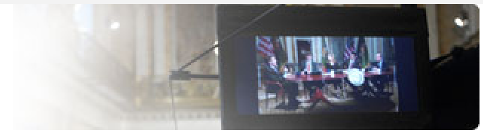

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Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprise of House Committee on Financial Services

Written Testimony as Prepared for Delivery

Chairman Kanjorski, Ranking Member Garrett, and members of the Subcommittee, thank you for the opportunity to testify today about housing finance reform and the progress made since the placement of Fannie Mae and Freddie Mac (the GSEs) into conservatorship in September 2008.

Before I talk about the state of the GSEs in conservatorship, it is important to remember how we got here.

Events Leading to Conservatorship

The GSEs were allowed to operate under an unacceptable "heads I win, tails you lose" system. They enjoyed the benefits of the perception of government support. They had inadequate oversight and inadequate capital, and the market did not instill appropriate discipline at Fannie Mae and Freddie Mac because the market assumed that they had a government backstop.

The events that led the last Administration to need to put the GSEs into conservatorship was symptomatic of a range of regulatory, management, and oversight failures throughout our financial system. As the private, unregulated mortgage market grew, and market players began to loosen credit standards to pursue ever-riskier business in a booming market, the GSEs, which initially stuck to their core business of guaranteeing well-underwritten loans, saw their market shares fall precipitously. Driven by profit motives and an effort to regain market share, the GSEs sought, and were permitted, to guarantee and to purchase riskier mortgages without holding adequate capital or employing appropriate risk management techniques. These moves left Fannie Mae and Freddie Mac dangerously exposed when the housing bubble began to burst.

As a result of the substantial deterioration in the housing market and Fannie Mae and Freddie Mac's growing inability to raise new capital, FHFA placed the GSEs into conservatorship on September 6, 2008 under the authority granted to them by Congress under the bi-partisan Housing Economic Recovery Act of 2008 (HERA). Under HERA authority, Treasury agreed to provide financial support to the GSEs through the establishment of Preferred Stock Purchase Agreements (PSPAs). The goal of the PSPAs and subsequent amendments was to preserve overall stability in financial markets and to allow the GSEs to continue to provide liquidity in the secondary market. The PSPAs ensured that the GSEs would be able to meet their obligations and continue to support the housing finance system, which was then on the verge of collapse.

Fannie Mae and Freddie Mac Under Conservatorship

Since September 2008, FHFA, in its role as conservator, has acted carefully to help ensure that Fannie Mae and Freddie Mac's assets are conserved while continuing to play a critical role in making mortgage credit available. By facilitating the flow of credit for responsibly underwritten mortgages, the GSEs have served as a source of stability for the housing market and enabled millions of Americans to continue to have the ability to take out a new mortgage or refinance.

Important progress has been made towards stabilizing the housing market; however, this critical sector of the economy remains fragile. Private capital has not yet returned to the market, and the GSEs and the government continue to play an unfortunately outsized, though necessary, role in ensuring the availability of mortgage credit. Roughly 95% of the mortgages originated in this country are currently financed through either the GSEs or Ginnie Mae (GNMA), via the Federal Housing Administration (FHA), the Department of Veterans Affairs (VA), and the Department of Agriculture (USDA). Put simply, without the GSEs and GNMA, there would be no functioning mortgage market today.

The new loans being guaranteed by the GSEs are not contributing in any material way to the losses the GSEs face. Quite the contrary. In fact, the FHFA Conservator's Report released on August 26 th shows that it is the GSEs' old book of loans, those acquired before conservatorship, which are the overwhelming source of losses. The losses that the GSEs are continuing to report today are the result of delinquencies and defaults on loans that were originated and guaranteed in 2006, 2007, and 2008. Those loans account for over 70% of all credit losses in the single-family guarantee book, with the balance of realized losses almost entirely coming from 2005 and earlier. Less than 1% of losses have come from loans originated in 2009 and 2010. The conservatorship is working in keeping GSE activities within prudent bounds.

Another myth that the FHFA Conservators' Report dispels is the perception that the retained portfolios were the main source of the GSEs' problems. Early on, large losses were recorded on the securities held in the retained portfolios as the secondary market prices for those securities declined sharply at the onset of the crisis. However, the retained portfolios have not been the largest drivers of loss over time. The bulk of the cumulative losses (73%) have occurred in the single-family guarantee book.

FHFA, acting as conservator, has carefully sought to ensure that the GSEs do not assume undue incremental risk to the taxpayer through their new loans. As a result, the credit quality and risk profile of the post-conservatorship book of business of the GSEs has dramatically improved compared to pre-conservatorship:

- Guarantee fees have been increased and the GSEs have risk-adjusted their pricing.
- Alt-A loans now account for 0% of the new book of business since conservatorship; this compares to 22% for Fannie Mae in 2006 and 18% for Freddie Mac in 2006.
- Low credit (<620 FICO scores) purchases are now only 1% as compared to 5% for both Fannie Mae and Freddie Mac from 2001-2008.
- Average FICO scores of new business improved from roughly 715 in 2006 to 750 or more for both Fannie Mae and Freddie Mac in 2010.
- While new mortgages with loan-to-value ratios greater than 90% are slightly up in 2010 from 2009, much of this is related to the Home Affordability Refinance Program (HARP) for GSE loans, which is a loss mitigation mechanism that reduces the risk of default and any potential losses at the GSEs.

The new, higher credit quality book of business from 2009 has seen substantially lower cumulative default rates when adjusted for loan age:

- 2009 cumulative defaults for Freddie Mac and Fannie Mae were 1.1% and 1.2%, respectively, in the loans' first 18 months, as compared to cumulative default rates for the first 18 months for loans originated in 2007, which were 22.3% and 28.7% for Freddie Mac and Fannie Mae, respectively. This performance is better than even earlier vintages (pre-2005).

The resulting quality of the loan book has made a huge difference. As I indicated previously, less than 1% of the post-conservatorship credit losses are a result of loans guaranteed in 2009 and 2010.

The country is unfortunately stuck with the consequences of the poor credit choices the GSEs made prior to conservatorship. No one can undo those decisions. Some suggest that taking time to get reform right will expose taxpayers to even greater losses at Fannie Mae and Freddie Mac. That is simply not true. The losses that Fannie Mae and Freddie Mac face are the result of mistakes made in the years leading up to the crisis, not the consequences of actions by the GSEs since 2008. There is nothing we can do to decrease the obligations Fannie Mae and Freddie Mac incurred ahead of this crisis; those exposures are already baked in. Given this unfortunate truth, the most responsible course is to minimize the risk that those losses get worse.

The GSEs today are working hard to apply loss mitigation techniques through loan modifications and foreclosure prevention. They are also managing their foreclosure and real estate disposition process to recover the value on those exposures. The GSEs are continuing to promote overall stability in the housing finance system. Housing market stability is the most important source of loss mitigation for the GSEs. If there is another downturn in the housing market, delinquencies and defaults could rise even further as performing loans from today would become delinquent.

Housing Finance Reform Process

While we continue to bring stability to the mortgage market, we are also hard at work on reform. It is not tenable to leave in place the system that we have today. The Administration is committed to delivering a comprehensive proposal for reform of Fannie Mae, Freddie Mac, and our broader system of housing finance to Congress by January 2011, as called for under the Dodd-Frank Act. Our proposal will call for fundamental change.

Congress began the process of reform with the passage of HERA in 2008. The prior Administration continued the path of reform when it placed Fannie Mae and Freddie Mac into conservatorship in September 2008. That action arrested the sharp deterioration of market confidence in these two institutions that was intensifying the broader financial crisis. And it finally put an end to the harmful practices that had contributed to the firms' failures.

This Administration put in place a housing market stability plan soon after coming into office. The plan included continuing to ensure that the GSEs have the necessary financial resources to meet their obligations on an ongoing basis, continuing to buy (alongside the Federal Reserve) agency mortgage-backed securities, and initiating foreclosure prevention plans, a first-time homebuyer tax credit, and state and local housing agency initiatives. These programs have helped to stabilize the market.

The next phase of reform came with the passage of the Dodd-Frank Act, which improves the regulation of lending standards so that the mistakes of the past are not repeated in the housing market in the future. The Dodd-Frank Act includes fundamental reform of mortgage market rules, including ability-to-pay requirements and risk retention standards for mortgages. This new Act will help to ensure that homeowners are not sold products that they cannot afford and that originators retain skin in the game when they originate risky mortgages. These necessary reforms are critical steps, and more remains to be done.

The Administration is committed to maintaining an open dialogue with the public, Congress, and other stakeholders as we all work together towards responsible reform. It is imperative that we get all of the best ideas, representing a wide range of views, onto the table and debated in a constructive fashion.

To that end, earlier this year the Administration began outreach efforts to key stakeholder groups and policy experts to assess existing GSE reform proposals. In April, Treasury and the Depart of Housing and Urban Development (HUD) posted seven questions for public comment, to which we received over 300 responses from a broad cross-section of stakeholders. There was a wide range of views represented in the comments; some argued for removing government support for the market all together while others argued to leave the system broadly in place as it is today. Some argued that we provided too much support for housing while others emphasized that we provided too little support for affordable rental options.

In August, Treasury and HUD hosted a Conference on the Future of Housing Finance in which we heard a wide range of perspectives from people with substantial expertise, ranging from academic experts, consumer and community organizations, industry groups, market participants, Congressional staff, and other stakeholders. We had a robust, constructive, honest debate. We are looking forward to continuing our outreach efforts over the coming weeks and months and the Administration is committed to working together with Members from both sides of the aisle as we move forward together towards reform of our nation's housing finance system.

Objectives and Goals for Housing Finance Reform

Earlier this year, Secretary Geithner and Secretary Donovan testified to the full committee and laid out, as a guide, some important objectives for reform and characteristics of systems that meet those goals. They are worth re-iterating. A stable, well-functioning market should achieve the following objectives:

- *Widely available mortgage credit.* Mortgage credit should be available and distributed on an efficient basis to a wide range of borrowers, including those with low and moderate incomes, to support the purchase of homes they can afford. This credit should be available even when markets may be under stress, at rates that are not excessively volatile.
- *Housing affordability*. A well-functioning housing market should provide affordable housing options, both ownership and rental , for low- and moderate-income households. The government has a role in promoting the development and occupancy of affordable single and multifamily residences for these families.
- *Consumer protection*. Consumers should have access to mortgage products that are easily understood, such as the 30-year fixed rate mortgage and conventional variable rate mortgages with straightforward terms and pricing. Effective consumer financial protection should keep unfair, abusive or deceptive practices out of the marketplace and help to ensure that consumers have the information they need about the costs, terms, and conditions of their mortgages.
- *Financial stability*. The housing finance system should distribute the credit and interest rate risk that results from mortgage lending in an efficient and transparent manner that minimizes risk to the broader financial and economic system and does not generate excess volatility. The mortgage finance system should not contribute to systemic risk or overly increase interconnectedness from the failure of any one institution.

The housing finance system could be redesigned in a variety of ways to meet these objectives. However, the Administration believes that any system that achieves these goals should be characterized by:

- *Alignment of incentives.* A well functioning mortgage finance system should align incentives for all actors – issuers, originators, brokers, ratings agencies and insurers – so that mortgages are originated and securitized with the goal of long-term viability rather than short term gains.
- *Avoidance of privatized gains funded by public losses*. If there is government support provided, such as a guarantee, it should earn an appropriate return for taxpayers and ensure that private sector gains and profits do not come at the expense of public losses. Moreover, if government support is provided, the role and risks assumed must be clear and transparent to all market participants and the American people.
- *Strong regulation.* A strong regulatory regime should (i) ensure capital adequacy throughout the mortgage finance chain, (ii) enforce strict underwriting standards and (iii) protect borrowers from unfair, abusive or deceptive practices. Regulators should have the ability and incentive to identify and proactively respond to problems that may develop in the mortgage finance system.
- *Standardization*. Standardization of mortgage products improves transparency and efficiency and should provide a sound basis in a reformed system for securitization that increases liquidity, helps to reduce rates for borrowers and promotes financial stability. The market should also have room for innovations to develop new products which can bring benefits for both lenders and borrowers.
- *Support for affordable single and multifamily housing.* Government support for multifamily housing is important and should continue in a future housing finance system to ensure that consumers have access to affordable rental options. The housing finance system must also support affordable and sustainable ownership options.
- *Diversified investor base and sources of funding.* Through securitization and other forms of intermediation, a well functioning mortgage finance system should be able to draw efficiently upon a wide variety of sources of capital and investment both to lower costs and to diversify risk.
- *Accurate and transparent pricing*. If government guarantees are provided, they should be priced appropriately to reflect risks across the instruments guaranteed. If there is cross-subsidization in the housing finance system, care must be exercised to insure that it is transparent and fully consistent with the appropriate pricing of the guarantee and at a minimal cost to the American taxpayer.
- *Secondary market liquidity.* Today, the U.S. housing finance market is one of the most liquid markets in the world, and benefits from certain innovations like the "to be announced" (or TBA) market. This liquidity has provided a variety of benefits to both borrowers and lenders, including lower borrowing costs, the ability to "lock in" a mortgage rate prior to completing the purchase of a home, flexibility in refinancing, the ability to pre-pay a mortgage at the borrowers' discretion and risk mitigation. This liquidity also further supports the goal of having well diversified sources of mortgage funding.
- *Clear mandates.* Institutions that have government support, charters or mandates should have clear goals and objectives. Affordable housing mandates and specific policy directives should be pursued directly and avoid commingling in general mandates, which are susceptible to distortion.

Transition

There are several important challenges that we will face in transitioning from our current housing finance system to a new one. The GSEs and the government are currently playing an outsized role in the housing finance market. Today they are practically the only game in town. This situation is neither sustainable nor desirable, but if the GSEs were to suddenly exit the market the stability of the housing market would be undermined. Mortgage rates would skyrocket and most homeowners would be unable to obtain mortgage credit. The transition to a new system must occur in an orderly fashion that is minimally disruptive to the market. Enabling households to maintain access to credit at reasonable rates throughout the transition is essential to our housing and broader economic recovery.

We also recognize that financial markets and the public are depending on the ability of the GSEs in their current form to perform on their obligations. The government is committed to ensuring that the GSEs have sufficient capital to perform under any guarantees issued now or in the future and the ability to meet any debt obligations. The Administration will take care not to pursue policies or reforms that would threaten to disrupt the function or liquidity of GSE securities or the ability of the GSEs to meet their obligations.

Designing an effective transition mechanism that ensures the GSEs' financial obligations are met and borrowers have continuous access to mortgage credit is critical to an effective reform plan.

Conclusion

The FHFA has carefully overseen the GSEs since they were placed into conservatorship by the Bush Administration in 2008, under the HERA legislative authority, to conserve their assets and ensure that Americans are still able to access the market for mortgage credit.

Fixing our nation's housing finance system is critically important to our economy and to our country's future. The housing market supports millions of jobs for Americans in construction, manufacturing, real estate, finance, and other industries. Moreover, for the majority of Americans homeowners, their house is their largest financial asset and the single largest purchase that they will make in their lifetimes. Housing is equally important to the tens of millions of families who choose to rent; their quality of life is directly affected by access to affordable, quality rental housing in good neighborhoods.

A new system must be designed to ensure that our housing finance system is more stable, consumers are protected, sustainable credit is widely accessible and important housing policies, such as affordable housing for low- and moderate-income families, are administered effectively and efficiently.

After reform, the GSEs will not exist in the same form as they did in the past. Private gains will no longer by subsidized by public losses, capital and underwriting standards will be appropriate, consumer protection will be strengthened and excessive risk-taking will be restrained.

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