Statement of

Edward J. DeMarco
Acting Director
Federal Housing Finance Agency

Before the U.S. House of Representatives

Subcommittee on Capital Markets, Insurance, and

Government-Sponsored Enterprises

"Legislative Proposals: Overhaul of Housing-Related Government Sponsored Enterprises"

March 31, 2011

Statement of Edward J. DeMarco
Acting Director

Federal Housing Finance Agency

Before the U.S. House of Representatives

Subcommittee on Capital Markets, Insurance, and

Government-Sponsored Enterprises

March 31, 2011

Chairman Garrett, Ranking Member Waters and members of the Subcommittee, thank you for inviting me to speak this morning on the Federal Housing Finance Agency's (FHFA) role as conservator of Fannie Mae and Freddie Mac (the Enterprises) and on proposals regarding the future of the Enterprises.

It is critically important that Congress and the Administration begin the work to define the long-term structure of housing finance. While substantive disagreements about the features of that structure exist, there is near universal agreement that we should not follow the old paradigm. We appreciate the efforts that the Subcommittee has taken to start this process.

In my testimony today I will address three broad topics. First, I will review the current performance and financial condition of the Enterprises. Second, I will describe how FHFA is carrying out its conservatorship and oversight responsibilities while Congress and the Administration consider the future of housing finance. Finally, as requested I will share some of FHFA's views on certain current proposals to limit the Enterprises' role in housing and ultimately unwind or transform them from their current situation.

Current Financial Performance and Condition

The Enterprises' financial results in 2010 were much better than in recent years, which resulted in smaller draws from the Treasury under the Senior Preferred Stock Purchase Agreements (PSPAs) with the Enterprises. In part, these results reflected much-improved underwriting on their post-conservatorship books of business. Still, the Enterprises had substantial losses for the year as they continued to experience credit losses associated with mortgages originated principally between 2005 and 2008.

Mortgage Market Presence

The Enterprises continued to provide the vast majority of liquidity to the residential housing market in 2010, guaranteeing 70 percent of single-family mortgage-backed securities issued. Mortgage origination for home purchases and refinances dropped 13 percent in 2010 from 2009, but refinance activity picked up in fourth quarter 2010 as mortgage rates remained near historic lows.

Credit Quality

During conservatorship, the Enterprises have improved the quality of new mortgages purchased. In addition to purchasing very few non-traditional mortgages in 2010, underwriting standards continued to remain strong. In 2010, the average borrower credit score using the Fair Isaac (FICO) credit score was over 750, and the average loan-to-value ratio was below 70 percent. Serious delinquency rates on the overall credit book declined during the year after peaking at the end of the first quarter of 2010.

Loss Mitigation Activity

Loss mitigation activities increased substantially in 2010. Since the fourth quarter of 2008, the first full quarter in which the Enterprises were in conservatorship, completed loss mitigation actions by the Enterprises totaled nearly 1.5 million. The majority of those actions, nearly 950,000**,** were completed in 2010. Loan modifications accounted for the majority of loss mitigation actions in 2010, more than tripling from the level in 2009 to 575,000 modifications in 2010.

Retained Portfolio

As of year-end 2010, mortgage investment assets of the Enterprises remained below the limit of $810 billion set by the PSPAs. Fannie Mae’s mortgage investment assets increased from $773 billion at the end of 2009 to $789 billion at the end of 2010. For Freddie Mac, mortgage investments declined from $755 billion to $697 billion. Importantly, nearly all of the mortgages added to the Enterprises' investment portfolios were delinquent mortgages removed from mortgage-backed securities pools guaranteed by the Enterprises. Early in 2010 both Enterprises changed their practice with regard to removing delinquent mortgages from pools so that such loans are removed once they are 4 months delinquent. This approach reduces the Enterprises' costs associated with delinquent mortgages and is also consistent with their efforts to modify or otherwise mitigate losses associated with these loans.

Capital

Combined Treasury support through draws under the PSPAs declined in 2010 to $28.0 billion from $66.1 billion in 2009 as a result of a decline in losses at the Enterprises. The Enterprises' single-family credit guarantee business continued to be the largest contributor to the charges against their capital and the corollary need to draw on the Treasury. Investments segment results were positive in 2010, partially offsetting single-family segment performance. The single-family segment accounted for $181 billion, or 78 percent of combined charges against capital of $232 billion since the end of 2007.

FHFA as Conservator

I would like to turn now to a discussion of FHFA's current activities as conservator. Until a new system of mortgage finance is established in the United States, mortgage finance is centered on Fannie Mae and Freddie Mac. I would like to describe some of the steps FHFA is taking to meet its statutory mission as conservator to preserve and conserve the Enterprises' assets while ensuring the Enterprises continue to meet their statutory mandate to support a stable and liquid secondary mortgage market.

The Housing and Economic Recovery Act of 2008 (HERA), which created FHFA, specified two conservator powers, stating that the Agency may "take such action as may be:

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

(ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity." (Section 1367(b)(2)(D) as amended, of the Federal Housing Enterprises Financial Safety and Soundness Act)

From the outset, FHFA stated that the goals of the conservatorships were to help restore confidence in the companies, enhance their capacity to fulfill their mission, and mitigate the systemic risk that contributed directly to instability in financial markets. Because the private mortgage securitization market had already vanished by this time and there were no other effective secondary market mechanisms in place, the Enterprises continued operations were necessary for continued liquidity in the secondary market and for mortgage originations to continue.

Today, FHFA is balancing three responsibilities: preserve and conserve assets, ensure market stability and liquidity, and prepare the Enterprises for an uncertain future. While the long-term course of housing finance is being debated and ultimately determined, FHFA meets these responsibilities by overseeing the Enterprises management of, and limiting the costs to taxpayers from, the Enterprises' $5.5 trillion position in the market. I would like to describe now how FHFA is balancing these responsibilities. I will begin with a broad view of operational priorities focused on the near-term and then consider what it means to conserve and preserve assets over a conservatorship period of uncertain length, which may have a long run still ahead. I will then describe the risks we must manage and the risk management approach we are employing.

FHFA has already taken important steps to accomplish the goals of conservatorship. For example, it is important to keep the Enterprises focused on their existing core business, not venturing into new products or lines of business. This approach ensures ongoing liquidity in the mortgage market, preserves the Enterprises' core business processes, and generates earnings, thereby benefiting taxpayers.

We are looking beyond just a holding pattern, though. Where appropriate and feasible, we are working with the Enterprises to make long-term improvements to the functioning of the housing finance system, improvements that should bring dividends down the road irrespective of the ultimate outcome of housing finance reform. We have announced two such initiatives, each of which is now well underway.

The first such initiative was announced last May when FHFA directed the Enterprises to develop uniform standards for data reporting on mortgage loans and appraisals. This Uniform Mortgage Data Program is designed to improve the consistency, quality, and uniformity of data that are collected at the front end of the mortgage process. By identifying potential defects at the front end of the mortgage process, the Enterprises will improve the quality of mortgage purchases, which should reduce repurchase risk for originators. This initiative will be phased in over the course of this year and next.

Developing standard terms, definitions, and industry standard data reporting protocols will also decrease costs for originators and appraisers. It will allow new entrants to use industry standards rather than having to develop their own proprietary data systems to compete with other proprietary data systems already in the market. The credit and pricing decisions Fannie Mae, Freddie Mac, or any future secondary market firm make based on the data, of course, will be where market participants compete. Proprietary reviews of appraisal and loan information will depend on each firm's own unique business models and policies. But common data definitions, electronic data capture, and standardized data protocols will improve efficiency, lower costs and enhance risk monitoring.

The second initiative started at the beginning of this year, when FHFA announced the Joint Servicing Compensation Initiative. On January 18th, 2011, FHFA directed Fannie Mae and Freddie Mac, in coordination with FHFA and HUD, to consider alternatives for future mortgage servicing compensation for their single-family mortgage loans. The goals of the joint initiative are to improve service for borrowers, reduce financial risk to servicers, and provide flexibility for guarantors to better manage non-performing loans, while promoting continued liquidity in the To Be Announced mortgage securities market.

As conservator, I have appeared before this Committee several times and have reported on FHFA's approach to meeting its statutory obligation to preserve and conserve assets and property. As the Committee begins to consider particular legislative next steps, it may help for me to review in more specific detail what are we preserving and conserving, why, and for whose benefit. In considering these questions, it is useful to think about the Enterprises' assets and property as having four broad categories:

- The legacy, pre-conservatorship book of business, including investments, mortgages owned and mortgages guaranteed;
- The post-conservatorship book of new business;
- The business platforms, operations, and processes; and
- The people who work at the Enterprises – the human capital that run the business, manage the risk, and support the operations.

The first two categories define the tangible assets that exist today and the latter two define the intangible assets that support the tangible assets and also create opportunities for undertaking profitable business tomorrow.

Given the structure of the Treasury PSPAs with the Enterprises, the entity with the greatest economic interest in the Enterprises today is the taxpayer. Thus, we are preserving and conserving the assets principally for taxpayers so that they may realize the greatest possible return from these assets, whatever the final form of the companies' transformation ends up being. We do this with a clear expectation that at some time in the future Fannie Mae and Freddie Mac, as we have known them, will no longer exist. But we do not know when, or in what fashion, this will happen. Each company, in whole or in pieces, may be transformed in some fashion so that taxpayers realize value from this investment in the way lawmakers determine is in the country's best interest.

What we do know is that the single-family mortgage market in the United States is more than a $10 trillion market. The nation's housing finance structure depends on institutions capable of absorbing the flows that a market of that magnitude generates. The coming debate will be about what those institutional arrangements look like, what degree of government support or subsidy will be involved, and what degree and role of government oversight is desired.

Turning to the “why” question – why preserve and conserve these assets – I offer this: to protect taxpayers from further losses, to ensure market stability and liquidity, to give lawmakers options for the future, and to protect the future value of the Enterprises’ intangible assets for future utilization and value recognition for the benefit of taxpayers and markets. Even though we do not know the future of the companies, it makes no sense to diminish, denigrate, or erode their tangible or intangible assets. As conservator, we oversee these assets so that value may be returned to taxpayers from them in a manner to be determined by financial market developments and the decisions of lawmakers.

Finally, let me turn to risk management issues in conservatorship. The risks and challenges associated with each of the four categories of assets are unique, so I will take them one at a time.

First, for the legacy book of business – the mortgages acquired or guaranteed pre-conservatorship – the key risk is further credit losses from delinquent mortgages. FHFA and the Enterprises’ boards of directors, senior management teams, and staff are focused on effective loss mitigation strategies to avoid foreclosure where practical and to minimize further credit losses through loan modifications and other loss mitigation strategies.

Second, for the post-conservatorship book of business, the key risk management challenge is establishing appropriate underwriting standards and risk-based pricing. Since conservatorship, underwriting standards have been strengthened and several price increases have been initiated to better align pricing with risk. FHFA will continue seek more progress in these areas, but pacing changes in underwriting standards and pricing will be a challenge. Because government-supported mortgage activity constitutes nearly the entire mortgage market today, we will need to balance contraction of Enterprise business with what we trust will be a growing capacity of private firms to step in. Having better data and an improved mortgage servicer compensation model, such as we are seeking through the initiatives I mentioned earlier, are also important steps in support of improved risk management of future business.

Third, the Enterprises' business platforms, operations, and processes, present multiple risk management challenges. FHFA and others have reported previously on the operational and risk management shortcomings that contributed to the Enterprises ending up in conservatorship in the first place. Both companies have been remediating those deficiencies and much progress has been made.

Beyond that, how do you build for the future when you do not control the ultimate fate of the companies? A fundamental responsibility of a corporate board is strategic planning, preparing a company for the challenges and opportunities that lie ahead, and directing corporate investments in infrastructure and operations to maximize profit opportunities. For a company in conservatorship, and unlikely to continue to exist in its current form, thinking about whether and how to invest in and develop infrastructure and operations presents unique and difficult challenges.

Standing still is not the answer, and would be inconsistent with the goals of conservatorship. In particular, the mortgages guaranteed by the companies and backed by the taxpayer are 30-year assets. We need to continue to develop and maintain the infrastructure supporting these securitizations in order to preserve and conserve the value of those securities and enhance the overall control structure. On the other hand, some long-term investments in overhauling information technology and other infrastructure may not be appropriate. Finding the right balance is a key challenge.

Finally, how does one preserve and conserve the value of a company's human capital in the face of an uncertain future? Recruiting and retaining executives and staff is one of FHFA's principal risk management challenges as conservator. The boards, senior management, and staff at each Enterprise who have remained since conservatorship, or joined one of the companies since that time, should be acknowledged for the hard work that has been and is being done to fix each company's shortcomings, to develop and execute improved loan loss mitigation strategies, and to ensure the continued functioning of the country's secondary mortgage market.

Leadership changes will continue to take place. Already in 2011 we have seen several key executive-level departures at each company. The Enterprises need to be able to continue to attract and retain executive-level talent and professional staff to navigate through this period of uncertainty. For the duration of the conservatorships, I believe the best way to protect taxpayer interests in the Enterprises is by ensuring each company has experienced, qualified people managing the day-to-day business operations. Any other approach puts at risk the management of more than $5 trillion in mortgage holdings and guarantees supported by taxpayers through the Treasury PSPAs.

Legislative Proposals

Now I would like to address some broad areas where Congress is considering changes to various portions of the Enterprises' activities and operations. The Administration also suggested changes in some of these areas. At the outset I would like to note that the ultimate resolution of the Enterprises in conservatorship awaits Congressional action. While Congress or the Administration may propose or take intermediate steps toward that end, ultimately Congress will need to define a structure and transition path for the role in housing finance the Enterprises are currently playing. Achieving that solution may take time and much debate, so considering some near-term changes may be appropriate. This is especially the case given that while the Enterprises are operating under conservatorship, they are still operating under their congressionally granted charters and other statutory provisions that generally were not designed for conservatorships of extended duration and uncertain futures. As Congress considers legislation to restrict, limit, transform and wind down the Enterprises, I respectfully ask that care be taken to provide FHFA, as conservator, with sufficient flexibility to use its best judgment to preserve and conserve the Enterprises' assets as it has done since September 2008.

As requested, I will now offer some comments on the topics covered in various specific pieces of legislation introduced by members of the Subcommittee earlier this week.

Risk Retention

Earlier this week, the federal agencies charged in the Dodd-Frank Act with implementing Section 941 of the Dodd-Frank Act issued a proposed rule on risk retention. Chairman Garrett's bill would clarify that Enterprise loan purchases and securities do not affect the underlying status of the loans for purposes of this rule. We are still studying the proposed legislation but I would like to clarify that the agencies' proposed rule does not classify Enterprise loans as qualified residential mortgages; it stipulates that Enterprise single-family mortgage securities are structured with a 100 percent risk retention by the securitizer (i.e., the Enterprise), obviously the maximum possible and far beyond the 5 percent retention required by Section 941. So, the proposed rule does not classify the loans as qualified residential mortgages (QRM), but it acknowledges that the risk retention by the Enterprises is already complete. Furthermore, since the risk retained by the Enterprises is itself backed by the Treasury through the PSPAs, not by private capital, it is unique from any other 100 percent risk retention structure that might some day exist.

If the Enterprises were subject to the risk retention requirements for non-QRM loans, they would be forced to hold on their balance sheet five percent of the securities they issue backed by non-QRM loans. To impose such a requirement would add nothing further to the Enterprises' "skin in the game" or credit risk exposure as they already have 100 percent of the credit exposure. However, such a requirement would require the Enterprises to increase their portfolios by financing five percent of their mortgage-backed securities themselves. This outcome is inconsistent with the current 10 percent per-year wind down in the retained portfolios contained in the PSPAs, and other efforts to seek faster reductions in the retained portfolios. It also is not clear how having the Enterprises meet the risk retention requirement as described above would encourage private capital to enter the market.

Reducing the Enterprises' Retained Portfolios and Limiting Debt Issuance

The risk associated with Enterprises' retained portfolios and questions about whether they served any meaningful public purpose generated a considerable amount of attention prior to enactment of HERA. However, it was not the interest rate risk associated with the retained portfolios that led to the Enterprises' financial problems, but rather credit losses associated with investments in private label mortgage backed securities and credit losses in the Enterprises' Single-Family guarantee business.

Recognizing the risk posed by the Enterprises' retained portfolios, the PSPAs contain a provision that provides for a 10 percent per-year reduction in the retained portfolio of each Enterprise. The portfolio limit under the PSPAs was $810 billion as of year-end 2010. At that time Fannie Mae's retained portfolio totaled $789 billion, and Freddie Mac's retained portfolio was $697 billion. Both companies are on track to meet or be below the $729 billion limit as of year-end 2011.

The only material additions to the retained portfolios today come from removing delinquent mortgages from the Enterprise's mortgage-backed securities. Adding these mortgages, along with the normal run-off of other mortgage investments has fundamentally changed the composition of the Enterprises' retained portfolios relative to pre-conservatorship days. In particular, the Enterprises' portfolios are no longer predominantly made up of liquid mortgage-backed securities. The majority comprises non-performing and illiquid whole loans and private-label securities. While some faster reduction of the Enterprises' retained portfolios may be possible, a Congressional mandate for a significantly faster reduction could cost taxpayers unnecessarily, as some of the illiquid assets may recover some or much of their lost value over time.

Requiring specific Treasury approval for the Enterprises to issue debt could serve as another way to reduce the Enterprises' retained portfolios. However, any potential faster reduction in the retained portfolio could be achieved in a number of ways, and it is unclear how adding an additional procedural hurdle would provide an effective mechanism. Given a choice between focusing on reducing assets through portfolio reductions on the one hand, and limiting debt issuance by adding constraints to the debt issuance process on the other, I would suggest Congress focus on asset reduction.

As I noted, the Enterprises are on track to meet or exceed the current 10 percent per-year reduction in their retained portfolios. We would be glad to work with Congress on evaluating the impact of alternative approaches to reducing the Enterprises' retained portfolios.

Limiting New Activities

FHFA is not permitting the Enterprises to offer any new products or enter new lines of business. Their operations are focused on their existing core businesses and on loss mitigation. This limitation on new business activity is consistent with the standard regulatory practice when dealing with financially troubled companies – and it is even more pertinent for the Enterprises given their uncertain future and reliance on taxpayer funds.

I understand Representative Schweikert's bill to codify this position of the agency and, in principle, I support doing that. As the Subcommittee deliberates the particulars of such a mandate, it may wish to consider whether any exceptions should be provided for products that advance other purposes of the transition. For example, if the mandate is too narrow it could preclude the development of Enterprise risk-sharing structures that could meet the goal of attracting more private capital to the market and reduce the taxpayers' exposure. Perhaps a prohibition on new products should have an exception for activities that might attract private capital inflows or otherwise promote the statutory mandate of the conservatorship. Otherwise, though, I support the concept and FHFA is already operating in a manner consistent with that approach.

Enterprise Housing Goals

The Enterprises' housing goals, and the refinements in HERA, were put in place for a different operating environment than conservatorship. The housing goals reflected, in part, an arrangement between Congress and two private companies that effectively acknowledged the unique benefits Congress had provided those companies by establishing certain housing goals to ensure those benefits were made available to the targeted parts of the market.

Working with the statutory structure that is in place today, FHFA has finalized housing goal regulations for the Enterprises that effectively require that the Enterprises' involvement in the affordable housing markets should mirror the industry's participation in those markets and not lead the market. This approach was chosen to acknowledge that the Enterprises still have a housing goal mandate, but that mandate should more closely reflect their current situation of operating in conservatorship.

Given that the housing goal structure was not designed to address the extended period of time that the Enterprises have been operating in conservatorship, eliminating the goals could be consistent with the current state of the Enterprises. Similarly, the Enterprises' duty to serve requirements that were put in place under HERA, were designed to stimulate the Enterprises to innovate and undertake other activities to address particular markets. Similar to the housing goals, eliminating the duty to serve requirements could be consistent with the realities associated with the Enterprises operating in conservatorship.

Eliminating these requirements would, at the margin, reduce operational and compliance burdens at the Enterprises and at FHFA but need not result in less attention to these market segments. The Enterprises charters require them to serve the affordable housing segments of the market and the various reporting regimes in place to monitor their activity in these segments could be retained or modified to ensure some public accountability in these areas.

Reports to Congress on Activities of Enterprises

FHFA is pleased that HERA provided an Inspector General (IG) to assist FHFA in carrying out its duties. At the most basic level, it is FHFA's responsibility to oversee the Enterprises and the Federal Home Loan Banks, and to carry out its duties as conservator of the Enterprises. It is the IG's responsibility to oversee FHFA, and evaluate and report on FHFA's activities. Establishing a requirement for the IG to submit quarterly reports to Congress during the conservatorship summarizing the activities and condition of Fannie Mae and Freddie Mac would have those responsibilities reversed. FHFA would be glad to work with the Subcommittee to establish reasonable reporting requirements as envisioned in the proposed bill. Indeed, FHFA already reports on many of the activities of the Enterprises voluntarily.

In short, FHFA supports the thrust of Representative Biggert's bill and would be glad to work with her and the Subcommittee on enhancing the reporting regime. But, FHFA believes it should be FHFA and not the FHFA-IG that carries out the reporting function. The FHFA-IG would have a proper role in overseeing FHFA's preparation and reporting in response to any such mandate.

Guarantee Fees

Since the beginning of conservatorship, FHFA has been steadily overseeing increases in guarantee fees for the Enterprises. We are required to report to Congress on the Enterprise guarantee fees and will complete our third annual report in July 2011. FHFA supports the principle advanced by both the Administration and by Representative Neugebauer that guarantee fees should continue to be gradually increased to those that best approximate what a fully private company might charge for the same risk. As described earlier, since being placed into conservatorship, the Enterprises' underwriting standards have been strengthened and several price increases have been initiated to better align pricing with risk. FHFA expects to continue to evaluate further changes along these lines, and we will continue to work with the Congress on legislative approaches for determining appropriate changes to the Enterprises' strategy for setting guarantee fees and a timing for those changes that might encourage additional private sector capital to come into the housing market.

Enterprise Employee Compensation

As I stated above, retaining human capital in the face of a very uncertain future is a difficult task and setting a compensation strategy in such an environment requires a delicate balancing act. The combined assets of the Enterprises exceed $5 trillion, and sudden changes in their compensation structure would put the management of those assets at risk and increase taxpayer exposure to greater losses. It is difficult to make compensation comparisons to government programs like the Federal Housing Administration and Ginnie Mae, as the underlying structures of those programs were designed over many years to operate with government oversight of private sector participants. This is not the case with the Enterprises where the underlying structure was developed based solely on private sector interactions between the Enterprises and their business partners.

As conservator, we have reduced the Enterprises' compensation overall. Since conservatorship, there has been a 40 percent decrease in overall executive compensation at the Enterprises. Average executive pay is at the same level it was 12 years ago. Consistent with the approach taken for Federal workers, FHFA directed each Enterprise to maintain 2011 compensation for all employees at 2010 levels. When higher compensated employees leave, the companies seek to fill those positions at lower compensation levels than paid to the departing employee, including at the executive level. FHFA is very mindful of keeping Enterprise compensation costs down, while retaining the talent to carry out the operations of the companies.

With these considerations in mind, I am concerned that legislation to overhaul the compensation levels and programs in place today with the application of a federal pay system to non-federal employees carries great risk for the conservatorships and hence the taxpayer. I understand and have sympathy for what might motivate such a proposal, but I must report to this Subcommittee my firm view that such an action would, on balance, increase costs to taxpayers and risk further disruptions in housing market.

Conclusion

Much uncertainty lies ahead for the future of our Nation's housing finance system, both in the direction that Congress will take and in the path outside the legislative arena. While a lengthy transition is probable, we are pleased that Congress is beginning to consider legislative approaches.

I would be happy to discuss any of these ideas with you and look forward to working with the Congress on any of the pending housing reform issues, including an ultimate resolution of the Enterprises. I recognize you have difficult and important decisions to make in the coming months and FHFA is glad to offer technical assistance in considering policy alternatives.