The Conservatorships of Fannie Mae and Freddie Mac

Edward J. DeMarco
Acting Director
Federal Housing Finance Agency

National Association of Federal Credit Unions Congressional Caucus
Washington, DC

September 13, 2012

Introduction

Thank you Fred.

Last week we marked the four year anniversary of when Fannie Mae and Freddie Mac -- which I will refer to as the Enterprises -- were placed into conservatorship. Today I thought I would take my time to discuss where the Federal Housing Finance Agency (FHFA) is headed with the conservatorships in the future.

I would like to update you on three key matters: guarantee fee pricing, reps and warrants, and the strategic plan for the conservatorships.

Guarantee Fees

First, as we work to restore prudent underwriting and risk-based pricing to a housing finance system that went badly off-track, we have been taking steps to improve the Enterprises' pricing of credit risk.

Besides strengthening market practices, these steps also contribute to our stated goal of gradually reducing Fannie Mae's and Freddie Mac's footprint in the mortgage market. Since being placed into conservatorship, the Enterprises have steadily raised guarantee fees, which, over time, should gradually reduce taxpayer's risk from the financial support they provide to the two companies.

Over the past year there have been two guarantee fee increases, the first announced in late December 2011 that took effect in April and the second announced two weeks ago that takes effect later this year. The first increase was an across-the-board 10 basis point increase. The second was designed to average 10 basis points across the companies' books of business but the actual increase will vary depending on loan terms and other factors.

These increases will move Enterprise pricing closer to what it would be were mortgage credit risk borne solely by private capital, and it could begin to incentivize private firms to increase their participation in the mortgage market. We intend to stay on this path with future increases.

Another area that we will be considering is guarantee fee pricing that takes into consideration certain costs of doing business across different parts of the country. FHFA will soon release a paper for public input that outlines a pricing approach to better capture the costs associated with state and local policies.

Representations and Warranties

Second, another area that is important to the future of housing finance is the representation and warranty framework. Fannie Mae and Freddie Mac have long operated under a representation and warranty model that relied on monitoring at the back-end of the process after a mortgage defaulted or the borrower missed payments. While that model may have worked reasonably well in stable credit conditions, it did not work so well under stressed conditions. For example, it delayed recognition of deterioration in the quality of loan originations and that resulted in the Enterprises accepting large volumes of mortgages that had not been originated according to the contractual standard. Yet by concentrating loan quality reviews at the time the loan goes bad, the problems have been harder to correct and the losses have been greater than what may have occurred had the reviews been focused at the time of sale.

As the Enterprises have enforced their contractual rights through loan reviews and repurchase requests, there has been much discussion that the uncertainty with representation and warranty exposure may be affecting the willingness of lenders to extend credit.

To help give lenders more clarity, earlier this week FHFA and Fannie Mae and Freddie Mac announced that the companies are launching a new representation and warranty framework for conventional loans sold or delivered on or after January 1 of next year. This is a major step toward transitioning from the secondary mortgage market of the past to the secondary mortgage market of the future.

The objective of the new framework is to clarify lenders' repurchase exposure and liability on future deliveries. Under this framework, lenders will be relieved of certain repurchase obligations for loans that meet specific payment requirements.

For example, certain representation and warranty relief will be provided for loans with 36-months of consecutive, on-time payments. Lenders participating in streamlined refinance programs, including the HARP program, will be eligible for relief after an acceptable payment history of only 12 months following the acquisition date.

Importantly, in the new representation and warranty framework, the focus of the Enterprises' quality control reviews will be shifted earlier in the loan process, generally between 30 to 120 days after loan purchase.

The Enterprises will establish consistent timelines for lenders to submit requested loan files for review and they will evaluate loans to ensure a focus on identifying significant deficiencies. They will leverage data from the tools they currently use to enable earlier identification of potentially defective loans. And they will make available a more transparent appeals process for lenders to appeal repurchase requests.

Ultimately, better quality loan originations and underwriting, along with consistent quality control, will help to maintain liquidity in the mortgage market while protecting the Enterprises from loans not underwritten according to prescribed standards.

With better data and improved loan quality, we are providing a framework that will give lenders a higher degree of certainty and clarity around repurchase exposure as well as consistency around repurchase timelines and remedies. This is an important step in improving upon past business practices. But it is only a first step. As the Enterprises and market participants gain experience with this new framework, and as technology and automated processes develop, we expect additional improvements in this area.

In the end, focusing loan quality reviews on the time loans are originated and sold into the secondary market will improve market efficiency and safety and soundness. It will also provide greater certainty for borrowers, lenders, and investors that loans are being originated according to prescribed standards and that remedial actions are implemented timely when deviations from those standards emerge.

Strategic Plan

Finally, we are looking at long-term improvements to the functioning of the country's housing finance system.

We at FHFA have formalized our thinking along these lines by issuing a Strategic Plan for the Enterprise Conservatorships in February of this year.

The Strategic Plan sets forth a series of initiatives and strategies that will improve current mortgage processes, inspire greater confidence among prospective market participants, and set the stage for an improved future system of housing finance.

The plan identifies three strategic goals for the next phase of Fannie Mae and Freddie Mac conservatorships:

- **First is Build** – build a new infrastructure for the secondary mortgage market;
- **Second is Contract --** gradually contract the Enterprises' dominant presence in the marketplace while simplifying and shrinking their operations; and
- **Third Maintain --** maintain foreclosure prevention activities and credit availability for both new and refinanced mortgages.

The Strategic Plan sets forth objectives that are consistent with FHFA's legal mandate and the policy direction that has emerged from the Administration and Congress.

Given that the document is a Strategic Plan and not a step-by-step guide, I want to mention some of the specific actions FHFA is taking to implement the plan. In particular, I want to focus on a couple of steps we are taking toward building a secondary mortgage market infrastructure.

A cornerstone of what we are seeking to build is a new securitization platform that could serve both Fannie and Freddie while in conservatorship -- and potentially serve the secondary mortgage market in a post-conservatorship world that has multiple issuers of mortgage-backed securities. In addition to the securitization platform, the new infrastructure would provide new standards for a variety of contractual agreements, rules and regulations of which the pooling and servicing agreement is a cornerstone.

In the Strategic Plan, we said that FHFA would determine how the Enterprises can work together to build a common platform to replace their current systems. This analysis is well under way, as is analysis of a proposed model pooling and servicing agreement.

Now, given that the securitization infrastructure could serve as a utility that would outlast Fannie and Freddie as we know them, we are committed to seeking input from all market stakeholders. Consistent with this commitment, FHFA anticipates issuing in October a white paper on a new securitization infrastructure for public comment.

The Enterprises are working together with FHFA to develop this new infrastructure and identify issues that would benefit from such public input. However, we anticipate the actual building of the securitization platform to be a multi-year effort.

There may be some confusion between the securitization platform and the establishment of a single Enterprise security. Enterprise security performance has been a long standing issue in the market and the establishment of the conservatorships has affected this issue in various ways. Our immediate priority is a single, common platform not a single security.

I want to be clear about our Strategic Plan's vision for the future. I strongly believe in the value and importance of competitive markets. A common securitization platform may one day operate as a public utility that enhances liquidity, standardization, and transparency, which should promote a more competitive market. In our view, whatever the structure of the secondary mortgage market of the future, certain key functions will need to be performed. And in many cases, like developing data reporting standards, the standardization of such functions will benefit the overall market.

As part of my belief in competitive markets, I believe in the value of having numerous lenders competing in the mortgage market, including credit unions. As we build towards the future housing finance system, I am very mindful of building systems, like the securitization platform, and standards for the secondary mortgage market that are accessible to small, mid-size, and large lenders alike.

As we prepare to transition to a new secondary mortgage market that will operate in a post-conservatorship world, we anticipate that Fannie and Freddie will maintain its own distinct securitization operations and continue to issue their own securities. And while Fannie Mae and Freddie Mac continue their respective corporate activities while in conservatorship, as Conservator, FHFA is thinking ahead to a secondary market with multiple firms competing to bring the capacity of global capital markets to finance individual mortgages around the country.

Conclusion

In the four years since FHFA established the conservatorships of Fannie Mae and Freddie Mac, we have made significant strides towards maintaining a functioning mortgage market, keeping borrowers in their homes, and remediating the problems that led to the Enterprises being placed in conservatorship.

But there is still so much to be done. Today, the government touches more than 9 out of every 10 mortgages. In practical terms, this means that taxpayers are accountable for 90 percent of mortgages in this country. It is imperative that we work to transition the mortgage market to a more secure and sustainable and competitive model.

The conservatorships were never intended to be a long-term solution. Coming as they did just two months before our last presidential election, the conservatorships 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.

It is vital to the long-term health of our country's housing and financial markets that Congress and the Administration seek to bring the conservatorships to a conclusion and to define the government’s role and requirements for housing finance in the future.

Thank you again.