Statement of

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Federal Housing Finance Agency

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

"The Future of the Mortgage Market and the Housing Enterprises"

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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 twelve Federal Home Loan Banks (FHLBanks).

The Federal Housing Finance Agency (FHFA) just completed its 14^{th} 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 two 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 mid-year 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.

<u>Foreclosure Prevention / Making Home Affordable</u>

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 five 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 every day 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.