Statement of

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

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

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

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

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

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

Goals of Conservatorship

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

(i) necessary to put the regulated entity in a sound and solvent condition; and

(ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity."

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

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

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

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

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

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

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

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

1. **Build**. Build a new infrastructure for the secondary mortgage market.

2. **Contract**. Gradually contract the Enterprises' dominant presence in the marketplace while simplifying and shrinking their operations.

3. **Maintain**. Maintain foreclosure prevention activities and credit availability for new and refinanced mortgages.

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

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

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

Maintain

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

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

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

- The nearly 1.1 million HARP refinances in 2012, almost equaled the number of HARP refinances over the prior three years. An additional 97,000 HARP refinances were completed in January of this year.

- HARP refinances with greater than 105 loan-to-value ratios made up 43 percent of total HARP refinances in 2012, compared to 15 percent in 2011. In January of this year, 47 percent of HARP refinances were for borrowers with a greater than 105 loan-to-value ratio.

- HARP refinances with greater than 125 percent loan-to-value ratios made up 21 percent of total HARP refinances in 2012 and nearly 25 percent of total refinances in January of this year.

- HARP refinances into a shorter-term mortgage made up 18 percent of total HARP refinances in 2012 for underwater borrowers, compared to 10 percent in 2011, and stand at 18 percent of total HARP refinances in January 2013.

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

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

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

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

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

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

Build

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

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

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

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

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

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

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

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

Contract

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

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

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

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

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

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

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

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

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

Additional Priorities for 2013

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

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

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

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

FHFA as Supervisor

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

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

- Assess the risks posed by new initiatives to ensure that they are being implemented under a sound control framework. These initiatives include SAI, the common securitization platform, the contract harmonization project, multifamily bulk loan sales and REO disposition programs.

- Maintain a full understanding of the Enterprise's overall risk profile, particularly for the incremental risk created by implementing the new initiatives while maintaining and upgrading information systems and internal controls.
- Determine if the board and management are taking appropriate steps to comply with conservatorship and supervisory directives.
- Develop a formalized process for the ongoing monitoring program.
- Implement the CAMELSO rating system.

Financial Condition and Performance of the Enterprises and FHLBanks

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

<u>Housing Market Conditions</u>

- We are seeing signs of recovery in the housing market across a number of dimensions and, while the marketplace is by no means "normalized," conditions are promising in many ways.

- According to the latest data from the National Association of Realtors, the inventory of homes available for sale was only 1.9 million units in February. Given that the annualized rate of home sales during that month was nearly 5 million properties, this represented only about 4.7 months' worth of supply. Just a year earlier, the relative supply was a still modest 6.4 months. And at its peak—in July 2010—the supply was 12.1 months.

- According to the FHFA index, national home prices grew 5.5 percent between the fourth quarters of 2011 and 2012. For the 12 month period ending in January, home prices rose 6.5 percent.

- Census data from December 2011 estimated the seasonally adjusted annualized rate of housing starts to be about 700,000 units. By September 2012, that rate had grown to roughly 840,000 units and, in March, the rate was estimated at 1,036,000 units. This compares to a low of about 480,000 units in April 2009, and is 71 percent of the long-run average.

- The latest CoreLogic information, which includes data for October, indicates that shadow inventory dropped roughly 12.3 percent between October 2011 and October 2012. This decline represented a reduction in the shadow inventory pool of about 300,000 units.

<u>Freddie Mac</u>

- Net income for the fourth quarter of 2012 totaled $4.5 billion, and represented the fifth consecutive quarter of positive earnings. Annual net income of $11.0 billion represented a record level of earnings for Freddie Mac and compares to a net loss of $5.3 billion in 2011.

- In 2012 Freddie Mac required $19 million of funding from Treasury bringing the cumulative Treasury draw to $71.3 billion. Through December 31, 2012, Freddie Mac has paid $23.8 billion in cash dividends to Treasury on the company's senior preferred stock. Under the PSPAs, the payment of dividends cannot be used to offset prior Treasury draws. This provision has remained unchanged since the PSPAs were established. So while $23.8 billion has been paid to Treasury in dividends, Treasury still maintains a liquidation preference of $72.3 billion on its senior preferred stock. Freddie Mac has $140.5 billion remaining in available support from Treasury.

- The credit quality of new single-family acquisitions remained high in the fourth quarter of 2012, with a weighted average FICO score of 756. The average loan-to-value (LTV) ratio for new business was 75 percent. This higher LTV ratio is due to the expansion of HARP eligibility to borrowers whose mortgages have LTV ratios above 125 percent and to relief provided to lenders for borrowers with LTV ratios above 105 percent. These high LTV refinances represented 43 percent of HARP loans in 2012.

Fannie Mae

- Net income for the fourth quarter of 2012 totaled $7.6 billion, and represented the fourth consecutive quarter of positive earnings. Annual net income of $17.2 billion represented a record level of earnings for Fannie Mae and compares with a net loss of $16.9 billion for 2011.

- Fannie Mae did not require funding from Treasury in 2012. Fannie Mae's cumulative Treasury draw remains at $116.1 billion. Through 2012, Fannie Mae has paid $35.6 billion in cash dividends to Treasury on the company's senior preferred stock. Under the PSPAs, the payment of dividends cannot be used to offset prior Treasury draws. This provision has remained unchanged since the PSPAs were established. So while $36.5 billion has been paid to Treasury in dividends, Treasury still maintains a liquidation preference of $117.1 billion on its senior preferred stock. Fannie Mae has $117.6 billion remaining in available support from Treasury.

- The credit quality of new single-family acquisitions was strong in 2012, with a weighted average FICO score of 761. The average LTV for new business was 75 percent in 2012, compared with 69 percent in 2011. The year-over-year increase in average LTV ratios is due to the expansion of HARP to borrowers with high LTV mortgages.

Federal Home Loan Banks

- The FHLBanks have emerged from the financial crisis in generally good condition. They are profitable and have strengthened capital positions. The FHLBank System reported net income of $2.6 billion in 2012, the highest annual earnings since 2007.

- Retained earnings have grown significantly in recent years and totaled $10.4 billion, or 1.37 percent of assets, as of year-end 2012. Retained earnings are at their highest level ever, and will continue to grow as a result of provisions included in each FHLBank's capital plan. The FHLBank System regulatory capital ratio of 6.8 percent exceeds the regulatory requirement of 4.0 percent. The market value of the FHLBanks is 124 percent of the par value of capital stock, the highest ratio in at least 11 years.

- The aggregate balance sheet of the FHLBanks has shrunk considerably in recent years, led primarily by declining advance volumes due to market liquidity and sluggish economic growth. Advances totaled $426 billion as of year-end 2012, down 58 percent from a peak of $1.01 trillion in the third quarter of 2008.

- Viewed over the past business cycle, the FHLBanks carried out their public purpose of providing credit when needed to support the mortgage investments of their members.

Role of the Government in Housing Finance

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

<u>Standard-Setting</u>

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

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

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

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

Federal Backstop

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

- Preserving the availability of credit in times of stress is an important function. Is there a role for the government, perhaps through the Federal Housing Administration to take on this role if necessary? Or alternatively, with a more standardized market and infrastructure, would it be possible for an existing guarantor, like Ginnie Mae, to play such a temporary guarantee function?

- Preserving liquidity in the market and the financial system in this framework would be an important function. Is there a need for a backstop source of funding when financial markets become temporarily illiquid? For example, could the Treasury Department, the Federal Reserve or the Federal Home Loan Banks play a role in a market that had this type of standardized structure?

Government Guarantee

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

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

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

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

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

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

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

Conclusion

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

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

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

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

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

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