Testimony of Laurel Davis

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Before

The U.S. Senate Committee on

Banking, Housing and Urban Affairs

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Chairman Johnson, Ranking Member Crapo and members of the Senate Banking Committee, thank you for the opportunity to testify today. My name is Laurel Davis and I am the Vice President for Credit Risk Transfer at Fannie Mae.

I appreciate the opportunity to share with the Committee information on the credit risk transfer transactions that Fannie Mae conducted this year. My testimony today will address how those transactions were structured and brought to market and the results of the transactions.

I. Background

Before I address the specific transactions, I think it would be helpful to provide additional background on how Fannie Mae manages credit risk, the credit risk that we currently hold and how we have sought to reduce this risk substantially during conservatorship. This is important because what we learned from these particular transactions was that investors are willing to purchase mezzanine credit risk on a high quality pool of loans if they receive a yield that meets their investment targets and where the credit is actively managed by an intermediary.

In order to assess the risk they were purchasing, potential investors in our Connecticut Avenue Securities transaction (C-Deal) and our counterparty in the mortgage insurance (MI) transaction received significant information about our credit policies, our monitoring of lender operations, their exposure to the sellers' representations and warranties, and our reviews of loan origination quality. Investor comfort with our processes and our ability to enforce representations and warranties facilitated the investor demand in the transactions. While this testimony will not address our servicing standards and oversight of servicers, those factors play a strong role in reducing our risk of loss and are important considerations for investors evaluating the credit risk on Fannie Mae loans.

Because we accept the credit risk on securities we guarantee, we have a rigorous process for managing this risk. We do so through both the pricing of loans based on the risk such loans entail and the establishment of underwriting standards that lenders with whom we do business must follow. Our Selling Guide, which is extensive, is our legal contract with lenders. It sets forth the underwriting standards to which lenders are required to adhere.

Our standards are not static. We revise them continuously based on our analysis of the performance and quality of our acquisitions and our existing book of loans, changes in market conditions and new issues that might arise. We also review the loan origination processes of our lender customers to ensure that their controls are working properly. During conservatorship, Fannie Mae has made numerous changes to our analysis of credit risk and to our underwriting and eligibility requirements to reduce our credit risk. Some of the significant changes include:

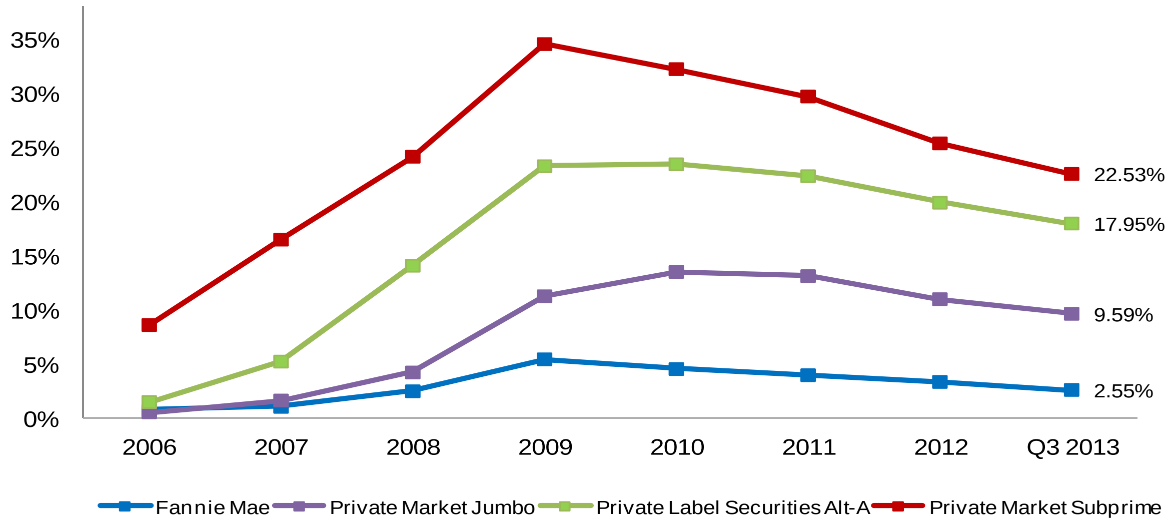
- Creating external tools and internal risk models to improve assessment of collateral value;
- Creating a process and risk models to assess the quality of new loan acquisitions, track defect rates and enforce contractual rights soon after delivery to mitigate risk;
- Standardizing our credit policy by eliminating most negotiated credit terms with specific lenders;
- Tightening our underwriting and eligibility requirements for higher risk products, including interest only loans and adjustable-rate mortgage loans;
- Implementing a minimum credit score of 620; and
- Eliminating contract terms that would allow delivery of Alt-A loans or other reduced-documentation loans.

As a result of our efforts, and improvements in market conditions, our serious delinquency rate has fallen dramatically (see Illustration A). This rate peaked in February 2010 at 5.59% and has since fallen to 2.55% as of the end of the Q3 of this year. Even at its highest point, our serious delinquency rate was substantially lower than loans in private label securities or held on bank balance sheets.

In addition, the loans we have acquired since 2009 have performed well. The serious delinquency rate for loans acquired since January 2009 is 0.32%. These new, well-performing loans now make up approximately 75% of our total book of business.

The performance of these loans and improving conditions in the housing market are two of the primary reasons for our recent financial performance. We have recorded seven straight quarters of profit and, as of December 31, we will have paid almost $114 billion in dividends to the Treasury Department versus total draws of approximately $116 billion.

Illustration A: Single-Family Serious Delinquency Rates



II. <u>Credit Risk Sharing Transactions</u>

Our credit risk sharing initiatives are aimed at reducing our retained credit risk, thereby reducing our footprint in the mortgage market and providing a way for greater private investment in mortgage credit risk.

It should be noted that Fannie Mae's Charter requires that there be private risk ahead of Fannie Mae's guarantee for high loan to value (LTV) ratio loans or loans with less than 20% down payment. This has not changed during conservatorship. For all loans with LTV ratios greater than 80%, our charter requires that Fannie Mae seek credit enhancement. This is predominantly done through the required purchase of mortgage insurance through regulated insurers capitalized by private capital. Our standard coverage requirements, however, require greater protection than just the first 20% of the property value. Loans with LTVs in excess of 80% generally have coverage that protects the company down to 68% to 75% of the loan amount.

With that background, I would like to turn now to the two transactions we conducted this year to transfer additional credit risk to other market participants – our C-Deal transaction and our mortgage insurance risk transfer deal. The transactions have a few key similarities. First, in both transactions, Fannie Mae retained a first loss credit risk position vis-à-vis investors, while selling mezzanine risk to investors to cover "unexpected losses" after that first loss risk piece is exhausted. Mezzanine risk is located between the first loss and the top loss risk levels. For both transactions, the first loss piece we retained covered at least 2 times what we modeled as our expected losses on the loans underlying the transactions. Fannie Mae also retained the risk of catastrophic loss, which was sized at greater than what was experienced during the recent housing crisis.

Second, both transactions were aided substantially by the fact that an intermediary stood between investors and originators, in this case, Fannie Mae. Investors did not need to underwrite the credit themselves, ensure that the underlying loans are properly serviced or make certain that representations and warranties with originators are enforced. In these particular transactions, this intermediary role allowed the 77 investors involved in our credit-risk note transaction to rely on Fannie Mae's credit policies, underwriting standards, lender oversight requirements and servicing standards rather than understanding the standards of more than 1000 lenders with whom we do business. Moreover, Fannie Mae serves as an ongoing and active credit risk manager on behalf of itself and the investors.

While we have purchased pool mortgage insurance policies for two decades, the C-Deal transaction was a successful first attempt to transfer portions of our credit risk to private securities investors. We intend to engage in additional transactions to learn more about investor appetite for credit risk.

These two transactions were positive first steps in transferring credit risk, but it is early in the process and therefore difficult to extrapolate the extent to which broad investor demand exists for securities with residential mortgage credit risk or what yield might be required.

Connecticut Avenue Securities (C-Deals)

On October 15, 2013, Fannie Mae priced its inaugural credit-risk note transaction under its Connecticut Avenue Securities series, also known as C-Deals. This first transaction settled on October 24, 2013.

Fannie Mae's C-Deals were structured to meet certain program goals:

- First, to provide an additional avenue to manage the credit risk of our guaranty business, in addition to our active management of credit risk as discussed above;
- Second, to create a program that is sustainable and scalable for Fannie Mae;
- Third, to explore the most cost efficient means for transferring credit risk;

- Fourth, to not interfere with how lenders currently sell loans into the secondary market;

- Finally, to have no impact on how a loan is serviced.

Loans included in this risk sharing transaction will be serviced in the same manner as all other loans in our book. Servicers have no knowledge of which loans are in a C-Deal reference pools and which are not.

By design, Fannie Mae's C-Deal is structured very similarly to Freddie Mac's two STACR offerings, the first of which closed in July and the second in November. There are slight differences between Fannie and Freddie's deals. Some differences were due to the response to market feedback, and others were due to how Fannie Mae evaluated the cost/benefit trade-off of particular deal features.

The C-Deal notes are debt issuances of Fannie Mae. One of the main differences between C-deal series debt and Fannie Mae's standard debt is that investors in C-Deals may experience a full or partial loss of their initial principal investment, depending upon the credit performance of the mortgage loans in the related reference pool. Another difference is that the repayment of C-Deal notes is tied to the credit and prepayment performance of a reference pool of loans. The reference pool for our first transaction included approximately 112,000 single-family loans with an outstanding unpaid principal balance of $27 billion, which represented about 12% of our total acquisitions for Q3 2012.

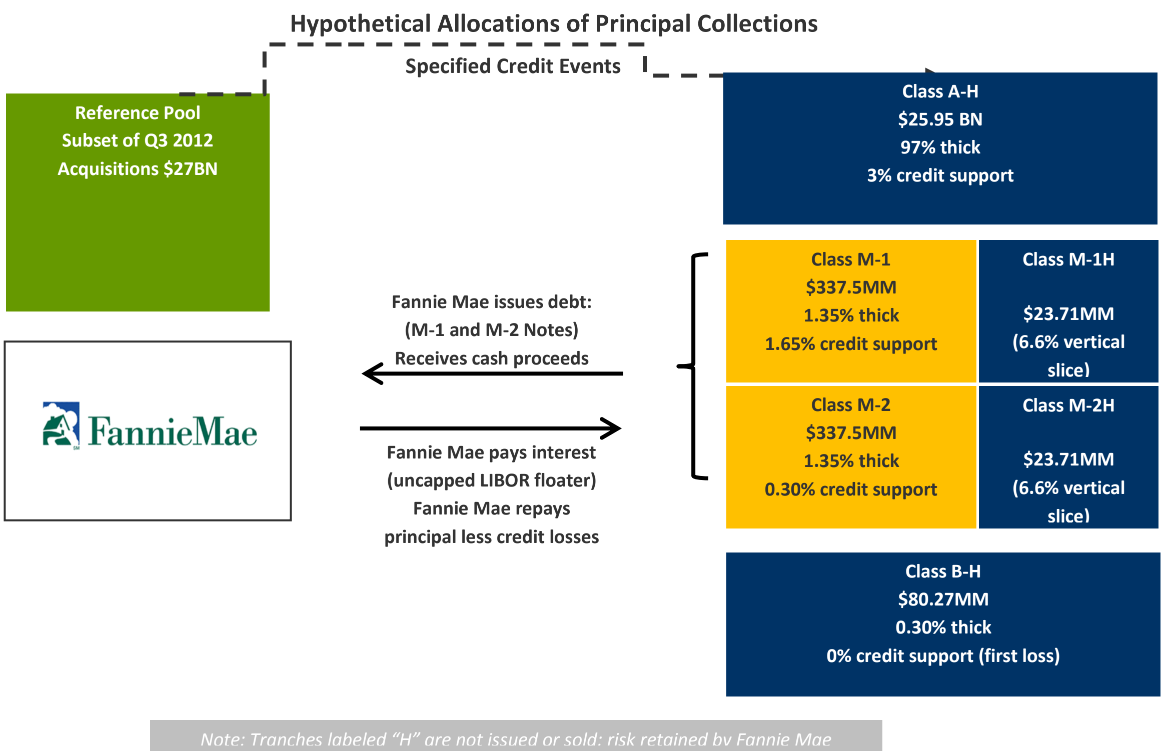
To arrive at the pool, we applied certain selection criteria to the entire population of loans acquired in Q3 2012 to create an eligible population of loans. For a loan to be included, it had to be: (1) a 30-year fixed-rate mortgage; (2) not a HARP loan; (3) with an LTV between 60 - 80%; and (4) current in terms of payments since acquisition. From the eligible population, we used a random selection process to derive the reference pool. By only referencing the loans, they remain in the MBS pools, thereby avoiding any disruption to the TBA market.

If the loans in the reference pool experience credit defaults, the investors in the C-Deals may bear losses. Credit defaults occur in the C-Deal when a loan in the reference pool reaches 180 days of delinquency, a short sale, a third party sale, a deed-in-lieu, or an REO (Real Estate Owned) disposition occurs prior to 180 days of delinquency.

In the first transaction, Fannie Mae retained the first loss position and holds both the catastrophic risk and a vertical slice of the transaction (see Illustration B). The first loss piece of the structure is intended to cover a multiple of our expected losses on the underlying loans. We decided to hold the first loss piece for a number of reasons. First, any securities that represented a first loss position may not have been considered "debt" for tax purposes and could carry significant tax consequences to potential investors. Second, given that this was a new program, we believed that retaining the first loss would make the transaction easier for investors to understand, model and price. Lastly, it was unclear if private investors would be willing to purchase the first loss position at pricing that made economic sense for Fannie Mae. However, Fannie Mae may choose to sell the first loss in subsequent transactions if the economics are appropriate and the associated regulatory issues are resolved.

In addition, we sold two classes of mezzanine risk to the market in order to shed the risk of unexpected losses on the underlying loans. Fannie Mae retained the catastrophic piece in the structure, which is a multiple of a stress scenario based on the recent financial crisis experience. Finally, we kept a roughly 6% vertical slice of the mezzanine risk sold to the market. This was done to align our interests with investors and give them confidence that we will diligently service the loans in the reference pool so as to limit losses to both investors and Fannie Mae.

Illustration B: Connecticut Avenue Securities: Deal Structure for CAS 2013-C01



The mezzanine risk that we sold was comprised of $675 million of notes split evenly between a senior and junior class. The senior class of notes, otherwise known as M-1 notes in the marketplace, received an investment grade rating of BBB- from Fitch Rating Agency. These notes were priced at one-month LIBOR + 200 basis points. The investment grade rating on the M-1 notes opened up investor participation to a wider variety of accounts, and we believe this will help promote secondary market liquidity.

The junior class of notes, otherwise known as M-2 notes in the marketplace, priced at one-month LIBOR + 525 basis points. Fannie Mae did not pursue a rating on the M-2 notes. We did not receive strong feedback from investors that a rating on the M-2 notes would be particularly important. Both notes were issued with 10-year final maturities.

A diverse group of 77 investors participated in the offering, including asset managers, mutual funds, pension funds, hedge funds, insurance companies, banks and Real Estate Investment Trusts (REITs).

Fannie Mae has disclosed details of our credit risk sharing activities on our website at fanniemae.com. Loan level data, such as interest rate, LTV and original debt to income ratio, was provided on the reference pool as part of the initial disclosure. This loan level data, as well as ongoing performance on the transaction, will be updated monthly.

We considered other transaction structures, including a senior-subordinate cash transaction, or "cash senior/sub", and a credit-linked note transaction.

As it relates to a cash senior/sub, we closely examined the use of this structure to transfer credit risk. In a cash senior/sub structure, loans must be deposited into a trust and therefore could not be in TBA securities. There are several reasons why we decided not to pursue this structure. First, compared to the structure we used, the cost of doing a cash senior/sub transaction would have been greater. Second, a cash senior/sub structure could present scalability issues. In a cash senior/sub structure, the loans themselves are sold and thus there is a transfer of both interest rate and credit risk. By contrast, in a credit-risk note structure, only credit risk is sold, since the interest rate risk was previously conveyed in the TBA markets. Accordingly, if Fannie Mae had used a cash senior/sub structure to transfer credit risk for the same amount of loans as occurred in the first transaction, we would have had to sell $27 billion of securities backed by mortgage loans, as compared to selling only $675 million in credit securities, given that the loans had already been funded through the MBS market. Lastly, a cash senior/sub structure could introduce a number of operational inefficiencies for lenders compared to how they now conduct business.

With a credit-linked note structure, there are a variety of outstanding regulatory issues. As alluded to in the press, these issues include the impact of Commodity Futures Trading Commission (CFTC) regulations and whether Fannie Mae and investors would need to register with, and be regulated by, the CFTC. In addition, there are certain issues under proposed conflicts of interest rules being considered by the Securities and Exchange Commission, as well as potential tax issues for certain investors under Internal Revenue Service regulations. These regulatory concerns, and potentially other issues, will need to be resolved prior to this type of structure being a viable option.

We gained several insights from the C-Deal transaction. First, as noted above, in this particular transaction, having an intermediary that served as an active credit manager was important to potential C-Deal investors. Our comprehensive approach to credit risk management helped to build market reception for the C-Deals well before the transactions took place.

Second, it is essential to be transparent and provide detailed information to investors. The rollout and launch of the C-Deals were designed to provide transparency to the marketplace on our requirements and processes. Over the course of two years, Fannie Mae held extensive discussions with investors and engaged in a road show to assess the market appetite and structure preferences. It was also critical that we provided historical loan-level credit performance data to investors on over 18 million loans acquired by Fannie Mae over the past ten years so that investors could make their own assessment of expected loan performance.

Lastly, we learned that in these particular market conditions, investors will buy mezzanine risk on a high quality pool of loans if they receive a yield that meets their investment targets.

It is too early in the process to reach further conclusions from these transactions. Fannie Mae's next transaction is tentatively scheduled for January 2014. This will be a debt issuance deal that references a pool of loans and will be very similar to Fannie Mae's October deal. The reference pool will be comprised of single-family loans acquired in Q4 2012 with the same criteria used in our first deal.

Mortgage Insurance (MI) Risk Transfer Deal

After a competitive bidding process, Fannie Mae entered into a transaction with National Mortgage Insurance Corporation ("National MI" or "NMI") to provide credit risk coverage on over $5 billion in single-family mortgages. The agreement was reached on July 15, 2013 and coverage went into effect September 1, 2013.

The MI risk transfer deal covers 2% percent of the loans acquired by Fannie Mae in Q4 2012, each of which had an original LTV of 70-80%. These loans were not HARP refinances nor had any credit enhancements. None of these loans were covered by mortgage insurance prior to the commitment with NMI.

The coverage was provided in the form of a "pool insurance" policy, a form of insurance that we have utilized since the mid 1990s, to enhance the credit of certain segments of our acquisitions. The pool insurance policy that we negotiated with NMI will result in Fannie Mae's loan-level exposure on the covered loans being reduced to approximately 50% of the original property value, subject to a pool deductible amount and an aggregate pool loss limit, as explained below. The pool insurance policy sunsets after ten years.

Similar to the C-Deal transaction, Fannie Mae will be responsible for the first losses on the pool. We are insuring for "unexpected losses" through the establishment of an aggregate pool deductible. The deductible was set at 20 basis points of the initial balance of the pool, or approximately $10.3 million of initial losses for which Fannie Mae will be responsible.

The insurance policy will cover the next $90 million of claimable losses. The aggregate pool loss limit was set to 2% of the initial balance of the pool. At an approximate $5.17 billion initial pool balance, the aggregate pool loss limit is approximately $103 million, including the deductible layer. Thus, once aggregate claimable losses on the pool of loans exceed approximately $103 million, the policy would terminate. Fannie Mae would be responsible for losses in excess of the pool loss limit. The aggregate pool loss limit was set to a level that exceeds our projected losses in a stress scenario comparable to the recent experience (2006-2012).

This pool insurance credit enhancement has several advantageous features. First, it will preserve the ability for lenders and Fannie Mae to pool mortgage loans into a highly liquid TBA market. This will enable the current efficient origination process, allow borrowers to lock financing in advance and lenders to hedge that interest rate risk, and lower mortgage rates for borrowers because of the liquidity of this TBA market. A second advantage is that the mortgage insurance policy form for the transaction preserves Fannie Mae's ability to pursue all appropriate and needed loss mitigation which Fannie Mae deems acceptable, e.g. loan modifications and short sales. Thus, servicers follow standard Fannie Mae servicing protocols and service these loans as they would other loans, irrespective of the credit enhancement.

We solicited insurance bids from seven MI companies, which are currently approved by

Fannie Mae to provide charter-compliant coverage for loans that we acquire. In addition to the terms of the pool policy structure, we stipulated that MI companies participating in these transactions would need to meet certain counterparty requirements, including a minimum level of statutory capital relative to their outstanding risk in force. Six of the MI companies provided insurance bids in response to our request. Only three of those MI companies would have met the transaction counterparty requirements without needing to raise additional capital.

We chose to commit the transaction to NMI for several reasons. NMI had the materially lowest pricing of all six bidding MI companies, agreed to cover all loans in the targeted pool, met our counterparty capital requirements, and agreed to the terms of the new pool policy form that we requested, including coverage certainty provisions that provide for rescission relief.

One key observation was that although this coverage structure could be repeated in the future, the mortgage insurance industry is currently capital constrained. Pricing might need to rise considerably in connection with possible future transactions, unless the MI industry is able to raise new capital.

In conclusion, I appreciate this opportunity to present testimony before the Committee and look forward to answering any questions you may have.