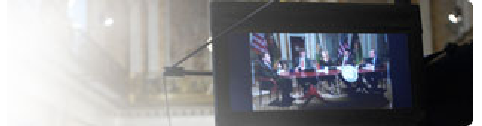
U.S. DEPARTMENT OF THE TREASURY

Press Center



Remarks Of Counselor To The Secretary For Housing Finance Policy Dr. Michael Stegman Before The ABS Vegas 2014 Conference

1/22/2014

As prepared for delivery

Thanks to the Structured Finance Industry Group for giving me this opportunity to discuss the Administration's housing priorities for short-term action and comprehensive housing finance reform.

Let me begin by emphasizing how important it is for Congress to renew as soon as possible the Mortgage Forgiveness Debt Relief Act, which expired at the end of the year. Since 2007, distressed borrowers who received principal reduction—as part of a mortgage modification, short sale, or deed-in-lieu of foreclosure—did not have to pay taxes on the forgiven principal. Failing to extend this provision could force struggling families to settle for a less effective mortgage modification, or choose foreclosure over better alternatives for families and their community. Congress often passes tax extenders late in the year and makes them retroactive to the beginning of the tax year. While this is generally well understood and incorporated into firms' decision-making, it does not work for families in danger of losing their homes today. Congress should do the right thing and extend this targeted tax forgiveness now.

As many of you know, one of the most successful crisis-era housing programs is the Home Affordable Refinance Program. Nearly 3.0 million homeowners with a GSE-backed mortgage have completed a streamlined refinance, including close to one million who owed more than their home was worth. More than 2.0 million homeowners are still HARP-eligible and we believe that the current marketing campaign that FHFA and the GSEs are pursuing is a good way to make sure that homeowners with little or no equity in their homes know about this opportunity.

Some have suggested that the eligibility date for HARP should be changed so that borrowers who took out mortgages after the May 31 2009 cutoff date could also obtain a HARP refinance. Treasury believes there should be no change in the HARP eligibility date. Very few homeowners whose loans were originated after the cut-off date are underwater and advancing the date would do more harm than good by prolonging market and investor uncertainties.

At the same time, we must not forget about the inability of performing underwater borrowers whose loans are held in private label security trusts to access refinancing. This has motivated some communities whose housing markets have yet to recover to consider using eminent domain to help families refinance and "right size" their mortgage debt. While we understand their frustration, we think refinancing legislation is a better way to go. So as we work to reform the housing finance system, we will seek to ensure that neither the source of one's mortgage nor who owns the credit risk should determine a borrower's eligibility for refinancing or mortgage assistance.

Any future system must include a healthy and robust non-agency private label securitization market. Increasing guarantee fees to crowd in private capital is necessary, but not sufficient to attract private capital back into this space. And as I think about the three critical focal points for leadership in housing finance reform, I see one glaring void.

There is now a confirmed director of the Federal Housing Finance Agency with broad responsibilities to wind down the GSEs and ensure a smooth transition to a future system whose contours and role of government will be determined by the Congress. And there is strong bipartisan commitment to housing finance reform by the leaders of the Senate Banking Committee, with whom the Administration has been intensively engaged. But where can we turn to find the focal point for reforming and reinvigorating the private label securities sector? Where is the center of gravity for addressing standards around reps and warranties, trustee obligations, data and disclosure, loss mitigation, and related issues? In the absence of an apparent leader, Treasury plans to coordinate a series of conversations with relevant regulators, market participants, and other stakeholders to help accelerate necessary reforms in the non-agency space.

As we work to expand the pool of qualified borrowers who can obtain mortgage credit during the transition and in the new system, we must also work to ensure borrowers are prepared for homeownership and equipped with tools to be successful homeowners. One lesson from the crisis has been that providing housing counseling at the time of purchase and during the loan modification process is a cost effective investment for all parties.

A study by Freddie Mac of mortgages made to first-time homebuyers and low- to moderate-income families between 2000 and 2008 indicates that pre-purchase housing counseling may reduce, by an average of 29 percent, the likelihood of the homebuyer becoming seriously delinquent. An evaluation of the National Foreclosure Mitigation Counseling program found that counseled borrowers were 67 percent more likely to remain current on their mortgage nine months after receiving a loan modification than non-counseled borrowers. Given such evidence, the mortgage and investor communities should find a way to ensure that quality housing counseling is funded, and remains available for borrowers that will benefit from it.

It is also critical that we pursue comprehensive housing finance reform. Many of the structural flaws of the legacy GSE-centric mortgage finance system have not been fixed. After more than 5 years, Fannie Mae and Freddie Mac are still in conservatorship; a duopoly with a combined current market share by dollar volume of more than 61 percent of mortgage originations for which the American taxpayer is directly at risk. Indefinitely continuing a taxpayer-backed duopoly is neither sustainable nor sensible public policy.

Yet, some stakeholders mistakenly argue that housing finance reform is no longer needed – that the GSEs are so financially flush and with the confirmation of FHFA Director Mel Watt—the Administration can achieve virtually all of its housing policy priorities without legislation. We could not disagree more. The Administration is still firmly committed to comprehensive housing finance reform.

It is good news that the GSEs have generated record earnings over the past several quarters. It reflects positive trends in the housing market, and that is good for American families, taxpayers, and the economy. But we believe that their recent financial results may significantly overstate the true financial condition of the

enterprises, especially on a go-forward basis. For example, approximately $75 billion of combined GSE net income through the third quarter of 2013 was in one-time tax reversals; another $11 billion in comprehensive income was due to the release of loan loss reserves; and $10 billion came from one-time settlements of legacy MBS litigation. Excluding these one-time gains, in the first nine months of 2013, more than 60 percent of the rest of the GSEs' combined income was generated through their retained investment portfolios, which are required to shrink by 15 percent per year on a go-forward basis under Treasury's Preferred Stock Purchase Agreements.

From a high of $1.65 trillion in March 2009, the retained portfolios still have a combined balance of nearly a $1 trillion and are currently a significant source of income, but also remain a continuing source of volatility and taxpayer risk. At the time they were taken into conservatorship, the GSEs' used their portfolios like hedge funds. They took advantage of their lower government subsidized borrowing costs to invest in both their own securities as well as in higher risk, higher yielding private label mortgage backed securities that became the source of very large losses.

Recent financial results at the enterprises have also benefited significantly from strong home-price appreciation and low interest rates, both of which may moderate in future periods.

We believe that keeping the GSEs' in a conservatorship whose contours and restrictions were defined by emergency legislation is not the best framework for broadening the availability of mortgage credit over the longer term. The GSEs in conservatorship have done an exceptional job of maintaining a deep and liquid secondary market in and following the recent crisis. However, we believe that continued uncertainty about their political future will continue to be a headwind impeding access to credit especially for average families with less than pristine credit. For all these reasons, comprehensive housing finance reform remains a top Administration priority.

Last August, the President outlined the Administration's objectives for housing finance reform legislation: require private capital to play the dominant role in providing mortgage credit; ensure creditworthy borrowers, including first time homeowners, have broad access to safe and responsible mortgages; put in place strong safeguards to protect taxpayers; and help ensure access to affordable rental options for middle class families and those who are working toward joining the middle class.

We are actively engaged with the Senate Banking Committee, providing our technical expertise and helping to shape policy that is in line with our principles. We are hopeful that comprehensive, bipartisan housing finance reform is achievable this year.

While there are many choices that must be made in standing up the new system, in the remainder of my remarks, I will briefly discuss several Administration priorities for reform that should make the new system work for consumers and for market participants.

Let me begin by reiterating the Administration's commitment to preserving a deep and liquid TBA market. A full faith and credit catastrophic government guarantee of qualified mortgage backed securities standing behind substantial private capital in a first loss position is critical to maintaining market liquidity and preserving broad access to the 30-year fixed rate mortgage. Avoiding segmenting and compromising the liquidity of the TBA market also requires that the GSEs' legacy securities receive the same full faith and credit government guarantee that would be operative in the reformed system.

A good first step toward a single security-based future system that could be taken during the transition is to reduce the price gap at which Freddie Mac securities trade relative to Fannie Mae's securities by linking the two securities. This would reduce the cost to taxpayers and improve liquidity in the TBA market. We think it is worth pursuing and are looking to find a workable solution that would not disrupt markets.

We also believe that in a reformed system, the holding of credit risk or syndicating credit risk to the capital markets should be separated from the act of securitizing mortgages. Separating the holding of credit risk from the issuance of government-backed securities would help prevent a situation where entities holding credit risk are too important to fail because they also control the pipes and infrastructure needed to create securities. This separation would also improve competition by lowering the barriers to entry for new players willing to take credit risk since they will have to build less infrastructure in the new system. Our preference would be that all single-family mortgages that receive a government-backed wrap be securitized through a single, non-profit securitization utility that would issue standardized mortgage backed securities. The securitization utility would replace the securitization functions that the GSEs perform today.

To attract significant private capital to take credit risk, the regulator should be able to approve various forms of first loss as long as they meet specified criteria. Markets evolve, risk appetites change, and it is not possible to predict what the next period of severe stress will look like. Allowing different types of first loss mechanisms can help attract a wide source of private capital to take credit risk. But making sure any approved mechanism promotes an alignment of interest, with the government taking the catastrophic risk, is critical.

There are two phases of the mortgage credit cycle in which alignment of interest issues arise between the first loss-taker and the government: (1) when mortgage pools are formed; and, (2) throughout life of the loan -- as credit risk is managed through the servicing and loss mitigation cycle. Where there is a well-capitalized guarantor responsible for paying all credit losses on a given pool that triggers the government guarantee only when all of its capital is exhausted,--here, the interests of the Guarantor entity and the government are powerfully aligned.

In capital markets executions, where there is a stop loss at the MBS level, after which the government guarantee is used to cover all subsequent pool level losses, interests are less well aligned. In capital markets transactions, you may need some minimum requirements on size and diversification of pools backing a security to prevent gaming.

If a misalignment of interests is inherent in a stop-loss risk structure, there could be a higher likelihood of triggering the government guarantee. This may warrant charging a higher fee for the catastrophic wrap for capital markets executions to make up for this additional risk. Additionally, national loss mitigation standards, including net present value frameworks, and standardized pooling and servicing agreements are necessary to help reduce diversification uncertainty and misalignment of interests in capital markets first loss executions. Loss mitigation standards should also set out treatment of second liens when the first lien is modified, taking into consideration lien prioritization.

And while setting subordination levels for capital markets executions is critical, even more critical is translating those requirements into the equivalent capital requirements for guarantor entities. It is important that guarantors be able to compete with capital markets first loss executions in good times so that they are available during downturns when capital markets investors withdraw from the marketplace.

Creditworthy borrowers in all geographies, and with varying income levels, must have access to the system. In line with Administration principles, all originators, guarantors, and aggregators that deliver loans to be included in government guaranteed securities will be required to provide mortgage credit on an equitable and non-exclusionary basis. They must serve credit-worthy borrowers of all backgrounds, including in traditionally underserved areas. Additionally, guarantors and aggregators who deliver eligible loans will be required to provide equitable access for lenders of all sizes. A strong independent regulator should enforce compliance and take action if an entity has a pattern of violating fair lending laws. The reformed system cannot just work for a privileged class. It needs to work for the entire country and these requirements will help achieve that.

Owning a home is not right for everyone and the future system must provide liquidity to the rental market. While Fannie Mae and Freddie Mac-- and now the taxpayers--guarantee virtually 100 percent of the credit risk on their single-family books of business, their multifamily business models are different. The GSEs operate successful multifamily programs that feature private capital taking significant first-loss risk, which is consistent with the President's housing finance reform principles. Our intention is to enable these and other types of risk-sharing models to be prevalent in the future. The new system should have many more participants and be more competitive than the current marketplace, where the two Enterprises dominate.

While we support the repeal of GSE affordable housing goals, we would incorporate affordability standards for multifamily housing into the new system to help ensure that the beneficiaries of guaranteed mortgages use their funding advantage to produce or preserve broadly affordable rental homes.

We also believe that data accuracy and transparency would be significantly improved by establishing a national mortgage database. During the housing and financial crisis, regulators, policymakers, investors, and other market participants were severely hampered by the low quality and idiosyncratic coverage of mortgage data. Investors were not able to assess their true risk because data was often incomplete. It was tough to connect subsequent liens to first liens in commercially available databases. Points, fees, borrower income, and other critical fields to assess risk were often unreliable. A comprehensive database covering residential loans and liens would be a significant step to improve these data failures.

Finally, transition must be done in a way that does not disrupt liquidity and access to credit. Any transition from our current market facilitated by the government-sponsored enterprises to one centered on private capital in front of a government guarantee on MBS will take time – at least five years. There needs to be annual, public reports on the transition. Clear benchmarks must be set, progress must be documented, deficiencies reported, and addressed—all in a transparent process. In the lead up to a successful transition, the GSEs should ramp up their risk sharing transactions, and make strong progress on their Common Securitization Platform, since a single securitization utility is central to the future system. We also would want to see a number of new guarantors during the transition period prior to terminating the GSEs' authority to do new business. These steps are important so that we get transition right without disrupting the flow of mortgage credit.

In closing, let me congratulate you, Richard, and the Structured Finance Industry Group for building this organization in such a short time into one whose voice and positions command attention by market participants and public decision-makers alike. We look forward to more opportunities to discuss some of the issues I have raised this morning, and others important to your members and those here today.

###