all sorts of options, and they could be priced. The problem is what is a standard option that is pro-home-ownership and pro-building of wealth for families. The prepayment penalty, while for some people is, in fact, a good option, for many households who wish to—or need to move, let us say, because they need to get a job in another part of the country, they have lost a job, if they had to pay a prepayment option, might find that their loan-to-value ratio in their home was such that there would not be enough funds to do so. Their only alternative would be to default.

So, in fact, this is a complicated decision whether from a borrower's perspective it is optimal to have a prepayment option or not. And for those who are sophisticated, this is a good choice, and I do not think that we should preclude them from the marketplace. However, we should have a standard mortgage with standard features that borrowers understand.

Senator CORKER. Mr. Chairman, thank you for the additional time and certainly all of you for your testimony. My sense is that there is a way to create some of the standardization that has been discussed but do so on the private sector side. And I guess I asked the question, and I will ask it continually through. I do not know why we artificially do things to stimulate the housing industry. I know the Chairman mentioned early on wealth creation. You mentioned it again. I think the things we have done artificially to stimulate the housing market have lowered household wealth in our country over the last year hugely. And my sense is that if we had not artificially done that, our country as a whole would be in a much—the world would be in a much more stable situation.

So thank you, Mr. Chairman.

Senator JOHNSON. I thank the witnesses for your testimony, and this hearing is adjourned.

[Whereupon, at 12:16 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Good morning. Today, we meet to discuss the Government-Sponsored Enterprises—Fannie Mae and Freddie Mac—and the role they will play as we seek to restore normalcy to the mortgage market.

But let's not forget what we're really talking about.

We're talking about whether responsible homeowners will have the access to the home loans they need to realize their American dreams.

Last year, when the mortgage market collapsed, the Director of the Federal Housing Finance Authority put Fannie Mae and Freddie Mac into conservatorship.

At the same time, Secretary Paulson exercised the authority he was given by last year's bipartisan Housing and Economic Recovery Act to provide back-up funding for the two companies, ensuring that they could continue financing mortgages during the housing crisis.

Today, we consider where we need to go from here.

Now is the time to look forward. But with so much damage done by this financial crisis, the role of the GSEs in that crisis is still hotly debated.

Let me just say: Fannie and Freddie were neither the villains that caused the crisis, as some claim, nor the victims of that crisis, as others would make them out to be.

They didn't create the subprime and exotic loan market—but they did chase it to generate profits.

And, like many of the supposedly private financial institutions that ended up becoming equivalent to GSEs, Fannie and Freddie enriched their shareholders and management, while the public took the losses.

We can't let that happen again.

As we look forward, we must start by setting benchmarks to determine whether the mortgage market is healthy, so that American families can once again begin to build wealth—not the kind of wealth that buys mansion and yachts, but the kind of wealth that sends kids to college and ensures a comfortable retirement.

First: the mortgage market must remain liquid and stable, especially in times of stress. Otherwise, rates are driven up, prices are driven down, and American families lose.

Second: we must encourage product standardization, such as the widespread availability of the 30-year, fixed-rate mortgage without prepayment penalties. This helps both borrowers and lenders.

Third: mortgage credit must remain consistently available and affordable. Home ownership remains part of the American dream. That dream should be accessible to everyone—and sustainable for everyone.

Today, the market is meeting these tests—but only through massive Government intervention.

The Federal Reserve, for example, has committed to pumping more than \$1 trillion into the mortgage market. That can't go on indefinitely.

Therefore, it is time to begin the conversation about how we can re-create a functional market that stands on its own two feet, and to decide what role, if any, the GSEs should play. I want to start that conversation by posing a number of questions:

Can the market function with no Government involvement?

Should, on the other hand, the Government completely and explicitly take over the job previously done by Freddie and Fannie?

Do we want a model where there is some private capital at risk, but only under strict Government control, like a utility?

These are important questions. The answers are critical to ensuring the American dream. And I look forward to considering these questions with our distinguished panel today.

Before turning to Senator Shelby, I want to quickly add that I am hopeful that the higher GSE and FHA loan limits, which we first established in HERA, will be extended again in the HUD appropriations bill currently being negotiated. These higher loan limits are helping many borrowers purchase homes or refinance their mortgages. I think we need to keep this support in place.

I'd now like to recognize Senator Shelby.

PREPARED STATEMENT OF SENATOR RICHARD C. SHELBY

Thank you Mr. Chairman.

As we consider the future of the GSEs, we would be wise to remember the disastrous consequences that poorly regulated GSEs can have on our financial markets.

Just 1 year ago, Fannie Mae and Freddie Mac were placed into conservatorship when they could not cover billions of dollars in losses. Despite repeated warnings by me and others about the risks the GSEs presented, they were allowed to accumulate more than \$5 trillion in financial obligations with only minimal amounts of capital.

The Congressional Budget Office now estimates that resolving the GSEs will cost American taxpayers \$389 billion. We must ensure that this never happens again.

This hearing, therefore, comes at an opportune time as this Committee is considering financial regulatory reform. There is no doubt that the failure of Fannie and Freddie was a significant factor in the financial crisis because their activities touched nearly every aspect of our financial system.

In addition, their debt is among the most widely held in the world. They are also major counterparties to our most prominent financial institutions. Accordingly, regulatory reform must involve the GSEs. Unfortunately, the Administration made no effort to include the GSEs in its financial regulatory reform proposal. Instead, the Administration has said that it will not propose how to deal with GSEs until next year.

I believe that this is a grave mistake that will make it more difficult to reform our financial system and that will potentially expose taxpayers to even greater losses. What we need is a clear plan that addresses both the GSEs' ongoing financial difficulties and the role the GSEs should play in our economy going forward.

I fear that the longer we wait, the more it is going to cost the American taxpayer. Certainly, the question of what to do with the GSEs is difficult and complex. Yet, it is a question that we ignore at our peril.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF EDWARD J. DEMARCO

ACTING DIRECTOR, FEDERAL HOUSING FINANCE AGENCY

OCTOBER 8, 2009

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify on the current condition of, and challenges facing, the Nation's housing Government-sponsored enterprises (GSEs)—the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the 12 Federal Home Loan Banks (FHLBanks).

The Federal Housing Finance Agency (FHFA) just completed its 14th month of existence, Fannie Mae and Freddie Mac (the Enterprises) have been in conservatorship for 13 months, and I have just completed my first month as FHFA's Acting Director. During its short existence, FHFA has been involved in many of the Federal Government's efforts to respond to the crisis in the Nation's housing and housing finance markets. I will begin this morning by briefly reviewing FHFA's key activities and accomplishments. I will then describe the financial, managerial, and operational challenges facing the housing GSEs and their efforts to respond to those challenges while bringing liquidity, stability, and affordability to the housing market. In closing, as requested, I will offer some thoughts on the future of the housing finance system.

FHFA—A Brief Review

FHFA came into existence on July 30, 2008, upon enactment of the Housing and Economic Recovery Act of 2008 (HERA). To create FHFA, Congress combined the Office of Federal Housing Enterprise Oversight (OFHEO) and the Federal Housing Finance Board (FHFB), and added certain staff from the Department of Housing and Urban Development. FHFA was given safety and soundness and mission oversight responsibilities for the housing GSEs, including safety and soundness authorities that had been lacking at OFHEO.

In the midst of all the market turmoil of the past year, FHFA has devoted long hours to working through the housing crisis and its implications for all the housing GSEs we oversee. Among our accomplishments:

- We conducted examinations and targeted supervisory reviews at both Enterprises and all 12 FHLBanks to assess their safety and soundness and their support for housing finance and affordable housing.
- We are serving as conservator of the Enterprises—Fannie Mae and Freddie Mac—even as we continue to oversee them as their regulator.
- We have been working with the housing GSEs regarding the valuation of their private-label mortgage backed securities (PLS) and appropriate recognition of other than temporary impairment (OTTI) of those PLS. In particular, we

worked with the FHLBanks on their adoption of a common platform for accounting for the impairment of their PLS.

- FHFA staff worked with the Obama administration and others to address foreclosure prevention and borrowers with “underwater” mortgages with the aim of keeping people in their homes whenever possible.
- We set new, more feasible affordable housing goals for 2009 for Fannie Mae and Freddie Mac and are working on a new housing goal framework for the Enterprises and the FHLBanks for 2010.
- We combined the personnel and financial systems of two separate organizations and established an infrastructure for FHFA, including systems, procedures, and policies that serve as the foundation for accomplishing the mission of the agency.
- We published our first strategic plan, our first human capital plan, our first Performance and Accountability Report, and our first annual Report to Congress.
- We issued numerous regulations, guidances, and reports to Congress as required by HERA.

We remain committed to the effective supervision of the housing GSEs with the objective of promoting financially safe and sound operations and ensuring operations consistent with their housing finance mission, which includes supporting a stable and liquid mortgage market. In that context, I see three priorities for the housing GSEs, and hence three supervisory priorities for FHFA.

First, as the country continues to work through the housing market collapse, I am looking to all the housing GSEs to provide ongoing support to the mortgage market, consistent with their mission and charters. For the Enterprises, this means continuing to provide a secondary market outlet for mortgages, including mortgages that meet the Enterprises’ affordable housing goals. For the FHLBanks, this means making advances to member institutions collateralized principally by mortgage loans and carrying out their responsibilities to support affordable housing and community investment programs.

Second, the housing GSEs must remediate identified weaknesses and further strengthen their operations and risk management practices that have been stressed in this housing crisis. As financial institutions focused on housing finance, they must address their direct and indirect exposure to serious mortgage delinquencies. Our oversight of their response to these conditions is core to our mission and our assessment of their safety and soundness.

Third, as part of their overall housing finance mission, the housing GSEs each have important roles to play in preventing avoidable foreclosures and providing programs that assist the housing market recovery. The Enterprises are implementing the loan modification and refinance programs under the Administration’s Making Home Affordable program. The FHLBanks are implementing troubled homeowner refinance assistance available through our recent Affordable Housing Program (AHP) regulation.

Current Financial Conditions of the GSEs

Let me now address the current financial conditions at the housing GSEs.

Fannie Mae and Freddie Mac. In the first 2 full years of this housing crisis—from July 2007 through the first half of 2009—combined losses at Fannie Mae and Freddie Mac totaled \$165 billion. In the first half of 2009, Fannie Mae and Freddie Mac together reported net losses of \$47 billion. The Enterprises’ financial performance continues to be dominated by credit-related expenses and losses stemming principally from purchases and guarantees of mortgages originated in 2006 and 2007.

Since the establishment of the conservatorships, the combined losses at the two Enterprises depleted all their capital and required them to draw \$96 billion from the U.S. Treasury under the Senior Preferred Stock Purchase Agreements. With continuing uncertainty regarding economic conditions, employment, house prices, and mortgage delinquency rates, the short-term outlook for the Enterprises remains troubled and likely will require additional draws under the Senior Preferred Stock Purchase Agreements.

Beyond the preferred stock purchases, the Treasury Department and the Federal Reserve have made other, sizeable purchases of housing GSE securities to instill confidence in their securities, provide stability to mortgage markets, and lower mortgage rates. Treasury has purchased approximately \$192 billion of the Enterprises’ mortgage-backed securities (MBS). The Federal Reserve has purchased \$831 billion worth of Enterprise MBS and \$134 billion in debt issued by Fannie Mae,

Freddie Mac, and the FHLBanks. This combined support from the Federal Government exceeds \$1 trillion and has allowed Fannie Mae and Freddie Mac to continue providing necessary liquidity to the mortgage markets.

Federal Home Loan Banks. The FHLBanks have not been immune from mortgage-related credit losses. The most important financial development among the FHLBanks in 2009 is the deterioration of the PLS portfolios held by the FHLBanks. As of June 30, 2009, the FHLBanks held \$56.6 billion worth of PLS with an estimated fair value of \$46.3 billion, down from a December 31, 2008, carrying value of \$73.0 billion and a fair value of \$53.7 billion. The decline in the carrying value reflects impairment charges of almost \$8.2 billion and principal payments and prepayments of \$8.9 billion. However, a change in accounting rules resulted in only \$953 million charged against income.

Net income was \$1.4 billion in the first half of 2009, compared to \$1.2 billion for all of 2008. The apparent improvement reflects new accounting rules from the Financial Accounting Standards Board for other-than-temporary impairment on PLS.

The FHLBanks ended the first half of 2009 with assets of \$1.1 trillion, down \$201 billion, or 15 percent, since the end of 2008. Advances, which had peaked at \$1.0 trillion at the end of September 2008, fell to \$739 billion by the end of June 2009 and \$659 billion as of September 30. The 35 percent decline in advances in just 12 months is largely due to a rise in deposits at member banks, decreased loan demand, the emergence of new or expanded Federal liquidity programs, increased use of the Fed's discount window, and some return of liquidity in financial markets. The expansion and contraction of FHLBank advances demonstrates that the FHLBanks' capital structure has the ability to meet demands for liquidity on the part of member financial institutions while leaving the FHLBanks with the portfolio flexibility to shrink without untoward consequences.

At the end of June, total regulatory capital for the FHLBanks was \$60.6 billion, or 5.3 percent of assets. Total retained earnings were \$6 billion, but negative accumulated other comprehensive income (AOCI) exceeded retained earnings at the six FHLBanks with the greatest PLS exposure.

Conservatorship of the Enterprises

FHFA placed Fannie Mae and Freddie Mac into conservatorships on September 6, 2008. This action was a result of substantial deterioration in the housing markets, rapidly rising credit expenses, and the inability of the Enterprises to raise new capital and access debt markets in their customary way.

At that time, FHFA along with Treasury and the Federal Reserve recognized that Fannie Mae and Freddie Mac would be unable to fulfill their mission of providing liquidity and stability to the housing market without substantial Government support. Uncertainties remain about the future structure of the Enterprises, but one thing is clear: the conservatorships have accomplished their objective of ensuring that the Enterprises continue to provide a secondary market outlet for new mortgages.

Despite unprecedented market events, both Enterprises have been able to maintain a significant presence in the secondary market. The Enterprises' combined market share of mortgages originated in the second quarter of 2009 was 74 percent, up from 54 percent in 2007 and 37 percent in 2006. Most other loans this year have been guaranteed by the Federal Housing Administration (FHA).

FHFA has also sought to align the Enterprises' housing goals with safe and sound practices and market realities. This summer we finalized the affordable housing goals for 2009 and are working on a new housing goal rule for 2010 as directed by HERA. FHFA meets monthly with each Enterprise to review its progress against the goals.

We recognize that FHFA's duties as conservator means just that, conserving the Enterprises' assets. These two companies have \$5.3 trillion in mortgage exposure. Given the Enterprises' importance in the mortgage market, Enterprise activities to stabilize the housing and mortgage markets are closely linked to conserving assets. Over the long term, effective mortgage modifications, refinancings, short sales, and other loss mitigation activities assist homeowners and neighborhoods and will save the Enterprises billions of dollars.

Challenges the Enterprises Face

I would like to turn my focus now to some of the challenges the Enterprises face and the steps they have taken during conservatorship to strengthen and improve safety and soundness.

1. Executive Leadership/Management and Staff Retention. Both Enterprises have filled significant vacancies at the executive management level. Since conservatorship, each company's CEO position has turned over twice and most executive vice-

presidents at each company have changed. These changes have included individuals most responsible for the problems that led to conservatorship and have improved each company's ability to appropriately focus on key business strategies given conservatorship and the problems in the housing market. We have also replaced the majority of both boards of directors. The new boards are now actively overseeing the affairs of the Enterprises. However, personnel risk at both Enterprises remains a major challenge and risk going forward. Several key officer vacancies remain below the executive levels. Moreover, uncertainties about the future of the Enterprises keep staff retention a key concern. As we see improvements in the economy, opportunities for employees and officers to seek other employment will increase, adding to the current retention challenge. Both Enterprises, along with FHFA, are working on available options to manage personnel risk.

2. Credit Risk and Loss Mitigation. The size and credit characteristics of Fannie Mae and Freddie Mac's mortgage books of business remain supervisory concerns. While a few positive signs of recovery in housing have begun to emerge, we remain concerned and recognize the risk associated with increasing numbers of seriously delinquent loans, higher forecasted foreclosures, and the uncertain path of the market's recovery. In particular, we are concerned with the continued increase in serious delinquency rates, even among prime mortgages.

More than one in four subprime mortgages today is seriously delinquent. Among subprime adjustable-rate mortgages, nearly 40 percent are seriously delinquent. While mortgages in the prime market are performing better, the numbers are still very high. The serious delinquency rate is 3.1 percent at Freddie Mac and 4.2 percent at Fannie Mae. These rates are disturbing both in their magnitude and in the fact that they continue to increase. Currently the Enterprises are managing a real estate owned (REO) inventory of almost 100,000 properties, a number expected to grow. Certainly rising unemployment has contributed to defaults as people have lost incomes and the employment situation adds to the uncertainty regarding future delinquencies.

On a positive note, both Enterprises are devoting significant resources to programs aimed at reducing default rates and preventing avoidable foreclosures. Credit underwriting practices during conservatorship have been strengthened, resulting in higher quality mortgage purchases.

In addition to the stress in the single-family mortgage market, the multifamily market is experiencing declining property values and record vacancy rates. As of midyear 2009, rental vacancy rates hit their highest level since the U.S. Census Bureau began tracking vacancy rates in the 1950s. Still, the Enterprises are working to support the multifamily market while adhering to clear and consistent credit risk management principles. As of June of this year, the Enterprises' combined multifamily portfolios had grown to \$357 billion, and their market share has increased substantially, growing from 34 percent in 2006 to 84 percent last year.

Going forward, we are looking to Freddie Mac and Fannie Mae to continue to provide liquidity to the multifamily sector while ensuring safety and soundness. For instance, in setting the housing goals for 2009, FHFA lowered all of the single-family goals but actually raised the special affordable multifamily goal. We recognize that this will be a challenge for each company given the depressed environment for multifamily lending, but we expect each Enterprise to remain focused on this sector and bring prudent approaches to enhancing their support for this market.

3. Market Risk. The Enterprises' investments in mortgage assets expose them to market risk. Given the uncertainties in the marketplace, managing market risk continues to be a challenge.

4. Operational Risk. Both Enterprises are addressing operational risk weaknesses. The systems and models upon which the companies have relied in the past have been greatly stressed in this market environment and the new management teams are working on appropriate remediation. The implementation of the new consolidation accounting standard, which will require the Enterprises to bring off-balance-sheet mortgage backed securities onto their balance sheets beginning next January, is a substantial operational challenge, one that has required significant resources at each company.

Foreclosure Prevention/Making Home Affordable

I have already reviewed the substantial credit risk to the Enterprises from mortgage delinquencies in their own books of business. Because the Enterprises own or have guaranteed securities backed by about 58 percent of the residential mortgages in this country, it is fair to say that activities that bring stability to housing markets generally are of direct financial benefit to the Enterprises. It is in that context that I would like to discuss the Enterprises' current efforts to support foreclosure

prevention and, more generally, their activities under the Obama administration's Making Home Affordable program.

The Enterprises are applying the Home Affordable Modification Program (HAMP) to their own mortgage books, and as agents of the Treasury Department they are extending the program to mortgages in PLS and in bank portfolios. Fannie Mae is the administrator of the program and Freddie Mac has responsibility for overseeing program compliance.

The loan modification initiative is a critical effort to combat the slide into foreclosure facing the many households that are seriously delinquent on their mortgages. It represents a serious response to help those homeowners dedicated to preserving their home if given the opportunity through a more sustainable mortgage payment.

Under the umbrella of the Administration's Making Home Affordable program, the Home Affordable Refinance Program (HARP) is an effort by FHFA with the Enterprises to enhance the opportunity for homeowners to refinance. For homeowners today who have mortgages owned or guaranteed by Fannie Mae or Freddie Mac, and who are current on those mortgages, HARP provides the opportunity for those homeowners to reduce their monthly mortgage payment by taking advantage of the low mortgage rates in the market today.

While a 5 percent mortgage rate creates an inviting opportunity to refinance, in today's environment many homeowners have been unable to do so. The decline in house prices has raised the current loan-to-value ratio for many, and for some, put them underwater on their mortgage. Combined with the limited availability of private mortgage insurance in the marketplace today, many homeowners have been unable to qualify for a refinance.

HARP has been designed to address these barriers. Fannie Mae and Freddie Mac today will refinance mortgages they currently hold, even up to a current loan-to-value of 125 percent. For homeowners with a current loan-to-value ratio between 80 and 125 percent, the Enterprises will refinance those mortgages without requiring additional private mortgage insurance. If there already is mortgage insurance on the existing mortgage, that coverage will carry forward to the new mortgage. If the existing mortgage did not have mortgage insurance, it will not be required in the new mortgage. This program recognizes that the Enterprises already have the credit risk on their books for these mortgages. Enhancing the ability of these homeowners to refinance their mortgage improves the credit quality of the loan.

FHFA has been reporting monthly to Congress and the public on the Enterprises' loss mitigation activities, including those under HAMP and HARP, in our *Federal Property Managers Report*.

Challenges the FHLBanks Face

While much attention remains focused on the Enterprises, the FHLBanks have challenges of their own that warrant the Committee's attention. The FHLBanks have served their core statutory function of bringing liquidity to member institutions holding mortgage assets. From June 2007 to September 2008, advances to members increased from \$640 billion to more than \$1 trillion. When liquidity sources for many large and small banks were drying up, the FHLBanks provided much needed liquidity. I have already described the subsequent decline in advances since last Fall.

The FHLBanks face several important challenges, two of which I would like to note:

1. *Private Label Securities.* Working through the impairments and fair value losses associated with their investments in private label mortgage backed securities is an immediate and ongoing challenge for the FHLBank System and the potential for losses on those securities poses a serious problem for several FHLBanks.

2. *Concentration Risks.* The failure or consolidation of System members has shifted business volumes among the FHLBanks and increased concentration of ownership by, and advances to, a select number of large institutions. This raises long-term structural questions regarding the FHLBank System.

Future of the Housing GSEs and Mortgage Finance System

With that Mr. Chairman, let me move to the final topic that you asked me to address: my views about the future of the mortgage market and the role of the GSEs. To properly consider the future of the housing GSEs, one should first consider the goals policymakers have for the U.S. housing finance system and specifically the secondary mortgage market.

In its broadest terms, the housing finance system is comprised of a set of institutions and financial arrangements that connect capital markets to local mortgage lending transactions. The mortgage market is a \$12 trillion market (\$11 trillion in

single-family mortgages and \$1 trillion in multifamily mortgages). This market is one of the largest individual credit markets in the world, nearly the size of all domestic nonfinancial corporate borrowing and 65 percent greater than the Federal debt held by the public. Yet this massive size is attained through millions of individual transactions that have an average size of \$200,000. Today, the Enterprises, the FHLBanks, FHA, private mortgage insurers, and portfolio lenders are among the primary participants in our housing finance system.

For many years, Fannie Mae and Freddie Mac have been the two leading conduits that connected capital markets to individual mortgage transactions. Given the extraordinary losses to these companies and the need for financial support from the Federal Government resulting from the present mortgage crisis, to say nothing of the toll on individual households and communities, we as a Nation need to ask and answer some hard questions about what we want out of our housing finance system going forward. In particular, we need to clearly define the proper public policy objectives and the degree and characteristics of Government involvement in this housing finance system to best serve those objectives.

We might begin with the following simple purpose statement: To promote the efficient provision of credit to finance mortgages for single-family and multifamily housing. An efficient system of credit allocation would typically have a number of characteristics:

- *Allows Innovation.* Financial technology, products, and risk management tools and understanding all evolve over time. An efficient housing finance system should be constantly striving to innovate. Competition is the natural generator of market innovation yet the GSE structure limits competition by the grant of exclusive charters to a few firms. At the same time, regulation is necessary in many cases to protect the financial system and other Government interests. The key is a regulatory approach that accomplishes the latter without hindering the former.
- *Provides Consumer Choice.* A Nation of 50 million plus homeowners is not likely to be well-served by a one-size-fits-all approach to mortgage availability. Given the wide array of household structures, income patterns, wealth, age, financial sophistication, other assets, and so on, a robust housing finance system should be able to cater to varying demands and to suitably customize its product offerings.
- *Provides Consumer Protection.* The costs to individual households of the current record delinquencies and foreclosures reminds us of the need to have a housing finance system that appropriately protects households. Even for households with a substantial degree of financial sophistication, mortgage transactions are not an everyday occurrence and pitfalls and blind spots may exist. Transparency and basic fairness in the lending process need to be assured. Consumer responsibility should also be a goal tied to strong disclosure and financial education.
- *Facilitates Transparency.* Investors in and guarantors of mortgages and mortgage-related securities need clear, timely information on the mortgages in which they invest in order to make optimal investment decisions and to properly manage the risks of those investments. Market mechanisms that are transparent are more attractive to investors. They also facilitate Government oversight of institutional and systemic risk.

While the characteristics described above provide a broad framework for thinking about the future of the housing finance system, there are a number of specific areas related to the current activities of the housing GSEs that deserve special attention. In particular, some key decisions that policymakers will have to address include what role the Federal Government should have in the following key areas of the housing finance system: ensuring that the mortgage market has adequate sources of liquidity; absorbing credit risk; and promoting the availability of mortgage credit.

Briefly, ensuring liquidity in this context addresses the concern that periodic disruptions in credit markets cause investors to temporarily exit from holding, or purchasing new, mortgage-related instruments. For example, during periods of interest rate volatility, the heightened uncertainty makes it difficult to judge mortgage prepayment and default risks, so investors may depart that sector. Likewise, the extreme credit stress of the current mortgage crisis would have caused severe disruptions in the flow of mortgage credit were it not for the establishment of Government support programs. During such episodes, do we need to ensure there is a balance sheet of last resort?

Second, up to the present crisis, arguably the markets relied upon an implicit Government guarantee of Enterprise securities. Going forward, a threshold question

is what level of Government credit support is needed to have a mortgage market that operates efficiently. As opposed to more broadly expanding Government guarantees, one approach to consider is having the Government take a more limited catastrophic credit insurance position backing mortgage assets. Another approach could be a combination of enhanced private sector market discipline and regulatory oversight to get a more economically accurate market price of mortgage credit risk.

Third, for many decades the Federal Government has sought to affect housing finance in ways that promoted the availability of credit for low-and moderate-income homeowners and renters. Under the current structure, the many subsidies granted the Enterprises were exchanged for various requirements, including housing goals, to ensure the Enterprises did not ignore these segments of the marketplace. Going forward, policymakers may consider alternative approaches to defining and targeting subsidies to achieve public policy objectives. For instance, subsidies intended to support the financing of affordable rental units or to assist first-time homebuyers could be more efficiently targeted through down payment assistance or other measures than by a general subsidy provided to all types of mortgage credit.

As policymakers deliberate the future of the housing finance system, it is important to keep in mind the benefits that the secondary mortgage market provides. Notable among those benefits are standardization in the terms of conventional mortgages and a highly liquid forward market for mortgage backed securities that allows applicants to lock in interest rates when they are planning to buy a home or refinance an existing loan. We should strive to maintain those benefits while addressing the significant challenges we face.

Mr. Chairman, I believe we are in the early stages of an important national discussion about them, one that I know the Administration has committed to addressing in the coming months. There are options available to us. The GAO, which will testify at the next panel, has a broad framework setting forth some of these options. I have hoped to add a few elements to the discussion here. I believe that private capital, properly regulated, has a critical role to play in the housing finance system of the future. But to do so, we must clearly articulate the rules of the road before private risk capital will fully return to this market sector. As for the Enterprises and the FHLBanks, they each may have important roles to play in this future system. But the place to begin the discussion is outside the existing framework of institutional arrangements.

Thank you for the opportunity to appear here today. I would be glad to answer any questions.

PREPARED STATEMENT OF WILLIAM B. SHEAR
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ACCOUNTABILITY OFFICE

OCTOBER 8, 2009

GAO

United States Government Accountability Office

Testimony
Before the Committee on Banking,
Housing, and Urban Affairs, U.S. Senate

For Release on Delivery
Expected at 9:30 a.m. EDT
Thursday, October 8, 2009

**FANNIE MAE AND
FREDDIE MAC**

**Analysis of Options for
Revising the Housing
Enterprises' Long-term
Structures**

Statement of William B. Shear, Director
Financial Markets and Community Investment



Chairman Dodd, Ranking Member Shelby, and Members of the Committee:

I am pleased to be here today to discuss the results of our recently issued report on options for restructuring two government-sponsored enterprises (GSE): Fannie Mae and Freddie Mac (enterprises).¹ On September 6, 2008, the Federal Housing Finance Agency (FHFA) placed Fannie Mae and Freddie Mac in conservatorship out of concern that their deteriorating financial condition and potential default on \$5.4 trillion in financial obligations threatened the stability of financial markets. Since then, the Department of the Treasury (Treasury) has provided nearly \$100 billion to the enterprises, and the Congressional Budget Office (CBO) estimated that the total cost of Treasury financial assistance will be nearly \$400 billion.² Moreover, the Board of Governors of the Federal Reserve System (Federal Reserve) has committed to purchasing up to \$1.45 trillion in the debt and securities of the enterprises (and other entities) to support housing finance, housing markets, and financial markets. While the conservatorships can remain in place as efforts are undertaken to stabilize the enterprises and restore confidence in financial markets, FHFA said that the conservatorships were not intended to be permanent. Over the longer term, Congress and the executive branch will face difficult decisions on how to restructure the enterprises and promote housing opportunities while limiting risks to taxpayers and the stability of financial markets.

Congress originally established Fannie Mae and Freddie Mac as government entities in 1968 and 1989, respectively, chartering them as for-profit, shareholder-owned corporations.³ They share a primary mission that has been to stabilize and assist the U.S. secondary mortgage market and facilitate the flow of mortgage credit, including in periods of economic

¹GAO, *Fannie Mae and Freddie Mac: Analysis of Options for Revising the Housing Enterprises' Long-Term Structures*, GAO-09-782 (Washington, D.C.: Sept. 10, 2009).

²On September 7, 2008, Treasury agreed to provide up to \$100 billion in financial support to each enterprise through the purchase of its preferred stock so that the enterprises could maintain a positive net worth. In February 2009, Treasury increased this commitment to \$200 billion per enterprise. Treasury also agreed to purchase the enterprises' mortgage-backed securities and establish a lending facility to meet their borrowing requirements if needed.

³Congress initially chartered Fannie Mae in 1938 but did not establish it as a shareholder-owned corporation until 1968. Congress initially established Freddie Mac in 1970 as an entity within the Federal Home Loan Bank System and reestablished it as a shareholder-owned corporation in 1989.

stress. To accomplish this goal, the enterprises issued debt and stock and used the proceeds to purchase conventional mortgages (conforming mortgages) that met their underwriting standards from lenders such as banks or thrifts.⁴ In turn, banks and thrifts used the proceeds to originate additional mortgages. The enterprises held some of the mortgages they purchased in portfolio, but packaged most into mortgage-backed securities (MBS) sold to investors in the secondary mortgage market.⁵ For a fee, the enterprises guaranteed the timely payment of interest and principal on MBS that they issued. Charter requirements for providing assistance to the secondary mortgage markets also specify that those markets are to include mortgages on residences for low- and moderate-income families (targeted groups). In 1992, Congress instituted authority for requiring the enterprises to meet numeric goals set by the Department of Housing and Urban Development (HUD) annually for the purchase of single- and multifamily mortgages that serve targeted groups.

While the enterprises operated profitably for many years, their structures long have been in question. For example, critics questioned the extent to which private for-profit corporations could be expected to serve a federally mandated housing mission. Furthermore, critics stated that federal sponsorship conveyed certain financial and other advantages that encouraged them to engage in riskier activities than otherwise would be the case. In particular, despite the lack of an explicit government guarantee on enterprise debt and MBS, the assumption in financial markets of an “implied” federal guarantee enabled the enterprises to borrow at lower rates than other for-profit corporations. Critics argued that this implicit guarantee and access to less costly credit created a moral hazard, or encouraged the enterprises to assume greater risks and hold less capital than would have been the case in the absence of a guarantee.

⁴For example, the enterprises typically purchased mortgages with loan-to-value ratios of 80 percent or less (mortgages with down payments of at least 20 percent) and required private mortgage insurance on mortgages with higher loan-to-value ratios. The enterprises also had a limit on the size of mortgages they purchased (the conforming loan limit), with mortgages above this limit called jumbo mortgages. The conforming conventional market differs from other markets (such as the subprime market) that generally have differing underwriting standards, or markets in which the federal government insures or guarantees mortgages (for example, through Federal Housing Administration or Department of Veterans Affairs programs).

⁵Each enterprise’s portfolio also includes MBS that it issued.

We initiated our recently issued report—on which my statement is based—as part of a broader effort to assist Congress in its efforts to address the current financial crisis and weaknesses in the U.S. financial regulatory system. The report provides Congress with information on the roles, benefits, and risks associated with the enterprises' activities and is intended to help inform the forthcoming deliberation on their future structures. In my testimony, I will

- summarize the enterprises' performance in achieving key housing mission objectives;
- identify various options for revising the enterprises' long-term structures;
- analyze these options in terms of their potential capacity to achieve key housing mission and safety and soundness objectives; and
- discuss how the federal government's management of the conservatorships and response to the housing crisis could affect any transition.

To meet our objectives, we reviewed reports, studies, and data on the enterprises and their regulation, including our reports, as well as proposals to revise their structures. We met with researchers who wrote relevant reports on or were knowledgeable about enterprise-related issues and with representatives from FHFA, Treasury, the Federal Reserve, HUD, the Government National Mortgage Association (Ginnie Mae), CBO, the enterprises, banking and mortgage organizations, the National Association of Home Builders, and community groups. In addition, FHFA provided written comments on a draft of the report. FHFA stated that the report is timely and does a good job summarizing the dominant proposals for restructuring the enterprises and some of their strengths and weaknesses. FHFA also offered key questions and principles for guiding initial decisions that will have to be made about the future of the mortgage market.

Enterprises Had a Mixed Record in Achieving Housing Mission Objectives, and Risk Management Deficiencies Compromised Their Safety and Soundness

It is generally accepted that the enterprises were successful in achieving key housing mission objectives to support the secondary mortgage market and facilitate the flow of mortgage credit: (1) We reported that the enterprises established a viable mortgage market for secondary loans that enabled capital to flow to areas with the greatest demand for mortgage credit. (2) The enterprises' activities have been credited with lowering interest rates on qualifying mortgages below what they otherwise would have been, although estimates regarding the extent of this benefit vary.⁶ (3) Furthermore, the enterprises established underwriting practices and forms for conventional mortgages that became standard in the industry, increased the efficiency of underwriting, and helped develop the MBS market.

However, it is not clear to what extent the enterprises have been able to support a stable and liquid secondary mortgage market during periods of economic stress, which is another key objective. As noted in our 1996 report, we did not find clear evidence that Fannie Mae's mortgage purchase activities during the 1980s supported mortgage markets in certain states that had experienced substantial economic setbacks.⁷ During the current financial crisis, the enterprises have provided critical support to mortgage finance as private-sector MBS issuance largely collapsed. Yet the enterprises have been able to provide this support to mortgage finance only with the substantial financial assistance from Treasury and the Federal Reserve discussed earlier.

While the enterprises also were to facilitate mortgage credit opportunities for targeted groups, it is not clear that the numeric mortgage purchase program materially benefited such groups. HUD administered the program

⁶In 1996, we participated in research with CBO, HUD, and Treasury that included analysis of the degree to which the advantageous borrowing rates the enterprises derived from government sponsorship were passed to borrowers. We estimated the benefit on interest rates on 30-year, fixed-rate, single-family mortgages below the conforming loan limits ranged from 15 to 35 basis points (a basis point is equal to one 1/100 of a percent). This amounted to a savings of about \$10–\$25 on the monthly payments on a \$100,000 mortgage. See GAO, *Housing Enterprises: Potential Impacts of Severing Government Sponsorship*, GAO/GGD-96-120 (Washington, D.C.: May 13, 1996). More recent research by Federal Reserve staff suggests that borrower savings ranged from 0 to 7 basis points. See Wayne Passmore, Shane M. Sherlund, and Gilliam Burgess, "The Effect of Housing Government-Sponsored Enterprises on Mortgage Rates," *Real Estate Economics*, 33, Fall 2005: 427-463, and Wayne Passmore, Diana Hancock, Andreas Lehnert, and Shane Sherlund, "Federal Reserve Research on Government-Sponsored Enterprises," Proceedings from the 42th Annual Conference on Bank Structure and Competition, May 2006.

⁷GAO/GGD-96-120.

from 1992 until the authority was transferred to FHFA in 2008. Recent research indicates that, although the enterprises have enhanced their product offerings to meet the housing goals, the effects of the housing goals on affordability and opportunities for targeted groups have been limited. For example, one study found that as the enterprises' activities increased in certain areas pursuant to the mortgage purchase program, they may have been offset by a decline in FHA's existing activities in those areas.⁸ Earlier research sponsored by HUD in 2001 found that the enterprises generally did not play a leading role in affordable multifamily mortgage finance because their underwriting standards were considered conservative and fairly inflexible, compared with those of other multifamily mortgage providers.⁹ In contrast, I should note that representatives from mortgage finance, housing construction, and consumer groups we contacted said that the benefits from enterprise purchases of multifamily mortgages were significant. The representatives said that the enterprises' involvement in or guarantees of the financing of affordable multifamily projects were crucial to their successful completion. In addition, they said that during the current financial crisis the enterprises were the only source of funding for multifamily projects because many other traditional providers, such as banks and insurance companies, largely have withdrawn from the market.

While housing finance may have benefited from the enterprises' activities over the years, GAO, federal regulators, researchers, and others long have argued that the enterprises' structures (for-profit corporations with government sponsorship) undermined market discipline and provided incentives to engage in potentially profitable but risky business practices that did not necessarily support their public missions. As examples,

- We and others raised consistent concerns about rapid growth in the enterprises' retained mortgage portfolios, which reached a combined \$1.6 trillion by 2005. Although increasing the size of the portfolios may have been more profitable than issuing MBS, it exposed the enterprises to significant interest rate risk. We reported that the rapid increase and the

⁸Xudong An and Raphael Bostic, "GSE Activity, FHA Feedback, and Implications for the Efficacy of the Affordable Housing Goals," *Journal of Real Estate Finance and Economics* 36 (2008) 37: 207-231.

⁹Abt Associates, "Study of the Multifamily Underwriting and the GSEs' Role in the Multifamily Market: Final Report," prepared for HUD (August 2001).

associated interest rate risk did not result in a corresponding benefit to the achievement of their housing missions.

- In 2003 and 2004, the enterprises were found to have manipulated accounting rules so that their public financial statements showed steadily increasing profits over many years and thereby increased their attractiveness to potential investors. The misapplication of accounting rules generally involved standards for reporting on derivatives, which the enterprises used to help manage interest rate risks associated with their large retained portfolios. The enterprises had to restate their financial statements and adjust their earnings reports by billions of dollars.
- Finally, beginning in 2004 and 2005, the enterprises purchased a large volume of questionable mortgage assets, such as private-label MBS and Alt-A mortgages, which typically did not have documentation of borrowers' incomes and had high loan-to-value or debt-to-income ratios. According to FHFA, these questionable mortgage assets accounted for less than 20 percent of the enterprises' total assets but represented a disproportionate share of credit-related losses in 2007 and 2008. FHFA stated that the losses on these assets helped precipitate the enterprises' financial deterioration and resulted in the decision to place them in conservatorship in September 2008.

**Options for
Restructuring the
Enterprises Aim to
Achieve Housing
Mission Objectives
while Mitigating
Safety and Soundness
Risks**

The enterprises' mixed records in achieving their housing mission objectives and the losses and weaknesses that resulted in the conservatorships reinforce the need for Congress and the executive branch to fundamentally reevaluate the enterprises' roles, structures, and business activities in mortgage finance. Researchers and others believe a range of options could better achieve housing mission objectives (in some cases through other federal entities such as FHA), help ensure safe and sound operations, and minimize risks to financial stability. These options generally fall along a continuum, with some overlap among key features, and advocate (1) establishing a government corporation or agency, (2) reconstituting the enterprises as for-profit GSEs in some form, or (3) privatizing or terminating them (see table 1).

Table 1: Summary of Options to Revise the Enterprises' Structures

Potential structure	Proposed function
Government corporation or agency	Focus on purchasing qualifying mortgages and issuing MBS but eliminate mortgage portfolios, which are complex to manage and can result in losses due to fluctuations in interest rates. Responsibilities for promoting homeownership for targeted groups could be transferred to FHA, which insures mortgages for low-income and first-time borrowers.
Reestablish for-profit enterprises with government sponsorship	Restore the enterprises to their previous status but add controls to minimize risk. These controls might include eliminating or reducing mortgage portfolios or imposing public utility-type regulation, which involves business activity restrictions and profitability limits, and establishing executive compensation limits. Or, convert the enterprises from publicly traded, shareholder-owned corporations to cooperative associations owned by mortgage lenders.
Privatization or termination	Abolish the enterprises and disperse mortgage lending and risk management throughout the private sector. Some proposals involve the establishment of a federal mortgage insurer to help protect mortgage lenders against catastrophic mortgage losses.

Source: GAO.

The following paragraphs summarize key principles and aspects of each option:

*Government corporation or agency.*¹⁰ Supporters of these proposals maintain that the implied federal guarantee and the enterprises' need to respond to shareholder demands to maximize profitability encouraged excessive risk taking and ultimately resulted in their failures. They believe that a government entity, which would not be concerned about maximizing shareholder value, would best ensure the availability of mortgage credit for primary lenders while minimizing risks associated with a for-profit structure with government sponsorship. Establishing a government corporation or agency also would help ensure transparency through appropriate disclosures of risks and costs in the federal budget. Elements of the proposals include eliminating retained mortgage portfolios over time; establishing sound underwriting standards and risk-sharing arrangements with the private sector; establishing financial and accountability requirements for lenders; instituting consumer protection standards for borrowers; and eliminating responsibility for the numeric mortgage purchase program (instead, FHA's mortgage insurance programs would be expanded to address this objective).

¹⁰See Dwight M. Jaffee, "Reforming Fannie and Freddie," *Regulation*, Winter 2008-2009: 52-57, and Thomas H. Stanton, "Lessons from Public Administration: Recommendations for the Future of Fannie Mae and Freddie Mae," presented at the 45th Annual Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, May 7, 2009.

Reconstituted GSEs. Market participants and commenters, trade groups representing the banking and home construction industries, and community and housing advocates we contacted believe that reconstituting the enterprises would help ensure that they would remain responsive to market developments, continue to produce innovations in mortgage finance, and be less bureaucratic than a government agency or corporation. But they also advocate a variety of additional regulations and ownership structures to help offset the financial risks inherent in the for-profit GSE structure, such as substantially downsizing or eliminating the enterprises' mortgage portfolios; breaking up the enterprises into multiple GSEs to mitigate safety and soundness and financial stability risks; establishing public utility-type regulation for the enterprises (for example, limiting their rates of return); and converting the enterprises into lender-owned associations (creating incentives for mortgage lenders to engage in more prudent underwriting practices).

Privatization or termination. Some analysts and financial commenters contend that privatizing or terminating the enterprises (including dispersing key functions among private-sector entities) represents the best public policy option.¹¹ Advocates believe that privatized entities would align mortgage decisions more closely with market factors and that the resultant dispersal of credit and interest rate risk would reduce safety and soundness risks. Federal Reserve Chairman Ben S. Bernanke has suggested that privatized entities may be more innovative and efficient than government entities, and operate with less interference from political interests.¹² Elements of the proposals include introducing a transition period to mitigate any potential market disruptions and facilitate the development of a new mortgage finance system; and establishing a federal entity to provide catastrophic mortgage insurance for lenders and help

¹¹We treat "termination" and "privatization" as equivalent terms.

¹²Federal Reserve Chairman Ben S. Bernanke, "The Mortgage Meltdown, the Economy, and Public Policy," presented at the University of California at Berkeley/University of California at Los Angeles Symposium (Berkeley, California, Oct. 31, 2008).

ensure that mortgage markets would continue functioning during stressful economic periods.¹³

**A Framework for
Analyzing Trade-offs
Associated with the
Options and Potential
Oversight and
Regulatory Structures
to Help Ensure Their
Effective
Implementation**

We sought to assess each restructuring option in terms of its capacity to meet key housing objectives (providing liquidity and support to mortgage markets and facilitating housing opportunities for targeted groups) while also mitigating safety and soundness and financial stability risks. Our analysis indicates that each option involves important trade-offs, which are summarized in table 2. The table also identifies regulatory and oversight structures that might help ensure that any option implemented would achieve housing mission and safety and soundness objectives.

¹³See Arnold Kling, "Freddie Mac and Fannie Mae: An Exit Strategy for the Taxpayer," Cato Institute Briefing Papers, no. 106 (Washington, D.C.: Sept. 8, 2008). For additional information on privatization and transition issues, see Peter Wallison, Thomas H. Stanton, and Bert Ely, *Privatizing Fannie Mae, Freddie Mac, and the Federal Home Loan Banks: Why and How*, The AEI Press (Washington, D.C.: 2004); and HUD, Policy Development and Research, *Studies on Privatizing Fannie Mae and Freddie Mac* (Washington, D.C.: 1996). See also Diana Hancock and Wayne Passmore, "Three Mortgage Innovations for Enhancing the American Mortgage Market and Promoting Financial Stability" The University of California at Berkeley/University of California at Los Angeles Symposium. (Berkeley, California, Oct. 31, 2008).

Table 2: Trade-offs Associated with Enterprise Reform Options as They Relate to Long-Established Enterprise Objectives and Potential Oversight Structures

Proposed reform option	Provide liquidity and support to mortgage markets, including in bad economic times	Support housing opportunities for targeted groups	Ensure safe and sound operations	Possible elements of regulatory and oversight structure
Government corporation or agency	A government entity, with access to Treasury-issued debt to fund its operations, may be in a better position to provide liquidity to the mortgage market during normal economic periods and when capital markets are impaired. However, because in some cases investor demand for its MBS may be limited in times of financial stress, a government entity that does not have a retained portfolio may face challenges supporting mortgage markets during such periods. Treasury or the Federal Reserve may have to purchase mortgage assets under such circumstances (as has been the case during the current disruption in mortgage credit markets).	A government entity most likely would be expected to pursue housing opportunity programs for targeted groups because of its public status. However, if the government entity does not have a retained mortgage portfolio, it may face certain challenges in managing a housing goal program, since some types of affordable loans, like multifamily loans may be difficult to securitize, and therefore, often have been held in portfolio. As alternatives, fees could be assessed on the government entity's activities to support housing opportunities for targeted groups or FHA's mortgage insurance programs could be expanded.	This structure may represent less risk than has been the case with the GSE structure because MBS issuance is less complicated and risky than managing a retained mortgage portfolio. However, this activity still would be more complicated than Ginnie Mae's (a government corporation that does not buy or sell loans or issue MBS) and could result in substantial taxpayer losses if mismanaged. A government corporation could face greater challenges than private-sector entities in obtaining the human and technological resources needed to manage complex processes or it might lack the operational flexibility to do so.	Key elements for consideration include (1) certain operational flexibilities to obtain appropriate staff and information technology to carry out responsibilities, (2) risk-sharing agreements with private lenders or mortgage insurers, (3) appropriate disclosures in the federal budget of risks and liabilities to ensure financial transparency, and (4) robust congressional oversight of operations.

Proposed reform option	Provide liquidity and support to mortgage markets, including in bad economic times	Support housing opportunities for targeted groups	Ensure safe and sound operations	Possible elements of regulatory and oversight structure
Reconstituted GSEs	As reconstituted GSEs, the enterprises may provide liquidity and other benefits to mortgage finance during normal economic times, as they did for many years. However, their ability to provide such support during stressful economic periods is questionable given current experience. Furthermore, with significantly reduced or eliminated retained mortgage portfolios, the capacity of reconstituted GSEs to provide support to mortgage markets during periods of economic distress also may be limited.	Reconstituted GSEs, with their responsibility to maximize profits for their shareholders, might find it difficult to support some public policy housing initiatives. Moreover, without a retained mortgage portfolio, the reconstituted GSEs may face challenges in implementing a numeric housing goal purchase program. This challenge could be addressed by permitting a reconstituted GSE to maintain a relatively small portfolio or by supporting housing opportunities for targeted groups through assessments on its activities.	The current financial crisis highlights problems with the traditional GSE structure, including incentives to increase leverage and maximize portfolios. Reconstituting the GSEs would reestablish and might strengthen the incentive problems, which could lead to even greater moral hazard and safety and soundness concerns and increase systemic risks. Proposals to regulate GSEs like public utilities in principle could constrain excessive risk-taking, but the applicability of this model to the enterprises has not been established. Moreover, FHFA has not been tested as an independent safety and soundness and housing mission regulator, as the agency has largely acted as a conservator since its establishment in July 2008.	Key elements for consideration include (1) reducing or perhaps eliminating retained mortgage portfolios as deemed appropriate depending on prioritization of numeric housing and safety and soundness objectives, (2) establishing capital standards commensurate with relevant risks, (3) developing additional regulations such as executive compensation limits or perhaps including public utility-type regulation, (4) requiring appropriate financial disclosures in the federal budget to enhance transparency, and (5) ensuring strong congressional oversight of the enterprises' and FHFA's performance.

Proposed reform option	Provide liquidity and support to mortgage markets, including in bad economic times	Support housing opportunities for targeted groups	Ensure safe and sound operations	Possible elements of regulatory and oversight structure
Privatization or termination	Privatizing or terminating the enterprises would eliminate many problems with the current GSE model, including the conflict between public policy and private shareholders. If key enterprise activities such as mortgage purchases and MBS issuances are provided by other financial institutions, liquid mortgage markets could be reestablished in normal economic times. There is significant reason to question the capacity of private banks to support mortgage markets in times of financial distress without government support, given the failure or near failure of key financial institutions and the absence of private-label securitization during the current financial crisis. A federal mortgage insurer could help such lenders provide liquidity and other benefits in times of financial stress.	Privatization or termination would remove the traditional legislative basis, government sponsorship, for the enterprises to implement programs to serve the mortgage credit needs of targeted groups. However, the basis for such programs may remain if a government insurer for mortgage debt is established and the federal government guarantees its financial obligations. Furthermore, Congress might justify the programs on the grounds that large lenders that assume responsibility for key enterprise activities or purchase their assets are viewed as "too big to fail" and benefit from implied federal guarantees of their financial obligations.	Termination and reliance on private-sector firms would leave market discipline and regulators of financial institutions with responsibility for promoting safety and soundness. However, moral hazard concerns would remain if some mortgage lenders were deemed "too big to fail." These concerns may be heightened because the current financial regulatory system already faces challenges in overseeing such organizations. Additionally, safety and soundness concerns may remain if a federal entity were established to insure mortgage debt and did not charge appropriate premiums to offset the risks it incurred. FHA and the FHLBank System may become more prominent if the enterprises were privatized or terminated.	The need for a new financial regulatory system, due to concerns about the current fragmented system, may be heightened to the extent that terminating or privatizing the enterprises results in larger and more complex financial institutions. In considering a new system, Congress should consider the need to mitigate taxpayer risks and consider establishing clear regulatory goals and a systemwide risk focus. If a new federal mortgage insurer is established, there should be an appropriate oversight structure for such an entity. This structure might include appropriate regulations and capital standards, the disclosure of risks and liabilities in the federal budget, and congressional oversight.

Source: GAO.

While the table provides a comprehensive overview of our analysis, let me highlight some implications and trade-offs as they relate to the critical issues of safety and soundness and systemic risk. In some regards, a government entity may mitigate the safety and soundness and systemic risk concerns of the traditional GSE structure. That is, it would eliminate the concern that publicly held profit-maximizing corporations would be able to operate with relatively low levels of capital and take excessive risks because of an implied federal guarantee that undermined market discipline. And, if a government entity were to focus on MBS issuances and not retain a mortgage portfolio, then it would be less complex and potentially less risky than the GSEs were. Nevertheless, a government entity may find successfully managing a large conventional mortgage purchase and MBS issuance business to be challenging. As described in our previous work on FHA, government entities may lack the financial

resources to attract highly skilled employees and obtain information technology to manage complex business activities.¹⁴ The failure to adequately manage the associated risks also could result in significant losses for taxpayers. For example, the enterprises' losses in recent years have been credit-related (because of mortgage defaults), including substantial losses in their MBS guarantee business. This risk may be heightened if a government entity was expected to continue purchasing mortgages and issuing MBS during stressful economic periods.

Reconstituting the GSEs could present significant safety and soundness concerns as well as systemic risks to the financial system. In particular, the potential that the enterprises would enjoy explicit federal guarantees of their financial obligations, rather than the implied guarantees of the past, might serve as incentives for them to engage in risky business practices to meet profitability objectives. One option to mitigate these safety and soundness concerns would be to make the enterprises into lender-owned associations. By selling mortgages to the enterprises, lenders would have financial incentives to adopt sound underwriting practices (as any losses the reconstituted GSEs incurred on such mortgages would affect the lenders' investments in them). While the public utility model of regulation also has been proposed to help mitigate the risks associated with reconstituting the GSEs, it is not clear that this model is appropriate. Unlike natural monopolies such as electric utilities, the enterprises faced significant competition from other providers of mortgage credit over the years.

It is difficult to determine the extent to which privatizing or terminating the enterprises mitigates current safety and soundness and financial stability risks. Under one scenario, such risks would be mitigated because large and complex enterprises that might engage in risky business practices due to an implied federal guarantee would not exist. Instead, private lenders would be subject to market discipline and be more likely to make credit decisions on the basis of credit risk and other market factors. However, if a federal entity were established to insure mortgage debt and did not set appropriate premiums to reflect its risks, then lenders might have incentives to engage in riskier business practices than otherwise

¹⁴See GAO, *Federal Housing Administration: Modernization Proposals Would Have Program and Budget Implications and Require Continued Improvement in Risk Management*, GAO-07-708 (Washington, D.C.: June 29, 2007) and *Information Technology: HUD Needs to Strengthen Its Capacity to Manage and Modernize Its IT Environment*, GAO-09-675 (Washington, D.C.: July 31, 2009).

would be the case. Moreover, if large private-sector financial institutions assumed responsibility for key enterprise activities or purchased a significant portion of their assets, the perception could arise that the failure of such an institution would involve unacceptable systemic financial risks. Therefore, perceptions that the federal government would provide financial assistance to such financial institutions could undermine market discipline. As we previously reported, the fragmented and outdated U.S. financial regulatory structure already lacks the capacity to effectively oversee large financial conglomerates and reform is urgently needed.¹⁵

Oversight and regulatory structures could help ensure that each option mitigated safety and soundness and systemic risk concerns while helping to achieving housing mission objectives. These oversight and regulatory structures could include the following:

- for the government entity, granting operational flexibility to obtain staff and informational technology to carry out responsibilities, requiring appropriate disclosures in the federal budget of risks and liabilities to ensure transparency, and instituting robust congressional oversight;
- for the reconstituted GSE option, reducing or perhaps eliminating mortgage portfolios, establishing capital standards commensurate with risk, and establishing executive compensation limits; and
- for the privatization or termination option, reforming the current regulatory structure, setting capital standards commensurate with risks (if a federal insurer is established), disclosing risks and liabilities in the federal budget in the interests of transparency, and instituting robust congressional oversight.

¹⁵GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, GAO-09-216 (Washington, D.C.: Jan. 8, 2009).

Federal Efforts to Support Housing Markets during the Conservatorships Could Affect Transition to New Structures

Since the beginning of the FHFA conservatorships, the enterprises have been tasked to initiate a range of programs, such as assisting homeowners to refinance or modify their mortgages. These initiatives could benefit housing markets and, in doing so, potentially improve the enterprises' financial condition. However, the initiatives also may involve additional risks and costs for the enterprises, which could increase the costs and challenges associated with transitioning to new structures. For example, borrowers who received mortgage loan modifications could redefault, incurring additional losses.

Similarly, certain provisions in the Treasury agreements with the enterprises may affect their long-term financial viability and complicate any transition. For example, the enterprises must pay quarterly dividends that accrue at 10 percent annually to the Treasury, and in a liquidation proceeding the department has a claim against the assets of any enterprise that cannot pay such dividends. Since Treasury has already purchased \$50 billion in preferred shares of Freddie Mac to date, the enterprise is responsible for paying a dividend to Treasury of \$5 billion annually. Prior to the conservatorship, Freddie Mac's reported annual net income twice came close to or exceeded \$5 billion, and the dividends it distributed to shareholders in those years likely were substantially lower.

Although it is not possible to predict what effects federal initiatives to respond to the housing crisis and the Treasury agreements with the enterprises could have on any transition, they could be substantial. For example, under the proposal to reconstitute the enterprises, potential investors might not be willing to invest in reconstituted GSEs that had a substantial volume of nonperforming mortgage assets or financial obligations to Treasury. To minimize this risk, the federal government could retain nonperforming assets in a "bad bank," spin off the performing assets to a "good bank," and devolve key functions, such as issuing MBS, to investors in a reconstituted GSE.¹⁶ Or, the federal government could use this process to terminate or privatize the enterprises. However, to the extent that the enterprises previously engaged in activities or incurred financial obligations inconsistent with maintaining long-term financial viability, the level of nonperforming assets and long-term costs to taxpayers may be higher than otherwise would be the case.

¹⁶Such proposals generally involve the federal government maintaining existing guarantees on the assets in the "bad bank" as well as assets in the "good bank" as may be required.

Regardless of what changes are implemented, policymakers should pay careful attention to how a potential transition is managed to mitigate potential risks to the housing finance system. The enterprises evolved to become dominant participants in housing finance, and, in some respects, their roles have expanded during the conservatorships. Therefore, transitioning to a new structure could have significant consequences for housing finance and should be managed carefully and perhaps implemented in phases, with periodic evaluations to determine if corrective actions were necessary.

Finally, regardless of any enterprise structural reforms that are adopted, we urge Congress to continue to actively monitor the progress of such implementation and to be prepared to make legislative adjustments to ensure that any changes are as effective as possible. In addition, we believe that it is important that Congress provide for appropriate GAO oversight of any structural and related reforms to help ensure accountability and transparency in any new system. GAO stands ready to assist the Congress in its oversight capacity and evaluate the progress that is being made in implementing any changes.

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, this concludes my prepared testimony. I would be pleased to address any questions that you or the members of the committee may have.

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PREPARED STATEMENT OF PETER J. WALLISONARTHUR F. BURNS FELLOW IN FINANCIAL POLICY STUDIES, AMERICAN ENTERPRISE
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OCTOBER 8, 2009

Chairman Dodd, Ranking Member Shelby, and Members of the Committee: I very much appreciate this opportunity to testify before this Committee. The role and structure of Government sponsored enterprises (GSEs), and particularly Fannie Mae and Freddie Mac, has been an interest of mine since I was General Counsel of the Treasury in the early 1980s.

While most of the attention to the GAO report in today's hearing will focus on the agency's analysis of the options for their future, the report contains a lot of useful background about Government housing policies in general that the Committee should take into account. Table 1, for example, records the large number of housing programs that the U.S. Government now pursues, beginning with the establishment of the Federal Home Loan Bank System in 1932, the Federal Housing Administration in 1934, and Fannie Mae in 1938, and extending through the many programs for direct outlays currently run by HUD and the tax subsidies that are enjoyed by most homeowners today. The sheer number of these programs is a reminder that there will still be plenty of Government support for housing and home ownership in the United States, even if Fannie Mae and Freddie Mac are ultimately privatized or liquidated.

Unfortunately, the table does not include or describe the system of savings and loan associations (S&Ls), originally operated and regulated by the Federal Home Loan Bank Board (FHLBB). The Board was the predecessor of the Office of Thrift Supervision, which now regulates the S&Ls that are a vestige of the much larger system that collapsed in the late 1980s. One of the reasons for abolishing the FHLBB was that its mandate included the promotion of housing, and that was deemed to be inconsistent with the responsibility of a regulatory agency. As I will discuss in this testimony, the same issue of conflict in missions occurs in the case of Fannie and Freddie and severely impairs their effectiveness. Indeed, for more than just this reason, the example of the S&L system has great relevance to what the Committee is considering today—both the future of Fannie Mae and Freddie Mac and the wider issue of new regulations that are intended to prevent the recurrence of the financial crisis we are now experiencing.

The Lesson of the S&Ls

The S&L system was established in 1932 to provide housing finance. At the time, this was only the latest in many Government efforts during the 20th century to increase home ownership in the United States. For good reason, Americans believe in home ownership. It has many indirect benefits—better housing, better neighborhoods, better family conditions, less delinquency, and others—that are worthy of Government support if they do not occur through operation of the market alone. But recalling the history of the S&Ls and their collapse as an industry is important for understanding what we should do with Fannie Mae and Freddie Mac today.

This is true for two major reasons. First, the S&Ls were an attempt by Congress to use a financial mechanism—a depository institution—to achieve a social purpose, an increase in home ownership. S&Ls were limited to making housing loans, which meant that they were locked into a structure in which they were compelled to carry long-term assets with short-term liabilities—a prescription for depository institution failure if there ever was one. Commercial banks also carry long-term assets with short-term deposits, but they have many more short-term assets they can acquire. Fannie and Freddie were initially developed simply to make the secondary mortgage market function more effectively by purchasing mortgages from banks and S&Ls, thus making these long-term assets more liquid. However, after the S&L industry failed, Congress adopted another way to increase home ownership. In this case, Congress gave Fannie and Freddie an additional responsibility—an affordable housing "mission"—intended to direct housing finance resources to certain groups that were thought to be underserved in the normal credit markets. This effort worked too well. The loans made to the borrowers Congress designated, borrowers who did not have the financial resources or the credit standing necessary to meet their obligations, were largely responsible for Fannie and Freddie's insolvency. Accordingly, the failure of both the S&Ls and the GSEs should tell us that attempts to manipulate financial institutions in order to achieve a particular social purpose are likely to end badly.

Second, the S&Ls failed because the system was not flexible enough to survive in a market where interest rates were set by supply and demand. This is important, and bears on many of the issues raised by the financial crisis. The S&Ls remained

a stable source of housing finance only during a unique time—when the deposit interest rates at banks and S&Ls were controlled by regulation and depositors had nowhere else to go. Under what was known as the Fed’s Regulation Q, banks could not pay more than 5 percent interest on deposits and S&Ls could not pay more than 5¼ percent.

This created a very stable banking system for many years, and many of the advocates of greater regulation today point to this period—roughly from the end of World War II through the end of the 1970s—as a period of “great moderation” when we didn’t have many banking crises. The implication is that we should have more regulation now. What the proponents of regulation don’t mention is that during this period we had many very serious recessions and housing finance crises when there was insufficient liquidity in the economy because the banks and S&Ls could not raise sufficient funds for lending when money market rates exceeded what Regulation Q permitted them to pay for deposits. After the deregulation of deposit rates in the early 1980s, we really did have a great moderation, with only two mild recessions until the early 2000s, when the Dot-Com bubble deflated. Even that recession did not implicate the banking system, which remained reasonably strong from the time of the S&L collapse (when almost 1600 commercial banks also failed) until the current crisis.

The lesson of the S&L collapse is that it was a serious policy error to impose a rigid regulatory structure on an institution that is supposed to be operating in a market where the cost of its principal raw material—*i.e.*, money—is subject to the law of supply and demand. The policy worked for a while, as long as the general public had no other choices, but with the advent of ordinary money market mutual funds, people could get access to higher rates and safe short-term investments in the money markets and withdrew their funds from banks and S&Ls. These institutions were forced to replace these fleeing depositors with funding sources that required them to pay higher rates, and the losses that resulted (paying more for funds than the assets that they were holding were yielding) caused the collapse of the whole industry. It is important to recognize that Regulation Q penalized the public and trapped them in low-paying deposit accounts. In effect, they were freed by technological changes—primarily the advent of computers—that made it possible for mutual funds to calculate their net asset value at the end of every day.

The S&L analogue at Fannie and Freddie is that no financial institution can serve two masters. Government-sponsored enterprises—to the extent that they are owned by shareholders but also have a Government “mission”—are living contradictions. They were set up to achieve two Government purposes—creating a more liquid and efficient secondary mortgage market and reducing the interest rates on mortgage loans. But they are also private, shareholder-owned companies, and their managements have a fiduciary duty to maximize value for the shareholders. Just as the S&Ls’ rigid structure could not survive in a market where their depositors had alternative investments, Fannie and Freddie could not serve both their Government purpose and their shareholders at the same time. In the end, the shareholders come first—if only because in serving the shareholders the managements could assure themselves of rich rewards by exploiting the Government franchise they had been given. This is part of the story of Fannie and Freddie, and why they did not actually reduce mortgage interest rates for the great middle class of the United States. As the GAO points out, Fed studies showed that the interest rate reductions attributable to their operations actually amounted to only 7 basis points.

One of the reasons that they achieved only this paltry sum for home buyers is their affordable housing mission, which was adopted by Congress in 1992. This created another inherent conflict of interest in their charter. In this case, Fannie and Freddie were required to devote a substantial portion of their resources to purchasing loans made to home buyers at or below the median income. When HUD first began to implement this mandate, the requirement was 30 percent, but it was ratcheted up over time, and by 2005 HUD’s affordable housing regulations required that 55 percent of the loans Fannie and Freddie purchased had to be loans to home buyers at or below the median income, including 25 percent to low-income home buyers. Of course, the HUD regulations said that these loans were to be prudent, but Fannie and Freddie were also importuned to be “flexible” in their standards, and that resulted in their looking for and buying loans that had been made to people with blemished credit or limited ability to make downpayments. By the early 2000s, Fannie and Freddie were buying loans which involved no downpayment at all. The result is clear today. At the time Fannie and Freddie had to be taken over by the Government, they held or had guaranteed 10 million subprime and Alt-A loans, with a total value of \$1.6 trillion. These loans are defaulting at unprecedented rates, and when it is all said and done, cleaning up the mess at Fannie and Freddie will probably cost the American taxpayers \$200 to \$400 billion.

The losses that finally overwhelmed Fannie and Freddie were hidden for a long time in the huge profits that the two companies were able to earn from exploiting their Government franchise. It looks today as though the allocation of those profits was pretty much as one would expect—first to the management, then to the losses incurred in their affordable housing mission, then to the shareholders in the form of dividends, and finally 7 basis points of benefit to home buyers. Of course, the embedded losses were reserved for the taxpayers, who never had an opportunity to reject the honor.

There are certainly good policy reasons for the U.S. Government to encourage home ownership, but imposing the burden on companies that are supposed to be shareholder-owned and profit-making is not the way to do it. A Government program that provides downpayments for people who can't afford them would make a lot more sense. Then the losses, if any, would be visible and could be balanced against the gains from increasing home ownership. But requiring Fannie and Freddie to perform this mission—to find an increasing number of “prudent” loans that met HUD's requirements—was a mission impossible, and the result is the insolvency of the two companies and huge eventual losses for the taxpayers.

The Future of Fannie Mae and Freddie Mac

What do these two lessons say about the future of Fannie and Freddie? First, I think the GAO's conclusions about the options available to Congress are correct. The realistic options are only nationalization, privatization, or a return to GSE status, but there are some ideas that are refinements of these general categories. For example, the Mortgage Bankers Association has proposed a well thought-out proposal that falls somewhere between privatization and GSE status. In addition, the Treasury under Hank Paulson published a plan for a covered bonds structure that might get the Government completely out of the mortgage market. An evaluation of these ideas as substitutes for Fannie and Freddie is beyond the scope of this testimony. Instead, I'd like to review each of the possibilities raised by the GAO, beginning with a return to GSE status.

Fannie and Freddie as GSEs

From what I have said above, a return to GSE status would be the worst choice, especially if Fannie and Freddie were to continue to have an affordable housing mission. That mission seems unnecessary when FHA's activities could be expanded to achieve the same result, and if the objective is to increase home ownership, a program that provides downpayments for prospective homebuyers with otherwise good credit records is likely to be more effective. At least such a downpayment subsidy program would be transparent, which Fannie and Freddie's affordable housing losses certainly were not.

But even if Fannie and Freddie are no longer required to support affordable housing, and even if their activities are limited to securitizing mortgages (so that they are prohibited from holding portfolios of mortgages and mortgage-backed securities), it would be a mistake for them to be set up again as GSEs. The GSE form is a prescription for moral hazard. If there had ever been any doubt that GSEs are backed by the Federal Government, the Federal takeover of Fannie and Freddie in 2008 removed it. If they are again set up as GSEs, creditors will assume that the Government will rescue them again if they get into trouble. There will be no market discipline, no market-based restraint on their risk-taking. They and their supporters will argue that strong regulation will prevent substantial risk-taking, but this is an error. Since FDICIA was adopted in 1991, in the wake of the S&L crisis, we have relied on the strongest regulation we could think of to make sure that insured banks were safe and sound. Yet, today, we have the worst banking crisis since the Great Depression. Accordingly, it seems clear that strong regulation cannot overcome the incentives of management—indeed their fiduciary obligations as managers of shareholder-owned companies—to exploit the GSE franchise to the maximum possible degree. No regulator will be able to tease out the myriad ways in which the management of a future GSE will be able to take risks in order to enhance the returns with which they and the shareholders will be rewarded. Risk-taking is appropriate for private companies—they should take risks for profit—but not when companies are operating with the taxpayers' credit card. Yet that is exactly what we will be doing if Congress accepts the facile argument that strong regulation will prevent serious risk-taking and losses.

I should add here that if Fannie and Freddie return as GSEs, and creditors assume that their liabilities are backed by the Federal Government, the potential losses on their activities will be greater than the potential losses to the Government arising out of the FDIC's insurance on bank deposits. Bank deposits are only insured up to \$250,000, but all of Fannie and Freddie's debts will be covered in the

event of another failure in the future. So the stakes will be high for the taxpayers if Fannie and Freddie are returned to GSE status.

Nationalization of Fannie and Freddie

The next question, then, would be whether nationalization would solve this problem. In other words, if Fannie and Freddie were combined into a single Government institution, could they more effectively perform their secondary market role without a danger of excessive risks to the taxpayers? In effect, the new entity would be doing what Ginnie Mae is doing, but for a broader range of mortgages. Because a Government agency would have no profit motive and no capital requirement, it could, in theory, offer less expensive mortgages.

Again, the question arises whether the new entity would have an affordable housing mission, and whether that obligation would require them to take on the excessive risks that Fannie and Freddie seem to have taken on in pursuit of that mandate. In addition, while there is little incentive for a Government entity to take risks, there is also little incentive to be careful about the credit risks they might be taking on inadvertently. Unless the agency can pay the salaries necessary to attract high-quality employees, its staff may not be able to understand the complexity of the mortgages that might be created in the future. As we saw with Fannie and Freddie, these risks can build up over a long period and not come to light. When they do, the losses can be substantial, in this case for the account of the Government. In this connection, the Government entity could be securitizing trillions of dollars in mortgages, and only small errors in risk management could be very costly over time.

The GAO report does not consider the budgetary impact of nationalizing Fannie and Freddie. Fannie was originally turned into a private company in order to take it out of the budget process. As the housing market grew, Fannie's purchases of mortgages were larger than the revenues it received on the sale or refinancing of the loans, and this added to the budget deficit. The same problem would appear to arise if Fannie and Freddie were now to be nationalized. Even if they are no longer permitted to accumulate portfolios of mortgages, their purchases of mortgages will precede the sale of these loans to trusts or other special purpose entities in the securitization process, and this will add to the deficit. This phenomenon will be more pronounced in a growing housing market, when the size of the GSEs purchases will precede the proceeds of sale in a securitization.

The Nexus Between Fannie and Freddie and the Administration's Reform Proposals

At this point, it is worthwhile to consider the nexus between the issues that concern the future of the GSEs and the issues that arise in connection with the Committee's consideration of various proposals to prevent a repeat of the financial crisis. The GAO did not address these issues, but they should be of concern. As part of its effort to prevent another financial crisis, the Administration has proposed that in the future banks hold more capital and the securitization process be revised so that both loan originators and securitization sponsors retain some portion of the credit risk associated with the securitized mortgages. These proposals have important implications for the restructuring of Fannie and Freddie—whether they are re-established as GSEs or merged into a single Government entity. The new capital requirements and securitization rules, if they go into effect, will increase the costs of securitization-based credit. This seems to be acceptable to the Administration, apparently because it believes it will reduce or eliminate the risk of another financial crisis.

But these new capital requirements and securitization rules will have major implications for Fannie and Freddie as GSEs or as a consolidated nationalized entity performing a secondary market function. In both cases, explicit Government backing—or its equivalent in the case of the GSEs—would have the potential to substantially reduce the cost of the mortgages that go through a securitization process run by a GSE or a Government entity. At the same time, the new capital and securitization requirements for private sector operators would substantially increase their costs. The gap between the cost of mortgages in the two systems—Government and private—could be very wide. Mortgages that fall within the conforming range for Government or GSE securitization would have major advantages over those that do not, and this could distort investment in the housing market. This will substantially increase pressure for the Government or the GSEs to take over all secondary market securitization. The usual groups—homebuilders, realtors, and others in the business of constructing or selling homes—will press Congress to cover all mortgages, not just those that are at or below some maximum permitted size. If Congress accedes to this pressure, it will significantly increase the amount of mortgage

debt that becomes a Government risk. For this reason, when the Committee gets to a consideration of the Administration's proposals for reform of bank capital and the securitization process, it should weigh these in light of their effects on the future role of Fannie and Freddie in the housing finance system.

In addition, if Fannie and Freddie survive as GSEs, there is a question whether they will be subject to both the new capitalization and securitization requirements. If we assume that they will be, then we are starting down the track of allowing Fannie and Freddie again to accumulate a portfolio of interests in mortgages. To carry these interests, they will be required to borrow, and if they borrow they will be required to hold more capital in order to protect the Government against losses. However, the Government's potential exposure would grow over time, and could get quite large if the GSEs take on growing numbers of mortgages for securitization.

Privatization

The previous discussion suggests that there are serious flaws and taxpayer risks associated with both the GSE and the Government agency structures. Ideally, Congress and the Administration should be considering new and better ways to finance residential housing in the United States, but there is no indication that any effort is being made to address this issue. Under these circumstances, the Committee should consider the privatization of Fannie and Freddie as a better policy than the two flawed approaches we have previously discussed.

There is no reason in principle why mortgages cannot be securitized through solely private sector activity, like any other asset that creates a cash flow. Car loans, boat loans, insurance premiums, credit cards, and many other assets have been securitized without problems. The difficulties in the mortgage market come primarily from Government interventions to promote home ownership in ways described above. Indeed, the current freeze-up in the asset-backed securities market was caused by investors' loss of confidence in mortgages and rating agencies after unexpected losses appeared in pools of subprime mortgages that had been rated AAA. The resulting losses to investors caused the entire asset-backed market to shut down in 2007, and it has remained largely closed since then. The right kind of reforms—simple requirements, such as downpayments for mortgages and transparency for the underlying rationale of the rating it received—will encourage a return of investor confidence, although it will take time.

There are many advantages to a fully private housing finance market—some of which were clear in the lessons of both the S&L collapse and the failures of Fannie and Freddie. Principal among these advantages is the fact that the taxpayers are unlikely to suffer any losses on a fully privatized mortgage finance system. Failures in today's mortgage financing system are increased, not reduced, by Government backing. Government support creates moral hazard; creditors don't pay attention to risk-taking because they believe the Government will ultimately bail them out, and regulators regularly fail to prevent excessive risk-taking. All these factors increase the risk of failures. In a fully private system, however, creditors will not lend to a Fannie or Freddie if they believe the company is undercapitalized or taking excessive risks. If the mortgages are securitized through structured arrangements, investors will insist on full disclosure concerning the nature and risks of the securities they purchase, and, given the recent track record of rating agencies, will want to know how a rating on a particular tranche in the structure was established. This will mean that the taxpayers will not again be burdened with hundreds of billions of dollars in losses by Government-backed vehicles that were able to take unreasonable risks because of their Government support.

In addition, a private system will encourage more innovation, efficiency, and competition; with many other players joining the secondary mortgage market, competition should bring down mortgage rates. Privatized entities would have the flexibility to react to changes in the economy and the financial markets, and the incentives to do so. Finally, privatized companies are not likely to have an obligation to provide affordable housing financing to targeted groups—a mission that was responsible for Fannie and Freddie's overwhelming losses. This mission would be assigned to Government agencies such as FHA, so the losses—if they occur—will be transparent.

Privatization can be achieved relatively easily after investor confidence in securitization returns. The simplest way would be to gradually reduce the size of the loans that Fannie or Freddie are permitted to buy. This will gradually move them out of the market and make room for new private sector entrants. It will also probably stimulate the development of new ways of financing mortgages, such as covered bonds, or the MBA's recent proposal, which—although designed to use a Government guarantee—could work as a fully private sector structure. If at any time the reduction in the GSEs' role is interfering with the orderly financing of

mortgages, the process can be stopped. In current market conditions, it would not be good policy to reduce conforming loan levels—investors are still too nervous about the private securitization process—but as investor confidence returns, and in the absence of any new thinking on how to finance housing in this country, this approach would be the best way to prevent future taxpayer losses while creating a viable housing finance system.

To conclude, the choices available to the Committee are rather limited. Both the GSE and nationalization option have serious flaws that probably make them unworkable. That leaves some form of privatization. There are many good reasons to adopt a privatization strategy as the future of Fannie and Freddie, but the best is that as private entities without an affordable housing mission, they will not create losses for the taxpayers. Ultimately, however, we must develop a better system of financing housing in the United States, and it is an unpleasant fact that no serious thinking along these lines appears to be going forward in Congress or the Administration.

PREPARED STATEMENT OF SUSAN M. WACHTER

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OCTOBER 8, 2009

Chairman Dodd, Ranking Member Shelby, and other distinguished Members of the Committee: Thank you for the invitation to testify at today's hearing on the "Future of the Mortgage Market and the Housing Enterprises." It is my honor to be here to discuss the future of the mortgage market in the United States. Historically home ownership for Americans has served as bedrock of social prosperity. Given recent history, we must ask ourselves how to envision a safe, sound mortgage market for sustainable home ownership going forward.

As we consider the future of the mortgage market, we need to step back and understand the sources of the global financial debacle. Treasury Secretary Geithner correctly points out: we need to get this phase right in order to minimize future crises. Understanding the crisis and its sources is essential as we evaluate the broad options before us of nationalization, privatization, and a public/private system. While Federal support of the mortgage system is now necessary, nationalization is not a long-run solution as it ultimately expands taxpayer exposure, while privatization without a stabilizing public role also leads to the inevitable socialization of risk, as this crisis has demonstrated.

This crisis resulted from the explosion of risky mortgages, made in the USA, the result of a lethal race to the bottom for short term profits, enabled by regulatory failure. This explosion can be traced to the issuance of private-label securities (PLS). These privately issued securities were neither standardized nor transparent; they were not traded, and, therefore, they were not subject or accountable to private sector forces of market discipline. The common sense defying loans they funded including, interest only, negative amortization, zero equity, and teaser-rate ARMs, were not designed to be affordable when full rates came into effect; and these loans drove the market to an episode of irrational exuberance of historic proportions, causing the housing bubble and inevitable bust. As these loans were pushed into the market, overall household debt to GDP rose, due to mortgage debt, with the increase coming from these risky loans.

As nonstandard mortgages proliferated, the market share of traditional mortgages declined. From 2000 to their peak in 2006, nontraditional mortgages grew in origination market share from 10 percent to almost 50 percent at their height (Wachter 2009b). In particular, the housing enterprises' share of the market dropped, as did the market share of the long-term fully amortized fixed rate mortgage that they fund, protecting borrowers from the interest rate risk which can undermine sustainable home ownership. The result of the tsunami of debt was not an immediate disaster; rather, the initial impact was an artificial house price bubble. As financial institutions loaded up balance sheets on the upswing (Pavlov and Wachter, 2009a and 2009b), they were brought to their knees on the downswing, triggering the liquidity crunch and subsequent foreclosures and the now far-reaching and ongoing economic crisis.

Incentives of mortgage issuers were negatively aligned with the production of safe, sound loans or even loans with a likelihood of payback. Riskier mortgages were more profitable in the short term, even though in the long term they brought down the system. Their greater margin was due to highly inflated fees, which uninformed borrowers paid without realizing their divergence from the norm. Fees drove the de-

mand for securitization at every stage of production: Banks received fees to originate and distribute, the secondary market received fees to bundle mortgages, and rating agencies received fees to rate pools. At each stage, entities were able to book fees without exposure to long run risks. Ultimately investors purchased MBS. But investors could hedge their risk also. With the purchase of newly available credit default swaps (CDS), their positions could be insured against possible loss. There was counterparty risk to be considered, but if this was evaluated, investors might have concluded that these instruments had to be backed up or the entire system would fail. The providers of the credit default swaps perhaps would have been viewed as—and certainly in the event were—“too big to fail.”

The fundamental problem, then, was the lack of accountability in the system to the long-run risks being generated. Due to the illiquidity of their markets, mortgage backed securities and related derivatives traded infrequently, and short-selling these assets was not feasible—this unbalanced market dynamic led to further overpricing for MBS. Without short-selling pressure or frequent trading, prices were driven to high levels that could not be sustained. The result was that artificially inflated asset prices increased further as credit underwriting eroded, which meant that financial institutions’ balance sheets were also artificially inflated (Pavlov and Wachter, 2009a and 2009b). In summary, as these balance sheets grew, the assets reflected ever-eroding standards for mortgage issuance. In the short term, cash flowed in through fees, but each fee that was accounted for represented one more mortgage that did not account for the lack of qualifications of the borrower.

For 25 years, securitization worked well and supported sustainable home ownership in the U.S. The GSEs were strictly regulated. Contrary to popular misconception, they were not allowed to securitize subprime or Alt-A mortgages. After they started losing market share to PLS, however, shareholder and other pressures led them to purchase PLS backed by nonstandard mortgages for their portfolio. To be clear, they did not create the risky mortgage-backed securities that caused the crisis, but they did become a burden to the taxpayer because they were allowed to purchase them after private institutions had manufactured them. My fellow panel member Peter Wallison has documented how several GSE observers suggested Congress put limits on the portfolios, but to no avail.

More generally, financial regulators did not do their part in tracking or preventing systemic risk. With the profusion of mortgage instruments it was exceedingly difficult to determine in real time the amount and type of debt that was being issued. The extent of the asset bubble being generated by this debt explosion was also difficult but not impossible to detect. In a forthcoming paper (Pavlov and Wachter 2009b), we trace the identifiable impact of the debt on asset prices across America, especially in the bubble States, where such loans aggressively expanded.

The most striking aspect of this story is that it never should have happened. While trading partner countries experienced house price increases as interest rates fell from the mid-1990s on, housing price inflation accelerated in the U.S. but not elsewhere, even with the increase in interest rates, in 2003, as nonstandard mortgages and PLS securities issuance took market share in the U.S. The increases in 2003 and 2004 occurred with the dramatic rise in the issuance of private label securities and the aggressive lending they supported. Colleagues and I have separately detailed the regulatory competition and regulatory failure that enabled the profusion of unsafe loans by institutions that were supposed to be regulated for safety and soundness by the Federal Government. While the opportunity for extraordinary compensation, in the short run, drove these markets, regulators were complicit. They failed to hold the suppliers to the long-term consequences of their actions. Federal Reserve Governor Ned Gramlich, and others, warned us as this was occurring.

To ensure the safety and long term sustainability of a reenvisioned mortgage finance system, we should pursue policies that embody three principles. First, policies and procedures are needed to identify and prevent out-of-control asset bubbles and systemic risk, under the supervision of a risk regulator. Proactive measures to warn and protect against asset bubbles must be in place in order to assure sustainable home ownership. Loan-to-value ratios, in particular, must be maintained over time. This will require specific analytics for the identification and monitoring of risks and controls to prevent the procyclical production of risk.

Second, borrowers must have effective, informed choice: safe mortgages should be the presumed mortgage vehicle for borrowing. The standard mortgage must be a safe mortgage and mortgage regulation should favor safe products. To this end, it is important to create a dedicated agency, such as the proposed Consumer Financial Protection Agency. Consumer choice is inconsistent with nonstandard options that cannot be compared or priced.

Third, we need a structure that promotes and provides safe and standard mortgages through liquidity and standardization. Effective borrower choice is impacted

by the structure of the system. Standard mortgages must be cost efficient. Liquidity in funding sources can assure this.

I would also like to draw your attention to a feature of today's mortgage market that we all take very much for granted, namely that a borrower can lock-in a rate in advance of closing, which means that the borrower can come into the closing knowing what the mortgage rate will be. This is possible only because of the forward or "To Be Announced" (TBA) market. In the TBA market, the originator enters into a forward contract with the GSE issuer, in which the originator promises to deliver in the future a package of loans meeting the GSE's requirements in exchange for GSE MBS to be identified in the future. This is possible because GSE MBS of the same type, coupon, and maturity are interchangeable, unlike private-label MBS, each of which is unique in terms of credit risk and interest rate risk. The interchangeability of GSE MBS is a function of a large degree of standardization. This standardization produces sufficient liquidity to support a TBA market, which benefits consumers with guaranteed rate quotes and prevents bait-and-switch mortgage offers. Because the originator is able to resell the loan to the GSE for a guaranteed rate before closing, the originator is not exposed to interest rate fluctuations between the time it quotes a rate and closing. Without the TBA market, originators would have to bear the risk that the market value of the loan would change before closing due to fluctuations in market rates. Because of the liquidity in GSE MBS, a TBA market is possible that allows originators to offer borrowers locked-in rates in advance of closing. This is of course key to the ability of a borrower to choose a mortgage that in fact the borrower will receive at closing.

More generally, securitization should be the way to bring liquidity and cost efficiency to bear on the provision of safe and standard 30-year fixed-rate mortgage. This can assure effective choice and support for a mortgage system that becomes the bulwark of sustainable home ownership in the U.S.

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PREPARED STATEMENT OF ANDREW JAKABOVICS

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PROGRESS ACTION FUND

OCTOBER 8, 2009

Any discussion of the housing finance system's future should start from a clear sense of what we want the system as a whole to accomplish. The recent GAO report considers the range of roles historically played by the housing enterprises, specifically Fannie Mae and Freddie Mac. But if the Committee restricts its analysis of the past and prescriptions for the future to simply the GSEs, it will miss the most significant origins of the current crisis and produce a system that is inadequate to support the essential role of housing finance in our economy. The real question for the Committee's consideration is what are the goals of the system and what combination of public, private, and hybrid arrangements, if any, will deliver those objectives.

My goal for today's testimony is to therefore lay out a series of principles that describes the essential functions that the housing finance system must serve. In short, the specific principles are: access to credit and liquidity, countercyclicality, risk management and oversight, standardization, transparency and accountability, systemic stability, and consumer protection. I hope that these principles are useful as a starting point for reform of the housing finance system, particularly with respect to the secondary market and its participants—both public and private. I will also touch upon important lessons to be learned from the past so that we do not learn the wrong lessons from the subprime crisis, as some may be inclined to do. In short, the systemic failures stemmed from the proliferation of poorly underwritten mortgages channeled through the so-called "shadow banking system" of unregulated private label securities.

The principles that I present today are the result of the collaborative efforts and discussions of a group of experts and stakeholders in mortgage finance convened by the Center for American Progress that have been meeting for more than a year. The group is known as the Mortgage Finance Working Group, or MFWG. These principles, which are available on the Center for American Progress's Web site,¹ were publicly released at an event in March. While we at CAP have tremendously benefited from MFWG members' insights and expertise over the past year, my remarks this morning should not be construed as their personal or institutional endorsement of my testimony. Needless to say, any errors herein are my own.

Looking at any proposal that is made going forward, based on these principles, the Committee should ask the following questions:

- Will institutions of any size in any market have access to capital and liquidity in all markets at all times?
- How well will it do in ensuring a steady supply of 30-year fixed-rate mortgages?
- How well will it do in ensuring a steady supply of finance for affordable multi-family house?
- Will it support and speed innovation?
- Will it support and encourage transparency?
- Will all our communities, especially those devastated by this crisis, have access to credit on fair and nondiscriminatory terms?
- How can we transition to a new system without disruption?

With these questions in mind, policymakers can design a regime that not only sets the policy framework for the primary and secondary market actions of purely pri-

¹See, http://www.americanprogress.org/issues/2009/03/pdf/mortgage_finance_principles.pdf.

http://www.americanprogress.org/issues/2009/03/pdf/mortgage_finance_principles.pdf

vate entities and public credit enhancement agencies and provides carefully designed Government backing only for those select activities of private actors that are determined to be necessary to ensure that there is credit available to support all the Nation's housing needs.

Liquidity Across Products and Time

The first concern of policymakers in contemplating any redesign the U.S. mortgage finance system must be ensuring sufficient credit liquidity at all times to meet the needs of U.S. homeowners. American borrowers have shown a strong preference for long-term, fixed-rate, self-amortizing loans that have allowed them to build assets and plan loan repayment. Most investors, on the other hand, seek short-term, liquid investments. Mortgage markets in the United States in recent decades have done a remarkable job of intermediation between those different needs. (As Susan Wachter has mentioned, no other housing finance system provides long-term, fixed-rate mortgage lending as well as the American system.)

What do we mean by liquidity? An investor needs to know that there will be a market for their assets—in the context of mortgage-backed securities, their particular share of loans made to individual homeowners—at all times. If an investment is not liquid, investors will charge more, if they make the capital available at all. If they don't, a new homebuyer cannot get a loan and an existing owner may be unable to sell.

In thinking about liquidity, two important aspects must be considered: first, the need to have consistent credit liquidity through booms and busts; and second, the need to have broad availability of credit across places and housing types. Each is of paramount importance in thinking about the future of U.S. housing finance.

Broad demands for liquidity must be consistently met over time. In the most recent housing cycle, we saw too much credit flow into the U.S. housing markets during the boom, creating a housing price bubble that misallocated trillions of dollars of capital. Private mortgage securitization played an unquestionably procyclical role during these bubble years. Conversely, during the aftermath of the housing bust, there has been a notable drying up of credit liquidity, one which has only been filled by the housing enterprises, Fannie Mae and Freddie Mac, both before and particularly after being placed in conservatorship, and FHA/Ginnie Mae. If not for these governmental and Government-backed sources of housing finance, the downturn would have been much more severe, and no one would be talking about the possibility that we've seen a bottom, either for the housing market or the broader economy.

Any housing finance reform efforts must consider the importance of ensuring sufficient credit liquidity during down times, and who might provide that liquidity. Institutions with the capacity and responsibility for countercyclical activity are a requirement for a well-functioning system. This countercyclical role is one that will require some measure of Government backing, as the private sector has proven itself unable or unwilling to independently provide sufficient and necessary capital during periods of retrenchment.

Credit liquidity must also be deep in addition to being broad. Policymakers must consider how a revised system will succeed in maintaining the confidence of domestic and international investors to continue directing their capital into U.S. housing markets. This confidence has been shaken, most particularly with respect to the primary lenders and secondary market institutions that are at the heart of mortgage finance today. Perhaps the biggest question policymakers face is whether U.S. housing finance can attract sufficient capital to meet its needs without a significant Government role, particularly in the wake of massive failures in the private securitization market which have caused the global investment community massive losses on U.S. mortgage securities. I believe the answer to the question is that there remain critical roles for Government to play in the provision of mortgage finance liquidity.

Beyond the issue of constant and deep liquidity, U.S. housing finance must provide liquidity across geographies to support the acquisition and refinancing of a wide range of housing types, from the single-family suburban home to the high-rise apartment building, from double-wide manufactured housing to triple-decker row homes. An emphasis on ensuring the availability of mortgage finance to support home ownership remains appropriate, even in the aftermath of the housing crisis, as home ownership is still the key route to economic mobility and wealth accumulation for large segments of the American populace.

But home ownership is not appropriate for everyone at every point in their lives. If the reformed housing system fails to provide sufficient financing for the production and maintenance of affordable rental housing, the system will fail to serve the needs not only of a large and sometimes vulnerable segment of the population, but

also of the rest of us. Not only have almost all of us rented at some time in our lives, but the lack of quality affordable rental housing affects the fabric of our entire economy and society.

The idea of ensuring sufficient credit liquidity translates for most Americans into ensuring a supply of capital flowing to originators of single-family mortgages. But policymakers should also be careful to consider the needs of multifamily housing as well. In the context of the secondary mortgage market, providing liquidity for multifamily housing in particular will be a challenge to policymakers going forward. Because multifamily housing is not as easily securitized or underwritten as single-family mortgages are, ensuring constant liquidity is more difficult. In periods of significant stress to the banking system during the past two decades, permanent financing for multifamily housing was predominantly financed by the GSEs, both through their direct efforts as well as through their role as an active purchaser of the tax credits that helped finance the equity portions of multifamily housing deals. Research by the National Multi Housing Council highlights the critical role the housing enterprises played during the S&L crisis, providing \$9 billion for multifamily housing at a time when savings and loans were responsible for \$43 billion of disinvestment in the sector. Similarly, between October 2007 and September 2008, the GSEs provided a combined 82 percent of the \$83 billion in net new multifamily financing.²

Demographic changes coupled with the fallout from the housing crisis make it a certainty that demand for rental units will soar in the near future, and much of that demand will be for affordable rental housing in places with access to decent job opportunities. During the height of the boom, much of the multifamily construction took the form of condominiums and higher-end developments.³ Any reformed housing finance system will need to meet the demand for financing multifamily housing across the range of price points; this will likely require a range of delivery channels for deeply subsidized, narrowly subsidized, and unsubsidized units.

Fair and Affordable Access to Credit

We should expect private capital to provide consumers with access to credit on profitable but fair terms. In particular, underserved communities should receive access to credit on terms that reflect their actual, not perceived, credit risk and not on predatory terms. These are the communities that have been hardest hit by the housing and economic crisis and will need the most capital to rebuild. While an emphasis on better risk management is likely to lead to tighter underwriting standards, policymakers should be careful in ensuring that those changes are based on criteria empirically tied to credit risk—while remaining sensitive to the true costs of providing that credit—rather than on ideological or discriminatory assumptions about the credit profiles of certain communities. Stronger underwriting should ultimately lead to a more careful allocation of credit within all communities, not a deprivation of credit to underserved communities.

It is worth noting that the modern long-term fixed rate mortgage, where the homeowner does not bear interest rate risk, such as the 30-year fixed-rate mortgage that we all take for granted, is actually an affordable housing financial product created by Government policy. In the 1920s and early 1930s, private-sector mortgages were short-term, nonamortizing bullet loans—many of same features found in the most toxic of the toxic mortgages originated at the height of the bubble. The Home Owners' Loan Corporation was created in 1933 at the height of the depression to refinance distressed borrowers into stable, long-term—then 15-year—mortgages at up to 80 percent loan-to-value. FHA followed the HOLC offering these innovative long-term products. The adoption of the self-amortizing, fixed-rate mortgage by the private sector was a reflection of a need to compete on the best terms with public entities—in contrast to the race to the bottom among lenders we have witnessed over the past several years.

Long-term, fixed rate loans are a unique feature of the American system. As a policy matter we should want to ensure their continued availability, because they remain essential to creating wealth/asset building opportunities for consumers. Moreover, unlike adjustable-rate mortgages, these loans shift interest rate risk

² Mark Obrinsky, "NMHC Research Notes: The GSEs' Role in Multifamily Finance", National Multi-Housing Council, February 3, 2009; Available at <http://www.nmhc.org/Content/ServeContent.cfm?ContentItemID=5039>. See also Paul Weech, "More than Home Ownership: The Role of the Housing GSEs in Multifamily Housing Finance" (Forthcoming from the Center for American Progress).

³ Joint Center for Housing Studies, "America's Rental Housing: The Key to a Balanced National Policy." Harvard University, 2008. http://www.jchs.harvard.edu/publications/rental/rh08_americas_rental_housing/rh08_americas_rental_housing.pdf.

away from homeowners, the party with the least ability to manage that risk, onto institutions and individuals with greater risk-management capacity.

Absent a policy intervention to ensure the availability of these long-term mortgages, they probably will not exist, a point implicitly acknowledged by Wells Fargo CEO John Stumpf in a recent call for the GSEs to be given permission to purchase jumbo mortgages as a way to “help revive the moribund market for big mortgages.”⁴

Another important goal is the provision of affordable housing finance products to all communities, not just the middle and upper class, but also to those underserved traditionally by decent and fair financial products and sources. Unfortunately, many have taken the wrong lessons from this crisis about the ability of low and moderate income people to be homeowners.

And while society has sometimes overemphasized home ownership over the last two decades at the expense of rental housing, we should not learn the wrong lesson. The current high rate of default on subprime mortgages does not mean that home ownership is inappropriate for low- and moderate-income households. Indeed, from 1998 to 2006, only 9 percent of subprime mortgages went to first-time homebuyers, with 62 percent being used to refinance existing homes.⁵ As I will discuss shortly, the lesson policymakers should be taking away from the crisis is that level playing fields are necessary, particularly when it comes to affordable access to credit. When safe, affordable, and well underwritten loans must compete against unregulated exotic mortgage products priced without regard to underlying asset value or risk and marketed by brokers with misaligned incentives, the results are disastrous, both for homeowners and for the larger economy. We must ensure that parallel systems cannot again emerge that put the soundly underwritten loans in competition with unregulated and nontransparent products.

Many nonprofit, CDFI, and other innovators such as the Self-Help Credit Union were finding compelling and sound ways to lend to lower income families that proved to be far more successful than the track record of subprime product.⁶ The originations and servicing of these successful Self-Help mortgages were by banks motivated by CRA, with the liquidity provided by Fannie Mae. The Ford Foundation provided a guarantee and Self-Help provided management. In other words, this model presents a partnership that relied on Government incentives and provided safe loan products to consumers at no risk to the originating lender. The real lesson of these loans is that standard, well underwritten, low downpayment mortgages to low-wealth, low-income borrowers just like those offered through myriad CRA lending programs offered a safe and durable alternative to subprime products.

It is important to understand that affordable housing finance for lower income and minority families was at a marked disadvantage in competing with predatory subprime product that was irrationally priced, poorly underwritten, and/or marketed with predatory practices. In 2005, 55 percent of borrowers given subprime loans that were sold into private label securities qualified for prime loans at the time of origination.⁷ Good affordable lending was driven out—a perfect example of Gresham’s law, “Bad money drives out good.”

We need to ensure that all the money in the game is available under the same rules. This doesn’t mean that lenders should not differentiate between legitimate credit risks and price their offerings appropriately, but recent CAP research found that even among borrowers earning at least twice area median incomes, African-American and Hispanic borrowers were about three times as likely as whites to be given higher-priced mortgages. This is hardly a characteristic found in a system that ensures equal access to fairly priced credit.

We must reestablish such efforts to allocate capital on fair but economically viable terms, particularly through innovation, not shy from doing affordable home ownership right.

Consumer Protection

There has been a lot of discussion about the merits of consumer protection in the context of the Administration’s proposal for a Consumer Financial Protection Agency, so I won’t go into great detail here to explain CAP’s support for that proposal. Rather, I will make a few brief points about the importance of consumer protection to an effective system of housing finance and vice versa—points that have been absent from the broader conversation to date.

⁴ http://www.ft.com/cms/s/0/85c9c1c8-a258-11de-9caa-00144feabdc0.html?ncklick_check=1.

⁵ <http://www.responsiblelending.org/mortgage-lending/research-analysis/Net-Drain-in-Home-Ownership.pdf>.

⁶ <http://www.self-help.org/secondary-market>.

⁷ Rick Brooks and Ruth Simon, “Subprime Debacle Traps Even Very Credit-Worthy”, *Wall Street Journal*, December 3, 2007. <http://online.wsj.com/article/SB119662974358911035.html>.

First, it is worth noting that to a large extent, consumer protection—*i.e.*, efforts to prevent predatory lending and encourage the origination of safe and sustainable loans—is really also a means to protect investors as well. If loans are originated with aligned incentives, consumers should tend to receive sustainable, well-underwritten loans, which benefits investors by making their investments safer. What we saw in the last market cycle was mortgage brokers and originators with misaligned incentives to sell unsustainable, high-fee mortgages because compensation was immediate and risks were divested.

At the origination level, brokers and originating lenders had no incentives to make sustainable loans, and typically had perverse compensation incentives to sell high-risk, high-fee mortgages over safer products. Subprime and Alt-A mortgages, mainstays of private label securitization, were a particular problem, as we all know. Originating lenders like Countrywide paid originators more if they sold higher risk mortgages such as option ARMs and interest only loans. (They also got paid more for higher interest rate loans, which has led to our suggesting the need for greater scrutiny of whether there had been fair lending violations at the height of the housing bubble.)⁸

With such misaligned incentives, it is not surprising that there have been rampant reports of origination fraud, and more importantly, that the mortgages composing private-label MBS were across the board poorly underwritten with historically astronomical default risks. For example, 44 percent of subprime mortgages, and 9 out of 10 Alt-A option ARMs, originated in 2005 were made without full income documentation.⁹

At all levels of the shadow banking system, the incentives for market actors, including credit rating agencies, were to generate as much volume as possible, with no regard for credit risk and often perverse incentives to generate higher cost, higher risk loans. Because the costs generated by their poorly underwritten mortgages were not ultimately borne by the key market actors in the private securitization process, but were instead borne by others (including the taxpayer)—an externality—their incentives were all aligned towards generating high short-term fees and payments, and away from the long-term viability of the underlying mortgages.

In thinking about these problems, one potential solution stems from greater transparency and standardization. It's a lot easier to shop for a product where you can do comparison shopping, so to the extent that the current system encourages the mass availability of certain standard mortgage products (15/30yr FRM in particular), it empowers the consumer. This is not to say that certain innovative mortgage products should be excluded entirely from the marketplace; borrowers with unique circumstances should not be forced to accept a standard product that is unsuitable for them. Nevertheless, even in these instances, terms should be easily understood and presented in a fashion that allows for consistent comparisons across offerings.

The benefits of standardization accrue to the consumers of securitized mortgages—investors—as well. As we have seen, securities with the same AAA rating have performed very differently over time. Transparency in MBS down to the loan level is often available only to market participants with very deep pockets, leaving other investors to guess how much future impairment is already priced into the security. MBS and collateralized debt obligations trade without TRACE requirements, which also impede market participants' ability to accurately price securities that may have been sliced and diced multiple times over.

The secondary market ultimately drives the standardization that benefits consumers. Investors who innovate with exotic products should have a higher, not lower, obligation for transparency and consumer protection. Products with transparency that allows for ease of comparison across offerings in both the primary and secondary mortgage markets provide much greater efficiency and stability for individual participants and for the system as a whole.

These consumer protection considerations are essential not only for primary market regulation. The secondary market plays a key role as well.

Risk Management and Oversight Creates Transparency

Finally, there is the principle of risk management. In contemplating the reform of the housing finance system, most policymakers have understandably focused on the need to restore stability and sufficient risk oversight to the housing finance system. But those who would focus primarily on GSE reform are missing the bigger

⁸ See, http://www.americanprogress.org/issues/2009/08/tarp_lending.html.

⁹ Wei Li and Keith Ernst, "Do State Predatory Lending Laws Work?", *Housing Policy Debate*, Vol. 18, Issue 2 at p. 361 (2007), available at http://www.mi.vt.edu/data/files/hpd%2018.2/6.hpd_wei-ernst_web.pdf.

picture. After all, it is clear that the unregulated private securitization markets caused this crisis through poor underwriting and misaligned incentives that ultimately became the toxic MBS whose losses infected seemingly invincible institutions. And so we believe that any efforts to reform the housing finance system that ignore the private securitization markets are destined for failure. We must ensure a level playing field.

In discussing the crisis that hit the housing finance system, it is critical that the difference between GSE-conforming MBS and private-label MBS is understood. This is something that is clearly not well understood by many.

GSE-conforming MBS have been around since at least the 1970s and involve a guarantee from one of the Government sponsored entities Fannie Mae or Freddie Mac on the timely payment of principal. This guarantee was thought to carry the implied backing of the Federal Government, something which was confirmed in the recent crisis, when the Federal Government took over the GSEs in a conservatorship and near-explicitly guaranteed their obligations. GSE-guaranteed MBS are securities based upon “conforming mortgages,” which typically are safe and standard mortgages—such as the 30 year FRM—with strong underwriting requirements. The GSEs also purchased ARMs, Alt-A, and even subprime mortgages, but even in those cases, the quality of those loans were mostly better than what was securitized through PLS, in part because the terms of the loans contained fewer predatory features.¹⁰

GSE-conforming mortgages, in large part due to the standards set by the GSEs themselves and the requirement of private mortgage insurance on loans in excess of 80 percent of the property’s value, have historically performed very well. Even in this historically unprecedented housing downturn, GSE-conforming mortgages have seen default rates that are small relative to PLS. In fact, serious delinquency rates for PLS are considerably higher than Fannie Mae or Freddie Mac’s portfolios (including their held Alt-A and subprime mortgages) as of the end of the second quarter of 2009. PLS make up 13 percent of the outstanding single-family first mortgages but account for 35 percent of the serious delinquencies. The housing enterprises, in contrast, collectively hold 57 percent of those mortgages but only 26 percent of the serious delinquent mortgages.¹¹ In other words, there are more than one-third more delinquent mortgages in PLS than owned by the GSEs, despite the GSEs’ market share being more than three times the size.

The Housing and Financial Crisis Originated in “Toxic” Private-Label MBS

Having laid out the principles that describe the essential functions of the housing finance system, I would like to also touch upon the key points of failure of the existing system.

Specifically, the rapid expansion of a “shadow banking system” consisting of private label securities and their complex derivatives distorted the secondary mortgage market and chased safer loan products out. The proliferation of PLS comprised of loosely underwritten mortgages was made possible by a lack of prudential oversight and misaligned incentives throughout the origination and securitization processes.

The unregulated private MBS market, free from any direct safety and soundness supervisory oversight, was hailed as a paradigm for efficient markets, with sophisticated private actors and cutting-edge quantitative analysis efficiently managing and allocating risk, whose complexities were boiled down into a series of letter grades issued by credit rating agencies who were paid handsomely by those packaging mortgages into securities. Despite the inherent conflicts of interest in ratings agencies’ business model, belief that the “shadow banking system” could manage its own risk while providing strong returns was nearly universal. Thus, the regulatory playing field was tilted to the advantage of private securitization, as regulators and legislators alike were reluctant to regulate a market that seemed to be functioning efficiently without regulation. The lack of regulation allowed the shadow banking system to enjoy cost advantages over other sources of housing finance, which allowed it to dominate the marketplace.

Because private securitization had relatively little regulation but the near-universal belief that its products were safe—AAA ratings coupled with expectations of perpetual house price appreciation—global capital flooded into the shadow banking system, and thus the U.S. housing markets, during the Bush administration. Private-label MBS have been created and sold for more than two decades, but their

¹⁰ See, <https://www.efanniemae.com/sf/mortgageproducts/pdf/armmatrix.pdf> for the types of adjustable rate mortgages that Fannie Mae would purchase. Note that the factors that determine the interest rates (index plus margin) are generally favorable to the borrower and prohibit negative amortization and no lifetime floors.

¹¹ http://www.freddiemac.com/corporate/company_profile/pdf/fm_housing_crisis.pdf.

expansion was dramatic in the earlier part of this decade, expanding almost nine-fold from \$135 billion 2000 to almost \$1.2 trillion in 2005.¹²

The U.S. PLS share of MBS went from 12 percent in 2002 to nearly 50 percent in 2006, which had the effect of distorting the overall economics of the U.S. housing market. Coupled with low interest rates, this flood of capital caused massive appreciation in housing prices that was unsupported by the underlying economic trends. By the end of 2007, U.S. housing prices had seen an inflation-adjusted 86 percent increase since 1996, even as household income stagnated.¹³ The PLS-induced housing bubble burst and has today left approximately one in three mortgages underwater,¹⁴ and that number could rise to nearly 50 percent by 2011, according to a recent study from Deutsche Bank.¹⁵

The growth in mortgages originated for private securitization displaced the so-called “plain vanilla” mortgage products offered by the GSEs, FHA, and portfolio lenders. GSE conforming mortgages shrank to less than 30 percent in 2006, down from 50+ percent in the 1990s. 2005 was the first year in which PLS originations outstripped mortgages originated for agency MBS—including GNMA. Unsurprisingly, 2005 also marked the year in which mortgage lending standards deteriorated markedly, based on the proportion of loans where the intersection of credit score and LTV ratios had historical lending precedents.¹⁶ “By June 2006,” notes Whitney Tilson based on loan performance data presented by Amherst Securities Group, “mortgage lending standards had collapsed, even for the best loans.”¹⁷

This unprecedented market share of the “shadow banking system,” which performed the basic functions of bank lending but without the risk oversight imposed on banks, was tied to the belief that these market players could self-regulate their own risk, and therefore this process of private securitization didn’t need regulation for safety and soundness. As Alan Greenspan noted:

Deregulation and the newer information technologies have joined . . . to advance flexibility in the financial sector. Financial stability may turn out to have been the most important contributor to the evident significant gains in economic stability over the past two decades Recent regulatory reform, coupled with innovative technologies, has stimulated the development of financial products, such as asset-backed securities, collateral loan obligations, and credit default swaps, that facilitate the dispersion of risk.¹⁸

In hindsight, this was clearly a tremendously flawed assumption, but one which enjoyed huge support at the time.

Private-Label MBS Imploded Because of a Lack of Prudential Oversight and Misaligned Incentives

All modern banking systems have a prudential oversight regime, but when regulators fail to use their authorities, or loopholes are created that allow certain products and market participants to avoid oversight, the stability of the entire system is threatened.

At the origination level, the Federal Reserve, which had specifically been tasked by Congress to develop guidance on subprime mortgages, ignored this obligation for more than a decade. And when State-level regulators sought to provide much-needed guidelines for products and institutions operating within their borders, the Bush administration’s Office of the Comptroller of the Currency sued them arguing that national banks were already subject to Federal regulation, despite the OCC’s determined unwillingness to protect consumers from dangerous loan products. The former attorney general of North Carolina, Roy Cooper, was led to remark, the OCC “took 50 sheriffs off the job during the time the mortgage lending industry was becoming the Wild West.”¹⁹

The problem of regulators being philosophically opposed to regulation was an even more critical failing in light of the problem of misaligned incentives throughout the system. Put simply, virtually none of the participants in the mortgage securitization

¹²http://www.fdic.gov/bank/analytical/regional/ro20063q/na/2006_fall01_chart02.html.

¹³<http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/senate-testimony-10-16-08-hearing-stein-final.pdf>.

¹⁴First American CoreLogic.

¹⁵<http://www.bloomberg.com/apps/news?pid=20603037&sid=ac9y1xr7yNhQ>.

¹⁶<http://www.moremortgagemeltdown.com/download/pdf/>

¹⁷<http://www.moremortgagemeltdown.com/download/pdf/>

¹⁸*Ibid.*

¹⁹<http://www.federalreserve.gov/boarddocs/speeches/2005/20051012/default.htm>.

²⁰Robert Berner and Brian Grow, “States Warned About Impending Mortgage Crisis”, *BusinessWeek*, October 12, 2008. <http://www.msnbc.msn.com/id/27121535>.

process had the incentive to originate and sell loans that were viable over the long term.

At the securitization level, loan underwriters had no incentives to verify the underwriting of the loans they were pooling, or to take measures to ensure that defaults were limited. Instead, they merely needed to attain a AAA rating for as high a volume of securities as possible.

Credit rating agencies were tasked with assessing the risk associated with these private label MBS. As Chairman Dodd, Vice Chairman Shelby, and Senator Schumer, among others, have described, these rating agencies faced inherent conflicts of interest, as they were paid by the MBS issuers, and paid more for higher volumes of new issues.

Indeed, we have begun to see renewed activity among re-REMICs, wherein previously downgraded MBS are reorganized into new securities with better ratings, even as the underlying impaired mortgages are left untouched. This alone should put pause to anyone claiming that the market has learned its lesson (once burned, twice shy) and the worst excesses of originators and the PLS market are unlikely to return. Similarly, some who have put forth proposals that ignored the possibility of a reinvigorated PLS market and therefore saw no need to develop a regulatory structure for it are inviting a return of these distortions on the conventional market.

One possibility we at CAP are considering to ensure that whatever PLS market emerges competes on fair and transparent terms with future conventional mortgage lending would be to require all those who securitize residential mortgages to obtain a license that brings with it certain duties to transparency, risk management, and a countercyclical market presence. There are advantages and disadvantages to this model, but it is worth exploring further.

The Costs of Excessive Risk Taking by Private MBS Market Participants Were Borne by Others

In 2007, Fed Chairman Ben Bernanke famously stated that the damage from the subprime mortgage crisis had been contained. In fact, as we now know, this was terribly incorrect, as the excessive defaults from subprime and Alt-A securities, as well as those caused by the depreciation of housing markets artificially inflated by the surge of global capital into U.S. housing, became so great that they paralyzed our entire global financial system, necessitating massive injections of public funds into private Wall Street financial institutions and the housing enterprises.

By 2007, all of the world's largest financial institutions had assumed enormous exposure to the U.S. private-label MBS market. As a result, when these securities began to see higher defaults as a result of their poor mortgage origination practices and the overall inflation of U.S. housing prices, the resulting losses impacted areas of the financial markets far beyond private mortgage origination. Financial institutions as disparate as Citigroup (primarily a bank holding company regulated by Federal banking regulators), AIG (primarily an insurance company regulated by State insurance regulators), and Bear Stearns (primarily an investment bank and broker-dealer regulated by the SEC) experienced losses related to their private label MBS exposure that were so severe that it impacted their other financial activities.

Ironically, the housing enterprises also experienced enormous losses as a result of the private-label MBS market. This occurred through losses on their guarantee book of business as well as through more profound losses on the private-label securities they themselves had bought in an effort to boost profits in response to lost market share from the vary same PLS.

Conclusion

In summation, the housing finance system as a whole must offer access to credit and liquidity, countercyclicality, risk management and oversight, standardization, transparency and accountability, systemic stability, and consumer protection. A robust system will likely require a combination of public, private, and hybrid entities to deliver all of these objectives. It is instructive to look back at the rapid expansion of the PLS market at the expense of conventional lending to identify the failures of the past as we begin to consider how to reform the housing finance system to achieve the principles we have laid out.

Appendix

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Center for American Progress



Principles to Guide Development and Regulation of a Renewed Mortgage Finance System

1. Access to credit and liquidity

The first goal of a mortgage finance system must be to provide sufficient credit for the development and purchase of single family and multifamily units adequate to meet the housing needs of the country. Consistent and adequate liquidity is essential to the availability of quality credit. To achieve this goal our country needs:

a. Strong primary lending facilities

Although secondary mortgage markets have grown to encompass a large share of overall mortgage lending—discussed in greater detail below—primary lenders are still the foundation of the mortgage finance system. Bank lenders are directly and intimately overseen by regulators, and their relationship to borrowers is typically a direct one. As such, primary lenders are a key to maintaining consistent and comprehensive access to credit and liquidity, and are less likely to see fluctuations in these areas that occur as a result of rising and falling investor demand.

b. Well-functioning secondary markets

Over the past few decades, funding from capital markets became an increasingly important part of mortgage lending. Initially this funding came through guaranteed mortgage backed securities from Fannie Mae, Freddie Mac, and Ginnie Mae; then through private-label, mortgage-backed securities, and most recently through the introduction of mortgage derivative products such as collateralized debt obligations. Worldwide investor demand for high yields spurred excessive risk taking to create ever larger issuances of bonds and derivatives based on mortgages. Coupled with a lack of regulatory oversight, this high demand created improper incentives and skewed the market into excessively complex and risky products, without any concomitant safeguards or changes in risk pricing.

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Secondary market incentives must be aligned with credible and sustainable credit risk management (discussed in greater detail below). Secondary markets, however, remain important to liquidity and thus to a renewed mortgage finance system. Well-functioning and robust secondary markets will attract investors to provide capital for housing finance and maintain market confidence in mortgage-backed securities—on a continuous basis—in all economic environments.

c. Careful but creative innovation

While recent history suggests that innovation without adequate regulation or standards is dangerous, a system that encourages appropriate innovation remains essential to ensuring sufficient credit access and liquidity. At its best, financial innovation has the potential to provide increased liquidity at lower cost and thus make credit more available to serve more of the market. Innovation is important in origination, business processes, and secondary market vehicles. For example, innovations such as CAP's proposal for Shared Equity Ownership, which would pay down the principal owed by troubled homeowners in exchange for homeowner concessions that would effectively place the home into an affordable housing trust, have the potential to help communities and lenders alike. Process innovation that leverages technology to improve workflow and document management, enhances communication between borrowers and lenders, and enables more transparent mortgages and securitized mortgages, is a critical feature of a well-functioning market. While innovation can be highly beneficial for consumers, it must also be augmented by direct government support for some types of housing and carefully balanced with the goal of consumer protection.

d. Adequate access to credit for all appropriate forms of housing

Public subsidies, tax policy, fiscal policy, and systemic biases toward homeownership may have contributed to an imbalance in capital availability for homeownership and rental housing. While there can be significant societal and individual wealth accumulation benefits from homeownership, there are many consumers for whom it is not appropriate at certain times. A renewed system of mortgage finance should provide liquidity and capital access for all forms of housing and meet the needs of consumers throughout society whatever their income and wherever located. Special attention should be paid to ensure that the renewed system provides sufficient capital to meet society needs for affordable rental housing. While the current market-based model is providing adequate capital for large multifamily properties and in the luxury end of the market, there is significant room for improvement in the delivery of credit to smaller properties that provide much of the supply of affordable rental housing.

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2. Countercyclicality: measures to ensure consistent access to credit and liquidity

A successful housing financing system should ensure a consistent flow of credit, appropriately priced for market risks whether in good or bad times. This means preventing the overextension of credit during periods of expansion in order to prevent asset bubbles and reduce the impact of consequent deleveraging. This also means creating mechanisms to provide countercyclical liquidity during periods of contraction. One possible mechanism might be the adoption of fluctuating capital requirements, increased during times of easy credit, and decreased during times of deleveraging.

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3. Risk management and oversight

A vital component of a stable and successful mortgage finance system is ensuring that credit risk is appropriately measured, priced, distributed and overseen. Regulation of credit risk should be comprehensive and robust, covering all aspects of the mortgage markets, including the secondary markets. A commitment to improving credit risk oversight will help craft a fairer system that will see fewer homeowners default on their mortgage obligations. Key steps to ensure this happens are:

a. A level-playing field: robust and comprehensive regulation

Regulators possess ample regulatory authority over the federally insured primary lenders to address capital adequacy and levels of risk, but largely failed to exercise it during the housing bubble. Non-bank lenders were not subject to similar regulation. Going forward, bank regulators must exercise their significant regulatory power over primary lenders consistently and thoroughly.

Currently, there is a large gap in regulatory coverage of the secondary markets. Major market players, such as Bear Stearns Cos. and American International Group, Inc., were woefully under regulated, as were complex financial products such as credit derivatives, which became an enormous part of the financial system. The market events of the last few years have made clear the interconnectedness of our financial system—unregulated products and institutions can have enormous consequences on regulated products and institutions. Regulatory coverage must be extended over many of the currently unregulated products and institutions.

It is also important to ensure that opportunities for regulatory arbitrage, such as charter shopping, are eliminated. All financial transactions should be treated uniformly by regulators, regardless of the charter held by the institution engaging in the transactions.

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b. Strong underwriting standards

Stronger underwriting criteria that are based on a thorough understanding of these variables will undoubtedly be a part of minimizing credit risk both institutionally and systemically. Mortgage finance cannot ultimately be successful in managing risk if its core underwriting standards are weak. Strong underwriting means both the incorporation of stringent documentation and measures to eliminate fraud—such as in assessments or borrower stated income—as well as a better allocation of credit based on the borrower’s risk profile.

Stronger underwriting standards should, however, be tied into actual credit risk, and not simply be a proxy for withdrawing credit availability from underserved communities. Much of the credit failure driving the current crisis is the result of loan features such as prepayment penalties, adjustable rates, reduced or no documentation, as well as other factors that were not directly linked to borrower credit risk. More analysis must be done to understand the underlying credit drivers of mortgage performance, especially for borrowers with a low level of assets seeking access to non-traditional credit.

c. Risk assessment and capital adequacy

Risk assessment was horribly mismanaged during the past decade. Financial institutions and regulators alike were overly reliant upon credit risk ratings of private label mortgage-backed securities provided by the rating agencies, which we now know were terribly flawed. As a result, these bonds were mispriced against the risk they represented, contributing to the overextension of credit and the creation of an asset bubble. Consequently, banks were left holding inadequate capital against their actual risk, which has exacerbated the deleveraging process and contributed to the credit crunch. Any reforms of credit risk oversight must include changes to how the markets assess risk, currently through the rating agencies, as well as how risk-based capital requirements are determined for banks and bank holding companies, as well as other financial institutions.

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4. Standardization

Standardization provides benefits to consumers and investors, helps ensure the safety and soundness of financial institutions and improves the transparency and liquidity of housing finance. The benefits of standardization, however, must be balanced against the benefits of innovation and meeting unique needs, especially of underserved borrowers.

For consumers, standardization provides products that are more easily compared. As we saw during the lending boom earlier this decade, many borrowers are ill-equipped to assess different types of mortgages, such as an interest-only adjustable rate mortgage as compared

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to a standard 30-year-fixed rate loan. While innovative products may help to meet consumer needs in unique circumstances, they should be limited to places where appropriate and the terms should be written so their features are easily compared and understood.

For investors, standardization provides certainty which increases liquidity and thus capital availability. The diversity in the terms of pooling and servicing agreements for private label mortgage-backed securities is one reason why restructuring mortgages has proven so difficult, creating greater uncertainty and risk for investors than was properly understood.

Standardization also allows for better risk regulation. Where underwriting and documentation standards are the same across the board, it is easier for regulators to assess risk and set capital and liquidity requirements accordingly. Case in point: Fannie Mae and Freddie Mac sustained their greatest credit losses from their investments in non-standard Alt-A mortgage products. Losses on their standard books of business are more severe than predicted in large part because economic conditions have been more severe than anticipated.

Ultimately, standardization appears most likely to be created in one of two ways. The first is through secondary market institutions, which are in an excellent position to drive standardization through their provision of capital—either through their existing structures (Fannie Mae and Freddie Mac) or through something new—throughout the system and across primary lending platforms. The second is through comprehensive regulation of primary and secondary market actors.

5. Transparency and accountability

One of the major failures of the mortgage finance system that led to our current situation was the lack of accountability by key players at each rung of the mortgage finance delivery process, including mortgage brokers, originating lenders, securitizing banks, and rating agencies. In many cases, all of these institutions lacked sufficient incentives to insure that the mortgages or mortgage instruments they were promoting were ultimately sustainable. In the “originate to distribute” model, all too often key market participants lacked any “skin in the game.”

This lack of accountability was accompanied and exacerbated by a lack of transparency. Buyers, sellers, and issuers of mortgage-backed securities and collateralized debt obligations shrouded their credit risk and credit loss exposures in a cloud of opacity, lessening confidence in the overall financial system and contributing to extreme credit illiquidity. Loan-level data information about the make up of mortgage-backed securities and collateralized debt obligations are typically only available to those willing to pay a hefty price for it, again decreasing transparency and causing investors to assume the worst about individual mortgages and their ultimate loss levels. And at the origination level, mortgage brokers were less than transparent about the various mortgage options, and their relative

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benefits available to consumers, resulting in poor selections of mortgage products and a greater likelihood of defaults and foreclosures.

Reforms of the mortgage finance system must be cognizant of aligning incentives, promoting accountability, and ensuring adequate transparency. Greater accountability and transparency will inevitably lead to better risk assessment and management as well.

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6. Systemic stability

A critical issue that needs to be addressed in any reform of U.S. mortgage finance is the need to curb systemic risk, with a reformed system able to lessen the possibility of future shocks through the entire financial system. As Federal Reserve Board Chairman Ben Bernanke has noted, systemic risk regulation is important to consider as the financial system has become less bank-centered and as the risks of contagion are high. It is important to ensure that risk is appropriately understood and allocated, such that those holding the ultimate risk can afford to bear it. Better measures of gauging counterparty and systemic risk must be adopted and consideration given to other mechanisms for containing and minimizing risk.

Design of a renewed mortgage finance system should also recognize the global nature of today's financial markets. While individual nations will inevitably retain separate regulatory regimes, far greater transparency and coordination through regulatory networks is necessary.

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7. Enhanced consumer protection

The purchase of a home is a complicated, highly technical transaction unlike any other consumer purchase, and it usually represents a household's single largest asset. Buyers are understandably reliant on the professionals they encounter during the process; however, in recent years, these professionals who typically owe no fiduciary duties to borrowers, have been compensated through incentives that are misaligned with consumer interests.

To address unequal information in the transaction, the system should have a built-in bias towards the long-term best interests of the borrowers. One example of this is a proposal for default mortgage model in which consumers would have to explicitly opt out of a 30-year-fixed rate mortgage in order to enter into a more complex loan agreement. Reforms should not only protect borrowers against bad actors but also set up a system of better outcomes by default.

8. Equitable and fair access to credit for consumers and communities

The mortgage finance system should be designed so as to eliminate disparities in the allocation of capital, although it is a mistake to think this is solely a matter of finance. What is more, there is a societal interest in ensuring that communities that have historically suffered from denials of credit or credit on discriminatory or predatory terms have appropriate access to credit from all parts of the finance system. This means ensuring that low-income households and underserved communities, many of which have high concentrations of minorities, have access to credit on terms appropriate to the level of risk represented. These are the communities hardest hit by the mortgage crisis and it is imperative that it is these communities and their residents are better protected and also better served in the future.

While a drive for better risk management is likely to lead to tighter underwriting standards, as well as lower loan-to-value ratios and higher down payment requirements, we must be careful to ensure these changes are based on criteria that are empirically tied to credit risk rather than on theoretical or ideological assumptions about the credit profiles of certain communities of borrowers. Stronger underwriting should ultimately result in a more careful allocation of credit, not a deprivation of credit to underserved communities.

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This product was developed in collaboration with the Mortgage Finance Working Group (MFWG) convened by the Center for American Progress (CAP), and made up of the members listed below. Affiliations are shown for identification purposes only. Neither the MFWG members nor their organizations have endorsed the views represented in this product or any other materials produced by CAP or the MFWG, unless expressly noted.

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Barry Zigas	Consumer Federation of America

**RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN DODD
FROM EDWARD J. DEMARCO**

Q.1. *Availability of Mortgage Capital*— Mr. DeMarco, a witness on our second panel will testify that “Perhaps the biggest question policymakers face is whether U.S. housing finance can attract sufficient capital to meet its needs without a significant Government role, particularly in the wake of the massive failures in the private securitization market . . .” What is your answer to this question— Will the United States be able to attract the capital necessary to meet our housing needs if the U.S. Government does not play such a role?

A.1. In responding, I assume that the Federal Government continues to provide direct credit support to the mortgage market through its existing programs such as FHA and VA mortgage insurance. Thus, I take the question to be in reference to attracting private capital to support the conforming, conventional market. In the long run, I believe the answer to that question is yes and I hope that policymakers will seek institutional and regulatory structures aimed at such an outcome. In the near-term, however, with the Enterprises in conservatorship and much uncertainty in the marketplace today regarding housing in the United States, I believe that some continued Government support is important to maintaining market stability. It may also be a necessary component of a transitional period as we move to a post-conservatorship set of structures for the secondary mortgage market.

Q.2. *Enterprises and Foreclosure Prevention*— Mr. DeMarco, to date, the loan modification effort has focused largely on payment modifications rather than principal reductions. At the very least, I believe principal reductions may be necessary to prevent foreclosures for borrowers who are deeply underwater. Is there more that Fannie Mae and Freddie Mac can do to encourage principal forgiveness? Is this the kind of thing you are prepared to explore?

A.2. As an alternative to a principal write-down, the Home Affordable Modification Program (HAMP) program incorporates principal forbearance as the final step in the waterfall—in the event it’s needed to create an affordable payment. However, with the other features of the program—interest rate reduction to 2 percent and term extension—there are few cases when principal forbearance is needed.

The impact of principal forbearance is comparable to a principal write-down in that the amount of principal subject to forbearance is not amortized and is not subject to interest. However, it is due and payable at the time the loan is paid off and is included in the payoff quote. If at payoff the value of the property is less than the payoff quote, the servicer can forgive some or the entire principal forbearance amount. This accomplishes several things. First, it minimizes the potential for moral hazard. Second, it allows the investor to recover some or the entire amount of principal forbearance, if the housing market recovers. Third, it’s more acceptable to the investor community as an option. There are investors and other industry stakeholders who take a very strong position against principal write-downs.

Where principal forgiveness may be a viable strategy is with addressing the needs of borrowers with option ARMs who may not have understood the product and how it worked, and have seen the principal balance of their loans increase due to negative amortization. Many would say this is the most logical and justifiable scenario for a principal write-down. It is one that's being considered.

Finally, I would note that any borrower has an obligation to repay their debt even if that debt is backed by an asset that has declined in value. Borrowers with an ability to pay should be expected to make their payments without regard to declining house prices.

Q.3. *The Affordable Housing Mission of the Enterprises*— In his testimony, Mr. Wallison argues that enterprise purchases of both subprime and Alt-A loans were driven by their affordable housing mandate imposed in the law. However, my understanding from talking to FHFA staff is that the Alt-A book of business, which is responsible for 40 to 45 percent of the enterprises' losses, was not really used to meet the housing goals. You seemed to indicate during the hearing that this is your understanding as well. Is that correct?

A.3. FHFA assumed responsibility for setting affordable housing goals—previously set by HUD—upon enactment of the Housing and Economic Recovery Act of 2008 (HERA) on July 30, 2008. The decisions by Fannie Mae and Freddie Mac to purchase certain loans with layers of risks, *e.g.*, subprime and Alt-A loans, were influenced by several factors, including a desire to preserve market share and to achieve the anticipated higher yield on such, as well as the affordable housing goals. The purchase of Alt-A loans, which has contributed significantly to losses at both enterprises, had the effect of making it more difficult for the enterprises to meet their income-based affordable housing goals, because, by definition, such loans often lacked information on borrower income. Purchase of such loans did have a modest positive impact on enterprise performance on the underserved area goals.

Q.4. You suggest in your testimony that, rather than creating housing goals, it might be more efficient to provide more targeted subsidies. Senator Reed, with my strong support, included in HERA a provision that requires the enterprises to contribute to a National Housing Trust Fund, assuming they return to profitability. Is that the kind of targeted subsidy you think makes sense?

A.4. HERA established a Housing Trust Fund to increase and preserve the supply of rental housing for extremely low and very low income families, including homeless families, and to increase home ownership for extremely low and very low income families. This approach might well be more effective than the housing goals. Currently, because of the financial condition of the companies, Enterprise contributions have been suspended. As a general matter, my view about subsidies is that taxpayers should clearly see the cost and the delivery mechanism should ensure that the subsidy gets to the intended beneficiaries.

Q.5. *Liquidity and Standardization*— Mr. DeMarco, you note, as I did, that we need a market to ensure standardization and liquidity,

particularly in times of stress. In your view, is some sort of a Federal role necessary to achieve these goals? If not, how would we be assured that product standardization would result from a purely private marketplace?

A.5. Taking each goal separately, I do not believe that a direct Government role is necessary to ensure the standardization necessary to create a deep and liquid secondary mortgage market in normal times, but a Government role probably is necessary if we want depth and liquidity during a period like we have experienced recently. Standardization can be achieved in several ways. It can be imposed by the Government; it can be achieved through a self-regulated organization or trade association such as the stock exchanges or the Securities Industry and Financial Markets Association (SIFMA); or it can be imposed by dominant firms (think of video formats or computer operating systems). With respect to market liquidity, it seems unlikely that private market-makers will be large enough to ensure liquidity in the secondary mortgage market during crises. Therefore, some sort of Government buyer of last resort authority maybe necessary to avoid severe periods of illiquidity in this market.

Q.6. *Portfolios Under Conservatorship*— Under the conservatorship, FHFA has directed the GSEs to begin shrinking their portfolios beginning in 2010. With the Federal Reserve announcing it does not intend to extend its MBS purchase commitment beyond the current \$1.25 trillion limit, does FHFA intend to maintain its requirement that the enterprises shrink their portfolios? If so, please assess the market outlook for agency MBS in the absence of either enterprise or Fed portfolio purchases. What impact do you project this outlook will have on mortgage rates?

A.6. The portfolio limits referenced are a part of the Treasury's Preferred Stock Purchase Agreement with the Enterprises. In the absence of any change in the current Senior Preferred Stock Purchase Agreements and the Federal Reserve's MBS purchase program, it seems reasonable to expect there could be a gradual, modest increase in mortgage rates over time. Still, the market is well aware of these pending changes yet mortgage rates remain very low and, in fact, have declined since the Federal Reserve announced its intention to terminate new purchases by March 31, 2010.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR
MENENDEZ FROM EDWARD J. DEMARCO**

Q.1. What were Fannie and Freddie's respective shares of the total mortgage market from 2003 to the present? Did Fannie and Freddie lose market share to subprime and nontraditional markets during those years? What share of Fannie and Freddie's business were subprime mortgages as defined at the time? Nontraditional mortgages as defined at the time? Which of these types of mortgages caused the most significant losses for Fannie and Freddie?

A.1. Table 1 below shows total originations of single-family mortgages in 2003 through 2008 and combined Enterprise acquisitions of such mortgages during that period. The decline in the share of

total originations represented by combined Enterprise acquisitions in 2004 through 2006 resulted both from the boom in subprime and nontraditional lending during those years and a reduction in the volume of Enterprise acquisitions, as some mortgages that the Enterprise would likely have acquired in previous years were financed through private-label securitization.

Table 1. Originations of Single-Family Mortgages and Fannie Mae and Freddie Mac Single-Family Mortgage Purchases, 2003–2008

(dollars in millions, unpaid principal balance)

Year	Single-Family Mortgage Originations	Fannie Mae and Freddie Mac Combined Purchases	Fannie Mae and Freddie Mac Share of Originations
2003	\$3,945.0	\$2,023.7	51.3%
2004	2,920.0	942.9	32.3%
2005	3,120.0	918.7	29.4%
2006	2,980.0	875.6	29.4%
2007	2,430.0	1,125.4	46.3%
2008	1,500.0	940.5	62.7%

Sources: Fannie Mae, Freddie Mac, Inside Mortgage Finance Publications.

There is no common industry definition of a subprime mortgage, so it is not possible to indicate the volume of subprime loans acquired by the Enterprises. However, most industry participants would consider a mortgage made to a borrower whose credit score is below 620 to be a subprime loan. Both Freddie Mac and Fannie Mae have reported that, as of September 30, 2009, loans to borrowers with credit scores below 620 comprised 4 percent of the unpaid balance of their respective portfolios of conventional single-family mortgages. From 2002 through 2008, each Enterprise's acquisitions of such loans accounted for 3–6 percent per year of their total single-family acquisitions.

During the mortgage lending boom of the middle years of this decade, private-label mortgage-related securities often were backed by pools of mortgages that issuers designated as subprime loans. Table 2 provides information on issuance and Enterprise purchases of such securities in 2002 through 2008. The data on securities issuance were obtained from Inside Mortgage Finance Publications. The data on each Enterprise's purchases in each year and combined Enterprise purchases in 2006 through 2008 were obtained from the Enterprises and published in FHFA's 2008 Annual Report to Congress. The data on combined Enterprise purchases for 2003 through 2005 were obtained from Inside Mortgage Finance Publications and previously reported in annual research reports published by the Office of Federal Housing Enterprise Oversight, one of FHFA's predecessor agencies.

Table 2. Issuance and Enterprise Purchases of Private-Label Mortgage-Related Securities Backed by Subprime Mortgages, 2002–2008
(dollars in millions, unpaid principal balance)

Year	Issuance of Subprime Private-Label MBS	Fannie Mae		Freddie Mac		Combined	
		Purchases	Share*	Purchases	Share*	Purchases	Share*
2002	\$122,680.9	\$5,143.9	4.2%	n.a.	n.a.	n.a.	n.a.
2003	194,958.5	25,768.6	13.2%	n.a.	n.a.	\$81,000.0	41.5%
2004	362,549.3	67,003.6	18.5%	n.a.	n.a.	176,000.0	48.5%
2005	465,036.3	24,468.8	5.3%	n.a.	n.a.	169,000.0	36.3%
2006	448,599.6	35,606.1	7.9%	\$74,761.0	16.7%	110,367.1	24.6%
2007	201,546.7	15,970.5	7.9%	43,667.0	21.7%	59,637.5	29.6%
2008	2,261.4	637.4	28.2%	106.0	4.7%	743.4	32.9%

n.a. = not available.

Sources: for issuance data 2002–2008 and combined data 2003–2005, Inside Mortgage Finance; Fannie Mae and Freddie Mac for all other data.

* Reported "share" is Enterprise purchases of subprime private-label MBS in each year expressed as a percentage of total subprime MBS issued during the year. However, it cannot be assumed that the subprime private-label MBS purchased by an Enterprise in a given year were issued in that year.

Defining a nontraditional mortgage is even more problematic than defining a subprime loan, since the use of the former term varied widely across lenders and over time. For that reason, it is not possible to indicate the volume of nontraditional mortgages originated or acquired by the Enterprises. Information is available on issuance and Enterprise purchases of private-label mortgage-related securities backed by Alternative-A (Alt-A) mortgages. Table 3 provides such information for 2002 through 2008. The data on securities issuance were obtained from Inside Mortgage Finance Publications. The data on each Enterprise purchases were obtained from the Enterprises and published in FHFA's 2008 Annual Report to Congress.

Alt-A mortgages acquired by Fannie Mae and Freddie Mac have contributed disproportionately to each Enterprise's credit losses. In Fannie Mae's earnings statement for the second quarter of 2009, the Enterprise reported \$18.8 billion in credit-related expenses. Alt-A mortgages accounted for 9.8 percent of Fannie Mae's total single-family mortgage portfolio at that time, but 41.2 percent of the Enterprise's credit-related expenses in that quarter. Freddie Mac reported \$5.2 billion in credit-related expenses in the second quarter of 2009. The Enterprise stated that Alt-A mortgages accounted for 9 percent of its single-family mortgage portfolio at that time, but caused 45 percent of its credit losses in the first half of the year.

Data on single-family mortgages that are seriously delinquent—past due 90 days or more—sheds additional light on how nontraditional mortgages are contributing to Enterprise credit losses. As of September 30, 2009, the serious delinquency rate on Fannie Mae's conventional single-family mortgage portfolio was 4.72 percent; the comparable rate on Alt-A loans acquired by Fannie Mae was 73.97 percent. On that date, the serious delinquency rate on Freddie Mac's single-family mortgage portfolio was 3.43 percent; the comparable rates on Alt-A, Interest-Only, and Option adjustable-rate mortgages acquired by Freddie Mac were 10.94 percent, 15.52 percent, and 15.55 percent, respectively.

Table 3. Issuance and Enterprise Purchases of Private-Label Mortgage-Related Securities Backed by Alt-A Mortgages, 2002–2008

(dollars in millions, unpaid principal balance)

Year	Issuance of Alt-A Private-Label MBS	Fannie Mae		Freddie Mac		Combined	
		Purchases	Share*	Purchases	Share*	Purchases	Share*
2002	\$53,462.7	\$1,756.0	3.3%	n.a.	n.a.	n.a.	n.a.
2003	74,151.0	8,104.0	10.9%	n.a.	n.a.	n.a.	n.a.
2004	158,585.8	21,999.0	13.9%	n.a.	n.a.	n.a.	n.a.
2005	332,323.2	16,109.0	4.8%	n.a.	n.a.	n.a.	n.a.
2006	365,675.8	11,973.0	3.3%	\$30,546.0	8.4%	\$42,519.0	11.6%
2007	249,610.0	5,288.0	2.1%	10,008.0	4.0%	15,296.0	6.1%
2008	1,854.7	175.0	9.4%	618.0	33.3%	793.0	42.8%

n.a. = not available.

Sources: Fannie Mae, Freddie Mac, Inside Mortgage Finance Publications.

* Reported "share" is Enterprise purchases of Alt-A private-label MBS in each year expressed as a percentage of total Alt-A MBS issued during the year. However, it cannot be assumed that the Alt-A private-label MBS purchased by an Enterprise in a given year were issued in that year.

Q.2. We know that a large percentage of delinquent borrowers eligible for the HAMP program are either not responding to servicer requests or returning incomplete documentation. Freddie has initiated a program to reimburse servicers who hire qualified third-parties to help reach out to borrowers. Why are GSEs not doing this to help more struggling borrowers, and could you launch a pilot program to see whether in person outreach would improve the effectiveness of the loan modification programs?

A.2. Both Freddie Mac and Fannie Mae are testing the concept of reaching out to borrowers with third parties who go door-to-door to initially solicit borrowers for modifications and/or to follow-up on outstanding documentation required by HAMP. Early results indicate in-person contact is effective. It mirrors the face-to-face contact that occurred when many of these borrowers took out their loans and needed individual guidance and to be educated. Fannie Mae and Freddie Mac continue to evaluate the successes and shortcomings of the current programs to look for additional means of addressing shortfalls and reaching more borrowers. The Enterprises will continue to work with FHFA and the Administration on cost-effective ways of reaching out to borrowers and improving the overall effectiveness.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR KOHL
FROM EDWARD J. DEMARCO**

Q.1. Currently, the GSEs own more than half of the mortgages across the country. For a period of time, Fannie and Freddie started to purchase more exotic and riskier mortgages while no additional safeguards put in place. The GSEs, have before, required that homeowners who meet a certain criteria receive prepurchase counseling. Additionally, Fannie Mae recently reinstated a homebuyer education piece for the MyCommunityMortgage. Finally, it has been proven that homeowners who have received prepurchase counseling have a lower default rate and should they get in trouble, they have the information on where to get help.

Do you support expanding a homebuyer education requirement to first-time homebuyers who will have their loan guaranteed by the

GSEs? Do you think this will be an effective tool to help better protect the GSE's investments?

A.1. Recent studies have found that households that receive prepurchase counseling have slightly lower default rates and, if they do default, are likely to seek help from the entity that counseled them. Such studies cannot control for differences in the quality of counseling services provided by different firms or in different jurisdictions, however, so that it is not clear that requiring prepurchase counseling for all first-time homebuyers whose mortgages were acquired by Fannie Mae and Freddie Mac would lower default rates on those loans.

In addition, default losses would not necessarily go down, since there is no evidence that lenders incur smaller average losses on defaulted loans whose borrowers were precounseled and seek help when they become delinquent. Further, the current market counselors who are certified to provide prepurchase counseling are very busy working with servicers to assist distressed homeowners modify their delinquent mortgages. There are also shortages of counselors in nonurban areas.

For all those reasons, at this time I do not favor requiring prepurchase counseling for all first-time homebuyers whose loans are acquired by the Enterprises. Still, in view of how many homebuyers in the past few years got into mortgages they did not understand or could not manage, it seems logical that prepurchase counseling should be encouraged for certain classes of homeowners and required in certain specified circumstances.

Q.2. Fraudulent and inaccurate appraisals have been identified as one of the problems that caused the housing bubble. Steps have been taken to create a firewall between appraisers, real estate agents and mortgage lenders. While it is a good first step in trying to ensure that there is not a conflict of interest and the homebuyer is getting a fair and accurate appraisal of the property, there might be other safeguards that can be put in place?

How often does the Agency review and update appraisal standards for the mortgages that the GSEs guarantee? Do the GSEs ever ask for a second opinion on appraisals that they might find questionable? Does the Agency feel that the new reforms for appraisers and lenders will be strong enough to get more accurate appraisals?

A.2. Fraudulent and inaccurate appraisals were a contributor to the rapid run-up in home prices and have resulted in significant problems for lenders and homeowners. Safeguards now appear to be adequate and numerous; the critical issue turns on enforcement. State regulators—entrusted with authority to administer appraisal rules—admit to being underfunded and understaffed. Registration of appraisers may help. However, strong education and ethical standards work most effectively when supported by real enforcement.

FHFA does not update appraisal standards; that is the work of the GSEs. FHFA examines the GSEs to assure that their guidelines are being carried forward in dealing with their seller servicers. The recently adopted Home Valuation Code of Conduct will expire next year in November and new rules will add to or

amend that code. Further, at any time, the GSEs may add to their appraisal guidelines in response to market conditions.

There has been some indication that appraisals have improved. This may be a combination of appraisal standards by the Enterprises and stronger underwriting and appraisal requirements by lenders. For example, Freddie Mac recently stated that appraisals received had improved some 15 percent, when tested against the automated valuation models they employ for quality control.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORKER
FROM EDWARD J. DEMARCO**

Q.1. How is FHFA overseeing the way in which Fannie Mae, Freddie Mac, and the Home Loan Banks are managing credit risk?

A.1. *Fannie Mae and Freddie Mac*—FHFA is keenly focused on credit risk at Fannie Mae and Freddie Mac. Examiners and analysts in the Division of Enterprise Regulation, with the support of other offices within FHFA, continuously assess the drivers of credit risk for single- and multifamily mortgages owned and guaranteed by the Enterprises. We also assess the creditworthiness of a wide range of counterparties to which the Enterprises are exposed, including loan originators and servicers, mortgage insurers, bond guarantors and derivatives counterparties. The Enterprises are also exposed to credit risk from private-label mortgage-backed securities that they have purchased or guaranteed in structured products, and FHFA continuously evaluates the performance of these securities.

Our staff assesses mortgage credit performance, as well as the processes used by the Enterprises in assessing their own performance, by reviewing a wide range of performance metrics, including delinquency statistics, loss severity upon disposition of real-estate owned (*i.e.*, properties acquired through foreclosure), losses incurred through foreclosure alternatives such as short-sales and deeds-in-lieu of foreclosure, and redefault rates on modified mortgages. FHFA personnel also assess credit metrics gauging the performance of mortgages by various categories, including credit score, year of origination, original and current loan-to-value ratios, geographic locale, product type and originating lender, among others.

In addition to continuously monitoring credit performance, we assess the quality of the models used by the Enterprises to underwrite and price mortgages, as well as models used to forecast credit expenses. We also assess a wide range of operational processes that directly affect the amount of credit risk that ultimately is realized, including processes for quality control, fraud prevention and remediation, mortgage repurchases and the disposition of real estate acquired through foreclosure. Further, we work closely with both Enterprises and the Department of Treasury to evaluate controls surrounding the Making Home Affordable program, which has a direct effect on ultimate credit losses.

Federal Home Loan Banks—Structurally, the Federal Home Loan Banks (FHLBanks) face limited credit risk in their advances portfolios. The principal source of their credit risk is in their holdings of private-label mortgage-backed securities (MBS), which con-

stitute approximately 5 percent of their aggregate asset portfolio, or \$56.6 billion, as of June 30, 2009.

Sixty-four percent of FHLBank assets are advances to members. By law, all advances must be collateralized by residential mortgage loans, deposits in an FHLBank, Treasury and agency securities, or “other real estate-related collateral.” No FHLBank has ever incurred a credit loss on an advance to a member.

Seven percent of their assets are whole mortgage loans. These nonjumbo, fixed-rate loans, principally from 2004 and before, have high FICO scores and low loan-to-value ratios. They were written to traditional underwriting standards, and the originating member retains some credit risk on these loans. At June 30, 2009, only 0.35 percent of these loan balances were 90 or more days delinquent and not accruing interest.

Fifteen percent of assets are non-MBS investments, mostly prime money market investments and Federal agency securities. Approximately half of these money market investments have an overnight maturity. The FHLBanks face regulatory limitations on the amount of investments with any counterparty based on the capital levels of both the FHLBank and the counterparty as well as the credit rating of the counterparty.

Mortgage-backed securities are the remaining 14 percent of the portfolio. Of these, \$56.6 billion were private-label MBS and 594.4 billion were agency MBS. By regulatory policy, an FHLBank may currently invest in MBS up to six times its capital, but any investments in excess of three times its capital must be agency MBS.

FHFA examiners review credit risk at each examination, and each FHLBank receives a credit risk component rating at each examination. The rating reflects the amount of credit risk at the FHLBank and the quality of its credit risk management. The FHFA is also completing a targeted review of credit risk across all 12 FHLBanks, and will release a report on that review within several months.

The targeted review focused on collateral operations and private-label MBS. The principal credit risk stems from the private-label MBS. While all these investments were rated triple-A at the time of purchase, the credit quality of these investments has deteriorated. Approximately 40 percent are now rated below investment grade and an additional 29 percent are rated investment grade but either have been downgraded or are on negative watch. The private-label MBS portfolios are in run-off mode. In the first half of 2009, the FHLBanks incurred credit-related impairment charges on these investments of \$953 million. Additional losses on these investments are possible and depend on house prices, unemployment, and other housing market conditions. For the past 18 months, the Division of FHLBank Regulation and its predecessor entity have devoted intense supervisory efforts to private-label MBS.

Q.2. Assuming that the GSEs may be taking on additional risk as part of the Administration’s effort to help keep people in their homes, what is being done to make sure that the increased risk to the taxpayer is manageable?

A.2. FHFA does not believe the GSEs have taken on additional credit risk as a result of their participation in the Making Home

Affordable (MHA) program. The MHA program is designed to reduce preventable foreclosures. Consistent with this objective, underwriting standards are in place. Income and employment are verified. Modified mortgages are better aligned with the borrowers' capacity to service the debt. This in turn lessens the likelihood of foreclosures and reduces the risks to Fannie Mae, Freddie Mac, and ultimately the U.S. Treasury and taxpayers. If the MHA programs are applied consistently and uniformly, they will contribute to stabilizing the mortgage market and home prices, so that the value of the collateral underlying the GSEs' portfolios can stabilize and increase. This can have only a positive impact on their risk profile and capital position.

That said, FHFA recognizes that implementing and managing the program results in increased operational complexities for the GSEs. FHFA is closely monitoring the GSEs' roles under the "Treasury Agency" agreements to ensure that the program is implemented and managed in a safe and sound manner.

Q.3. FHFA was given greater authority to oversee new programs—including the imposition of new fees—initiated by the housing GSEs. What are you doing to implement that new authority, and how is that process working?

A.3. One of the important new powers that FHFA received in the Housing and Economic Recovery Act of 2008 was the authority to review and approve "new products." FHFA has established an interim rule implementing that authority, which empowers the agency to review both new activities and, as an important subset, new "products," which in most cases must be subject to public notice and comment before they can be approved and commenced.

FHFA has received public comments on the interim rule, and is working to incorporate those comments in a final rule. FHFA is working to implement an operational process for reviewing new activities and new products that will meet the statutory directive and the needs of the public, while meshing with the Enterprises' own internal processes for developing and reviewing new business initiatives and efficiently deploying the agency's supervisory resources. FHFA has reviewed a number of Enterprise initiatives to date, none of which have been determined to be new products, an outcome consistent with the fact that both Enterprises are currently in conservatorships and are managed to conserve and preserve their assets while carrying out their mission. Several more initiatives are under review today, both for safety and soundness considerations and to be sure that the agency and the Enterprises address the Congressional desire that new products be exposed to public review through the notice and comment process.

**RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN DODD
FROM WILLIAM B. SHEAR**

Q.1. *Affordable Housing Mission*—Mr. Shear, in its review of the GSEs' housing goals performance in 2004–2005, HUD concluded that both Fannie Mae and Freddie Mac produced a higher share of their financings in low mod borrowers than the primary mortgage market. Yet your report concludes that there is no evidence

that the housing goals expanded credit for such loans. Can you please explain how to reconcile these two assertions?

A.1. While HUD first established the housing goals in 1993, their effectiveness in supporting home ownership opportunities for targeted groups and areas is not clear. For example, for many years, the goals were set conservatively and do not appear to have materially enhanced the enterprises' performance in funding such mortgages compared to the primary mortgage market. In 1998, we found that the goals HUD has set for the period 1996 through 1999 were conservative goals, which placed a high priority on maintaining the enterprises' financial soundness.¹ According to HUD's 2004 final rule, which set the enterprises' housing goals for the period 2005 through 2008, while Freddie Mac's performance in funding affordable mortgages had improved in prior years, it consistently lagged the performance of the primary market.² Specifically, HUD found that Freddie Mac lagged the primary market in funding affordable home purchase loans for special affordable and low-moderate income borrowers and underserved neighborhoods targeted by the housing goals. From 2001 through 2003, HUD found that Fannie Mae led the primary market in funding special affordable and low- and moderate-income loans, but lagged the market in funding underserved area loans. HUD also found that Fannie Mae and Freddie Mac lagged by a rather wide margin the primary market in funding mortgages for first-time homebuyers, and that their share of the market for minority first-time homebuyers was very small. HUD increased the goals starting in 2005 to encourage the enterprises to facilitate greater financing and home ownership opportunities for the groups targeted by the goals.

Recent research also indicates that, although the enterprises have enhanced their product offerings to meet the housing goals, the effects of the housing goals on affordability and opportunities for target groups have been limited. For example, a 2006 study found that as the enterprises' activities increased in certain areas pursuant to the mortgage purchase program, they may have been offset by a decline in FHA's existing activities in those areas.³ Earlier research sponsored by HUD in 2001 found that the enterprises generally did not play a leading role in affordable multifamily mortgage finance because their underwriting standards were considered conservative and fairly inflexible, compared with those of other multifamily mortgage providers.⁴ In contrast, as discussed in our September 2009 report, representatives from mortgage finance, housing construction, and consumer groups we contacted said that the benefits from enterprise purchases of multifamily mortgages were significant. The representatives said that the enterprises' involvement in or guarantees of the financing of affordable multifamily projects were crucial to their successful completion. In addition, they said that during the current financial crisis the enter-

¹ GAO, "Federal Housing Enterprises: HUD's Mission Oversight Needs To Be Strengthened", GAO/GGD-98-173 (Washington, DC: July 28, 1998).

² 69 Fed. Reg. 63580, 63692 (Nov. 2, 2004).

³ Xudong An and Raphael Bostic, "GSE Activity, FHA Feedback, and Implications for the Efficiency of the Affordable Housing Goals", *Journal of Real Estate Finance and Economics* 36 (2008).

⁴ ABT Associates "Studies of Multifamily Underwriting and the GSEs' Role in the Multifamily Market: Final Report", prepared for HUD (August 2001).

prises were the only source of funding for multifamily projects because many other traditional providers, such as banks and insurance companies, largely have withdrawn from the market.

Q.2. *Implied Guarantee*—Mr. Shear, your report argues that the GSEs' implied guarantee encouraged them to take greater risks than a fully private entity would. In reviewing the last few years' experience, did you compare the GSEs' portfolio performance to that of other institutions, such as Lehman Brothers, Bear Stearns, Merrill Lynch, and others holding large amounts of mortgages and mortgage backed securities, particularly private label securities? If so, how does the performance of these fully private portfolios compare with those of the GSEs?

A.2. The enterprises' structures (for profit corporations that derived benefits from their Government sponsorship, particularly the implied Federal guarantee on their financial obligations) undermined market discipline and provide them with incentives to engage in potentially profitable business practices that were risky and not necessarily supportive of their public missions. In particular, the large retained mortgage portfolios that the enterprises acquired over the years, while potentially more profitable than their mortgage securitization and guarantee business, exposed them to considerable interest rate risk without a clear link as to how such large portfolios benefited housing finance and other mission objectives. In conjunction with the ineffective regulatory structure that existed for the housing GSEs for many years, the enterprises' activities involved significant risks to taxpayers and financial stability. While the enterprises' recent financial deterioration involved credit losses rather than losses resulting from interest rate fluctuations, their mortgage portfolios have proven to be a significant source of operational and financial risk. As stated in our September 2009 report, the substantial financial restatements that both Fannie Mae and Freddie Mac were required to make earlier in this decade are generally attributable to the misapplication of accounting rules for reporting on derivatives, which the enterprises used to manage the interest rate risks associated with their large mortgage portfolios. The report also noted that, more recently, the enterprises purchased large volumes of questionable subprime mortgage assets, which were held in their portfolios. According to former FHFA Director Lockhart, by June 2009, 60 percent of the AAA-rated private label MBS that the enterprises had purchased had been downgraded to below investment grade and the losses on such asset had contributed to the need to place the enterprises in conservatorships.

While our September 2009 report did not compare the GSEs' recent business activities, particularly their investments in private label MBS and guarantees on Alt-A mortgages, with those of other private financial institutions, we acknowledge that their appears to have been a breakdown in basic risk management practices used to manage credit risk in a range of corporate structures in addition to those of the GSEs, including commercial banks and investment banks. It may take a considerable period to determine why basic risk management principles were ignored at so many companies and other market participants, such as creditors and ratings agen-

cies, as well as why financial regulators failed to exercise sufficient oversight and better ensure sound business practices. It does appear, though, that the previously identified weaknesses in the enterprises' corporate structures and regulatory oversight structure facilitated their participation, along with many other financial participants, in mortgage asset investments that were unsafe and unsound and ultimately threatened financial stability.

Q.3. *Serving the Underserved*—A number of witnesses, including Director DeMarco, have said that they would prefer to see some more transparent subsidy, like downpayment assistance, instead of affordable housing goals in the future. However, one purpose of the goals is to try to draw people into the mainstream financial system. For example, FDIC Chairman Bair is trying to bring the unbanked into the banking system because of the overall benefits of doing so. Aren't there many additional benefits to pulling people into the mainstream system, over and above simply helping them get an affordable home?

A.3. Yes, there are clearly a range of additional benefits associated with bringing individuals into the mainstream financial system. In previous work, for example, we noted that Federal officials and consumer advocates maintain that predatory lenders often target certain populations, including the elderly and some low-income and minority communities.⁵ Some advocates say that in many cases, predatory lenders target communities that are underserved by mainstream institutions, such as banks and thrifts, leaving borrowers with limited credit options. A number of tools, including numeric mortgage purchase goals, have the potential to bring individuals, especially those that may be underserved by the market, into the mainstream financial system.

Q.4. *Availability of Fixed-Rate, 30-Year Mortgage*—One of the crown jewels of our mortgage finance system is the availability of a 30-year, fixed rate mortgage that a borrower can prepay without penalty when interest rates decline. How do we ensure that this product remains available for American families?

A.4. While the fixed-rate, 30-year mortgage is likely to endure under any of the options to revise the enterprises' long-term corporate structures, we did state in our September 2009 report that privatizing or terminating the enterprises could have a limiting affect on their availability compared to prior experience. If the enterprises were privatized or terminated, the report noted, any ensuing private-secondary market alternatives (such as a consortium of private-sector lenders) might be less willing to purchase such mortgages than the enterprises had been. As a result, lenders may be less willing to originate fixed-rate 30-year mortgages due to the interest rate risks associated with holding them in their portfolios. However, the potential exists that the establishment of a Government mortgage bond insurer for catastrophic risk, as has been proposed in conjunction with proposals to privatize or terminate the enterprises, could provide a mechanism for primary mortgage origi-

⁵GAO, "Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending", GAO-04-280 (Washington, DC: Jan. 30, 2004).

nators to sell mortgages into secondary markets and thereby help maintain the availability of fixed-rate, 30-year mortgages.

**RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN DODD
FROM SUSAN M. WACHTER**

Q.1. *Serving the Underserved*—A number of witnesses, including Director DeMarco, have said that they would prefer to see some more transparent subsidy, like down payment assistance, instead of affordable housing goals in the future. However, one purpose of the goals is to try to draw people into the mainstream financial system. For example, FDIC Chairman Bair is trying to bring the unbanked into the banking system because of the overall benefits of doing so. Aren't there many additional benefits to pulling people into the mainstream system, over and above simply helping they get an affordable home?

A.1. While down payment assistance is indeed a potential policy tool, the cost of mainstreaming such a program is likely to limit its availability. The housing finance system can successfully encourage home ownership through cross-subsidization. That is, marginal borrowers whose risk is acceptable nonetheless pay a risk-adjusted rate that reflects the average risk for the entire mortgage book of business, without putting the financial system at risk. As to the benefits of bringing the "unbanked" into the system, they are real and important.

Q.2. *Availability of Fixed-Rate, 30-Year Mortgage*—One of the crown jewels of our mortgage finance system is the availability of a 30-year fixed-rate mortgage that a borrower can prepay without penalty when interest rates decline. How do we ensure that this product remains available for American families?

A.2. Fixed-rate mortgages are too risky for depositary institutions to hold on their books because of interest-rate risk. Thus, the availability of a 30-year fixed-rate mortgage, which a borrower can prepay without penalty when interest rates decline, cannot be ensured without a secondary market in which mortgages are securitized. Throughout the world, there is only one other country (Denmark) where fixed-rate prepayable mortgages are offered, and the Danish mortgage system is based on regulated securitization.

The Savings and Loan (S&L) crisis and similar crises in other countries have made this point clear: fixed-rate mortgages cannot be offered and held on portfolio by banks without causing systemic risk. The result globally was that banks shifted away from fixed-rate to adjustable-rate mortgages. Because long-term, fixed-rate products are essential to protect against the systemic risk of defaults caused by volatile interest rates, a secondary market is an indispensable part of a stable future housing finance system.

Nonetheless, we have seen the results, in the present crisis, of the creation of secondary markets for mortgage-backed securities without strict Government regulatory oversight. In markets without such oversight, firms will compete to offer aggressive lending instruments funded by mortgage-backed securitization. As banks and securitization firms compete for market share, the inevitable result is the lowering of lending standards to increase

securitization profits over time. The result is increased demand for housing and higher prices, making it appear as though real estate markets are healthy and that lending is safe. The spread throughout the market of aggressive lending boosts artificial demand for real estate assets, fueling an unsustainable boom. When the boom eventually busts, the resulting property value declines lead to sharp declines in credit availability, which negatively reverberates throughout the entire economy.

Regulatory control and oversight are needed to prevent reckless lending from overcoming markets. Such regulatory control is not possible without information on the loans that are being securitized, their underwriting standards, and the terms on which they are offered. In order to process such data and to monitor markets and identify reckless lending, some standardization is necessary. Without standardization, the heterogeneity and complexity of MBS make real-time analysis of what is in fact being offered in markets in the aggregate, and how these terms are changing over time, nearly impossible.

Standardization both of mortgages and mortgage-backed securities can assist in enabling risk and underwriting to be monitored over the cycle, preventing the procyclical erosion of lending standards. Standardization promotes liquidity, ensures suitability, and enhances system stability, but standardization will not come about without strict regulatory oversight. Thus there must be a mechanism for limiting residential mortgage-backed securitization to entities that are strictly monitored. Without such risk monitoring, securitization, while necessary for the steady provision of a 30-year fixed-rate mortgage, will not be sufficient. It will subject homeowners and the overall economy to credit-induced crises, which will cause housing prices to plummet, putting the availability of all credit for mortgages, including the 30-year fixed-rate mortgage, cyclically at risk.

**RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN DODD
FROM ANDREW JAKABOVICS**

Q.1. *Serving the Underserved*—A number of witnesses, including Director DeMarco, have said that they would prefer to see some more transparent subsidy, like downpayment assistance, instead of affordable housing goals in the future. However, one purpose of the goals is to try to draw people into the mainstream financial system. For example, FDIC Chairman Bair is trying to bring the unbanked into the banking system because of the overall benefits of doing so. Aren't there many additional benefits to pulling people into the mainstream system, over and above simply helping them get an affordable home?

A.1. Connecting the underserved with the mainstream banking system has benefits that flow to underserved families and communities as well as to the institutions that extend credit. Access to credit on fair and affordable terms allows low-income and other "unbanked" individuals and families to keep more of their hard-earned money. While credit card issuers have rightly been chastised for recent moves to hike interest rates on their cards prior to more stringent regulations coming into effect, even the relatively

high rates charged on those cards are far less usurious than fees charged by payday lenders. From an institutional perspective, bringing the unbanked into the mainstream banking system allows the institutions to grow their depository base. Moreover, lending to low- and moderate-income households is often a profitable, not charitable, endeavor, in part because these borrowers have typically been less likely to refinance their mortgages as interest rates fall.

Q.2. *Availability of Fixed-Rate, 30-Year Mortgage*—One of the crown jewels of our mortgage finance system is the availability of a 30-year, fixed-rate mortgage that a borrower can prepay without penalty when interest rates decline. How do we ensure that this product remains available for American families?

A.2. Absent a policy intervention to ensure the availability of these long-term mortgages, they probably will not exist, a point implicitly acknowledged by Wells Fargo CEO John Stumpf in a recent call for the GSEs to be given permission to purchase jumbo mortgages as a way to “help revive the moribund market for big mortgages.” Indeed, the existence of such mortgages can be directly traced to public policy. The Home Owners’ Loan Corporation was created in 1933 at the height of the depression to refinance distressed borrowers into stable, long-term—then 15-year—mortgages at up to 80 percent loan-to-value. FHA followed the HOLC offering these innovative long-term products. The adoption of the self-amortizing, fixed-rate mortgage by the private sector was a reflection of a need to compete on the best terms with public entities—in contrast to the race to the bottom among lenders we have witnessed over the past several years.

As we contemplate both the regulatory environment and the institutions likely to emerge to provide capital and liquidity to the mortgage markets, it will be necessary to ensure the presence of an entity that has the ability to bridge the gap between homeowners’ desire for long-term affordable mortgages and secondary market participants’ need for easily marketable securities that allow them to appropriately hedge against interest rate risk. This role is currently being played by FHA/Ginnie Mae and the GSEs, but we should not discount the private sector’s willingness to come back into the market in the future. (There are a number of proposals that have been put forth describing a restructured secondary mortgage market that ignore the potential reemergence of a private label securities market, thus leaving potential securitizers entirely unregulated.)

Earlier this year, the Mortgage Finance Working Group (MFWG) convened by the Center for American Progress released a set of principles to guide redevelopment and regulation of a renewed mortgage finance system. (The principles are available here: http://www.americanprogress.org/issues/2009/03/pdf/mortgage_finance_principles.pdf.) I believe that a system based upon these principles offers the best way to ensure the ongoing availability of 30-year, fixed-rate mortgages while still leaving space for innovative (but safe) mortgage products to be introduced into the marketplace. Members of the MFWG have been developing a more complete blueprint of a restructured mortgage finance system that

we hope to introduce before the new year that will more fully address the mechanisms through which we can ensure a continuous presence of the loans that have proven so critical in building the middle class.