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The Conservatorships of Fannie Mae and Freddie Mac: Current and Future Operations

Introduction

Thank you for inviting me to speak here today. We just passed the third anniversary of placing Fannie Mae and Freddie Mac – or what I will refer to as the Enterprises – into conservatorship. Today I would like to review the basic guiding principles of how the conservatorships have been operated over the last three years, the challenges faced by the Federal Housing Finance Agency (FHFA) in carrying out its conservatorship responsibilities, and in light of those challenges, where we are headed with the conservatorships in the future.

The Backdrop and Framework of Conservatorship

The events taking place in the months leading into September 2008 are generally familiar by now. As market conditions deteriorated significantly, concerns about the Enterprises' credit loss exposure and capital positions became more urgent, and it became clear that neither company was able to raise additional capital. The key concern at the time was that the private secondary mortgage market had vanished and the Enterprises' significant position in capital markets meant that their disappearance from the market could have posed a systemic threat to financial markets and the broader economy.

On September 7, 2008, FHFA announced that it had placed both Enterprises into conservatorship and the Treasury Department announced it was supporting the ongoing operations of the two companies in conservatorship with a commitment of ongoing capital injections, as needed, to ensure the companies' continued solvency. Continued

solvency was an announced policy goal in order to avoid triggering mandatory receivership and it gave comfort to the companies' debt holders and mortgage-backed securities holders that the government was providing adequate financial support to those securities. Some market discipline was realized because none of the classes of equity securities were protected and senior executives, starting with the two CEOs and the two boards of directors, were replaced.

As conservator and regulator, FHFA has three principal mandates set forth in law that direct and motivate FHFA's activities and decisions involving the Enterprises.

First, FHFA has a statutory responsibility as conservator of the Enterprises to "take such action as may be: necessary to put the regulated entity in a sound and solvent condition; and appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity." As FHFA has noted on numerous occasions, with taxpayers providing the capital supporting the Enterprises' operations, this "preserve and conserve" mandate directs us to minimize losses on behalf of taxpayers.

Second, even though the Enterprises are in conservatorship, without further statutory changes they have the same mission as they did prior to being placed into conservatorship, which is broadly to support the secondary mortgage market. FHFA has a statutory responsibility to ensure the Enterprises "operate in a safe and sound manner" and that "the operations and activities of each regulated entity foster liquid, efficient, competitive, and resilient national housing finance markets." We typically refer to this requirement as "supporting a stable and liquid mortgage market."

Third, under the Emergency Economic Stabilization Act of 2008, FHFA has a statutory responsibility to "implement a plan that seeks to maximize assistance for homeowners and use its authority to encourage the servicers of the underlying mortgages, and considering net present value to the taxpayer to take advantage of … available programs to minimize foreclosures."

These three mandates form the basis for how FHFA views its responsibilities as conservator of the Enterprises. In view of the critical and substantial resource requirements of conserving assets and restoring financial health, combined with a recognition that the Enterprises operate today only with the support of taxpayers, FHFA has focused the Enterprises on their existing core business, including minimizing credit losses. This means that FHFA is not permitting the Enterprises to offer new products or enter new lines of business. Their operations are focused on their core business activities and loss mitigation. This type of limitation on new business activities is consistent with the standard regulatory approach for addressing companies that are financially troubled. And it is even more pertinent for the Enterprises given their uncertain future and reliance on taxpayer funds.

A Brief History of Priorities in the Housing Crisis

Before providing a preview of the next phase in the conservatorships of Fannie Mae and Freddie Mac, let me recap some of the highlights of the story thus far. These highlights reflect the key challenges we have faced since September 2008. While some have been resolved, others remain a dominant part of the ongoing narrative. From that backdrop, I'll try to provide a peek at what may lie ahead.

The initial phase was one of ensuring the companies opened for business on the day after being placed into conservatorship, and that the country's secondary mortgage market continued to function. In particular, policymakers wanted to ensure that the mortgage market did not seize up as a result of conservatorship and that the Enterprises continued to provide mortgage originators with a functioning, liquid secondary market outlet for new loan production. The failure of Lehman Brothers the following weekend and the resulting market turmoil is well known and need not be repeated here.

Once ongoing daily operations at the companies were assured, and market trading of their debt and mortgage-backed securities (MBS) continued to function, the next phase saw attention turn to the looming foreclosure crisis. The first wave of foreclosures was led by defaults in non-traditional mortgages, principally subprime and Alt-A loans, and the bursting of the housing bubble in certain key states such as Florida and California.

At the end of the Bush Administration and in the early days of the Obama Administration, attention focused on loan modifications as a way of stabilizing troubled borrowers' monthly payments and aiding them in avoiding foreclosure. These efforts resulted in the Home Affordable Modification Program, or HAMP. For much of 2009, the key priority was developing and then implementing HAMP; in late 2009 and into 2010, the challenge became making HAMP more operationally effective and converting borrowers from trial modifications to permanent modifications.

Both Fannie Mae and Freddie Mac implemented HAMP as the first option for troubled borrowers. The Enterprises also refined their own proprietary loan modification programs to address borrowers who are not eligible for HAMP. Separately, the Enterprises also act as agents for Treasury in implementing HAMP for non-Enterprise mortgages.

After months of effort on developing and implementing loan modifications, the HAMP program began to expand into other areas – unemployment forbearance, short sales, second liens, and ultimately principal forgiveness. But the next wave was about to hit – problems, real and perceived, in foreclosure processing suddenly dominated the headlines. The newest priority was fixing mortgage servicing, especially as it concerned responding to delinquent borrowers and processing foreclosures for borrowers unable or unwilling to avoid foreclosure through one of the several methods developed through HAMP and its derivate activities and programs.

The servicing alignment initiative is a key contribution that FHFA and the Enterprises made in response to these issues. While still in the implementation stage, I am pleased

that months of effort have finally led to a sensible set of mortgage servicing standards for working with delinquent borrowers that are designed to correct some of the deficiencies of past approaches and reflect what we have learned from this crisis.

Current priorities are focused on issues at the two ends of the foreclosure process – at one end, we are enhancing efforts to keep current borrowers from going delinquent in the first place and at the other end, we are now focusing on the challenges of disposing of the real estate owned that is left after a foreclosure.

First, let me talk about the Home Affordable Refinance Program or HARP.

Introduced in 2009, HARP provides more borrowers with an opportunity to refinance into a lower interest rate and/or more stable mortgage product, in an effort to avoid future mortgage defaults and thereby reduce credit losses for Fannie Mae and Freddie Mac (and hence taxpayers). The program covers only mortgages owned or guaranteed by Fannie Mae or Freddie Mac and originated before June 2009. To be eligible, borrowers must be current on their payments and have a current loan-to-value ratio (LTV) between 80 and 125 percent.

An essential element of this program is allowing borrowers to carry forward into the new loan any existing private mortgage insurance from the prior mortgage or, if no mortgage insurance existed, not requiring any for the refinanced mortgage.

HARP is not a mass refinancing program; it was designed to address a particular segment of borrowers with loans guaranteed by the Enterprises. The Enterprises control certain features of HARP, but they do not make loans to borrowers nor set the rates that borrowers pay. Primary mortgage market originators determine the note rate offered to borrowers, and the ultimate benefit to borrowers will also be affected by the pricing and underwriting decisions of originators.

As of June 30, more than 838,000 borrowers had refinanced through the HARP program – a meaningful number but fewer than expected or eligible for the program. In the meantime, continued declines in house prices and recent declines in mortgage interest rates to historic low levels suggest that more households could benefit from this program and, importantly, such refinances could reduce the Enterprises' credit risk.

FHFA is carefully reviewing the mechanics of the HARP program to identify possible enhancements that would reduce barriers for borrowers already otherwise eligible to refinance using HARP. If there are frictions associated with the origination of HARP loans that can be eased while still achieving the program's intent of assisting borrowers and reducing credit risk for the Enterprises, we will seek to do so. Loan level price adjustments, representations and warranties, valuation requirements, and portability of mortgage insurance coverage are among the matters being considered.

Most creditworthy borrowers outside of the HARP program parameters and with positive equity should be able to refinance their mortgage through normal market mechanisms.

Indeed, since HARP's inception the Enterprises have completed more than 1 million streamlined refinances outside of HARP and nearly 7 million standard "rate and term" refinances.

FHFA is also considering the barriers to refinancing mortgages that would otherwise be HARP-eligible but for having a current LTV above 125 percent, HARP's current ceiling. There are several challenging issues to work through here and the outcome of this review is uncertain. Still, FHFA is carefully analyzing this group of Enterprise loans for inclusion in HARP. As we do so, our objective is to achieve the original and central purpose of HARP – provide borrowers in high-LTV loans who have a history of making on-time mortgage payments with an opportunity to refinance, resulting in reduced credit risk to the Enterprises and added stability to housing.

The second area I would like to briefly discuss is the disposition of Real Estate Owned or REO. In August, FHFA, Treasury, and HUD issued a Request for Information (RFI) on ways to dispose of REO properties. While the Enterprises have considered various approaches to disposing of REO over time, the RFI represents an opportunity to consider new approaches, including possible approaches that include both the Enterprises and the Federal Housing Administration (FHA). By taking this collaborative approach, the three agencies seek ways to improve returns to taxpayers and bring greater stability to local housing markets. We have received nearly 4,000 submissions in response to the RFI. We are encouraged by the strong response and interest in this effort. Obviously it will take a little time to review so many responses but we are already hard at work doing so.

To be clear, this effort is not intended to develop a single, national program for REO disposition. Rather, we are most interested in proposals tailored to the needs and economic conditions of local communities. I am also encouraged by the apparent collaboration among for-profit and not-for-profit organizations in submitting proposals.

A Look Ahead

As I noted at the outset, we just passed the three-year anniversary of placing the Enterprises into conservatorship. In 2008, the actions taken by FHFA and the Treasury Department were characterized as a "time out" to allow policymakers to devise a new structure for our Nation's housing finance system. We all knew that reforming the housing finance system was going to be difficult, but I think the general expectation was that more progress would have been made by now.

It ought to be clear to everyone at this point, given the Enterprises' losses since being placed into conservatorship and the terms of the Treasury's financial support agreements, that the Enterprises will not be able to earn their way back to a condition that allows them to emerge from conservatorship. In any event, the model on which they were built is broken beyond repair. Conservatorship allows the Enterprises to continue serving their public purpose while lawmakers determine the ultimate resolution of the conservatorships and the future legal structure for housing finance.

Yet, after three years, there still is no clear direction as to what legal and institutional structures will replace the Enterprises and their central position in the housing finance market. This puts FHFA in a difficult position as it provides direction to the Enterprises' ongoing activities and future business strategies.

FHFA has directed the Enterprises to work on initiatives that focus on key conservatorship issues such as improving their internal operations, mitigating credit losses, and ensuring continued liquidity in the market. We have also been considering 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. To-date, we have announced four such initiatives.

We announced the first initiative in May 2010 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 rest of this year and next.

The second initiative started at the beginning of this year, when FHFA announced the Joint Servicing Compensation Initiative. 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. Part of the goal in undertaking this initiative is to consider changes to the compensation structure that would improve competition and liquidity in the market for mortgage servicing.

The third initiative we announced in late April. This one, our servicing alignment initiative, produced a single, consistent set of protocols for servicing Enterprise mortgages from the moment they first become delinquent. This initiative responds to concerns about how delinquent mortgages have been getting serviced and it will simplify the procedures for mortgages servicers by giving them just one set of procedures to follow whether the mortgage is owned by Fannie Mae or Freddie Mac. I am hopeful that these procedures gain even broader acceptance in the marketplace, beyond just servicing Enterprise loans.

Lastly, we are considering ways to enhance loan-level disclosures on Enterprise MBS, both at the time of origination and throughout a security's life. I believe that improving Enterprise MBS disclosures over time will help establish consistency and quality of such data. Moreover, it will contribute to an environment in which private capital has the information needed to efficiently measure and price mortgage credit risk, thereby facilitating the shifting of this risk away from the government and back into the private sector.

These four initiatives constitute meaningful steps to improving housing finance and preparing for the future. Still, without direction on the future of the Enterprises, as the length of the conservatorships extend, real risks exist beyond the normal business risks associated with guaranteeing new mortgages. Previously, I have characterized these risks as the problem of how to preserve and conserve the Enterprises' intangible assets – their business platforms, operations, and processes, and their human capital – while operating in conservatorship with the general policy position of the Administration and many in Congress that market reliance on the Enterprises for mortgage finance should be greatly reduced or eliminated over time.

One way to mitigate this risk is for the Enterprises' market presence to shrink, not only the size of their retained portfolio, which we are doing, but also the size of their credit guarantee book.

Another statutory goal of conservatorship is to move the Enterprises toward a sound and stable financial condition. It is important to further consider what that means. Prior to enactment of the Housing and Economic Recovery Act of 2008 (HERA), the Enterprises operated under a regulatory capital regime in which the regulator had limited capacity to set standards. This provided a regulatory capital advantage to the Enterprises over other regulated financial institutions and private market participants. It also meant the Enterprises entered the housing crisis with far less capital than needed. HERA gave FHFA the authority to establish a regulatory capital regime that addressed many of these problems, but with the Enterprises being placed into conservatorship barely a month after HERA's enactment, that regime was never put into place.

While the Enterprises are operating in conservatorship with capital provided by Treasury, capital requirements do not apply. However, the requirement to move the Enterprises to a sound and stable financial condition suggests that further consideration should be given to pricing and to other forms of risk sharing that build off of private sector disciplines and that move Enterprise operations to better reflect what might be expected of them as private companies not in conservatorship.

Let me begin with pricing.

Guarantee-Fee Pricing

Since being placed into conservatorship, as discussed in FHFA's annual reports to Congress on guarantee fee pricing, the Enterprises have steadily increased guarantee fees and lessened the degree of cross subsidization in credit pricing.

However, even with these improvements, the Enterprises' current pricing for credit guarantees is less than one would likely observe in a purely private, competitive market. Given the high degree of uncertainty in real estate and financial markets today, it appears reasonable to assume that fully private firms operating with their own capital at risk would be more likely to give greater weight to more negative scenarios or model

uncertainty than the Enterprises do operating under the umbrella of conservatorship and government capital. In addition, private firms would likely target a higher rate of return than the Enterprises, and the market would demand higher levels of capital.

Therefore, a logical next step in conservatorship is to continue down the path already started of gradually increasing guarantee fee pricing to better reflect that which would be anticipated in a private, competitive market. Two immediate words of caution are required. First, there is substantial effort long underway to bring stability to housing and housing finance, so such increases should not undermine those efforts. Second, we can model and make educated guesses about the price a purely competitive, private market would charge for a given set of mortgage credit characteristics presented by any given borrower, but we can't know this with certainty. For these reasons, it is my view that a series of periodic, gradual price increases makes more sense than one or two larger price adjustments.

So, in providing a peek ahead, I would anticipate the Enterprises will continue the gradual process of increasing guarantee fees. This will not happen immediately but should be expected in 2012, with some prior announcement as is typically done by each company. As I will now discuss, this is a bit more complicated than simply an across-the-board uniform price increase. In particular, we also will be considering a number of other changes to guarantee fee pricing that are consistent with private sector pricing discipline while mindful of the unique circumstances associated with conservatorship.

- Cross Subsidization – Through greater risk-based guarantee fee pricing, the Enterprises have reduced the degree of cross subsidization in current pricing. Nonetheless, cross subsidization still exists across product type (*e.g.*, 15 versus 30-year mortgages) and product characteristics (*e.g.*, down payment and other credit characteristics). Some of this cross subsidization was related to the government sponsored enterprise mission and business model that provided additional focus to certain targeted populations and geographic areas. However, being fully mindful of fair lending concerns, the past degree of Enterprise cross subsidization would not be present in a private sector model that did not operate benefits provided by the government.

- Geographic Pricing Differentials – The Enterprises have long operated by essentially providing credit guarantee pricing that did not take into account differences in risk across the country. While this had benefits of broadly leading to a general mortgage price across the country, it also meant the Enterprises would be absorbing but not pricing for added credit risk associated with specific local market conditions and policies. In particular, even if we put aside local economic conditions, various state and local laws can greatly impact the Enterprises' costs. For example, given the vast differences in foreclosure laws across the states, foreclosure timelines and processes vary considerably. Private sector participants in the mortgage credit risk market would likely take these factors into consideration.

- Pricing Across Lenders – The Enterprises have long charged different guarantee fees to lenders based on volume and risk characteristics. While some of these guarantee fee differentials may be warranted by risk characteristics, some of the differential is related to competition among the Enterprises to gain market share. While volume discounts and certain other pricing concessions might be appropriate in the private market that type of competition does not fit well with the Enterprises operating in conservatorship.

Risk Sharing

Another way to meet the dual goals of reducing the Enterprises' long-term risk exposure and placing them in a more stable and sound financial condition in line with private market disciplines is to consider methods of sharing risk. FHFA will be considering a number of alternatives, such as expanded use of mortgage insurance and securities structures that allow for private sector risk sharing.

A traditional way that the Enterprises shared risk with the private sector was through the use of private mortgage insurance. The law has long required that the Enterprises obtain some form of credit enhancement on mortgages with loan-to-value ratios greater than 80 percent. Most often the Enterprises meet this requirement through private mortgage insurance, and the Enterprises often require deeper mortgage insurance coverage than strictly required by law. Consideration could be given to requiring greater mortgage insurance coverage, but doing so would need to be weighed against the financial condition of individual mortgage insurers.

Another way to allow for greater private sector risk sharing is to develop security structures that allow for a portion of the credit risk currently undertaken by the Enterprises to be sold off. There are numerous securities structures that could be considered in this space, and we will be evaluating some of those in the coming months.

Considering these types of risk sharing alternatives has an added benefit of providing feedback into the Enterprises' guarantee fee pricing decisions. If the market price to absorb a portion of the Enterprises' risk exposure is greater than the charged guarantee fee, that would be a signal of how much prices would have to rise to attract private capital and move the Enterprises' guarantee fee pricing more in line with private markets.

Conclusion

Through the establishment of the conservatorships and financial support from Treasury, the goals were to provide stability to financial markets and continue to have the Enterprises support a struggling mortgage market. It was understood at the time that conservatorship was not going to be a long-term solution. It also validated the policy argument made by some over the past decades that the government sponsored enterprise (GSE) model – where private companies are provided benefits and tasked with performing a public mission – had fundamental flaws. But given the severity of the

financial problems in the fall of 2008, the speed with which those problems developed, and the difficulty with reforming the GSE model in the short-term, conservatorship was viewed as a "time out" to provide stability in the mortgage market while policymakers developed a new structure for housing finance.

I think we all realized in 2008 that developing a new structure for housing finance was not going to be an easy task. But without a new structure, FHFA is left to manage the conservatorships within the current Enterprise statutory structure and FHFA's statutory mandates.

Thank you.