Association of Government Accountants
7th Annual National Leadership Conference
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James B. Lockhart III
Director, Federal Housing Finance Agency

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Thank you for the kind introduction. It is an honor to be here with you. AGA's Certificate of Excellence in Accountability Reporting program has meant a great deal to me since my days at the Social Security Administration, which is the longest running winner of that award. I'm proud that the Office of Federal Housing Enterprise Oversight (OFHEO) received the CEAR award last year for producing an outstanding *Performance and Accountability Report.* This year, we have high hopes of being recognized again, only this time as a new agency, the Federal Housing Finance Agency. We came up with an innovative way to present the FY 2008 performance results of all three of our merged agencies all in the same report.

Today I would like to talk to you about the extraordinary market turmoil that wracked the economy over the last year, how the government responded, our strategy to keep people in their homes and staunch the bleeding in the mortgage markets, and what lies ahead for the government-sponsored Enterprises (GSEs) as the new Administration seeks to repair and rebuild our nation's economy. Most of you heard Gene Dodaro's talk last session about the Government Accountability Office's (GAO's) recently released list of the 13 issues that need attention from the new Administration and Congress, one of which is oversight of financial institutions and markets.

The source of many of GAO's issues was the *High Risk* series, which it has published every two years since 1990. The series focuses on specific areas of federal activity particularly vulnerable to waste, fraud, abuse, or mismanagement, or because they need broad-based transformation to address major efficiency or effectiveness challenges. While I was at the Pension Benefit Guaranty Corporation (PBGC), we successfully addressed such issues and GAO removed it from the high risk list. While I was the Deputy Commissioner at Social Security, we implemented a program to get the Supplemental Security Income (SSI) program—the largest cash-based government program for the poor—removed from the high risk list after many years. The key to those successes were root-cause analysis, detailed action plans, and commitment by senior management to implement the plan. Unfortunately, PBGC and government disability insurance programs (including SSI) are back on GAO's high risk list.

Both PBGC and SSI are government insurance programs, as is Social Security's retirement program and, as it turned out, the government-sponsored Enterprises, Freddie Mac and Fannie Mae. So why do government insurance programs pose such high risks? Having managed or overseen private, public, and quasiprivate sector insurance companies, my answer is that all insurance programs pose significant risks, but the government structure tends to magnify those risks.

The risks associated with offering insurance are often compounded by the inability in government programs to properly charge for the risk or change with the market without legislative action. Both those limitations increase two of the overriding challenges facing an insurer: adverse selection and moral hazards. Adverse selection refers to the tendency of those seeking insurance to be more likely than others to expect payouts, while moral hazard refers to the tendency of the insured to take more and greater risks knowing the insurance is in place. When government insurance programs are barred from charging actuarially fair premiums or adjusting premiums as insured risks change, they invite both adverse selection and moral hazard.

In addition, insurance programs require strong prudential oversight as managers often face conflicting demands from shareholders, politicians, and customers that produce another layer of moral hazard, especially with respect to catastrophic risk-taking.

In my view, the key to reducing these risks to the government is to design a program that is built on sound management, strong underwriting, flexibility to react to changes in the market, and strong prudential oversight. As Congress and the Administration look at redesigning Fannie Mae and Freddie Mac, which are essentially insurance companies, those principles should be kept in mind.

Today, the biggest challenge we face is the stabilization of the housing market. Declining prices will demand continued concentrated action by the public and private sectors. FHFA has a four-pronged strategy to ensure the housing government-sponsored enterprises (GSEs) meet this challenge and fulfill their mission of providing liquidity, stability, and affordability to the housing market. First, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks must support the market in a safe and sound manner, with special emphasis on affordable housing. Given the current predominant role the GSEs play in the nation's mortgage market, it is imperative that FHFA ensure their continued functioning and safety and soundness.

Second, we are working with our governmental partners to get mortgage interest rates down. Third, we are working with the Enterprises to set best practices for the whole mortgage market. Finally, we are actively working on foreclosure prevention to help homeowners in trouble.

Before I discuss these four points in detail, let me try to put the housing GSEs in perspective for you.

Putting the GSEs in Perspective

The Federal Home Loan Banks were created in 1932 to improve the liquidity of thrifts and be the principal source of housing finance. Congress created Fannie Mae in 1938, and its original job was to purchase only mortgages insured by the Federal Housing Administration (FHA). To reduce the federal debt during the Vietnam conflict, Congress spun off Fannie Mae as a publicly traded company in 1968. Freddie Mac was established in 1970. It was owned by the 12 Federal Home Loan Banks until 1989, when Congress turned it into a public company, in part to help resolve the thrift crisis.

Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are known as GSEs, hybrid creations that were both public *and* private financial institutions, created by Congress with federal charters but with private sector ownership. Both Fannie and Freddie are listed on the New York Stock Exchange. The Federal Home Loan Banks are owned by more than 8,000 banks, credit unions, and insurance companies. The structure for what we call the Enterprises, Fannie Mae and Freddie Mac, was especially problematic. On the one hand, the Enterprises were supposed to fulfill the social goals of expanding affordable housing opportunities and providing liquidity and stability to the mortgage market. On the other, they tried to maximize shareholder value. Clearly, these goals created tensions for the two companies, their shareholders, and Congress. By the 1990s, the two were powerful lobbying forces, and they had managed to gain enough political support to get low capital requirements enshrined in statutes. Efforts to make their bottom lines look better led to accounting misdeeds we had to fight to uncover and make them correct from 2003 to 2006.

(SLIDE 2) It is important to recognize how incredibly large the GSEs are. Their combined debt outstanding and guaranteed mortgage-backed securities (MBS) are $6.7 trillion. Despite the very rapid growth in Treasury issuance, they still exceed the publicly held debt of the United States by $300 billion. Over the last two years especially, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks have played a tremendously important role in the mortgage market.

(SLIDE 3) Fannie Mae and Freddie Mac have two businesses: (1) guaranteeing residential and multifamily mortgage-backed securities (MBS)—in blue; and (2) investing in whole mortgage loans and MBS, including their own—in green. Their retained portfolios pose large market and credit risks. We kept that under check by capping the growth of those portfolios after discovering those serious accounting and internal control problems at the Enterprises. As part of the conservatorship, the cap has been temporarily raised to $850 billion and just yesterday to $900 billion for each this year. Their MBS guarantee business continues to grow to support the market.

(SLIDE 4) This slide shows the history of the mortgage market over the past 10 years. From 1997-2003, Fannie Mae’s and Freddie Mac’s market share of mortgage originations gradually grew to almost 55 percent. From 2004-2006, the private mortgage market predominated, and Fannie’s and Freddie's business sank pretty dramatically, with their market share dropping below 35 percent. Then as the private market started to freeze up in 2007, Fannie’s and Freddie's market share took off—up to 73 percent in 2008. The market share of mortgages insured by FHA/VA (Veterans Administration), which are generally pooled into Ginnie Mae (GNMA, the Government National Mortgage Association) mortgage-backed securities, has risen even more dramatically, rising from 3 percent in 2006 to more than 35 percent in the fourth quarter of 2008. A very worrisome issue to any insurance program, but especially a government one, is very rapid growth, because it may indicate that risk is being underpriced.

A key reason for the Ginnie Mae growth is that Fannie and Freddie cannot buy loans with original loan-to-value (LTV) ratios greater than 80 percent without a credit enhancement. With the demise of the piggy-back mortgage and the stresses on mortgage insurance company capital, borrowers without substantial down payments are increasingly dependent on government insurance programs. The private mortgage insurers’ market share versus FHA/VA fell from nearly 80 percent in the first quarter of 2007 to about 20 percent in the fourth quarter of 2008.

(SLIDE 5) Turning to the Federal Home Loan Banks, they continue to play an important role in the mortgage market by providing secured advances to banks, credit unions, and insurance companies. Federal Home Loan Bank advances hit the trillion dollar mark in October. Historically, we have always thought of the Federal Home Loan Banks as providing low-cost funding to small and medium-sized banks, but their customer range goes well beyond that. With the recent consolidations, about one-third of their total advances are to the Big Four bank holding companies.

In total, the Federal Home Loan Banks have almost $1.4 trillion in assets. Only 5 percent is in private-label mortgage-backed securities, but these have turned out to be very high risk, even though they were originally rated AAA.

How We Got Here

Following the 2001 recession, very low interest rates sparked a boom in housing and single-family mortgage markets that allowed the housing sector to enjoy unprecedented growth until late 2005. New and existing home sales were at record levels during that period, and owner-occupied homes increased by 4.7 million. House prices grew much faster than household incomes, which facilitated widespread equity withdrawals through cash-out refinances and home equity loans. The surge in housing activity and house prices was financed in part by rapid growth in the volume of nontraditional, especially subprime, mortgage lending, which was made possible by increased demand for private-label mortgage-backed securities and innovations in the mortgage securitization process. Those developments were accompanied by the buildup of three significant vulnerabilities that are easy to discern today, but were not widely appreciated at the time.

First, the risk of a sizable house price correction increased as house prices rose, especially after interest rates began rising in late 2005, the housing sector weakened and homebuilders expanded the supply of new homes faster than new households were being formed. That was true not just for properties financed with subprime and other nontraditional mortgages, but also for properties financed with the prime conventional loans in which Fannie Mae and Freddie Mac specialize. Virtually everyone involved in home mortgage lending—builders, borrowers, lenders, mortgage insurers, credit rating agencies, the Enterprises, and other secondary market investors—failed to appreciate the likelihood of a severe house price correction. The pricing models of Fannie Mae and Freddie Mac, for example, assumed throughout the boom that house prices would continue to go up.

Well, prices did not rise forever, as this chart shows. **(SLIDE 6)** Since January of 2000 through July 2006 (peak), the more volatile S&P/Case-Shiller house price index rose by 106 percent only to fall by 25 percent since then. The less volatile FHFA House Price Index, which reflects Fannie Mae's and Freddie Mac's books of business, peaked later, and has since declined 10.5 percent from its peak.

Second, the mortgage credit boom was accompanied by a steady deterioration in underwriting standards and pricing discipline. Risk in the mortgage and many other markets were underpriced. As house price appreciation and rising interest rates reduced housing affordability, low documentation Alt-A, interest-only loans, and adjustable-rate mortgages (ARMs) proliferated. Subprime market share tripled to more than 20 percent of the market. The performance of those relatively new and untested financial products in a period of rising interest rates and low or negative house price appreciation was quite uncertain. Lenders also accepted more loans with higher loan-to-value (LTV) ratios and lower borrower credit scores and allowed a growing share of borrowers to take out a second loan at origination to cover downpayments. Secondary market investors such as the Enterprises did not have complete information on those second loans and could not fully reflect the actual total LTV. Overall, the industry allowed the credit risk of new mortgages to rise substantially without increasing mortgage rates, mortgage insurance premiums, or guarantee fees enough to compensate for the heightened risk.

For years Fannie Mae, Freddie Mac, and FHA set the standards for prudent mortgage underwriting and credit practices. Those standards were adopted by the private, prime jumbo market, and largely prevailed until the ascendance of the private-label securities market. Increasingly, the private market—driven primarily by the Wall Street distribution model, rating agency criteria, and over-enthusiastic investors—lowered the credit bar. Eventually, in response to declining market share, Fannie Mae and Freddie Mac began to follow suit not only lowering their own underwriting standards, but also buying hundreds of billions worth of AAA private-label MBS.

Borrowers with payment option ARMS or ARMS with low initial teaser interest rates experienced payment shock when their interest rates and principal adjusted. They could no longer afford their mortgage payments. Because many had increasingly taken on more debt and spent the money, they defaulted on their mortgages. **(SLIDE 7)** Over the past two years, serious delinquencies of 90-days or more have risen across the board. For subprime mortgages, serious delinquencies are almost 20 percent. They are far lower at Fannie Mae and Freddie Mac at about 2 percent, which is even lower than the prime market at 2.9 percent or the whole market at 5 percent. Serious delinquencies across all categories are continuing to rise.

Third, a large proportion of subprime, Alt-A, and other nontraditional mortgages was financed with private-label MBS, and increasingly complex derivative instruments, such as collateralized debt obligations (CDOs). Failures of due diligence by credit rating agencies and bond insurers, facilitated weak underwriting and pricing discipline of the underlying mortgages. Market participants failed to appreciate that even the most highly-rated private-label MBS posed significant credit risk.

Those vulnerabilities became more evident in late 2006 and 2007, as rising delinquency and default rates on recently-originated subprime mortgages made investors aware of the extent of poor underwriting in subprime lending. In the second half of 2007, these factors led to a virtual collapse of the primary and secondary markets for subprime and nontraditional mortgages and contributed to disruptions in broader financial markets.

Because mortgage assets were considered safe, the 1992 law that established OFHEO required the agency to deem the GSEs adequately capitalized even if their mortgage credit exposure to capital was more than 100 to 1. Recognizing the systemic risk of Fannie Mae and Freddie Mac, OFHEO worked for many years to obtain legislation to give us greater authority over their capital requirements and the size of their portfolios. It was my top priority.

The legislation we had worked for so diligently for so long finally became reality on July 30th last summer. Former President Bush signed the Housing and Economic Recovery Act of 2008 (HERA) in a small, early morning ceremony in the Oval Office. FHFA was finally created from the merger of OFHEO with the Federal Housing Finance Board, and the HUD housing mission team. *But it was too late.* I believe, and I told President Bush this just a few days before he left office, that if we had gotten GSE reform legislation passed several years earlier, we could have prevented many of the problems that led us down the path we are now traveling.

Before HERA was enacted, OFHEO had tenaciously used all the powers that we had and then some, including jawboning. We imposed an extra 30 percent capital requirement on the GSEs because of their accounting problems. We capped their portfolios in 2006. We stopped them from investing in below AAA-rated private-label securities, taking positions in the ABX market and other risky activities. We encouraged them to conserve capital and to raise additional capital. They did raise more than $20 billion, but it was not nearly enough.

By September, the facts made it clear that there was no other choice than conservatorship if the Enterprises were going to be able to continue to fulfill their mission of providing stability, liquidity, and affordability to the market. We made the decision working closely with the Treasury Department and the Chairman of the Federal Reserve. It was a very tough, but right, decision. If we had not taken the conservatorship action, the Enterprises would have had to pull back dramatically from the market, which would have accelerated the downward spiral.

Government Support for the GSEs

HERA created the tools that made it possible for the Enterprises to operate in conservatorship. It gave the Treasury Department authority to support Freddie and Fannie and fund them in a variety of ways. **(SLIDE 8)** We could not have put Fannie and Freddie into conservatorship without Treasury's $100 billion Senior Preferred Stock facility, which provides *an effective guarantee* of the Enterprises' debt and mortgage-backed securities by ensuring each Enterprise has a positive net worth. That is about *three times* the minimum capital the old law required. In return, Treasury received from each Enterprise a billion dollars in senior preferred stock and warrants for 79.9 percent of the common stock. At the same time, we eliminated the dividends on both the common and preferred stock.

This facility protects not only present senior and subordinated debt holders and MBS holders but also *any future* debt and MBS holders. It lasts until the facility is fully used or until all debt and mortgage-backed securities are paid off. To date, Freddie has accessed about $13.8 billion and indicated it needs another $30 billion to $35 billion to cover fourth quarter losses. Fannie only just recently announced that it will need $11 billion to $16 billion to cover its fourth quarter losses.

As Secretary Geithner and President Obama announced yesterday, Treasury has doubled the Senior Preferred Stock Facility to $200 billion each to remove any possible doubt from the minds of investors that the U.S. Government stands behind Fannie Mae and Freddie Mac.

(SLIDE 9) Two additional facilities were also implemented when the conservatorships began. Under the first, Treasury has purchased $94 billion in mortgage-backed securities and yesterday made it clear it will continue to be an active buyer. The second is an unlimited secured credit facility which acts as a liquidity backstop for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, but is never been needed.

Reducing Mortgage Rates

The Federal Reserve Bank announced two critically important programs in November to reduce mortgage rates. In the first, it will purchase $500 billion or more in Fannie Mae, Freddie Mac, and Ginnie Mae MBS. Since the beginning of January, they have already purchased $115 billion. The second program is a purchase of up to $100 billion in Fannie Mae, Freddie Mac, and Federal Home Loan Bank debt. To date, the Federal Reserve has purchased $30 billion in Fannie, Freddie, and Federal Home Loan Bank notes. Both these programs are a significant part of the government's overall efforts to restart the housing market.

When you add this all up, the U.S. government has made it critically clear to every investor that it is standing behind Fannie Mae, Freddie Mac, and the Federal Home Loan Banks That is why I call it an effective guarantee. **(SLIDE 10)** These programs have had a very positive impact on mortgage rates, which have fallen more than 100 basis points. They even dropped below 5 percent for 30 year rates, but crept back up to 5.16 percent in Freddie Mac's latest weekly report. These lower rates provide an important opportunity to do two things—refinance and modify mortgages to help stabilize housing prices. If confidence is restored and the present large spread to Treasury rates is reduced, mortgage rates could move lower.

Setting Best Practices

(SLIDE 11) Fannie Mae and Freddie Mac need to continue to provide a leadership role in developing mortgage market best practices. In early January 2008, FHFA revised policy guidance on examination of mortgage fraud programs at Fannie Mae and Freddie. The Enterprises have led the industry in developing and implementing strategies to identify mortgage fraud, and reporting to the Department of the Treasury's FINCEN database.

In late December, FHFA announced Fannie Mae and Freddie Mac will implement a revised *Home Valuation Code of Conduct,* effective May 1, 2009. The code enhances protections for the independence of appraisers while maintaining lenders' ability to address unprofessional appraisal practices and ensure appraisal quality. The code also requires appraisal quality control testing, reporting on appraiser misconduct, and the creation of the Independent Valuation Protection Institute.

FHFA announced last month that it will require loan-level identifiers for loan originators and appraisers beginning January 1, 2010. This will allow the Enterprises to identify originators and appraisers at the loan-level and to monitor their loans. If originators or appraisers have contributed to the incidences of mortgage fraud, these identifiers will enable the Enterprises to address the problem.

Foreclosure Prevention

As conservator of the Enterprises, FHFA has not only taken strong action to ensure the maximum effort by the Enterprises to modify loans to prevent foreclosures but also has taken a leading role in efforts to address the foreclosure crisis in the private-label securities market. **(SLIDE 12)** As you can see in these pie charts, while Fannie Mae and Freddie Mac own or guarantee almost 31 million mortgages, about 56 percent of all single-family mortgages, the mortgages they own or guarantee only represent 19 percent of serious delinquencies. Private-label mortgage-backed securities represent 16 percent of the mortgages but more than 62 percent of the serious delinquencies.

Let me pause on these pie charts for a moment, because they represent the crux (not the pie *crust*) of the problem we face in foreclosure prevention. If we are going to stabilize the housing market, we have to address that 62 percent. We believe Fannie Mae and Freddie Mac must be leaders in improving, promoting, and enforcing industry standards and best practices for all mortgages.

(**SLIDE 13)** In November, I announced the new streamlined modification program (SMP) developed jointly with the U.S. Treasury, HUD, Fannie Mae, Freddie Mac, and HOPE NOW's members. Beginning in January, more than 90,000 solicitation letters and modification agreements were sent to eligible borrowers. We are carefully monitoring the success of the program, but it is clear that the program needs to be more aggressive to reach more troubled borrowers. The Enterprises have taken a whole series of other activities to help avoid preventable foreclosures. They suspended foreclosures and evictions and developed programs to protect renters living in foreclosed properties. They are working with credit and housing counselors.

FHFA began in September a *Foreclosure Prevention Report*, which is a transparent review of key performance data on foreclosure prevention efforts. These monthly and quarterly reports present data from more than 3,000 approved servicers on 30.7 million first-lien residential mortgages serviced on behalf of Fannie Mae and Freddie Mac, of which 84 percent are prime. The just released November report showed that for the first full two months of conservatorship, October and November, the number of loan modifications increased 50 percent from the previous two months.

As an Oversight Board member, I have worked closely with Treasury on their Troubled Assets Relief Program (TARP). Although TARP I was controversial, it did what it had to do, which was to provide capital to financial institutions. Lending would have been much less without it. There was a significant risk of the financial system freezing up. Foreclosure prevention activities have picked up especially amongst the largest sellers/servicers and independent servicers, but much more needs to be done.

FHFA understands the nation's deep concern over the human tragedies of the foreclosure crisis. We maintain that significant loan modifications are the best way to help both the people involved and the economy in the long run. Any legislative changes to existing bankruptcy laws should be approached in as careful and considered way as possible to avoid unintended consequences for individuals and for our weakened financial institutions. We must do everything we can to give homeowners incentive to achieve an affordable mortgage payment through loan modifications rather than endure the hardships of bankruptcy.

<u>Homeowner Affordability and Stability Plan</u>

(SLIDE 14) That is why FHFA was pleased to work with the White House, the Treasury Department, and the Enterprises in the development of the *Homeowner Affordability and Stability Plan* that President Obama announced yesterday. It is a major step forward in reducing preventable foreclosures and stabilizing the housing market. It aggressively builds on the FDIC's and our streamlined mortgage modification programs. The key elements of the plan are:

1. **Fannie Mae and Freddie Mac will provide access to low-cost refinancing for loans they own or guarantee. This will help up to 4 to 5 million homeowners avoid foreclosure and reduce their monthly payments.** This program is designed for current borrowers who seek to refinance at a lower rate or into a safer mortgage but who have experienced difficulties due to declining home values. They will be eligible for a refinanced mortgage with a current loan-to-value of up to 105 percent.

2. **A $75 billion loan modification plan, called the Homeowner Stability Initiative, will reach up to 3 to 4 million at-risk homeowners.** This program will help homeowners stay in their homes and protect neighborhoods. Importantly, there will be a national standard for loan modifications that will reduce borrowers' housing costs to 31 percent of their gross incomes through a combination of interest rate reductions, maturity extensions, principal forbearance, and/or principal forgiveness.

TARP will pay half the cost of the reduction from 38 percent to 31 percent. There will be “pay for success” incentives for servicers, incentives to encourage borrowers stay current, incentives to reach borrowers early, and reserve payments to encourage lenders to modify mortgages even though prices could fall further.

3. **Treasury will support low mortgage rates by strengthening confidence in Fannie Mae and Freddie Mac.** As I previously mentioned, the Treasury Department doubled the size of its Preferred Stock Purchase Agreements to $200 billion each, continues to purchase Fannie and Freddie MBS, and increased the GSE’s allowable mortgage portfolios by $50 billion to $900 billion.

Over the next two weeks, FHFA will be working with the Administration and the Enterprises to finalize the details and implement the program.

The Future of Fannie Mae and Freddie Mac

The Obama administration has indicated that Fannie and Freddie will continue having a key role in the nation’s economy as we go forward. At this point our primary focus has to be getting through the present crisis. However, I do think it is useful to look beyond it. Congress and the Administration will have to determine how the Enterprises will be structured and how they will operate. There is no shortage of ideas. For example, in a January speech to the Economic Club of Washington, former Treasury Secretary Paulson suggested an array of options for the future of secondary mortgage markets in the United States including nationalization, privatization, or establishment of “housing utilities” to issue MBS with government support and governed by a rate setting commission. Federal Reserve Chairman Bernanke and others have suggested a variety of other options to reform or replace the Enterprises.

Before deciding among the wide variety of possible legal and ownership structures for the Enterprises or their successors, we first must establish some very basic principles that will guide our evaluation of those options and choice among them. **(Slide 15)**

The first principle is that the Enterprises should have a well-defined and internally consistent mission. They should exist to achieve clear public objectives, and their activities should be well-tailored to achieving those objectives. Current law suggests that the Enterprises should promote the stability and liquidity of the secondary mortgage market and support financing for housing that is affordable. That raises various issues: How, specifically, should the Enterprises promote market stability and liquidity? Should their business volumes be strongly countercyclical? How much risk should they bear to promote affordable mortgage lending? Should they focus their activities on supporting long-term, fixed-rate mortgage lending and on loans whose terms are simple and easy to understand?

The second principle is that there should be a clear demarcation of the respective roles of the federal government and the private sector in the secondary mortgage market. The old hybrid model of private, for-profit ownership underwritten by an implicit government guarantee allowed the Enterprises to become so leveraged that they posed a large systemic risk to the U.S. economy. The questions now are: What roles are best played by the federal government? What roles are best played by private firms? How can we best harness the strengths of market capitalism, while mitigating the risks and avoiding unintended consequences? Can we avoid excessive risk-taking and mitigate systemic events? Should we charge an explicit, risk-based fee for the catastrophic risk that the federal government has borne only implicitly up to now? Should the existing book of business be split from new business on emergence from conservatorship? How can we prevent undue political influence that may increase risks to the government?

The third principle is to base any organization providing credit guarantees in the secondary mortgage market on sound insurance principles, such as those I outlined at the beginning of this speech: sound management, strong underwriting, strong capital positions, risk-based pricing, and flexibility to react to changes in the market. Does the retained mortgage portfolio compound or diversify risks?

The fourth principle is to create a regulatory and governance structure that ensures risk taking is prudent. A stronger regulatory structure for the GSEs was enacted by the Congress as part of HERA. That act afforded FHFA greater flexibility to establish capital and other prudential standards for the GSEs, and we are in the process of examining options to both strengthen capital requirements and to make them more countercyclical. Beyond prudential regulation, the internal governance—board composition, management structure, compensation and incentives—should be examined and strengthened. Consistent with this principle, rethinking financial regulation is on GAO's list of 13 urgent issues. As we move through and emerge from the current crisis, regulatory structures and powers must be reexamined. Why and how did one of the most heavily regulated sectors of the economy collapse? Did regulators have the appropriate powers? The right incentives?

In any organization there will be tension between sometimes conflicting principles. The key is to try to design an insurance program that prudently balances the risks and rewards and prudently designates the roles of the public and private sector.

Using these principles, there are three key options for Fannie Mae's and Freddie Mac's futures. A first option would be to nationalize the Enterprises. One variation of that idea would be to merge them with either FHA or Ginnie Mae. I am opposed to nationalization because, as I pointed out at the beginning of this speech, government insurance programs are particularly high risk.

The second and most obvious alternative would be to keep the Enterprises as GSEs building upon HERA. There are several variations on that theme that might work. They could continue with Treasury net worth protection, government reinsurance for catastrophic risk and/or a sharp reduction of retained portfolios. As former Secretary Paulson suggested, a public utility model could be established. A cooperative ownership model similar to that of the FHLBanks should also be considered.

A third option is to establish purely private-sector firms to supply liquidity to mortgage markets with or without government catastrophic insurance.

I will close here with a final note that all market participants, the government, and the GSEs, have to be creative and work together to help the U.S. economy and housing market recover. The fall in mortgage rates that the Treasury and Federal Reserve's purchases have triggered are very important steps in stabilizing the mortgage market. **(SLIDE 16)** Housing affordability has reached an all-time high. The recently passed stimulus package, Secretary Geithner's announcement of the new

Financial Stability Plan, and President Obama's housing announcements yesterday are all extremely important next steps to recovery for the housing markets and the U.S. economy. **(END SLIDE)**

Thank you. I will be happy to answer questions.

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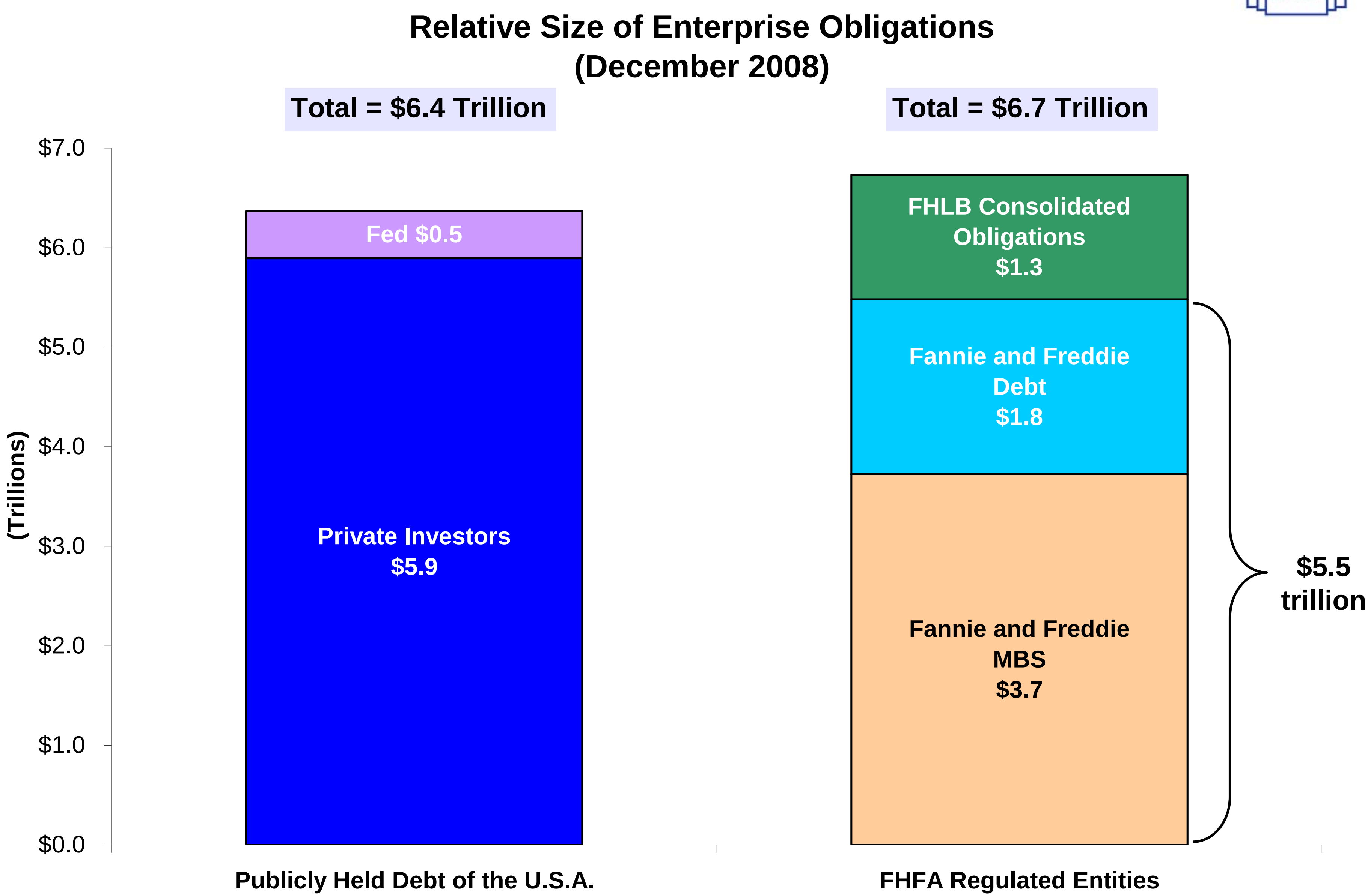
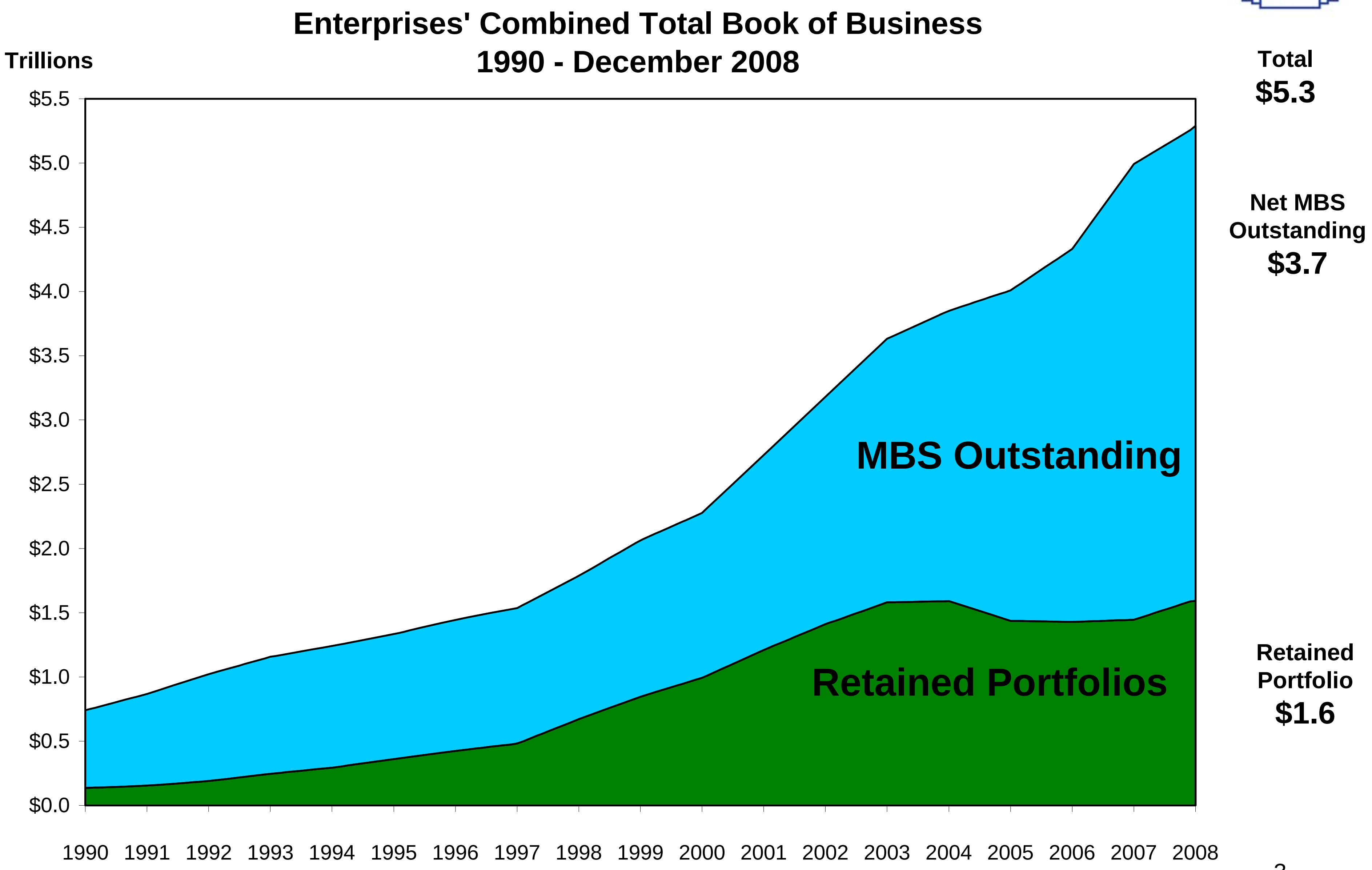
Housing GSEs Exceed the Public U.S. Debt



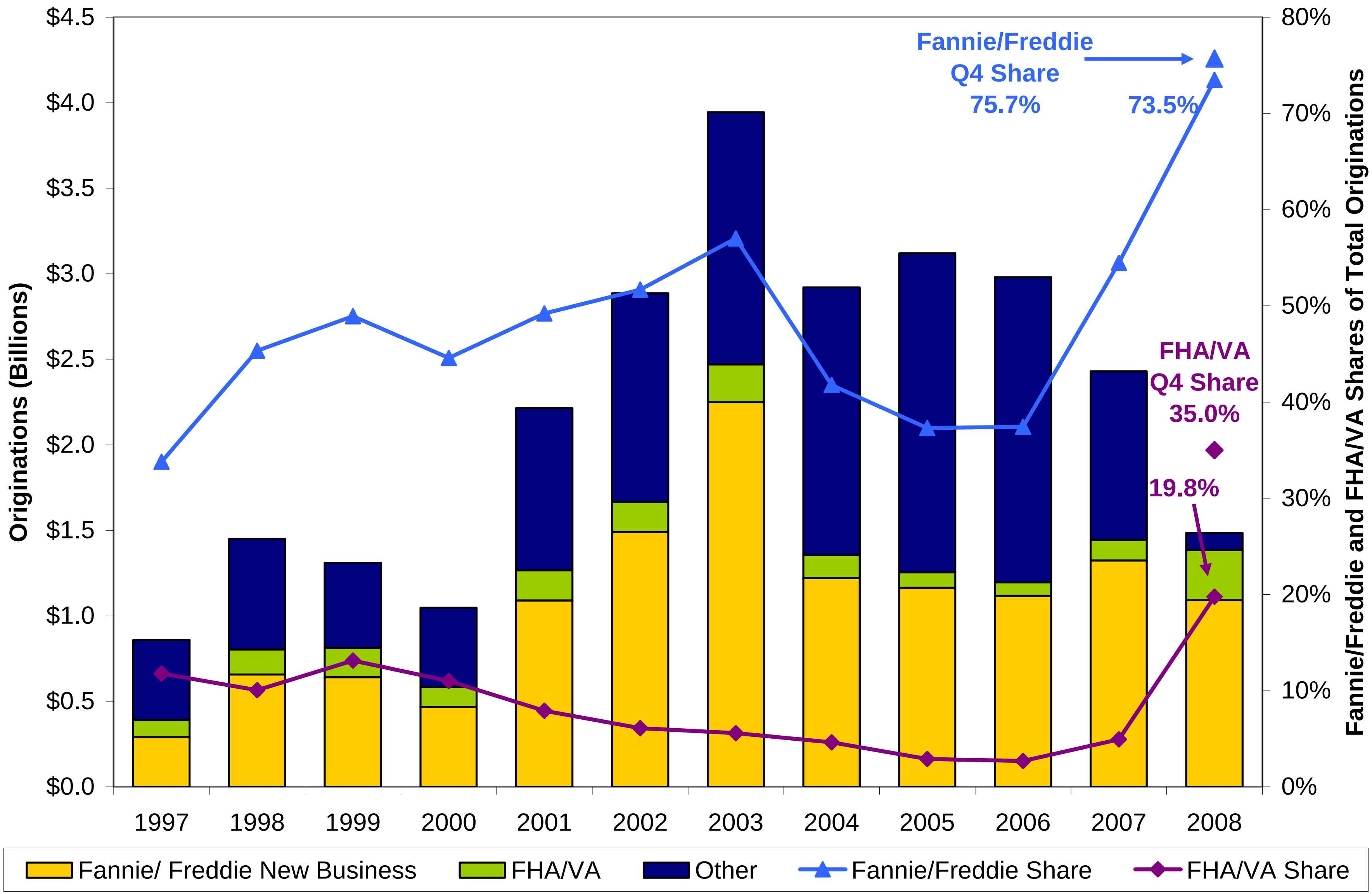
Sources: Fannie Mae and Freddie Mac Monthly Volume Summaries, TreasuryDirect.gov, Federal Reserve H.4.1 Release.

Fannie and Freddie Continue to Grow



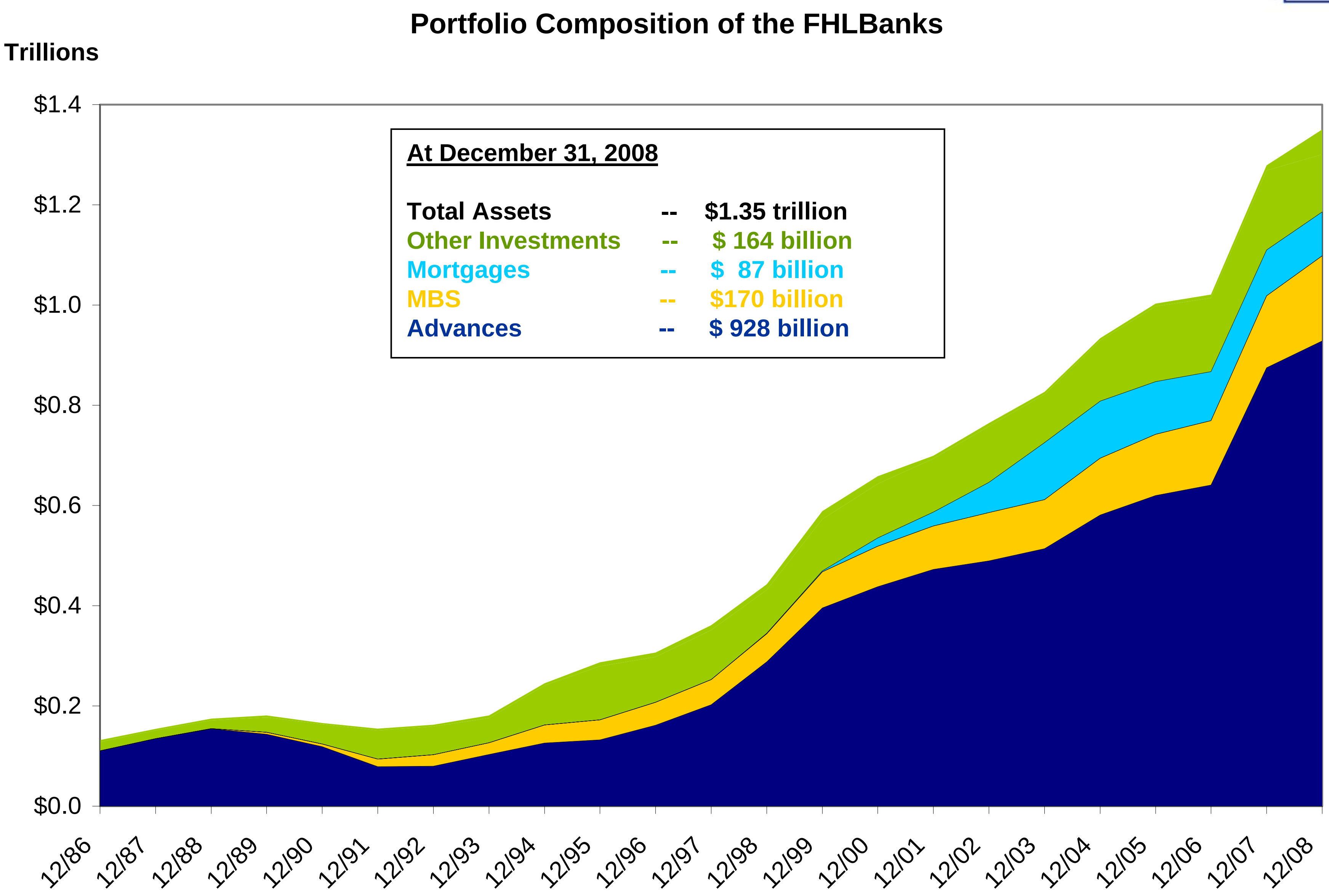
Sources: Fannie Mae and Freddie Mac Monthly Volume Summaries and 2007 OFHEO Report to Congress.

Enterprise and FHA/VA Shares of Originations

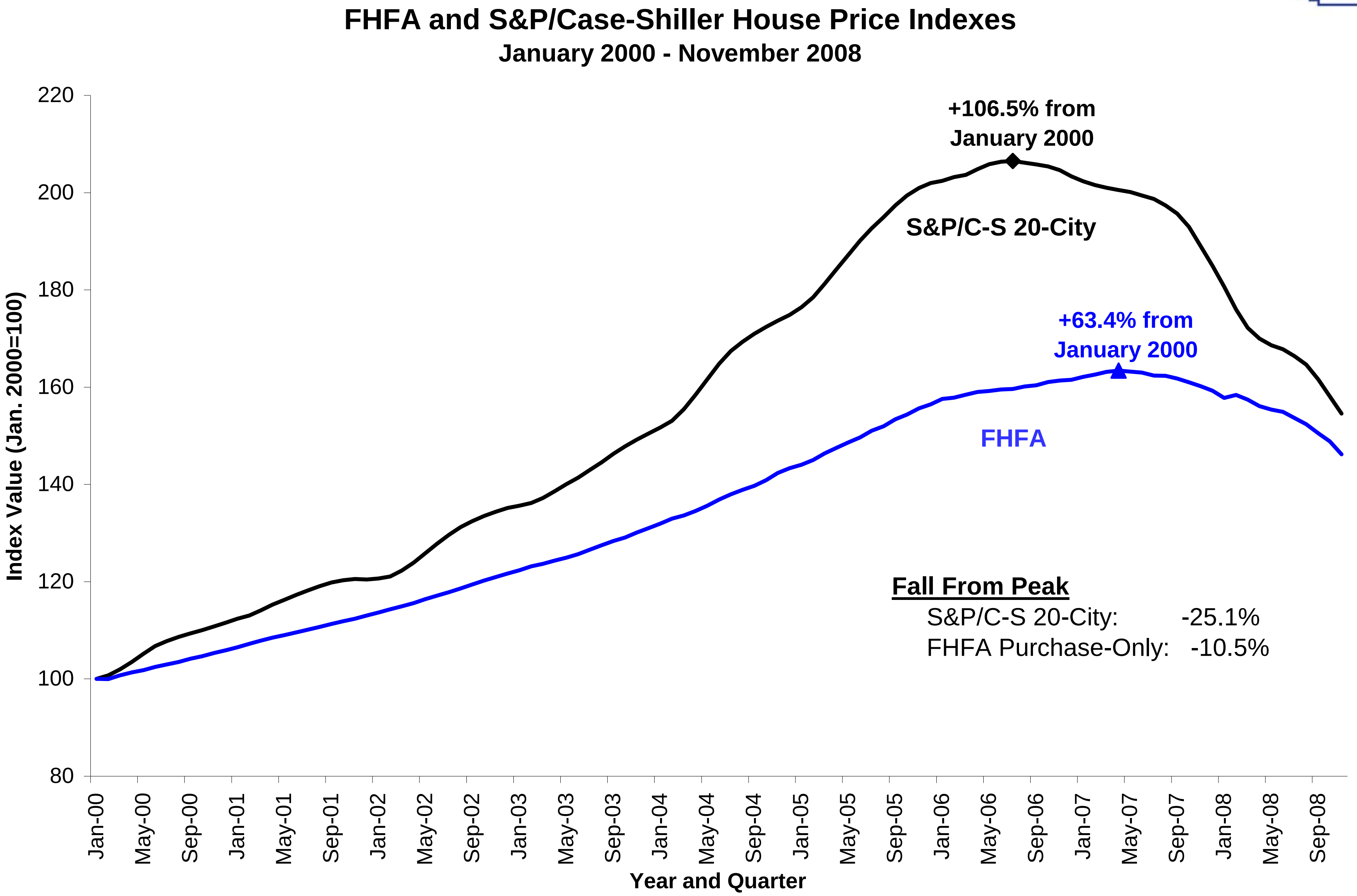


Sources: Inside Mortgage Finance, Enterprise Monthly Volume Summaries.

FHLBanks Also Continuing to Grow

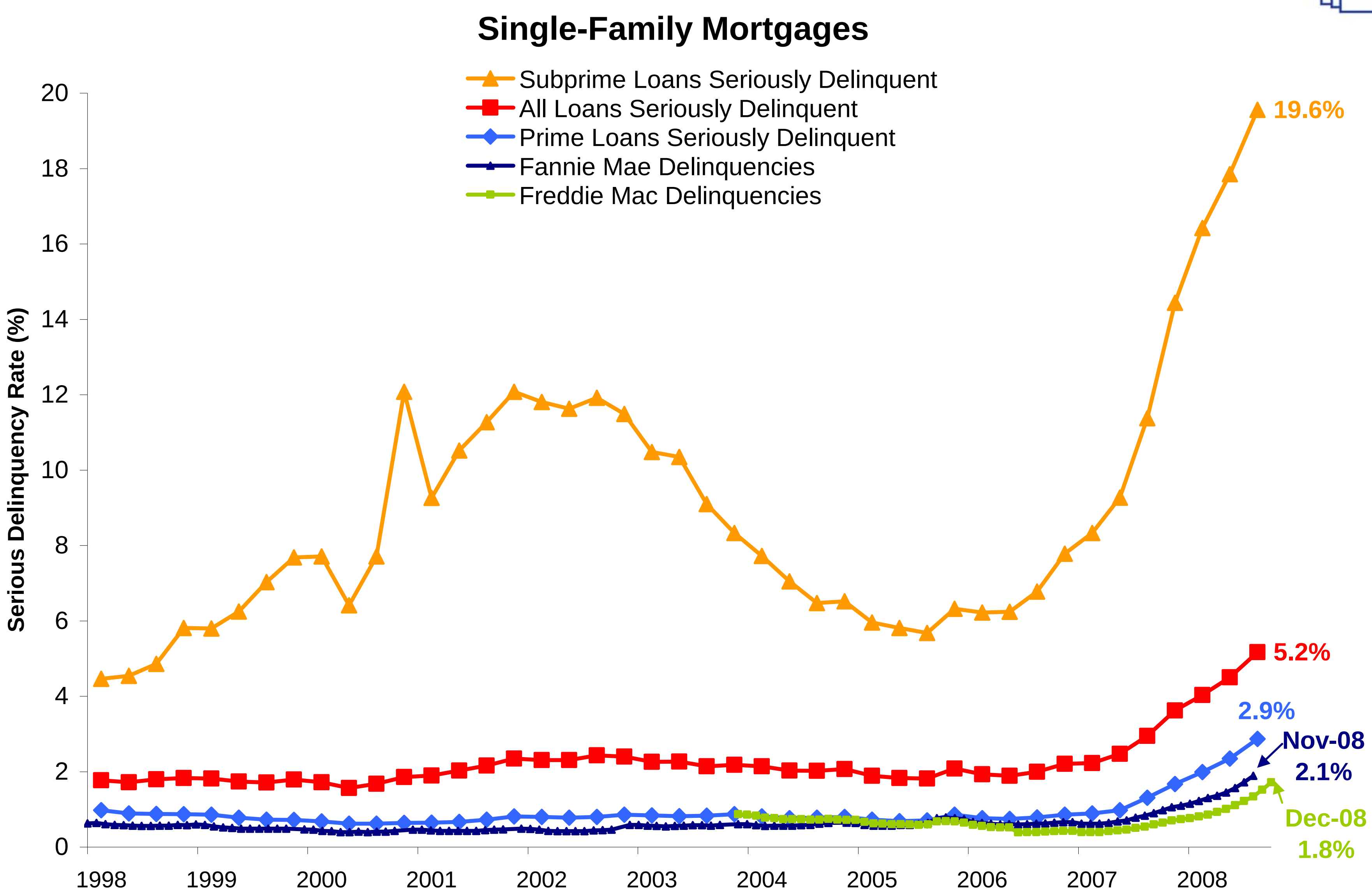


House Prices Continue to Fall



Note: For purposes of comparison, the FHFA purchase-only index has been re-based to January 2000=100 (the standard series is set so that January 1991=100)

Serious Delinquencies Rising Rapidly



Sources: Mortgage Bankers Association, Fannie Mae, Freddie Mac.

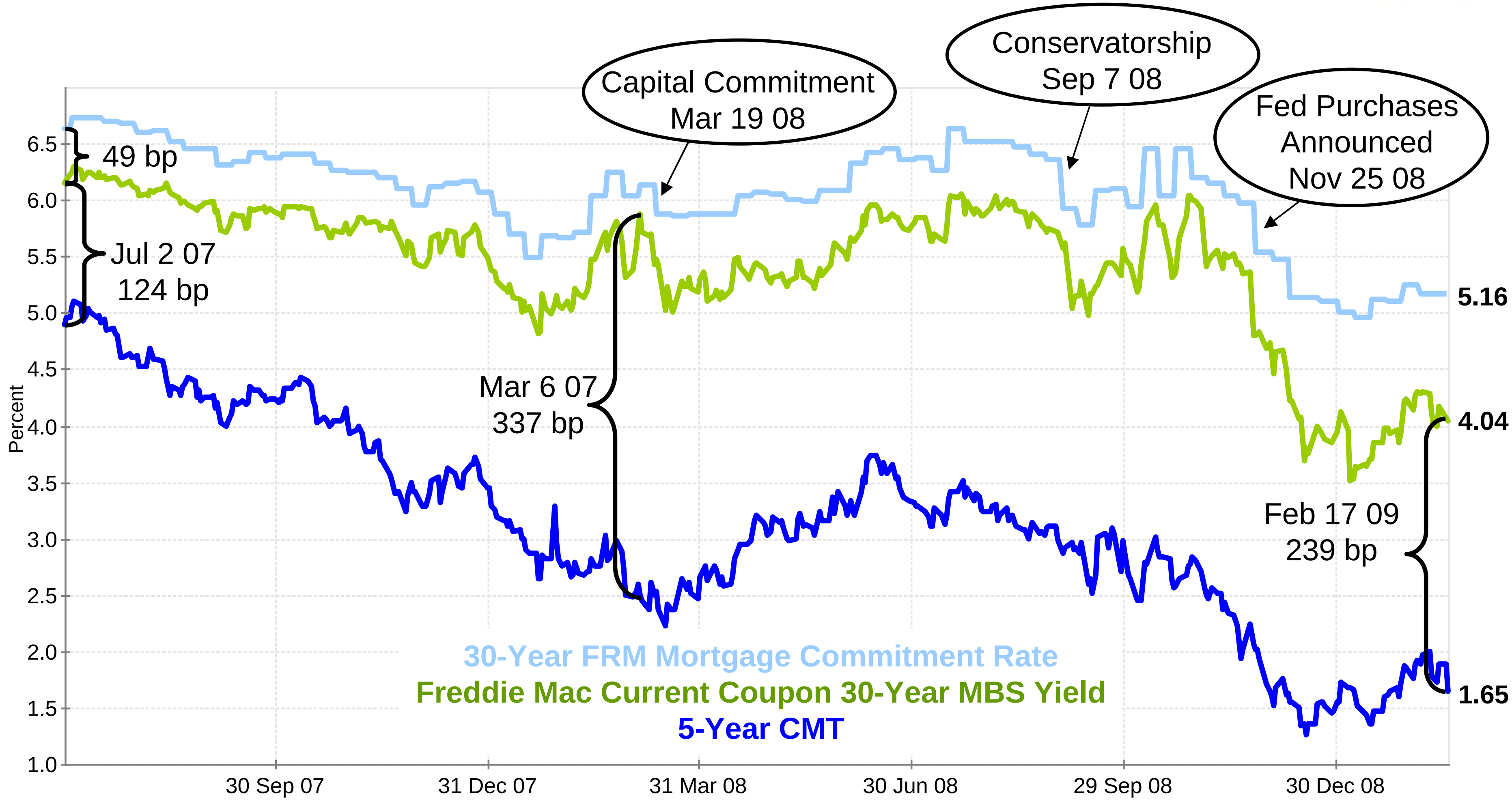
Treasury Provides Effective Guarantee

- **Senior Preferred Stock Purchase Agreement – no expiration date.**
  - Binding legal agreement that ensures that GSEs maintain a positive net worth through Treasury purchases of up to $200 billion of senior preferred stock each. DOJ opinion.
  - Enterprises each paid Treasury $1 billion in senior preferred stock and warrants for 79.9 % of common stock.
  - Existing and future holders of MBS, senior debt and subordinated debt, including all maturities are effectively guaranteed by the U.S. Treasury as facility can only terminate if:
    - Facility is fully funded,
    - GSE liquidates and Treasury has topped up net worth or
    - GSE satisfies all its liabilities.

Strong GSE Financial Support

- **Treasury - GSE MBS Purchase Program – Expires 12/31/09.**
  - Treasury purchases Fannie Mae and Freddie Mac MBS in open market. Over $94 billion purchased.
- **Treasury - GSE Credit Facility – Expires 12/31/09.**
  - Unlimited secured funding provided directly to Fannie Mae, Freddie Mac and FHLBanks by Treasury as a backstop. Not used.
- **Federal Reserve – “Agency MBS Purchase Program”**
  - $500 billion of Fannie, Freddie and Ginnie MBS. $115 billion purchased. (source: New York Fed)
- **Federal Reserve – GSE Debt Purchase Program**
  - $100 billion of Fannie, Freddie and FHLB debt via auctions. $30 billion purchased. (source: New York Fed)

Mortgage Rates Falling, But Spreads are Wide



Provided by Credit Suisse LOCuS

Sources: Credit Suisse, Freddie Mac, and Federal Reserve Board H15.

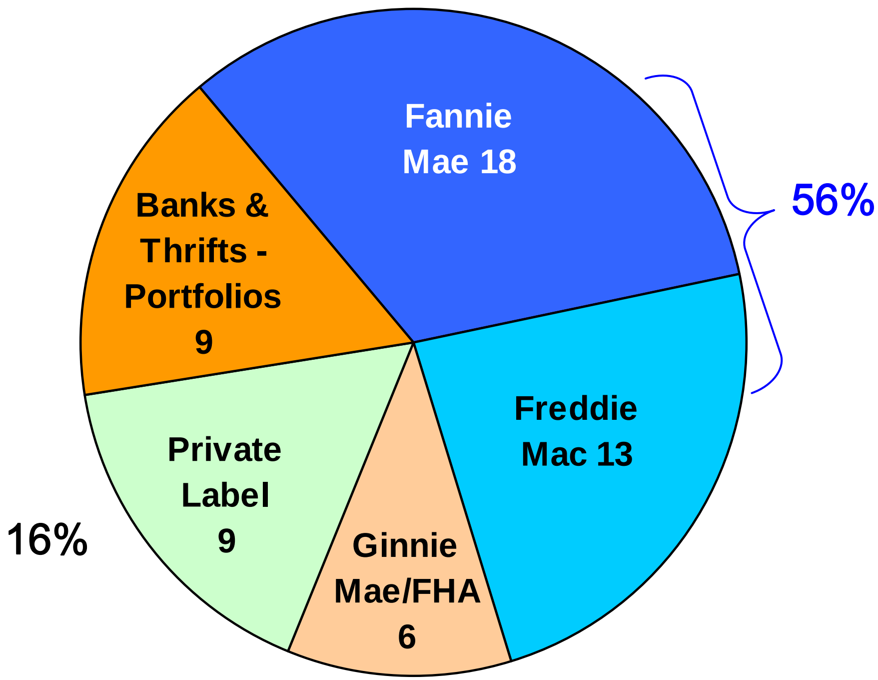
Best Practices

- Guidance on Mortgage Fraud
- Appraiser Code of Conduct
- Loan Level Identifiers – originators and appraisers
- Loan Modifications

PLS Modifications Key to Foreclosure Prevention

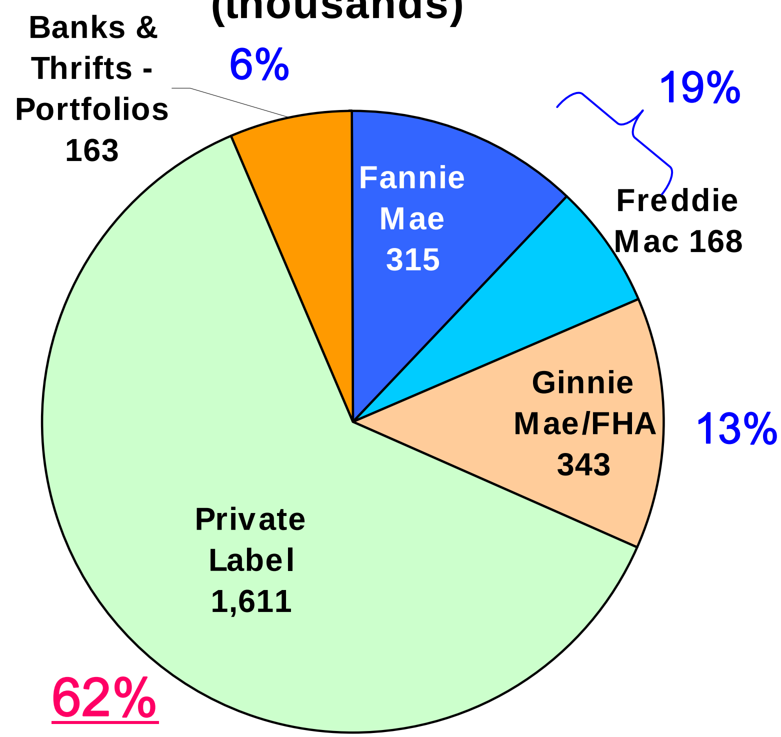
Q3 2008

Mortgages Outstanding (millions)



Total: 55 million

Seriously Delinquent Mortgages (thousands)



Total: 2.6 million

Source: Freddie Mac.

Foreclosure Prevention Activities

- Working with PLS trustees, servicers and ASF to be more aggressive
- Fast track streamlined loan modification (SMP) program to reduce mortgage payments – started December 15
- Foreclosure and eviction suspension
- FHFA produces monthly and quarterly Foreclosure Prevention Reports
- TARP, Part I and II

Homeowner Affordability and Stability Plan

- Fannie Mae and Freddie Mac refinance responsible homeowners - 4 to 5 million

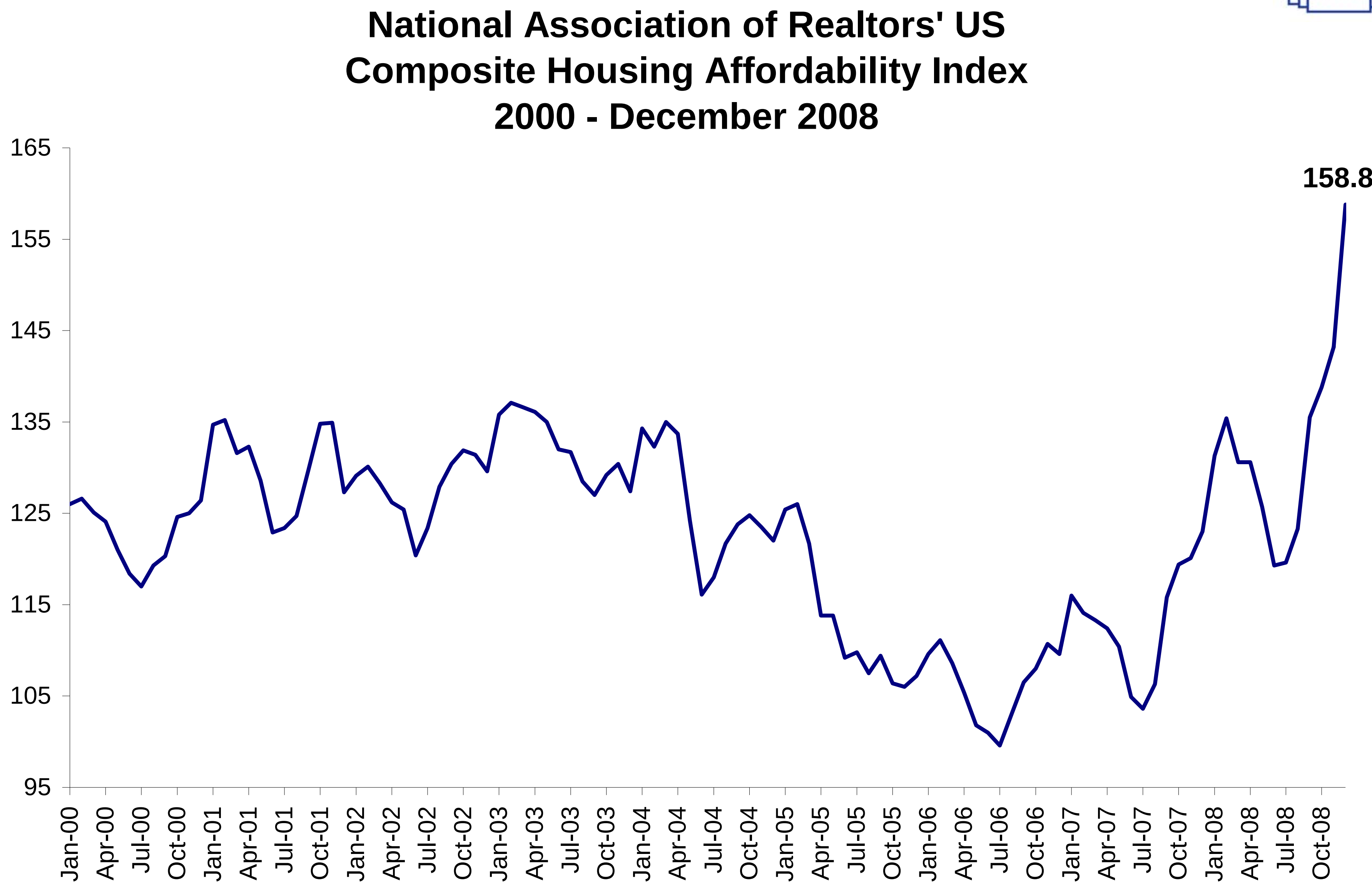
- $75 billion Aggressive Loan Modification Program – 3 to 4 million

- Support Low Mortgage Rates by strengthening confidence in Fannie Mae and Freddie Mac

Principles for Fannie Mae and Freddie Mac's Future

- Well defined and consistent mission
- Clear demarcation of private and public sector roles
- Base on strong insurance principles
- Regulatory and governance structure to ensure prudent risk taking

Housing Affordability is Recovering



Source: National Association of Realtors

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