THE PRESENT CONDITION AND FUTURE STATUS OF FANNIE MAE AND FREDDIE MAC

HEARING

BEFORE THE

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THE PRESENT CONDITION AND FUTURE STATUS OF FANNIE MAE AND FREDDIE MAC

Wednesday, June 3, 2009

U.S. House of Representatives,
Subcommittee on Capital Markets,
Insurance, and Government
Sponsored Enterprises,
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:07 p.m., in room 2128, Rayburn House Office Building, Hon. Paul E. Kanjorski [chairman of the subcommittee] presiding.

Members present: Representatives Kanjorski, McCarthy of New York, Baca, Miller of North Carolina, Scott, Klein, Perlmutter, Carson, Speier, Foster, Adler, Grayson, Himes; Garrett, Price, Castle, Lucas, Manzullo, Royce, Biggert, Capito, Hensarling, Barrett, Campbell, Neugebauer, McCarthy of California, Posey, and Jenkins.

Also present: Representatives Miller of California and Kaptur.

Chairman Kanjorski. The committee will come to order. This hearing of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises will be in order.

I ask unanimous consent that Ms. Kaptur have permission to participate in today's hearing.

Pursuant to a prior agreement with the ranking member, each side will have 15 minutes for opening statements today. Without objection, all members' opening statements will be made a part of the record. I yield myself such time as I may consume.

We meet today to examine the present condition and future status of Fannie Mae and Freddie Mac, which together have lost more than $150 billion since the third quarter of 2007. This hearing is not only the first hearing in the 111th Congress on the two Government-Sponsored Enterprises, but is also the first in a series that the Capital Markets Subcommittee will convene to review these matters.

Last summer, Congress completed work on an 8-year project by enacting the Federal Housing Finance Reform Act. Shortly thereafter, the new Federal Housing Finance Agency placed Fannie Mae and Freddie Mac in conservatorship.

Since then, the Treasury Department has purchased $85.9 billion in senior preferred stock at the two Enterprises. This investment could ultimately grow to as much as $200 billion per institution under current agreements.

In recent months, the Treasury Department has supported Fannie Mae and Freddie Mac in other ways as well, by purchasing $5 billion of their mortgage-backed securities in 2008, and requesting $249 billion more in 2009.

In addition, the Federal Reserve now has a sizeable interest in the success of the two companies, holding more than $71 billion of their bonds and $365 billion of their mortgage-backed securities. In total, these growing taxpayer commitments are quite sizeable, if not staggering.

They have also led many to conclude that the implicit government guarantee toward the Enterprises has now become an explicit one. Our hearing today will therefore examine the government's financial support for Fannie Mae and Freddie Mac, and explore the options for the future of their relationship with the government.

From my perspective, the emergency actions taken to date by the Federal Housing Finance Agency, the Treasury Department, and the Federal Reserve were needed to ensure the continued functioning of our Nation's housing finance system during this period of considerable economic turmoil. With all of these problems and imperfections, Fannie Mae and Freddie Mac have ensured that millions of Americans can continue to purchase and own their homes.

While the existence at this time of Fannie Mae and Freddie Mac is essential for our Nation's economic recovery, this is also an appropriate moment to begin to consider how we might modify their mission, operations, and ventures going forward.

As former Treasury Secretary Henry Paulson has observed, we need to use this period while Fannie Mae and Freddie Mac stabilize to decide what role they should play in the markets. I must, however, caution everyone that this debate will be a long-distance relay between Congresses, not a 100-meter sprint within the 111th Congress.

This debate over what roles and functions Fannie Mae and Freddie Mac should perform has, of course, raged for many years. Many good reform ideas have started to come to light in recent months, and we should study them closely.

Some of our choices include: reconstituting the Enterprises as they were before the conservatorship decision; splitting them into smaller operating companies like we did with AT&T; regulating the prices they charge, like a utility; creating cooperative, nonprofit ventures; or revolving them back into the government.

Many have also called for privatizing Fannie Mae and Freddie Mac, and there is some precedent for such actions. In the 1990's, for example, we enacted a law that allowed Sallie Mae to graduate from the school of Government-Sponsored Enterprises. While we could do the same here, we ought to move cautiously.

We created Fannie Mae and Freddie Mac because of a market failure, and we ought to ensure that any new system of housing finance continues to provide a stable source of funding and long-term credit to help people to purchase homes.

In short, we must keep our minds open to all reform proposals, and refrain from drawing lines in the sand about what each of us will or will not support until we have had the chance to consider the pros and cons of the many different options.

That being said, I will use one key factor in my examination of these choices: Namely, I want to ensure that community banks and retail credit unions continue to have access to a neutral source of affordable funding to help them compete against large institutions.

These mortgage providers are important participants in our markets, and we must ensure that they continue to have an opportunity to help hard-working families to achieve the American dream of homeownership.

In sum, this hearing is timely. Congress has a constitutional responsibility to conduct effective oversight of the work of the Federal Housing Finance Agency to make sure that it is operating as we intended. We also have an obligation to ensure that the Executive Branch is effectively allocating Federal tax dollars and helping as many people as possible to remain in their homes.

Finally, Congress needs to begin to think about how it will structure the government's relationship with Fannie Mae and Freddie Mac once we emerge from this financial crisis. I look forward to a vibrant debate on these important issues.

I recognize the gentleman from New Jersey, Mr. Garrett, for 5 minutes.

Mr. GARRETT. Thank you, Mr. Chairman. I also want to thank the chairman for your comments, saying that you are open to different ideas with regard to restructuring our mortgage finance system. I think the one agreement is that doing right and keeping the status quo is unacceptable.

You know, Fannie and Freddie played a leading role in adding fuel to the mortgage finance fire that burned down a good portion of our financial system and the economy as a whole. By financing roughly 36 percent of the subprime housing market, and increasing their leverage, they really used the governmental-granted advantages in the marketplace, and then ran up a bill to the taxpayers of $85 billion and counting.

The total bailout costs of Fannie and Freddie are expected to climb much higher. When the Housing and Economic Recovery Act was passed, an arm-twisted CBO scored the GSE titles of the bill as $25 billion, and said there was less than a 50 percent chance that a bailout authority would ever be used, and less than a 5 percent chance that the costs would ever run over $100 billion.

Now, the chairman of this committee, Chairman Frank, chastised Republicans on the Floor who said that the costs would likely go well over the CBO estimates. He said, "It is the most inflationary arithmetic I ever heard." Of higher cost estimates being used by Republicans, he stated, "These numbers that are being thrown around are simply inaccurate and misleading."

Well, speaking of inaccurate and misleading, the CBO recently updated their scores, and the cost estimates have increased by over 1,500 percent. So as we begin this month with a more formal debate over regulatory restructuring and providing the government with an explicit bailout authority, I think it is essential that any conversation begins and ends with GSEs, and any regulatory reform that does not include GSEs is not true reform.

Fannie and Freddie were a large part of the problem, and reforming them should be a large part of the solution. Also, I am very worried that proposals being discussed by the Administration and some others to create a so-called systemic risk regulator will actually create what amounts to another new set of government-sponsored entities.

By creating a new systemic risk regulator, we could essentially establish a dozen new Fannies and Freddies that will be too-big-to-fail and have the inherent market advantage that will come with that distinction. As our distinguished ranking member from Alabama points out, privatizing profits and socializing risk is a bad business model, and we should learn from our past mistakes and not repeat them.

So going forward, I do believe it is very important that we have a viable and liquid secondary mortgage market to provide additional funding so that people can experience the American dream of owning their own homes. And one tool that I believe that we can do that with—and I may have talked about it here before—is covered bonds.

You know, covered bonds are debt instruments offered by financial institutions. They are backed by a collateralized pool of mortgages. Investors purchase these bonds, and the pool of mortgages are treated as secured collateral.

Investors also continue to have a full recourse on the institution in case there is a failure. This type of securitization is widely used in Europe to provide liquidity over there, and I believe we can do it here in the United States as well.

I also want to thank Chairman Frank for his comments some time ago when he said he would hold a hearing on this important topic. And I do look forward to working with him and all my colleagues as we continue to move forward on this.

So I want to again thank the chairman, and thank the witnesses as well for coming forward. Thank you.

Chairman KANJORSKI. Thank you very much, Mr. Garrett.

We will now hear from Mr. Scott for 3 minutes.

Mr. SCOTT. Thank you, Mr. Chairman. I want to thank the chairman and the ranking member for holding this important hearing concerning the state of Fannie Mae and Freddie Mac. This continues to be of utmost concern to our economy.

The collapse of these two mortgage giants had a profound impact on our markets and total economy. And I am interested to hear more details and opinions about the risk of a prolonged economic slump, and how long the GSEs plan to proceed in the future as well as access their current conservatorship situation.

I am further interested to hear what the Federal Housing Finance Agency has to say about the future of GSEs, and what this Agency believes they should or will look like down the line, especially as mortgage markets continue to face turmoil.

There are many ideas and proposals regarding the direction that GSEs should take: making them a government entity or absorbing them into another government entity such as the FHA; splitting them up into multiple GSEs; or privatization, simply eliminating all implicit and explicit government backing for mortgage-related instruments.

The Fannie/Freddie fallout not only affected the economy overall, but it affected Main Street as well. Many of our Nation's community banks have been hard hit because they have held some 85 percent of lenders that held Fannie and Freddie stock.

Our community banks are the backbone of communities across this country. And this is especially true in my State of Georgia, as we are currently experiencing a very large number of bank closures. This whole situation is helping to reduce bank capital and impede upon the ability of banks to make new loans and renew existing ones.

And I just want to mention one particular situation that has raised big questions. When Freddie Mac ignored the two leading rating agencies, Moody's and Standard & Poor's, on rating the market's securitization in 9 months, relying instead on the market's two small agencies, Fitch and Canadian agency Dominion Bond Rating Services, that $1 million deal has led to AAA ratings. Some close to the deal claim that Moody's and S&P lost the Freddie mandate as their rating method used was considered too rigorous.

So the question that has to be answered and dealt with today is this: Is it not the role of these agencies to be more vigilant in their rating process after getting chastised by Congress and the media over the handling of AAA ratings on complex securities that began to falter when home buyers could no longer pay their mortgages?

And of course the flip side of that, is that the big credit rating agencies may be making some of these institutions jump through hoops that aren't necessary.

Serious questions, and a very timely hearing. I look forward to hearing from our witnesses. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Scott.

We will now hear from Mr. Baca for 3 minutes.

Mr. BACA. Thank you, Mr. Chairman. I appreciate you convening this hearing.

Congress established Fannie Mae during the New Deal to make homeownership more affordable. And they created Freddie Mac with a similar purpose in 1970. Neither provides home loans. Instead, their purpose is to increase the funding available for home mortgage financing, either by providing credit guarantees on mortgage-backed securities or by directing investing in mortgages and mortgage-related securities through their retained mortgage portfolios.

To further their missions, the GSEs' congressional charters granted them unique privileges, shielding them from many of the financial standards and tax burdens imposed upon their competitors. These benefits created a perception that Fannie and Freddie were backed by the U.S. Government, and this implicit guarantee also provided them a funding advantage over private sector participants.

Not surprisingly, over time, the GSEs' advantages enabled them to dominate the secondary mortgage market. Today they have more than $5 trillion in obligations outstanding, an amount that is nearly 40 percent of the size of the entire U.S. economy.

The systemic risk posed by the size of these entities was only magnified by investor perceptions that GSE securities were backed by the full faith and credit of the U.S. Government. In September, those perceptions became reality.

On September 7, 2008, shortly after Congress passed the GSE regulatory reform legislation, the Federal Government placed Fannie and Freddie into conservatorship. That rescue was one of the most extraordinary Federal interventions into the private sector, and is on track to become one of the most expensive, if not the most expensive.

As part of the GSEs' conservatorship agreement, Treasury committed up to $200 billion to purchase preferred stock from each company through December 31, 2009. In exchange, Fannie and Freddie provided the Treasury with $1 billion in senior preferred stock and warrants to acquire 80 percent of each GSE.

In addition to Treasury purchases of preferred stock, both the Treasury and the Fed are also scheduled to purchase trillions of dollars' worth of GSE debt in mortgage-backed securities. As of May 29th, Treasury has purchased $167 billion of GSE MBSs using authority granted under the HERA Act of 2008. The CBO estimates in March that the GSEs' titles will cost $384 billion. The Fed currently holds $81 billion of GSE debt, and $507 billion of agency MBS.

On March 18th, the Fed announced its purchases of agency MBSs will total $1.25 trillion by the end of the year. Finally, the Treasury has also initiated a credit facility for both GSEs to provide liquidity.

Mr. Chairman, in conclusion, the magnitude of the trillion-dollar GSE bailout demands our full engagement about the future of the GSEs. Congress must work to develop a new model for housing finance. Some, like former Treasury Secretary Hank Paulson, have endorsed a utility model. Others, myself included, have proposed shrinking and privatizing the GSEs.

Whatever the GSEs' ultimate fate, we can agree that the GSEs cannot continue as before. Socializing risk and privatizing profit, as Mr. Garrett said, must end. The American people demand an end to the bailouts. Any discussion of the long-term future of the GSEs must include a bailout exit strategy.

I would like to thank our witnesses for appearing today, and look forward to the hearing and their ideas for a transition period for the GSEs. And I yield back the balance of my time.

Chairman KANJORSKI. Thank you very much.

We will now recognize the gentleman from Illinois, Mr. Foster, for 2 minutes.

Mr. FOSTER. I would like to follow up on Ranking Member Garrett's expression of interest in covered bonds. I think we should all show some humility in our current situation and look laterally at countries that have systems that did not get into this mess.

And in particular, the American Expertise Institute has recently had some public presentations and meetings on converting the present GSE-based system and mortgage-backed security-based system to a variant of covered bonds that is known as the Danish system for mortgage origination, which I personally think has tremendous potential.

It has provided an efficient and liquid model for housing finance ever since the Great Fire of 1795 in Copenhagen, survived numerous booms and busts, and as I say, I can't see what is wrong with it.

There is a fairly worked-out scenario in these presentations for actually transitioning Fannie and Freddie into this system. And I would be very interested in pursuing this, if not in this hearing, in subsequent hearings and conversations.

Thanks you. I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Foster.

And now we will hear from the gentleman from Delaware, Mr. Castle, for 1½ minutes.

Mr. CASTLE. Thank you, Mr. Chairman, and thank you, Mr. Garrett, for holding today's hearing.

I believe debating the future of Fannie Mae and Freddie Mac is of importance as these entities have tremendous impact on our housing and finance markets. I also believe that we cannot neglect talking about the future of other elements of the housing market. While the GSEs are important, we also need to consider other aspects of housing finance and their role in the market moving forward.

The events that began unfolding last summer have led many to believe the public/private business model of Government-Sponsored Enterprises is inherently flawed. Does this model invoke moral hazard, where entities backed by the government take unnecessary risks all because they know they will be provided a lifeline if things go really bad?

On the other hand, does this argument apply to all public/private partnerships, even though some of these partnerships have worked well? Perhaps it is not necessarily the model it bought, but perhaps some of the practices adopted by the GSEs themselves that are in need of reform.

So the question is raised: What do we do with Fannie and Freddie in the future? Should they return to GSE status after we have exhausted the conservatorship role? Should they become an official government entity? Or do we privatize them and eliminate the government backing role altogether?

I am looking forward to the testimony of the panel before us to try and hash out this issue. I also hope that the experts before us today will be able to address the future of the housing and mortgage market in general, as Fannie and Freddie are simply parts of the greater debate this committee needs to address.

Thank you, and I yield back the balance of my time.

Chairman KANJORSKI. Thank you very much, Mr. Castle.

And now we will hear from the gentleman from California, Mr. Royce, for 1½ minutes.

Mr. ROYCE. Thank you, Mr. Chairman.

I think I have warned 16 times in this committee about the danger of government involvement in the market with respect to GSEs. The goal of government should be to be a regulator. What we did was we replaced political pull with market forces.

And in 2003, I introduced the first legislation to bring Fannie and Freddie under one regulator. In 2005, I got the amendment onto the House Floor, frankly, that would allow the GSEs' regulator to control for systemic risk, to actually step in—which is exactly what the regulators wanted to do. But political pull and the lobby by Fannie and Freddie prevented this from happening.

Now we have $6 trillion worth of a mortgage market out there. And basically what we did was we allowed a quasi-political Government-Sponsored Enterprise here to borrow at a much lower rate in the market. We allowed them to form a system in which they could arbitrage and in which they could build up a portfolio of $1.5 trillion.

And then forces in Congress forced the majority of that loan portfolio to be in subprime and Alt-A loans. And when we called attention to this repeatedly, we were told, there is no risk, or we are going to roll the dice on this risk.

Well, the consequences have been not only to drive up a balloon in the housing market, but with the collapse, to lose billions of dollars for stockholders; but more importantly, to lose for those who were involved in the housing market, and the side effect that this has had on housing prices in the United States.

So the observation I would make first is, I would get ahold of any member who is interested in this debate. I would get ahold of economist Thomas Sowell's new book, "The Housing Boom and Bust," and see the role that Congress played in terms of helping create this crisis. And second, I would think long and hard in the future about creating political manipulation into the market. We should be the regulators. We shouldn't be tying the hands of the regulator.

In 1989, we had, from Freddie Mac, the chairman of that organization come up here and say it would risk safety and soundness to allow these kinds of portfolios to develop. And instead, we allowed a 101 to 1—a 101 to 1 leverage out of these institutions, and the resulting collapse, and the systemic risk. And we ignored the very institutions and regulators that tried to warn us, and we tied the hands of those regulators.

That is the debate we should be having today, and we should be learning a lesson from it. I thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mr. Royce.

We will now hear from the gentlelady from West Virginia, Ms. Capito.

Mrs. CAPITO. Thank you, Mr. Chairman. I would like to thank you for holding this hearing today. It is my hope, as others have shared, that this will be the first in a series of discussions on the future of the GSEs, Fannie and Freddie.

As we are all too well aware, the long debate over whether or not the GSEs' Federal guarantee was explicit or implicit was resolved last fall; due to an overabundance of risk on their portfolios, Fannie and Freddie were placed in conservatorship by the Treasury and the Federal Housing Finance Agency.

Since then, the government has set up new management teams within the two GSEs to control day-to-day operations, but remains in tight control of other overall operations. I look forward to hearing the Director of FHFA—did I get that right?—on the current status of the GSEs, the role they continue to play in the mortgage markets, and the future of the two entities.

The current situation is not ideal, and it is my hope that we can return the GSEs to the private markets as quickly as possible. What shape or form this will take is unknown at this time, but it is clear that the previous business model was not sustainable as it allowed the GSEs to take on too much risk, leaving the taxpayers to step in when the losses became too great. There are many proposals out there for the future, and our witnesses will be elaborating upon them.

One issue that does concern me, and that I have heard from numerous constituents throughout the last several months, is the effect that adverse market fees from the GSEs are having on my constituents' abilities to purchase a home. In some cases, these additional fees are actually pricing home buyers out of the market.

I look forward to hearing the Director speak on the genesis of these fees and their effect on liquidity in the mortgage markets. I look forward to hearing from all of our witnesses today, and I want to thank the chairman for holding the hearing.

I yield back.

Chairman KANJORSKI. Thank you very much, Ms. Capito.

And now we will hear from the gentleman from Florida, Mr. Klein, for 3 minutes.

Mr. KLEIN. Thank you, Mr. Chairman. Thank you for holding this hearing, and I thank Ranking Member Garrett as well.

The current downturn has certainly showed weaknesses at Freddie and Fannie, and it is important to determine the proper structure and goals of these programs going forward. However, it is equally important to ensure that FHFA is currently doing everything possible to stabilize the mortgage market and prevent foreclosures.

I am particularly concerned about the current condition of housing markets where I come from in south Florida, particularly because of the lack of the quantity of staff at Freddie Mac and Fannie Mae servicing Florida. I have heard from plenty of loan modification specialists, law firms, and other distressed asset management in my district and throughout Florida, that are ready to assist Fannie with the vastly increased caseload of foreclosures, modifications, and refinancings, yet they are having trouble being approved by Freddie and Fannie because of red tape.

My concern is that foreclosures are occurring because there isn't enough staff to do proper loan modifications. And we also understand it is unacceptable—and we all know it is unacceptable—for families to lose their homes to foreclosure because there isn't enough staff to do proper loan modifications.

I would just like to point out, as I said, that we have had some conversations, and we certainly recommend and ask that as we work through this difficult time period, that we have the staff and support to get these modifications working through the process.

I look forward to hearing the comments and I look forward to working with all of our members and the representatives to accomplish this. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Klein.

And now we will hear from the gentleman from Texas, Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman. From my perspective as a member of this committee, and as a member of the Congressional Oversight Panel for the TARP program, I believe there are a number of "but for" causes of our economic recession.

None loom larger than the monopoly powers that were granted to Fannie and Freddie, coupled with the so-called housing mission, that essentially mandated they loan money to people to buy homes that ultimately they could not afford to stay in.

Many of you have said, though, that under H.R. 1427, passed in May of 2007, that somehow this situation has been rectified. Since that legislation has passed, the conforming loan limits have increased to $729,000, increasing taxpayer liability. The portfolio limits of the GSEs have been increased to $900 billion, more taxpayer exposure.

Their share of new mortgages have gone from 50 percent to 90 percent, more taxpayer exposure. Taxpayers have now been forced to invest almost $87 billion through the preferred stock agreements. They are exposed to up to $400 billion under those particular agreements.

The Congressional Research Service has estimated the cost of the conservatorship to be $384 billion, at a time when Americans are struggling to pay their taxes and keep their jobs.

I am glad, Mr. Chairman, that you are holding this hearing since certainly H.R. 1427 hasn't taken care of the worst of Fannie and Freddie. Ultimately, we need to see this conservatorship have a time certain to end, and transition these Enterprises back to the private market and get the hand of government out of this Enterprise that has caused this taxpayer debacle for generations to come.

Thank you, and I yield back the balance of my time.

Chairman KANJORSKI. Thank you very much, Mr. Hensarling.

Now we will hear from the second gentleman from Texas, Mr. Neugebauer, for 1½ minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. I look forward to the testimony of our witnesses today.

And I believe the task ahead for this committee and for Administrator Lockhart and his team is, number one, stop the bleeding. As obviously you are going to testify, the American taxpayers have had to put an extremely large amount of money into this entity, and it looks like we are going to have to put more.

Number two, as we go down the road, is how do we keep this from happening again? Because certainly we want to take steps in the future that do not put us back in the position that we are in now.

Number three, making sure that we develop an exit strategy that protects the money that the taxpayers have already invested in these entities.

And number four, while we are doing all of this, though, we have to ensure that there is a substitute, another entity, another way to ensure that there is not a major disruption in housing finance in this country.

If we do not have a way to transition to a housing finance source that will take up the slack—because what we are going to see is testimony that basically, the only game in town now is Freddie and Fannie and FHA—if we do not have entities in place to take up that slack, we will cause another major disruption in the housing market at a time when American families have already lost a substantial part of their equity. We do not want to be in a situation where we are creating that.

So it is easy to identify the problems that need to be addressed. Obviously, many people have reasons why we got here, but more importantly, the important question is, where do we go from here? I look forward to hearing from the witnesses today as to where do we go from here.

Thank you, and I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Neugebauer.

And now we will introduce the panel, if I may. I want to thank you for appearing before the committee today, and your written statement will be made a part of the record.

Today, the Honorable James B. Lockhart, Director of the Federal Housing Finance Agency, will present a single statement on behalf of the Agency. Also joining him at the table are two of his Deputy Directors: Mr. Edward DeMarco, Chief Operating Officer and Senior Deputy Director for Housing Mission and Goals; and Mr. Christopher Dickerson, Deputy Director for Enterprise Regulation. These two individuals have the responsibility for regulating Fannie Mae and Freddie Mac.

Mr. Lockhart, you are recognized for such time as you may consume to make your remarks.

STATEMENT OF THE HONORABLE JAMES B. LOCKHART III, DIRECTOR, FEDERAL HOUSING FINANCE AGENCY; ACCOMPANIED BY MR. EDWARD J. DeMARCO, CHIEF OPERATING OFFICER AND SENIOR DEPUTY DIRECTOR FOR HOUSING MISSION AND GOALS, FEDERAL HOUSING FINANCE AGENCY, AND MR. CHRISTOPHER DICKERSON, DEPUTY DIRECTOR FOR ENTERPRISE REGULATION, FEDERAL HOUSING FINANCE AGENCY

Mr. LOCKHART. Thank you, Mr. Chairman. Chairman Kanjorski, Ranking Member Garrett, and committee members, thank you for inviting me to speak today about Fannie Mae, Freddie Mac, their future, and Federal involvement in the housing finance system.

With almost $12 trillion in outstanding mortgage debt, housing finance is critical to the U.S. economy. As the conservator, FHFA's most important goal is to preserve the assets of Fannie Mae and Freddie Mac. That is our statutory responsibility.

As the regulator, FHFA's mission is to ensure the Enterprises provide liquidity, stability, and affordability to the mortgage market in a safe and sound manner. That is also our statutory responsibility, as it is the public purpose that Congress gave the Enterprises.

The Enterprises own or guarantee 56 percent of the single-family mortgages in this country, for a total of $5.4 trillion. Given that massive exposure, the best way to preserve their assets and fulfill their mission is to stabilize the mortgage market and strengthen their safety and soundness.

Working with the Federal Reserve, the Bush and Obama Administrations, and other regulators, that has been our top priority since the conservatorship began, and will continue to be so. Supporting mortgage modifications and refinancings for homeowners into safer mortgages are an important element of stabilizing the housing market, and thereby the U.S. economy.

The form in which Fannie Mae and Freddie Mac exit from conservatorship once the housing market is stabilized should be addressed by Congress and the Administration, and I think it is a great first step to have this hearing.

FHFA continues to classify Fannie Mae and Freddie Mac as critical supervisory concerns. As there were significant risks that they would be unable to fulfill their missions, we placed them into conservatorship last September. Since then, the Treasury Department has purchased $86 billion in their senior preferred stock.

The Enterprises' short-term financial outlook remains poor, which will result in additional requests for preferred stock investment from the Treasury Department. However, both Enterprises have stress-tested their capital or shortfalls, and expect the Treasury's commitment to fund up to $200 billion in capital for each of them to be sufficient.

The senior preferred stock purchase agreements have given investors confidence that there is an effective guarantee of GSE's obligations. In addition, the combined financial support of the Treasury Department and the Federal Reserve of over three-quarters of a trillion dollars to date for housing GSE debt and MBS have ensured they remain liquid.

Because of this support, both Enterprises have been able to maintain a critically important presence in the secondary mortgage market. Their combined share of mortgage originations in the first quarter of 2009 and also in 2008 was 73 percent. That was double the 37 percent in 2006.

While the Enterprises have continued to support the secondary mortgage market, new senior management teams have worked with FHFA to establish and implement comprehensive remediation programs. The Enterprises have made progress, but they face numerous, significant challenges to their operations. The staffs of the Enterprises and FHFA have been working hard to help to strengthen their safety and soundness.

In the current mortgage crisis, the Enterprises have focused on mortgage availability, mortgage affordability, and foreclosure prevention. Loan modifications undertaken for their own book of business are critical for eliminating their own credit losses and, even more importantly, stabilizing the mortgage market.

The Enterprises and FHFA worked closely with the Administration to develop the Making Home Affordable Program. Both Enterprises have undertaken a home affordable refinance initiative to enable homeowners who are current on their Enterprise-owned or guaranteed mortgages to refinance at lower rates. FHFA expects both modifications in the refinance program, which is expected to really ramp up rapidly by late summer.

In my written testimony, I summarize what went wrong in the housing and mortgage markets. I identified some lessons learned and raised basic questions that policymakers face at this juncture.

I will now focus on my thoughts on the potential roles for the Federal Government in the housing finance market, and some principles that I think should guide policy choices going forward.

The starting point has to be the future role of the secondary mortgage market, which connects global investors to local lenders and borrowers. Doing so helps to lower borrowing costs for home buyers, in part because large institutional investors may be better able to fund mortgages and manage the risk in those mortgage portfolios. Whatever options are chosen, the country's financial system will continue to require a vibrant secondary mortgage market, including the functions performed by the Enterprises.

There are three specific roles in the secondary mortgage market. The first role is that of a liquidity provider to the secondary mortgage market for mortgage-backed securities. The second role is that of a structurer and/or insurer of the credit risk of conventional mortgage-backed securities. Private firms are limited in their ability to ensure against catastrophic events, but government insurance comes with significant risks and moral hazards.

A third role is to alter the allocation of resources by providing subsidies to attempt to increase the supply or reduce the cost of mortgage credit to targeted borrowers. Such a role has really been central to all the housing GSEs, not just Fannie and Freddie but the Federal Home Loan Banks, which we now regulate. Unfortunately, as the present crisis shows, it has had some mixed results.

With these roles in mind, I would like to turn to what I consider are some of the basic principles you have to consider as you are looking at the future of the mortgage market and Fannie and Freddie.

The first principle is these institutions should have well-defined and internally consistent missions, missions that do not encourage excessive risk-taking.

A second principle is that there must be a much clearer demarcation of the responsive roles of the Federal Government and the private sector in the secondary mortgage market. Any Federal risk-bearing should be provided explicitly and at an actual, real cost. The old hybrid model, as many of you said, of private, for-profit ownership underwritten by an implicit Federal guarantee poses a large systemic risk to the U.S. economy, as we found out.

The third principle is to base any organization that provides mortgage guarantees or insurance on sound insurance principles. That requires strong underwriting, strong capital positions, risk-based pricing, and flexibility to react to changes in the marketplace.

The fourth principle is to create a regulatory and governance structure that ensures risk-taking is prudent. From nearly the first day on my job 3 years ago, I pointed out the folly of allowing the Enterprises to have such large portfolios, which we did cap, and also the folly of allowing them to be legally leveraged on mortgage credit by over 100 to 1. And of course many others, including many in this room, did as well. Congress did provide a strong regulatory structure of the housing GSEs as part of HERA last July. But unfortunately, it was much too late.

The fifth and final principle is that the housing finance should be subject to supervision that seeks to contain both the riskiness of individual institutions and the systemic risk associated with housing finance. The latter type of supervision would include countercyclical capital and policies that counter the private sector's tendency to generate lending booms and busts.

With those principles in mind, there are really three basic structures for the future of Fannie Mae and Freddie Mac: a government agency; a hopefully much improved GSE; and a fully privatized firm.

The first option would be the equivalent of nationalizing the Enterprises, which I am opposed to because I believe government insurance programs are particularly high risk and rife with moral hazards.

The second alternative would be to keep the Enterprises as GSEs, building upon HERA. They could be a public utility or a cooperative structure. They could continue with Treasury net worth protection or government reinsurance for catastrophic risk. But extreme care would have to be taken to prevent the inherent conflict always present in the GSE model.

A third option is to establish purely private sector firms to supply liquidity to mortgage markets with or without some form of government catastrophic reinsurance. Private firms could offer greater competition and improve operational efficiency. However, to maintain the level of liquidity the MBS market has enjoyed under Fannie Mae and Freddie Mac, a high degree of standardization and quality control across firms would be necessary.

I would like to close with a few personal thoughts. Having worked at several private sector insurance companies and having advised many others, and actually run several government insurance programs, I can tell you government insurance programs are high risk. They invite the private sector to shift risk to the government.

Among other issues, it is often difficult in a political environment to calculate or charge an actuarially fair price. It is difficult to resist pressure to broaden the mission and prevent inadequately compensated increases in risk-taking.

Nevertheless, government has an important role to play in providing certain types of insurance, especially reinsurance against catastrophic risk. But again, that insurance has to be prefunded and then actuarially sound, and that is difficult in the government.

The Enterprises and the Federal Home Loan Banks are playing a vital role in helping to stabilize housing in the economy today. Fannie Mae's and Freddie Mac's participation and leading role in the Making Home Affordable Program is extremely important in helping to stabilize the mortgage market and their own books. As Congressman Neugebauer said, that will help stop the bleeding if we can make this program work.

As markets and the Enterprises stabilize, there will be a need to address the complex issues I have outlined in this testimony. It is important to get the mortgage market model right and the restructuring of the GSEs right for the U.S. economy and also for all present and future American homeowners and renters.

I will be happy to answer any questions, as will my colleagues. Thank you.

[The prepared statement of Mr. Lockhart can be found on page 135 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Lockhart.

Mr. Lockhart, you know, part of the problem that we have, and I would probably like to clear it up very early, is we have never had a definitive set of hearings or a commission appointed to designate what the cause of the disaster, the economic crisis over the last year, year-and-a-half, has been.

And I hear many of my colleagues, as I hear other commentators throughout our economy, asserting that it was caused for several reasons, and quite extreme reasons. I never knew that CRA was so extensive within our system that they brought down the whole system, but I have heard some people make that charge.

I have also heard people make the charge that Fannie Mae and Freddie Mac brought down the system. And I guess I want to ask you the question: Is that your opinion? I can express mine, that Fannie and Freddie fell after the credit crisis occurred. And the credit crisis basically occurred more in the securitization in the private markets, particularly of subprime loans, than of Fannie and Freddie. They followed in the destruction of credit in the country.

Is that relatively true?

Mr. LOCKHART. There are many, many factors and lots of people guilty over this bubble we had in the economy and, in particular, the housing market.

There was excess liquidity. As former Secretary Paulson used to say, risk was mispriced, not only in the housing market but across financial markets and across financial institutions.

Certainly, in the housing market, underwriting standards fell dramatically and, in particular, the subprime and Alt-A market. Most of that did go into the private label securities. I have to admit that Fannie and Freddie were big buyers of those securities, but only the AAA ones. They and everybody else, including the rating agencies, did not do enough analysis on those securities.

Certainly, to keep some market share—and their market share actually dropped over about a 3-year period, from over 50 percent to about 33 percent—they did lower their standards in 2006 and 2007. They didn't lower them as far as the rest of the market, but they did lower their standards.

I do not think Fannie and Freddie were the cause. As I said, there were a lot of reasons for what happened, including the poor regulatory structure that OFHEO had. We didn't really have the powers to stop them from being 100–to–1 leveraged. We actually had an extra capital charge on them. We froze their portfolios, and still there were problems.

There were a lot of different reasons. Regulations: We were too slow to get the new legislation. The housing market bubble was caused by worldwide financial issues and not just Fannie and Freddie.

Chairman KANJORSKI. And as you know, the reform legislation, to correct your present agency and give you the powers of a world-class independent regulator, that started considerably before it actually became law. If I remember, in 2005 we put that legislation forth and it failed to get Senate confirmation, and therefore did not proceed to the President for his signature.

But after that, it was not enacted, either. And not to place blame, because I think that is the worst mistake we can make in placing blame. It was a Republican Administration, a Democratic Administration, a Republican Congress, a Democratic Congress. But so we do entertain the facts that at all times during this immediate runup to this crisis, that is the 4 or 5 years of the real estate bubble, the Senate and the House were in the control of the other party than they are now, that is, the Republican party. Is that correct?

Mr. LOCKHART. Yes, sir.

Chairman KANJORSKI. And the Presidency of the United States was in the control of a Republican. Is that correct?

Mr. LOCKHART. That is correct. And that Republican was asking for reform from almost to the day he took the job. Yes, sir.

Chairman KANJORSKI. And his party's Congress did not respond. Is that correct?

Mr. LOCKHART. As I understand the history, and I wasn't here in 2005 so you will have to bear with me, but they wanted stronger legislation than was passed.

Chairman KANJORSKI. There is no question that he wanted stronger legislation. But the people who controlled the House and the Senate were his own party. Is that correct?

Mr. LOCKHART. That is correct.

Chairman KANJORSKI. Now, I do not want to place blame.

[laughter]

Chairman KANJORSKI. I think if we could leave today's hearing—I enjoin my colleagues on the other side that they appreciate my attempts here—I think we have to finally draw the lines on finding fault. It is not going to get us anywhere.

The one thing that does disturb me, though, as we talk through that, there is a tendency to think that maybe if this had been done totally in the private market and government had not been involved.

Do you see that as a viable alternative, that we can just let Fannie Mae and Freddie Mac dry on the vine, become prunes, and forget about them and let the private market go on? Or will there be a negative impact in the United States in terms of real estate, ownership of real estate?

And so that history is correct, Fannie and Freddie were not instrumentalities forced upon the American people even though one of them was done in the depressionary times. It was to fill a void that the private market was not filling. We did not have a secondary market in real estate until government took the responsibility of establishing Fannie Mae. Is that correct?

Mr. LOCKHART. That is correct. In the recent decade, the private market through these private label securities did increase their market share pretty dramatically from Fannie and Freddie and from the FHA, for that matter.

Chairman KANJORSKI. And they did it—

Mr. LOCKHART. And unfortunately, they did it in an unregulated and an unsafe and unsound fashion.

Chairman KANJORSKI. I just want to say, they did not do it in a very superior way, did they?

Mr. LOCKHART. That is correct.

Chairman KANJORSKI. If we had to say anything in making the comparison between the government agency of creating a secondary market and Wall Street left to its own designs, Wall Street those last 2 or 3 years became an absolute disaster

Mr. LOCKHART. Right. And I think going forward we need a private sector of the market, though. There is a lot of activity going on—

Chairman KANJORSKI. Okay. We are going to try Wall Street again.

Mr. LOCKHART. A much reformed version with much more transparency and much stronger underwriting. One of the things we did in 2007 is we told Fannie and Freddie that they couldn't buy any more private label securities unless they conformed to the non-traditional mortgage guidance, the subprime guidance. Those kinds of rules have to come forward so that we do have much better transparency.

Chairman KANJORSKI. Last night, I had an interesting dinner with an interesting gentleman, and members of the committee were there—Mr. Simon, who is a financier, and quite renowned in the United States.

He made a proposal to us, and I think it merits consideration. I would like your opinion of what it roughly is. He feels that one of the major blows to the securitization market was the failure of the rating systems, the institutions that were there to rate and did in fact create all these AAA ratings that we found out much later on were nonsense.

And his suggestion and opinion was that we should take up forming a nonprofit, governmentally sponsored and supervised, super rating agency that does not make money from the issuer, but gets paid independently and separately, either through an assessment or a fee; and that it have to rate all of these bundled securities or securitized operations.

Have you given any consideration to that type of thought?

Mr. LOCKHART. There is no doubt that the rating agencies failed. If you look at the AAAs that Fannie and Freddie bought, about 60 percent of them are now junk and only 5 percent are still AAA, not on downgrade. So there is no doubt that they failed and there is no doubt that they should be reformed.

I had not really thought about that. There is somewhat of an analogy in the insurance world, where the NAIC does rate for insurance companies. Whether that works or not, I am not sure. It is something that could be considered.

More importantly, we need to reform the rating agency, and we need to get them back to rating and not consulting and getting fees for structuring bonds.

Chairman KANJORSKI. Thank you, Mr. Lockhart. I have already run over my time. And now I would like to recognize Mr. Garrett of New Jersey to proceed with his time.

Mr. GARRETT. Thank you, and I too will not try to lay blame or be partisan on any of these things. I appreciate the fact that you are just laying out the history of things, that it was—the reforms did get through the House. They were requested by—well, you were here sometimes. Other people during the Bush Administrations were here. I remember Secretary Snow was here and a number of people pushing for limitations on portfolio, and other limitations as well.

We were able to get it through the House. It did go to the Senate, and then Senator—not President—Obama, I guess, was in the Senate at that time, and not being partisan one way or the other, just saying that we just couldn't get cloture, as I recall, to be able to get that piece of legislation to the President's desk.

Had we done it at that time, perhaps we wouldn't be sitting here today looking back to say, why didn't the world-class regulator do the job? Because the world-class regulator potentially could have been doing the job.

I also find interesting your comment with regard to whether the GSEs or other Federal regulations were part and parcel of the cause of it. Just very quickly, you ran down—you said it was excess liquidity. I guess that is in part and parcel—although I am not an economist—due to the excess by the Fed on monetary policy.

You talked about lowering of underwriting standards. And I guess that is part and parcel again of the Fed and the Boston Fed and others, which instructed Wall Street to lower their underwriting standards. And also with regard to the GSEs, I appreciate your candor saying that those standards themselves were actually lowered at a period of time.

And so we can't say that this one factor was the cause of it. But certainly we can say that this one factor helped to exacerbate a problem when they bought up some of these bad securities that had bad underwriting standards.

With that all said, one of my objectives has been to try to lower the risk that the GSEs have posed to the taxpayer. Both Enterprises have a significant amount of interest rate risk due to their hedging practices, with a limited number of counterparties.

We have discussed this before, just a handful that you are able to deal with. These interest rate swaps really are basically standardized, bilateral transactions to help you manage your portfolio and hedge the risk.

Now, there are new clearinghouses that have been popping up, if you will, being established, and they have the potential to significantly reduce the counterparty risk posed to the Enterprises through these transactions if you were just to funnel them through. And of course, you know how that works.

So could you elaborate how you are working to try to reduce the risk to the taxpayer with their counterparty risk through clearinghouses like this for these swaps?

Mr. LOCKHART. Counterparty risk is a big issue in the financial markets today. There has actually, over the last year, been a concentration of counterparties as there have been mergers and acquisitions, whether it is the mortgage market, the deposit market, or other areas.

Certainly as the quality of some financial institutions has suffered, that has meant that Fannie and Freddie and many others have had to concentrate their derivatives activity. Fannie and Freddie both hold well over $1 trillion of derivatives, as do the Federal Home Loan Banks.

So one of the concerns we have about counterparty risk is what can be done about it. We have certainly talked to them, and they are looking very seriously about starting to move some of their business into clearinghouses and exchanges to diversify the risk and lower the risk.

Mr. GARRETT. The product here is basically a standard product that we are dealing with. Right?

Mr. LOCKHART. Right. Fannie and Freddie hedged the interest rate risk and the prepayment risk, basically. They used swaps to a large extent. Sometimes they used more exotic instruments, but they do a lot of interest rate swaps.

Mr. GARRETT. Is there something holding you back, then, or is there a timeline that—

Mr. LOCKHART. As you said, these are relatively new vehicles. We are looking at them. We want to make sure that they are done in a safe and sound manner.

Mr. GARRETT. On another note, with regard to the portfolio, which is one of the areas that there was a request 4 years ago to try to rein them in, what is the purpose of keeping the portfolio where it is now?

Actually, it has gone up since this whole problem began. I know it is supposed to begin to run down starting in 2010, next year. But why don't we just begin running that down right now and then just say, we are going to eliminate that?

Mr. LOCKHART. The key thing that the portfolio has been used for since the conservatorship is to support the mortgage-backed securities market. Now, obviously, the Treasury has been buying a lot. The Fed has been buying a lot. And that is extremely important to getting those mortgage rates down.

Since the conservatorship, we have seen mortgage rates drop about 150 basis points, 1½ percent, to about 5 percent from 6½ percent. And part of that has been the Treasury, the Fed, and also Fannie and Freddie buying those mortgage-backed securities.

Obviously, the Fed and Treasury have much more firepower. And at this point, the portfolios are relatively stagnant.

Mr. GARRETT. They are stagnant. But are you actually—well, they went up over the course of—

Mr. LOCKHART. They went up, and now they are coming down.

Mr. GARRETT. And so can you give us a timeline projection, then, on when they will be—

Mr. LOCKHART. Well, a lot of it will depend on what happens in the mortgage market. I mean, to be perfectly honest, what we need to do is to stabilize this mortgage market, and then we need to figure out, you know, what to do with the portfolios.

The key job, the number one job, is to stabilize the mortgage market. And that is by bringing mortgage rates down. It is by modifications. It is by refinancing.

Mr. GARRETT. And I guess that is my last question, if you will, is that your overall job—and this is one of your opening comments, is what is the job of the conservator. And you said it was to preserve the assets of the GSES. What you didn't say in any sentence or paragraph after that, and balance it against the interest to the taxpayer.

Do you see that actually—are you charged with that or you see that as part of your role?

Mr. LOCKHART. Oh, very much so. If the assets of Fannie and Freddie go down, that means more money from the taxpayer.

Mr. GARRETT. Absolutely.

Mr. LOCKHART. So part of the job is to try to, over time, limit the draws from the Treasury Department. In my view, the best way to do that again is to stabilize the mortgage market through modifications and refinancings.

Mr. GARRETT. Yes. And we have had correspondence in the past with regard to the last point, and that is as far as the statutory authority to the GSEs to enter into these modifications. Some outside experts have said that there is not that statutory authority to enter those modifications, and in fact that doesn't actually inure to the benefit to the taxpayer as well as a side issue as well.

I just want to comment on your statutory authority to engage in what—

Mr. LOCKHART. Right. You are asking about the modifications that are higher than an 80 percent loan-to-value.

Mr. GARRETT. Right. Right.

Mr. LOCKHART. Our view is that these are the risks that they are already holding. They already hold these mortgages. And by lowering the payment through a refinancing, they are lowering their risk and therefore helping the taxpayer, potentially, going forward.

The guarantee fees on these new mortgages tend to be higher than the ones they are replacing. So it is really a benefit to the third party.

Mr. GARRETT. My understanding is that Fannie Mae's financial statement indicated that would actually increase risk for the GSE.

Mr. LOCKHART. Not on refinancings. I think what they may have said is that modifications could potentially have the impact of increasing short-term losses. But my view is, over the long term, they will be a benefit to the GSEs and to the taxpayers.

Mr. GARRETT. What is your foreclosure rate now?

Mr. LOCKHART. The foreclosure rate is relatively low at Fannie and Freddie at the moment. We are talking about 100,000 properties.

Mr. GARRETT. That is on everything. I am just talking about what we are talking about here, on the refinance side.

Mr. LOCKHART. On the refinance side it is too early for these new refinancings to—

Mr. GARRETT. Oh, really?

Mr. LOCKHART. They haven't missed a payment let alone re-default. Yes.

Mr. GARRETT. So the figure that I was, I guess, thinking about, the 70 percent figure, that is—

Mr. LOCKHART. If you are talking about the historical redefault rate at Fannie and Freddie—

Mr. GARRETT. Yes.

Mr. LOCKHART. —it has actually been relatively low, around 30 percent. But in the last year, it has been raising quite rapidly with the downturn in the economy.

Mr. GARRETT. Right. But that is what we are talking about with these—with this provision, as far as the modifications.

Mr. LOCKHART. Again, these new modifications are significantly deeper than the ones even a year ago. I just saw a chart that a year ago in the first quarter, only 2 percent of the modifications had payment reductions of 20 percent. This quarter, the first quarter of this year, it was 52 percent.

The modifications have changed so dramatically over the last year that it is really hard to use those historical numbers to say that we are going to have those high redefaults.

Now, the economy still has troubles. And certainly the reasons for the default tend to be lost jobs, lower income—

Mr. GARRETT. Right.

Mr. LOCKHART. —and the things that are affected by the economy.

Mr. GARRETT. I appreciate it.

Mr. LOCKHART. Thank you.

Chairman KANJORSKI. We are in the midst of four votes right now. They should take probably 30 minutes. And we will recess until that time.

[recess]

Chairman KANJORSKI. The committee will reconvene. And we probably will get interrupted very shortly for another vote, but we are going to continue questioning while we can.

Mr. Campbell, you are recognized for 5 minutes.

Mr. CAMPBELL. Thank you, Mr. Chairman, and thank you, Director Lockhart.

There is a Bloomberg report out today about a letter from then-SEC Chairman Christopher Cox written to you, I guess, in January of this year with a number of subjects, including suggestions that perhaps Fannie and Freddie are being encouraged to make loans that might not be in the best interests of the profitability of that entity, or something.

Are you familiar with this letter?

Mr. LOCKHART. We don't comment on correspondence from Board members. I can tell you that Chairman Cox was a member of the new Board that was created out of HERA. I can also tell you that we worked closely with Chairman Cox over the 3 years that I was at OFHEO, and now FHFA, where he was very involved, actually, in the Fannie fines that we did about 3 years ago.

The issue as reported, and I will comment on the issue as reported in the Bloomberg article, and the issue, I think, if you want to sum it up, is: Does modifying mortgages and refinancing them cause damage to Fannie and Freddie? And in my view, as I think I said earlier, they sit on $5.4 trillion of mortgages. That mortgage book is so large and so important that what they can do to stabilize the market will be good.

Now, one of the problems is, from an accounting standpoint, when you modify a loan, they have to take it out of their mortgage-backed securities and they have to write it down as if it wasn't modified. There is a large deduction.

There is a short-term cost. My view is if it goes into foreclosure, the costs will be worse on that mortgage, but more importantly, it will be worse than the neighborhood and it will be worse for their $5.4 trillion book.

So the view I have had, and I share it with the management of Fannie and Freddie, is that their number one job at the moment is to help try to stabilize the mortgage market.

Mr. CAMPBELL. Even if that, maybe in the short term or whatever, is not the best thing for the financial result of Fannie and Freddie?

Mr. LOCKHART. It is really a very short-term negative on the financial result because they get to take it back in. In fact, that accounting is going to change January 1st of next year with the consolidation of all their mortgage-backed securities. It is an extremely short-term effect, and then some of that actually may be written back.

Mr. CAMPBELL. Let me ask you, Director Lockhart, if I can, could we, the members of this committee, see this letter?

Mr. LOCKHART. I don't think that is appropriate, but I will check with my lawyers.

Mr. CAMPBELL. Okay. Yes. Because I don't—Mr. Chairman—

Mr. LOCKHART. I think it was an SEC letter so it may be better to ask the SEC.

Mr. CAMPBELL. Okay. Mr. Chairman, there was a letter written from then-SEC Chairman Christopher Cox to Director Lockhart in January. And so that is something I think the committee members should be able to see.

And I will just say I would have a hard time understanding why members of the committee, given that Fannie and Freddie are under receivership—

Mr. LOCKHART. Conservatorship.

Mr. CAMPBELL. Conservatorship, sorry; you are correct, my bad—would not be allowed to see this letter. But I would hope that the chairman and the committee would support that position.

Mr. LOCKHART. I can tell you this letter has been discussed at the first meeting of the new Board, as the new Secretaries came in. We have gone through the contents, and we are continuing to look at those issues. And we will continue to work through those issues.

It is an advisory board and they have been very helpful. I think it is very useful to have that kind of dialogue. But I think to the extent that dialogue gets out into the public, it is not as helpful and we may not have as much dialogue in the future.

Chairman KANJORSKI. It is a very confidential letter. The only people that I know who have it are the press.

[laughter]

Mr. CAMPBELL. I guess that probably makes my point for me. Thank you, Mr. Chairman. I think since we have an oversight responsibility, we should be seeing that letter.

But another question is that I believe the SEC—I think your belief, sir, is that we have about $150 billion in risky—Fannie and Freddie have about $150 billion in risky outstanding mortgages. But the SEC believes that it is closer to $1.7 trillion.

How do you reconcile that difference, or why do they feel it is so dramatically higher than, I believe, if I have the numbers right, that you believe?

Mr. LOCKHART. I don't know where the $150 billion came from. It might be that they have about $170 billion in private label securities, which are risky. There is no doubt about it.

They also have the rest of their book, which is well over $5 trillion. There are obviously higher-risk mortgages in that book. There is some subprime, not a lot, but there are Alt-A mortgages, interest-only mortgages, option ARMs and a series of other things.

Mr. CAMPBELL. That add up to about—

Mr. LOCKHART. They don't add up to $1.7 trillion. The SEC double-counted some of the mortgages. The number, I would say, is about 1.4 out of the 5.4.

Mr. CAMPBELL. Okay. I would love to ask more questions, but I believe my—well, then I will ask a question we discussed earlier.

It is my understanding that some of the early default rates, first payment default, that sort of thing, on loans made since the first of the year—so in other words, long after we knew about this crisis—at Fannie and Freddie are equivalent to some default rates that were done before all of the subprime stuff kind of became out there.

Is that true? And if so, is that part of the strategy of helping the housing market by continuing to make loans to subprime and other lower-qualified buyers and lower underwriting standards?

Mr. LOCKHART. It does no one any good and it is one of the lessons we really learned in the last 2 years. To make a loan that we think they are gong to default on, or Fannie and Freddie think they are going to default on, hurts the individual. It hurts the neighborhood. It is just terrible. It is certainly not part of the strategy to make loans that we or Fannie and Freddie think there are going to be defaults on.

Fannie and Freddie have tightened their credit standards over the last year, since the conservatorships. Frankly, they have gotten grief from many groups for doing that. I think it is appropriate. You have to take a balanced look at the credit, and it certainly does no one any good to make a loan that someone is going to default on.

Mr. CAMPBELL. Do you know what the first payment default rate is?

Mr. LOCKHART. I don't have the number in front of me. I can provide it to you. It is not only a function of the loan, but it is a function of the economy. It also, as I told you earlier, can be a function that the underwriting was poorly done. In that case, Fannie and Freddie have the right to return it to the financial institution that sold it to them.

Mr. CAMPBELL. Thank you for your forbearance there, Mr. Chairman.

Mr. GARRETT. Will the gentleman yield on that—

Mr. CAMPBELL. I am happy to yield whatever time the chairman will allow me to have.

Mr. GARRETT. Maybe, actually, it would be—along the analogy that there may be some costs involved short-term on some of the aspects of things, but in the long term, the overall goal, overarching goal, is just to stabilize the marketplace, maybe it is not a bad thing—from that analysis, it may not be a bad thing to say, we are going to underwrite loans on rates—at terms that aren't necessarily likely to get paid back because it will prop up the economy over the long term. I am just—

Mr. LOCKHART. Again, Congressman, a default doesn't help anything, and it certainly doesn't help individuals, neighborhoods, and—

Mr. CAMPBELL. Particularly a first payment default, if that information that I have is correct.

Mr. LOCKHART. Right.

Chairman KANJORSKI. We have two votes. We will take a recess that will probably consume at least 15 minutes, and then we will reconvene. The committee stands in recess.

[recess]

Chairman KANJORSKI. The subcommittee will reconvene.

We will recognize Mr. Hensarling of Texas for 5 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman.

Mr. Lockhart, in your testimony, you stated that, "As conservator, FHFA's most important goal is to preserve the assets of Fannie and Freddie. But as regulator, FHFA's mission is to ensure liquidity, stability, and affordability in the mortgage market."

It seems to me that kind of gets to the crux of the matter. How do you reconcile these two missions? How are you serving two masters?

Mr. LOCKHART. We actually reconcile it pretty easily because the safety and soundness that you left out of that statement is also important on the mission side. And certainly conserving assets is a safety and soundness principle.

What my view is, and this is critical, is that the best way to conserve assets for Fannie and Freddie is to be able to be aggressively modifying loans, refinancing loans, and ensuring the liquidity in the mortgage market. They sit on $5.4 trillion of mortgages and, if the market continues to fall, those losses will continue to mount.

The best way to conserve assets is for them to continue to fulfill their mission of providing liquidity, stability, and affordability to the housing market.

Mr. HENSARLING. Under what scenario would you recommend an alteration of the status from conservatorship to receivership? Already we are at about $85 billion of taxpayer exposure—$400 billion has been authorized. But yet Uncle Sam is 80 percent owner of the GSEs, ostensibly really on the hook for $5.3 trillion, I believe.

Is there a scenario under which you say conservatorship simply is not working?

Mr. LOCKHART. We had looked at receivership versus conservatorship last August and September as we considered what to do with Fannie and Freddie, and we weighed the pluses and minuses. It was our view that conservatorship was the better alternative for the mortgage markets and for the U.S. economy, and that is still my view. If we are going to stabilize the mortgage markets, receivership might have the wrong impact and might destabilize the markets.

At this point, we are not contemplating receivership. I really don't see the advantage of receivership versus conservatorship.

Mr. HENSARLING. Is the taxpayer on the hook for the $5.3 trillion or not?

Mr. LOCKHART. The taxpayer is on the hook for the senior preferred facility that the Treasury Department negotiated, which is $200 billion each to Fannie and Freddie.

Mr. HENSARLING. But the $5.3 trillion, the Federal Government is an 80 percent owner. Correct? Of the GSEs?

Mr. LOCKHART. The Federal Government has an 80 percent warrant. It has never exercised that warrant, but it has the right to exercise that warrant. It is a common warrant. And as you know, if you are a shareholder, you are not responsible for the debts of a company.

Mr. HENSARLING. Well, it is a very unique shareholder at the moment.

It seems to me that part of the problem that was created was the whole implicit versus explicit guarantee. And we know that one of the reasons that Fannie and Freddie seemingly are the only game in town, and their market share of new mortgages is roughly doubled, is because of that guarantee.

Is there any scenario where you would recommend that the full faith and credit of the United States be behind all $5.3 trillion of MBS?

Mr. LOCKHART. The implicit guarantee was a problem. We talked about it in this room many times, and other places, that there was no market discipline for these two companies because of that. And we didn't have the powers as others regulated to, for example, control their growth, and the market wasn't doing it, either.

My view is that there is no reason at this point to make that explicit. I think the $200 billion senior preferreds give an effective guarantee, and I think that is all that is necessary at the moment. Certainly, there are buyers of their debt and mortgage-backed securities—

Mr. HENSARLING. Don't you think the buyers of this paper think that, once again, Congress would come to the rescue and bail them out?

Mr. LOCKHART. The buyers of this paper think that there is strong support from the U.S. Treasury through the senior preferred, yes.

Mr. HENSARLING. So what is the exit strategy?

Mr. LOCKHART. The exit strategy is partially the new structure we have been talking about here today. And you can't do that, in my mind. You can't bring them out of conservatorship until the market is stabilized and you can see a profitable future.

There may be a portion, as in receivership, that gets left behind in what you might call a bad bank, if you will, that is protected by the senior preferred. And then there is a bridge to a new organization.

Mr. HENSARLING. Thank you. I see I am out of time.

Chairman KANJORSKI. The gentlelady from Illinois, Mrs. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman.

I have several questions, Director Lockhart, so if we could run through them rather quickly in my time allotted.

Mr. LOCKHART. Okay.

Mrs. BIGGERT. Number one is many consumers in my district are thinking long and hard about purchasing a condo based on all of the new GSE requirements, which are also causing strain for home builders and community bankers. You know, so many people start and then they say, well, I am just not going to go through the process when they get into that.

Could you comment on that?

Mr. LOCKHART. The GSEs have historically had standards for a new condo that 70 percent has to be pre-sold. During the period when they lowered the credit standards in many areas, they lowered the credit standard there as well. Now, they have restored that old standard.

In some markets, there is a big issue of very empty condos. Again, it doesn't make sense to make a loan that might go into default. So, they continue to work with condo developers, and to the extent that they see that it is a good project, they can bend and change those rules. But it is something that they think, from a safety and soundness standpoint, makes sense.

Mrs. BIGGERT. So it is a waiver, or just bending the rules?

Mr. LOCKHART. It would be a waiver. Bending the rules is probably not the right phrase. Basically, they look at projects, and to the extent that they see that it is a good, sound project, they will make the loans.

Mrs. BIGGERT. Thank you. And why is it that nonprofit social services in—this is in Illinois—who provide housing to very-low-income people and families with disabilities can't qualify for lower refinancing rates? You know, these are multi-family houses or homes that are now considered commercial versus home-occupied properties. And why is that designation for them?

Mr. LOCKHART. I am not sure about that. I am going to have to look into that. I really had not heard about that issue before.

Mrs. BIGGERT. Okay. Would you get back to me? Thank you. Then another Illinois issue is why is it that Fannie and Freddie still have a policy, for example—in the State of Illinois, they only permit a handful of law firms, and I think in Illinois it is two, to handle foreclosures? And this continues to bottleneck the system, it is anti-competitive and, I think, a disservice to lenders and sellers and borrowers.

Mr. LOCKHART. I am not sure about the situation in Illinois. But I know in some other States, they are trying to expand their legal representation. Historically, there weren't a lot of foreclosures. Now that we are seeing, unfortunately, a pretty rapid growth in them, they too will be looking at how to more expeditiously work through the issue.

Mrs. BIGGERT. Is that something—is there any regulation on this, or is it just—

Mr. LOCKHART. Not that I'm aware of. We will certainly go back to ask Fannie and Freddie about that issue.

Mrs. BIGGERT. Okay. Then why is it that the home valuation code of conduct has been implemented without the traditional public scrutiny and review? It seems like this new policy wasn't vetted through Congress, but only on a side deal made with the officials from the State of New York.

You know, I think it really is a dramatic policy that could severely impact many small businesses, in my district and elsewhere.

Mr. LOCKHART. The new appraisal code actually is by Fannie and Freddie and they have historically had appraisal codes. This is a strengthening of that code and it was done after a lot of comment. They received many comments from a whole series of different groups and they made significant changes in the appraisal code from what they had originally agreed to.

It is really designed not to hurt small businesses. What it is designed to do is in many ways the opposite, that is, to take pressure off appraisers to do bad appraisals or to do too high an appraisal.

There were a lot of problems that went on in the last 3 or 4 years in the housing market, and one of them was appraisal fraud. This code was designed to help reduce that. Chairman Kanjorski has obviously been working on—

Mrs. BIGGERT. Right. He is head of—yes.

Mr. LOCKHART. —a companion piece of legislation as well, and we applaud that effort. Certainly, Fannie and Freddie will comply with it.

Mrs. BIGGERT. Then just quickly, what is the compelling reason to increase consumer fees?

Mr. LOCKHART. If you are talking about the fees related to guarantee fees that Fannie and Freddie have in place, they have a 25 basis point adverse market fee that they have had for a while. They were going to raise that another 25 basis points after the conservatorship. They decided not to.

They have also done some risk-based pricing. So where they have raised fees is because the risks are higher. This is the balance of trying to conserve assets versus helping the mortgage market. There are things that have to be done there.

We have watched what they have done, and certainly we have talked to them about what they have done. We are trying—and they are very much trying—to achieve balance between safety and soundness and mission.

Mrs. BIGGERT. Well, thank you. There is no question that we need a GSE reform package. I don't know that we want to have the taxpayers eternally bailing out all of these various companies, including the mortgage giants. So thank you very much for being here.

Mr. LOCKHART. I agree with you, Congresswoman.

Chairman KANJORSKI. Thank you very much, Mrs. Biggert.

And now we will hear from Mr. Adler from New Jersey for 5 minutes.

Mr. ADLER. Thank you, Mr. Chairman.

Mr. Lockhart, I want to follow up on some questions on some of the dialogue I heard earlier. My sense is that mortgage insurers lack the capital to underwriting new mortgages. I am wondering what you suggest the FHFA could do to solve that problem for America.

Mr. LOCKHART. That is a good question. As you know, Fannie and Freddie cannot write mortgages above 80 percent loan to value so they have relied historically on mortgage insurers. In the more recent past, there was something called piggyback mortgages, but those have totally disappeared.

They have relied on mortgage insurers to make greater than 80 percent loan to value mortgages. The mortgage insurers, like many other players in the mortgage market, have suffered some very significant losses, and their capital has been depleted. And that has meant that they can do less mortgage insurance than they have in the past, and rightfully so. They have tightened their standards as a result.

And that has meant that Fannie and Freddie can make less loans in that space, which historically has been an affordable space. And we have been working with the mortgage insurers, "we" being FHFA. Fannie and Freddie have also worked with the mortgage insurers. FHFA in particular has been working with the Treasury Department, and we are looking at whether there is some mechanism under the TARP funding to help them get back into the marketplace and help bring some more liquidity to the mortgage market.

Mr. ADLER. Do you think the TARP is a proper vehicle to achieve more—

Mr. LOCKHART. It is certainly well within the philosophy of the TARP that was related to mortgages and housing as one of the key target markets for the TARP funds. We have been talking to Treasury to see how it is structured because it is different.

The TARP banks all have Federal regulators. The insurance companies, as you know, do not have Federal regulators. It was the Federal regulators that made the recommendations to the Treasury team. We are working our way through the various issues there.

Mr. ADLER. Leaving aside TARP for a second, are there other governmental solutions, congressional solutions, you would seek for us to consider that would try to right the situation?

Mr. LOCKHART. My view is that the better mechanism would be TARP. It is difficult to see, as these are State-regulated entities, what Congress could do to help.

Mr. ADLER. I think there is enormous concern that Fannie and Freddie are big, and maybe too big. There is some discussion that maybe we need to have a few smaller entities to provide the GSE service that Fannie and Freddie have traditionally provided. Do you have any view on that?

Mr. LOCKHART. I have always said that their portfolios are too big. One way to shrink them would be to shrink their portfolios over time, and that is part of the senior preferred agreement. I don't think it should be done right away. I think we need to get through this crisis first.

There are proposals on the table that say maybe there should be more GSEs or more players in the secondary mortgage market space. I think that is something that has to be looked at. I really have not formed an opinion one way or the other, but it definitely should be looked at.

Mr. ADLER. I am sure we are going to look at it. Thank you very much. I yield back the balance of my time.

Chairman KANJORSKI. Thank you very much, Mr. Adler.

And now we will hear from the gentleman from California, Mr. Royce.

Mr. ROYCE. Thank you very much, Mr. Chairman.

I think when we look at the factors that created this economic catastrophe here, I don't think anybody says there was a sole cause.

I think most economists believe that one of the major causes—besides Fannie Mae and Freddie Mac—one of the major causes was the Fed funds rate in Europe and here in the United States, the central banks setting a negative interest rate when adjusted for inflation for 4 years running. There is no way that wouldn't cause a housing bubble.

But the question about the involvement in Fannie and Freddie purchasing subprime, purchasing Alt-A loans, purchasing the instruments that otherwise would not maybe find ready buyers out there, that is unique. And that is a part of their role as Government-Sponsored Enterprises, really, that they evolved into.

And as I said, originally in 1989, they wouldn't go near a lot of these practices, and especially wouldn't go near the idea of buying these things for their own portfolio. But then that process changed, and politics took over.

What I wanted to ask about—and I will mention a couple of other factors as well.

I don't think anybody says it was solely Fannie and Freddie. But a number of economists worry about the amount of bullying of the market that went with CRA in terms of the direction of loans to be made.

There is a lot of worrying about what we placed in statute in terms of the NRSROs, in terms of the credit-rating agencies, in the way in which we replaced by statute what otherwise would have been done by market discipline.

The implication there was that because these were government-sponsored, or because the government was engaged in setting up these standards, that it removed market discipline from the equation. And that helped compound the problem. This is the root of my question, and I wanted to ask this of Mr. Lockhart and Mr. Dickerson.

I think one of the most telling statements of the GSEs' impact on the entire mortgage market came, for me, from a former Freddie Mac employee, who mentioned that the executives at the company understood that when they began purchasing junk mortgage-backed securities, as he called them, based on subprime and Alt-A mortgages, they were sending a clear message to the market that these were in fact safe investments.

In other words, if the duopoly that controls most of the market is now going out and buying this from Countrywide, it is a message to the market that these have been analyzed as safe.

As you know, prior to that, Fannie and Freddie were exclusively known for buying more conserve conforming loans. So when they began purchasing junk mortgage-backed securities, it was a clear deviation from their prior endeavors.

Do you believe the executives at Fannie and Freddie understood the message they were sending when they began to invest in junk mortgages, and especially at such a large scale?

Mr. LOCKHART. They were investing in these private label securities that had subprime, Alt-A, option ARMs, and other higher risk mortgages that were nontraditional mortgages. There is no doubt about it. They stayed in the AAA space. As it turned out, they and the rating agencies' models failed dramatically.

Yes, they probably had some endorsement factor by buying them. There is no doubt about that. Whether the management realized it or not, I cannot speak for them. I can tell you, to pick up your other point, that they did get affordable housing goals credit from HUD for buying these securities. They thought they were profitable. They were buying them because they thought they were profitable. It also did help them to get those credits.

Mr. ROYCE. I wanted to go to something that the Treasury Secretary mentioned; former Secretary Paulson actually said this. And this has to do with the three objectives that he thought we should have in terms of a reformed GSE structure. I will ask Mr. Dickerson about this, too.

These three objectives are: no ambiguity as to government backing; a clear means of managing the conflict between public support and private profit; and a strong regulatory oversight of the resulting institution, taking politics out of the regulatory oversight function, and allowing the regulators to actually do their job.

Now, going forward, do you agree that these three objectives should be achieved? And what do we risk if we fail to meet that task in the future?

Mr. LOCKHART. I definitely agree with the three objectives. I believe I incorporated them in my five principles as well. It is extremely important to get it right. The ambiguity between public and private and the ambiguity between mission and safety and soundness helped cause some of the problems we have today.

As we go forward, we are going to have to really concentrate on what I said were five principles and what he said were three, to make sure that we can recreate the secondary mortgage market in this country in a safe and sound fashion.

Chris, do you want to—

Mr. DICKERSON. Right. I would agree with that. Certainly, the need for strong regulatory oversight is going to be a need that we will need to continue, with no ambiguity as far as the private/public.

Mr. ROYCE. Thank you very much.

Chairman KANJORSKI. Mr. Manzullo, for 5 minutes, please.

Mr. MANZULLO. Thank you, Mr. Chairman.

Mr. Lockhart, I personally want to thank you for the phone conversation that we had several weeks ago concerning the home valuation code of conduct. But I am very disappointed in the answer that I got to our letter dated April 30th under your pen on May 8, 2009.

The ostensible purpose of the home valuation code of conduct, as set forth in your news release of December 23, 2008, is to improve the reliability of a home appraisal. My question to you is: If a homeowner gets an appraisal that he doesn't like, what is his remedy?

Mr. LOCKHART. If a homeowner gets an appraisal he doesn't like—

Mr. MANZULLO. That is correct. What is his remedy?

Mr. LOCKHART. His remedy is to try to get another appraisal.

Mr. MANZULLO. That is not correct. If you take a look at page—

Mr. LOCKHART. And a different lender.

Mr. MANZULLO. Well, he would be forced to go to a different lender.

Mr. LOCKHART. Yes.

Mr. MANZULLO. Well, that—

Mr. LOCKHART. The lender has the right to make the decision whether they want to make—

Mr. MANZULLO. No. I understand that. But what if the lender is open to another appraisal?

Mr. LOCKHART. What if the lender is open to another—

Mr. MANZULLO. That is correct.

Mr. LOCKHART. My view is that the lender cannot shop around for appraisals.

Mr. MANZULLO. That is not—

Mr. LOCKHART. That is one of the big problems we had in the last 2 or 3 years.

Mr. MANZULLO. Right. I understand. The other problem is this: I would refer you to page 3, no. 9. We discussed this at length on the telephone and you gave me no answers in the written inquiry:

"If an appraisal comes back that is an error, the only way that you can get another appraisal, second or subsequent appraisal, is if there is a reasonable basis to believe that the initial appraisal was flawed or tainted, and such basis is clearly and appropriately noted in the loan file; or unless such appraisal or automated valuation model is done pursuant to written, pre-established, bona fide pre- or post-funded appraisal review or quality," etc., etc.

Your inability to understand my question and the inability to answer is based upon the fact that I don't think that your organization knows anything about real estate closings.

You know, the people who came up with this rule—

Mr. LOCKHART. The people who came up with this rule are the biggest mortgage lenders in this country.

Mr. MANZULLO. Well, that is interesting.

Mr. LOCKHART. It is Fannie and Freddie that came up with the rule.

Mr. MANZULLO. I understand. I understand that. But my question—

Mr. LOCKHART. The point is that if there is a mistake, the mistake can be—

Mr. MANZULLO. Not under your rules. If you read—

Mr. LOCKHART. If there is a problem, every State has an appraiser regulatory board. They can go to that.

Mr. MANZULLO. So here we are. We are trying to close a real estate sale and there is a big problem with an appraisal. Let me give an example.

In a townhouse area that I know, end units are selling for $500,000 and inside units for $470,000. And an end unit just sold for $350,000 because the party had died and it was out-of-State heirs and they were in a hurry in order to get that sale done.

So the appraisal comes in at $350,000. And the guy who wants to sell a townhouse that is an end unit that should be selling for around $500,000, under these rules—I mean, these are your own rules here—he has to either go to another lender, which is absurd under the circumstances, or he has to show a reasonable basis to believe that the original appraisal was flawed or tainted.

I mean, your rules can purposely devalue a home that somebody is trying to sell because you have so much bureaucracy tied up in it.

Mr. LOCKHART. If the appraiser is a professional, he will have looked at the circumstances of that $350,000 sale.

Mr. MANZULLO. Ah, that is not correct. That is not correct because you may have somebody who may not know that the original owner died, and that it was a fire sale.

I mean, my whole point here is if your job is to come up with a fair appraisal, which you say to improve the reliability of home appraisals, there is no recourse in here for the homeowner. And the homeowner doesn't choose who the mortgage company will be to say, let's get another appraisal. Somehow you think that is collusion. And I think that is just a lack of foresight on the part of the people who came up with the regulations.

Mr. LOCKHART. A lot of this regulation is based on the USPAP, as you know, and that—

Mr. MANZULLO. Based on the what?

Mr. LOCKHART. The U.S. appraisal practices that have been—

Mr. MANZULLO. Well, I understand that. But that is a methodology of doing it, in fairness. But I am just talking about—it is a very simple situation that I brought up.

Mr. LOCKHART. I would be happy to see your proposal. We will certainly forward it to Fannie and Freddie.

Mr. MANZULLO. I would like you to answer my letter, number one. And number two, we asked in there the number of banks that actually own these appraisal—

Mr. LOCKHART. We tried to answer your questions in the letter. If there are some areas that you feel that we didn't—

Mr. MANZULLO. I would like to submit this under the authority of the Chair, if it is okay with Mr. Kanjorski, and force you to answer my questions. I mean, one of the basic questions in there—

Mr. LOCKHART. I think we tried to answer your questions.

Mr. MANZULLO. If I may finish.

Mr. LOCKHART. If there are some that you feel we haven't answered as well as—

Mr. MANZULLO. Well, you haven't answered. I mean, just take a look at my questions and your answers to them. One of my questions was very simple: How many banks actually own AMCs? And you said, well, we don't know. Well, would you consider—

Mr. LOCKHART. We don't know, but we will try to find out for you.

Mr. MANZULLO. Yes. Well, that is not what you told us in the letter.

Mr. LOCKHART. Well, that is what I am telling you now.

Mr. MANZULLO. Well, then, I would like—would you consider regulations forcing any bank that owns an AMC to disclose that so that you can avoid any collusion, which is the purpose of this document? Would you consider regulations to that effect?

Mr. LOCKHART. We don't have powers over banks. We only have powers over Fannie and Freddie.

Mr. MANZULLO. Oh, no. You could make the suggestion, or you could even put it into an amended rule if your whole purpose is to stop collusion. Wouldn't you agree with that?

Mr. LOCKHART. Excuse me?

Mr. MANZULLO. I mean, you could amend your rule here, couldn't you?

Mr. LOCKHART. It is Fannie and Freddie's code, not—

Mr. MANZULLO. No. I understand that. But you are the regulator for them.

Mr. LOCKHART. As I said earlier, Congressman Kanjorski is working on legislation in this area. If there is something that you feel that Fannie and Freddie did not do properly, what Fannie and Freddie were trying to do, and I think it is an extremely important role that, frankly, they didn't do as well the last two or three, is set better standards in the marketplace.

Mr. MANZULLO. No. I understand. But what—

Mr. LOCKHART. And that is what we are really trying to do here. And to the extent—

Mr. MANZULLO. But what you gave here was banks—you gave banks the sole authority to pick the appraisers. That is what you did.

Mr. LOCKHART. No. I don't think that is what we did at all.

Mr. MANZULLO. Well, that is what you did because it is the bank that chooses the appraiser either through an in-house appraisal company that the bank owns or through picking somebody else.

Mr. LOCKHART. What we tried to do is definitely separate the lending officer from the person who was choosing the appraiser.

Mr. MANZULLO. Well, that is like asking people to go to separate restrooms. I mean, that doesn't work. You know that doesn't work. I mean, if you had the opportunity to stop collusion, you would say, look, the banks cannot own these AMCs. Wouldn't you agree that would be the better way to do that?

Mr. LOCKHART. Again, it is up to the bank regulators as to the ownership of AMCs.

Mr. MANZULLO. No. I know. But you could have made that suggestion, could you not?

Mr. LOCKHART. We can make suggestions, but it wouldn't have the power of a regulation.

Mr. MANZULLO. No. I understand that. But I mean, do you understand what I am trying to get at here?

Mr. LOCKHART. I certainly understand your concern in this area, and certainly will try to respond. We will be happy to have another meeting with you to go through these issues to figure out what you think should be changed in the code that would make it more responsive to your needs.

Mr. MANZULLO. Fair enough. Thank you.

Chairman KANJORSKI. Thank you very much, Mr. Manzullo.

And if I may recognize for a motion Mr. Royce.

Mr. ROYCE. Just for a second, Mr. Chairman. I would like to introduce for the record a highly confidential restricted report from 2005 that Fannie Mae staff presented to management at that time which showed the tradeoffs between staying the course and maintaining strong credit discipline in the company versus accepting higher risk, higher volatility, and higher credit losses in order to drive up profits for their shareholders.

Chairman KANJORSKI. Without objection, it is so ordered.

And now we will recognize the gentleman from California, Mr. Miller.

Mr. MILLER OF CALIFORNIA. Thank you, Mr. Kanjorski. And I have great respect for the chairman. We just happen to disagree on this one issue, which is very unusual.

I did write you a letter, and I appreciate your response. But I have read the letter several times, and it basically boils down to one sentence, your response: "Business practices have been adjusted, and each market participant can adapt to a more responsible system that avoids coercion of appraisers and reduces the opportunity for fraud."

And I guess the problem I have with this is I know a lot of Realtors and mortgage brokers and appraisers—I have been in the real estate business since I was in my early 20's—who are really good people. And it seems like we have struck a deal here between the attorney general of New York—and perhaps fraud is prevalent in New York; I don't know—and your Office that impacts 80 percent of all the loans made in this country, period.

It didn't go through the Administrative Procedures Act or the Regulatory Flexibility Act, which I think normally it should have. And I am really bothered that we are in a very difficult real estate market—I mean, most of the people I know are somewhat involved in development or real estate; I was a real estate broker and a developer since I was in my early 20's—and everybody I know is doing pretty badly out there.

I know banks are suffering out there because they are having to foreclose homes and they are having to shove them on the marketplace, which is further declining the value of homes out there that are for sale. And I think it is problematic and ever reaching a real bottom in the market so the market can somewhat recover.

And if we are going to look and say, what can we do that really helps consumers? What can we do that is really fair to business people and everybody in a broad base? It seems like we are going in the wrong direction. This is just my opinion.

You could have a mortgage broker who has a client, and they are really trying to shop for the best loan that they possibly can. But they can't even shop for the best loan and provide an appraisal associated with it that lenders can look at, and where they can determine where they can really get the best deal for their client because now we solely have to rely on the bank to do the appraisal.

Now, when I was a developer, building subdivisions, that was very common. You would go a bank and the bank would do their appraisal on your subdivision. But a subdivision is altogether different and much more complicated than making a loan on an existing single-family home or a new home that has just been completed and you can establish some reasonable fair market value.

One has much broader pitfalls and more areas that can go wrong for a lender when you are dealing with a subdivision than when you are dealing with an individual home.

And I just—I am really concerned that—we are dealing with a very difficult marketplace. We are dealing with consumers who are having very difficult times even getting loans today, as you know. They have to have stellar credit to get a good loan, and if GSEs weren't in the market, they would be making no loans in California, to be quite honest with you, because they are the only ones really willing to lend, especially in a jumbled marketplace. Most lenders can't make a fixed 30-year loan and sit on that loan for that period of time because they don't have the liquidity to do it.

So when you have consumers out there who go to their Realtor or they go to their local mortgage broker, who is trying to package a loan for them, and go out and shop that loan in the marketplace, it seems like we are making it much more difficult and hamstringing them in more ways by saying that an agreement that perhaps works in New York—and maybe it is the best thing for the State of New York; I don't know—but I can say it doesn't seem to be the best thing for the State of California and for many other parts of this Nation, to make it much more difficult and place much more control in the hands of one bank rather than having an individual being able to shop a loan with numerous banks.

Because the problem is, if you go approach a bank with a loan, they are going to do the appraisal. You can't take that to another bank because the appraisal is propriety property of the lender.

And I don't know why we are going in this direction. So maybe you can tell me—I mean, I understand fraud. But we can deal with fraud. If you have appraisals, writing improper or fraudulent appraisals, you can hold that appraiser accountable, and it is very easy to do. That is why we have laws in this country and there are laws against that.

And it seems like we have all these laws on the books that prohibit coercion and prohibit fraud, and yet we are saying, yes, that we might have laws, but that is not good enough. We are just going to make it illegal altogether.

Could you—I mean, I would like to understand the benefit of why we are doing this.

Mr. LOCKHART. I certainly agree with you that we don't need to make life more difficult for the housing market at this point. I think you are right on there. On the other hand, we also want to make sure things are done on a safe and sound basis.

The mortgage broker can take an appraisal ordered by one bank and use it for the other banks. That is certainly—

Mr. MILLER OF CALIFORNIA. It is a propriety appraisal in many cases, where they prohibit that package from being shopped.

Mr. LOCKHART. As I understand it, the bank regulators do permit the transfer of that—

Mr. MILLER OF CALIFORNIA. Well, they permit them, but the banks donate necessarily, is the problem. They paid for the appraisal, the bank did. That is like I am not allowed to go to use—I am not trying to interrupt you. I am saying I am not allowed to go—without authorization, I am not allowed to use somebody else's appraisal because somebody paid for the work product.

Mr. LOCKHART. Yes, you will have to get another appraisal from another bank. There may be some occasions where more than one—another bank will order its own appraisal. Unfortunately, there is a little extra friction in the system that could happen.

The idea was that in too many cases, brokers were getting inflated appraisals during that period that so many things went wrong in the mortgage market. And I think it is—

Mr. MILLER OF CALIFORNIA. Well, let me back up. What went wrong in the mortgage market was GSEs did a great job of bundling mortgage-backed securities for years. They really did.

Mr. LOCKHART. Yes.

Mr. MILLER OF CALIFORNIA. And if a loan that they bundled went bad, they would replace that loan. And then a lot of these other private sector lenders said, that is a really good idea because look at all the money coming from Wall Street.

And they started making loans, just forgoing normal underwriting standards and appraisals and to see if a person had a job. I mean, we can go back to predatory versus subprime and we can really define what went wrong in this marketplace. And I can blame the lenders who made that amount of business today who made a fortune bundling mortgage-backed securities, making loans that were not even junk bond quality because they never even confirmed the person had a job.

But I don't want to go back and blame my local mortgage broker and Realtor who didn't participate in that fraudulent act and say, perhaps there are a few bad apples out there, so let's overturn the entire bucket. And I am not trying to argue with you. I just—I don't think we have thought that particular process through.

I think we are lumping—and I agree there was a lot of fraud. But I can point to a few people out there who made it, that caused a lot of this problem, that I don't need to publicly point out because a lot of them are gone today. They have been bought by other groups.

But we know who bundled these, and we know who made a fortune bundling them and who left the investors holding the bag who bought the junk. But we seem to be going after a sector of the marketplace that was not responsible for that, and drawing—I would just ask you—I am not—I am trying to be polite in this.

Mr. LOCKHART. I appreciate it.

Mr. MILLER OF CALIFORNIA. I am not trying to argue with you, and I not trying to be rude and cut you off. I have the greatest respect for Mr. Kanjorski. I really do. We just don't agree on this one issue.

I would really hope that you would just take a moment and have somebody go back and review the process that normally took place, how we would deal with this. Look at the existing laws that are on the books if modifications need to be made as far as corrupt brokers and corrupt mortgage brokers and corrupt appraisers or whatever, that we deal with that effectively without taking and turning the entire cart over.

Because an agreement between one State and your Office that perhaps—maybe there is a real problem in the State of New York. I don't know. Maybe there is a real reason why the attorney general would come to you saying, there is such rampant fraud within our housing market here that we need to turn the laws over.

Perhaps they need to shine a light on their own problem. But I think we have done it nationally and impacting 80 percent of the marketplace in a very, I think, negative way at the worst time.

And I would just ask that you please take a moment and revisit this and say, did we really do the right thing? I understand what you were trying to get at, and I applaud you for that, for getting the bad apples out of the marketplace.

But what caused us to get in this problem we are in today are not the people I believe who are being impacted by it. I am just asking you if you would take time—and Mr. Kanjorski, you have been very generous with your time on something you hate for me to talk about.

So I want to thank you for being generous and granting me more time. But we are good friends, and I have great respect for the individual. And Mr. Lockhart, I have a great respect for you, and I am asking that—and you did mention something earlier that—for years, I think we sent five bills to the Senate that were really good, fighting a strong regulator over GSEs and changing the way they could do business.

We never accomplished that, but we tried hard. And I would just ask you to please revisit with earnestness what we have done here because I think we are going at the wrong people, trying to resolve a legitimate problem.

Mr. LOCKHART. Yes. There is a legitimate problem there, and it is not just in New York State. Why the attorney general of New York got involved is all these securities, the ones you don't like—

Mr. MILLER OF CALIFORNIA. I understand that.

Mr. LOCKHART. —were sold in New York. Fannie and Freddie have put out the rule, and they are continuing to look at the impact. As they get impact back and they understand better what is happening out there, they certainly have the ability and will continue to—

Mr. MILLER OF CALIFORNIA. And you will look at this?

Mr. LOCKHART. We will look at the—I mean, we don't see it directly. We see it through—

Mr. MILLER OF CALIFORNIA. That is what I am asking. But you responded to my letter, so I am going to you. You are the one who signed it, and I want to thank you for taking the time to respond.

Mr. LOCKHART. There you go. We continue to dialogue. I have meetings now with both CEOs once a week.

Mr. MILLER OF CALIFORNIA. Good.

Mr. LOCKHART. Certainly, this issue has come up in the last month with both CEOs. And so we are continuing to dialogue as to what is happening out there in the marketplace, and we will continue to do so.

Mr. MILLER OF CALIFORNIA. And I was elected to dialogue and have my picture taken. So let's continue this dialogue. Is that fair?

Mr. LOCKHART. Yes, but the other point you have to realize, too, is that the bank regulators are also looking at this issue at this point, and are looking at potentially making changes as well.

Mr. MILLER OF CALIFORNIA. Yes. But see, I have a problem with—when you say bank regulators are looking into it, we are focusing on one sector. And I think I would like to look at all the people who are being impacted by this.

Mr. LOCKHART. Right.

Mr. MILLER OF CALIFORNIA. And I agree that bank regulators need to look at it. But if we just revisit it. And I thank you, sir, and I thank you, Mr. Chairman.

Mr. LOCKHART. Thank you.

Chairman KANJORSKI. Thank you very much, Mr. Miller.

Mr. Lockhart, I am sure we would have more questions from more members. We still have one left, the gentleman from Florida, Mr. Grayson, for 5 minutes.

Mr. GRAYSON. Thank you, Mr. Chairman.

I have here the Form 10–Q filed by Fannie Mae the month before it went broke. I actually went through it and read it myself personally, and I had some questions I want to ask you about that to try to get a sense of how this happened and what we can learn from it.

Specifically, on page 112, it says, "Risk Management Derivatives," and there is a table there, and it indicates that between December 1, 2007, and June 30, 2008, Fannie Mae increased its notional balances for derivatives by $255 billion.

Can you give me some idea of the justification for a company like Fannie Mae increasing its exposure to derivatives at seemingly the worst possible time by a quarter of a trillion dollars?

Mr. LOCKHART. Fannie and Freddie had many problems that surfaced over the last year. Certainly, in their June 10–K of last year, they mentioned many issues.

The derivatives have not been an issue that actually caused any significant problems at the two firms. The derivatives were used to hedge their mortgage portfolios.

What they do oftentimes as the market changes, is they add a derivative. Then rather than closing it out, they just buy one to counter the one that they had before. And so you get this piling up of derivatives. It is an issue that we have talked to them over the years about. Could they close these derivatives out rather than just buying a counter one?

Oftentimes, they buy it with the same counterparty, and so the actual exposure is not that large. It is an issue that we have been talking to them about before the conservatorship and after the conservatorship. As I think Congressman Garrett asked earlier, there are ways to lessen the exposure through exchanges and clearinghouses. And that is something we are looking at, at the moment.

Mr. GRAYSON. I wonder if it is really true that this had no effect on them. I mean, logically, having an exposure that as of June 30, 2008, totaled $1,141,000,000,000 is something that could conceivably have some effect on your operations, particularly since we are talking about a time just 2 months before it went broke.

Mr. LOCKHART. Right.

Mr. GRAYSON. Why would they have such an exposure like that unless it were for a purpose? And for that purpose, couldn't it easily have been something that went wrong?

The reason I am asking this question is because if you look at page 78 of this same 10–Q, what you see is that for nonperforming single family and multi-family loans together in their portfolio, which was almost a trillion dollars by itself, the amount of interest income that they lost because of nonperforming loans was only $192 million and going down—$192 million versus $255 billion—isn't it more likely that they got into trouble over the $255 billion than they did over the $197 million?

Mr. LOCKHART. I can tell you, in retrospect, they haven't lost significant money in the derivatives area. They are using derivatives to hedge their mortgage-backed exposure.

The vast majority of those losses, the over $100 billion in combined losses in the two companies, has been not on their interest rate risk and their interest rate risk management, although there has been some there. Most of it has been in credit losses. And it is credit losses related to the private label securities, and credit losses related to their books.

When we did a very extensive look at the two companies in August, we worked with the OCC and the Fed. Also, Treasury had hired an investment bank as an advisor.

As we looked through all the issues in these two companies, the derivatives was an issue but nowhere near the top. The key issues really were they had a deferred tax asset and they had credit exposures in their private label securities. The three quarterly reports since then have shown that is where the big losses were.

Mr. GRAYSON. Well, again, let's look at the information I just provided to you. If in fact the interest income that was lost—and interest income is defined in the 10–Q as, "the amount of interest income that would have been recorded during the period for on-balance sheet nonperforming loans had the loans performed according to their contractual terms."

If those losses are only $192 million, how could a $192 million loss result in a $100-billion-plus loss to the taxpayers? How is that possible?

Mr. LOCKHART. What has happened since then is they have had to put up reserves for loans that are in default. And they have also had to take other-than-temporary impairments on their private label securities. And they booked a lot of losses related to the credit.

The interest give-up is a very small issue. Under proper GAAP accounting, if you think you cannot recover, you have to take an other-than-temporary impairment. Or if it is a loan, you have to write it down to the value that you expect to recover. And that is what has happened.

Mr. GRAYSON. Well, I see my time is up. But let me just ask you this last follow-up question, and thank you, Mr. Chairman, for your indulgence.

I still don't have a clear understanding from you about how a relatively tiny amount, like $192 million in unpaid mortgage interest on what is a trillion-dollar portfolio, how that possibly lead to the taxpayers having to shell out $100 billion plus.

Mr. LOCKHART. They have had a lot more missed payments since then. It has spread throughout not only their lower quality book, but even to some of their prime loans. They have had to put up reserves. They have built the reserves very dramatically since June because of the deterioration in the mortgage market and the deterioration in the economy.

We would be happy to go through those numbers with you, and meet with you and show you what really happened, and go through not only the June numbers but the September, December, and March numbers, and how these losses have unfortunately marched through their financial statements.

Mr. GRAYSON. Well, that would be great. Thank you very much for doing that because, as we know, those who don't understand history are doomed to repeat it.

Mr. LOCKHART. Yes, sir.

Mr. GRAYSON. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Grayson.

Mr. Lockhart, I want to thank you very much for appearing. And gentlemen, I am sorry that we had two interruptions and have taken such a long time. But I am actually sorrier to the next panel because you are going to—but thank you very much.

And we may ask your indulgence again to appear, because I think this is an important area where we want to spend a little more time on it.

Mr. LOCKHART. Thank you for having the hearing, and we would be happy to come back.

Chairman KANJORSKI. Okay. Thank you, Mr. Lockhart.

I am pleased to welcome our second panel. Each of you will have 5 minutes to verbally summarize your written statement. First, we have the Honorable Bruce Morrison, chairman of the Morrison Public Affairs Group, a former member of our committee, and the former head of the Federal Housing Finance Board.

Mr. Morrison, welcome.

STATEMENT OF THE HONORABLE BRUCE A. MORRISON, CHAIRMAN, MORRISON PUBLIC AFFAIRS GROUP

Mr. MORRISON. Thank you, Mr. Chairman, and members of the committee. I appreciate the opportunity to be here, and I commend you on starting this process. You have correctly said that it is not something that can be done in a sprint.

These institutions were built over a long period of time. Our mortgage industry and our secondary market have been built over a substantial period of time. Repairing what has gone wrong needs to be done carefully.

When you are talking about an industry of $11- to $12 trillion of assets, you are talking about real money. And it is important that the future of housing opportunity in the country not suffer as it has suffered in the last several years because of mistakes, misjudgments, that have been made historically.

I think it is important to acknowledge that the Federal role is not going away and cannot go away. We can pretend that this entire industry could be operated without Federal risk, without government risk, and then wait until the calamity comes.

But you can ask, where was the Federal role in AIG? And yet there are all those credit default swaps which related to the housing market, among others, resulted in huge Federal intervention, nothing that anybody really anticipated before it happens.

With respect to the mortgage industry, we have used the Federal Government to facilitate liquidity on a broad international basis for a very long time, and on an increasing basis.

I think our challenge is not to try to privatize our way away from that, but to narrow and focus what the Federal role is, and to make sure that the guarantees that are being given are paid for and are priced up front so that the system really insures itself, rather than wait for the calamity and go out looking for the taxpayer money for the bailout.

We have gained a lot in this country by a broad liquidity function that the secondary market provides. We need to preserve that. We don't have to preserve the precise institutional structures that provided it in the past, but we have to protect the function.

It is important when we talk about this subject to separate who bears the credit risk and other risks involved in the mortgage industry, and who owns which entities that participate. A lot of the discussion that goes on on this subject tends to fuzz up which is it that the Federal Government is going to do and the private sector is going to do. Who is going to own the GSEs?

The most important question is who is going to take which risks? And I think that the Federal Government should take a very narrow and catastrophic risk, that is, the risk of catastrophic failures, and that the private sector should take as broad and extensive a risk position as possible, as we are able to define.

And I think in the past that the GSEs have taken more risk than they needed to take; that their role in the market, their limitations and their size, both of which led to the growth of the private label securities market in a way that undermined the entire structure.

And it wasn't Fannie and Freddie who led the way, but it was Fannie and Freddie who followed along and become part of the problem. I don't think we should be drawing those lines. I think we need a broader structure that brings the entire mortgage industry under one structural scheme.

And we can do that without implicating the Federal Government more. We can actually implicate the Federal Government less. But we are going to have the Federal Government as the ultimate guarantor, not as the guarantor of all risks but of the catastrophic risk.

So that goes in the credit risk and the scope of the guarantee. And I think if you think about all of the credit risk that can be and will be covered by a securitization model—a first loss protection that mortgage insurers and others carry; a general expected loss coverage; the kind of structured debt that parcels out different levels of credit, but which requires a rating agency system that is not corrupted in the way that the system we currently have was during the crisis.

You can design a model that has a narrow Federal guarantee that will give the kinds of liquidity, the international access to funding that we have had, but have the Federal Government very rarely if ever have to step up to the plate. And you can pay for it through guarantee fees from the beginning if you design it that way. And I think that is what we ought do.

I think other attempts to carve up the market, that leaves the Federal Government's role not that broad, will lead to regulatory arbitrage, as we have already had, will lead to the situation in which the private market brings down the whole system because it is not part of the scheme.

With respect to ownership of the entities, as I say in my testimony, I really think that a serious look ought to be given to cooperative ownership of Fannie and Freddie or whatever comes after Fannie and Freddie.

I think that the Federal Home Loan Bank system is a success in terms of its ownership structure; that it is better than the GSEs have been at aligning the interests of the public sector and the interests of the capital providers; that it doesn't require government capital; that it is able to scale its capital to the needs of the people who are the customers of the entity; and that you don't hear people saying, the Federal Home Loan Banks are displacing us out of the marketplace, as you always heard about Fannie and Freddie from other players in the mortgage business.

Because the people in the mortgage business own the Federal Home Loan Banks, and in the same way the people in the mortgage business can own the secondary market outlet and get an advantage in terms of an overall Federal catastrophic guarantee, but can provide both the capital and the risk-taking to make the system run. And in routine times, there will be no calling forth of any Federal participation beyond that.

Finally, I would say that in thinking about your regulatory restructuring that you are going to be thinking about across a broad range of financial institutions, think about the mortgage industry as a subject for functional regulation.

Right now you just heard from FHFA, and you have heard when certain issues were being raised about appraisals, about how they don't regulate this or that, they would have to go to the bank regulators. The mortgage industry should not have its regulatory structure divided into so many pieces because looking just at the GSEs as a regulator doesn't give you the authority nor the perspective to see that the mortgage industry is properly regulated.

So think of mortgage industry regulation as a functional regulation subject. And maybe when you overall change the financial institution regulatory structure, that will mean a specialization within one agency, a coordination among several agencies. But there ought to be a mortgage regulator. There ought not to be just a GSE regulator. Thank you very much.

[The prepared statement of Mr. Morrison can be found on page 158 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Morrison.

And now we will hear from the Honorable Susan Wachter, the Richard B. Worley Professor of Financial Management of the Wharton School at the University of Pennsylvania. Professor Wachter?

STATEMENT OF THE HONORABLE SUSAN M. WACHTER, RICHARD B. WORLEY PROFESSOR OF FINANCIAL MANAGEMENT, THE WHARTON SCHOOL, THE UNIVERSITY OF PENNSYLVANIA

Ms. WACHTER. Chairman Kanjorski, members of the committee, thank you for the invitation to testify at today's hearing on the present condition and future status of Fannie Mae and Freddie Mac. It is my honor to be here today to discuss the role of secondary mortgage market institutions in contributing to the crisis, and what form these institutions should take going forward.

The Government-Sponsored Enterprises, Fannie Mae and Freddie Mac, have historically provided a secondary market for mortgages. But in considering their future role, today it is most important to consider how we may develop and maintain a housing finance framework that supports homeownership that is sustainable and contributes to overall financial stability.

Broadly speaking, there are three options for the future of GSEs: first, privatization; second, nationalization; and third, a return to their original Federal charter as hybrid public/private entities. I will outline here the pros and cons of these three approaches and the facts that can be and should be considered as the subcommittee, and indeed, the Nation, weigh the options.

Privatization of the GSEs in theory could have the benefit of desocializing the risk involved with secondary market housing finance. Critics argue that the GSEs' special access to cheap credit and high leverage expose the taxpayer to large liabilities. However, as we have seen with the socialization of private entities' losses, privatization does not exempt the taxpayer from such liabilities.

A second option is to nationalize the GSEs and have a solely public secondary market—essentially, FHA/Ginnie Mae for everyone. Taxpayer exposure to large liabilities is still a risk in a solely public sector approach. There is automatic socialization of risk and no market check on underwriting because of the U.S. Government guarantee.

The third possibility is a hybrid public/private secondary market. Hybrid public/private base financing worked fairly well until private label securitization arose. The GSEs found themselves losing market share, and shareholders pressured the GSEs to lower underwriting standards to compete while Federal regulators did not stop it.

In fact, it is useful to think of privatization and nationalization as one choice and not two choices because nationalization effectively means that the existing FHA function is augmented with a larger sphere for lending, and the private sector of course would originate and securitize mortgages much as it did in the run-up to the crisis. Thus, a private label mortgage securitization would take off again.

Within the hybrid public/private approach, there are various options such as cooperative versus shareholder ownership, and choices on regulation such as public utility approach versus a larger role for the Federal Government in governance.

These choices are not inconsequential in system design. But today I will focus on the larger pros and cons of this middle ground versus the alternative of a Federal Government entity and GSE privatization, that is, a private label mortgage-backed securities market, which it would lead to.

While this issue is complex and multi-faceted, the overriding question is: Which of these two alternatives best serves the interests of the public? The public has an interest in systemic stability in the financial system. Individual households are the least well-equipped to weather instability in the financial system.

In addition to financial stability, a key public interest in mortgage finance is consumer protection. Moreover, from a household portfolio perspective, the long-term fixed-rate mortgage supports the goal of most families to at least have the option of continuing to live in their homes and neighborhoods. And the availability of this mortgage and this option depends on securitization.

To understand why and to understand the importance of the secondary mortgage market, it is only necessary to note that historically in the United States, housing finance was provided through banking systems funded by demand deposits.

In most countries today, deposit-funded banks remain the predominant, if not the sole source of funding, for mortgage borrowing. In countries with bank-provided mortgages, adjustable rate mortgages predominate, and the long-term fixed-rate mortgage is largely absent.

As colleagues and I have shown, real estate, including residential real estate, has been linked to banking and financial crisis, not just once but many times. Real estate crashes and banking crises tend to occur together. In our own recent history, the savings and loan crisis of the 1980's both contributed to the recession of 1990/1991 and destabilized the financial system, requiring a Federal bailout.

Securitization was the answer to this crisis. With the recognition that the stability of the banking system depended upon banks not lending long, financed by short-term demand deposit liabilities. Securitization enabled the housing finance system to continue to offer the long-term fixed-rate mortgage to America's homeowners without endangering banks' stability.

Elsewhere, in the absence of secondary market institutions, banks provide borrowers with adjustable rate mortgages. As I noted, the long-term fixed-rate mortgage is essentially absent. The exceptions to this, besides the United States, are Denmark, and to a lesser extent, Germany. Both of these countries, also historically, had in place extensive secondary market institutions which, while they differ from those of the United States, do in fact link long-term funders to long-term borrowers.

Fannie Mae and Freddie Mac grew with banks' continued securitization of long-term mortgages originating and securitizing. The growth occurred both in the GSEs' guarantee business, in which they guaranteed mortgages, bundled into pass-through securities, and sold to investors, and in their portfolio purchases.

The growth of the secondary market coincided with a period of financial and economic calm in the United States known as the Great Moderation. Nonetheless, controversy arose over the GSEs' continued growth, to a great extent focused on the growth of their portfolios.

Ultimately, it was viewed that these institutions were implicitly guaranteed by the Federal Government. Thus, with the growth of their portfolios, taxpayers were liable for interest rate risk taken on by these institutions. Interest rate risk was and is an unnecessary risk for the GSEs to take on.

Importantly, however, the GSEs' Federal charters did and does require them to set standards for default risk, to minimize default risk, and to monitor and standardize contracts to do so.

The current crisis originated not with the growth of GSEs, but rather with the growth of private label mortgage securitization. In an era of deregulation, private label securitization drove the supply of risky mortgages. The demand for scrutinized mortgages fed the demand for recklessly underwritten loans.

As private label MBS grew in market share, so did nonstandard mortgages, from only 15 percent of market origination in 2002 to almost half of market origination in 2006.

Lending standards were not monitored by private label securitization, and declined over time. Surprisingly, so did risk premiums, and Wall Street encouraged such lending despite growing risk. Home prices were artificially inflated due to the willingness of institutional investors across the world to buy these subprime mortgages in the form of complex securities created by investment banks.

As lending standards deteriorated, the demand for homes and the price buyers were willing and could pay was artificially driven up. There was no and is no regulation in place to stop the deterioration of lending standards over time, driven by the competition for market share for private label securitized loans.

This lending was not sustainable, and resulted in a credit bubble that burst, bringing down not only poorly underwritten nontraditional loans, but carefully underwritten traditional loans as well.

The private label securities backing these loans were not liquid, nor did they bear risk premium based on their issuers and the underlying loans' originators' balance sheets. Because these securities were not backed by standardized assets, they generally did not trade.

Even if short sellers knew of the heightened risk and mispricing of securities, they could not easily trade on this knowledge. Private label securities were marked to model with the imprimatur of rating agencies and not to market. Thus, market discipline was absent and could not work.

While it is clear that systemic risk derives from the procyclical erosion of lending standards, there is not yet a consensus on how to avoid this going forward. While no system is perfect, securitized, fixed-rate, long-term mortgages are critical for a stable mortgage system. And that robust standardized securitization is unlikely to be accomplished by an FHA-like entity alone.

Chairman KANJORSKI. Professor, could we wrap it up?

Ms. WACHTER. I will finish up now.

In any event, standardization need not only apply to securitized mortgages. Financial institutions could still originate nonstandard mortgage products and hold onto them on their books or resell them to each other. This means that financial institutions could continue to serve as a laboratory for product innovation. But they would be required to retain the risk on those products. This is the proper niche for niche products.

And in closing, the GSEs should not be removed from conservatorship until the economy is on a stable recovery path. They are currently helping to stabilize the economy through their support of the housing market. This effort is especially critical in light of recent discussion over government purchase of toxic assets that may be difficult to price and liquidate.

In the future, the benefits for long-run stability and consumer protection point to the need for strongly regulated and private market disciplined entities to support the U.S. housing finance system. Thank you.

[The prepared statement of Professor Wachter can be found on page 179 of the appendix.]

Chairman KANJORSKI. Thank you very much, Professor.

And next we will hear from Ms. Frances Martinez Myers, senior vice president, Fox & Roch/Trident, LP, on behalf of the National Association of Realtors. Ms. Myers?

STATEMENT OF FRANCES MARTINEZ MYERS, SENIOR VICE PRESIDENT, FOX & ROACH/TRIDENT, LP, ON BEHALF OF THE NATIONAL ASSOCIATION OF REALTORS (NAR)

Ms. MARTINEZ MYERS. Chairman Kanjorski, Ranking Member Garrett, and members of the committee, thank you for inviting me to testify today on the current condition and future status of Fannie Mae and Freddie Mac.

I am a senior vice president for Fox & Roach/Trident LP, the holding company of six home services financial and relocation-related companies located in southeastern Pennsylvania. I am here to testify on behalf of more than 1.1 million Realtors, who are involved in all aspects of the real estate industry.

Realtors believe that the GSEs' housing mission and the benefits that are derived from it continue to play a vital role in our Nation's real estate market. Had no government entity existed when private mortgage capital dried up in 2008, America's housing market would have come to a complete halt, throwing our Nation into a deeper recession.

We need only look at the current status of the affairs in the commercial and jumbo residential mortgage market to see how different things might be today in the traditional residential mortgage market without Fannie Mae and Freddie Mac.

For those reasons, Realtors believe that pure privatization of the GSEs is unacceptable. Rather, NAR supports a secondary mortgage market model that includes some level of government participation, protects the taxpayers, and ensures that all creditworthy consumers have reasonable access to affordable mortgage capital.

NAR is currently conducting research to determine what model for the secondary mortgage market would best achieve these goals. We will share that information with you as soon as it is compete For now, I would like to briefly outline a set of nine principles that NAR's board of directors has adopted, and that we are using to guide in our research:

1. Capital must flow into the mortgage market in all market conditions.

2. Qualified borrowers should have access to affordable mortgage rates.

3. Affordable housing goals should ensure that all qualified borrowers, including low- and moderate-income households, have an opportunity to realize the dream of homeownership. However, such goals must also promote sustainable homeownership.

4. Financial institutions should be required to pass on the advantage of lower borrowing costs and other costs of raising capital by making mortgages with lower rates and fees available to qualified borrowers.

5. Conforming loan limits should be based on increases in median sale prices, including higher index limits for areas with high housing cost.

6. Sound underwriting standards must be implemented and adhered to.

7. Institutions must uphold the highest standards of transparency and soundness with respect to the disclosure and structuring of mortgage-related securities.

8. There must be sufficient capital to support mortgage lending in all types of markets.

9. The government must provide rigorous oversight. Simply stated, the housing market must work in all economic conditions at all times, and mortgage capital needs to be available to all potential qualified housing consumers.

In conclusion, NAR respectfully asks that Congress and our partners in the industry carefully consider these nine principles when discussing a new secondary mortgage model. Working together, I believe we can create a solution that will serve our best interests now and become a model for the global real estate and financial markets well into the future.

I thank you for this opportunity to present our thoughts on the current and future status of Fannie Mae and Freddie Mac. And as always, the National Association of Realtors is at the call of Congress and our industry partners to help facilitate a housing and national economic recovery.

Thank you.

[The prepared statement of Ms. Martinez Myers can be found on page 163 of the appendix.]

Chairman KANJORSKI. Thank you very much, Ms. Martinez Myers.

Next we have Dr. Lawrence J. White, the Arthur Imperatore Professor of Economics at the Leonard Stern School of Business at New York University. Dr. White?

STATEMENT OF LAWRENCE J. WHITE, ARTHUR E. IMPERATORE PROFESSOR OF ECONOMICS, LEONARD N. STERN SCHOOL OF BUSINESS, NEW YORK UNIVERSITY

Mr. WHITE. Thank you, Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee. My name is Lawrence J. White. I am a professor of economics at the NYU Stern School of Business. During 1986 to 1989, I served as a board member on the Federal Home Loan Bank Board, and in that capacity, I also served as a board member of Freddie Mac. Thank you for the opportunity to present my views on the present condition and future status of Fannie Mae and Freddie Mac.

The hybrid private/public model that is and was and continues to be at the heart of the operation of the two companies is broken and should not be reconstructed. Before addressing what should be done, however, it is important to step back and remember that Fannie and Freddie have been just one part of a much larger mosaic of government policies to encourage the construction and consumption of housing.

Much of this encouragement is broad-brush, unfocused. It mostly just encourages people who would otherwise buy a home anyway, so it is really not encouraging homeownership but just encouraging them to buy a bigger, better-appointed house on a large lot. I don't see a big social purpose in that kind of encouragement, instead of doing what social policy should be doing, which is focusing on encouraging homeownership itself.

Now, Fannie and Freddie's structure was just part of and still is just part of this broad brush approach through the implicit and now somewhat more explicit support for their debt by the United

States Government. It looked like a free lunch, something for nothing, but we have now found out just how costly this meal has been.

So what is to be done? For the short term, it is clear. Fannie Mae and Freddie Mac need to continue to be wards of the United States Government, wards of the FHFA. The financial markets are simply too fragile to support anything else.

However, for the longer term, because the model is broken, Fannie and Freddie should be really, truly privatized. To replace their implicit broad brush, off-budget effects in housing finance, there should instead be an explicit, on-budget, adequately funded, targeted program to encourage—and of course, including appropriate counseling—low- and moderate-income households who might not otherwise be homeowners to become homeowners, focusing on the first-time home buyer in the low- and moderate-income household category through targeted help on downpayments and targeting help on monthly payments.

This is an appropriate function for government to really deal with that important spillover effect that yields benefits when a neighborhood is more stable, with more homeowners.

Finally, there are some other things that the Congress could do that could lower the real costs of housing, make housing more affordable, that would improve the efficiency of markets and benefit consumers. I would hope all of the people at this table as well as the people on your side of the table could support these measures.

They would include: making sure that there aren't impediments to shipments of timber from Canada so that we can keep the costs of construction of housing lower; making sure that there aren't impediments to shipments of cement from Mexico so that we can keep the costs of constructing housing lower; leaning on the States and localities to relax unduly restrictive zoning that would otherwise keep the costs of property higher and make it hard to build lower cost housing; and leaning on the States and localities to undo restrictive building codes that inefficiently cause the costs of constructing housing to be higher. These are all things that could really make housing more affordable.

Thank you again for the opportunity to appear here before the subcommittee. And I will be happy, of course, to answer questions.

[The prepared statement of Dr. White can be found on page 186 of the appendix.]

Chairman KANJORSKI. Thank you, Dr. White.

Next we have Mr. Michael Berman, vice chairman of the Mortgage Bankers Association. Mr. Berman.

STATEMENT OF MICHAEL D. BERMAN, CMB, VICE CHAIRMAN, MORTGAGE BANKERS ASSOCIATION (MBA)

Mr. BERMAN. Thank you, Mr. Chairman.

Every part of the real estate finance industry was deeply impacted by the financial crisis which led to the conservatorship of Fannie Mae and Freddie Mac—large and small lenders, servicers, investors, multi-family lenders, and most importantly, consumers. A smoothly functioning secondary mortgage market is not only important for our industry but for the entire economy.

Despite their financial situation, the GSEs currently participate in over two-thirds of single family mortgage transactions and about

75 percent of all multi-family mortgage transactions. While the FHA also facilitates a significant share of residential mortgages, the GSEs currently are the prevailing force in the mortgage market.

In addition to falling housing prices and an unprecedented foreclosure crisis, the GSEs face severe management challenges. At the same time, they are being used as instruments of public policy.

While MBA supports the temporary use of the GSEs in this manner, this is an unsustainable and artificial business model. We are committed to working with you to create a new structure for the future.

Before we discuss the future, we must ensure that the current market works as efficiently as possible. For example, the credit facilities established by Treasury for the GSEs expire at the end of this year, as does Treasury's authority to purchase GSE mortgage-backed securities in the open market. We must ensure that these important programs are extended at least until the East Coast recovers.

Congress should also help make mortgage credit more available and affordable by permanently raising the GSE loan limits. The higher loan limits have benefitted consumers, but because they are temporary, investors have been hesitant to purchase high-balance loans.

This dilutes the full benefit of higher loan limits because liquidity has artificially restricted them. Ultimately, consumers are forced to pay higher interest rates on their loans.

After the conservatorship was announced, MBA convened a council of mortgage finance experts from every part of the real estate finance industry to examine these issues. The Council on Ensuring Mortgage Liquidity, which I am privileged to share, has identified the key ingredients of a functioning security market and established a set of principles for you and the policy community to consider when debating how to rebuilt the secondary mortgage market in the future.

Our approach has been to examine the issues so that stakeholders could assess options in a measured and thoughtful way. We agreed early to avoid an overly prescriptive approach, and instead to assess the market and present alternatives, which we plan to refine in the coming weeks and months.

I have attached to my testimony a white paper on this issue that has been cited as one of the more helpful compilations of options available today. This paper presents a set of building blocks to aid in understanding and discussing the merits of various market structures. It also lists and begins to describe nine alternative models for channeling government support to the housing finance system.

I have also attached to my testimony a set of guiding principles based on the key considerations mentioned in the white paper. The scope of these principles is the entire secondary market, including responsibilities of the private market participants as well as the role of the Federal Government.

I hope to address our principles at greater length during the question-and-answer period. But let me close with a few thoughts to help guide the policy discussion moving forward.

First, secondary market transactions should be funded by private investors seeking market returns who understand, accept, and are held accountable for the risks that they take.

Next, in order to attract consistent levels of private capital from a wide range of investors, the MBA believes that there is a role for an explicit Federal Government credit guarantee on mortgage-related investments in the core single family and multi-family products. There is also a clear government role as a liquidity backstop in times of market distress.

Finally, a careful, measured approach should be adopted so that current markets are not further destabilized. Safeguards should be established to ensure a smooth transition from the present to whatever future model is developed.

Thank you for the opportunity to appear before you today, and I am happy to answer questions that any of you may have.

[The prepared statement of Mr. Berman can be found on page 85 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Berman.

And next, and last, we will hear from Mr. Robson of the Robson Companies and chairman of the board of the National Association of Home Builders. Mr. Robson?

STATEMENT OF JOE ROBSON, ROBSON COMPANIES, AND CHAIRMAN OF THE BOARD, NATIONAL ASSOCIATION OF HOME BUILDERS (NAHB)

Mr. ROBSON. Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee, I too am thankful for the opportunity to be here and testify today.

The housing GSEs, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are viable components of the housing finance system, providing liquidity to the mortgage markets and supporting the flow of credit to meet affordable housing needs.

Fannie Mae and Freddie Mac recently have encountered severe problems, and are currently operating under conservatorship under their new regulator, the Federal Housing Finance Agency.

The Federal Home Loan Bank system has also experienced stresses which, while considerably less intense, have affected its capacity for mission pursuit.

NAHB believes that the housing benefits that the GSEs have provided in the past, and their significant roles in dealing with the current financial system's problem, clearly demonstrate the need for Federal Government support for the secondary mortgage markets. There is broad agreement, however, that Fannie Mae and Freddie Mac will not be able to emerge from conservatorship without alteration in their current structure.

While NAHB believes the liquidity and affordable housing mission must continue with Federal Government backing, the primary objective is a system that assures that the continued availability of affordable housing credit, that facilitates healthy housing markets and consistency in satisfying community housing needs. Therefore, NAHB looks forward to discussing different models for achieving that objective.

As the credit crisis has worsened, Fannie Mae and Freddie Mac have tightened underwriting standards and increased loan delivery fees at the same time their combined market share has increased, and now represents nearly 75 percent of the single family market.

The continual ratcheting up of delivery fees and tightening of underwriting standards has swung the pendulum too far, denying credit to viable buyers. NAHB urges the repeal of these obstacles to help to increase mortgage affordability, enhance policymakers' attempts to reduce foreclosures, and help the country get back on the road to economic recovery.

Last year, NAHB housing finance task force recommended a permanent Federal backstop to the housing finance system in order to ensure a consistent specially of mortgage liquidity as well as to allow rapid and effective responses to market dislocations and crises.

The current crisis has clearly demonstrated that the private sector, unaided, is not capable of consistently fulfilling this role. The task force concluded that the Enterprises should not be transformed into fully private companies because such companies could not be counted on to provide liquidity in times of crisis or to consistently address affordable housing needs.

And they should not be converted to Federal Government agencies because such entities would be burdened by government red tape and would lack the resources and ability to respond effectively to market developments and housing finance needs.

NAHB's task force recommended that Fannie Mae and Freddie Mac be recast, retaining Federal backing but limited primarily to providing credit enhancement of mortgage-backed securities. Some portfolio capacity should be permitted to accommodate mortgages and housing-related investments that do not have a secondary outlet, although Fannie Mae and Freddie Mac should have the flexibility to support the mortgage market under the types of conditions we are currently experiencing.

Specific principles for restructuring the housing finance system are outlined in my written testimony.

In closing, NAHB urges that any changes to the role and structure of the GSEs not proceed until the current financial turmoil passes, and that the markets return to more normal conditions. It would be extremely difficult, if not impossible, to restructure Fannie Mae and Freddie Mac when they are so intertwined in ongoing efforts to address the deepening financial morass.

NAHB looks forward to working with you to develop an effective, safe and sound, and reliable flow of housing credit under all economic and financial market conditions.

Again, I thank you for the opportunity to testify today, and I would be happy to answer any questions.

[The prepared statement of Mr. Robson can be found on page 169 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Robson.

Listening to all this testimony here today, I have sort of come to the conclusion that maybe we should go back to basics. I want to pose just some basic questions, if I may.

Who says that the government should have a role in ownership of real estate? I mean, I hear some arguments posed and form sometimes questions or opinions, that the private sector and the private marketplace can take care of it. Is there anybody on this panel who agrees that we do not need government involvement in real estate?

[no response]

Chairman KANJORSKI. Unanimous consent. I do not know if I am going to ask for party registration.

It seems to me that there is a little bit of an analogy—not clear, but a little bit—of what happened in the late 1920's and what happened most recently in the real estate bubble and burst, and that is that greed, to an extent, caused people to overinflate and create a false value that kept on feeding on itself, to the extent that just as the boiler shops did in the 1920's with securities that did not have the financial worth behind them in the ultimate end, the real estate did not have the ultimate end.

Fortunately or unfortunately, I sat here and watched this fever. And I remember quite well having Alan Greenspan before us not too many years ago, about 5 years ago, and I posed a direct question to him. I think we have a tape of that; I think I will play that at my retirement party.

[laughter]

Chairman KANJORSKI. And I asked him whether or not he had any fear whatsoever of the real estate bubble, and he said, "Absolutely not." This was in 2005. And it could not cause a problem. They had it all handled and managed and analyzed.

Now, I have a lot of respect for Mr. Greenspan's economic capacity and ability to calculate economics. But he certainly missed that one. And it seems to be the story today that we always miss the one at hand.

And then somebody in their testimony used those horrible words, "So this will never happen again." Could we knock those words out of our vocabulary? It is going to happen again regardless of what we do. It is just in another form or another method.

Now, the question is: Do we owe some loyalty to the private market, that government should stand behind these things? And if, in fact, it is necessary—you know, one of the methods I was thinking about here, if we pay the average people just a few percentage, maybe 10 or 20 percent more, in wages and income in this country, we would not have a problem. You would think that because it is a difficulty in some of these people in honoring their commitments.

Now, on the other hand, we do know that some people, regardless of the amount of money they have, they always overbuy, overshoot. But what is the role of government? Are we to put a label of teaching responsibility through government action? Yes, Dr. White?

Mr. WHITE. Yes, Mr. Chairman. I have been thinking about your earlier question as well as this one. And I didn't raise my hand before because there is a role for government in housing. But I think it is a much more limited role than in fact we see government playing. It ought to be dealing with the true social spillover effects, the positive externalities, to use an economist's term, that comes with homeownership.

There is a role for encouraging innovation. After all, it was Ginnie Mae, an arm of the Department of Housing and Urban Development, that was the first securitizer of home mortgages.

Freddie Mac was a fast second a year later, but it was Ginnie Mae that was first. So there is a role for government to play.

But markets can be terrifically efficient in allocating resources. I think we are all appreciative of that. And I believe that there is— yes, there is room for government, but it is a much more limited role. We ought to—

Chairman KANJORSKI. I did not ask whether there is room for it. That seems to say that we want to compete. As a member of the government, I do not want to compete. The only reason I vote for housing is I want people to have good housing to live in. And if they cannot otherwise do it, I would not give them a penny. I mean, I would not support any—

Mr. WHITE. There are better ways: by funding direct transfers rather than trying to lean on housing markets. By broadly subsidizing housing, all we do is encourage inefficiency in housing markets. We end up investing too much of our income, too much of our total capital stock in housing, not enough in productive physical capital, not enough in social capital, not enough in human capital, that could help people earn higher income.

Chairman KANJORSKI. We have two more activists here, so we want to get to them.

Mr. MORRISON. Mr. Chairman, you will always get the answer from the economists that, you know, if you appropriate the money directly and you target it most narrowly, that will be the best outcome. And yet our political system doesn't really work that way. And we have been much more successful in providing fundamental benefits that work for the society as a whole when they work for the whole society.

And it is really that you can just compare how successful our Social Security program is compared to targeted income support that only goes to the worthy, or those things that are most needy. And the fact is that we gain public support for a broadly successful intervention and a necessity like housing when it is broadly shared.

And that doesn't mean that the targeted interventions that Dr. White is suggesting aren't good ideas. But our basic access to housing for individuals, both multi-family and single family, need an ultimate liquidity backstop to make it most affordable and most broadly available.

And that can be done with a minimal government risk and a maximum private sector operation and risk-taking. It is not the system we have because certainly Fannie and Freddie took on much more risk and much more power than they needed to take on. But it can be redesigned so that you get minimal government, but something that is broadly available and has broad political support, as the system has had.

So I think we should be careful of not facing up to the political realities of how we get the best overall result. You and I both have worked for years on what goes on in the committee on specific targeted matters. We have limited success. The broadly available benefits have broad political support.

Chairman KANJORSKI. Thank you, Mr. Morrison.

Doctor, and then I have to get to my friend. But we are going to get a lot of time because I do not see a heavy population here. Doctor?

Ms. WACHTER. We need mortgages for homeownership. I think that is obvious. People can't put down $200,000 or $300,000. We need mortgages. We need government to set the rules for a mortgage market. If we don't have a secondary market, we will have short-term variable rate mortgages. Many crises in other countries have come from that system. And of course, our savings and loan crisis came from that system.

Thus, we need a secondary market. If we have a secondary market without standards, we have a private label securitized system. I am not calling it a market because it is not a market. Rather we actually did not have a mortgage market. In order to have a market that works, you need to have the structure, the rules of the game, set out for the market players.

In the private label securitized market, heterogeneous mortgage securities were not traded. Thus we did not have the discipline of a market. The heterogeneity itself was a way of hiding the true costs and prices, both to investors and to borrowers.

Chairman KANJORSKI. Thank you, Doctor. I have another couple of questions myself, but I am going to allow my friends here on the other side to be heard. Mr. Garrett?

Mr. GARRETT. Mr. Chairman, thank you. Thank you to the panel. And I appreciate your opening comments as far as some basic questions. When you said, is there a role for the government here, I thought your next was going to go—and everybody concurred.

Is there a constitutional basis for the Federal Government here? I know we have a professor. Anybody want to cite the constitutional basis for the Federal Government intervening directly or indirectly in assisting someone to buy a House?

Mr. WHITE. I am not a lawyer, and I never try to practice law without a license.

Mr. MORRISON. It is the commerce clause.

Mr. GARRETT. That commerce clause, we can do just about everything. I am not exactly sure why we have 50 States any more, actually, since we had that.

But also on a broader note, is there—we sort of had this discussion back when things were going well in the housing market, and the past Administration would oftentimes be championing the fact that things are going well in the housing market, and the percentage of homeownership was always going up?

And some of us who would hear from those in the rental community and construction trades and what have you would say, well, you know, there is another trade out there as well. And how about us?

And so the question would be: Is there a target number that we should be looking at and saying, this is what we are trying to get to in homeownership, that when we reach 65 or 68 or 69 or 70 percent—we are never going to get a 100 percent homeownership rate—that we have reached the approximate number that we should be striving for in homeownership, realizing that there will always be some people who have to rent and there will always be some construction guys out there and investors who say, we should be building multi-family housing?

Ms. MARTINEZ MYERS. Our view on that, I think, would be that if you limit—if you decide that once we get to a 75 percent homeownership rate, we should stop pushing that button, also says that you would stop pushing the button that allows people to create wealth through homeownership.

And homeownership creates so many other opportunities for people and families and the government because there is a higher paying of taxes, there is greater investment in the community, and all those things that you would sort of limit its capability.

So in my view, if you are going to limit the homeownership rate by saying, oh, once we get there, that is good enough, you are also saying you would limit the possibilities of what it could mean to the—

Mr. GARRETT. Now, I am not going to put words in his mouth. But Dr. White might say that there are other ways to create wealth in this country other than homeownership—is that something we are—we might go down that road?

Mr. WHITE. I was going to say that in the last 3 years, it hasn't been a creator of wealth, among other things.

Mr. GARRETT. Yes. There you go.

Mr. WHITE. Yes, it was, for previous decades. Look, I don't know what that number is. It can't be 100 percent because it is clear: Homeownership is not for everyone. It requires a relatively steady income. It requires budgetary discipline. It requires an understanding of the obligations you are taking on.

There are, as Ms. Martinez Myers just indicated, positive consequences for communities. That is why we want to be encouraging it. But, you know, within limitations, and for sure the very broad brush approach mostly doesn't encourage homeownership. It mostly just encourages people who would otherwise buy anyway to just buy a bigger house with five bedrooms rather than four, four bathrooms rather than three, on a bigger lot. Where is the social value in that?

Mr. GARRETT. Right.

Ms. WACHTER. This deregulated environment did not encourage homeownership. Contrary to what Dr. White said, homeownership rates have declined in the last 3 years. Homeownership rates were at the maximum in 2004. And since 2004, homeownership rates have declined in this country.

What is important is a mortgage market that works, not only for homeownership but also for multi-family housing. A mortgage market that works supports multi-family options as well.

Mr. GARRETT. Did you comment on recourse loans in your testimony with regard to—I guess you talked about the Danish system?

Ms. WACHTER. I would be pleased to talk about that.

Mr. GARRETT. Just a sentence because I don't have much time. Their system has recourse loans. Right?

Ms. WACHTER. That is correct.

Mr. GARRETT. We generally don't.

Ms. WACHTER. That is correct.

Mr. GARRETT. Which is better? Which works better?

Ms. WACHTER. Well, certainly recourse is decided by the States. And I do think we can have a viable system that is consistent with financial stability with non-recourse. We had it for decades. It is only with the growth of the private label mortgage-backed securities that we have had the financial instability that we have seen the last few years.

Mr. GARRETT. Okay. I will go to Mr. Morrison. Really quick, though, with regard to the private label, what I hear is it didn't work because, in part, we didn't have all the rules and regulations in place so you would have all those problems.

But if we come up here with all the right rules and regulations in place for the private label marketplace, could we see that with one of my pet projects, which you heard before, the covered Bond situation? Could we see those combined to basically expand the level that we need for a secondary market and the—

Ms. WACHTER. I am sorry, Congressman. I may not be understanding your question completely.

Mr. GARRETT. Sure.

Ms. WACHTER. But my understanding of the Danish mortgage system is actually it is not that different than our GSEs.

Mr. GARRETT. Mr. Morrison?

Mr. MORRISON. Yes. Mr. Garrett, I am a proponent of recourse. I think recourse is an important part of a good system. And there is no reason you can't have recourse of various structures.

Recourse is actually wrung out of our system by Basel I capital rules, which made a transferred asset with recourse look exactly the same as a retained asset in terms of capitalization. And that is really why we have a non-recourse market.

And we could have a recourse market if we designed the capital rules sensibly to measure the risk. So you can have a recourse market, and it is one option for ways for the private sector to bear the risk. And it is not the only model; it can be a part of a model. It can be a mixed model.

So I would support your notion. Covered bonds are no magic—

Mr. GARRETT. Right.

Mr. MORRISON. —vehicle. It is another way of putting certain amounts of collateral behind your credit guarantee. So it is a way for the originating institution to stand behind it.

The question at the end of the day still is: Where does the liquidity come from? The system as a whole. And what kind of liquidity do you get for those bonds versus bonds which have some kind of guarantee on them?

And you can do both. I don't think we are really at war with each other on the options. I think it is a question of maximizing the benefit in the end.

Mr. GARRETT. Right. And I will close on this, then, is that we are hopefully coming up with a solution. And in light of your comments on the political realities, some great sage one said, "Don't let any great crisis go to no good use."

Mr. MORRISON. Right.

Mr. GARRETT. We are going to try to use this crisis to come up with something that actually works.

And one last comment is is that I know you made a comment to Mr. White's comment as far as—and I appreciate your thought as far as targeting the money. And you are suggesting you can't always target, and you gave the example of Social Security being the broader system that really works, as an example, of course.

But we know that within a decade or so, Social Security is broke. And so that may not be the best example of saying—giving us a system that is really working well across-the-board. And targeting health care systems or targeting things might actually be—

Mr. MORRISON. Whatever system you have, you have to pay for it.

Mr. GARRETT. Yes.

Mr. BERMAN. If I may respond to an earlier part of your question, with respect to multi-family—

Mr. GARRETT. Yes?

Mr. BERMAN. —in that instance, and I happen to be a multi-family lender, Fannie, Freddie, FHA—that system today as well has become totally reliant on the GSEs. Over 75 percent of lending today in the multi-family sector in through the GSEs.

And so it in part points to another role of the government, which is to smooth out times—certainly times like this, when we are in crisis. But also it is not just when there is a 100-year flood. But between those times, to create a stable system where there is always liquidity in those markets for both multi-family and for single family.

Ms. MARTINEZ MYERS. I wanted to add to that as well. And I guess to go back to some of the original questions around the role and why the government should continue to play a role, I guess when you look at real estate in general, the industry, and we looked at it honestly and said all the various sectors of the industry combined represent, what would you say, 20 to 25 percent of our GDP?

I would think the government would have an interest in preserving and keeping a healthy industry because it is so much of our GDP.

Chairman KANJORSKI. Mr. Manzullo. And after you get your reservation, if you guys do not mind, we will open it up to the three of us to throw questions back and forth and sort of make it a roundtable panel because I think we could get some interesting responses that way.

Mr. Manzullo?

Mr. MANZULLO. Well, I want to thank you guys for sticking around. I had some other things to do, but I called my wife and I said, these people have been here all day, and it is a very interesting and tremendously important topic.

I have been listening to the testimony going on here, and this is very interesting. Ms. Martinez Myers, on behalf of the National Association of Realtors, you want to have this hybrid. And Dr. White, you say no hybrid. Let's let the market forces determine everything.

But the real mess has to do with the fact that people bought homes who couldn't afford them in the first place. Isn't that correct?

Mr. WHITE. Certainly. In many instances, that has to have been true.

Mr. MANZULLO. I mean, that is what made the loans go bad, is they closed on these loans, the so-called cheater loans, and the—

Mr. WHITE. But it is because everybody was drinking the Kool-Aid that housing prices can only go up. And if housing prices can only go up, it is never going to be a problem.

Mr. MANZULLO. Right. But even under the Fed, the Fed had the authority, has the authority, to do, among other things, two things. Number one, the Fed can govern the instruments. And number two, it can set forth underwriting requirements. Okay?

So the regulator that could have stopped all of this was already in place. And it wasn't until December of 2007 that the Fed did this top to bottom review and came to the incredible decision that you can't buy a house unless you can afford to buy it.

I was stunned when the testimony came forth. And then again, that testimony came forth in October of last year. But the requirement is not effective until October of this year.

And I am listening to your testimony and see the tremendous angst that goes on from the builders, with Mr. Robson, to the Realtors and the mortgage folks in between. But, I mean, if somebody had just—if the Fed had said, look, you can't sell a house to somebody who can't afford it—I mean, the regulatory agency was in place. Don't you think that would have stopped this? Yes?

Ms. MARTINEZ MYERS. If I may comment, because your comment that says that all of this is only because people got loans they couldn't afford to pay. And I know that in the light of our conversation around the GSEs, I think that we need to kind of step back a moment and say, okay. For many, many years, decades, the GSEs did a really great job at providing affordable product that was sustainable.

And in fact, their foreclosure rate was something less than 1 percent. So for years they did a very good job at helping to grow homeownership, particularly among low- to moderate-income folks.

Now, their biggest crime is probably diverting from that and buying those bulk loans with some assets and loans that were not the kind of loans—

Mr. MANZULLO. Under pressure from both parties.

Ms. MARTINEZ MYERS. That's right. They diverted from what they normally would do. So I think when we are sort of using the hammer to sort of hit them over the head for that action, I think everybody has to take a little responsibility for that.

And I think the industry has to take some responsibility because there is no doubt—and I think Chairman Kanjorski said—there is a lot of greed out there. The fuel got hotter. People kept selling. People kept pushing. People thought it would continue. People took loans thinking that they could flip the house or sell it and make a profit. And when it stopped, it was not a good story.

So I think there are lots of different factors that contributed to that. Some people themselves—I mean, a lot of people who have been homeowners for years refinanced their house, took out that equity, used it for things unrelated to their home, and the market changed, and guess what? Now their house is worth less.

Mr. MANZULLO. But, you know, there are—there have been, in the past 20 years, periods of time when people paid "X" amount for their house, and then the houses have fallen in value. You have seen it happen here in northern Virginia.

But they just hang on, and then 5, 6, 7 years later they recover. And, you know, that is a lot different than whether or not they could afford the house when they bought it in the first place.

But what I don't understand, and maybe somebody here can clue me in, why did the Fed sit back and do nothing? Does anybody want to take a stab at that?

Mr. MORRISON. I think it is a very good question. I think the Federal Reserve fed this crisis in two ways. They fed this crisis by keeping interest rates low for an excessive period of time, and they didn't discharge their regulatory responsibility with respect to the subprime market.

Those things I think you are absolutely right about, although it doesn't do us much good to be right about that.

Chairman KANJORSKI. Whoa, whoa, whoa. Let me break in here a second. What obligation does the Federal Government have to do anything? You are the guys on that side saying, stay out of our bedroom. Now why do you want us to get into all your business?

Mr. MANZULLO. No, no, Mr. Chairman. What I was saying is that we are looking for a new regulatory system that will—

Chairman KANJORSKI. Not really. Not really. We are looking really for the answer of why do we get ourselves so involved, create systems that fail—

Mr. MANZULLO. Right.

Chairman KANJORSKI. —and then we end up blaming the person who was not originally part of the transaction?

Mr. MANZULLO. Well, no. But—

Chairman KANJORSKI. Your indication here is the Federal Government had a responsibility to see that prices were not too high or—

Mr. MANZULLO. No, no, no.

Chairman KANJORSKI. What was the Fed supposed to do?

Mr. MANZULLO. No, no. The Federal Reserve has the authority to—they could have stopped the 2/28 mortgages and the 3/27 mortgages. And the Federal Reserve could have said, look, we have some very basic underwriting requirements that when you buy a house, you have to have, you know, a minimum of 5 percent down or some other type of mortgage insurance, etc.

I am just saying that those—that the means by which these subprime mortgages could have been stopped—because they were too easy; the credit was too easy—that regulatory process was already there. It just wasn't used. That is what Mr. Morrison just said.

Chairman KANJORSKI. You know, I think you all convinced me at this point we have to prevail upon the Speaker and the Leader of the Senate to convene a committee to determine what caused this thing. If we think 2/28 mortgages caused this thing, no wonder we cannot solve this thing.

It has nothing to do with it. It is minuscule. Who testified earlier, Mr. Lockhart, about the $200 million in lost interest on a $100 billion loss. It is minuscule. Our problem is why are we accepting the presumptions that we have a role to play, a committed role, a have to play? And why are we blind to what really happened?

And I have a suggestion. I did the—got here a little earlier. You know, our severeness in the real estate breakup occurred in the last 4 years.

Mr. MANZULLO. Right.

Chairman KANJORSKI. And it is when securitized mortgaging left government-regulated entities, went to Wall Street, and Wall Street discovered a way to sell crap for a AAA rating, and did. And they sold it all around the world.

And the only reason we felt obliged to go in and buy that crap from around the world is it looked like it had a Good Housekeeping seal of approval of the United States of America. And we were too embarrassed to recognize we stole this money all around the world with crap.

Mr. MANZULLO. No. I agree. I mean, crap is crap. But the—

Chairman KANJORSKI. Well, then, why do we not identify who put that crap together? It was the private—

Mr. MANZULLO. Mr. Robson wants to clear up this crap.

Mr. ROBSON. Well, I wish I could.

[laughter]

Chairman KANJORSKI. It helps things grow.

Mr. MANZULLO. Mr. Chairman, are we in the informal portion of the hearing now? All right. Okay.

Mr. ROBSON. There are a number of issues, and I don't want to claim that I am the expert on how what is whole crisis came. But I think it goes to the point of—I think if you have too much government or too much private side, there can be a problem.

There needs to be checks and balances. And I am not going to get into whether the Fed could have stopped it, or whether they could or would have or anything else. But I think there are a number of issues.

If you look back where the private sector, the private mortgage security started, it was really because there was a failure of FHA to a certain extent, that they had not monetized. They had not kept up with a number of—really, kind of providing mortgages on the low end of the market.

The private sector stepped in and started offering a lot of things that FHA was not able to do because of government red tape and a lot of bureaucracy that was there. That kind of started the whole ball rolling. Certainly—

Chairman KANJORSKI. We can cut that red tape real fast by taking away any tax consequences of letting interest be deducted from income. Would you recommend we do that?

Mr. ROBSON. No, I wouldn't.

Chairman KANJORSKI. Why not?

Mr. ROBSON. As far as what?

Chairman KANJORSKI. I will bet I can identify three people at that table who would disagree with doing that because you get an advantage in your business with it. You have bought interest an advantage.

I am not castigating it. I vote for it. I think it is a good principle to get private housing out there. But everybody sitting at that table and everybody in this country is pushing their own self-interest, and have extended to the point it took the system down.

Now the question is: How do we get out of it? I am trying to suggest that let us not get out of it by redoing what we did before.

Mr. ROBSON. And that is to my point. I mean, GSEs were—their primary responsibility was liquidity. I mean, it wasn't necessarily guaranteeing. It was providing liquidity because those of us who remember the days when you had a savings and loan, you couldn't get a new loan until they either sold them or you got new deposits in.

The whole liquidity question changed the mortgage finance system of this country. And the new system, whatever way—forget about how we are going forward. A joint private government system—and I would say start with the Federal Home Loan Bank, is a good place to start.

Mr. MANZULLO. Well, that is because the banks are shareholders in it. They eventually would be the losers if their loans went bad.

Mr. ROBSON. And they have skin in the game as owners of that bank system.

Mr. MANZULLO. No, but Dr. White, you were on the board for that, weren't you?

Mr. WHITE. It was a different time, but that's right. Part of the responsibility of being a board member of the Federal Home Loan Bank board was overseeing the Federal Home Loan Bank system, as well as Freddie Mac, as well as regulating the savings and loan industry.

Mr. GARRETT. But would that give us the problem that you were talking about before, of a subsidization that just is even more obscure than what we have today?

Mr. WHITE. Well, I mean, it is the same implicit guarantee that supports the Federal Home Loan Bank debt as is supporting the Fannie and Freddie debt. It is the same—the Federal Home Loan Bank system is a GSE as well.

The mutual ownership hasn't prevented a number of the banks from having their financial difficulties—not as serious as Fannie and Freddie, but still, they are suffering their difficulties as well.

Chairman KANJORSKI. That gets you in trouble. Good regulation and open regulation will tend to subside excess. Is that correct? I mean, I am a great supporter of the Home Loan Bank system. Mr. Morrison knows. But we know a few Federal Home Loan Banks that started to really get into serious trouble. If they had not been reined in by the regulator at the time, we would have been bailing them out, if we are not already.

And we have seen that in all of our financial institutions. But the problem really goes to excess, is the argument I am trying to make, that—you know, if you went back to the values that you are not trying to get a free lunch—not you but we, the American people.

If we are not trying to get a free lunch, if we are not trying to find pie in the sky over something that does not cost us anything, we will start evaluating things at their real value, and that is all we are going to pay. And if you are going to be a cosigner or a supporter of that, that is all you are going to support or cosign for. But we are always pushing the envelope.

There was a great gentlemen, this morning on the Secretary of the Treasury. It went through his purchase of his home in Westchester County, New York. Did anyone hear that, by any chance?

You know, he bought a $1.7 million McMansion and in a very short period of time had to sell it. And it showed what the drop of value was and how it went underwater very quickly for him.

But drive out in Virginia and look at the McMansions that are out there. And I think we need to start asking the question: Where are these people making all this money to buy all these McMansions? And they are not. They are getting it from institutions that government-supported or underwritten, are they not?

Unless there are an incredible amount of millionaires that I am not aware of in this country, it seems to me they are expending a great deal more for a piece of real estate than they should in rational terms.

Do you find that to be the case, Mr. Robson?

Mr. ROBSON. Those sorts of homes, I mean, if they are the McMansions, wouldn't be part of Fannie and Freddie anyway.

Chairman KANJORSKI. I agree. I agree. I am not—

Mr. ROBSON. Those are going to be the private label mortgages.

Chairman KANJORSKI. And are some of those underwater or not?

Mr. ROBSON. Sure.

Chairman KANJORSKI. And why should they be under? You know, here is a question I really—going to the private sector, I am very impressed with all of the home builders, the Realtors, all of—but I have to ask the question: Did you, any of you, see this happening 3, 4, 5 years ago as some of us did?

And some of us fought the question that—you know, I remember with embarrassment this committee passing an amendment to reduce the requirement—I think it was the FHA requirement, reducing it from 3 percent to 1 percent or zero on the downpayment. Does anybody remember that just recently? Actually doing it at the time, the market was starting to collapse because of these "crap mortgages" that were out there?

Now, some saw it here and some made a question about it. Did any of you in the industry see that, and did it not bother you? Okay. What did you—did it bother you?

Ms. MARTINEZ MYERS. Actually, the Realtors testified before this committee about predatory lending in 2004.

Chairman KANJORSKI. Yes. But I am not talking about predatory lending. That is not necessarily predatory lending. Predatory lending is a much higher price on a piece of real estate than it is worth according to a legitimate appraisal; and then a high price of interest to be paid that should not finance a piece of property that expensive.

I am talking about just a simple question: Did you not see the real estate excesses that occurred in this country in probably the last 4 or 5 years?

Ms. MARTINEZ MYERS. We put out brochures in 2005 and 2004 to help the industry and the consumers understand how to buy mortgages, and to prevent them from buying unsuitable loans. We talked about—

Chairman KANJORSKI. So all the smart people did not buy the loans, and all the stupid ones did?

Ms. MARTINEZ MYERS. No, no. I mean, at the end of the day, we have to face it. Whether people buy homes—well, people only buy homes once every 7 years, on average, I think, in this country. And they never become experts in the process.

And we know that as people in the industry. And we constantly have to educate them around what is available, what they should be watching for, and to watch out for predators who are out there giving them more mortgage and more promises than they probably should have been involved in.

We also tried to push for FHA reform, as Mr. Robson said earlier, in 2004.

Mr. GARRETT. But you also pushed for higher conforming loan limits. And so for those people who were buying those McMansions, and even though a $700,000 house is still a McMansion in most parts of the country.

Ms. MARTINEZ MYERS. Well, except only in high-market areas because affordability was outpacing the ability for a buyer to get into a starter home at that point. Incomes weren't increasing at the rate that housing was increasing. But—

Mr. GARRETT. A $700,000 house, even in New Jersey, I mean, they are still pretty darned nice houses.

Chairman KANJORSKI. That is not a starter home.

Mr. GARRETT. It is not a starter home.

Ms. MARTINEZ MYERS. Well, it is not. But in the State of California, it would be a starter home—$500,000. People could not get into the State of—not today, but—

Chairman KANJORSKI. That is economic discrimination. Maybe they should not be living in California if they cannot afford it.

[laughter]

Ms. MARTINEZ MYERS. But I think that the industry knew. The industry started—I can tell you at the National Association of Hispanic Real Estate Professionals, we started to talk to them about the changes that were coming on as well. So the Realtors have been very involved in trying to alert the brokers to protect their customers and to push for reforms.

Chairman KANJORSKI. How about the home builders? What do they do? They stopped building.

Mr. MANZULLO. I have a question.

Mr. ROBSON. You know, the private—it was really the private label mortgages that funded the McMansions and a lot of this, and the exotic stuff. I mean, Fannie and Freddie didn't fund exotic mortgages.

Chairman KANJORSKI. No. Quite frankly, they did not. They ended up buying the private stuff, and they ended up, you know, helping—

Mr. ROBSON. Unfortunately, yes.

Chairman KANJORSKI. Right.

Mr. ROBSON. I mean, they bought the stuff they wouldn't underwrite.

Mr. GARRETT. So should the FHA be raising its downpayments, then?

Mr. ROBSON. Down payment? From 3½ percent?

Mr. GARRETT. Yes.

Mr. ROBSON. I think in order to promote people to get into a home, I think they ought to pay something.

Mr. GARRETT. Should they be tightening up—you made the comment before that part of the reason why we—part of the reason people weren't going FHA before was because of the darned red tape, which some people could construe that as being underwriting.

Mr. ROBSON. Well, it was red tape and not keeping up with technology. I had a meeting with former Commissioner Montgomery last year. They were still hiring people who knew Fortran. And this was last year.

Chairman KANJORSKI. Were doing what?

Mr. ROBSON. Fortran. This is a 40-year-old computer programs. And as of last summer, they were still using Fortran computers.

Mr. GARRETT. So just as to the underwriting, I mean, Director Lockhart was here before, and I think he mentioned it yesterday, that—and I guess you probably know the numbers—is that the default rate on FHA loans is beginning to spike up as well.

So some might say, hey, that is like our first warning sign that we might have some problems over there that we all should be looking at. And so call it red tape or—I understand the computer stuff and what have you. But we should be tightening these things up over there before we create a whole new problem. Anybody agree?

Mr. MANZULLO. I have a legitimate question down here.

Mr. GARRETT. That's a legitimate question. Should we be tightening things up with the FHA despite the fact that it may have a dampening effect—right? I mean, if you tighten things up, it may have a dampening effect on what you guys do. But would that be a prudent thing to do?

Ms. MARTINEZ MYERS. Well, I am not sure it would be a prudent thing to do at this time since we are trying to absorb as much of those foreclosed properties and the inventory that is in the market to get things going again.

But I believe Secretary Donovan has just said that FHA is doing great, and that they expect to see a profit of $1.6 million this year. So—

Chairman KANJORSKI. That is only because we made the mark-to-market rule.

Mr. MORRISON. Mr. Garrett, I think you are right to ask questions about where FHA is going. So you had better look at FHA for sure.

Chairman KANJORSKI. Let me ask you this: Are we just going to be putting a patch on a tire as we come out of this? Or are we going to get the opportunity to focus and really make fundamental corrections to the system? And is that possible?

Now, Professor, you had mentioned non-recourse loans? I am not quite up on my real estate law. Are you talking about the principle that you cannot go back for excess assets against the owner? The Pennsylvania rule.

Ms. WACHTER. Yes. That is what I understood the Congressman to be asking. I don't know if that is what he is asking.

Chairman KANJORSKI. Right. Well, let me ask you about that principle. Where did that come from, that you can throw the keys in and walk away? In my State, you cannot do that. You throw the keys in and they say, okay, where is your car, your firstborn, and everything else you own?

Ms. WACHTER. It does vary by State.

Chairman KANJORSKI. Yes. It varies by State. And did anybody do a comparison as to the foreclosure rate in Pennsylvania, relative to California or almost any other State that has a recourse rule? It is very low. When I sat on a bank board, a foreclosure of ½ of 1 percent was huge because people did not want to give up their trucks or their guns. They like guns in Pennsylvania.

Mr. GARRETT. But that is when you were patching tires, too.

[laughter]

Mr. MANZULLO. I have a question that I would like to ask Ms. Martinez Myers.

I looked at your testimony, along with the testimony of everybody else, including the Libertarian to your left. And you talk about wanting this hybrid. Okay? Well, apparently in today's economy in the United States, any business is subject to being taken over by the Federal Government.

We have had several hearings here on systemic risk, and when Mr. Geithner testified before this committee—I believe it was in—gosh, I am not sure when it was. It was in January—and he talked about this great super-regulator that would be over all the companies that could pose a systemic risk or perhaps a moral hazard. And a moral hazard really is a teetotaler who drinks a beer, because nobody could define these terms.

But I guess what bothers me is, you know, in the old days, you got a mortgage, you went to the bank, and the bank held it. And the mortgage was securitized by an appropriate ratio of demand deposits. And the money was simply set aside to cover the mortgage in case there was a problem on it.

And then we lost that great personal contact. But my question to Ms. Martinez Myers is: You talk about having a system that is fluid and liquid and that works. But you also make the statement that you want to make sure that money is available during tough times, and only the government can make that possible, as Dr. White gives us his big smile on that.

Would you explain that? And Dr. White, could you respond to that?

Ms. MARTINEZ MYERS. I guess you are asking me to explain why we feel that way. Well, the government has proven, through the experience with the GSEs, that through their existence, we were able to have liquidity in the market in good times and bad times. When things are tough in bad situations, they pull their money back, they don't make it available, and the market gets unstable.

We are looking to make sure that we can continue to help people sell their homes, help people buy homes in any kind of market because people are going to have housing needs regardless of what the market is doing at any given time.

I mean, we have situations. If you look at the example in the commercial mortgage scenario and the jumbo residential mortgage scenario, those are not guaranteed by the U.S. Government.

Mr. MANZULLO. That is true.

Ms. MARTINEZ MYERS. Those folks, right now there are people who are in trouble, say, in the jumbo market who are looking to refinance their house. So let me give you an example.

You are somebody who has made a good living. You have a partner who loses a job. Suddenly you can't make this big payment anymore. You have one of those exotic loans. You want to go and try and refinance it. Now your house is worth less. And it is not guaranteed, and you don't fit into the program that the President has put out there. And there is no guarantee, and you can't refinance it because there is no money available.

So now you are going to be delinquent, when you have been trying to avoid that, and you are going to lose your house. And the likelihood is you are going to go into foreclosure. And there are lots and lots of stories like that, commercial folks who are looking to—their debt is coming due.

They are trying to get them refinanced. They can't get any liquidity in the market. There is no funding for them. And they are in the same boat. We are seeing delinquencies rise, and we are seeing them go into foreclosure.

Mr. MANZULLO. So that—

Ms. MARTINEZ MYERS. That would happen to the whole market.

Mr. MANZULLO. Okay. That is a good answer.

Dr. White, what is wrong with her answer?

Mr. WHITE. Look, we do have a Federal Reserve. They are a lender of last resort. They are a provider of liquidity. We have seen just how creative Mr. Bernanke has been able to be over these past few years, and I applaud his creativity. I really do. I think he has done a spectacular job.

At the same time, we saw that the GSEs weren't able to step up when hard times hit, and in fact, they went into the ditch. And it is only because the FHFA now is steering them and trying to get them out of a ditch that now they are part of the solution. But they weren't part of the solution, and were going into the ditch themselves.

And so we do have—back to my point. We have a Federal Reserve. They are the lender of last resort.

Mr. MANZULLO. Yes. But so you are substituting the private/public partnership that is advocated by Ms. Martinez Myers by saying privatize the GSEs but have Federal Reserve on a standby?

Mr. WHITE. I do believe in there being a lender of last resort in the financial system. I think that is terrifically important.

Mr. MANZULLO. Then you believe the same way she does.

Mr. WHITE. Well—

Mr. MANZULLO. That is okay.

Mr. WHITE. —I think by lending—

Ms. MARTINEZ MYERS. That is not a bad thing.

Mr. WHITE. Well, thank you.

Chairman KANJORSKI. Dr. White—

Mr. WHITE. You focus it in a single entity. You don't spread it out.

Mr. MANZULLO. I have always wanted to ask a professor questions like that. And thank you, Mr. Chairman, for the opportunity.

Mr. WHITE. I am happy to help.

Chairman KANJORSKI. Doctor, you are just switching insurance companies, are you not? You are changing—making the Federal Reserve the insurance company to the system.

Mr. WHITE. Well, I would—

Chairman KANJORSKI. I mean, to be sort of consistent with the free market system, you all should be pressing not to have the Federal Reserve as the lender of last resort.

Mr. WHITE. Oh, no. I'm sorry. But when we do have financial crises, that is exactly when we do need a lender of last resort.

Chairman KANJORSKI. So you do need the government?

Mr. WHITE. Oh, for sure. For sure. And I said that before. We need a Federal Deposit Insurance Corporation.

Chairman KANJORSKI. Why did you not say that when some of our members were here?

Mr. WHITE. Well, and we need a Federal—

Chairman KANJORSKI. These guys are telling me every day they do not need the government. We are interfering with them.

Mr. WHITE. All right. I am with you on this. And let me say for the record, we need a Federal Deposit Insurance Corporation.

Chairman KANJORSKI. Mr. Manzullo, did you hear that, that you guys are wrong on that side?

Mr. MANZULLO. This hearing started out pretty boring, but it has really picked up in the last hour or so.

Mr. BERMAN. Mr. Chairman? Mr. Chairman, if I may, you know, we have a situation today where we have a 100-year flood about every 10 years.

Chairman KANJORSKI. And the government causes it.

Mr. BERMAN. Well, no. What I would suggest is that the government can play a role in helping to smooth out those kinds of crises. And there is not only a role for the government as a lender of last resort, but there is also a role in providing ongoing liquidity for a core set of products for both single family and for multi-family that can really be the central nervous system, if you will, for the secondary mortgage market and providing that liquidity; stable pricing, which is also important for homeownership; and a stable set of mortgage products that the economy can be built on.

Chairman KANJORSKI. No. I agree with you. And of course I sound terribly radical up here. I mean to because I want to excite you people. But the reality is I am getting very tired of having witnesses come in and testify, and some of my friends on both sides of the aisle say, "We are going to pass this special law so this will never happen again."

Now, none of these people are that stupid. Okay? So they know it is going to happen again. It has happened all the way through our history. The fact of the matter is, if you really look at our present situation, we went 50 years minimally without having a financial crisis.

That was the first time in our history as a nation that we went that long; or we perhaps went 75 years. And I think everybody would have to admit the reason was we had good regulation until it went awry.

Now, our problem is we have to get back to "good regulation." Maybe we even have to go a little beyond that and say, we need to get back to good values. And that is what I am sort of digging you all on.

You and I have a responsibility, it seems to me, that when we see somebody who is hedging the system, feeding the system, hurting the whole system, we have to realize it hurts us, too, because if they destabilize this system, all of us are going to get hurt.

And the question is: What are we doing about it? And I don't think for the last 5 years, we did a lot; certainly not enough. And if we go right back into repairing this, correcting some of our regulation, but we allow all these people to function out there in the system until they can find another way to escape responsible regulation in capitalism and it goes critical, and it has in the last 5 years, what have we gained?

We have gained very little. All we are doing is chasing our tail around the block. Maybe that is not wrong. Maybe that is how the system is intended to be. But I would hope after—there is a lot of pain, an awful lot of pain. And we don't see it down here.

You know, quite frankly, all of you are probably wearing suits that exceed the cost of most Americans' suits. You are driving cars that exceed the cost of most Americans' cars. Your kids are going to universities, and it is not—no, seriously. In Washington, you do not see the pain that you see when you go back to my district or you go back to Mr. Manzullo's district.

There are people living in this country for whom a sickness is a disaster. Just meals, just food, a disaster. It is a worrisome thing. It is not a question of educating your children; the need to actually not have them in school because you cannot even afford to have them there.

Now, we are not making accommodation for that. Oh, we are passing goody acts and we are, you know, doing nice things that are covering it up with whitewash, if you will. But this time, my friend Rahm is right. A disaster should not go unused. We can fundamentally change some of this system to make it fairer, better, and more equitable. And in some respects, all of us are going to have to give a little.

I am going to ask a question, and we have to wrap this up. Do not worry, though, we checked. The airplanes are not flying because of the thunderstorm, so you are all safe.

But take a shot at us now. Republican, Democrat, Banking Committee. Give me the worst criticism you can of our failures as a government and as people. And do not pull any punches.

Ms. MARTINEZ MYERS. May I?

Chairman KANJORSKI. You may start. You seem to like to do that, Ms. Myers. Go.

Ms. MARTINEZ MYERS. I am going to give you two.

Chairman KANJORSKI. Yes.

Ms. MARTINEZ MYERS. Okay. I think that—and I am actually going to do one better. I am going to say, we are going to take some responsibility for this, too. The FHA piece, and we have talked about this and have alluded to this before.

Industry probably wasn't pushing the FHA reform soon enough. We should have been talking about this in 2001, maybe when we started to see changes, and we didn't. We got around to it in 2003/2004. We presented it to Congress. And it sat around and sat around.

And we have to ask ourselves: If we had the FHA program that we have today that was relevant in the marketplace, would we ever have had the need for subprime mortgages, and would we be here today? I think we all have to take responsibility for that.

The second area that I would point out to you is we have seen a lot of moratoriums on these foreclosed properties. We need to rip the band-aid off so we can start the how long because right now, if we keep those moratoriums—and now they are released, and we are going to see a big flood of real estate in the marketplace over the summer. There are something like 800,000 foreclosed properties that are going to hit the street.

That is going to have an impact on our market. We have to get those absorbed. If we are ever going to right this market, we have to get those absorbed. And the only shining light on that foreclosed property—and it saddens me and breaks my heart; like, you know, I am involved in some of that business myself—that people are losing their homes.

But the bright spot is there are a lot of first-time home buyers buying those homes. People who didn't jump into that subprime market, people who sat on the sidelines because they couldn't afford it, and are in there. And maybe our homeownership rate will get back to normal in the process.

But we have to get that—blow that inventory through here and out of here for those that we cannot save instead of dragging our feet. No good is going to come of that.

Mr. ROBSON. Mr. Chairman, could I—

Chairman KANJORSKI. Mr. Robson, do you have something to add? I just happen to know you have a pressing engagement.

Mr. ROBSON. I appreciate that.

Well, two things. I think I would just follow up to—

Chairman KANJORSKI. This is hate mail, now. You are supposed to give us the worst you have.

Mr. ROBSON. One, the whole credit problem, I mean, there is a whole credit problem in this country. It is not just mortgages. It is AD&C loans on the construction side. It is commercial. It is—credit has completely frozen up.

And what sprouts we are seeing in the economy, especially in housing, hopefully that it looks like we are maybe reaching a bottom on—at least as far as home sales are concerned, both new and existing.

But if we don't get credit flowing throughout this country—whether it is small business, whether it is construction of development loans or anything else—we will not have a recovery.

And then I just echo—and some of the other things that have been said today earlier that—some of the questions with Mr. Lockhart, the appraisal problems are a very, very big issue. If we don't correct some of the abuses on the appraisal problems, we will never recover, either.

Chairman KANJORSKI. Very good.

Mr. BERMAN. Mr. Chairman?

Mr. ROBSON. If I could, Mr. Chairman?

Chairman KANJORSKI. Yes. You are excused.

Mr. ROBSON. Thank you very much.

Mr. BERMAN. Two issues that I put out there that I think maybe we could have done better on. One is taking a more holistic approach. And there have been a number of comments about not only the GSEs today but FHA, the banks, the private label market, and the rating agencies. I think if we are too focused on just one piece of the regulatory puzzle, it is unlikely that we will be successful in solving and preventing this from happening again.

Secondly, it has troubled me a little bit that some of the members are eager to latch onto a label of a solution. I think that at this stage of the debate, it is absolutely critical that we focused on principles and that we drill down on: What kind of ownership do we want for the entity?

What kind of regulation do we want? What kind of products do we want? Where do we want the interest rate risk to be? Where do we want the credit risk to be? What do we need to do for liquidity? And jumping ahead and trying to put a label on that, whether it is a public utility model or a coop model or a bond model I think is a serious mistake.

And rather, I think, if we have a principled approach and we start building up with building blocks from the ground up, we will end up with a model that—we will figure out what the name of it is after we create it, as opposed to trying to latch onto a model and say, that is a good one or that is a bad one.

So I would encourage us to use that ground-up principled approach.

Chairman KANJORSKI. Very good. Shall we save Mr. Morrison or the professor for last?

Ms. WACHTER. Well, thank you. If I were to criticize, going backwards, one, the consideration of lowering the FHA mortgage downpayment to zero at that moment to me was just a 13th gong of the clock.

And related to that, although I have no evidence but this is hearsay, it is out there that the GSEs were being encouraged, by Congress as well, to move into Alt-A and to subprime to help support that market.

Going forward, I think that Congress has to be farsighted in understanding the problems with asset bubbles. Asset bubbles are just as lethal as inflation and recessions. Japan was brought to its knees for 10 years. The Asian financial crisis affected many of the tiger countries for more than 10 years.

We have seen one. We can see more. We have had a housing market for decades in the United States, more than that, hundreds of years, even, in part because we have a very elastic supply of housing historically. We do not have an elastic supply of housing any more.

And my colleague Dr. White argues for reducing restrictions locally so we would have a more elastic housing supply. But I just don't think that is in the cards for a variety of reasons, including concerns over the environment. And local control is simply in our blood

So I don't think that is going to happen. Therefore, like Europe, like Asia, we are in a different world now. We are in a world where housing supply is inelastic. That means we are in bubble-potential world. But I don't think we can do anything about that from the basic regulation side. I think that means that we have to be attentive when housing bubbles are being formed.

There were those of us in academe—I was one of them—who said, in the real estate academe, in the real estate department at the Wharton School, we were in a bubble in 2006. And I wasn't alone.

And paying attention to this, and therefore to the potential for a major crisis when even reasonable loans are being priced at a point where prices aren't going to decline 20 percent; a 20 percent downpayment gives you no protection under those circumstances—we will need to pay attention.

Chairman KANJORSKI. Let me stop you there for a moment because I am from Pennsylvania and I have a great deal of respect for the Wharton School. My father, my brother, my nephew, they are all Wharton people.

They do have telephones, do they not?

Ms. WACHTER. Excuse me?

Chairman KANJORSKI. You do have telephones at the Wharton School?

Ms. WACHTER. I was not at Wharton. I did put my papers out there. But why wasn't it picked up? And my understanding—and this is a question to which I do not know the answer; this is an historian kind of a question. It is not empirical. I can't do econometrics, to answer your question.

But my understanding is there were good models out there. There were people saying this. But the models were not being purchased because there was no money in purchasing those models. Where the money was was continuing to get the deals done.

Chairman KANJORSKI. Did you have absolutely no faith in government, either the congressional—

Ms. WACHTER. No. I absolutely have faith in government.

Chairman KANJORSKI. Why did you not take the time and the effort as an academic? You know, when a professor of your standing calls my office, you would probably get a priority because I assume that you would not waste your time or my time by calling. So I am going go talk to you about it, whatever the issue is.

Why did you not do that? We have a lot of lonely people on the committee. They would have been—

Ms. WACHTER. Well, that is wonderful. I am thrilled to hear that is an option. We did publish our papers. We gave our papers at all of these meetings. They were in newspapers.

There were models out that were—Case-Schiller had his models out there. You know, Case-Schiller is obviously out there. Mark Zandi was out there. Mark Zandi's company was purchased by Moody's. But prior to that, Moody's did not use Mark Zandi's models, which were excellent models.

Chairman KANJORSKI. Well, going forward, use the telephone.

Ms. WACHTER. I will. Thank you very much for the offer.

Chairman KANJORSKI. Thank you.

Mr. Morrison? You know, I just want to blame you. You were here. Why did you not cure this problem? It is your fault.

[laughter]

Mr. MORRISON. Well, I thought I fixed the savings and loan problem, so then I left.

Well, I think that just to go back to the GSE question, Fannie Mae and Freddie Mac were a wonderful symbolic battleground in the Congress. They either were the devil incarnate, and needed to be dismantled and got rid of so that the private market could function; or they were the best thing that was ever done for affordable housing. Without them, we would have no housing at all.

And they were allowed to run a model which was totally unsustainable, a portfolio model of chasing growth stock status in the markets, and whatever they had to do to get there. After the years and years of the regulatory debate, what was most surprising to all the participants was that they were both wrong.

Those people who wanted to take Freddie and Fannie down apparently thought that Freddie and Fannie were so powerful that they would never be taken down. And on the other hand, there were those who thought they were so powerful that they would be the cash cow forever for affordable housing.

And what really turned out is they were a house of cards that collapsed because of the very model that made them appear strong, the growth stock model: "We can get this capital from the marketplace. We can give them portfolios, whatever it takes."

I think everybody was blind to the reality behind that. It was parties warring over symbols. And I think by missing that, yes, they were not the ones who created the private market securities. But they in fact created that marketplace in many ways by funding the AAA tranche of subprime securities early on and made that market go, and then everybody else followed on.

So I think that if the debate had been more honest—in 1995, I had a conversation with Alan Greenspan about huge portfolios and the impact that they would have. And he was very concerned about the Federal Home Loan Banks, but not at all concerned about Fannie and Freddie because he said, "Jim Johnson is the smartest man in town."

Well, he might have been. But his legacy we see. So we should be watching out for smart people and maybe do our own research.

Ms. WACHTER. But Bruce, if I may, it wasn't that they bought these early on. They bought them—

Mr. MORRISON. They did.

Ms. WACHTER. What year did they start buying them?

Mr. MORRISON. No. They started buying them—they funded Ameriquest and others in 2002/2003 by buying their AAAs.

Chairman KANJORSKI. Well, now, Mr. Johnson was gone by that period.

Mr. MORRISON. Oh, yes. No, I am not blaming Mr. Johnson. I am just saying that we had a lot of people who were blind to a model that was not sustainable, including Mr. Greenspan in 1995.

Chairman KANJORSKI. No question about it.

Mr. Manzullo, are you going to wind us up? I think Dr. White should get a crack at us, too.

Mr. MANZULLO. No. You know, the district I represent, in 1980 and 1981, we had 25 percent unemployment. And there were more people unemployed in Rockford, Illinois, during the early 1980's than there were proportionally during the so-called Great Depression.

And Americans worked their way through that. A lot of it had to do with the inversion of the dollar and the collapse of the ability to sell manufactured items overseas, including machine tools, etc., because your district is very much like mine.

But, you know, maybe I am thinking too simplistically here, is that we would not be in this problem, in this trouble, had not people bought homes that they couldn't afford in the first place.

And Mr. Chairman, do you know who some of the people were that were waving a red flag 5 years ago? It was the National Association of Realtors. They would come in the office, and of course they were thrilled to sell real estate and make everything.

But I was questioning all the easy money going on, and you know that, and so were a lot of your Realtor colleagues, saying, this is great, but you just can't keep on going on like this because somewhere along the line something is going to happen.

Chairman KANJORSKI. I held hearings on it.

Mr. MANZULLO. Pardon?

Chairman KANJORSKI. I held hearings in my district.

Mr. MANZULLO. That's correct.

Chairman KANJORSKI. In 2004.

Mr. MANZULLO. That's correct. And these are the types of signals that were being sent out that people like myself and you were saying, there is something wrong here. It started with the laundering of the books by Fannie Mae in 1990—no, in 2003 and 2004, with Franklin Raines and those characters taking those incredibly high salaries.

And their bonuses were predicated upon the fact that they had to get to a certain point of profit, and they got down to the mill. Do you remember that, Mr. Chairman? It was mills, just so they could get that extra amount of money squeezed out. And we were screaming here.

In fact, Fannie Mae had hired 17 lobbyist firms that were out there getting bogus postcards from 2,500 of my constituents saying, don't change anything at Fannie Mae. We don't want any reforms. And then the reforms that we wanted really were to tighten up the lending standards.

But I guess we were just like John the Baptist, just crying out in the wilderness and no one was listening.

Mr. WHITE. All right. I will try to be brief. It is getting late.

If I were to offer the criticism that you invited, I would say you let us get way too deep into the whole housing issue. Again, there is a role for government. Bruce, you and I differ on this, but I have to speak truth to power. It ought to be a focused, targeted role.

The broad brush role just gets us with a far too large stock of housing, and a far too small stock of human capital, of physical capital, as a consequence. That is a big cost that we have paid. We are paying it now in the current crisis as well.

Let's see. Some other things. Some small things—

Chairman KANJORSKI. How could that have been—

Mr. WHITE. There is RESPA.

Chairman KANJORSKI. Yes. But how could that have been prevented?

Mr. WHITE. Sorry?

Chairman KANJORSKI. How could that have been prevented?

Mr. WHITE. Well, okay. You asked. The rating agencies.

Chairman KANJORSKI. They are the buggers.

Mr. WHITE. They are—you know, there is lots of blame to go around. But clearly they were one of the central parties here. And it was no accident that they became a central party. They were a central party because of financial regulation.

Had that whole structure, and again, you could see each step made sense. But by the time you went down the road, you had a handful, a literal handful of rating agencies—

Chairman KANJORSKI. I have to ask you: Should they have been federally regulated?

Mr. WHITE. Say again?

Chairman KANJORSKI. Should the rating agencies have been federally regulated?

Mr. WHITE. I would argue no. But they also should not have been thrust into the center of the bond markets the way the bank regulators, the insurance regulators, the pension fund regulators, the Securities and Exchange Commission, all forced them into the center of the bond markets. And when the securitization process started—

Chairman KANJORSKI. No. I am trying to figure out, then. You would have had us not have a rating agency in any way giving indications of—

Mr. WHITE. Oh, no. No. I would have the rating agencies still there, but not as a mandated source of information. I want banks to have safe bonds. I want the regulator to work with the banks to have safe bonds. But it should be the responsibility of the bank to either demonstrate the bonds' safety to the regulator or have an advisor that it can demonstrate to the regulator.

Chairman KANJORSKI. Something like AIG Financial Products in London? A small operation of 400 people who have a bank, and have a regulator come over for a couple of weeks every year to look them over. And they get involved in transact counterparty positions of $2.7 trillion. That is what you would like that unregulated—

Mr. WHITE. Oh, no. Heavens, no. Heavens, no.

Chairman KANJORSKI. Well, is that not what—

Mr. WHITE. They were running a big insurance operation and—

Chairman KANJORSKI. Is that not what an unregulated system brings us?

Mr. WHITE. If we are going to let entities get so big with so many counterparties, then we have to have a regulator.

Chairman KANJORSKI. So, now, that is a good point. Then you would have liked us not to have repealed Glass-Steagall?

Mr. WHITE. Say again?

Chairman KANJORSKI. Glass-Steagall should not have been repeated?

Mr. WHITE. No. No. The repeal of Glass-Steagall had absolutely nothing to do with the debacle—everything that has happened could have happened.

Chairman KANJORSKI. Well, that is what allows entities to become huge.

Mr. WHITE. Well, Merrill and Bear Stearns and Lehman and Morgan Stanley were all going to—and Goldman—were going to get huge regardless, and Citi. Citi got a little bit bigger because the repeal of Glass-Steagall allowed it to buy an insurance operation.

Chairman KANJORSKI. Well, I am not sure I catch your drift, though. Do you think the government should have had more or less regulation?

Mr. WHITE. It needed to be smarter regulation. In some places it needed to be less, and in other places it needed to be more. For sure it needed to be smarter.

Chairman KANJORSKI. That sounds like Monday morning quarterbacking. I am on the field on Saturday. We are calling the plays on Saturday.

Mr. WHITE. Well, okay. In the case of the credit rating agencies, I have been there for about 8 years now. So I could have told you basically this story 8 years ago, and did—well, sorry. I was publishing it.

Chairman KANJORSKI. Well, should they be allowed to be paid by their users?

Mr. WHITE. That is something that the institutional bond market could figure out on their own. I don't trust this guy because I am worried about his conflicts of interest. I am going to trust somebody else who's business model I think is a more solid model.

The bond market is fundamentally an institutional market, and those institutions can figure that out.

Chairman KANJORSKI. For some reason I think—I am sensing you are putting a foot on two icebergs here. You are not being straight with us. Give me an image of what you want the government to do.

We are the big government that you have a right to hack at us. So tell us what the right direction is, in your opinion, and then you are going to be held responsible for it.

[laughter]

Mr. WHITE. Okay. As I said, we cannot do anything radical at the moment. The financial markets are far too fragile.

Chairman KANJORSKI. So you would clearly give advice to us to go easy. Do not speed through this and have unintended consequences. Let us get back on the recovery stage, and then be very serious about reforming some of these institutions.

Mr. WHITE. For sure. And then I would privatize Fannie and Freddie. I would have a targeted program to be encouraging first-time homeownership.

Chairman KANJORSKI. So if we privatize Fannie and Freddie, they can do exactly what Wall Street did with their special securities that they privatized. Is that—

Mr. MANZULLO. Well, given the size and the systemic risk, like it or not, we need a systemic regulator.

Chairman KANJORSKI. Well, then you do not. You mean you want Fannie and Freddie privatized, but with a very stiff systemic risk regulator?

Mr. WHITE. For sure. For sure. Yes. Yes.

Chairman KANJORSKI. Well, then, all you are doing is where the money flows. You want—

Mr. MANZULLO. Well, no. I think it makes a difference.

Chairman KANJORSKI. You want the wealthy institutions to be making more money off mortgage securitization than they are now. Is that not the only difference?

Mr. WHITE. I don't—Congressman, I don't see it that way. But, you know, I think it makes—I think it makes a difference. Also, I would not have the kind of implicit guarantees that were—where everybody knew that Fannie and Freddie were—

Chairman KANJORSKI. You think if we have a private institution the size of $5.6 trillion, that there is not an implicit statement that the United States Government has to come in and rescue it when it fails or else it brings the entire system down?

You don't think we made that hard vote, going back to September of last year, because we wanted to "bail out" Wall Street? You do know the circumstances of that vote, don't you? You remember what—you know what the Secretary of the Treasury and Chairman Bernanke told us that famous meeting or several meetings that we had?

That we were 24 hours away from a total meltdown of the American economy, and 72 hours away from a total meltdown of the world economy, that it would take us back several hundred years, that we did not have even the security to feed America at the time if it happened. I could go on to other scary things. I am not about to do it now.

But you do not think we did that because we just did not want some rich people on Wall Street to lose their banks?

Mr. WHITE. For sure. For sure.

Mr. MANZULLO. I didn't do that.

Chairman KANJORSKI. What?

Mr. MANZULLO. I didn't believe it.

Chairman KANJORSKI. You did not believe him?

Mr. MANZULLO. It was $700 billion was supposed to buy up the bad assets. They still haven't been bought up.

Mr. WHITE. Anyway, I would be happy to expand on these. And I hope I can take up the invitation you offered to Professor Wachter.

Chairman KANJORSKI. Absolutely. All of you. The other two left already, and we will send them a letter. No, do not—really. If you have ideas on the subject, regardless of how wacky they may sound or out of the normal configuration of things, do not hesitate to tell us.

We are going to try and do the best we can to do some management of what has been a relatively disturbing, unstabilized system that we now have. And we are going to do our best.

We are looking for the best thought process in the world, and that is why we asked you all to testify today, so that, one, we could harass you, two, we could keep you here until 7:30 at night and get you—you know, I am actually leading a seminar for divorce lawyers. Anybody has spouses you are going to get into potential catastrophes with at home? No. We are going to close it up now.

I do want to thank you all very much. I hope you did not mind going informal like this.

Mr. WHITE. Thank you, Mr. Chairman.

Mr. MANZULLO. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you for appearing. And I am supposed to read something into the record now.

The Chair notes that some members may have additional questions for this panel which they may wish to submit in writing.

Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

Before we adjourn, the following items and statements will be made part of the record for this hearing: a statement from the Manufactured Housing Association for Regulatory Reform; a statement of the Independent Community Bankers of America; a letter from the National Association of Federal Credit Unions; the letter requested by Congressman Campbell from Mr. Cox to Mr. Lockhart; and an article by David Goldstein entitled, "Private sector loans, not Fannie or Freddie, triggered crisis."

Without objection, it is so ordered.

The panel is dismissed, and the hearing is adjourned.

[Whereupon, at 7:28 p.m., the hearing was adjourned.]

A P P E N D I X

June 3, 2009

OPENING STATEMENT OF CHAIRMAN PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON THE PRESENT CONDITION AND FUTURE STATUS OF FANNIE MAE AND FREDDIE MAC

JUNE 3, 2009

We meet today to examine the present condition and future status of Fannie Mae and Freddie Mac, which together have lost more than $150 billion since the third quarter of 2007. This hearing is not only the first hearing in the 111th Congress on the two government-sponsored enterprises, but it is also the first in a series that the Capital Markets Subcommittee will convene to review these matters.

Last summer, Congress completed work on an eight-year project by enacting the Federal Housing Finance Reform Act. Shortly thereafter, the new Federal Housing Finance Agency placed Fannie Mae and Freddie Mac into conservatorship. Since then, the Treasury Department has purchased $85.9 billion in senior preferred stock at the two enterprises. This investment could ultimately grow to as much as $200 billion per institution under current agreements.

In recent months, the Treasury Department has supported Fannie Mae and Freddie Mac in other ways, as well, by purchasing $5 billion of their mortgage-backed securities in 2008 and requesting $249 billion more for 2009. In addition, the Federal Reserve now has a sizable interest in the success of the two companies, holding more than $71 billion of their bonds and $365 billion of their mortgage-backed securities.

In total, these growing taxpayer commitments are quite sizable, if not staggering. They have also led many to conclude that the implicit government guarantee toward the enterprises has now become an explicit one. Our hearing today will therefore examine the government's financial support for Fannie Mae and Freddie Mac and explore options for the future of their relationship with the government.

From my perspective, the emergency actions taken to date by the Federal Housing Finance Agency, the Treasury Department, and the Federal Reserve were needed to ensure the continued functioning of our nation's housing finance system during this period of considerable economic turmoil. With all of their problems and imperfections, Fannie Mae and Freddie Mac have ensured that millions of Americans can continue to purchase and own their homes.

While the existence at this time of Fannie Mae and Freddie Mac is essential for our nation's economic recovery, this is also an appropriate moment to begin to consider how we might modify their mission, operations, and ventures going forward. As former Treasury Secretary Henry Paulson has observed, we need to use this period while Fannie Mae and Freddie Mac stabilize to decide what role they should play in the markets. I must, however, caution everyone that this debate will be a long-distance relay between Congresses, not a 100-meter sprint within the 111th Congress.

The debate over what roles and functions Fannie Mae and Freddie Mac should perform has, of course, raged for many years. Many good reform ideas have started to come to light in recent months, and we should study them closely. Some of our choices include reconstituting the enterprises as they were before the conservatorship decision; splitting them into smaller operating companies like we did with AT&T; regulating the prices they charge like a utility; creating cooperative, non-profit ventures; or revolving them back into the government.

Many have also called for privatizing Fannie Mae and Freddie Mac, and there is some precedent for such actions. In the 1990s, for example, we enacted a law that allowed Sallie Mae to graduate from the school of government-sponsored enterprises. While we could do the same here, we ought to move cautiously. We created Fannie Mae and Freddie Mac because of a market failure, and we ought to ensure that any new system of housing finance continues to provide a stable source of funding and long-term credit to help people to purchase homes.

In short, we must keep our minds open to all reform proposals and refrain from drawing lines in the sand about what each of us will, or will not, support until we have had the chance to consider the pros and cons of many different options. That said, I will use one key factor in my examination of these choices: Namely, I want to ensure that community banks and retail credit unions continue to have access to a neutral source of affordable funding to help them compete against large institutions. These mortgage providers are important participants in our markets, and we must ensure that they continue to have an opportunity to help hard-working families to achieve the American dream of homeownership.

In sum, this hearing is timely. Congress has a constitutional responsibility to conduct effective oversight of the work of the Federal Housing Finance Agency to make sure that it is operating as we intended. We also have an obligation to ensure that the executive branch is effectively allocating federal tax dollars and helping as many people as possible to remain in their homes. Finally, Congress needs to begin to think about how it will structure the government's relationship with Fannie Mae and Freddie Mac once we emerge from this financial crisis. I look forward to a vibrant debate on these important issues.

News From
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EMBARGOED UNTIL DELIVERY
Wednesday, June 03, 2009

Contact: Erica Elliott
Phone: 202-744-2693

Garrett Opening Statement for Fannie/Freddie Hearing

(Washington, DC)– **Rep. Scott Garrett (R-NJ) released the following opening statement for today's House Financial Services Subcommittee on Capital Markets hearing entitled "The Present Condition and Future Status of Fannie Mae and Freddie Mac":**

"Thank you, Mr. Chairman, for holding this important hearing today. I also want to thank the Chairman for his comments about being open to all the different options and I promise to keep an open mind as well as we discuss different ways to restructure our mortgage finance system. I think one thing we can definitely agree on is that doing nothing and keeping the status quo is unacceptable.

"Fannie Mae and Freddie Mac played leading roles in adding fuel to the mortgage finance fire that burned down a good portion of our financial system and economy as a whole. By financing roughly 36% of the subprime housing market and increasing their leverage to 100-to-1, they abused their governmentally granted advantages in the marketplace and have run up a bill with the taxpayers to the tune of $85 billion and counting.

"The total bailout costs of Fannie and Freddie are expected to climb much higher. When the Housing and Economic Recovery Act was passed, an arm-twisted CBO scored the GSE titles of the bill at $25 billion and said there was less than a 50% chance that the bailout authority would ever be used and less than a 5% chance that the costs would ever run over $100 billion. The Chairman of the committee, Chairman Frank chastised Republicans on the floor who said that the costs would likely go well over the CBO estimate saying, "It is the most inflationary arithmetic I ever heard." Of higher cost estimates being used by Republicans he stated, "these numbers that are being thrown around are simply inaccurate and misleading."

"Well, speaking of inaccurate and misleading, the CBO recently updated their scoring of those titles and the cost estimates increased by over 1,500%.

"As we begin this month with a more formal debate over regulatory restructuring and providing the government with explicit "bailout authority," I think it is essential that any conversation begin and end with the GSEs. Any regulatory reform that does not reform the GSEs is not true reform.

"Fannie and Freddie were a large part of the problem, and reforming them should be a large part of the solution.

"Also, I am very worried that proposals being discussed by the administration and this committee to create a so-called Systemic Risk Regulator will actually create what amounts to another new set of government sponsored entities. By creating a new Systemic Risk Regulator we could essentially establish a dozen new Fannie and Freddies that will be "too big to fail" and have the inherent market advantages that will come with that distinction. As our distinguished Ranking Member from Alabama points out, privatizing profits and socializing risk is a bad business model and we should learn from our past mistakes, not repeat them.

"Going forward, I do believe it is very important that we have a viable and liquid secondary mortgage market to help provide additional funding so that more people can experience the American dream of owning their own home. One tool that I believe offers a significant amount of promise to meet that goal is covered bonds.

"Covered bonds are debt instruments offered by a financial institution and backed by a collateralized pool of mortgages. Investors purchase these bonds and the pool of mortgages is treated as secured collateral and the investors also continue to have full recourse on the institution in case of a failure. This type of securitization is widely used in Europe to provide liquidity to their mortgage markets and I believe they could be very effective in increasing mortgage funding in the U.S. I thank Chairman Frank for his commitment to hold a hearing on this important topic and look forward to working with all of my colleagues to continue to move this forward.

"I want to thank all of the witnesses for coming today, especially Director Lockhart, and I look forward to the testimony."

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Opening Statement of Congressman Tom Price, M.D.
House Committee on Financial Services
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Hearing on "The Present Condition and Future Status of Fannie Mae and Freddie Mac"
Wednesday, June 3, 2009

Chairman Kanjorski, Ranking Member Garrett, thank you for holding this important hearing about the future status of Fannie Mae and Freddie Mac.

The current risk Fannie Mae and Freddie Mac pose to the American taxpayer is one of the most pressing issues facing this Congress. As Congress moves forward with debate over sweeping regulatory reform, the future fate of these government sponsored enterprises (GSEs) must play a central role in the debate.

Over the course of the last two decades, Fannie Mae and Freddie Mac drastically expanded their portfolios and the risks held therein. For many years Republicans fought to strengthen the GSE regulator, but were stymied by the Senate and the GSEs themselves. In 2008, under the Housing and Economic Recovery Act (HERA) Congress passed much touted reform of the GSEs; however, this reform was too little too late to protect the taxpayers.

In addition to strengthening the GSE regulator, under HERA the Department of the Treasury and the Federal Housing Finance Agency (FHFA) were given the authority to put Fannie Mae and Freddie Mac into conservatorship and given unlimited authority to commit taxpayer money to keeping these entities in business. In testimony given to the Senate Banking Committee, former Treasury Secretary Henry Paulson gave numerous assurances this authority would not be used: "If you have a bazooka in your pocket and people know it, you probably won't have to use it."

Despite these assurances, in September 2008, the GSEs were taken into conservatorship; the government took an 80% share in each company; and each GSE was given access to $100 billion line of credit from the American taxpayer.

Since this time, the GSEs line of credit has been increased to $200 billion each with a total of $85 billion disbursed to the GSEs; the Federal Reserve has purchased over $400 billion in GSE mortgage backed securities (MBS) and $80 billion in GSE debt; and the Treasury has purchased another $60 billion in GSE MBS.

Further, Fannie Mae and Freddie Mac have been allowed to increase the size of their portfolio of mortgages and MBS to $900 billion. While these lifelines were floated to Fannie Mae and Freddie Mac, these companies retained their private status and remain listed on the stock exchange. From the third quarter of 2007 to the present, the two GSEs combined have posted over $150 billion in losses to their shareholders, primarily the American taxpayer.

Thus, looking ahead, it is critically important the GSEs are fully privatized or required to liquidate and the American taxpayer is repaid in full for their temporary assistance. There is no excuse for Fannie Mae and Freddie Mac to continue their hybrid public-private mission and there is no excuse for the socialized losses the taxpayers are experiencing.

Thank you again Chairman Kanjorski and Ranking Member Garrett for holding this hearing.

MORTGAGE
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Statement of Michael D. Berman, CMB

**Vice Chairman,
Mortgage Bankers Association**

Before the

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Committee on Financial Services

United States House of Representatives

Hearing on

"The Present Condition and Future Status of Fannie Mae and Freddie Mac"

June 3, 2009

Chairman Kanjorski, Ranking Member Garrett, thank you for inviting the Mortgage Bankers Association[1] to testify on the very important issue of the present and future status of Fannie Mae and Freddie Mac. My name is Michael D. Berman, CMB, and I am MBA's Vice Chairman. I have been in the real estate finance industry for over 25 years and am the founder, President and Chief Executive Officer of CWCapital. Headquartered in Needham, Massachusetts, CWCapital is a national lender to the multifamily and commercial real estate industry, with over 135 employees in 10 offices throughout the U.S. My responsibilities include overseeing the strategic planning and operations for all of the company's loan programs, including multifamily programs with Fannie Mae, Freddie Mac and the Federal Housing Administration (FHA). Also, CWCapital has been active in the commercial mortgage backed securities arena as an investor, lender, issuer of securities, servicer and special servicer.

The Past

MBA has always been at the forefront of efforts to clearly define the role, function and objectives of the government sponsored enterprises (GSEs), and to bolster their oversight, even before accounting issues emerged in 2003 and made GSE reform a front-page issue. During the legislative deliberations and administrative actions that ensued, MBA consistently emphasized the GSEs' value to the housing finance system, while suggesting the need for a stronger regulator who would maintain their safety and soundness, focus them exclusively on the secondary market and ensure that they did not neglect their public purpose in pursuit of private profit. I also would like to note MBA's strong support for another housing GSE, the Federal Home Loan Bank System. However, my comments today are exclusive to Fannie Mae and Freddie Mac because they are the focus of this hearing.

The Present

After the Housing and Economic Recovery Act (HERA) was enacted in July of 2008, strengthening the GSE supervisory regime in line with MBA's earlier recommendations, financial market conditions worsened, and the GSEs were placed into conservatorship, thus beginning yet another chapter in the GSE restructuring debate.

Since then, Congress, the administration and others have directed their attention to stemming further deterioration of the GSEs' financial conditions, and the economy at large. This adds another layer of complexity to the reform debate because the GSEs have become lynchpins for many government programs aimed at revitalizing the housing finance system. In fact, despite their financial situation, the GSEs currently

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,400 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

participate in over two-thirds of all single-family and multifamily mortgage transactions While the FHA also facilitates a significant share of residential mortgages, the GSEs currently are the prevailing force in the market. MBA supports the use of the GSEs in this manner, however we recognize that this is an unsustainable and artificial business model.

The Future

While MBA is actively engaged in the search for solutions to resolve the current financial crisis, we also have been considering how the secondary mortgage market needs to change over the longer term. In 2008, MBA convened a council of mortgage finance experts to look beyond the current market turmoil to what a functioning market should look like for the long-term. This "Council on Ensuring Mortgage Liquidity" began with a two-pronged mission: identify the key ingredients of a functioning secondary market, and establish a set of principles for policy-makers to consider when debating the construct of the secondary market of the future.

I have the privilege of chairing this 25-member council with representatives from the single-family, multifamily and commercial components of the industry, including depository institutions, mortgage banking firms, mortgage insurers and more. Our approach has been to examine the issues so that stakeholders could assess options in a measured, thoughtful manner. We knew in setting up the Council that the policy winds would shift with economic circumstances. The Council agreed early to avoid an overly prescriptive approach and instead to assess the market and present alternatives, which we plan to refine in the coming weeks and months.

To accomplish the first objective of identifying the key ingredients of the secondary market, the Council hosted an industry-wide summit to gather input and perspective from academics, industry professionals, regulators and others. The recurring themes arising during the summit have been consolidated into a white paper (see attached) titled "Key Considerations for the Future of the Secondary Mortgage Market and the Government Sponsored Enterprises." This paper presents a set of building blocks to aid in understanding and discussing the merits of various market structures. It also lists and begins to describe nine alternative models for channeling government support to the housing finance system.

The Council next developed a set of guiding principles (also attached) based on the key considerations mentioned in the white paper. The principles serve as a tool for evaluating proposals that may arise for restructuring the secondary market. The scope of these principles is the entire secondary market, including the responsibilities of private market participants and the role of the federal government. The market-wide scope of the guiding principles conveniently serves as a foundation upon which to build other, more narrowly focused positions, such as on restructuring the GSEs, ratings agency reform and other issues. The following are some key findings related to the future of the GSEs or alternative framework.

Investors Should Fund Transactions and Assume Risk
One consistent theme emerging from the Council's work is that private investors should fund and bear the majority of risks associated with mortgage-related investments. The purpose of the secondary market is to attract a broad array of investors seeking market returns. The secondary market functions optimally when those investors also understand and assume the risks associated with those transactions.

Limited Government Support
MBA also acknowledges that a limited level of government support is needed to provide an adequate level of investor confidence regardless of market conditions. MBA recommends channeling this support through an explicit government guarantee against credit risks associated with certain mortgage investments. The cost to the government for providing this credit guarantee could be offset by risk-based premiums paid by investors.

MBA also believes the secondary mortgage market benefits by having a government-supported program to provide liquidity during periods of extreme market distress. This provides investors with greater comfort during liquid as well as illiquid periods, thus reducing the yields investors demand in good times and bad.

Target the Core Market
Although we refer to the secondary mortgage market in the singular form, the market's dynamics during the past two years reveal three distinct types of liquidity streams. One fosters liquidity for government-backed mortgages that further social policies such as increasing the availability of affordable housing finance. The second stream serves the core market of routine products and most borrowers, and the third provides liquidity for mortgage markets such as nonprime, jumbo, alt-A mortgages and other single-family and multifamily products.

Recent experience suggests that the core loan market also functions like a central nervous system for the entire real estate finance system. For example, the core market was the last sector of the market to experience liquidity shortages in the recent downturn. It is also likely that the entire market will not recover completely until this sector is revived. For these reasons, MBA believes this sector must possess an explicit government credit guarantee as well as liquidity assurance in times of market distress.

MBA also believes any future government role should remain ecumenical with respect to origination channels, business models or lender size so as to provide a consistent level of support, and avoid government-induced market distortions. The housing finance system comprises an abundant array of investors, funding programs and business models. By supporting all of these entities without preference, the federal government fosters a healthy climate for innovation, competition and efficiency.

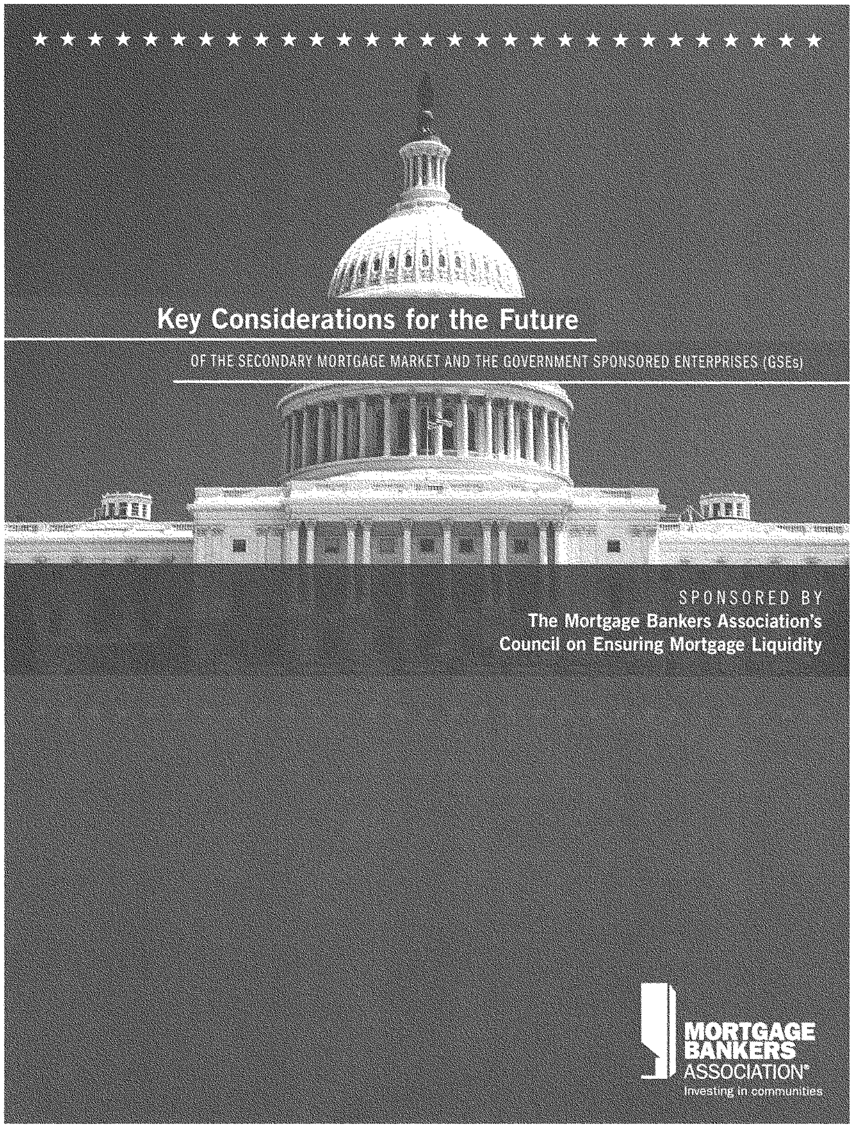
Transition Considerations are Important
MBA believes any restructuring proposal must facilitate the transition from the current to the future state. This is critical because the market's condition is still quite fragile and even the most carefully deliberated plan could destabilize the market further if implemented hastily. Although MBA recognizes the need for GSE reform, sustaining the viability of the current market also must be a top priority. In fact, MBA requests Congress take additional measures so that existing government run or government sponsored programs have the capacity to function as liquidity providers. For example, the credit facilities established by the Department of Treasury for Fannie Mae, Freddie Mac and the Federal Home Loan Banks expire at the end of this year, as does the Department of Treasury's authority to purchase GSE mortgage backed securities (MBS) in the open market. MBA believes it is imperative to suspend the expiration date for these programs until such time as an economic recovery is reasonably foreseeable.

MBA also requests Congress help make mortgage credit more available and affordable in the near term and going forward by setting the GSE loan limits at $625,500, and up to $729,750 in high-cost areas, on a permanent basis. The higher temporary loan limits established by the Economic Recovery Act enacted earlier this year have benefited the mortgage industry and consumers during the continued turbulence in our nation's economy. Because the higher loan limits are temporary, the investment community announced it will not purchase bundles of loans if they include more than ten percent of high conforming loan limit (CLL) loans. This dilutes the full benefits of the higher CLL because liquidity is artificially restricted.

In addition, because the GSEs are vital sources of housing finance liquidity, MBA believes it is important for these entities to provide market support to the broadest possible spectrum of home prices.

Conclusion
MBA believes secondary market transactions should be funded by private investors seeking market returns who understand, accept and are held accountable for the risks associated with those transactions. In order to attract consistent levels of private capital from a wide range of investors, MBA believes there is a role for an explicit federal government credit guarantee on mortgage-related investments. Additionally, policy-makers should establish safeguards to ensure a smooth transition from the present to whatever future model is developed. A careful, measured approach should be adopted so that current markets are not further destabilized.

Thank you for the opportunity to appear before you, and I am happy to answer any questions you may have.


Key Considerations for the Future
OF THE SECONDARY MORTGAGE MARKET AND THE GOVERNMENT SPONSORED ENTERPRISES (GSEs)
SPONSORED BY
The Mortgage Bankers Association's
Council on Ensuring Mortgage Liquidity
MORTGAGE
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The secondary mortgage market is broken. Investors have lost faith, lenders are limited in their ability to provide financing, and the federal government, through FHA, Fannie Mae and Freddie Mac, is the only major source of liquidity to the market.

In response to this crisis, the Mortgage Bankers Association (MBA) established the Council on Ensuring Mortgage Liquidity. The Council is a group of 25 leaders from the real estate finance industry who are working to provide a framework for a renewed secondary mortgage market with an initial focus on the government-sponsored enterprises (GSEs). The Council includes representatives from across the industry. The single-family, multifamily and commercial sides of the industry are represented, as are depository institutions, mortgage banking firms, mortgage insurers and more.

The Council's mission is to look beyond the current crisis, to what a functioning market should look like for the long-term. As a first step, on November 19, 2008, the Council hosted a summit that brought together academics, industry professionals, regulators and others to discuss what fundamental elements are required for a functioning secondary market. This white paper is drawn in part from that summit, and has been developed as input to the Council's deliberations.

The paper has been designed to provide a common foundation and language as the policy discussions take shape. As the introduction notes, "This paper is not a policy statement — it makes no attempt to weigh the merits of different systems or to recommend one or more approaches. Rather, this paper presents a set of building blocks from which policymakers, industry representatives, academics and others can begin to understand and discuss the merits of different options and recommendations." We trust that it will serve as a valuable resource.

In coming weeks and months, the Council will build on the work of the summit and this paper to identify key principles that policymakers and others should consider when evaluating proposals that will affect the market's future. The MBA looks forward to working closely with Congress and the Administration to ensure that legislation and regulatory reforms are enacted that will redesign the GSEs and will help speed the return of liquidity to the mortgage market.

Until recently, the U.S. mortgage market was the most liquid credit market in the world. It is our hope that with timely, deliberate planning and collaboration, it soon will be again.

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EXECUTIVE SUMMARY

A secondary mortgage market provides liquidity by attracting money from investors to real estate finance borrowers. Mortgages compete for investors' funds with a wide range of other investment options, including stocks, other bonds and various alternative investments. In exchange for providing capital to borrowers, investors receive, in some form, a share of the interest and principal payments made by a borrower repaying the loan.

A wide range of mechanisms have been developed to funnel investment dollars into mortgages. Each mechanism takes advantage of different methods of spreading interest rate and credit risk among participants. Each mechanism also provides differing levels of involvement for the investors. At any one time, most, if not all, of the mechanisms may be in use in the market. For example, some investors simply buy and hold whole loans. For other investors, instruments have been created like Fannie Mae's and Freddie Mac's pass-through mortgage-backed securities (MBS), and Ginne Mae's guaranteed pass-through MBS for FHA and VA loans. Other investors have preferred private label residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) that are broken out into different risk tranches (AAA, AA, etc.). Finally, some of these instruments have been reconfigured and packaged into CMOs and CDOs.

A number of key considerations come to the fore when thinking about how best to restore the secondary mortgage market. The careful consideration of these factors will be essential as policy makers and others assess the relative strengths and weaknesses of different models for the secondary market and the GSEs. These areas will need to be addressed regardless of what model or models become successful. Some of these areas are:

RISK ASSESSMENT: Risk assessment is an imperfect science, but it is at the heart of all secondary market actions. Given the importance of risk assessment, an effective secondary market must promote accurate, effective and stable risk assessment. Equally important, third-party assessments of risk must be highly credible to be widely used or adopted.

ALIGNING RISKS, REWARDS AND PENALTIES: A key consideration for the market going forward will be ensuring the alignment of risks with rewards and penalties. Loan attributes, such as whether a loan is adjustable-rate or fixed rate, or does or does not have a prepayment restriction, shift risks between the borrower and the investors. If investors or other market participants are not accountable for the risks they take on, they are prone to act irresponsibly by taking on greater risks than they otherwise would.

ALIGNING REWARDS WITH LONG-TERM PERFORMANCE: Given the long-term nature of a mortgage contract, as well as the imperfect state of risk assessment, some risks inherent in a mortgage asset may not appear for some time after the asset has changed hands. It is important to consider the degree to which participants in the mortgage process can be held accountable for the long-term performance of an asset.

ENSURING CAPITAL ADEQUACY OF PARTICIPANTS: Participants throughout the market need adequate levels of capital to protect against losses. Capital adequacy is keenly dependent on the assessment of risks outlined above. The greater the risks, as assessed, the greater the capital needed. In times of rapid market deterioration, when model and risk assumptions change dramatically, capital needs may change dramatically as well. If market participants that have taken on certain risks become undercapitalized, they may not be able to absorb those risks when necessary — forcing others to take on unanticipated risks and losses.

CONTROLLING FRAUD BETWEEN PARTIES IN THE SYSTEM: Given the size and scope of the mortgage market, there is potential for market participants to perpetrate fraud against other participants. A key consideration for an effective secondary mortgage market is the degree to which the market minimizes fraud. Key considerations include the ability to identify and prosecute fraud, and the degree to which fraud is deterred.

TRANSPARENCY: In order to attract investors, another key consideration for a secondary mortgage market is its transparency. The less transparent a market is, the more poorly understood it will be by investors, and the higher will be the yield those investors demand to compensate for the uncertainty. Accounting rules also affect how firms report the sale of mortgages and mortgage-related assets. In some instances, these rules have clouded the transparency of who holds certain assets, the risks associated with them and the capital required to adequately support them. Rules that affect the ways in which firms account for the sale of structured securities and how they mark their assets to market will have a profound impact on the shape that a future secondary market can take.

All the potential models for the secondary market and the GSEs involve tradeoffs. No one model results in a perfect combination of attributes for all investors in mortgages, which is one of the reasons we have historically seen multiple models. In order to be successful, a potential model needs to demonstrate its strengths and weaknesses in the following areas:

MEANS OF ATTRACTING A BROAD ARRAY OF INVESTORS: The secondary mortgage market has attracted a broad array of investors in recent years, including mortgage professionals steeped in the intricacies of the mortgage market as well as mid-tier and smaller investors with only a passing knowledge of mortgages or mortgage securities. A key consideration for future markets is how to again attract all levels of investors, whether through transforming credit and interest rate risk into counterparty risk, providing credible third-party assessments of risks or some other means.

LENDER / LIQUIDITY OF LAST RESORT: Even an effective secondary mortgage market will occasionally meet with periods of illiquidity. During such times, it has proven beneficial to have a "lender of last resort" that is willing to step in and absorb the cost of the illiquidity of certain assets.

TRANSITION: The secondary mortgage market is in an extremely fragile state. A key consideration for any actions regarding its future will be how to transition from the market's current state, to its desired state. The size of the market, and the depth of its infrastructure, will make any such transition a significant challenge.

INTRODUCTION

On November 19, 2008, the Mortgage Bankers Association's Council on Ensuring Mortgage Liquidity hosted the *Summit on the Future of the Secondary Mortgage Market and the Government Sponsored Enterprises (GSEs).* The Summit brought together 130 thought-leaders from industry, academia, government regulators, think-tanks and trade groups to discuss the recent failures of the secondary mortgage market and what is needed for a future system to be successful.

This white paper provides a framework for understanding the role of the secondary mortgage market and the GSEs and some of the key considerations for their futures. **This paper is not a policy statement — it makes no attempt to weigh the merits of different systems or to recommend one or more approaches.** Rather, this paper presents a set of building blocks from which policymakers, industry representatives, academics and the public can begin to understand and discuss the merits of different options and recommendations.

This paper is divided into four sections. The first section discusses the role of the secondary mortgage market, specifically in terms of the distribution of credit risk and interest-rate risk. The second section discusses various mechanisms through which the secondary market allows investors to fund mortgages and other mortgage-related assets. The third section discusses the key considerations for a restored secondary mortgage market, with a special focus on the items highlighted at the November 19 Summit. The fourth section reviews some of the secondary market models most frequently mentioned in public policy and other circles. A glossary at the end of the paper defines some of the key terms, including those found in bold throughout this paper.

SECTION I: A SECONDARY MORTGAGE MARKET

A **secondary mortgage** market attracts money from investors to real estate finance borrowers. Investors range from banks and thrifts putting deposits to work, to pension funds and life insurance companies investing contributions or premiums, to hedge funds seeking to maximize returns for investors, to central banks from countries around the globe. Borrowers include individuals and families purchasing or refinancing a home as well as real estate developers and investors building, purchasing or refinancing multifamily housing and other commercial properties with the intent of renting or leasing the space. As the industry has grown, participant roles have become more specialized. In many cases, different parties originate, underwrite, securitize, service and invest in the loan.

Mortgages compete for investors' funds with a wide range of other investment options, including stocks, other bonds and various alternative investments. In exchange for providing capital to borrowers, investors receive, in some form, a share of the interest and principal payments made by a borrower repaying the loan. Mortgage-related investments carry with them two fundamental forms of risk that must be assessed, priced, distributed and/or mitigated by the investor: credit risk and interest rate risk. (Other forms of risk such as liquidity, operational or reputation risk are not addressed here.) A key function of the secondary market is the pricing and distribution of these risks.

Credit risk is the risk associated with the borrower becoming unable to repay the loan, triggering the lender to foreclose on the property or to take other actions. In such cases, the lender will look to the loan collateral — usually the property itself and sometimes additional letters of credit or other assets — to repay the principal and any interest still owed on the loan. Credit risk is often thought of in terms of the **probability of default** of the loan, and the severity of a **loss given a default.** Investors attempt to control credit risk through underwriting that assesses the borrower's ability to pay (to minimize the probability of default) and the value of the collateral relative to the loan amount (to minimize the loss given default). Products such as **mortgage insurance** can be used to transfer credit risk from the investor to a third-party.

Interest rate risk is the risk associated with changes in interest rates. Because many single-family mortgages do not have prepayment restrictions, the borrower has the ability to prepay the loan at any point. If the interest rate environment changes and rates drop, borrowers are likely to refinance their loans at a lower rate, and the investors will be repaid more quickly than anticipated. Changes in rates can also increase the time over which an investor will be repaid: if rates go up, borrowers will be less likely to refinance. Because investors demand different yields to lend money for different periods of time, a mortgage that is likely to pay off in two years has a very different value (and therefore interest rate) than one that is likely to pay off in seven years. The **optionality** in mortgages without prepayment restrictions means that interest rate risk is an important part of their valuation. Many commercial / multifamily mortgages have **prepayment restrictions** that minimize the interest rate risk for the investor, thereby reducing the mortgage rate for the borrower.

Adjustable-rate mortgages and prepayment restrictions generally leave the interest rate risk with the borrower. Fixed-rate mortgages and a lack of prepayment restrictions transfer the interest rate risk to the mortgage investor.

Risks and Yields in the Secondary Market: Investors make investment decisions based on the risks and rewards associated with the different investment options available. A U.S. government security is generally viewed as a risk-free investment because there is little chance the government will not honor its obligations to repay the loan principal (little to no credit risk) and the term of the borrowing is fixed (little interest rate risk). In assessing other investment alternatives, investors demand higher yields to compensate them for any additional risks they take on. The interest rate a borrower pays is directly related to investors' assessment of, and appetite for, the risks associated with that loan.

A third form of risk that has come to the fore in the recent credit crunch is the risk of a significant change in the market value of a mortgage asset, not tied to any fundamental changes in the credit or interest rate risks of that asset. Even with no change in the interest rate or credit risks of an asset, shifts in investor demand may radically alter the market price of the asset. Theoretically, such a change would not affect a buy-and-hold investor, as they would continue to receive the yield they anticipated. The requirement that certain investors **mark-to-market** their assets, however, as well as the fact that many senior managers and investors use similar mechanisms for portfolio review, means that fluctuations in the market price of mortgage-related assets can represent a major risk to investors. Because this pricing risk is inherent in all investment vehicles, it is not discussed in subsequent sections in the same way that credit and interest rate risks are.

An effective secondary market allows participants to identify, assess, price and distribute the credit, interest rate and other risks of each investment vehicle.

SECTION II: METHODS OF INVESTING IN MORTGAGES

A wide range of mechanisms have been developed to funnel investment dollars into mortgages. Each mechanism takes advantage of different methods of spreading interest rate and credit risk among participants. Each mechanism also provides differing levels of involvement for the investors. It is important to note that the mechanisms discussed are complementary. At any one time, most, if not all, may be in use in the market.

Whole loans

Examples: Loans held in bank and thrift portfolios, loans held in the portfolios of Fannie Mae and Freddie Mac, loans held by life insurance companies and pension funds.

One of the most common methods of investing in mortgages is through whole loans. Here, the investor holds individual mortgage loans. In exchange for its investment in a mortgage, the investor receives principal and interest payments from the borrowers of the mortgage loans they hold. Unless mitigated or transferred, the investor takes on the entire risk associated with the mortgage, including both credit and interest rate risk. Investors in whole loan mortgages generally require an infrastructure to service the mortgages, including a capacity to receive and process mortgage payments, and to manage individual loan delinquencies, defaults and foreclosures. They also face the task and expense of acquiring a diverse portfolio of loans, preferably across different geographies.

Pass-through Mortgage-Backed Securities (MBS)

Examples: Private-label residential pass-through mortgage-backed securities.

A pass-through mortgage-backed security (MBS) provides the investor with a risk exposure similar to holding a portfolio of whole loans, but without the requirements of acquiring, servicing or managing the individual loans. Principal and interest payments made by borrowers are "passed through" equally to investors in the security. Any losses are shared equally among all investors. A strip of the mortgage payments is retained by the loan servicer to compensate for the services it performs. As with whole loans, investors retain any credit and interest rate risks associated with the underlying loans.

Guaranteed Pass-through MBS

Examples: Ginnie Mae MBS, Fannie Mae and Freddie Mac MBS, "wrapped" private-label MBS.

A guaranteed MBS transfers the credit risk of the mortgage pool to a third-party. The third-party provides some level of guarantee for the principal invested. The guarantor can be a private or public institution, including the federal government. In exchange, a strip of the borrower's principal and interest payments is paid to the guarantor. A guaranteed MBS will generally retain the interest rate risk associated with the underlying pool of mortgages. In guaranteed MBS, investors look more to the **counterparty risk** associated with the guarantor and less to analysis of the credit risk of the underlying mortgages. Unless it is mitigated, investors still need to assess and price the interest rate risk, with **prepayment speeds** being a key driver of the MBS' pricing.

Structured Residential Mortgage-Backed Securities and Commercial Mortgage-Backed Securities (CMBS)

*Examples: Private-label residential mortgage-backed securities or commercial mortgage-backed securities (CMBS). Both are often held in a trust entity called a **Real Estate Mortgage Investment Conduit** (REMIC).*

Structured residential mortgage-backed securities and commercial mortgage-backed securities (CMBS) strip out various risks inherent in a pool of mortgages and build securities tied to, or protected from, each. A typical structured MBS is built with a "waterfall" of payments, where principal and interest payments from borrowers are collected and then paid to the bond holders in a predetermined sequence. The bonds that have first priority of payment are generally the safest (i.e., have the lowest credit risk). Losses accumulate in the reverse order, with the lowest bonds taking losses first. Structured MBS were designed to mitigate credit risk for the holders of the top, safest bonds. Credit risk is concentrated in the lower, riskier **tranches.** Interest rate risk is similarly spread across the tranches. Investors in the safest bonds are willing to receive yields lower than the mortgage interest rate, while investors in riskier bonds will receive yields higher. As with other MBS, a strip of the borrower's payment is retained by the servicer as compensation for its services. Because of their complex structures and the number of parties involved in structured MBS, REMICs can limit the ways in which borrowers and investors are able to respond to unexpected events. Each structured MBS is different, and assessing the credit risk associated with each tranche requires complex models of cash flows and the structure of the waterfall. Rating agencies have been key players in providing external assessments of the credit risks involved in different tranches, and their ratings have become a part of the U.S. regulatory structure.

(Re-)REMICs/CDOs

Examples: single-family REMICs, Commercial/multifamily Re-REMICS, collateralized debt obligations (CDOs).

Re-REMICs and collateralized debt obligations (CDOs) are similar to structured MBS. In addition to mortgages, these investment vehicles can also hold other debt, including structured MBS and even other Re-REMICs and CDOs. A re-REMIC or a CDO, for example, may pool a variety of structured MBS, and then create a new set of structured bonds using the cash flows from the pooled MBS to support the new bonds' cash flows. The re-REMIC or CDO may pool low-risk tranches in an effort to increase the credit support of the new bonds, or may pool higher-risk tranches in an effort to increase the investors' yield. CDOs and Re-REMICS can thus considerably concentrate the risks (and rewards) associated with mortgage assets. The diversity gained from the multiple underlying bonds is intended to reduce risks. Investors looking to invest in the new bonds have to look across multiple underlying securities, and the myriad loans in each, to understand the underlying risk characteristics of their investment. These structures and the associated risks are often very complex. Accordingly, many investors have relied on rating agencies for assessments of the collateral and of the credit risks in these vehicles.

Mortgage REIT

Examples: Publicly- and privately-traded real estate investment trusts.

Real Estate Investment Trusts (REITs) are tradable investment vehicles for real estate-related assets. A REIT raises funds from equity investors and usually leverages this capital by borrowing additional funds. A mortgage REIT uses its funds to buy and sell mortgages and mortgage-related investments. To maintain its REIT status, tax laws dictate that a REIT must distribute at least 90 percent of its taxable income to shareholders annually in the form of dividends. The REIT, and its investors, takes on the credit and interest rate risks associated with the mortgages in which it invests.

Corporate debt

Examples: Corporate bonds issued by banks, thrifts, finance companies, etc.

Another option for investors is to lend directly to an institution that holds mortgage assets. The institution uses the borrowed funds to make or purchase mortgages. Corporate revenues, including the principal and interest payments of the mortgage assets, are used to pay the debt service of the borrowed funds. The corporation benefits from the difference between the higher yield on the mortgage-assets that they receive and the lower yield on the corporate debt that they pay. Even if a mortgage asset fails to pay, or pays off, the institution continues to pay the investor. The interest rate and credit risk of the mortgages are generally held by the institution rather than the investor, although **call and put options** provide a means to transfer the interest rate risk between parties. Rather than interest rate or credit risk, the investor faces counterparty risk. If the institution cannot cover its debt payments, the investor faces the prospect of joining other creditors in a bankruptcy or similar claim. In corporate debt, the corporation faces credit and interest rate risk, while the investor faces counterparty risk.

Guaranteed corporate debt

Examples: Corporate debt issued by Fannie Mae, Freddie Mac and the Federal Home Loan Banks (FHLBs).

Guaranteed corporate debt is similar to corporate debt, but with an added layer of insurance through a guarantee by a third-party. If the institution fails, the third-party fulfills the institution's repayment responsibilities. The guarantor can be a private or public institution, including the federal government. An investor's counterparty risk in the corporate debt is mitigated by the addition of another, usually stronger, counterparty. In the case of Fannie Mae and Freddie Mac corporate debt, the third-party guarantor has generally been assumed to be the federal government.

Secured debt and covered bonds

Examples: Secured loans to banks, thrifts, finance companies, etc.; covered bonds issued by banks and others.

Secured debt and covered bonds provide investors with a vehicle similar to corporate debt, but with additional collateral. Like corporate debt, the investor provides a loan directly to an institution that holds mortgage-related assets and the institution uses the borrowed funds to make or purchase mortgage assets. Through secured debt and covered bonds, if the institution fails to fulfill its debt obligations, the investor has a claim directly to the mortgage-related collateral. The interest rate and credit risk of the mortgage assets are generally retained by the institution, while the investor faces counterparty risk, albeit counterparty risk with additional collateral. Investors in covered bonds will generally assess both the counterparty risk of the institution and the credit and interest rate risk of the underlying collateral.

Shareholder equity

Examples: Equity in banks, thrifts, finance companies, Fannie Mae, Freddie Mac, etc.

Investor funds also enter the mortgage market through shareholder equity investments in firms that participate in the mortgage market. The equity investment provides capital that allows the firm to make or purchase mortgages. As equity, it can be leveraged with debt to multiply the amount of mortgage funding available. The equity investor here faces all the interest rate and credit risk retained by the firm, and receives a share of the profits generated. In the case of a bankruptcy of the firm, equity holders only have a claim to the assets remaining after all debts and all senior equity holders receive their share.

SECTION III: KEY CONSIDERATIONS FOR A SECONDARY MORTGAGE MARKET

A number of key considerations come to the fore when thinking about how best to restore the secondary mortgage market. The careful consideration of these factors will be essential as policymakers and others assess the relative strengths and weaknesses of different models.

Risk assessment

Participants in a secondary mortgage market assess and price the risks they take on. As outlined above, key risks include credit risk, interest rate risk and counterparty risk. Risk assessment can take the form of a primary assessment of risk or a secondary assessment.

A primary assessment of risk requires the identification, collection and analysis of pertinent information. In many cases this will involve complex, detailed computer models, such as those that attempt to quantify the credit risk associated with particular borrowers and loans based on credit scores, loan-to-value ratios, local property markets, etc. Other primary assessments of risk may attempt to quantify the interest rate risk associated with different interest rate environments. A secondary assessment of risks relies on assessments made by others, such as the rating agencies or investment banks.

Risk assessment is an imperfect science, but it is at the heart of all secondary market actions. Regulators use their risk models to assess capital adequacy, rating agencies use their models to assign ratings to companies and securities, and investors use their models to assess the relative risk-adjusted returns of various investment options.

Regulators and quasi-regulators (such as the rating agencies) are just as reliant on risk models and their accuracy and assumptions as are any private-sector participants. It is important to note that the transfer of risk assessment from market participants to regulators and quasi-regulators does not, in and of itself, improve the assessment of risk.

As new products are introduced or expanded, the assessment of risk is particularly difficult. Likewise, in times of extreme competition, investors will often compete based on risk as well as price. It is common to see underwriting standards loosen in times of capital availability and tighten in times of capital shortage. If a risk assessment does not fully capture the terms being used to compete, it is likely to misjudge the risks.

As has been seen recently, a rapid change in the perceived risks of mortgage-related assets can lead to dramatic changes in their value and pricing (valuation risk). For example, if a certain type of borrower that was generally thought to be a low or moderate credit risk is, through new information or modeling, perceived by the market to be a more significant risk, the value and pricing of assets dependent on that type of borrower will fall. Volatility and/or mistrust surrounding such risk-assessment and pricing can deter investment.

Given the importance of risk assessment, an effective secondary market must promote accurate, effective and stable risk assessment. Equally important, third-party assessments of risk must be highly credible to be widely used or adopted.

It is also important to note that models are fallible. Regardless of their sophistication, an overreliance on models, particularly when their results diverge from real-world experience, can promote failure in assessing risks.

Aligning risks, rewards and penalties

The secondary mortgage market has been extremely adroit at dissecting the credit, interest rate, counterparty and other risks associated with financing real estate. A key consideration for the market going forward will be ensuring the alignment of risks with rewards and penalties.

Loan attributes, such as whether a loan is adjustable-rate or fixed-rate, or does or does not have a prepayment restriction, shift risks between the borrower and the investors. Investor yields and borrower interest rates are directly affected by this distribution of risks and the expectation of the durability of the distribution.

As the industry has grown, participant roles have become more specialized. In many cases, different parties originate, underwrite, securitize, service and invest in the loan. As a result, participants throughout the mortgage market — from borrowers, to brokers, to lenders, to securitizers, to investors, to regulators — affect the long-term performance of a mortgage asset. Examples include the candor of loan applications, the rigor of underwriting, the accuracy of due diligence and the precision of models.

As participants add or remove risks to the system, it is important that those same participants accrue the costs/benefits associated with the risks they affect.

Similarly, investors in mortgage assets are paid to take on certain risks associated with the assets. If investors are not accountable for the risks they take on, they are prone to act irresponsibly by taking on greater risks than they otherwise would. Concerns about such moral hazard have been most commonly voiced in situations where the federal government bears the ultimate risk, either through GSE debt, federal insurance or a bailout or other after-the-fact intervention.

Regulators and quasi-regulators face a number of challenges in overseeing market participants. Given the enormous scope and innovation of the mortgage markets, regulators are often at a significant disadvantage in trying to identify, understand and evaluate the myriad products and players that make up the market. They also may face a "capture" issue in which their incentives become aligned with the entities they are overseeing or supervising. In such a case, the regulator may become as, or more, concerned with protecting the interests of the regulated institution as with protecting the public good.

A regulator's powers to change the behavior of investors and other market participants may also be limited by the size and scope of the regulated institutions. Institutions that are significantly larger than their regulator may be able to bring technical, political or other resources to bear to promote more amenable regulation.

Aligning rewards with long-term performance

Given the long-term nature of a mortgage contract, as well as the imperfect state of risk assessment detailed above, some risks inherent in a mortgage asset may not appear for some time after the asset has changed hands. It is important to consider the degree to which participants in the mortgage process can be held accountable for the long-term performance of an asset.

Mechanisms such as loan "buy-backs" and risk-sharing agreements have been common secondary mortgage market practices that tie participants to the longer-term performance of assets they affect. In the case of risk-sharing, for example, originators have a direct stake in the longer-term performance of the mortgages they underwrite. It is important to note that such activities transform other risks into counterparty risk – meaning that participants in the market become increasingly reliant on the ongoing health of other market participants and their ability to fulfill their obligations.

Ensuring capital adequacy of participants

Participants throughout the market need adequate levels of capital to protect against losses. Recently firms have faced a need for additional capital because of losses resulting from credit risk (because loans and securities did not perform as modeled). In other cycles, capital has been drawn upon to compensate for unexpected changes in asset values resulting from interest rate risk. In the current environment, many investors have also faced unanticipated losses resulting from liquidity risk; as investors tried to sell assets into an illiquid market, they were forced to accept a heavily discounted price to do so. Even investors not planning to sell their assets have been affected by the illiquidity, as accounting and other rules may require them to mark-down the value of their assets to the observed market price.

Regardless of the source of need, capital adequacy has become a key consideration for the secondary mortgage market. Such adequacy is generally measured by two groups, investors and regulators. Capital adequacy is keenly dependent on the assessment of risks outlined above. The greater the risks, as assessed, the greater the capital needed. In times of rapid market deterioration, when model and risk assumptions change dramatically, capital needs may change dramatically as well.

Under-capitalization can affect the entire value chain of mortgage assets. If market participants that have taken on certain risks become undercapitalized, they may not be able to absorb those risks when necessary — forcing others to absorb them. Capital concerns thus elevate counterparty risk as a concern for all parties in a chain of transactions.

Given different models, different regulators have often come up with different capital adequacy requirements. Such differences affect the costs of funds for the affected parties and can put some mortgage investors at an advantage, or disadvantage, to others.

Controlling fraud between parties in the system

Given the size and scope of the mortgage market, there is potential for market participants to perpetrate fraud against other participants. Some of the most common types of mortgage fraud include fraud in loan applications, in tax and financial statements, in verification of deposits, in appraisals and property valuations, in the verification of employment, in escrow and closing documents and in credit reports. Fraud can also extend to the creation and sale of complex mortgage investment vehicles.

Regardless of the intent or scale of the infraction, fraud increases risks and costs throughout the system.

A key consideration for an effective secondary mortgage market is the degree to which the market minimizes fraud. Key considerations also include the ability to identify and prosecute fraud, and the degree to which fraud is deterred. Information sharing among primary market participants and with law enforcement agencies is a critical component as well.

Transparency

In order to attract investors, another key consideration for a secondary mortgage market is its transparency. The less transparent a market is, the more poorly understood it will be by investors, and the higher will be the yield those investors demand to compensate for the uncertainty.

In the mortgage market, transparency means being able to see through from the investment vehicle to the credit and interest rate risks of the loan or loans underlying the asset. It means being able to analyze the characteristics of the borrower, the property and any other collateral or support the loan may have. It means being able to understand and model the structure of cash flows and repayment priorities, and to do so across pools of loans or securities when appropriate. Often transparency means lots of data in a complex, structured and dynamic system.

Transparency also means understanding how mortgage-related assets react to different events. As the complexity of structured products has advanced, the ability of market participants to understand and model them has been tested. To the degree some market participants have an ability to understand and model mortgage assets that others do not, the asymmetry of information gives the former participants an advantage over the latter.

Simplifying the range of mortgage offerings adds some level of transparency, to the degree that mortgages are structured in a similar way and/or have certain features in common. The **To-Be-Announced (TBA)** market, through which investors are able to buy mortgage bonds backed by Ginnie Mae, Freddie Mac and Fannie Mae before the actual security is created, is an example of such standardization. In order to be TBA-eligible, loans and pools must fit a predefined set of parameters.

Another consideration in transparency relates to changes in the operations of the market. Built into investors' risk models is an expectation of how the market operates, for example how foreclosures occur, how a servicer advances payments or how much capital must be reserved for different loan products. To the degree these operating assumptions change, the market becomes less transparent to participants and investors either turn away, or increase the yields they demand.

Accounting rules and regulations are intended to provide greater transparency. In certain instances, however, the creation and interpretation of accounting standards has been seen to have diminished, rather than improved, transparency. Many argue that mark-to-market accounting, in which certain firms must regularly value assets at the going market price and book to their earnings any gains or losses in those values, is the most recent example. Accounting rules also affect how firms report the sale of mortgages and mortgage-related assets ("True-sale treatment"). In some instances, these rules have clouded the transparency of who holds certain assets, the risks associated with them and the capital required to adequately support them. Rules that affect the ways in which firms account for the sale of mortgages and structured securities and how they mark their assets to market will have a profound impact on the shape that a future secondary market can take.

Means of attracting a broad array of investors

The secondary mortgage market has attracted a broad array of investors in recent years, including mortgage professionals steeped in the intricacies of the mortgage market as well as mid-tier and smaller investors with only a passing knowledge of mortgages or mortgage securities. The investment banks, rating agencies, the GSEs, and others have been key players in making mortgage assets accessible investments. Their activities have included establishing a level of confidence, standardizing risk assessment and guaranteeing the credit performance of investments.

A key consideration for future markets is how to again attract all levels of investors, including these mid-tier and smaller investors, whether through transforming credit and interest rate risk into counterparty risk, providing credible third-party assessments of risks or some other means.

Lender/liquidity of last resort

Even an effective secondary mortgage market will occasionally meet with periods of illiquidity. During such times, it has proven beneficial to have a "lender of last resort" that is willing to step in and absorb the cost of the illiquidity of certain assets. Having such a lender provides investors with greater comfort during liquid as well as illiquid periods, thus reducing the yields investors demand in good times and bad.

A lender of last resort faces challenges of differentiating issues of illiquidity from fundamental issues of credit; for example, if an asset's yield jumps because of a change in the fundamental performance of that asset, versus a jump because of a temporary lack of potential buyers.

The lender of last resort also faces the challenge of maintaining its capabilities during periods of liquidity, when it is not needed. If such a lender is not operating in the market during periods of normal market conditions, the time and resources needed to build an effective staff and infrastructure may mean it is not immediately available when needed.

Overlay of social policy goals

The importance of housing to the social and economic lives of Americans means that discussions of the secondary market often include an overlay of questions of how best to achieve social policy goals, such as serving underserved markets and providing affordable housing. The GSEs' implied federal guarantee, as well as their affordable housing goals and conforming loan limits are prime examples. By definition, the pursuit of such social objectives through secondary market activities, as opposed to explicit and targeted subsidies, distorts the market — promoting investment in some products and deterring it among others. The use of the secondary market for social policy objectives may also transfer risks from market participants, who would price and distribute the risks based on a competitive bidding process, to the government, which may socialize the risks based on its own internal assessments.

Transition

The secondary mortgage market is in an extremely fragile state. A key consideration for any actions regarding its future will be how to transition from the market's current state, to its desired state. The size of the market, and the depth of its infrastructure, will make any such transition a significant challenge.

SECTION IV: MENU OF SECONDARY MARKET MODELS

A key question in the policy debate about the future of the secondary mortgage markets and the GSEs is how the market will provide the investment options detailed in Section II of this paper. What follows is a brief discussion of selected models that could serve as alternatives for the potential redesign of the GSEs, and the types of investment products they would bring to the market. The models will determine the investment vehicles available, which in turn will determine the degree to which capital is attracted back to the real estate finance markets.

The list of potential models is by no means exhaustive and is not a recommendation of any one or more models. Rather, it is presented to help readers understand some of the types of options that may be available, and the various criteria and questions that must be considered for each. At any one time, multiple models may be required to augment the private markets in order to attract the breadth and depth of investors needed to fund the U.S. housing market.

Chart 1. High-level Menu of GSE-like Models

	Fully privatized	Covered bond	Hybrid covered bond	Co-op	Open charter	Limited charter	Improved GSE	Utility	FHA-Ginne-Type
Private Ownership	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No
Government guarantee	No	No	No	Govt backstop	Insurance fund	Insurance fund	Govt backstop	Govt backstop	Explicit
Regulator	Bank/other regulators	Bank regulators	Bank regulators	FHFA-type	FDIC-type	FHFA-type	FHFA	FHFA-type	n.a.
Required portfolio	Market driven	Yes	Yes	*de minimus*	*de minimus*	*de minimus*	Safety & soundness	*de minimus*	No
Investment vehicles brought to market									
Whole loans	Yes	No	No	No	No	No	No	No	No
Pass-thru MBS	Yes	No	No	Backstop	Govt	Govt	Backstop	Backstop	Govt
Structured MBS	Yes	No	No	Yes	Yes	Yes	Yes	Yes	Yes
(Re-)REMIC/CDO	Yes	No	No	Yes	Yes	Yes	Yes	Yes	No
Mortgage REIT	Yes	No	No	No	No	No	No	No	No
Corporate debt	Yes	No	No	n.a.	n.a.	n.a.	Yes	n.a.	n.a.
Secured debt	Yes	Yes	Yes	n.a.	n.a.	n.a.	No	n.a.	n.a.
Shareholder equity	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No

Fully Privatized Market

- Institutions hold whole loans, pool loans into securities and covered bonds and use other vehicles to allow investors and other financial institutions to invest in mortgage-related assets.
- Any guarantees within the system would be entirely private, with no explicit or implicit government backing.
- Underwriting, pricing, and policies on residual guarantees of originators as well as representations, warrants and repurchase requirements would be determined solely by market participants and based on market-determined standards.
- Capital supporting the market would come from private investors, loan aggregators, bank holding companies and other financial institutions.
- No special charter would be required other than the normal corporate, bank holding company or other financial institution charter.
- The market would be overseen by the existing regulators for the corporation or bank holding company and other market participants.
- Potential investment vehicles brought to market:
  + Whole loans
  + Pass-through MBS
  + Structured MBS
  + (Re-)REMIC/CDO
  + Mortgage REIT
  + Corporate debt
  + Secured debt/covered bonds
  + Shareholder equity

Covered Bonds

- Large commercial banks and other institutions would issue covered bonds as a form of marketable, collateralized deposits.
- Guarantees within the system would remain private, with no explicit or implicit government backing for the covered bonds.
- Underwriting, pricing, and policies on residual guarantees of originators as well as representations, warrants and repurchase requirements would be determined solely by market participants and based on market-determined standards.
- The institutions would set their own delivery and pricing criteria, and would essentially act as correspondent originators along with their own retail and/or broker networks.
- Safety and soundness guidelines would be set by the bank regulators.
- Potential investment vehicles brought to market:
  + Secured debt/covered bonds
  + Shareholder equity

Hybrid Covered Bonds

- Similar to the system above, except the banks would only be allowed to issue covered bonds backed by the securities issued by whatever a new government-related securitization entity turns out to be. For example, if something close to the current GSE model were adopted, covered bonds would essentially replace the portfolios of the GSEs.
- The banks and other institutions issuing the bonds would bear the interest rate risk associated with option-embedded mortgage-backed securities.
- Given the various layers of capital and guarantees associated with the securities, capital requirements would be set at appropriately low levels by the banking regulators.
- Potential investment vehicles brought to market:
  + Secured debt/covered bonds
  + Shareholder equity

Co-op Model

- The industry would operate one or more cooperatives that would pool mortgages from member firms.
- Similar to the Mortgage Purchase Program (MPP) offered by some Federal Home Loan Banks, originators would pay in capital based on the volume of mortgages submitted. The originators would also post as collateral a portion of the loan-sale proceeds to cover some initial level of losses. The collateral would be refundable as the loans age and rights to the collateral could be sold to third parties.
- The co-op would determine pricing, credit standards and eligibility requirements.
- The co-op would be subject to safety and soundness review by the federal government. The co-op members would not cross-guarantee each other's losses beyond their equity investments. The government would bear the risk of catastrophic losses beyond the capital and the pledged accounts.
- The co-op would not hold a portfolio beyond de minimis levels for operating and securitization purposes.
- Potential investment vehicles brought to market:
  + Pass-through MBS
  + Structured MBS
  + (Re-)REMIC/CDO
  + Shareholder equity

Open Charter Model

- A new type of financial charter would be created expressly for loan aggregators and securities-issuers.
- An FDIC-like insurance would be established to provide the Federal guarantee of the mortgage securities. It would be funded by an insurance premium on each security issued and the insurance premiums would be risk-adjusted based on the risk of the entity and the risk of the underlying mortgages.

- An FDIC-like entity would be established to grant charters and set safety and soundness standards and capital requirements.
- The individual chartered entities would set their own pricing and delivery guidelines, as well as representations, warrants and repurchase requirements, subject to safety and soundness guidelines of the regulator.
- Chartering would be open and the entities could be independent or subsidiaries of bank holding companies or other financial institutions. Firewalls could be established to prevent cross-guarantees between insured deposits and the credit guarantees on mortgage securities.
- Potential investment vehicles brought to market:
    + Pass-through MBS
    + Structured MBS
    + (Re-)REMIC/CDO
    + Shareholder equity

Limited Charter Model

- Similar to the Open Charter Model except that the number of charters would be limited by the regulator's view of how many charters were needed to maintain competitiveness and serve all aspects of the market, rather than by how many qualified applications were received.
- The government guarantee of mortgage-backed securities issued by the institutions would be provided by an FDIC-like insurance fund that would be funded by a deposit insurance premium on each security issued.
- The insurance premiums would be risk-adjusted based on the risk of the entity and the risk of the underlying mortgages.
- While the regulatory agency would not directly control pricing, it would determine whether there were an adequate number of competitors to ensure that there was sufficient competition to have market-driven pricing.
- Charters, since they would be limited, would not be available as subsidiaries to financial institutions. In that sense, very much like the current GSE model.

- An FHFA-like entity would oversee safety and soundness and set minimum capital standards.
- The entities would not be allowed to hold portfolios beyond de mimimis amounts.
- Potential investment vehicles brought to market:
  + Pass-through MBS
  + Structured MBS
  + (Re-)REMIC/CDO
  + Shareholder equity

Improved Current GSE Model

- Similar to the current GSE model, but with implementation of stronger credit controls and higher capital requirements.
- Portfolio restrictions would expand and contract based upon safety and soundness considerations and the regulator's view of the degree of support needed for the MBS market.
- The regulator would have oversight authority for pricing policies and target returns on equity.
- Potential investment vehicles brought to market:
  + Pass-through MBS
  + Structured MBS
  + (Re-)REMIC/CDO
  + Corporate debt
  + Shareholder equity

Utility Model

- A single entity with a federal charter but with private ownership.
- The utility charter would not be part of any other financial institution.
- Delivery guidelines, seller/servicer eligibility and requirements, as well as requirements for representations, warrants and repurchase requirements would be subject to review by the regulator and the pricing guidelines and other requirements would be transparent.

- Pricing and risk exposure would be subject to regulatory review, with utility-type targets on returns on equity.
- The utility would not be allowed to hold a portfolio beyond a de mimimis amount needed for transaction support and problem loan workout.
- Potential investment vehicles brought to market:
  + Pass-through MBS
  + Structured MBS
  + (Re-)REMIC/CDO
  + Shareholder equity

FHA/Ginnie Mae-Type Model

- Similar to the utility model except that the utility would be an agency of the government.
- The agency would not buy individual loans but would securitize packages of mortgages submitted for securitization.
- An FHA-like reserve fund would be established to provide the explicit support for the securities.
- The agency would establish, through the rulemaking process, pricing, counterparty and credit guidelines.
- Potential investment vehicles brought to market:
  + Pass-through MBS
  + Structured MBS

GLOSSARY OF SELECTED TERMS

Term	Definition
adjustable rate mortgage (ARM)	A mortgage loan or deed of trust which allows the lender to adjust the interest rate in accordance with a specified index periodically and as agreed to at the inception of the loan. Also called "variable rate mortgages" (VRM).
amortization	Repayment of a mortgage debt with periodic payments of both principal and interest, calculated to retire the obligation at the end of a fixed period of time.
asset	A property or right owned, tangible or intangible, that has monetary value and is capable of providing future benefits to its owner.
balloon mortgage	A mortgage with periodic installments of principal and interest that do not fully amortize the loan. The balance of the mortgage is due in a lump sum at a specified date, usually at the end of the term.
bankruptcy	Court proceedings to relieve the debts of an individual or business unable to pay its creditors. An individual, firm, or corporation who, through a court proceeding, is relieved from the payment of all debts. Bankruptcy may be declared under one of several chapters of the federal bankruptcy code.
basis point	One one-hundredth of one percent. Used primarily to describe changes in yield or price on debt instruments, including mortgages and mortgage-backed securities.
bond	An obligation written under seal. For example, the obligation may be to make good if a third party defaults (performance bond), or betrays a trust (fidelity bond), or an obligation to pay interest and principal as specified. The latter type of bond is a debt instrument which may be secured by a mortgage or a pool of mortgages.
borrower	One who receives funds in the form of a loan with the obligation of repaying the loan in full with interest.
call option	A contract granting the right, but not the obligation, to purchase a security at a specified strike price on a particular date.
capital	The net worth of a business represented by the amount that its assets exceed liabilities. Money invested to create income.
capital market	The financial market for buying and selling long-term investments (those with maturities of greater than one year), such as mortgages, Treasury bonds, and certificates of deposit.
collateral	Property pledged as security for a debt, for example, mortgaged real estate.
commercial real estate	Office buildings, shopping centers, apartment buildings and other property which is utilized for the production of income rather than as residences. If residential real estate has more than four units it is considered commercial real estate.
conduit	An entity which issues mortgage-backed securities backed by mortgages which were originated by other lenders.

core capital	One of the components of risk-based capital guidelines which includes common stockholders equity, retained earnings, noncumulative preferred stock, and minority interests in equity accounts of consolidated subsidiaries.
counterparty risk	The risk that a counterparty in a transaction will not fulfill its obligations.
coupon rate	Annual interest rate on a debt. The coupon rate on a mortgage is the contract rate stated in the mortgage note. The coupon rate on a mortgage security is the rate stated on the face of the security, not the rate of the mortgages in the pool backing the security.
credit	Financial status-ability of borrowers to meet the terms of their obligations.
credit rating	A rating given to a person or company that establishes creditworthiness based upon present financial condition, experience, and past credit history.
debt service coverage ratio	A ratio of effective annual net income to annual principal and interest payments. Also called debt service coverage.
debt service	A borrower's periodic mortgage payments comprised of principal and/or interest on the unpaid mortgage balance.
default	The non-payment of a mortgage or other loan in accordance with the terms as specified in the note.
derivatives	Investments whose returns derive from the change in value of other securities or indexes, such as bonds, interest rates or stocks.
duration	An estimate of the volatility or sensitivity of the market price of a bond to changes in interest rates; it measures the weighted average time until cash flow repayment.
exposure	The total amount a lender has tied up in a loan. Usually the outstanding principal balance of the loan plus accrued interest, and any capitalized costs including legal fees and expenses, appraisal and environmental fees, and all other costs associated with securing the lender's interest in the property.
Fannie Mae (FNMA)	The nation's largest mortgage investor created in 1968 by an amendment to Title III of the National Housing Act (12 USC 1716 et seq.) this stockholder-owner corporation, a portion of whose board of directors is appointed by the President of the United States, supports the secondary market in mortgages on residential property with mortgage purchase and securitization programs.
Fannie Mae DUS Lender	A lender designated by Fannie Mae who originates, underwrites, closes, and services Fannie Mae approved multifamily mortgage loans. DUS stands for "Delegated Underwriting and Servicing."
Federal Deposit Insurance Corporation (FDIC)	Originally established by the Banking Act of 1933 to protect depositors from loss. As a result of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), the FDIC administers the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF).
Federal Housing Administration (FHA)	A federal agency within the Department of Housing and Urban Development (HUD) that provides mortgage insurance for residential mortgages and sets standards for construction and underwriting. The FHA does not lend money, nor does it plan or construct housing.

Federal Housing Finance Administration (FHFA)	On July 30, 2008, President Bush signed the Housing and Economic Recovery Act of 2008 (HERA), which created the Federal Housing Finance Agency (FHFA). FHFA was created to combine the Federal Housing Finance Board (FHFB), the Office of Federal Housing Enterprise Oversight (OFHEO) and the Department of Housing and Urban Development's (HUD's) mission group as a single regulator for Fannie Mae, Freddie Mac, the 12 Federal Home Loan Banks (FHLBanks) and the Office of Finance (OF).
Financial Accounting Standards Board (FASB)	A private entity created by the accounting profession to develop and promulgate financial accounting standards and practices. Its membership is composed of top-level accounting professionals from business, government, and education professions. It derives its authority from official recognition by the Securities and Exchange Commission (SEC) and the American Institute of Certified Public Accountants (AICPA), and from the general support of corporate and investment communities. While the Securities and Exchange Commission (SEC) has the authority to regulate accounting standards, it nearly always defers to the FASB.
first mortgage	A mortgage that gives the mortgagee a security right over all other mortgages of the mortgaged property.
fixed-rate mortgage (FRM)	A mortgage in which the interest rate and payments remain the same for the life of the loan.
foreclosure	A legal procedure in which a mortgaged property is sold in a legal process to pay the outstanding debt in case of default.
Freddie Mac (Federal Home Loan Mortgage Corporation)	Created by Congress in Title III of the Emergency Home Finance Act of 1970 (12 USC 1451 et seq.). This stockholder-owned corporation, a portion of whose board of directors is appointed by the President of the United States, supports the secondary market in mortgages on residential and multifamily properties with mortgage purchase and securitization programs.
generally accepted accounting principles (GAAP)	Accounting practices mandated by recognized rule-making authorities.
Ginnie Mae	Created in 1968 by an amendment to Title III of the National Housing Act (12 USC 1716 et seq.), this federal government corporation is a constituent part of the Department of Housing and Urban Development. Among other governmental functions, it guarantees securities backed by mortgages that are insured or guaranteed by other government agencies. Also called Government National Mortgage Association (GNMA).
government sponsored enterprise (GSE)	Private organizations with government charters and backing. Examples are Freddie Mac and Fannie Mae.
guarantee	An individual's or entity's promise to pay in the event of an operational shortfall.
guarantor	A party who is secondarily liable for another's debt or performance (in contrast to a surety who is primarily liable with the principal debtor).
guaranty fee	Price for guaranteeing to an investor the timely payment of principal and interest from all the mortgages underlying a mortgage backed security.
hedging	A marketing strategy that reduces or transfers risk of loss from changes in market interest rate.

home loan	A mortgage loan secured by a residence for one, two, three or four families. Also known as a single family mortgage, even though the property may be designed for more than one family.
interest	Consideration in the form of money paid for the use of money, usually expressed as an annual percentage. Also, a right, share, or title in property.
interest rate	Percentage paid for the use of money, usually expressed as an annual percentage.
issuer	One who packages mortgages for sale as securities.
lender	Person or entity that invests in or originates mortgage loans, such as a mortgage banker, credit union, commercial bank, or savings and loan. In single-family property usage, the lender is generally whosever name the loan is closed in. (In a table funding transaction, the whole-saler mortgage company is usually considered to be the "lender.") In commercial property usage, the lender is the life insurance company, bank or pension fund that provides the funds and in whose name the loan is closed.
leverage	The use of borrowed money to increase the return on investment. For leverage to be positive, the rate of return on the investment must be higher than the cost of the money borrowed.
lien	A legal hold or claim of a creditor on the property of another as security for a debt. Liens may be against real or personal property.
liquidity	The ability to readily convert assets or investments to cash.
loan-to-value ratio (LTV)	The ratio of the amount of the loan to the appraised value or sales price of real property (expressed as a percentage).
loss given default	The proportion of the exposure at the time of default that will be lost if a default occurs.
mark to market	The process whereby the book value or collateral value of the security is adjusted to reflect current market value.
modified pass-through	Type of mortgage backed security (MBS) that requires the issuer to pay, on a timely basis, all principal and interest due to investors, regardless of whether the payments have been received from borrowers.
moral hazard	The danger that market participants will promote greater risks if they are insulated from those risks than they otherwise would.
Mortgage	A pledge of property, usually real property, as security for a debt. By extension, the document evidencing the pledge. In many states this document is a deed of trust. The document may contain the terms of repayment of the debt. By further extension, "mortgage" may be used to describe both the mortgage proper and the separate promissory note evidencing the debt and providing the terms of the debt's repayment.
mortgage-backed security (MBS)	An investment instrument backed by mortgage loans as security. Ownership is evidenced by an undivided interest in a pool of mortgages or trust deeds. Income from the underlying mortgages is used to pay interest and principal on the securities.
mortgage banker	An individual, firm or corporation that originates, sells and/or services loans secured by mortgages on real property.

mortgage bond	Bonds secured by mortgages.
mortgage insurance (MI)	Insurance which protects mortgage lenders against loss in the event of default by the borrower. This allows lenders to make loans with lower down payments. The federal government offers MI through HUD/FHA; private entities offer MI for conventional loans.
mortgage note	A written promise to pay a sum of money at a stated interest rate during a specified term. A mortgage note is secured by a mortgage.
mortgage pool	A group of mortgage loans with similar characteristics that are combined to form mortgage-backed securities.
mortgage portfolio	The aggregate of mortgage loans held by an investor or serviced by a mortgage banker.
mortgage servicing rights	The contractual obligations undertaken by one party to provide servicing for mortgage loans owned by another party, typically for a fee.
mortgagee	The lender in a mortgage transaction.
mortgagor	The borrower in a mortgage transaction who pledges property as a security for a debt.
multifamily housing	A building with more than four residential units.
negative amortization	The unpaid interest which is added to the mortgage principal in a loan where the principal balance increases rather than decreases because the mortgage payments do not cover the full amount of interest due.
note	A general term for any kind of paper or document signed by a borrower that is an acknowledgment of the debt, and is, by inference, a promise to pay. When the note is secured by a mortgage, it is called a mortgage note and the mortgagee is named as the payee.
Office of Thrift Supervision (OTS)	The successor thrift regulator to the Federal Home Loan Bank Board and a division within the Treasury Department. The OTS is responsible for the examination and regulation of federally chartered and state chartered savings associations.
option	A contract granting a right to purchase, sell, or otherwise contract for the use of a property at a stated price within a stated period of time. In secondary marketing, an instrument used to hedge marketing risk. Examples are over-the-counter mortgage options, or Treasury bond futures options.
optionality	The ability to exercise an option.
pass-through	A security in which principal, interest, and prepayments are passed through to investors of the security each month, as received. Mortgage collateral is held by a grantor trust in which investors own an undivided interest. In accounting terms, a pass-through is treated as a sale of assets.
pay-through bond	A type of mortgage-backed security that is a general obligation of the issuer, and is secured by mortgage collateral. Like a pass-through, cash flow from the mortgage collateral is passed through to investors, however, a pay-through is a debt offering and not a sale of assets.
pool	A collection of mortgage loans grouped by one or more similar characteristics.

portfolio	The collection of loans held for servicing or investment.
portfolio lender	A lender who holds loans in their portfolio and does not sell to investors in the secondary market. The lender usually holds these loans until maturity or until the loan is paid off.
prepayment	The payment of all or part of a mortgage debt before it is due.
prepayment restriction	A restriction on or charge the mortgagor pays the mortgagee for the privilege to prepay the loan.
prepayment speed	The speed at which mortgage borrowers prepay their mortgages.
primary market	The market in which mortgages are created and funds are loaned directly to borrowers.
private mortgage insurance (PMI)	Insurance written by a private company protecting the mortgage lender against financial loss occasioned by a borrower defaulting on the mortgage.
probability of default	The likelihood that a loan will not be repaid and will fall into default.
put option	A contract granting the right, but not the obligation, to sell the underlying security at a specified price (the strike price) at any time prior to the expiration date. See CALL OPTION.
real estate investment trust (REIT)	An investment vehicle where title to real estate assets is held and managed by one or more trustees who control acquisitions and investments much like a mutual fund.
Real Estate Mortgage Investment Conduit (REMIC)	A vehicle for issuing multiclass mortgage-backed securities which allows the issuer to treat the security as a sale of assets for tax and accounting purposes.
regulatory agency	An arm of the state or federal government that has the responsibility to license, pass laws, regulate, audit, and monitor industry related issues.
reinsurance	The practice of one insurance company (the reinsurer) accepting risks or business from another insurer (the ceding company). It allows insurers to maintain a larger spread of risk and avoid large catastrophes.
repurchase agreement	An agreement between a buyer and seller of securities whereby the seller agrees to buy back the securities at a specified future date and price.
reserves	Funded or non-funded accounts set up at either the property or portfolio level in anticipation of periodic or non-periodic capital expenditures or cash needs.
Resolution Trust Corporation (RTC)	A government agency responsible for managing and resolving the affairs of insolvent savings and loan associations placed into receivership by the FDIC. This includes the liquidation, operation, and sale of thrift institutions and thrift assets.
risk-based capital regulations	Rules established by financial regulators which dictate how much of certain types of capital a financial institution may hold.
risk/reward ratio	The relationship between risks of investment and the anticipated rewards for undertaking that risk.
seasoned mortgage	A mortgage on which payments have been made regularly for a year or longer.

second mortgage	A mortgage that has rights subordinate to a first mortgage. Also called "second trust."
secondary mortgage market	The market where lenders and investors buy and sell existing mortgages or mortgage-backed securities, thereby providing greater availability of funds for additional mortgage lending.
Securities and Exchange Commission (SEC)	A governing body that regulates the sale and registration of securities. The SEC protects investors and the general public against fraud and malpractice in financial markets.
securitization	The process of pooling loans into mortgage-backed securities for sale into the secondary mortgage market.
seller-servicer	A term used by Fannie Mae and Freddie Mac for a mortgage banker or other entity that has met the requirements necessary to sell and service mortgages for Fannie Mae or Freddie Mac.
servicing fee/servicing rate	The fee earned by a servicer for administering a loan for an investor usually expressed as a percentage of the unpaid principal balance of the loan and deducted from the monthly mortgage payment.
spread	The difference between the rate at which money can be borrowed and the rate at which it is loaned. Also, the difference between the ask and bid prices on a security.
stripped mortgage-backed security	A security formed by segregating principal from interest to make separate interest only and principal only mortgage-backed securities.
term	The period of time between the commencement date and termination date of a note, mortgage, legal document, or other contract.
to-be-announced (TBA) market	A forward market in which pass-through securities issued by Freddie Mac, Fannie Mae and Ginnie Mae trade. The market is a forward market because the trade occurs prior to the creation of the actual mortgage-backed security that will be delivered.
tranche	A level or class of investment interest in a CMO or REMIC, differentiated by maturity, interest rate, and/or accrual structure.
underwriting	In mortgage banking, the analysis of the risk involved in making a mortgage loan to determine whether the risk is acceptable to the lender. Underwriting involves the evaluation of the property as outlined in the appraisal report, and of the borrower's ability and willingness to repay the loan.
volatility	The sensitivity of a security's price to changes in the overall market. Also, interest rate fluctuations resulting from an unstable market.
whole loans	Unsecured mortgages sold individually to investors.
yield	The ratio of investment income to the total amount invested over a given period of time.
yield curve	A graphic representation of market yield for a fixed income security plotted against the maturity of the security.

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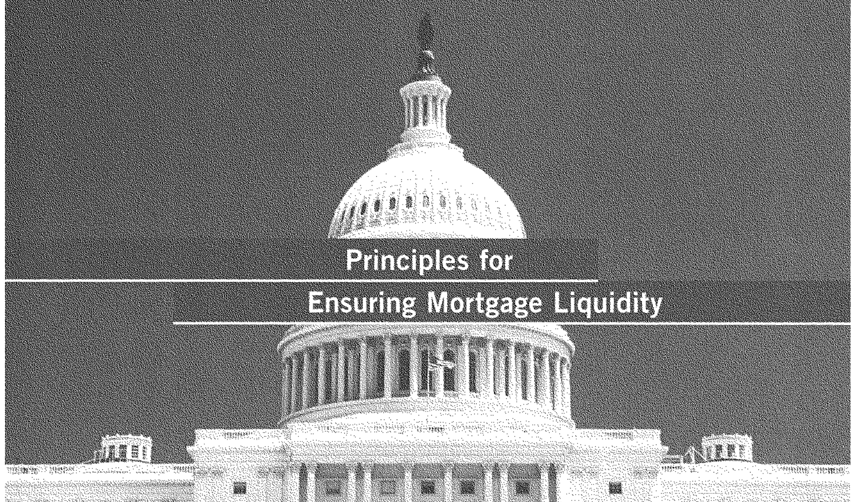

Principles for Ensuring Mortgage Liquidity

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Council on Ensuring Mortgage Liquidity

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In response to the severity and scope of the economic and housing finance crisis, the Mortgage Bankers Association (MBA) took a course of action to identify the root causes of the crisis and ensure that the core elements of a properly functioning secondary market are included in any recovery initiative.

MBA's first step was to convene a Council on Ensuring Mortgage Liquidity. The 25-member council comprises a cross-section of industry leadership. The single-family, multifamily and commercial components of the industry are represented, as are depository institutions, mortgage banking firms, mortgage insurers and other industry participant groups.

The council's mission was to look beyond the current crisis, to what a functioning market should look like for the long-term. The first action of the council was to host a summit on the future of the government sponsored enterprises (GSEs) and the secondary market. During the summit, a distinguished panel of industry policymakers offered its perspective on the essential functions and elements of the secondary market.

The council issued a secondary market primer titled "Key Considerations for the Future of the Secondary Mortgage Market and the GSEs" as one outcome of the summit. The primer serves as a reference piece for all market participants, as well Congress and the Obama administration.

The council's second task was to develop a set of guiding principles embodying the key considerations mentioned in the primer. The principles serve as a tool for evaluating proposals that may arise for restructuring the secondary market. The principles were presented as the council's recommendation to MBA's Boards of Governors, and ultimately the Board of Directors, regarding MBA's secondary market policy objectives.

This document includes the final principles developed by the council and adopted by MBA's Board of Directors. It is important to note the scope of these principles is the entire secondary market, including the responsibilities of private market participants and the role of the federal government. It is likely that this market-wide policy will form the foundation of other, more narrowly focused advocacy positions, such as on restructuring the GSEs, ratings agency reform and other issues.

John Courson
President and Chief Executive Officer
Mortgage Bankers Association

Michael Berman, CMB
President and Chief Executive Officer, CWCapital
Vice Chairman, Mortgage Bankers Association
Chair, Council on Ensuring Mortgage Liquidity

THE SECONDARY MORTGAGE MARKET

1. Secondary mortgage market transactions should be funded by investors.

a. Except for times of extreme market stress, and except for the availability of a credit guarantee program as described in section 7 below, secondary market transactions should be funded by investors seeking market returns and who take on the credit, interest rate and/or other associated market risks for market-derived yields.

2. Transparency is critical for a fully functioning secondary market.

a. The secondary mortgage market should enhance the level of transparency across all aspects of the market, and consistency between private and government sponsored/owned participants. Transparency and participant consistency are particularly important in the following areas:

   i. Loan-level information;

   ii. Bond structure (until market normalcy is established);

   iii. Risk assessments by rating agencies, bond underwriters and others, and

   iv. Regulatory oversight.

b. The secondary mortgage market should enhance the level of ongoing and systematic reporting on the performance of mortgage assets and changes in their risk characteristics.

c. The secondary mortgage market should promote standard reporting of loan-level information, as well as other information necessary to allow investors to assess the counterparties, bond structures and other contributors to the credit or other risks of a transaction.

d. The same transparency standards that apply to loans and bonds held in the private secondary mortgage market should apply to loans and bonds held or insured by government sponsored entities.

e. The secondary mortgage market should promote standardized agreements, including loan documents, pooling and servicing agreements and bond structures. Particularly at this time of transition, transparency combined with simplification is to be promoted. Standardization is one way of achieving simplification.

f. The secondary mortgage market should adequately support transparency efforts in a way that promotes accurate and timely disclosure of information.

g. Efforts to enhance transparency should be aligned with existing protections regarding individual privacy and proprietary business methods.

3. **Secondary mortgage market participants should know, accept and protect themselves against the risks associated with secondary market transactions.**

    a. Secondary mortgage market participants should be responsible for the risks they take. Alignment of interests is a key component that should be addressed. Compensation protocols, capital standards as well as the "skin in the game" of market participants could play a positive role in achieving such alignment. Capital standards to ensure that participants are adequately capitalized, or otherwise able to fulfill their obligations, relative to the risks they face is a demonstrable measure of aligned interests.

    b. Secondary mortgage market participants should support a robust fraud investigation and enforcement framework for the secondary mortgage market.

4. **Independent third parties should provide objective, independent risk assessments.**

    a. The secondary mortgage market should support access to independent third-party risk assessment tools. Rating agencies or other similar entities can provide important tools for investors' assessments of risks.

    b. Even while using third-party ratings or other assessments of risk, secondary market participants should be responsible for the risks associated with their transactions.

    c. The secondary mortgage market should support robust risk assessment and surveillance efforts in a way that avoids conflicts of interest and promotes accurate, timely assessments of risk, both at the time of purchase/issuance and throughout the life of the instrument.

GOVERNMENT ROLE

5. The secondary mortgage market should have a regulatory framework with a commensurate level of authority, sophistication and funding.

a. Secondary mortgage market regulators and regulations should promote, not hinder, responsible investments, innovation and liquidity.

b. Secondary mortgage market regulators and/or regulatory activity should be effectively organized and promote interagency cooperation. This may include synchronizing regulatory activities that cross traditional industry/regulator lines (e.g., depository and securities industries) and/or international markets.

c. The regulator of any government sponsored/owned entity and other secondary mortgage market regulators should be strong, empowered and adequately funded.

d. The government should foster a secondary mortgage market risk assessment framework that includes objective, third-party risk assessors (e.g., the rating agencies) overseen by a strong regulator.

e. Regulatory action should be transparent to secondary mortgage market participants.

6. Accounting standards should not interfere with financial transactions.

a. Accounting standards should accurately assess the value of a firm's assets. Valuation assessments such as mark-to-market must be principles-based and should not have an unintended pro-cyclical impact in broken or impaired markets from an overly mechanistic application of rules.

b. Accounting standards should promote the recording of the true economics of transactions in the secondary mortgage market. True sale and consolidation rules should, in a common sense way, be revised so that they distinguish between the assets/liabilities a firm retains and those that have been sold and/or transferred such that the transferor no longer has the real benefit of the assets and responsibility for the liabilities.

7. **There is a role for a government credit-guarantee program to help attract investment to the residential secondary mortgage market.**

    a. Any government credit-guarantee program should be explicit, and should clearly define the products, terms and conditions of the government program.

    b. Any government credit-guarantee program should be properly funded through a risk-adjusted charge to participants.

    c. Any government-sponsored entity or program should preclude the creation of a GSE-like investment portfolio assembled for the purpose of arbitrage profits. A GSE or GSE-like entity may require a portfolio to support its securitization activities (i.e. aggregation, incubation, innovation), to accommodate limited amounts for highly structured products not conducive to securitization and/or to maintain an infrastructure for serving as a liquidity backstop for the market.

8. **It is reasonable for the government to mandate social policy goals in exchange for its guarantee.**

    a. The government should balance and coordinate any pursuit of social policy goals through the secondary mortgage market operations of government sponsored/owned entities with their implications for safety and soundness, the efficient operation of the secondary mortgage market and their consistency with primary mortgage market and/or other requirements. Such policy goals should be limited to residential housing in a way that does not contain market distortions.

9. **Notwithstanding activities undertaken by FHA, VA, or RHS on or before January 1, 2009 that may be deemed to be Primary Mortgage Market activities, and therefore exempt from this restriction, all other activities of government owned or government sponsored entities must be restricted to the Secondary Mortgage Market.**

10. **The government should provide a liquidity backstop during times of extreme market distress.**

    a. In times of extreme market stress, the government should provide a mechanism to step into the secondary mortgage market as a liquidity-provider of last resort by providing a liquidity backstop.

TRANSITION

11. The government should ensure a smooth transition as part of any secondary market restructuring initiative.

a. The government should plan for a necessary period of transition as a part of implementing its role in the future secondary mortgage market.

b. The transition between the current secondary mortgage market and any future normalized market should leverage, as much as practical, the infrastructure, expertise and protocols of the existing secondary mortgage market.

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Statement of

James B. Lockhart III, Director

Federal Housing Finance Agency

Before the House Financial Services Committee

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

"The Present Condition and Future Status of Fannie Mae and Freddie Mac"

June 3, 2009

Statement of James B. Lockhart III
Director, Federal Housing Finance Agency
Before the Financial Services Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises
June 3, 2009

Chairman Kanjorski, Ranking Member Garrett, and the Members of the House Financial Services Committee, thank you for inviting me to speak to you today. In my testimony today I'd like to first provide a summary of the current status of the housing government-sponsored enterprises (GSEs) as reported in the Federal Housing Finance Agency's (FHFA's) first *Annual Report to Congress*. Then, I will provide my perspective on the future of those entities and federal involvement in the housing finance system. With $11.9 trillion in outstanding mortgage debt, housing finance is extremely important to the U.S economy, as we have seen in the present crisis.

As the conservator, FHFA's most important goal is to preserve the assets of Fannie Mae and Freddie Mac over the conservatorship period. That is our statutory responsibility. As the regulator, FHFA's mission is to ensure the Enterprises provide liquidity, stability, and affordability to the mortgage market in a safe and sound manner. That also is our statutory responsibility and is the public purpose Congress gave to the Enterprises.

The Enterprises own or guarantee 56% of the single family mortgages in this country or $5.4 trillion. Obviously, given that massive exposure, the best way to preserve their assets and fulfill their mission is to stabilize the mortgage market and strengthen their safety and soundness to serve the mortgage market better. Working with the Federal Reserve, the Bush and Obama Administrations, and other regulators, that has been our top priority since the conservatorship began in September and will continue to be so. Mortgage modifications and refinancing homeowners into safer mortgages are an important element of stabilization of the housing market and U.S. economy. The form in which Fannie Mae and Freddie Mac exit from the conservatorships once the housing market is stabilized should be addressed by Congress and the Administration. This hearing is a first step in the process, and I thank you for having it.

Part I—Current Situation of the Housing GSEs and FHFA

The Current Condition of Fannie Mae and Freddie Mac

As you are well aware, FHFA continues to classify Fannie Mae and Freddie Mac (the Enterprises) as "critical supervisory concerns." After many years of debate, substantial deterioration in housing and financial markets and in the outlook and financial status of the Enterprises in the second half of 2007 and in 2008 helped lead to the enactment of the Housing and Economic Recovery Act of 2008 (HERA) last July. The enhanced regulatory authorities provided by that legislation came too late to allow FHFA to prevent excessive leveraging and to address serious safety and soundness issues at Fannie Mae and Freddie Mac. As there were significant risks that the Enterprises would be unable to fulfill their missions, FHFA placed each Enterprise into conservatorship last September.

Critically, the Treasury Department exercised the authorities Congress had provided in HERA to support the housing GSEs. In conjunction with the conservatorships of Fannie Mae and Freddie Mac, the Treasury Department established three facilities to support the ongoing business operations of the Enterprises and to provide confidence to investors in the housing GSEs' debt and guaranteed mortgage-backed securities (MBS). Those facilities include the Senior Preferred Stock Purchase Agreements with Fannie Mae and Freddie Mac, the GSE MBS Purchase Program, and the GSE Credit Facility. In November, the Federal Reserve committed to supporting the housing GSEs and the mortgage market through purchases of their direct obligations and MBS, as well as MBS guaranteed by Ginnie Mae, as part of its open market operations. In total as of May 29, 2009, the Federal Reserve has purchased over $507 billion in MBS and $81 billion in direct obligations. The Treasury Department has purchased $167 billion through its GSE MBS Purchase Program. In addition, under the senior preferred stock purchase agreements with each Enterprise, the Treasury Department will have provided Freddie Mac $50.7 billion and Fannie Mae with $34.2 billion when the first quarter 2009 losses are funded **(Slide 1, see attached)**.

As reflected in the Enterprises' first quarter financial results reported in May, credit-related expenses continue to increase. First quarter net losses were $23.2 billion at Fannie Mae and $9.9 billion at Freddie Mac. The provision for credit losses—to build loan loss reserves—remains a primary driver of net losses at both Enterprises. Loan loss reserves at both Enterprises increased substantially in the first quarter to reflect higher expectations of credit losses from increasing mortgage delinquencies. Loan loss reserves increased by 70 percent at Fannie Mae to $42 billion and by 50 percent at Freddie Mac to $23 billion.

Also driving first quarter losses were other-than-temporary-impairments (OTTI) of private-label mortgage-backed securities (PLS). Those impairments accounted for $6 billion of Fannie Mae losses and $7 billion of Freddie Mac's. Losses on loans purchased out of trusts for loan modifications had a notably smaller effect on earnings, accounting for approximately $2 billion of each Enterprise's losses.

The short term outlook for the Enterprises' financial results is poor. Credit-related expenses and mark-to-market losses are influenced by market conditions that are expected to remain difficult during 2009. Continued poor financial performance will result in additional requests for preferred stock investment from the Treasury Department in 2009. However, both Enterprises have stress tested their capital shortfalls and expect the Treasury Department's commitment to fund up to $200 billion in capital for each Enterprise to be sufficient.

The combined financial support of the Treasury Department and the Federal Reserve have ensured that the markets for housing GSE debt and MBS remain liquid and that the Enterprises have both significant liquidity and access to capital. In particular, the Senior Preferred Stock Purchase Agreements have given investors confidence that there is an effective guarantee of GSE obligations, as any negative equity balance at either Enterprise will be offset by the Treasury Department's investment. This support will continue indefinitely into the future subject to the commitment limit of $200 billion per Enterprise.

Because of this support, both Enterprises have been able to maintain an ongoing, significant presence in the secondary mortgage market. Their combined share of mortgages originated in the first quarter of 2009 was 73 percent, unchanged from 2008 and up from 54 percent in 2007 and 37 percent in 2006 **(Slide 2)**.

While the Enterprises have continued to support the secondary mortgage market, new senior management teams have worked with FHFA to establish and implement comprehensive remediation programs to address the financial and operational deficiencies identified by FHFA's regulatory examinations and by internal and external audit activities. The Enterprises have made progress, but they face numerous, significant challenges to their operations, including:

- remediating the operational, financial, and risk management weaknesses that led to conservatorship;
- building and retaining staff and infrastructure;
- modeling credit risk in this uncertain environment;
- mitigating credit losses, including through loan modifications;
- pricing mortgage products given market uncertainties, modeling difficulties, and the uncertainties of operating in conservatorship;
- buying / guaranteeing mortgages with loan-to-value (LTV) ratios greater than 80 percent due to declining house prices when there are constraints on the availability of private mortgage insurance; and
- providing for mission and public policy objectives of housing market stability, mortgage availability, and mortgage affordability.

In the current mortgage crisis, the Enterprises have focused on mortgage availability, mortgage affordability, and foreclosure mitigation. In November, they announced a streamlined mortgage modification program. Loan modifications undertaken for their own books of business are critical for limiting their own credit losses and stabilizing the mortgage market. First quarter results on significant foreclosure prevention activity related to the 30.4 million Enterprise residential mortgages outstanding show that completed foreclosure prevention actions increased by 38 percent from the third quarter of 2008, the last quarter prior to putting the Enterprises into conservatorship. Repayment plans grew 15 percent. Loan modifications increased by 176 percent from the third quarter of 2008 and accounted for 48 percent of all foreclosure prevention actions in the first quarter of 2009. Seventy-one percent of loan modifications completed in the first quarter involved both interest rate reductions and term extensions. Completed alternatives to foreclosure—short sales and deeds in lieu—accounted for 10 percent of all completed foreclosure prevention actions. Those activities brought year-to-date home retention actions to a total of nearly 77,213 and foreclosure alternative actions to just nearly 9,000.

The Enterprises temporarily suspended all foreclosure sales on owner-occupied properties during the period from November 26, 2008 through January 31, 2009 and during the last two weeks of February and the first week of March. The suspension led to a substantial reduction in completed foreclosure sales in December 2008 and January

2009. However, when the moratorium on foreclosures was lifted during the first half of February, completed foreclosure sales surged to 28,897 for that month from 3,222 in January. The moratorium ended on March 6, 2009. Total foreclosure sales for the first quarter amounted to 41,264, down 13 percent from 47,497 in the third quarter of 2008.

The credit performance of all types of single-family mortgages owned or guaranteed by the Enterprises has continued to deteriorate, as approximately 41,000 more loans became delinquent 60 days or more in February, bringing the total of such mortgages to 1.1 million. One in 10 nonprime Enterprise-owned or -guaranteed loans was delinquent 60 days or more at the end of February, compared with two in 100 prime loans. Non-prime loans (those to borrowers with credit scores below 660) were 16 percent of the total 30.2 million Enterprise-owned or -guaranteed loans.

As of March 31, 2009, seriously delinquent loans accounted for 2.3 percent of single-family mortgages owned or guaranteed for Freddie Mac and 3.2 percent for Fannie Mae. While those are historically high levels, they compare favorably to industry averages of 4.7 percent for all prime loans, 7.2 percent for all single-family mortgages, 24.9 percent for all subprime mortgages, and 36.5 percent for subprime adjustable rate mortgages **(Slide 3)**.

The Enterprises and FHFA worked closely with the White House, the Treasury Department, and HUD to develop the Administration's Making Home Affordable program. Fannie Mae is working with mortgage servicers to implement the Home Affordable Modifications program, which is designed to help prevent foreclosures for homeowners willing and able to make affordable mortgage payments. Freddie Mac's role is to oversee the servicer compliance with program terms and conditions. The modification program is especially challenging as a key target is the loans backing PLS. Those loans represent only 15 percent of mortgages but 50 percent of serious delinquencies (loans 90 days or more past due). In contrast at yearend 2008, the loans the Enterprises held or guaranteed represented 56 percent of the U.S. single family mortgages outstanding, but only 20 percent of serious delinquencies.

The reported activity above does not yet reflect the Making Home Affordable modification plan (MHA). Servicers and the Enterprises have been working hard to increase efforts. In addition, the MHA plan offers the promise of greater impact because the government is offering incentives to offset the servicer costs, has created much more flexibility to lower payments to an affordable level (interest rates may be lowered to 2%), and is willing to compensate investors for a portion of the loss realized with modifications. The impact of MHA on the data will be delayed for two reasons. First, servicers have been required to register as an MHA participant, contractually agree to program terms and conditions, and operationally implement the MHA programs. Second, borrowers are required to submit the required documentation, be approved for a modification, and successfully perform under a three-month trial modification plan before their loans can be formally modified. Therefore, FHFA expects to see the results of current activities ramp up in late summer.

Both Enterprises also have undertaken the Home Affordable Refinance initiative to enable homeowners who are current on their Enterprise-owned or -guaranteed mortgages to refinance at a lower rate. Under that initiative, mortgages with current LTV ratios of up to 105 percent are eligible for refinancing, since the Enterprises already hold the credit risk and lower payments will reduce that risk. This program should assist millions of homeowners who otherwise would have difficulty refinancing due to declining house prices and lack of private mortgage insurance.

Both the Making Home Affordable and the Home Affordable Refinance programs have been launched and will be an important part of the Enterprises' business—and mission—activities this year. The goals of Enterprise participation in the Making Home Affordable programs are to stabilize housing markets while improving the credit position of their books of business. Given the Enterprises' substantial market position—they own or guarantee $5.4 trillion in mortgages—activities that promote responsible homeownership, reduce preventable foreclosures, and stabilize house prices should help reduce their future credit losses.

Those changes in the mission activities of the Enterprises come in the wake of their inability to meet most of the affordable housing goals and home purchase subgoals for 2008 established by the Department of Housing and Urban Development (HUD). In addition, FHFA suspended Enterprise contributions to the Housing Trust Fund in light of Enterprise losses and their draws on the Treasury Department's Senior Preferred Stock Purchase facility.

Fannie Mae failed to meet all but one of its 2008 affordable housing goals and home purchase subgoals. Freddie Mac missed all of the 2008 goals and home purchase subgoals. Both Enterprises met their multifamily subgoals. As permitted by Congress, FHFA is reconsidering the appropriateness of the goal levels for 2009 based on the current state of the mortgage market. Going forward, affordable housing goals should be in line with and responsive to actual market conditions and should promote sustainable mortgage options for low- and moderate-income families and neighborhoods. There is evidence that Enterprise efforts to meet previous housing goals, especially through the purchase of PLS, purchases of Alternative-A (Alt-A) mortgages, and overall loosening of underwriting guidelines, contributed to the unsustainable buildup of credit risk that led to the conservatorships.

The Current Condition of the Federal Home Loan Banks

When financial markets seized up in 2007 and 2008, the Federal Home Loan Banks (FHLBanks) played a critical role in providing liquidity to their members. FHLB advances, which are loans secured by eligible collateral, grew to more than $1 trillion by September 30, 2008, the height of financial market distress. Since then, advances have declined by roughly 25 percent to $759 billion as of May 15.

Despite stress in financial markets and among member financial institutions, investments in the FHLBank System have remained sound as a result of its capital structure and requirements and the FHLBanks' joint and several liability for their consolidated obligations. The capital structures of the FHLBanks ensures that each member's capital investment in each FHLBank of which it is a member generally increases with its advances outstanding at that FHLBank. In addition, even though several FHLBank members, including some large ones, were either troubled or actually failed in 2008, the advance business suffered no credit losses.

That said, FHFA has safety and soundness concerns about certain FHLBanks. Those concerns are largely centered on actual and potential losses associated with PLS. As of the end of the first quarter of 2009, PLS losses recognized by the System amounted to $6.6 billion at the eight FHLBanks that held such investments and had filed their first quarter financial statements by May 29, 2009.[1] Of that amount, only $618 million has flowed through the income statement or accounting transition adjustments to retained earnings as other-than-temporary impairments (OTTI), due to the fact that the FHLBanks are early adopters of the Financial Accounting Standards Board's (FASB's) new accounting rules. The remaining $6 billion has been booked as Accumulated Other Comprehensive Income, which is part of GAAP Shareholders' Equity but not of regulatory capital. That amount exceeds the total retained earnings of the FHLBanks.

The credit quality of the FHLBanks' investments in PLS has proven to be much worse than the initial triple-A credit ratings of those securities would have suggested. By the end of 2008, six FHLBanks had voluntarily or by regulatory requirement ceased paying dividends and repurchasing member stock in order to conserve capital. With ongoing uncertainty surrounding the true economic value of PLS, those investments will continue to raise safety and soundness concerns.

HERA Implementation and Conservatorship

HERA Implementation
We believe we have accomplished a lot in the short time since FHFA was created in July 2008 by the enactment of the Housing and Economic Recovery Act (HERA):

- We are working effectively with the Enterprises as their conservator, even as we continue to oversee them as their regulator.
- We have worked to establish an infrastructure for FHFA, including systems, procedures, and policies that serve as the foundation for accomplishing the mission of the agency. We are combining the personnel and financial systems of three separate organizations and this presents challenges that we are meeting.
- FHFA appointed new boards of directors for the Enterprises and implemented the HERA-required changes for the FHLBanks' boards of directors.
- We have been working with the 12 FHLBanks regarding valuing their PLS and their early adoption of the Financial Accounting Standards Board's new OTTI standard.
- We have smoothly transitioned to a new Administration and a new Federal Housing Finance Oversight Board, which I chair. The other members are the Secretaries of

[1] As of that date, the FHLBanks of Pittsburgh and Topeka were still computing other-than-temporary impairments.

Treasury and HUD, and the Chairman of the Securities and Exchange Commission (SEC).

- We are working with the Obama Administration, the Enterprises, other regulators, and the private sector in developing and implementing the new housing program, the Homeowner Affordability and Stability Program, to address this challenging housing market. Our work there has been particularly focused on foreclosure prevention and keeping people in their homes whenever possible.
- FHFA has a seat at the critical tables—the Financial Stability Oversight Board, which oversees the Troubled Asset Relief Program (TARP) and the President's Working Group on Financial Markets, which is responsible for responding to the crisis in financial markets. We have also consulted with the Chairman of the Federal Reserve as required by HERA. However, FHFA is not a liaison member of the Federal Financial Institutions Examination Council (FFIEC), which I believe would be very helpful in coordinating supervision of the mortgage segment of financial markets.
- The HUD team that oversaw the Enterprises' mission has joined us, and we have been developing new housing goals for Fannie Mae and Freddie Mac and, similarly, an affordable housing program rule for the FHLBanks, both of which are critical parts of our agency's mission.
- In accordance with Section 110 of the Emergency Economic Stabilization Act of 2008 (EESA), FHFA has produced the *Federal Property Management Report* for Congress.
- We are finalizing our first strategic plan.
- We are developing and issuing the many regulations, guidances, and reports required by HERA to ensure a stable and effective secondary mortgage market. One of these requirements is an annual *Report to Congress*, which we recently completed. FHFA has a number of regulations to promulgate. I am pleased to report that all rules required under HERA with a fixed date have been published on time and those remaining are on track to be published in line with the statute.

Conservatorship Operations

As conservator, FHFA is responsible for the overall management of the institutions and has delegated certain operational and other duties to the Enterprises' directors and officers as deemed appropriate. The Enterprises consult with and obtain approval of the Conservator before taking action on transactions involving capital; creation of any subsidiaries or affiliates; certain hiring, termination, and compensation decisions related to executive vice presidents and above; retention and termination of external auditors; and certain other actions that either involve transactions greater than $50 million, relate specifically to the conservatorship, or are likely to cause significant reputation risk.

Both Enterprises continue to carry on their daily business activities under the conservator's oversight, and all existing contracts of the Enterprises remain in effect, with the exception of lobbying contracts, which the conservator disaffirmed. All lobbying and political contributions by the Enterprises were immediately ordered stopped with the conservatorships. The Director also eliminated dividends on all common and preferred stock.

As conservator, FHFA changed some Enterprise management and governance practices. FHFA appointed new CEOs, nonexecutive chairmen, and Boards of Directors to both Enterprises. FHFA also worked with both Enterprises to establish a new Board committee structure, including key changes in charters and responsibilities. FHFA has worked with Fannie Mae on replacing its CEO, and continues to work with Freddie Mac in its search for a replacement CEO, CFO and the hiring of a COO. FHFA continues to work with the Enterprises and executive leaders at both Enterprises to retain key staff.

FHFA also has redirected certain decisions and refocused the Enterprises on strategic and mission-related goals. For example, FHFA issued a statement supporting the continuation of multi-family activities, reversed a planned increase in certain fees, and continue to review pricing and credit changes to ensure that changes are consistent with market conditions and support mission-related activities. Other activities have included the public release of 2007 and 2008 charitable giving, implementing internal controls around charitable giving, improving accounting consistency between the Enterprises, and working with Treasury to support initial and subsequent capital draws. FHFA encouraged Fannie Mae and Freddie Mac to lead foreclosure prevention initiatives and collaborate with the new Administration and other industry participants to address the economic crisis and keep people in their homes.

Late last August as we were planning the establishment of Enterprise conservatorships, we quickly identified retention of human capital as one of our most important challenges. With $1.9 trillion in assets and more than $3.7 trillion in guarantees, the Enterprises are two of the largest financial institutions in the world. Managing such a large and complex set of financial assets and guarantees requires skilled and experienced staff in a wide range of corporate activities, including financial asset and property management, operations, technology, and modeling, among others.

Even more important, the dependence of the mortgage markets and the American economy on the Enterprises in the continuing crisis had greatly accentuated the importance of maintaining their critical mission. Keeping the Enterprises operating at full speed was possible only if we retained the Fannie Mae and Freddie Mac teams. They are an important part of the solution, not the problems of the past.

Their conservatorships, new CEOs and the possibility of major changes in the structure of the Enterprises created considerable uncertainty for their employees. At the same time, we knew one of our first announcements would be that bonuses would not be paid to senior executives based on 2008 performance. Furthermore, the collapse in value of the Enterprises' stock had destroyed years of savings for many employees, and future vesting of previous stock grants no longer provided any retention incentives.

We hired a firm with expert compensation advisers to help us develop, in consultation with the Treasury Department, a program to keep key staff without rewarding poor performance. We felt it was extremely important to have a broad-based plan. The final retention programs, designed to incorporate market practices for troubled companies, included a total of 4,057 Freddie Mac employees, and 3,545 Fannie Mae employees. Payments were scheduled from late 2008 through early 2010. The total dollars paid and scheduled to be paid over that period equal 12 percent of 2008 salaries and employee benefits at Freddie Mac and 11 percent at Fannie Mae, or an average of $24,000 per recipient at Freddie Mac and $32,000 at Fannie Mae.

For the 2009 performance year, Freddie Mac has established short-term and longer-term incentive award plans for employees at the Vice-President level and below. The amount of money in the short-term bonus pool will depend on the Enterprise's achievement of a variety of important goals primarily relating to mission, risk management, accounting, internal controls, business infrastructure, financial performance, and foreclosure prevention. A longer-term incentive plan will payout over two years, depending on Enterprise performance in addressing FHFA examination findings and other infrastructure issues. Non-salary compensation plans have yet to be completed for senior Freddie Mac executives or for Fannie Mae employees, generally.

Other Current Concerns

At this juncture we see several other issues that we would like to call to your attention. The first relates to FHFA's Office of Inspector General (OIG), which HERA established. The Inspector General (IG) is a Presidentially-appointed and Senate-confirmed position. The Inspector General Act of 1978 requires that such offices be funded each year through the annual appropriations process, while HERA authorized FHFA to assess the regulated entities to finance its activities. No appropriation has been provided for FHFA's IG for fiscal year 2009, since, when Congress considered related funding issues, the IG had not been nominated or confirmed. I fully support the establishment of an OIG for the agency and encourage the Administration to move forward to fill this position. I also support Congress providing the IG with the necessary resources, through the annual appropriations process, to establish an appropriately staffed, high-quality office.

The vulnerability of the private mortgage insurance industry is also a concern. As you know, Fannie Mae and Freddie Mac have relied on the mortgage insurers because the Enterprises' charters bar them from buying or guaranteeing loans with loan-to-value (LTV) ratios above 80 percent where the mortgages lack credit enhancement. The Enterprises' substantial counterparty credit risk exposure to private mortgage insurers totaled $184 billion at year-end 2008 and accounted for 85 percent of those insurers' risk-in-force at that time. Currently, delinquency rates are increasing significantly for all mortgage insurers, their capital positions are eroding, and their credit ratings are falling. Many insurers are operating in a capital preservation mode in an attempt to avoid breaching risk-to-capital levels, which would require their regulators to put them in run-off, ending their ability to take on new business. Thus, the underwriting standards of the private mortgage insurers have become tighter and new business written fell approximately 65 percent in the first quarter of 2009 from the year-earlier period. Mortgage insurers' actions, although understandable given losses incurred and weak market conditions, cloud the long-term outlook for the industry and have limited the Enterprises ability to write higher LTV loans. I believe that a financially sound mortgage insurance industry is critical to the recovery of housing markets. FHFA has discussed with the Treasury Department ways to bring new capital to these institutions.

The staffs at FHFA and the housing GSEs have been working hard to restore or maintain the institutions' safety and soundness. For Fannie Mae and Freddie Mac, however, the consequences of the size and credit characteristics of their mortgage books of business create substantial uncertainty as to the form of the ultimate resolution of the conservatorships. In the next section of my testimony, I will speak to the future of the Enterprises and the federal role in the housing finance system.

Part II—Future of the Enterprises

Before we talk about the future of Fannie Mae and Freddie Mac, I will summarize what went wrong in housing and mortgage markets, identify lessons learned, and raise three basic questions that policy makers face at this juncture. Then I will offer my own thoughts on the potential roles for the federal government in the housing finance market, some principles that I think should guide policy choices, and the viability of alternative institutional structures.

To place this discussion in context, let me define the purpose of the secondary mortgage market. Simply put, it connects global investors to local lenders and borrowers. While the average mortgage in the United States is about $200,000, the entire U.S. mortgage market is an $11.9 trillion market. The secondary mortgage market provides a critical link between global capital market investors who deal in millions and billions of dollars, and local institutions that provide the personal service to individual borrowers seeking loans of thousands of dollars. Traditionally, Fannie Mae and Freddie Mac have provided standardization of forms and data, combined with sound underwriting, to give global investors confidence to invest in pools of mortgages in the form of mortgage-backed securities and debt issued by the Enterprises. The secondary market helps to lower borrowing costs for homebuyers, in part because large institutional investors may be better able to fund mortgages and to manage and hedge certain mortgage risks than primary market lenders.

What Went Wrong

A number of things went wrong in U.S. housing and mortgage markets in first decade of this century. Part of what happened was beyond the housing sector. The "dot com" bust at the beginning of the decade resulted in a shift of some investor funds out of the stock market and into real estate, among other investments. The 1997 tax changes that made capital gains from owner-occupied housing essentially tax free for most homeowners spurred that shift. In response to the recession of 2001 and the September 11th attacks, the Federal Reserve lowered the federal funds rate and committed to maintaining low rates for an extended period to combat fears of deflation. The low interest rates decreased monthly payments and enabled home buyers to bid more, putting upward pressure on home prices. Investors worldwide, in turn, were seeking higher returns without adequate consideration of the associated risks. Risk was mispriced in many markets, but especially in the mortgage market.

At the same time, private sector innovations stimulated rapid growth in mortgage lending. Those innovations included the development of alternative mortgages aimed at people who did not wish to provide standard documentation, who had blemished credit records, who could not make substantial down payments, or who wanted lower (initial) monthly payments. Such loans included low- and no-documentation mortgages, low- or no-down payment loans, piggy-back mortgages that eliminated the need for private mortgage insurance, interest-only loans, and payment-option mortgages. Many of these loans allowed more households to qualify for higher balance loans but were often relatively complex and posed risks that borrowers might have failed to understand. The rapid growth in the availability of alternative mortgages added to upward pressure on home prices that, as the boom proceeded, ultimately increased the credit risk of a broad range of outstanding mortgages.

Because many of these alternative mortgages were not eligible for purchase and securitization by the Enterprises, they would not have increased rapidly without another innovation—the development of PLS. By the mid-1990s, private firms were issuing their own MBS backed by nonconforming, mostly jumbo, mortgages. Unlike Enterprise and Ginnie Mae MBS, such securities were issued without the benefit of either an explicit or implicit federal guarantee of the timely payment of principal and interest. Instead, credit protection was achieved through dividing the securities into many pieces (or tranches) that differed in their priority to receive payments of principal and interest from the underlying mortgages. Private securitizers and their investors sought to increase profitability and hedge their risk through the use of complex structured financing and derivatives. Such instruments included credit default swaps (CDS), which act much like insurance against default, and collateralized debt obligations (CDOs and CDOs-squared), which were thought to reduce credit risk through diversification. As many market participants have now learned, however, the models and data used by credit rating agencies and investors, including the housing GSEs, to assess the risks of the new mortgages and securities based on them proved to be seriously flawed and inadequate.

The mortgage lending boom made possible by those innovations caused the dollar amount of single-family mortgages outstanding to grow at an unprecedented pace. At year-end 2000, \$5.1 trillion single-family mortgages were outstanding. By the end of 2008, that total had more than doubled to over \$11 trillion single-family mortgages. Between 2001 and 2007, the average growth rate in mortgages outstanding was 12 percent per year, which greatly exceeded overall growth in household income. Much of this increase was from non-traditional and, to a lesser extent, jumbo non-conforming mortgages.

Most non-traditional and jumbo mortgages were financed through the sale of PLS. Issuance of PLS surged beginning in 2004, when 46 percent of all single-family MBS issued were PLS. The PLS share peaked at 56 percent in 2006, but fell to 4 percent in 2008 **(Slide 4)**.

Private-label securitization competed to some degree with Fannie Mae and Freddie Mac. PLS as the Enterprises also integrated local lenders into national and international capital markets to reduce reliance on local deposit funding of mortgages. The rise of PLS, however, created a sort of competition in laxity by offering consumers mortgage credit on looser terms than the Enterprises traditionally offered. Ultimately, the Enterprises eroded their own credit standards in an effort to keep pace with the rapid growth of subprime and other non-traditional mortgages funded with PLS.

By 2004, the Enterprises found their share of total single-family mortgage originations eroding as the prevalence of alternative mortgages grew and issuance of PLS ballooned. At the same time, demand for Enterprise MBS by foreign and other investors reduced profit margins for the Enterprises' own retained portfolios. To maintain profitability of the retained portfolios and to meet HUD-designated affordable housing goals, each Enterprise increased purchases of PLS backed by alternative mortgages and of high-risk whole loans. Freddie Mac purchased more PLS, and Fannie Mae purchased more whole loans. This weakening of their traditional underwriting standards has been a key driver of their recent, massive credit losses.

The credit performance of those goal-rich investments, however, has been far worse than anticipated and has accounted for a large share of total Enterprise losses. For example, during 2008 Freddie Mac recorded realized and unrealized losses related its investments in PLS of $53 billion, compared to the provision for credit losses on the entire single family book of $16 billion.

Purchases of PLS ultimately proved disastrous for the Enterprises. Credit and market-value losses would have been even larger had the Office of Federal Housing Enterprise Oversight (OFHEO), one of FHFA's predecessor agencies, not increased the Enterprises' capital requirement by 30 percent and capped their asset portfolios because of accounting and control problems. Those losses have largely validated previously expressed concerns about the weaknesses of the GSE model as implemented for the Enterprises. That model created private, for-profit corporations with special privileges that protected them from market discipline and led them to manage political risk more aggressively than economic and financial risks. The model resulted in large, systemically important institutions with excessive leverage, which by statute could exceed 100 to 1.

Lessons Learned

A time of crisis is also a time of learning, and we are learning or relearning many important lessons from this crisis. Some of the more important lessons have to do with the behavior of private firms and markets and their potential impact on the stability of the financial system. We should not lose sight of the fact that the marketplace continues to generate tremendous wealth and other benefits for this country and its citizens. But poorly regulated innovations in products, risk management, and underwriting standards can undermine the safety and soundness of financial institutions and overall financial stability by increasing leverage and capital arbitrage and by allowing unrecognized risks to accumulate.

The risk that a market innovation will have adverse systemic effects increases as it becomes difficult for all parties to understand and analyze. The complexity of many alternative mortgages certainly confused many borrowers, and the complexities of many PLS and derivatives created from them appear to have confused and confounded analysts, ratings agencies, and professional investment managers. The PLS and related derivatives were often quite opaque, and the lack of adequate information confounded analysis of their risks. Protecting borrowers from predatory lending and protecting the liquidity of the secondary markets both require greater simplicity of securitized mortgages. Thus, we have learned that securitization does not inherently overcome poor underwriting and credit practices.

Another set of important lessons has to do with how we regulate financial firms and what we can hope to achieve through that regulation. It is now clear that regulation failed to contain excessive risk-taking in housing finance. That failure can be linked partly to structural weaknesses such as the limits to the regulatory authority of OFHEO, which were belatedly addressed in HERA. But many regulators also believed that damage from subprime mortgage excesses would be limited and would not affect their own regulated institutions to any great degree. Those beliefs reflected a focus on compliance with capital adequacy requirements that relied heavily on ratings from nationally recognized statistical ratings organizations (NRSROs), a failure to recognize the extent of off-balance-sheet risks, and a failure to recognize the extent of capital arbitrage. All those factors helped to magnify leverage and undermined capital adequacy. In 2006 and 2007, bank and thrift regulators did adopt guidance on nontraditional and subprime mortgages. OFHEO made the Enterprises comply with that guidance for the mortgages they bought and guaranteed as well as for the underlying mortgages in the PLS that they purchased.

Regulators and financial institutions also have learned that capital can disappear rapidly when asset markets become illiquid. The rapid disappearance of capital makes the combination of capital adequacy triggers and prompt corrective action embodied in regulation of banks and the Enterprises inadequate to protect taxpayers from the costs of resolving systemically important financial institutions when they founder. To protect taxpayers and the financial system, regulators and financial firms must prepare explicitly and in detail for widespread solvency and liquidity problems if they hope to address problems early and avoid full-blown crises. Preparation should include developing detailed plans for the orderly resolution of large, complex institutions to increase their incentives to limit risk of failure and the risk they pose systemically. Pre-existing and pre-funded mechanisms for the orderly resolution of large, complex financial institutions would also mitigate the need for taxpayer-funded rescues of such firms.

Key Questions Related to the Future of Housing Finance

Given what went wrong in housing and mortgage markets, I think the following are key questions that policy makers both in Congress and the executive branch must confront:

1. How can mortgage lending, including mortgage securitization, be changed to better serve our society? What is the role of regulation in achieving that goal?
2. How can financial institutions involved in mortgage lending and their supervision be reformed in order to protect overall financial stability better?
3. Beyond prudential regulation and supervision, does the government need to perform directly any specific functions in the secondary mortgage market? If so, how could the government best perform any such functions?

The answers to these questions have important implications for the future of housing finance and the potential structures and functions of the Enterprises.

Thoughts About the Future of the Enterprises

To begin contemplating the future of the Enterprises, we need to consider the potential functions in the secondary mortgage market that might best be accomplished by an institution or institutions with links to the federal government. We have learned that poor underwriting and credit practices cannot be overcome by securitization. It can be argued that three specific roles remain for the government or a special government-linked entity. Ultimately, the roles chosen for any government-linked entities going forward will have implications for their range of activities and institutional structure.

Potential Roles

The first potential role would be that of liquidity provider of last resort for the secondary market for MBS and possibly other asset-backed securities. In the past few decades, Fannie Mae and Freddie Mac have largely and profitably undertaken that role for their own MBS. However, they were unable to do so in the current crisis because of the magnitude of the disruption and their own weakened financial conditions. Consequently, during the current crisis, the Federal Reserve and the Treasury stepped in to do so. For the foreseeable future, the Enterprises' ability to perform this function will be limited by their financial weaknesses and the limits on their portfolios imposed by the Senior Preferred Stock Purchase Agreements with the Treasury Department.

The second potential role would be that of a guarantor or catastrophic risk insurer of the credit risk of conventional MBS. As we have seen, a catastrophic event in the housing sector—a severe house price decline, for example—can result in widespread financial losses and lead to a financial crisis. We have also seen that private firms are limited in their ability to insure against such catastrophic events. On the other hand, I know from my own experience at OFHEO, Social Security, the Pension Benefit Guaranty Corporation (PBGC), and now FHFA, that government insurance comes with significant risks of moral hazard and perverse incentives. However, a key advantage of a well-managed insurance program is that money is charged in the form of premiums in good times to offset losses during future bad times.

A final potential role of a government-linked entity is to alter the allocation of resources by providing subsidies or using other means to attempt to increase the supply or reduce the cost of mortgage credit to targeted borrowers. Such a role has been central to all the housing GSEs and has had mixed results as recent events have shown.

Principles for the Future

If policy makers decided to use the Enterprises in some reconstituted form or another institution or institutions with links to the federal government to perform any of those functions, issues about appropriate legal and ownership structures would arise. Before considering those questions, in my view it would make sense, first, to establish some very basic principles to guide our evaluation of those options and the choices among them.

Before laying out those principles, I'd like to reiterate that this is not just about Fannie Mae and Freddie Mac. As the key questions I posed above suggest, very important decisions have to be made about the future of the mortgage market and the appropriate role of the secondary mortgage market, including the roles of government regulation and programs, before we get to the future of the Enterprises themselves.

The first principle is that the Enterprises or any successors should have a well-defined and internally consistent mission. Their activities should be well-tailored to achieving that mission. Current law states 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 questions: Specifically, how should the Enterprises or successor institutions 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 with simple, easy-to-understand terms?

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, and any federal risk-bearing should be provided explicitly and at actuarial cost. 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 reducing the risks and avoiding unintended consequences? Should the existing books of business be split from new business on emergence from conservatorship, using a bridge bank structure, as provided for in HERA? How can we prevent undue political influence that may increase risks to the taxpayers?

The third principle is to base any organization (including any government corporation or entity) that provides credit guarantees or mortgage insurance on sound insurance principles: sound management, strong underwriting, strong capital positions, risk-based pricing, and flexibility to react to changes in the market. This raises several implicit questions: Do the Enterprises' retained mortgage portfolios compound their overall risks? Should the Enterprises or successor institutions be solely insurers of mortgage credit risk? Since private institutions cannot always reserve adequately for the bad times during the good times, should they pay the government an explicit, risk-based fee for the catastrophic risk the federal government will bear? Such coverage could take the form of reinsurance of private mortgage insurance or MBS guarantees. If so, what agency should manage that reinsurance program, and how should its coverage be structured relative to credit enhancements provided by the private sector?

The fourth principle is to create a regulatory and governance structure that ensures risk-taking is prudent. From nearly the first day of my job three years ago, I pointed out the folly of allowing the Enterprises to have such large portfolios and legally leverage their mortgage credit by well over 100 to 1, as did the Bush Administration well before I accepted the position. Congress provided a stronger regulatory structure for the housing

GSEs as part of HERA. That act afforded FHFA greater flexibility to establish capital and other prudential standards for the housing GSEs, and we are in the process of examining options to strengthen minimum and risk-based 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.

The fifth principle is that housing finance should be subject to supervision that seeks to contain both the riskiness of individual institutions and the systemic risks associated with housing finance. The latter type of supervision would include policies and countercyclical capital regulations that counter the private sector's tendency to generate lending booms and busts. Our recent experiences have driven home how important safe and sound practices in housing finance are to the stability of the financial system and the U.S. economy. Going forward, we should seek to monitor, understand, and prevent or contain the buildup of excessive risk caused by imprudent practices related to housing finance.

Potential GSE Structures

With those principles in mind, we can consider issues related to the structure of the Enterprises or successor institutions such as their ownership structure, range of activities, regulatory environment, and housing policy mission.

With respect to ownership structure, there are three basic options for the future of Fannie Mae and Freddie Mac: government agency, GSE, or fully private firms. Each of these options has several variants, and each variant in turn will have its own advantages and disadvantages. The first option would be the equivalent of nationalizing the Enterprises. One variation of that idea would be to merge them with either FHA or Ginnie Mae. I am opposed to nationalization because government insurance programs are particularly high risk and rife with moral hazard. The FHA model is being tested right now. The present mortgage market difficulties do not provide a sound rationale for permanently nationalizing the $11.9 trillion mortgage market.

The second alternative would be to keep the Enterprises as GSEs, building upon HERA. There are several variations on that theme. They could continue with Treasury net worth protection or government reinsurance for catastrophic risk. Such reinsurance offers three primary advantages over a direct government insurance program. First, it does not put the government in a first loss position, reducing the moral hazard concerns. Second, since financial crises often drive down the cost of federal borrowing, the government has a natural hedge against such risk that the private sector lacks. Finally, some have argued that the government cannot avoid being in the position of a catastrophic reinsurer and is better off acknowledging and pricing those services. The current agreements with Treasury call for a sharp reduction of the Enterprises' retained portfolios, which will reduce their ability to take risks, but may hinder their ability to provide a liquidity backstop for the MBS market. As former Treasury Secretary Paulson suggested in January, a public utility model could be established. A cooperative ownership model similar to that of the FHLBanks has also been suggested. Extreme care would have to be taken to prevent the inherent conflict always present in the GSE model—the tension between private profits, in part from publicly bestowed benefits, and public purposes.

A third option is to establish purely private-sector firms to supply liquidity to mortgage markets with or without government catastrophic insurance or reinsurance. Private firms could offer the benefits of greater competition such as improved operational efficiency and increased benefits to consumers. However, to maintain the level of liquidity the MBS market has enjoyed under Fannie Mae and Freddie Mac, a high degree of standardization and quality control across firms would be necessary. This approach raises transitional issues and would need to incorporate the principles set forth earlier. Whatever option is chosen, the country's financial system will continue to require a vibrant secondary mortgage market, including the functions currently performed by the Enterprises.

With respect to the future regulatory environment of the Enterprises or any private successor firms, the key issues involve choices regarding both safety and soundness and mission regulation. Recent experience has taught us that traditional prudential supervision may be insufficient to prevent the buildup of risks that threaten overall financial stability. FHFA therefore supports a shift to broaden supervisory activities to include the monitoring of systemic risk and the development of regulatory policies that focus on systemic stability. Such policies, often termed "macroprudential," include efforts to dampen credit cycles by making capital and other regulatory requirements more countercyclical.

FHFA is currently working on a new approach to mission regulation that is more sensitive to market conditions and better promotes sustainable mortgage options for low- and moderate-income households. We believe that the Enterprises' approach to meeting the HUD-designated housing goals was ultimately destabilizing. In this context, we urge Congress to consider how best to provide subsidies for lending to targeted borrowers. We believe that the approach taken to funding the FHLBanks' affordable housing mission, which is essentially a flat tax that finances direct subsidies to targeted borrowers and developments, is more consistent with safety and soundness than is the percent-of-business approach taken with Fannie Mae and Freddie Mac. In either case, some conflicts between safety and soundness and mission will arise and require tough decisions.

Regardless of the choices Congress and the Administration make about the future of the Enterprises, a number of cross-cutting issues will have to be addressed. Three such issues come to mind. First, should our approach to competition among secondary market institutions be different from elsewhere in the economy? Second, should secondary market institutions be specialized by sector or diversified across sectors? Third, how will the choices affect the future of the private mortgage insurance industry, FHA, and Ginnie Mae?

I'd like to close with a few personal thoughts. My career has included work with several private-sector insurance companies and several government insurance programs. My observation is that government insurance programs are high risk and invite the private sector to shift risk to the government. Among other issues, it is often difficult in a political environment to calculate or charge an actuarially fair price, resist pressure to broaden the mission, and prevent inadequately compensated increases in federal risk-bearing. Nonetheless, government has an important role to play in providing certain types of insurance, especially reinsurance against catastrophic risks. One possibility to improve financial stability going forward would be for the government to provide catastrophic reinsurance in the secondary mortgage market funded by premiums paid by participating companies.

Finally, the regulators need to take a more unified and cohesive approach to supervising mortgage products, markets, and institutions. A near term step would be for FHFA to have fuller participation in Federal Financial Institutions Examination Council (FFIEC). In particular, designating FHFA as a liaison member to the FFIEC would facilitate sharing of information with FFIEC members. Because of the importance of mortgage holdings for banks, FHFA should be part of the FFIEC in terms of sharing information and providing input. FHFA would learn of new initiatives that would affect the Enterprises and be better positioned to offer supervisory assistance to other regulators in fields where it has expertise. As a liaison member, FHFA would not vote on any FFIEC matters.

Conclusion

The Enterprises and the FHLBanks are playing a vital role in helping to stabilize housing and the economy today. Fannie Mae's and Freddie Mac's participation and leading role in the Making Home Affordable Program is extremely important in helping to stabilize the mortgage market and their own books, which encompass 56 percent of single-family mortgages in this country. As markets and the Enterprises stabilize, there will be the need to address the complex issues I have outlined in this testimony. It is important to get the restructuring right for the U.S. economy and all present and future American homeowners and renters. Hopefully, I have helped to clarify the range of issues and choices confronting you. I will be happy to answer any questions.

Treasury and Fed Support Is Strong

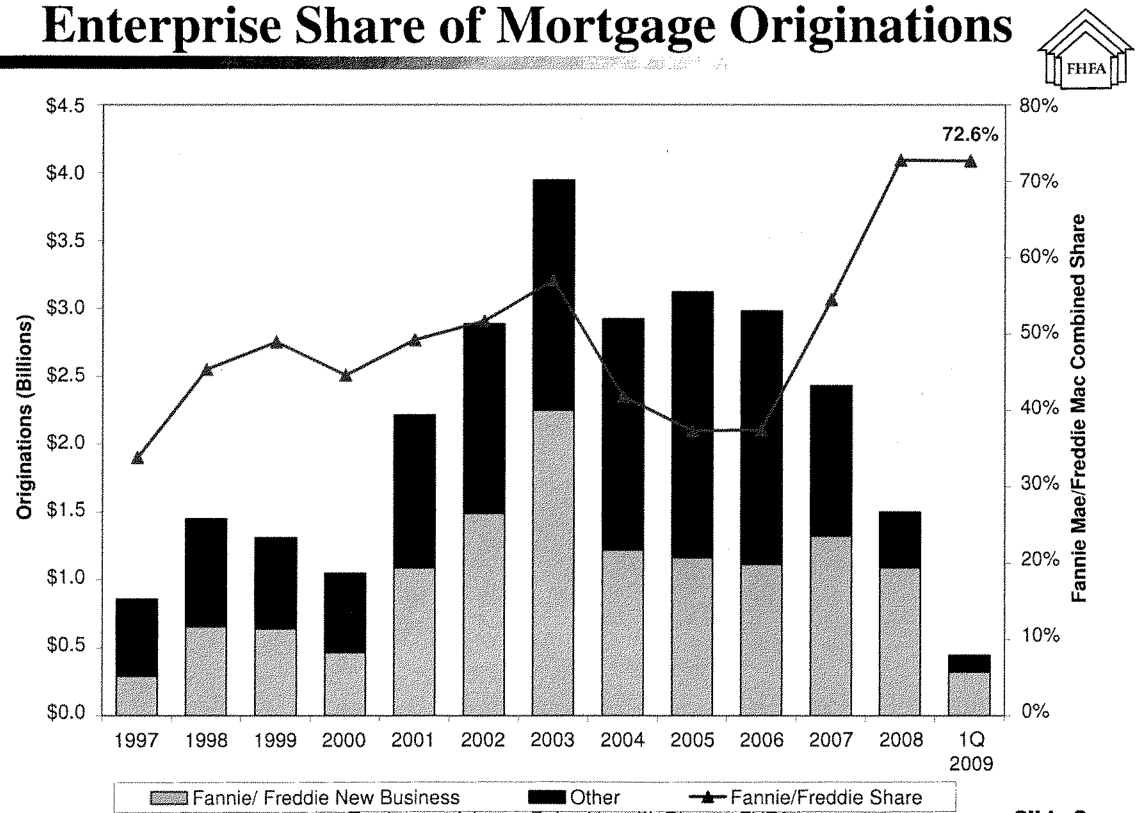
(in Billions)

	Available	Used
Treasury:		
Senior Preferred	$400	$85
Enterprise MBS	no limit	167 *
GSE Liquidity Facility	no limit	0
Federal Reserve:		
Enterprise Credit Facility	no limit	$0
Agency MBS	$1,250	$507
GSE Debt	200	81
Total:	**$2,017+**	**$840**

data as of 5/29/09

** included in available*

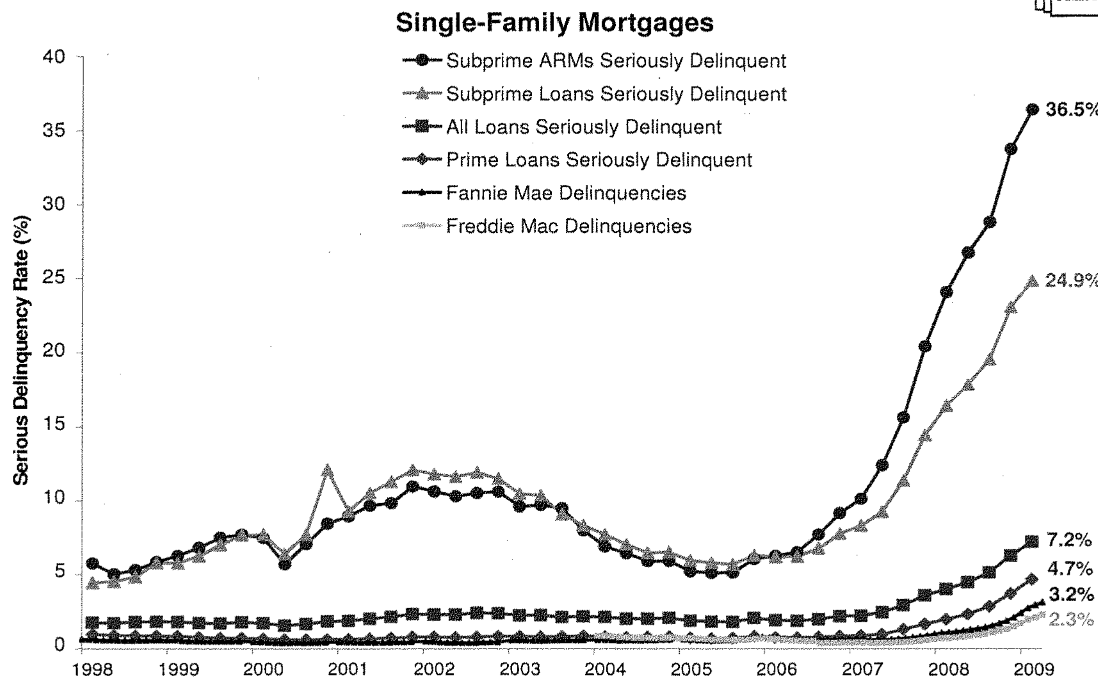
Enterprise Share of Mortgage Originations



June 3, 2009 Testimony of James B. Lockhart III, Director FHFA **Slide 2**

Sources: Inside Mortgage Finance, Enterprise Monthly Volume Summaries.

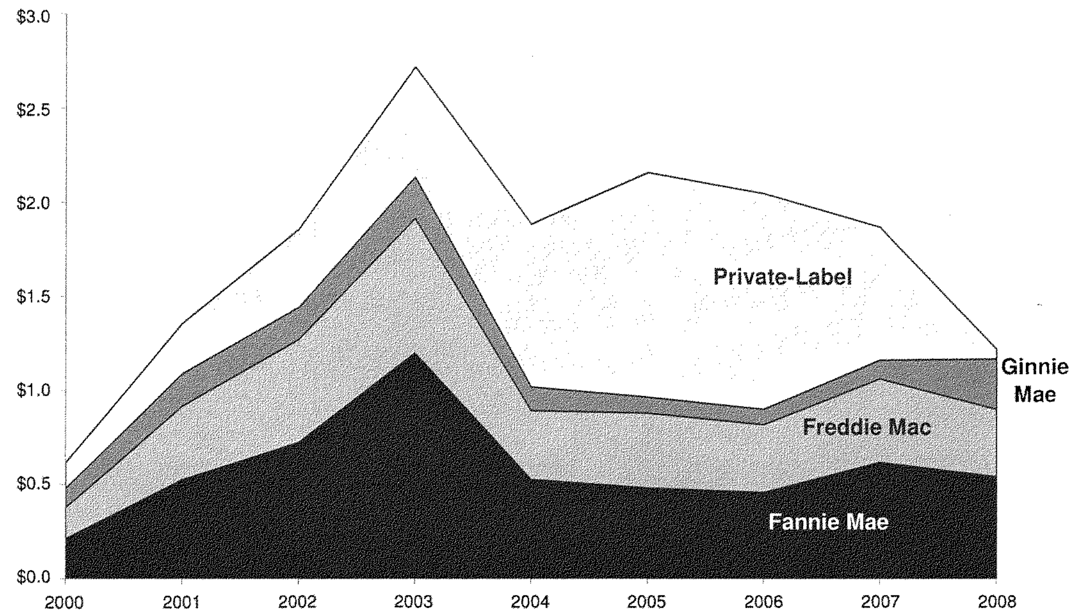
Serious Delinquencies Continue to Rise



Sources: Inside Mortgage Finance, Enterprise Monthly Volume Summaries.

Private-Label Issuance Grew and Declined Rapidly

MBS Issuance by Issuer, in Trillions
2000 - 2008



Source: *Inside Mortgage Finance* Publications.

June 3, 2009 Testimony of James B. Lockhart III, Director FHFA **Slide 4**

STATEMENT OF BRUCE A. MORRISON

CHAIRMAN
MORRISON PUBLIC AFFAIRS GROUP

SUBMITTED TO THE
COMMITTEE ON FINANCIAL SERVICES
OF THE
UNITED STATES HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

JUNE 3, 2009

Chairman Kanjorski, Ranking Member Garrett, and Members of the Subcommittee, thank you for the opportunity to participate in this important hearing. Probing future options for Fannie Mae and Freddie Mac necessarily entails probing the future of housing finance policy for the nation.

I have been deeply engaged in issues of housing finance since the 1970s when I worked as a legal services attorney specializing in housing matters. This work continued in the 1980s as a member of this committee and in the 1990s as Chairman of the Federal Housing Finance Board, then regulator of the Federal Home Loan Banks. Since 2001, I have advised several financial institutions involved in housing finance.

There is a lot to learn from nearly 80 years during which the Congress and the Executive Branch have created and directed agencies and programs to enhance housing opportunities for Americans. But I would summarize that experience by saying that the overall trend has been a positive one in which housing opportunity has been greatly enhanced and the broader economy significantly benefited. However, that trend has been interrupted at least twice by spectacular failures—the savings and loan collapse of the 1980s and the current crisis fueled by the puncturing of an unsustainable housing bubble.

The overall success of the government's investment in housing opportunity, as well as the significant derailments that we suffered and are suffering, have both demonstrated that housing is so important to the nation's families and so central to our economy that government support for housing finance is not an option, but a necessity. A radical privatization agenda is neither wise policy nor a politically viable choice.

At the same time, both of our big failures in housing finance shared some important characteristics. They were sparked by regulatory choices that pushed things in the wrong direction. And when the signs appeared that things were going in the wrong direction, the responses only made things worse. It took actual hard landings, not managed changes, to get to the point of making corrections. And most important, a look backward revealed that structural arrangements in the housing finance system had made the crises almost inevitable.

Before the S&L crisis, savings banks and savings and loans provided the backbone of single family mortgage lending. Fannie Mae had its origins in the 1930s and was separated from the federal government in 1968 and Freddie Mac began as part of the Federal Home Loan Bank System in 1970 and was sold to private shareholders in 1989. But despite these histories, the dominance of Fannie Mae and Freddie Mac in housing finance was a phenomenon of the 1990s with the collapse of one model—portfolio lending—and the explosion of another—widespread capital markets participation through securitization.

The point of this brief historical overview is to emphasize that the solution to one structural collapse can become the source of another. As the Congress decides how to redesign government oversight and participation in housing finance in the wake of the current crisis, it is best to avoid major departures from successful attributes from the past. It is better to concentrate on correcting what went wrong than at devising significantly altered arrangements, which will surely contain their own unintended seeds of future disasters.

For me, that suggests the following guides to the decisions the committee faces:

- **Both good politics and good social policy requires the federal government to provide structural and financial support to housing finance.** Yes, this is "credit allocation" different from what the market might do on its own, but it reflects the social and economic benefits that good housing brings to families and communities. From the 1930s forward, this role has been an overall success.

- **Government structural and financial support need not, and ought not, equate with government operational control, nor taxpayer risk beyond catastrophic events.** Private capital and private markets have been as integral to the successes of the past as have been the structures of government support. Neither innovation nor efficiency are hallmarks of government operations and maximizing the role of private sector institutions in mortgage finance is of equal importance to providing the public sector framework.

- **Regulatory strength, independence, and expertise is essential.** Neither the Federal Home Loan Bank Board in the 1980s, nor OFHEO in more recent times, was up to the task of preventing the excesses of their regulated entities, nor did they have influence over other major participants in the mortgage markets. It is not enough to restructure the role of Fannie and Freddie. Housing finance oversight requires its own integration into the regulatory structure.

- **Risks inherent in financial transactions do not disappear because they are transferred or repackaged.** There is a difference between financial engineering that broadens and better allocates the bearing of different risks of long term lending instruments like mortgages, and the use of financial structures to obscure risks from the oversight of counterparties, investors and regulators.

- **Discussions of the future of Fannie and Freddie often blur the distinction between who owns them and what risks they bear as opposed to the risks borne by others.** A "privately owned" entity can shift most of the risks of its activities to the government and a "government owned" entity can transfer most of the risks of its activities to the market. It is essential in this process to define the structure of ownership of the enterprises separately from the structure of risk-bearing in the mortgage market.

These general observations lead me to the following specific conclusions and recommendations:

- **The functions of mortgage finance are not being changed.** There is origination (including underwriting), funding, holding (both in portfolio and through securitization), insuring and servicing. Fannie and Freddie have a role in all of these activities, but they are concentrated on funding, followed by securitizing and portfolio holding, and insuring. But there are also private entities (such as brokers, mortgage bankers, depositories, investment banks, mortgage insurers, and public and private investors) as well as public entities (FHA, VA, GNMA, HUD, and state housing finance agencies) engaged in various of these activities as well.

- **Fannie and Freddie brought dependable, nationwide funding, lending and underwriting standards, and penalty-free refinancing to the bulk of the market.** It was the markets from which Fannie and Freddie were excluded—subprime and jumbo—that fueled both the innovations and the abuses that contributed to the mortgage bubble.

- **The government (aka the taxpayer) always ends up with the catastrophic risk.** And the beneficiaries of the rescues extend beyond those the government initially insures (and charges for the insurance). So it is better to design the structure to acknowledge the catastrophic risk role of the government, limit it in depth to the truly catastrophic, and broaden it in scope to finance what will be required in a calamity.

- **A corollary is that the private sector role should be as broad as possible in taking all but the catastrophic risk.** However, this requires nimble and expert functional regulation that assures that the government entity understands the risk, prevents its expansion by clever private counterparties, and imposes the discipline that makes the catastrophic event rare—underwriting and lending standards, credit rating processes and entities, capital standards—sweeping in activities by their relationship to the mortgage market, not by the type of firm or product involved.

- **The central role of Fannie and Freddie that should be preserved is that of mortgage market facilitator.** They create and enforce standards for the interface between the originations in the primary market and the funding in the secondary market. They apply the guarantee that provides the secondary market with its breadth and depth of liquidity. But that guarantee can no longer credibly be an "implied" rather than "explicit" obligation of the federal government, nor need it cover as much of the credit risk for most mortgages as it has in the past. Properly rated structured bonds can assign risks to private insurers and investors with only the most severe events calling on the federal government, and then through reserves funded by guarantee fees.

- **This role does not require a large portfolio of mortgages or mortgage-backed securities.** Most of the portfolio accumulation in the past was driven by the arbitrage profits it generated. Market-maker portfolios may be needed. And there may be certain types of "affordable" mortgages and low and moderate income multifamily mortgages for which portfolio holdings are appropriate. The difference is that the portfolio size and scope would be driven by the GSE mission, not shareholder profit expectations.

- **The risks inherent in GSEs with that kind of critical, but more limited role, are much less than those of Fannie and Freddie in the recent past.** And much of the risk previously embodied in the GSEs will be distributed elsewhere in the financial system. But it will not go away. Mortgage market regulation needs to be a part of the reformed financial regulatory structure and the regulation of the reformed GSE structure and remaining functions would be just one part of the mortgage regulator's duties. This does not dictate a separate institution, but it does demand a functional specialization within whatever regulator it resides.

- **The GSE role is essential to housing affordability for both single family and low to moderate multifamily.** The first priority is to make sure that the structure and operations serve this role. The desire for additional subsidies for low income housing, through Affordable Housing Programs and Housing Trusts, can be accommodated by contributions from the GSEs, but they should not be structured to encourage profitable risk taking that is unnecessary to the GSE basic mission. One way to fund affordable housing activities would be to make the GSEs tax exempt (as the Federal Home Lona Banks are) and divert a tax-equivalent amount of profits to the Housing Trust or similar entity.

- **It is possible to accomplish the described GSE functions through a variety of ownership structures.** And it is possible to envision them being carried out by one or several entities, rather than by just two. But the first question is whether the function can be properly performed by a purely private entity (like a financial services holding company or bond insurer) or by a fully government owned entity (like GNMA).

- **My conclusion is that the low risk, low return model that I envision to facilitate the mortgage market, support housing affordability, and distribute the limited government guarantee is not consistent with the demands of a third party shareholder entity.** The inherent conflict between mission and profit, which bedeviled Fannie and Freddie in recent times, would only be worse in a truly private structure with the power to distribute a federal guarantee.

- **Government ownership presents an alternative set of challenges, starting with the displacement of market judgments with political ones.** In addition, I believe that it is important to try to distinguish between the market facilitation role that should support the entire housing market and the explicit subsidy role traditionally played by GNMA and FHA, freed from the constraints to manage a balance sheet or make any particular return to retain private capital.

- **My preference is for a structure that harnesses private capital that can accept the low risk, low return model that best fits mortgage market facilitation.** This might be achievable though a public utility model, but it would require cost accounting and price regulation activities that do not currently exist. The return might need to be higher than ideal to minimize the burden on the mortgage market of the facilitation activities.

- **Cooperative ownership by mortgage originators seeking government guaranteed facilitation of capital market funding seems to hold the greatest promise for removing conflicts between the interests of shareholders and the mission of the enterprises.** Mortgage originators get the benefit of the conduit and guarantee functions of the GSEs and need only receive an adequate return to tie up capital in support of this activity, which they will measure on the overall costs and benefits of the activity. And by scaling capital contributions to levels of use will keep these interests aligned. Further, since the originators compete with each other, they have a market incentive to pass through the GSE benefit to their customers. This kind of cooperative capital structure has worke3d for the Federal Home Loan Banks as providers of low risk, low return products for the past 85 years.

- **There could be a single cooperative, or competing entities.** Competition is usually better than monopoly, so at least preserving Fannie and Freddie descendants seems wise. The Federal Home Loan Banks collectively might be authorized to establish a subsidiary to provide a third competitor.

This analysis leads me to the following specific recommendations:

- **Keep the Fannie and Freddie as privately capitalized, but closely regulated GSEs** with a narrow but critical public mission to impose standards and maximize liquidity to mortgage finance, including multifamily. Consider letting the Federal Home Loan Banks jointly form an affiliate to provide a third such entity.

- **Capitalize these GSEs through a cooperative structure** in which those who use the conduit provide the capital in proportion to that use.

- **Limit the GSEs** to issuing securities backed by loans they buy with a government-backed guarantee against and providing that guarantee on securities issued by others that meet appropriate underwriting and risk-bearing characteristics. Fees from the guarantee must provide reserves against the risk, fund the activities of the GSEs, and provide whatever affordable housing subsidies the Congress imposes.

- **Limit the scope of the guarantee to catastrophic loss** by imposing the maximum achievable private risk bearing through recourse (with necessary capital rule changes to align the capital charges with the risk retained rather than all the risks of the mortgage sold), mortgage insurance and properly regulated credit default derivatives, structured MBS (properly rated by independent and regulated ratings agencies). Think of bond insurers as a model.

- **Abandon arbitrary limitations on the size or credit quality of mortgages that can use the GSE conduit** to avoid the avoidance of the credit discipline that undermined the system most recently. If the GSE risk is limited to the catastrophic, the subsidy to jumbo loans is small and the benefit of keeping everything that can attract private risk-bearing inside the regulated structure. Most subprime still go to FHA and VA, with securitization by GNMA, but when private issuers are willing to compete within the GSE structure, everybody wins.

- **Rebuild a mortgage market regulatory capacity within the restructured financial regulatory system.** That means that the regulation of the GSEs should be coupled with oversight of mortgage activities by depositories, mortgage bankers, and investment banks, as well as coordinating with state regulation of brokers and insurers.

Thank you for the opportunity to present these observations and recommendations. I will be pleased to respond to questions from Members of the Subcommittee.

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TESTIMONY OF

FRANCES MARTINEZ MYERS

SENIOR VICE PRESIDENT, FOX & ROACH / TRIDENT, LP ON BEHALF OF THE NATIONAL ASSOCIATION OF REALTORS®

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES (GSEs)

HEARING REGARDING

"THE PRESENT CONDITION AND FUTURE STATUS OF FANNIE MAE AND FREDDIE MAC"

June 3, 2009

Introduction

Chairman Kanjorski, Ranking Member Garrett, and Members of the Committee, thank you for inviting me to testify today on the current condition and future status of Fannie Mae and Freddie Mac (the government sponsored enterprises, or GSEs).

My name is Frances Martinez Myers, and I am a Senior Vice President for Fox & Roach/Trident, LP, the holding company of six home services, financial and relocation related companies, located in southeastern Pennsylvania. I am responsible for the business development efforts of Prudential Fox & Roach Realtors, the 7th largest real estate company in America, as well as the Employee Transfer Corporation, a global corporate relocation company, and ETCREO Management, a national REO asset management company. I have been in the real estate and relocation industry 34 years, and am a Past Chairman for the National Association of Hispanic Real Estate Professionals, an organization with over 15,000 members and 60 chapters throughout the United States. Also, I am a former member of the Board of Directors for the National Association of REALTORS® (2005-2007), the 2006 Chair of the National Housing Advisory Council of Fannie Mae, a former member of the National Advisory Council for Bank of America (2005-2007), and a former member of the Affordable Housing Advisory Council of Freddie Mac.

I am here to testify on behalf of more than 1.1 million REALTORS® who are involved in residential and commercial real estate as brokers, sales people, property managers, appraisers, counselors, and others engaged in all aspects of the real estate industry. Members belong to one or more of some 1,400 local associations/boards and 54 state and territory associations of REALTORS®.

REALTORS® thank the Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee for holding this hearing on an issue that is paramount to the future viability of the U.S. housing market.

Housing Mission and the Secondary Mortgage Market

Congress chartered Fannie Mae and Freddie Mac to expand homeownership and provide a solid foundation for our nation's housing financial system. Unlike private secondary market investors, Fannie Mae and Freddie Mac remain in housing markets during downturns, using their federal ties to facilitate mortgage finance and support homeownership opportunity for all types of borrowers.

REALTORS® believe that the GSEs' housing mission, and the benefits that are derived from it, play a vital role in the success of our nation's housing system. Fannie Mae and Freddie Mac have demonstrated their commitment to housing by staying true to their mission during the current market disruptions by continuing to provide mortgage capital.

Current Status of the Government Sponsored Enterprises

Since being placed in conservatorship, NAR has closely monitored the impact of the current market turmoil on both Fannie Mae and Freddie Mac. As previously mentioned, REALTORS® are extremely aware that the role of the GSEs is crucial to housing consumers' ability to obtain fair and affordable mortgages, which stimulate real estate transactions, and thus the overall U.S. economy.

As the market turmoil reached its peak in late 2008, it became apparent that the role of the GSEs, even in conservatorship, was of utmost importance to the viability of the housing market as private mortgage capital effectively fled the marketplace. As private mortgage capital dried-up, should no government backed entity have existed, the housing market would have come to a complete halt and thrown our nation into a deeper recession, or even a depression.

We are currently witnessing this phenomenon in both the commercial and jumbo residential mortgage markets. Problems in these markets are delaying economic recovery.

<u>Commercial Mortgage Issues</u>

Currently, banks and the CMBS market represent 75% of all outstanding commercial real estate loans. However, banks have tightened their credit standards and moved to reduce commercial real estate exposure, while the CMBS market has ceased to function - all of which points to systemic dysfunction. Hundreds of billions of dollars of commercial real estate loans from a variety of sources are expected to mature in 2009 and over $1 trillion in the next few years. However, under current conditions, there is insufficient credit capacity to refinance this wave of loan maturities. With no liquidity, commercial borrowers face a growing challenge of refinancing maturing debt and the threat of rising delinquencies and foreclosures. Without the presence of a GSE to support liquidity and provide capital, the current crisis facing the commercial credit markets is even more profound.

<u>Jumbo Mortgage Issues</u>

For residential borrowers seeking to purchase or refinance homes that are above the existing GSE loan limits, the lack of government participation has caused a situation similar to that faced by commercial mortgage market participants. A severely reduced amount of private capital in the jumbo market space has constricted the consumer's ability to get an affordable loan, if funding is available at all. For homeowners needing to refinance to a more reasonable mortgage product, the lack of liquidity is all but forcing many homeowners into foreclosure or short sale, which continues to place severe downward pressure on housing and the economy

Therefore, REALTORS® believe that as we look toward the future, Fannie Mae and Freddie Mac, or the new secondary mortgage model, must have some level of support from the U.S. government. Moreover, provisions or entities that provide liquidity in the jumbo and commercial mortgage markets must be created to ensure that those markets continue to exist, as well. NAR is currently beginning research into potential new secondary mortgage models in order to be in a better position to offer specific suggestions.

New Secondary Mortgage Market Model Research

NAR will soon submit a Request for Proposals (RFPs) to a number of housing experts in the industry and academia to gather their ideas on a potential restructuring or wholesale revision of the U.S. secondary mortgage market. Currently, REALTORS® believe that a pure privatization model is unacceptable because of the extreme limitations that will occur during down markets. As we complete our research and make a determination on the model that we believe is the most safe and sustainable, we will make the information available to you.

Future Status of Fannie Mae and Freddie Mac

Although we have begun to embark on research into an appropriate secondary mortgage market model, NAR has adopted a set of principles that will be used to guide that research. REALTORS® believe that in order for the U.S. housing market and economy to thrive, the secondary mortgage market will require safe, sound and dependable participants. To this end, at NAR's November 2008 Annual Meeting and Conference in Orlando, the Board of Directors approved a set of principles recommended by the GSE Presidential Advisory Group (PAG) that looked into the issue of the GSEs and the secondary mortgage market. The goal of NAR's "Principles for Ensuring a Robust Financing Environment for Homeownership" is to ensure there is sufficient capital to support mortgage lending in all types of markets for qualified borrowers.

Principles for Ensuring a Robust Financing Environment for Homeownership

NAR believes that these principles, which require a continuing role for the federal government in the mortgage market, should be used in the development of a model for secondary mortgage market going forward, in order to encourage a safe and sustainable housing market. According to the principles, the secondary mortgage market model must:

1. Ensure an active secondary mortgage market by facilitating the flow of capital into the mortgage market, in all market conditions.

2. Seek to ensure affordable mortgage rates for qualified borrowers.

3. Establish reasonable affordable housing goals so all qualified borrowers, including low- and moderate-income households, have an opportunity to realize the dream of homeownership. Affordable housing goals should not provide incentives for the institution that are inconsistent with sustainable homeownership.

4. Require the institution to pass on the advantage of its lower borrowing costs (and other costs of raising capital) by making mortgages with lower rates and fees available to qualified borrowers.

5. Ensure mortgage availability throughout the nation. NAR supports indexing conforming loan limits based on increases in median sales prices, including higher indexed limits for areas with high housing costs.

6. Require sound underwriting standards.

7. Require the highest standards of transparency and soundness with respect to disclosure and structuring of mortgage related securities.

8. Ensure there is sufficient capital to support mortgage lending in all types of markets. And,

9. Provide for rigorous oversight.

These principles espouse two major themes. First, the housing market must work in all markets, and at all times, no matter the existing economic condition. As we have mentioned in numerous testimonies before the full House Financial Services Committee, the housing market has brought us out of nearly all of the major economic downturns, and will continue to do so if we as a nation protect the housing mission or the GSEs. Pure privatizing of the GSEs without any level of government support, which would incent them to act as current private investors and flee the market during an economic downturn, would create a major draft on future housing and U.S. economic recoveries.

Second, mortgage capital needs to be available to **ALL** potential, qualified housing consumers. NAR is not advocating going back to the excesses that we saw during the housing boom, where everyone, practically regardless of their ability to repay the loan, could get a mortgage. On the contrary, the housing goals that the government imposed on the GSES, when they were reasonable, fostered opportunity for many creditworthy consumers who were in the lower portion of the income spectrum to pursue and obtain the dream of homeownership. Removing the government's involvement in the secondary mortgage market will offer no incentive for market participants to reach out to lower income, creditworthy consumers which will ultimately deprive them of their ability to own a home, and build wealth that future generations can use to move up the economic ladder.

Conclusion

The National Association of REALTORS® supports a secondary mortgage market model that includes some level of government participation, but that protects the taxpayer while ensuring that all creditworthy consumers have reasonable access to mortgage capital so that they may attain the American Dream – homeownership. NAR believes that the principles we have set forth today will help Congress and our industry partners design a secondary mortgage model that will be in all of our best interest now, and in the future.

I thank you for this opportunity to present our thoughts on the current and future status of Fannie Mae and Freddie Mac. As always, The National Association of REALTORS® is at the call of Congress, and our industry partners, to help facilitate a housing and national economic recovery.

Testimony of

Joe Robson

On Behalf Of:

The National Association of Home Builders

Before:

The United States House of Representatives
House Financial Services Committee

Subcommittee on Capital Markets, Insurance and
Government-Sponsored Enterprises

Hearing on

The Present Condition and Future Status of
Fannie Mae and Freddie Mac

June 3, 2009

Introduction

On behalf of the more than 200,000 members of the National Association of Home Builders (NAHB), thank you for the opportunity to submit this statement for the Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises' hearing on "The Present Condition and Future Status of Fannie Mae and Freddie Mac." My name is Joe Robson, and I am a builder and developer from Tulsa, Oklahoma, and the 2009 NAHB Chairman of the Board.

The housing government-sponsored enterprises (GSEs) – Fannie Mae, Freddie Mac and the Federal Home Loan Banks (FHLBanks) – are charged with providing liquidity to the mortgage markets and supporting the flow of credit to meet affordable housing needs. In pursuing this mission, these institutions have become valuable and critical components of the housing finance system. Fannie Mae and Freddie Mac (the Enterprises) have encountered severe problems and are currently operating in conservatorship under the direction of their new regulator, the Federal Housing Finance Agency (FHFA). The FHLBank System has also experienced stresses which, while considerably less intense, have affected its capacity for mission pursuit.

These developments have raised important questions on the future structure and operation of Fannie Mae and Freddie Mac, as well as on the prospective configuration and roles of the FHLBanks. NAHB commends the Subcommittee for holding this hearing to discuss and explore these issues. An effective solution requires intensive review and thoughtful assessment of what has become an extremely complex system.

NAHB believes that the housing benefits that the GSEs have provided in the past and their significant roles in programs that have been instituted to deal with the current unprecedented turmoil in the financial system clearly demonstrate the need for federal government support for the secondary mortgage markets. There is broad agreement that Fannie Mae and Freddie Mac will not be able to emerge from conservatorship without alteration in their previous public mission/private ownership structure. While NAHB believes the liquidity and affordable housing mission must continue with federal government backing, the primary objective is a system that assures the continued availability of affordable housing credit that facilitates healthy housing markets and consistency in satisfying community housing needs. Therefore, NAHB is open to discussing different models for achieving that objective.

Present Condition of Fannie Mae and Freddie Mac

Since being placed into conservatorship, the financial conditions of the Enterprises have deteriorated as government has taken firmer control over the operations of the two companies. As the credit crisis has worsened, both firms have tightened underwriting standards and increased loan delivery fees which have made it more difficult for borrowers (both single family and multifamily) to obtain credit. At the same time, Fannie Mae's and Freddie Mac's combined market share has increased and now represents nearly seventy-five percent of the single family market and they are the primary source of credit in the multifamily market.

Recent Financial Statements

Over the last four quarters ending on March 31, 2009, Fannie Mae and Freddie Mac have reported a staggering $140 billion in net losses combined, a situation that would have been considered unimaginable a few short years ago. Just over half of this combined loss is attributable to credit losses on loans guaranteed by the two Enterprises. The Enterprises have also suffered billions of dollars of fair value losses related to derivatives transactions, the deteriorating private label mortgage-backed securities portfolio, and to wider credit spreads on assets held in trading accounts. In addition, the Enterprises' level of seriously delinquent loans continues to grow, which portends additional credit related losses in future reporting periods. Relative to the first quarter of 2008, Fannie Mae's first quarter 2009 seriously delinquent loan rate increased from 1.15 percent of guaranty assets to 3.15 percent. Freddie Mac's seriously delinquent loan rate increased from 0.77percent to 2.76 percent over the same period.

On May 6, 2009, the Treasury and FHFA, acting in its capacity as conservator, amended the Senior Preferred Stock Purchase Agreements (Agreements) whereby Treasury increased its total Enterprise funding commitment from $200 billion to $400 billion. Due to the aforementioned first quarter losses, the Director of FHFA has requested additional monies from Treasury under the terms of the respective Enterprise Agreements to eliminate the net worth deficit as of March 31, 2009, which would avoid a trigger of mandatory receivership under the *Federal Housing Finance Regulatory Reform Act of 2008*. Once this draw request is executed, the Treasury will have funded approximately $87 billion in Enterprise net worth deficits under the Agreements. Due to current trends in the housing and financial markets, it is expected that the Enterprises will continue to report losses in future periods and will therefore be required to obtain additional funding from the Treasury pursuant to the Agreements.

Tighter Underwriting Requirements and Delivery Fees

As the credit crisis has worsened, both Enterprises have lowered the maximum loan-to-value (LTV) ratio and raised the minimum FICO score requirements for eligible loan purchases. The maximum LTV is now 95 percent (97 percent for certain affordable mortgage products) and the minimum FICO score is 620. In addition, each has implemented risk based delivery fees, which they have continued to increase since August 2007, with higher fees for lower FICO, higher LTV loans. These fees have made it more expensive for eligible borrowers to buy a home or refinance into a more affordable mortgage.

For example, under the latest round of fee increases which became effective April 1st, the fee on a loan with a 620 FICO and a 20 percent downpayment rose to 300 basis points (including the 25 basis point adverse market delivery charge) on a loan sold to Freddie Mac, and 325 basis points on the same loan if it were sold to Fannie Mae. This translates into an increase in the borrower's mortgage rate of at least 75 basis points, which could significantly impair the ability of such a borrower to obtain credit. In addition, a new 75 basis point delivery fee was instituted for condominium purchases with loan-to-value ratios greater than 75 percent. This will add almost 20 basis points to the interest rate on the purchase of a condo, which in many communities is the most affordable form of homeownership.

The continual ratcheting up of delivery fees and tightening of underwriting standards by the Enterprises are significant factors restricting credit, particularly for low- and moderate-income homebuyers, but these factors are within the control of the Enterprises. We believe that the actions of the Enterprises have forced the pendulum to swing too far, and, as a result, viable buyers are being denied credit. While the Enterprises must operate in a safe and sound manner, beyond a point, such self-selecting measures become too restrictive.

The cumulative impact of these recent actions in combination with all previous risk-based fee increases could prove to be a significant counterweight to the benefits being achieved through the initiatives of the Treasury and Federal Reserve to drive mortgage rates down. With the Treasury now directly funding the Enterprises' ongoing net worth deficits, it is futile for these entities to attempt to increase their revenues at the expense of desperately needed mortgage credit. In the face of the Enterprises' dismal financial situation and the conservatorship actions, it can no longer be argued that risk-based fees are necessary to meet the demands of private equity or debt holders. Losses have overwhelmed incremental increases in revenues attributable to risk-based pricing, and will probably continue to do so into the future. These fees, however, do great harm to consumers by increasing the cost of mortgage credit, and they frustrate policymaker's attempts to reduce foreclosures.

NAHB has been rebuffed by FHFA and the Enterprises in response to several requests to roll back these fees. Therefore, as we discuss the future role and structure of the Enterprises, we urge the Committee to direct FHFA and the Enterprises to take the interim step of eliminating the risk-based delivery fees for their mortgage purchase programs introduced since August 2007. Elimination of these fees will directly increase mortgage affordability, enhance policymakers' attempts to reduce foreclosures, and help the country get back on the road to economic recovery.

Fannie Mae Condominium Requirements

Earlier this year, Fannie Mae implemented changes to its condominium project approval standards that have raised the presale requirement to 70 percent, without exception, for projects that lenders review and warrant to Fannie Mae. This increase represents a change from the customary 50 percent presale requirement that had existed for many years and it comes at a time when condominium developers and homebuyers need every financing tool available to consummate sales.

This change in Fannie Mae's condo presale requirement, which was effective on January 15, follows a year of review by Fannie Mae after it suddenly stopped conducting in-house condominium project reviews in late 2007. Prior to this action, Fannie Mae's internal condo project review process was long considered the "gold standard" and was widely accepted by investors and the Federal Housing Administration (FHA).

Following the shutdown of its internal review process, Fannie Mae only offered a web-based Condo Project Manager (CPM) system that lacked the flexibility to handle some condo projects because of the manner in which these projects are constructed and marketed in phases. While lenders may still use the CPM system, under the new condo approval guidelines, the presale requirement that will be determined by this system varies between 50 and 70 percent and is not known by the lender until a final, irrevocable determination has been made. Fannie Mae also has reinstituted a direct review process similar to that which existed in 2007. This process may, however, result in a presale requirement greater than 50 percent.

In contrast, Freddie Mac does not appear to have firm rules or written policy regarding condo presale requirements, opting instead to set this requirement in a 50 to 60 percent range depending on the lender and the area where the project is located.

NAHB believes that a 50 percent presale requirement based on marketing phases adequately balances the interests of lenders, investors and mortgage insurers with those of the builder/developer and with the need for condominium purchasers to be able to finalize their purchases in a timely manner. This requirement also conforms to the presale requirement for projects containing loans insured by the FHA.

NAHB is greatly concerned that Fannie Mae and Freddie Mac may move toward an irrevocable, non-negotiable 70 percent presale requirement for all condominium projects, regardless of the projects' locations or conditions. Such a gross overreaction would result in the denial of homeownership opportunities for thousands of prospective condominium purchasers and would lead to financial ruin for innumerable condominium projects and the projects' developers.

NAHB urges Congress to direct FHFA, the regulator and Conservator of Fannie Mae and Freddie Mac, to bring the Enterprises' condominium presale requirements into line with FHA's 50 percent pre-sale requirements.

Multifamily Financing

Fannie Mae and Freddie Mac have been key sources of multifamily financing over the past two years. Fannie Mae, Freddie Mac and the FHA Multifamily mortgage insurance programs have kept the multifamily market afloat. However, the Enterprises' underwriting requirements have tightened considerably, making it more difficult for borrowers to obtain needed financing. Equity requirements of 35 to 40 percent have become the norm. Debt service coverage (DSC) ratios have increased considerably, from 1.10 to 1.25 depending on the market and type of loan. Fees and interest rates are rising. Last week, two NAHB members reported that they secured a forward commitment for a permanent loan takeout on a Low Income Housing Tax Credit (LIHTC) project from Fannie Mae at a rate of 9.32 percent – 550 basis points over the 10-year Treasury. This rate is up 100 basis points from rates just above 8 percent in early March. Neither firm is providing construction financing for multifamily projects.

In early January 2009, Freddie Mac announced revisions to its underwriting standards for all of its multifamily loans, including conventional and targeted affordable housing loans. The revisions included increasing the minimum DSC to take into account the potential impact of declining cash flow from weaker market fundamentals and reducing the maximum loan-to-value limit for loan terms less than ten years. Freddie Mac is also making further adjustments to LTV and DCR limits across all product lines based on the risk associated with specific transaction characteristics such as financing options and/or type of asset. Freddie Mac continues to provide credit enhancement for tax-exempt bonds, but at a steep price to the borrower, as fees were increased in early 2009 and underwriting requirements also tightened.

Multifamily lenders and borrowers also continue to be concerned about the portfolio limits placed on Fannie Mae and Freddie Mac, which could negatively affect liquidity for multifamily mortgage credit. Although the Administration recently increased the portfolio limits, the expectation is that single family loans will be a significant portion of the GSEs' purchases. As the credit crisis worsened and other multifamily lenders left the market, Fannie Mae and Freddie Mac increased their market share of multifamily loans substantially. These loans have gone into their respective portfolios.

Both Fannie Mae and Freddie Mac are returning to securitization of their multifamily loans. This shift will affect the types of mortgages that can be offered to multifamily developers, because securitization will require more standardized loan structures. Although customized loans no longer will be possible, it is expected that securitization will lower interest rates. Fannie Mae once had an active securitization program, which was halted as it became more difficult for Fannie to compete with conduit lenders who were packaging multifamily, office, hotel and retail loans into Commercial Backed Mortgage Securities (CMBS). Freddie Mac has always relied more heavily on its portfolio lending. The Enterprises have been planning for this strategy, looking ahead to how they can remain competitive in all types of market environments and under more restrictive portfolio constraints.

Future Status of Fannie Mae and Freddie Mac

NAHB believes it is essential for the federal government to continue to provide a sound underpinning for the U.S. housing finance system. As demonstrated in the current financial crisis, the private sector cannot be counted on to provide and maintain a consistent and reliable flow of affordable housing credit. NAHB supports changes to the structure and operations of Fannie Mae and Freddie Mac to enable them to support mortgage market liquidity and address affordable housing finance needs without creating excessive taxpayer risk.

Continued Need for GSE Support of the Housing Finance System

NAHB believes it is critical for the federal government to provide a backstop to the housing finance system to ensure a reliable and adequate flow of affordable housing credit. In the secondary mortgage markets, the need for such support, which has been demonstrated historically, is heavily underscored by the current state of the system, where Fannie Mae, Freddie Mac, the FHLBanks and Ginnie Mae are the only conduits for home mortgage credit. NAHB believes that the federal backstop must be a permanent fixture in order to ensure a consistent supply of mortgage liquidity, as well as to allow rapid and effective responses to market dislocations and crises. It has been clearly demonstrated that the private sector, unaided, is not capable of consistently fulfilling this role.

Alternative Approaches to GSE Status

The conservatorship of Fannie Mae and Freddie Mac has raised fundamental questions regarding their future status and structure in the U.S. housing finance system. Former Treasury Secretary Henry Paulson has stated that the current public mission/private stockholder business model is unworkable and that Fannie Mae and Freddie Mac cannot continue to exist in their current form. The firms should be either government entities or entirely private companies. While this view is extremely black and white, there is a significant probability that the structure and function of Fannie Mae and Freddie Mac will undergo significant change and that such a shift could also bring changes to the Federal Home Loan Bank (FHLBank) System.

A number of alternate structures for carrying out the functions and mission of Fannie Mae and Freddie Mac are listed below.

1. Status Quo: Following conservatorship, Fannie Mae and Freddie Mac would resume operating with private stockholders, a public mission charter and an implicit federal government backing.

2. Full Government Ownership and Control: Fannie Mae and Freddie Mac are converted to government agencies (essentially a conventional market version of Ginnie Mae).

3. Completely Private Operations: Fannie Mae and Freddie Mac are converted to fully private companies with no public mission or government backing.

4. Private Utility Model: Fannie Mae and Freddie Mac are converted to private companies and granted monopoly powers over selected housing finance functions, with prices, fees and profits regulated by the government.

5. Government Sponsored with Private Stockholders and Reduced Operations: Fannie Mae and Freddie Mac would emerge from conservatorship as privately held corporations, retaining their public charter and implicit or explicit government backing. The key difference is that their scope of operations would be narrowed to primarily guaranteeing mortgage-backed securities and purchasing limited housing-related instruments that do not currently have a secondary market outlet.

6. Government Sponsored with Customer Stockholders and Limited Operations: Fannie Mae and Freddie Mac would emerge from conservatorship as privately held corporations, retaining their public charter and implicit or explicit government backing. Stockholders would be limited to financial institution customers of Fannie Mae and Freddie Mac, similar to the ownership model for the Federal Home Loan Banks. In addition, the scope of Fannie's and Freddie's operations would be narrowed to primarily guaranteeing mortgage-backed securities and purchasing limited housing-related instruments that do not currently have a secondary market outlet.

Last year, a NAHB Housing Finance Task Force reviewed the pros and cons of these alternative structures[1] and concluded that neither the status quo nor either extreme on the spectrum of possibilities is acceptable. Fannie Mae and Freddie Mac should not return to operating with a public charter while their stock is traded publicly, because the friction between housing mission and the interests of private stockholders would inevitably result in activities that are not in the best interests of housing or American taxpayers. Fannie Mae and Freddie Mac (and the FHLBanks) should also not be transformed into fully private companies because such companies could not be counted on to provide liquidity in times of crisis or to consistently address affordable housing needs. And Fannie Mae and Freddie Mac (and the FHLBanks) should not be converted to federal government agencies because such entities would be burdened by government red tape and would lack the resources and agility to respond effectively to market developments and housing finance needs.

The Task Force concluded that the public-private conflict in the Fannie/Freddie model must be eliminated and recommended that Fannie Mae and Freddie Mac be recast, retaining federal backing but limited primarily to providing credit enhancement of mortgage-backed securities. Limited portfolio capacity should be permitted to accommodate mortgages and housing-related investments that do not have a secondary market outlet. The Task Force concluded that a significant portion of credit and interest risk should be shared by the private sector institutions that benefit from the government's secondary market support.

The Task Force recommended several principles for federal government support and structure of the housing finance system. These recommendations were ratified by NAHB's Board of Directors at our annual Convention in January. The principles outlined below suggest a cooperative structure where the mortgage originators that sell loans to government sponsored secondary market housing finance entities would be required to purchase stock in the entities in proportion to the their mortgage sales volume. This model is similar to that currently utilized by the FHLBanks; thus, the FHLBanks' structure would not require significant modification. Further, it is not necessary to preserve the current institutional structures of Fannie Mae and Freddie Mac as there are a number of different ways to achieve the stated principles. At this time, however, NAHB does not have a position on a specific structure, such as whether the Enterprises should be merged into one operation or left as separate (or several) entities.

NAHB Principles for Federal Government Support of the Housing Finance System

- The Federal government must provide a permanent backstop to the housing finance system in order to ensure available and affordable mortgage credit in all geographic areas and under all economic circumstances.

- Secondary market entities (Fannie Mae, Freddie Mac and the Federal Home Loan Banks) should retain sufficient federal backing to allow them to reduce mortgage rates and fees.

- Fannie Mae and Freddie Mac should focus on the core business of securitizing mortgages and limited portfolio capacity should be permitted to accommodate mortgage and

[1] The Task Force's analysis of the pros and cons of each approach is provided in the appendix to this statement.

housing-related investments that do not have a secondary market outlet, including acquisition, development and construction (AD&C) loans.

- Fannie Mae and Freddie Mac must have the authority and ability to provide reliable liquidity to the mortgage markets during times of stress, which requires flexibility in terms of portfolio composition and size over the mortgage credit cycle, or with changing conditions in the secondary mortgage markets.

- Secondary market entities must be adequately capitalized.

- The secondary market must have a private sector component with risk shared by participants/shareholders, with governance by a board that includes public interest, housing industry and shareholder representatives.

- The Federal Home Loan Banks should be authorized to securitize housing-related loans (mortgage and AD&C).

- The regulator of secondary market entities should be an independent agency and have a strong housing focus (advocate for meeting housing finance needs).

- Flexibility in pursuing new mortgage programs and products should be balanced with accountability and safety and soundness.

NAHB also reaffirms its support for the affordable housing requirements mandated by the *Housing and Economic Recovery Act of 2008* (HERA), including affordable housing goals and the establishment of an Affordable Housing Fund (AHF). NAHB regrets that the conservatorship of the Enterprises has delayed implementation of the AHF. NAHB urges that the Fund be established as soon as the Enterprises emerge from conservatorship, regardless of their operation structure.

In addition, NAHB strongly recommends that the temporary loan purchase limit framework, enacted earlier this year under the *American Recovery and Reinvestment Act of 2009* (ARRA), be made permanent. ARRA restored the 2008 ceilings and local area loan limits for loans that can be purchased by the Enterprises, up to a maximum of $729,750. ARRA also authorizes the Director of the Federal Housing Finance Agency (FHFA) to establish separate conforming loan limits in subareas where home prices are significantly higher than the median home price for the county or MSA in which they are located. Congress enacted this provision to address areas of the country where the conforming loan limit is depressed due to a concentration of older homes and/or foreclosed properties which makes it difficult to purchase homes with conforming loans in higher-priced subareas of the county or MSA. To date, FHFA Director Lockhart has indicated that he does not intend to exercise this authority. NAHB urges Congress to require FHFA to establish subarea limits to address such situations.

Time Frame for Structural Reforms

While NAHB welcomes Congressional consideration of possible approaches to restructure the status and role of the Enterprises in the housing finance system, we urge caution in implementing any changes until the market returns to more normal conditions. It would be extremely difficult, if not impossible, to restructure the Enterprises when they are inextricably involved in ongoing efforts to address the deepening financial morass.

NAHB is particularly concerned about the winding down of the Enterprises' portfolios which pursuant to HERA must be reduced by 10 percent per year after December 31, 2009. We urge the Committee to direct FHFA to review the Stock Purchase Agreements, the basis for this requirement, and to adjust the criteria for reductions in the portfolios as warranted by market conditions. While portfolio restrictions may be prudent, now is not the time to wind down the portfolios as there is no apparent end in sight to the ongoing financial turmoil. During these times, the Enterprises' portfolios must be available to support market liquidity and to maintain the supply and low cost of mortgages. As the markets function in a more normal fashion, the Enterprises should be allowed to reduce their portfolios in an orderly manner to avoid unnecessary volatility.

Conclusion

The mission of providing mortgage market liquidity and meeting affordable housing needs must continue with federal government support. Fannie Mae's and Freddie Mac's structure must change when they emerge from conservatorship but the companies should not be either fully private or entirely public firms. There are several options of achieving the appropriate balance of public and private elements and NAHB would like to actively participate in deliberations on the best possible approach. Changes of this nature should not be undertaken amidst the current severe financial market turmoil as it is too difficult to implement effective changes while the Enterprises are enmeshed in a wide range of financial market rescue efforts. At the present time, Fannie Mae and Freddie Mac should roll back changes in single family and multifamily underwriting requirements that are resulting in the denial of credit to viable borrowers and projects and impeding economic recovery.

Thank you for the opportunity to participate in this important and timely hearing. NAHB looks forward to working with all stakeholders to develop an effective as well as safe and sound means to provide a reliable flow of housing credit under all economic and financial market conditions.

"Restructuring Fannie Mae and Freddie Mac"

Testimony prepared for

HEARING ON JUNE 3RD, 2009

BEFORE

THE SUBCOMMITTEE OF CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

WRITTEN TESTIMONY OF DR. SUSAN M. WACHTER

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I: Introduction

Chairman Kanjorski, Ranking Member Garrett, and other distinguished members of the Committee:

Thank you for the invitation to testify at today's hearing on "The Present Condition and Future Status of Fannie Mae and Freddie Mac." It is my honor to be here today to discuss the role of secondary mortgage market institutions in contributing to the crisis and what form these institutions should take going forward. My testimony is based on research in conjunction with co-authors Richard Green, Adam Levitin, Patricia McCoy, and Andrey Pavlov. (The articles are cited at the end of the written testimony.)

The government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, have provided a secondary market for mortgages originated by banks and mortgage brokers. In so doing the GSEs may have contributed to homeownership gains, but what is most important to the nation going forward is developing and maintaining a housing finance framework that supports homeownership that is sustainable and that contributes to overall financial stability.

Broadly speaking, there are three options for the future of the GSEs: (1) privatization; (2) nationalization, and (3) a return to their original federal charter as hybrid public-private entities. I will outline here the pros and cons of these three approaches and the factors that should be considered as the subcommittee, and indeed the nation, weigh the options.

Privatization of the GSEs in theory could have the benefit of de-socializing the risk involved with secondary market housing finance. Critics argue that their special access to cheap credit and high leverage exposed the taxpayer to large liabilities. However, as we have seen in recent experience, privatization does not exempt the taxpayer from such liabilities.

A second possibility is to nationalize the GSEs and have a solely public secondary market, essentially FHA/Ginnie Mae for everyone. Taxpayer exposure to large liabilities is still a risk in a solely public sector approach. There is automatic socialization of risk and no market check on underwriting because of the US government guarantee.

The third possibility is a hybrid public-private secondary market. An example of this is the current Fannie Mae/Freddie Mac system. Despite potential pitfalls, hybrid public-private GSE financing worked fairly well until private-label securitization arose. The GSEs found themselves losing market share, and the GSEs' shareholders pressured the GSEs to lower underwriting standards to compete, while federal regulators did nothing to stop it.

In fact, it is useful to think of privatization and nationalization as one choice not two because nationalization effectively means that the existing FHA function is augmented with a larger sphere for lending and the private sector would of course be likely to continue its securitization of residential mortgages much as it did prior to the crisis, with a major re-expansion of private label securitization, once markets are stabilized. Such an expansion would likely take over much of the market in the absence of government-regulated and -chartered entities.

Within the hybrid public-private approach, there are various options, such as cooperative versus shareholder ownership and choices on regulation such as a public utility approach versus a larger role for the federal government in governance. These choices are not inconsequential in system design. But today I will focus on the larger pros and cons of this middle ground versus the alternative of a federal government entity and GSE privatization. While this issue is complex and multifaceted, the overriding question is, which of these alternatives best serves the interests of the public?

This question needs to be addressed in the light of the fundamentals of the mortgage market and mortgage instrument itself and especially needs to take into consideration lessons learned from recent and past financial crises. The principles that need to be relied upon as choices of the form of restructuring are considered include the fundamental role of the mortgage instrument in consumer welfare outcomes and the effects of alternative structures on overall stability of the financial system. Changes in the form of the GSEs will impact whether and how mortgages are securitized going forward and through this the welfare of the borrower and stability of the overall financial system.

The public has an interest in systemic stability in the financial system. Individual households are the least well equipped to weather instability in the financial system. In addition to financial stability, a key public interest in mortgage finance is consumer protection. Consumers do not want to have to worry about whether fine print or predatory lending will result in them losing their home and their investment. Consumers want the process of financing homeownership to be fair and transparent.

Moreover, from a household portfolio perspective, it is economically beneficial for the duration of borrowing for and investing in the home to be matched. The long term fixed-rate mortgage supports the goal of most families to at least have the option of continuing to live in their homes and neighborhoods. Exposing borrowers to unpredictable short term cost fluctuations which is unavoidable with adjustable rate mortgages can undermine this objective. This duration matching is what a long term fixed-rate mortgage provides to homeowners. At the same time, the fact that mortgages can be prepaid rather easily allows households to duration match human capital with mortgages.

In all these regards, the public interest could be served by a secondary market of governmentally-regulated entities with private sector capital at risk that securitized only a standardized mortgage product. Such a hybrid public-private secondary market system could promote sustainable homeownership *and* systemic stability.

The original purpose of the federal charters for the GSEs was to provide a link to long-term capital markets to support fixed-rate mortgages, which evidence suggests, banks are otherwise unlikely to offer. This purpose supports systemic stability both through the prevalence of a standard fixed-rate mortgage and through standardization and limitation of default risk. While regulation of this risk is supervised by an entity of the federal government, losses through excessive risk-taking are also borne by private shareholders.

To understand the importance of a secondary mortgage market and the standardization of mortgage products for fair, affordable, and sustainable homeownership that does not engender systemic risk, it is only necessary to note that historically in the US, housing finance was provided through banking systems, funded by demand deposits. In most countries today deposit-funded banks remain the predominant, if not sole, source of funding for mortgage borrowing. In countries with bank provided mortgages, adjustable-rate mortgages predominate and the long term fixed-rate mortgage is largely absent.

As colleagues and I have shown real estate, including residential real estate, has been linked to financial crises not just once but many times. Real estate crashes and banking crises tend to occur together. In our own recent history, the savings and loan crisis of the 1980s both contributed to the recession of 1990-1991 and destabilized the financial system requiring a federal bailout. Securitization and the growth of the secondary market was the outcome of this crisis with the recognition that the stability of the banking sector depended upon ending banks' lending long, financed by short-run demand deposit liabilities.

The US was an exception in continuing to provide fixed-rate mortgages in the aftermath of the Savings and Loan and related crises. In response to the Great Depression, the Federal National Mortgage Association ("Fannie Mae" or FNMA) had been set up as a government entity to buy mortgages at par from banks. After the S&L debacle, Fannie Mae was used to purchase bundled underwater mortgages from troubled thrift institutions. Going forward, banks continued to use Fannie Mae and later Freddie Mac to purchase fixed-rate mortgages. The transfer of interest rate risk on fixed-rate mortgages from banks to the GSEs and thus to the capital markets allowed United States banks to continue to offer borrowers access to fixed-rate loans.

Elsewhere, in the absence of a secondary market institution, banks provided borrowers adjustable rate mortgages. The exceptions to this besides the United States is Denmark and, to a lesser extent, Germany. Both of these countries also historically had in place extensive secondary market institutions, which while they differ from those of the US, do in fact link long-term funders to long-term borrowers.

Fannie Mae and Freddie Mac grew with banks' continued securitization of long-term mortgages. The growth occurred both in the GSEs' guarantee business, in which they guaranteed mortgages bundled into pass-thru securities and sold to investors and in their portfolio purchases of mortgage securities. The growth of the secondary market coincided with a period of financial and economic calm known as the Great Moderation.

The controversy over their continued growth was to a great extent focused on the growth of their portfolios. Ultimately it was viewed that these institutions were implicitly guaranteed by the federal government. Thus, with the growth of the portfolio, taxpayers were liable for interest risk taken on by these institutions. Interest rate risk it was viewed was an unnecessary risk for the GSEs to take on.

Importantly, however, their federal charter did require them to set standards that they could verify for mortgages to minimize default risk. This was necessary for their purpose because the GSEs guarantee mortgages originated by other institutions from across the United States. The GSEs adopted uniform mortgage codes, which were implemented through issuing guidelines, monitoring, and standardized contracts and eventually automated underwriting.

The current crisis came about not with the growth of the GSEs, but rather with the growth of private-label mortgage securitization. In an era of deregulation, private-label securitization drove the demand for new types of risky mortgages. The demand for securitized mortgages fed the demand for recklessly underwritten loans. As private-label MBS grew in market share, so did non-standard mortgages from 15% of market origination in 2002 to almost half of market origination in 2006. Lending standards were not monitored for private-label securitization and declined over time. Surprisingly, so did risk premiums, as Wall Street encouraged such lending, despite growing risk. Home prices were buoyed by the willingness of institutional investors across the world to buy these subprime loans in the form of complex securities created by investment banks.

As lending standards deteriorated and the cost of these mortgages declined at least for the short run, the demand for homes and the price buyers were willing and could pay was driven up. There was no and is no regulation in place to stop the deterioration of lending standards over time driven by the competition for market share for loans. This lending was not sustainable and resulted in a credit bubble that burst, bringing down not only poorly underwritten nontraditional loans, but carefully underwritten traditional loans as well.

The private-label securities backing these label loans were not liquid nor did they bear risk premia based on their issuers and the underlying loans' originators' balance sheets. Because these securities were not backed by standardized assets, they generally did not trade. Even if short sellers knew of the heightened risk and mispricing of securities, it was difficult to trade on this knowledge. Private-label securities were marked to model, not to market. Evidence of misallocated investment and growing risk was masked by the fact that the looser standards buoyed housing prices in the short term. The price bubble fueled by poor underwriting also increased the risk exposure of the entire mortgage system given the inevitable collapse of inflated prices. Home prices plummeted, so sharply that by the spring of 2009, every fifth borrower owed more than his or her home was worth and defaults rose to postwar records: almost one out of every twenty-five borrowers is in foreclosure. This is the systemic risk that securitization without regulation engendered.

While it is clear that systemic risk derives from the pro-cyclical erosion of lending standards, there is not yet a consensus on how to avoid this going forward. While no system is perfect, securitized fixed-rate long term mortgages are critical for a stable mortgage system and that robust, standardized securitization is unlikely to be accomplished by an FHA like government entity alone. Central to the success and stability of a housing finance system is regulation of mortgage securitization, and, as I discuss in an article with Georgetown University Law Center Professor Adam Levitin, a key piece of this is the regulatory standardization of securitized mortgages. Standardization promotes liquidity, ensures suitability, and enhances system stability.

Standardized mortgage products enhance secondary market liquidity because there is substantial interchangeability to securitized mortgage pools. This means investors have to spend less effort investigating mortgage investments. Liquidity makes investment in the secondary mortgage market more attractive to investors, and this benefits consumers in the form of cheaper and more plentiful mortgage credit.

A key part of standardization is to ensure that mortgages are negotiable, meaning that there is not assignee liability; negotiability protects good faith secondary market purchasers from the mortgagor's claims and defenses against the originating lender. This means that secondary market purchasers do not need to worry about the particular circumstances of any mortgages' origination, which means they can purchase with more confidence, which enhances liquidity.

Standardized mortgage products also benefit consumers in terms of suitability. For the vast majority of consumers, a fixed-rate, fully amortizing mortgage is a suitable product. The purpose of home purchasing is long-term residency, and fixed-rate mortgages are well-designed for long-maturity loans. The long-term fixed-rate mortgage provides a stabilizing factor in household finance. Mortgages are typically consumers' largest single monthly payment obligation. A fixed, steady housing obligation allows consumers to plan their finances around it, and shields consumers from interest rate shocks that they are poorly positioned to predict or hedge against. A standardized mortgage product also protects consumers from negative innovation; there's no place for tricks and traps in a standardized product, and consumers are able to benefit from shared social knowledge about the product. Finally, standardized products make it very easy for consumers to get the best price on a mortgage because it enhances price disclosure; when consumers compare mortgages apples-to-apples, they can easily find the best deal.

Standardization also promotes system stability. Real estate has been the source of many economic crises because it is impossible to short real estate directly. While real estate can be shorted synthetically through derivatives, such as credit default swaps, if standardized and liquid, real estate cannot be shorted directly due to inherent heterogeneity. By enhancing liquidity, standardization makes it possible to short real estate, which provides an important market discipline counterbalance to the optimism that has fueled past bubbles.

To be sure, mandatory standardization can stifle innovation. Innovation, however, is not always positive for social welfare. Indeed, many of the innovations in the mortgage market in recent years have had affirmatively negative impacts. Many of the innovations in the mortgage market have begun as niche products (pay-option ARMs, stated income loans, interest only loans) for sophisticated, targeted consumer groups, but were expanded to mass markets for which they were entirely unsuited. The risks with these niche products were not well understood by either consumers or investors.

In any event, standardization need only apply to securitized mortgages. Financial institutions could still originate non-standard mortgage products and hold them on their books or resell them to each other. This means that financial institutions could continue to serve as a laboratory for product innovation. But they would be required to retain the risk on those products. This is the proper niche for niche products.

The hybrid public-private approach has advantages for financial stability and consumer protection because it encourages standardization of mortgages. A private-bank, deposit-based system cannot deliver long-term, fixed-rate mortgages without severe cycles and crises such as the savings and loan crisis of the late 1980s. The charter approach can resolve this challenge by increasing the accessibility of long-term, fixed-rate mortgages, which are clearly in the public's interest. Thus as we consider the future of securitization we need to keep in mind that for decades regulated securitization led to the ubiquity of the standard long term fixed-rate American mortgage which provided both stability to borrowers and to the financial system.

The federal charter required the GSEs to standardize, and therefore commoditize, mortgages, and so they allowed investors and borrowers to understand mortgages and evaluate risks based on knowledge. If we are to return to a federally chartered system of GSEs, I believe that there should be safeguards in place to discourage excessive risk taking and to specifically discourage such short-term profit seeking. Moreover attention should be paid to the role of the public members of the board of directors of these entities. From a corporate governance perspective, their responsibilities should explicitly include the oversight of systemic risk. Since regulation in itself is not fool proof in maintaining lending standards it is useful to have capital at risk, nonetheless.

The GSEs should not be removed from conservatorship until the economy is on a stable recovery path. They are currently helping to stabilize economy through their support of the housing market. This effort is especially critical in light of recent discussion over government purchase of toxic assets that may be difficult to price and liquidate. In the future, the benefits for long run stability and consumer protection point to the need for strongly regulated and private-market-disciplined entities to support the U.S. housing finance system.

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STATEMENT OF
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FOR THE HEARING ON
"THE PRESENT CONDITION AND FUTURE STATUS
OF FANNIE MAE AND FREDDIE MAC"

BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

JUNE 3, 2009

Chairman Kanjorski, Ranking Member Garrett, and members of the Subcommittee: My name is Lawrence J. White, and I am a Professor of Economics at the NYU Stern School of Business. During 1986-1989 I served as a Board Member on the Federal Home Loan Bank Board. In that capacity I also served as a Board Member of Freddie Mac. Thank you for the opportunity to present my views on the present condition and future status of Fannie Mae and Freddie Mac.

Since early September 2008, both companies have been in government conservatorships, operating under the auspices of the Federal Housing Finance Agency (FHFA). Both companies are deeply insolvent: The value of the assets of each company is inadequate to cover the value of that company's liabilities. In February of this year the U.S. Treasury stated that it was setting aside $200 billion for each company to cover their potential losses.

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The hybrid private-public model that was at the heart of both companies is clearly broken and should not be reconstructed. Instead, after the current financial crisis has receded, both companies should be truly privatized, with all ties to the federal government severed. To replace their implicit broadbrush effects in the U.S. housing markets, targeted programs that provide explicit on-budget subsidies to encourage low- and moderate-income households to become first-time home buyers should be expanded.

The remainder of this statement will expand on these ideas.

A. Background.

Until their government takeover in September 2008, Fannie Mae and Freddie Mac were two large, hybrid (private-public) companies that dominated the secondary residential mortgage markets. They engaged in two lines of business: securitizing mortgages that generally conformed to high lending standards, with the mortgage-backed securities (MBS) carrying their guarantees if the mortgage borrower failed to repay; and investing directly in similar mortgages, funded overwhelmingly (around 96%) with debt.

Though they were publicly traded companies with shares listed on the New York Stock Exchange, the two companies were also creatures of Congress that had special governmental ties and advantages, as well as limitations (e.g., they were restricted to secondary mortgage markets, there was a ceiling [the conforming loan limit] on the size of mortgage that they could buy or securitize, and they were subject to prudential regulation) and obligations (they were expected to make a special effort to support lending to lower-income households -- an obligation that was tightened in 2003). Within the past few years the term "government-sponsored enterprise" came into common use to describe the two companies (as well as the Federal Home Loan Bank System, a wholesale bank for banks and thrifts that similarly enjoys special privileges and limitations).

As a consequence, the financial markets believed (correctly, as it turned out) that if Fannie Mae or Freddie Mac were ever in financial difficulties, the federal government would likely keep their creditors whole.

This belief in the federal government's "implicit guarantee" meant that Fannie Mae and Freddie Mac were able to borrow in the bond markets (in normal times) at about 0.35-0.40 percentage points less (i.e., at lower interest rates) than their financial condition would otherwise have justified. In turn, they caused interest rates for the mortgages that they could securitize or hold to be about 0.20-0.25 percentage points lower than otherwise would have been the case.

Both Fannie Mae and Freddie Mac grew rapidly in the 1990s and in the early years of this decade. Accounting scandals at Freddie Mac in 2003 and at Fannie Mae in 2004 caused their growth to slacken, especially for the mortgages that they held in their portfolios. Nevertheless, at year-end 2007 their holdings of mortgages and their outstanding mortgage-backed securities (which carried their guarantees) together totaled about $5 trillion, or over 40% of the total residential mortgage market.

It is easy to understand the political popularity of their hybrid structure, since they appeared to be providing a "free lunch": lower interest rates on mortgages, some efforts to expand lending to lower-income households, and no explicit cost to the federal government. The way that these outcomes were reconciled with adequate returns to shareholders was through low capital requirements (only 2.5% for holding a mortgage in portfolio; only 0.45% to support the guarantees on their MBS) and thus high leverage.[1]

The creation and expansion of Fannie Mae and Freddie Mac did not occur in a vacuum. They were, and continue to be, only one part of a much larger mosaic of governmental policies, at all levels of government, to encourage the construction and consumption of housing. These policies include: income tax deductions and exemptions for home owners; subsidies for renters; tax breaks for housing construction; explicit subsidies for mortgage finance, through the Federal Housing Administration (FHA), the Department of Veterans Affairs (VA), and the Government National Mortgage Association (Ginnie Mae), as well as through some states' mortgage finance subsidy programs; implicit subsidies through the GSEs; specialized charters for depository institutions (thrifts) that are expected to focus on residential mortgage finance; and direct provision of rental housing ("public housing").

"Too much is never enough" is a not unreasonable characterization of U.S. housing policy.

The encouragement for home ownership has at least four underlying motivations: First, it is simply seen as part of "The American Dream". Second, since housing prices in most parts of the U.S. had tended (over most time periods) to trend upward since the 1940s, housing investment was seen as a good way of building household wealth (and on a leveraged basis, as well, since a 20% down payment meant that the house purchase was leveraged five-to-one). Third, it is a way to internalize the agent-principal problems that

[1] Critics of the two companies and their hybrid structure feared that their thin capital levels were inadequate to withstand the interest rate risks that were embedded in their large mortgage portfolios. In the end, however, it was credit risk that overwhelmed their thin capital levels.

otherwise arise between landlords and tenants. And it is a means of exploiting the positive social spillover effects or externalities that appear to accompany home ownership.

On this last point, the theory that argued that there should be positive social externalities from home ownership -- that a homeowner is more likely to care about his/her community than is a renter, more likely to participate in community activities, etc. -- has been around for decades. But only since the middle 1990s has a small but growing body of empirical studies provided support for this notion.

An important caveat should immediately be added to these positive motivations for home ownership: Home ownership is not for everyone. A house is a large, illiquid asset, which can impede labor mobility across geographic regions. Home ownership requires a relatively steady income stream and requires disciplined budgeting. And, as millions of households (and their lenders) have discovered to their regret over the past three years, housing prices do not always increase.[2]

Further, a sensible and efficient approach to addressing the social externality would be to have a modest and focused program that is aimed at the likely margin for action: modest subsidies (e.g., for down payments and/or monthly payments) for low- and moderate-income households so as to encourage them to become first-time homeowners. Unfortunately, with only minor exceptions,[3] housing encouragement instead is broadbrush in scope. The most extensive subsidy, for example, is the income tax deduction for mortgage interest and the capital gains exclusion of the gain on sale of a household's principal residence.

[2] Also, of course, rental subsidies run counter to the goal of encouraging households to become homeowners.
[3] One exception is the American Dream Downpayment Assistance Act of 2003, which instructs the Department of Housing and Urban Development (HUD) to provide down payment assistance to low- and moderate-income families. However, the appropriations for HUD's administration of this program have been relatively modest.

Such broadbrush subsidies tend to encourage households who would be homeowners anyway simply to purchase larger and better appointed houses on larger lots. Further, the main beneficiaries are higher-income households who would be more likely to itemize their deductions (and thus be able to take advantage of the interest deduction) and who would tend to have larger capital gains to shield. The implicit subsidy on mortgage interest provided through Fannie Mae and Freddie Mac operates through the same broadbrush path (and also subsidizes the purchase of second homes and rental housing), with the same broad encouragement of larger amounts of housing on larger lots.[4] It is hard to see the social benefit that accrues from encouraging upper-income households, who would likely purchase homes anyway, to buy larger quantities of housing on larger lots and/or to buy second homes.

Indeed, the research of the past quarter century indicates that U.S. housing policies have distorted consumption and investment choices, causing an inefficiently large fraction of U.S. investment to be devoted to housing (and correspondingly less devoted to other productive physical capital, as well as to human capital).

B. The debacle.

Although Fannie Mae and Freddie Mac were not at the center of the subprime debacle, their portfolios and MBS did become more risky in the middle of this decade, as they expanded into "Alt-A" (between prime and subprime) mortgages. Further, as housing prices fell steeply in some areas like Las Vegas, parts of California, Arizona, and south Florida, even some "prime" mortgages (i.e., those where the borrower made a 20% down

[4] Also, even before the sharp increase that was legislated in early 2008 in the conforming loan limit for mortgages that could be bought or securitized by Fannie Mae and Freddie Mac, the conforming loan limits were substantially above the median house price in most parts of the U.S.; as a consequence, Fannie Mae and Freddie Mac were not especially well focused on encouraging home ownership by low- and moderate-income households.

payment, had an adequate income, and had a good credit score) yielded borrower defaults and losses. Other apparently good mortgages, where private mortgage insurance was covering the shortfalls in borrowers' down payments, came into doubt because of rising questions about the solvency of the mortgage insurers and thus their ability to make good on their obligations. And Fannie Mae and Freddie Mac were also burned on investments (intended to help satisfy their distributional requirements) in supposedly safe tranches of mortgage-based securities that had lower-quality mortgages as their underlying collateral.

At the end of the day, however, it was inadequate capital for the overall risks in their investment portfolios and in their MBS that caused their downfall. Recognizing their inadequate capital, the FHFA placed both companies in conservatorships on September 6, 2008.[5] As was mentioned above, in February 2009 the U.S. Treasury stated that it was setting aside $200 billion for each company to cover their potential losses.

The free lunch has turned out to be a costly meal indeed.

C. Future Status.

In the current shaky financial environment, Fannie Mae and Freddie Mac should remain as wards of the federal government. But the hybrid model is clearly too fraught with problems. Efforts to harness the private sector to subsidize housing consumption, through implicit rather than explicit subsidies, simply create too many strains and temptations. The hybrid model should not again be a tool of long-term housing policy.

After the financial markets have stabilized, the two companies should be fully and truly privatized, with no remaining special ties to the federal government[6] -- but also no

[5] A discussion of FHFA's conservatorship actions, as well as much other recent information about Fannie Mae and Freddie Mac, can be found in FHFA's Report to Congress 2008 (May 18, 2009).

[6] However, at the time of the privatization, all of the existing debt of the two companies should carry an explicit government guarantee (since they have been GSEs); but from that point forward, all new debt of

special burdens or restrictions on their activities, except for those that would be part of any special prudential regulatory regime that is likely to be established by the federal government to deal with large financial companies that pose systemic risks.[7] The federal government will have to fill the large negative net worth "holes" of the two companies before privatizing them; but those "hole-filling" expenditures will be necessary regardless of what happens to the two companies, since the federal government is highly unlikely to "stiff" the creditors of the two companies.

To replace their implicit broadbrush effects on housing markets, targeted programs that provide explicit on-budget subsidies to encourage low- and moderate-income households to become first-time home buyers should be expanded. Recall that there are strong arguments and good evidence for encouraging households to become home owners (although, again, home ownership is not for everyone). These arguments point to the need for focused (rather than broadbrush) programs that are targeted on households that are on the cusp of whether (or not) to buy a home. Low- and moderate-income households would appear to be the best targets for these subsidies, which should take the form of down payment assistance and monthly mortgage payment assistance (as well as extensive counseling on the pluses and minuses of home ownership).

As was noted above, the American Dream Downpayment Assistance Act of 2003 provides a model for such targeted subsidies, although it has been only modestly funded. Its funding should be expanded, and the program should be broadened to include monthly payment subsidies as well. The $8,000 "first-time home buyer tax credit" provision in the American Recovery and Reinvestment Act of 2009 is another potential avenue. As it is

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the two privatized companies should cease having any explicit or implicit government guarantee.

[7] The privatization of the Federal Home Loan Bank System should similarly occur, for similar reasons

currently constituted, however, the tax credit is more targeted on providing short-term assistance to the slumping U.S. housing markets than in providing sustained assistance to low- and moderate-income households. For example, the tax credit expires at the end of 2009, and it applies to households with incomes that are substantially higher than "low" and "moderate".[8] An extension of the tax credit, with much lower income ceilings, would be a worthwhile modification.

In sum, long-term housing policy should involve the complete privatization of Fannie Mae and Freddie Mac and a program of targeted assistance to low- and moderate-income households to encourage them to become homeowners. That assistance should be focused, explicit, and on-budget, not broadbrush, implicit, and off-budget. We have paid far too high a price in pursuing the chimera of a "free lunch" in housing policy. "Never again" should be the operative phrase.

Recent Relevant Writings by Lawrence J. White

"Comments on 'The Privatization of Fannie Mae and Freddie Mac,'" in U.S. Department of Housing and Urban Development, Studies on Privatizing Fannie Mae and Freddie Mac, 1996.

"Focusing on Fannie and Freddie: The Dilemmas of Reforming Housing Finance," Journal of Financial Services Research, February 2003.

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"Emerging Competition and Risk-Taking Incentives at Fannie Mae and Freddie Mac," in Federal Reserve Bank of Chicago, How Do Banks Compete? Strategy, Regulation, and Technology, 40th Annual Conference on Bank Structure and Competition, 2004 (with W.S. Frame).

[8] The tax credit applies to married couples earning up to $150,000 (and then phases out for higher incomes, reaching zero at an income of $170,000); by contrast, median household income in the U.S. in 2007 was $50,233.

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"Fannie & Freddie: Part of the Solution, or Part of the Problem?" Milken Institute Review, Second Quarter 2008.

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BIOGRAPHICAL SUMMARY

Lawrence J. White

Lawrence J. White is Arthur E. Imperatore Professor of Economics at New York University's Stern School of Business and Deputy Chair of the Economics Department at Stern. During 1986-1989 he was on leave to serve as Board Member, Federal Home Loan Bank Board, and during 1982-1983 he was on leave to serve as Director of the Economic Policy Office, Antitrust Division, U.S. Department of Justice. He is currently the General Editor of The Review of Industrial Organization and Secretary-Treasurer of the Western Economic Association International.

Prof. White received the B.A. from Harvard University (1964), the M.Sc. from the London School of Economics (1965), and the Ph.D. from Harvard University (1969). He is the author of The Automobile Industry Since 1945 (1971); Industrial Concentration and Economic Power in Pakistan (1974); Reforming Regulation: Processes and Problems (1981); The Regulation of Air Pollutant Emissions from Motor Vehicles (1982); The Public Library in the 1980s: The Problems of Choice (1983); International Trade in Ocean Shipping Services: The U.S. and the World (1988); The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation (1991); and articles in leading economics and law journals.

He is editor or coeditor of eleven volumes: Deregulation of the Banking and Securities Industries (1979); Mergers and Acquisitions: Current Problems in Perspective (1982); Technology and the Regulation of Financial Markets: Securities, Futures, and Banking (1986); Private Antitrust Litigation: New Evidence, New Learning (1988); The Antitrust Revolution (1989); Bank Management and Regulation (1992); Structural Change in Banking (1993); The Antitrust Revolution: The Role of Economics, 2nd edn. (1994); The Antitrust Revolution: Economics, Competition, and Policy, 3rd edn. (1999); The Antitrust Revolution: Economics, Competition, and Policy, 4th edn. (2004); and The Antitrust Revolution: Economics, Competition, and Policy, 5th edn. (2009). He was the North American Editor of The Journal of Industrial Economics, 1984-1987 and 1990-1995.

Prof. White served on the Senior Staff of the President's Council of Economic Advisers during 1978-1979, and he was Chairman of the Stern School's Department of Economics, 1990-1995.

Prof. White's webpage is found at http://pages.stern.nyu.edu/~lwhite/. His e-mail address is Lwhite@stern.nyu.edu.

McClatchy Washington Bureau

Print This Article

Posted on Sun, Oct. 12, 2008

Private sector loans, not Fannie or Freddie, triggered crisis

David Goldstein and Kevin G. Hall | McClatchy Newspapers

last updated: October 27, 2008 03:12:24 PM

WASHINGTON — As the economy worsens and Election Day approaches, a conservative campaign that blames the global financial crisis on a government push to make housing more affordable to lower-class Americans has taken off on talk radio and e-mail.

Commentators say that's what triggered the stock market meltdown and the freeze on credit. They've specifically targeted the mortgage finance giants Fannie Mae and Freddie Mac, which the federal government seized on Sept. 6, contending that lending to poor and minority Americans caused Fannie's and Freddie's financial problems.

Federal housing data reveal that the charges aren't true, and that the private sector, not the government or government-backed companies, was behind the soaring subprime lending at the core of the crisis.

Subprime lending offered high-cost loans to the weakest borrowers during the housing boom that lasted from 2001 to 2007. Subprime lending was at its height from 2004 to 2006.

Federal Reserve Board data show that:

- More than 84 percent of the subprime mortgages in 2006 were issued by private lending institutions.
- Private firms made nearly 83 percent of the subprime loans to low- and moderate-income borrowers that year.
- Only one of the top 25 subprime lenders in 2006 was directly subject to the housing law that's being lambasted by conservative critics.

The "turmoil in financial markets clearly was triggered by a dramatic weakening of underwriting standards for U.S. subprime mortgages, beginning in late 2004 and extending into 2007," the President's Working Group on Financial Markets reported Friday.

Conservative critics claim that the Clinton administration pushed Fannie Mae and Freddie Mac to make home ownership more available to riskier borrowers with little concern for their ability to pay the mortgages.

"I don't remember a clarion call that said Fannie and Freddie are a disaster. Loaning to minorities and risky folks is a disaster," said Neil Cavuto of Fox News.

Fannie, the Federal National Mortgage Association, and Freddie, the Federal Home Loan Mortgage Corp., don't lend money, to minorities or anyone else, however. They purchase loans from the private lenders who actually underwrite the loans.

It's a process called securitization, and by passing on the loans, banks have more capital on hand so they can lend even more.

This much is true. In an effort to promote affordable home ownership for minorities and rural whites, the Department of Housing and Urban Development set targets for Fannie and Freddie in 1992 to purchase low-income loans for sale into the secondary market that eventually reached this number: 52 percent of loans given to low-to moderate-income families.

To be sure, encouraging lower-income Americans to become homeowners gave unsophisticated borrowers and unscrupulous lenders and mortgage brokers more chances to turn dreams of homeownership in nightmares.

But these loans, and those to low- and moderate-income families represent a small portion of overall lending. And at the height of the housing boom in 2005 and 2006, Republicans and their party's standard bearer, President Bush, didn't criticize any sort of lending, frequently boasting that they were presiding over the highest-ever rates of U.S. homeownership.

Between 2004 and 2006, when subprime lending was exploding, Fannie and Freddie went from holding a high of 48 percent of the subprime loans that were sold into the secondary market to holding about 24 percent, according to data from Inside Mortgage Finance, a specialty publication. One reason is that Fannie and Freddie were subject to tougher standards than many of the unregulated players in the private sector who weakened lending standards, most of whom have gone bankrupt or are now in deep trouble.

During those same explosive three years, private investment banks — not Fannie and Freddie — dominated the mortgage loans that were packaged and sold into the secondary mortgage market. In 2005 and 2006, the private sector securitized almost two thirds of all U.S. mortgages, supplanting Fannie and Freddie, according to a number of specialty publications that track this data.

In 1999, the year many critics charge that the Clinton administration pressured Fannie and Freddie, the private sector sold into the secondary market just 18 percent of all mortgages.

Fueled by low interest rates and cheap credit, home prices between 2001 and 2007 galloped beyond anything ever seen, and that fueled demand for mortgage-backed securities, the technical term for mortgages that are sold to a company, usually an investment bank, which then pools and sells them into the secondary mortgage market.

About 70 percent of all U.S. mortgages are in this secondary mortgage market, according to the Federal Reserve.

Conservative critics also blame the subprime lending mess on the Community Reinvestment Act, a 31-year-old law aimed at freeing credit for underserved neighborhoods.

Congress created the CRA in 1977 to reverse years of redlining and other restrictive banking practices that locked the poor, and especially minorities, out of homeownership and the tax breaks and wealth creation it affords. The CRA requires federally regulated and insured financial institutions to show that they're lending and investing in their communities.

Conservative columnist Charles Krauthammer wrote recently that while the goal of the CRA was admirable, "it led to tremendous pressure on Fannie Mae and Freddie Mac — who in turn pressured banks and other lenders — to extend mortgages to people who were borrowing over their heads. That's called subprime lending. It lies at the root of our current calamity."

Fannie and Freddie, however, didn't pressure lenders to sell them more loans; they struggled to keep pace with their private sector competitors. In fact, their regulator, the Office of Federal Housing Enterprise Oversight, imposed new restrictions in 2006 that led to Fannie and Freddie losing even more market share in the booming subprime market.

What's more, only commercial banks and thrifts must follow CRA rules. The investment banks don't, nor did the now-bankrupt non-bank lenders such as New Century Financial Corp. and Ameriquest that underwrote most of the subprime loans.

These private non-bank lenders enjoyed a regulatory gap, allowing them to be regulated by 50 different state banking supervisors instead of the federal government. And mortgage brokers, who also weren't subject to federal regulation or the CRA, originated most of the subprime loans.

In a speech last March, Janet Yellen, the president of the Federal Reserve Bank of San Francisco, debunked the notion that the push for affordable housing created today's problems.

"Most of the loans made by depository institutions examined under the CRA have not been higher-priced loans," she said. "The CRA has increased the volume of responsible lending to low- and moderate-income households."

In a book on the sub-prime lending collapse published in June 2007, the late Federal Reserve Governor Ed Gramlich wrote that only one-third of all CRA loans had interest rates high enough to be considered sub-prime and that to the pleasant surprise of commercial banks there were low default rates. Banks that participated in CRA lending had found, he wrote, "that this new lending is good business."

ICBA
INDEPENDENT COMMUNITY
BANKERS of AMERICA

June 2, 2009

The Honorable Paul E. Kanjorski
Chairman
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

RE: Hearing on the Present Condition and Future Status of Fannie Mae and Freddie Mac – June 3, 2009

Dear Chairman Kanjorski:

The Independent Community Bankers of America, on behalf of its 5,000 community bank members, appreciates your leadership on housing finance issues and for calling a hearing on the Present Condition and Future Status of Fannie Mae and Freddie Mac. We would like to offer our views on this topic for the record.

Fannie Mae and Freddie Mac have long been important partners of community banks by providing community banks an important source of housing finance funding and an impartial outlet to convey community bank mortgages to the secondary market. The two government sponsored enterprises (GSEs) continue to play a vital role in supporting residential mortgage lending and homeownership, particularly in these difficult times when other sources of credit have dried up or offer only above market rates.

In a recent survey of ICBA members, nearly 50 percent of the respondents indicated that they sell mortgages directly to the two GSEs, while nearly 40 percent indicated they sell indirectly to the secondary market (most likely because they do not generate adequate volume to sell directly). The volume of sales to the GSEs has increased recently. In 2009, ICBA members have increased the volume of loans sold to the GSEs by 300 percent over the prior year as they worked to fill the credit gap left by other lenders. Without access to a secondary market, most if not all of these loans would not have been made because community banks would not be able to keep the loans in portfolio due to interest rate risk. Thus, Fannie Mae and Freddie Mac have enabled community banks to competitively offer fixed-rate mortgages to their customers.

The future of the government sponsored enterprises must be resolved in a manner that ensures the continued existence of a strong, impartial secondary market for community

INDEPENDENT COMMUNITY BANKERS of AMERICA *The Nation's Voice for Community Banks*®
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bank residential mortgages so that community banks can continue to offer this important mortgage product to the communities they serve.

Community banks need a strong, impartial secondary market for residential mortgages where they can sell mortgages without fear that the entity to which they sell mortgages will steal away their customers. Community banks have been responsible lenders, conservatively underwriting mortgages. Many current and prospective homeowners are turning to community banks to meet their mortgage needs. As Congress looks to the future structure of our residential mortgage secondary market entities, we urge Congress to ensure a secondary market that does not directly compete with the private sector and that provides equitable access and pricing to all lenders regardless of size or volume.

Recent market events demonstrate the important role Fannie Mae and Freddie Mac have played in providing liquidity and market stability. In that regard, the secondary market entity or entities that emerge from the GSE conservatorship need to have the operational flexibility to hold mortgages when market conditions dictate, along with their securitization authorities. Fannie Mae and Freddie Mac's government ties have enabled them to continue to function and provide a critical source of housing finance during the recent market upheaval. The future secondary market for housing finance should continue to have some type of government ties, to insure that homeownership will continue to play a crucial role in the financial well-being of American families and the American economy.

In addressing the future of Fannie Mae and Freddie Mac, GSE preferred shareholders also need to be made whole. Notably, more than $35 billion in Fannie Mae and Freddie Mac preferred stock was outstanding on September 7, 2008 with community banks holding significant amounts of this regulator-approved investment. Unfortunately, the government's surprise GSE conservatorship on September 8th was instituted in a manner that unfairly wiped out the value of the GSE preferred shares and continues to cause considerable stress on the capital of many community banks, impeding their ability to lend. Any GSE reform cannot ignore restoring appropriate value for community bank holders of GSE preferred stock.

ICBA looks forward to working with you and other policymakers as decisions are made about the future structure of Fannie Mae and Freddie Mac.

Sincerely,

/s/

Camden R. Fine
President and CEO

cc: The Honorable Scott Garrett, Ranking Member
Members of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Manufactured Housing Association for Regulatory Reform

1331 Pennsylvania Avenue, NW • Suite 508 • Washington, DC 20004 • 202-783-4087 • Fax 202-783-4075

June 3, 2009

VIA HAND-DELIVERY

Hon. Paul E. Kanjorski
Chairman, House Subcommittee on Capital Markets,
Insurance and Government Sponsored Enterprises
Room 2129
Rayburn House Office Building
Independence Avenue & S. Capitol Street, S.W.
Washington, D.C. 20515

Re: The Present Condition and Future Status of Fannie Mae and Freddie Mac in Connection with Manufactured Housing and the Duty to Serve Underserved Markets

Dear Mr. Chairman:

On behalf of the Manufactured Housing Association for Regulatory Reform (MHARR), we appreciate the opportunity to submit written comments in connection with today's hearing on "The Present Condition and Future Status of Fannie Mae and Freddie Mac." We ask that this letter (and accompanying documents) be made part of the official record of today's hearing.

MHARR is the nation's only trade organization dedicated exclusively to representing the views and interests of producers of manufactured housing regulated by the Department of Housing and Urban Development (HUD) pursuant to the National Manufactured Housing Construction and Safety Standards Act of 1974, as amended by the Manufactured Housing Improvement Act of 2000.

The manufactured housing industry today is suffering from an unprecedented economic decline, due, in significant part, to the virtual unavailability of private consumer financing for manufactured housing purchases. In 2008, manufactured home production fell below 100,000 homes for the first time since 1961. This decline has continued and deepened in 2009, with annualized shipments of fewer than 50,000 homes projected, based on first quarter results. And because manufactured housing is the nation's leading provider of non-subsidized affordable home-ownership, the impact of this decline falls most heavily on moderate, lower and low-income American families in need of affordable housing opportunities.

In substantial part, the unavailability of private financing for manufactured home purchases is a direct result of policies adopted by the two Government Sponsored Enterprises (GSEs) -- Fannie Mae and Freddie Mac -- that discriminate against manufactured homes and manufactured housing consumers. As a consequence of these policies, manufactured housing obligations -- while never a large component of the GSEs' activities -- have, in recent years, fallen to less than one percent of the business portfolios of both GSEs. This has decimated the manufactured housing market at a time when Americans need more non-subsidized affordable housing, not less.

The GSEs were created and charged by Congress with the specific mission of providing liquidity to the market to promote and support affordable housing. Yet both Fannie Mae and Freddie Mac have failed in this mission almost totally with respect to the nation's <u>most</u> affordable type of housing -- manufactured homes. Freddie Mac, historically, has not been deeply involved in the manufactured housing finance market. And while Fannie Mae has had limited programs for manufactured housing, those programs have selectively favored certain elements of the industry, leaving the vast majority of the industry and its consumers un-served or under-served. All of which begs the question, if the GSEs are unwilling to provide support for inherently affordable manufactured homes and the moderate, lower and low-income families who constitute the bulk of manufactured housing consumers, how can they possibly be meeting their mission?

To correct this, Congress passed section 1129 of the Housing and Economic Recovery Act of 2008 (HERA). This provision constitutes a congressional finding that the GSEs have "underserved" the manufactured housing market, as well as a directive to the GSEs to correct this anomaly by conforming their manufactured housing finance practices with their broader affordable housing mission.

This "duty to serve underserved markets" (DTS) directive was signed into law on July 30, 2008. Nearly a year later, however, notwithstanding the continuing dramatic decline of the manufactured housing market and the availability of non-subsidized affordable manufactured homes, neither Fannie Mae nor Freddie Mac have adopted programs to implement this directive.

While MHARR has had an active and positive dialogue with the Federal Housing Finance Agency (FHFA) on DTS, as demonstrated by the attached documents, it is essential that Congress remain engaged on this issue -- and cognizant of the potential need for future legislation -- in order to ensure the full, complete and expeditious implementation of DTS for the benefit of American consumers of affordable housing. Regardless of whether the GSEs' function, in the future, is performed by a government entity, a private entity, or if the GSEs are dissolved, some effective mechanism must be available to securitize private housing loans for the moderate, lower and low-income consumers who wish to purchase non-subsidized affordable manufactured homes.

MHARR recognizes the strains that all segments of the housing and housing finance markets have experienced in the past year, particularly the financial impacts on the GSEs. However, as our nation seeks to reignite the housing market, now must be the time to increase support for the affordable housing options offered by manufactured housing. Consequently, we ask that the Subcommittee and Congress include the proper and timely implementation of the DTS directive in their ongoing oversight of the current and future mission and activities of the GSEs, and provide a congressional monitoring mechanism to ensure compliance.

Sincerely,

Danny D. Ghorbani
President

Attachments

APPLICATION OF THE DUTY TO SERVE UNDERSERVED MARKETS
H.R.3221 -- THE HOUSING AND ECONOMIC RECOVERY ACT OF 2008

MANUFACTURED HOUSING LENDING

PREPARED BY THE

MANUFACTURED HOUSING ASSOCIATION FOR REGULATORY REFORM

February 2009

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INTRODUCTION

Recently, Congress passed H.R.3221, The Housing and Economic Recovery Act of 2008. The passage of this legislation is historic in many ways, but none more marked or important than the "Duty to Serve Underserved Markets" contained in Section 1129. This bill was written to reform the laws that govern the operation of Fannie Mae and Freddie Mac, the two Government Sponsored Enterprises (GSEs), which have the greatest impact on capital liquidity, loan products and the nation's ability to offer mortgage financing for home ownership.

Part of the mission of the GSEs has always been to provide loan programs to fulfill established goals for affordable housing (the law specifically enumerates Manufactured Housing as Affordable Housing). Today Manufactured Housing ("MH") stands alone in its ability to house America affordably without significant support from government subsidies. Yet the GSEs have largely ignored and discriminated against Manufactured Housing. By the GSEs' own admission, MH loans make up less than 1% of their portfolios, even though historically MH has represented 10% to 15% of annual new single family housing starts in the United States. (Over the past twenty-five years, MH has represented as high as 25% and as low as 5% of annual single family housing starts. The large swings have been brought about by the boom or bust mentality of finance in both the site-built market and the MH market. Historical averages place annual volumes of sales of new manufactured homes at approximately 250,000 homes per year which is approximately 15% of recent housing trends.)

It is because of these discriminatory practices that the idea of Duty to Serve was included in the law. The requirements of Duty to Serve cannot be interpreted loosely. The GSEs, by nature, are capital raising entities that support the liquidity of capital available for mortgage financing. The law now requires specifically that the GSEs "increase the liquidity of mortgage investments and improve the distribution of investment capital available for mortgage financing for underserved markets," which specifically includes Manufactured Homes. Furthermore the law states that "the enterprise shall develop loan products and flexible underwriting guidelines to facilitate a secondary market for mortgages on manufactured homes for very low, low and moderate-income families."

While there may be various ideas about the establishment of benchmarks for the measurement criteria related to the Duty to Serve, it cannot be denied that historically the MH industry has been "grossly" underserved. The primary "push-back" by the GSEs over the years to the inclusion of loan products for MH products in the fulfillment of their affordable housing goals has been that MH loans will not perform and cannot be profitably originated and serviced. This paper has been prepared to provide:

1. A review of historical MH loan performance;

2. A discussion of profitable MH lending models; and

3. Action steps necessary for the GSEs to fulfill the Duty to Serve.

HISTORICAL LENDING

Since 1976, the Manufactured Housing Industry has been comprehensively regulated by HUD. The original regulatory legislation, the National Manufactured Housing Construction and Safety Standards Act of 1974, had a remarkable impact, resulting in an improvement of the industry's homes. Subsequent legislation, the Manufactured Housing Improvement Act of 2000 (2000 Act), filled gaps left in the regulation of the industry related to standards for installation and dispute resolution to assist consumers with issues in the field.

Even though much of the regulation that has improved industry practices, products and installation is just now being implemented, for several years industry lenders built successful lending models that served the industry well and produced profitability for the lenders. These new regulations will only serve to enhance these lending models. The industry has actually received a "bad rap" concerning the idea that lenders cannot produce performing loans on Manufactured Homes. This stereotype has been propagated by three events.

First, during the 1980's the failure of the "oil patch" economy caused significant repossessions and foreclosures of Manufactured Homes. This occurred because the states of Louisiana, Texas and Oklahoma suffered horrendous economic devastation during a time of upheaval in the oil industry. These states also accounted for approximately 25% of the market for Manufactured Homes in the U.S. While the industry acknowledges that many loans failed, the fact is the economic devastation was not limited to MH loans. Mortgage loans on site-built homes and commercial loans also failed to perform to the same degree as the failure of MH loans. These failures were brought about by the economic anomaly suffered by the oil patch states. MH loan performance was a function of the economic landscape, not a failure of the lending model or the underlying collateral, and was impacted to the same degree as other classes of assets.

Second, in addition to the problems stemming from the oil patch economy, during the 1980's, the Savings and Loan industry was devastated by poor loan performance due to bad and fraudulent lending practices. These bad practices were applied to commercial and site-built loans, but did not follow MH loans. The reason MH loans originated by the thrifts were not subject to similar loan performance is due to Advance Based Lending Models as opposed to Appraisal Based Lending Models. Abuses in appraisal led to significant overvaluation practices which impacted loan performance for commercial and site built home loans ultimately causing the failure of the thrift system and the creation of the Resolution Trust Corporation. The fact is, MH loans significantly out-performed other classes of assets originated by the thrifts.

However, despite the performance of its loans, Manufactured Housing suffered because the thrift system originated approximately 30% of the loans on Manufactured Homes during the mid-80's. The failure of the thrift system eliminated a significant portion of MH lending capacity, although loan performance was better than other classes of assets. This fact is understood with more clarity by looking at the start-up of Greentree Financial. Greentree was a spin-off of an MH portfolio from a failing S & L that started the growth process of the nation's leading MH lender in the 1990's. The only performing portfolio of the S & L was an MH portfolio acquired by Greentree in its start-up.

Greentree led the way to the creation of a market for Asset Backed Securities for MH loans during the late 1980's and early 1990's. By 1992 there were two companies that were public issuers of debt secured by MH loans. This market was approximately $2 billion annually. These lenders proved to be very profitable and the paper performed exceedingly well. However, from 1992 through 1998 the lending community in the industry grew from two lenders to fifteen, and the annual volume of loans grew from $2 billion to $18 billion. With this increase in competition, lending practices deteriorated leading to poor underwriting practices and ultimately poor loan performance (especially during the years of 1997 through 2001) and the devastation of lending for the industry.

This period of time in industry lending is the basis for the third reason MH loans are given a bad rap. It is important to note that the situation that occurred in MH lending in the late 1990's is almost identical to the problems that are occurring today in the Mortgage Industry. Increased competition in lending for site-built mortgages created poor lending practices which led to the fall in the housing industry generally and the tipping point for the current credit crisis and recession. The point to understand is that bad lending practices in MH lending are just as destructive as in mortgage lending. The underlying collateral of MH did not cause the poor loan performance; bad lending practices did, just as it has in the Mortgage Industry.

Since the exit of many lenders from the industry, many improvements have been made by the industry to return to sound lending practices and insure a profitable lending model. One of these improvements includes the passage of the 2000 Act, which provides for the nationwide regulation of installation and a dispute resolution process for consumers. These facts are proven by the survival of several lenders in the MH industry. These lenders have continued to operate with sound underwriting practices and have remained profitable. However, the current credit crisis has eliminated the ability, even for these lenders, to sell MH loans in the marketplace, creating considerable stress for an already troubled industry.

HISTORY OF GSE LENDING ON MANUFACTURED HOMES

The GSEs have continued to push-back against creating MH loans because of the myths related to the aforementioned issues, which has been exacerbated by their poor understanding of MH lending models and lack of oversight of MH lending practices as it relates to conforming mortgage products. During the time of deterioration of MH lending in the industry (as mentioned above), retailers sought other avenues of finance. The deterioration in chattel and hybrid non-conforming loan products led to the sale of homes utilizing conforming mortgages as a finance vehicle. At that time, the GSEs had established no real differences in mortgage criteria for site-built homes as it compared to traditional MH product. Accordingly many homes that had differing collateral characteristics were appraised and underwritten to the same standards as other classes of collateral (i.e., site-built homes). These homes were placed on pier block foundations with non-structural skirting and steps, but appraised as homes installed on permanent foundations. While these classes of collateral perform differently than their site-built counterparts, when underwritten and financed properly, they can and do perform profitably for lenders. The primary issue here is that MH products were "over-valued" because there was no difference in appraisal standards, which ultimately led to poor performance. The problem was not the underlying collateral, but the system used to underwrite and value the homes.

In 2003, the GSEs made significant changes in the way that MH products were underwritten and appraised. These changes have led to an improvement in loan performance for MH conforming loan products (albeit coinciding with the deterioration of site-built products to such a degree that conservatorship has been instituted to keep the GSEs viable). Although there has been an improvement in MH loan performance for the GSEs since 2003, there have been no steps taken by the GSEs to insure that MH is reasonably served to meet its affordable housing goals. The lack of these steps has led to insignificant MH originations as compared to other forms of housing.

There has been no attempt by the GSEs to look at traditional lending models or to provide creative loan product designs that both support the origination of MH loans and provide profitability for lenders. All of these issues have been compounded by today's current credit crisis, producing a significant shortage of available lenders and loan programs for purchasers of Manufactured Homes. The sad commentary here is that profitable MH lending models exist and MH products are the most affordable housing alternative available without subsidy from the government. In a time where record federal deficits exist, the fulfillment of the Duty to Serve for Manufactured Housing has never been more important.

With MH lending being applied to lower price points (traditionally from $35 to $55 per square foot, exclusive of land, significantly less than most site-built homes) 100,000 families a year could be financed in affordable housing for approximately $10 billion in originations annually. Currently, $600 billion has been set aside by the government to purchase the securities of the GSEs and the industry believes that there should be a portion of these funds earmarked to insure the fulfillment of the Duty to Serve mandate.

Today's Manufactured Home is a much superior product to years past, due to the maturing of the industry, innovative manufacturing techniques, competition with the site built segment of the housing industry, establishment of lending transparency and best practices (this pre-dates the efforts of regulators currently reviewing mortgage lending practices) and updates to the laws and building codes that govern the production, sale and installation of the home. Today, there are profitable lenders in the industry, but there is no viable market for the sale of their loans. Furthermore, Manufactured Housing has provided millions of Americans with the most affordable housing option available, other than government sponsored subsidy programs. Literally, Manufactured Housing stands alone in its ability to help lower and moderate-income Americans fulfill the dream of home ownership. However, while the industry has worked hard to overcome its lending woes, the industry has continued to suffer due to a lack of available financing.

LENDING PROGRAMS

Traditional finance models for Manufactured Housing have generally included a variety of finance options. The various loan products all have characteristics that are designed to mitigate lender risk based on the collateral characteristics involved. These characteristics include, but are not necessarily limited to, interest rate, term of loan, down payment requirements and the like. These long-standing industry options need to be combined with an improvement to the way MH is treated in the Conforming Mortgage market as well. Below is a discussion of the various types of programs necessary to revive lending for Manufactured Homes and to make an important first step toward fulfilling the requirement of Duty to Serve.

Chattel Financing: A Chattel Loan (personal property) is an installment loan that uses the "home only" as collateral for the loan. This lending product has traditionally been the backbone of the industry, with many homes going on private property, sometimes owned by the homeowner but not included in the collateral of the loan, or in land-lease parks and communities. The amount financed is calculated via an Advance Based System using the invoice of the home manufacturer. The advance worksheet (a typical worksheet has been provided in the attached Appendix) generally provides a maximum amount available to finance up to 150% of the manufacturer's invoice amount (subject to certain limitations) for the home to the retailer, plus add-on amounts (allowances) for set-up and installation, skirting or foundation walls, steps, air conditioning and other appurtenances. While many lenders use various criteria in their proprietary lending models to determine the advance rate (amount available for finance) and the interest rate on the loan, most lenders utilize a system which uses some or all of the following loan characteristics to determine the amount available for finance: term of the loan, purchaser credit score or criteria, type of collateral (single-section or multi-section, new or used), age of the home, down payment and manufacturer invoice disclosures among other factors. Minimum down payments start at 5% and typical standard loan models include programs of up to 20% down payments. The term of the loan varies from 7 to 15 years for single-section homes and from 10 to 20 years for multi-section homes. Chattel based financing is typically done in an accelerated closing and installation process because no mortgage is required on the land. Today's lenders have addressed concerns with escalating rents in parks through agreements with park owners and typically get landlord waivers from private property owners.

Land-Home Financing: A Land-Home Loan is a special type of non-conforming mortgage loan. The home and the land are both included as collateral for the loan in the mortgage. Additionally the closing process and certain requirements of conforming mortgages are waived, streamlining and accelerating the loan process. (An example of these waivers is the elimination of mortgage insurance. Typically this is accomplished without additional lender risk through higher rate structures than Conforming Mortgages.) The amount financed is based upon a hybrid system using the appraised value for the land and an Advance Based System similar to Chattel Loans (otherwise described as "a modified cost basis approach") for the home plus the cost (subject to allowance maximums) for appurtenances. The maximum amount available for finance is the appraised value of the land, plus up to 150% of the manufacturer's invoice for the home to the retailer (Please refer to the Chattel Loan Worksheet in the Appendix), plus the cost of add-on amounts (allowances) for set-up and installation, skirting or foundation walls, steps, air conditioning, porches, garages and other appurtenances. Land-Home loans allow for both the installation of Manufactured Homes on traditional pier block systems with non-structural skirting and for permanent foundations systems. While many lenders use various criteria in their proprietary lending models to determine the advance rate on the home (amount available for finance) and the interest rate on the loan, most lenders utilize a system which uses some or all of the following loan characteristics to determine the amount available for finance: term of the loan, purchaser credit score or criteria, type of collateral (single-section or multi-section, new or used), age of the home, down payment and manufacturer invoice disclosures among other factors. Minimum down payments start at 5% and typical standard loan models include programs of up to 20% down payments. The term of the loan varies from 10 to 20 years for single section homes and from 10 to 25 years for multi-section homes. Land-Home financing also includes a construction loan type feature (also known as staged funding) for the retailer, which allows for the funding of the land, improvements and the home, through construction draws.

Conforming Mortgage Financing: A Conforming Mortgage Loan is based on the finance model determined by the GSEs. The home is attached to a permanent foundation and both the land and home are included in the mortgage. Conforming mortgage products carry specific requirements for surveys, appraisals, mortgage insurance, etc. While Conforming Mortgage Loans have generally been available from the GSEs for some time, Manufactured Housing Loans are appraised and underwritten to discriminatory standards compared to site built homes with higher interest rates, thus only producing a small number of loans annually. (Today's MH loans represent less than 1% of the portfolios of the GSEs.) The Manufactured Housing Industry builds many homes that have the same aesthetic and construction characteristics as site-built homes. For these "high end" Manufactured Homes there should be no difference in standards applied for interest rate, term, appraisal or underwriting criteria than are applied to site built homes.

SPECIAL CONSIDERATIONS

While the above information is a synopsis of loan product designs, in order to serve the low-to-middle income and first-time home-buyer, there is a great need for special programs as well. These programs include the following:

1. **Land In Lieu of Down Payment**: Many customers already own a piece of land. Programs must be established to allow the customer to use the equity in their land in lieu of all or a portion of the down payment requirements for the loan. Amounts available for substitution of the cash down payment should be up to 65% of the appraised value of the land.

2. **Higher Equity Loans**: Many customers have issues with their credit history. Programs should be established that allow the purchase and finance of a home with lower credit scores through higher down payment requirements. Because Manufactured Homes are less expensive than site built homes, higher equity programs for lower credit score customers are much more attainable.

3. **Buy-For and Co-signer Loans**: Many customers purchase homes (primarily through Chattel Loans) where their parents or a relative help the customer with the purchase of the home. This additional help is considered a credit enhancement and particularly helps first-time home buyers.

4. **Stated Income Loans**: Some purchasers of homes are self-employed and

find it difficult to verify income. These issues affect all segments of the housing industry. Site-built lenders have traditionally provided for underwriting criteria to allow such borrowers to qualify for a loan. Similar types of loan programs should be applied to Manufactured Housing as well.

5. **Other Innovative Products**: The Duty to Serve includes support for very low, low and moderate-income families. While Manufactured Housing is uniquely positioned to serve these markets because of lower price points, consideration should be given to varying down payment programs and other innovative loan programs.

LENDING PROGRAM HIGHLIGHTS

Chattel Loans
Quick Closing Process
Personal Property Installment Loan
Advance up to 150% of Invoice
Minimum 5% Down Payment
Rate Buy Downs Available

Land-Home Highlights
Hybrid Mortgage Loan
Construction Loan/Staged Funding Included
No PMI Required
Rate Buy Down Available
14 Day Closing
Construction to Permanent Single Closing
Minimum 5% Down Payment
Appraised Value of Land and 150% of Invoice, plus cost of Appurtenances

MH Conforming Mortgage
On Par With Site Built
Longer Finance Term
Lower Rates Available
Appraisal Based System

CURRENT CONSIDERATIONS MAINTAINED BY THE GSEs

While it is clear that the GSEs have not moved to create lending products necessary for the industry to survive, the GSEs have expressed a concern related to their ability to offer securities that allow the inclusion of these types of loan products in their Mortgage Backed Securities ("MBS") offerings. The GSEs have stated that the prevailing reasons for this include:

1. Appraisal based lending as opposed to other valuation methods such as Advance Based Lending (Modified Cost-basis Approaches).

2. The inability to accept industry practices relating to title perfection through the combination of title lien perfection and real estate mortgage liens.

3. Differing prepayment speeds.

4. Lack of PMI.

5. Lack of available market for the securities.

A brief discussion of each issue follows.

Advance-Based Lending: GSEs have long held that appraisal-based systems are the "holy grail" to valuation of collateral. The current lending crisis, and the previous crisis in the thrift industry, prove that appraisal-based lending has its limitations. Over the years, Advanced Based Lending systems used by the MH industry have a long-standing track record of reasonable collateral valuation. Recovery rates on defaults have been fairly consistent except during times of poor lending practices. (No industry or collateral class is immune to finance abuses as demonstrated by the current credit crisis.) The industry believes it is prudent for the GSEs to modify the appraisal guidelines to allow for alternative methods of value based on the manufacturer's invoice for the home.

Combination Title Lien Perfection: While there may be disclosure requirements that have to be added to MBS offerings, the industry has securitized billions of dollars of loans with combination title perfection methods. These methods have proven sound for the lender to effect repossessions and foreclosures and maintain a proper security interest in the underlying collateral.

Differing Pre-payment Speeds: While the industry does not argue that chattel loans may have a different pre-payment speed than traditional mortgage loans, there is adequate industry data available to predict the pre-payment characteristics of such loans. These pre-payment speeds may have to be managed through changes in disclosures or the separation of asset classes in differing securities.

Lack of PMI: Currently mortgage insurers have limited their coverage of MH loans due to significant problems of their own. While these issues may also be linked to charter requirements and disclosures, the finance industry has successfully offered profitable securities under the lending models presented without mortgage insurance for years. The additional risk is mitigated through higher rates and other changes in loan characteristics as mentioned.

Lack of Available Investors: While this paper does not discuss the merits of whether MH loans originated under the lending models presented are includable in current MBS offerings of the GSEs, today the two major investors of the GSEs securities offerings are the Treasury Department and the Federal Reserve. It is apparent that the GSEs have many issues related to the issuance of any security regardless of the inclusion of MH loans. Accordingly there must be a consolidated effort for FHFA, the GSEs, the Treasury and the Federal Reserve to work together to create both a viable security offering for MH loan products and a working market for MH securities.

ACTION STEPS TO FULFILL DUTY TO SERVE

There are a number of things that must be done in order for the GSEs to fulfill the requirements of Duty to Serve. These include the following:

1. FHFA must initiate significant discussions with the MH industry and the GSEs to provide for the creation of innovative loan products to serve consumers of affordable housing. This paper serves as a background document to facilitate such a discussion. Information is readily available from current industry lenders to assist in the creation of such loan products.

2. While, in due course, regulations and rules will need to be established governing benchmarks and measurement criteria to determine whether the GSEs are meeting their obligations under the law, it is obvious that a sense of urgency must be applied to spark lending immediately. The early establishment of loan products could produce an additional 30,000 to 40,000 home sales annually. This situation would provide significant aid to the ailing MH industry and would be a positive first step toward meeting the Duty to Serve requirements. Over the course of time, final benchmarks and improvements in loan products could be accomplished to insure the ongoing compliance with the law by the GSEs. However, without immediate action there will be no industry left to serve.

3. The creation of loan products may also require the facilitation of market investors which most likely will require intervention by the Treasury and the Federal Reserve until markets stabilize. This situation will require coordination and communication among the various federal agencies to create an immediate market for MH loan products.

SUMMARY

Traditional lending models for Manufactured Housing have included all of the loan products and programs discussed above. For several years, lenders were able to originate loans using these products and experienced good loan performance and achieved profitability. Some of these lenders are still operating today, but there is a significant under-capacity to sell these loans in the marketplace. While some Manufactured Housing Lenders, just as Mortgage Lenders in the site built industry, got away from solid underwriting criteria and pushed the envelope on lending, leading to bad loan performance and the loss of lending capacity, the lending model for profitable loans exists today, but is restrained by access to the capital markets.

The industry believes that Manufactured Housing Loans can be made profitably by using traditional lending models and methods, but currently there is very little financing available. The credit crisis has further exacerbated this issue by forcing the largest lender from the marketplace. Without consumer financing for Manufactured Homes, America will lose one of its greatest asset, an industry built on affordable, non-subsidized housing.

The industry currently has a number of lenders that can provide additional information related to these lending programs and models. MHARR stands ready to facilitate information for the GSEs and its regulator necessary to meet the requirements of the Duty to Serve.

Please see attached Appendix for Chattel Loan Worksheet Example on the next page

APPENDIX

CHATTEL LOAN WORKSHEET

MAXIMUM HOME SALES PRICE CALCULATION

Total Factory Invoice				60,000
Deletions				
Freight			1,500	
Taxes				
Furniture				
Wheels and Axles			1,200	
Fees			300	
Other: ____________				
Total Deletions				(3,000)
Net Invoice				57,000
Advance Ratio		Select		
New-less than 1 year	145%	X		82,650
New-less than 2 years	140%			
New-less than 3 years	135%			
New-less than 4 years	130%			
Mfg VEP Code		Select		
If Code = 0, then add 5%				
If Code = 1, then no adjustment		X		-0-
If Code = 2, then deduct 5%				
Adjusted Mark-up Amount				82,650
Additions				
Freight			1,500	
Sales Tax			1,500	
Delivery and Set			2,000	
Air Conditioner			1,400	
Skirting			800	
Steps			500	
Fees			300	
Other: ____________				
Total Additions				8,000
Total Home Value				90,650

Maximum LTV (100% minus minimum conditioned down-payment 95%

Maximum Advance (Total home value X Max LTV) 86,118

Manufactured Housing Association for Regulatory Reform

1331 Pennsylvania Avenue, NW • Suite 508 • Washington, DC 20004 • 202-783-4087 • Fax 202-783-4075

February 26, 2009

VIA FEDERAL EXPRESS

James B. Lockhart, III
Director
Federal Housing Finance Agency
1700 G Street, N.W.
Washington, D.C. 20552

Re: Manufactured Housing -- Duty to Serve Underserved Markets

Dear Director Lockhart:

It was good to meet with you and your colleagues on February 12, 2009, to address the implementation of the "duty to serve underserved markets" mandated by the Housing and Economic Recovery Act of 2008 (HERA), as it specifically pertains to manufactured housing regulated by the U.S. Department of Housing and Urban Development (HUD).

As we described at our meeting, the manufactured housing industry today is suffering from an unprecedented contraction, due, in significant part, to the extremely limited availability of private consumer financing for manufactured home purchases. In the ten years since 1998, manufactured home production and sales have declined by nearly 78 percent and, in 2008, fell below 100,000 for the first time since 1961. This contraction is a source of continuing harm to American consumers in need of affordable housing and directly threatens the survival of the manufactured housing industry.

The "duty to serve," enacted by Congress in response to this crisis, is both a finding and a directive. It is a finding that the Government Sponsored Enterprises (GSEs) have underserved the manufactured housing finance market and the needs of lower and moderate-income purchasers of HUD-regulated manufactured homes, as is demonstrated by the fact that manufactured housing loans currently comprise less than one percent of the portfolios of both GSEs, even though the statutory mission of the GSEs is to advance affordable housing and manufactured housing is specifically designated and protected as "affordable housing" under federal law. At the same time, the "duty to serve" is a congressional directive to the GSEs to correct this anomaly by conforming their manufactured housing finance practices with their overriding affordable housing mission.

In order to assist the GSEs and FHFA with the implementation of this directive, MHARR has previously provided a conceptual model for new loan programs for post-Manufactured Housing Improvement Act of 2000 (2000 Act) homes to Fannie Mae, Freddie Mac and FHFA. As was discussed and promised at our meeting, however, MHARR has now developed this conceptual model into a more detailed approach for implementation of the "duty to serve," based on manufactured housing lending programs that have been -- and continue to be -- used successfully by private sector lenders (see, attachment). The established profitability of these programs demonstrates that the GSEs, using such a framework and approach, can successfully foster and support the type of active and viable secondary market for manufactured housing obligations (and related access to capital) -- compliant with the "duty to serve" -- that the industry needs to survive and continue serving consumers of affordable housing.

The viability of these existing programs illustrates that past issues affecting the performance of manufactured housing loans resulted primarily from --

> (1) bad lending practices that have long since been eliminated by the industry and replaced by a commitment to best practices; and (2) the absence of viable loan products for chattel and non-conforming land-home packages which led to the incorrect classification of certain manufactured housing loans as "conforming," even though the homes in question were not permanently installed -- rather than the intrinsic value of manufactured housing as finance collateral.

Indeed, the recent difficulties faced by other segments of the housing industry show that loans secured by any type of collateral can experience significant losses in the face of poor or improper lending practices. Just as importantly, the performance of manufactured housing obligations going forward will be positively impacted by major reforms adopted by Congress in the 2000 Act, including nationwide regulation to ensure proper installation and enhanced consumer protection (through a nationwide system of alternative dispute resolution).

As always, we stand ready to provide you with any and all additional information you may need, or assist you in any other way. While we are aware that there are certain issues that will need to be addressed in implementing proper "duty to serve" programs at both GSEs (e.g., recent changes in the availability of mortgage insurance for manufactured home transactions), it is essential -- given the condition of the industry, the needs of consumers of affordable housing and the current availability of funds for the GSEs to implement such programs as a result of legislation and new initiatives put in place by the new Administration and 111th Congress -- that FHFA and the GSEs move forward as quickly as possible, to fully and completely implement this directive.

Sincerely,

Danny D. Ghorbani
President

cc: Mr. Edward J. DeMarco, FHFA
Mr. Herbert M. Allison, Jr., Fannie Mae
Mr. David A. Moffett, Freddie Mac
Mr. Kirk G. Willison, Freddie Mac
Mr. Charles Rumfola, Fannie Mae
MHARR Members

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Fred R. Becker, Jr.
President and CEO

June 3, 2009

The Honorable Paul Kanjorski
Chairman
Subcommittee on Capital Markets, Insurance,
and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Scott Garrett
Ranking Member
Subcommittee on Capital Markets, Insurance,
and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Kanjorski and Ranking Member Garrett: Mr. Chairman

The National Association of Federal Credit Unions ("NAFCU"), the only national trade association exclusively representing the interests of our nation's federal credit unions, thanks you for convening today's hearing on "The Present Condition and Future Status of Fannie Mae and Freddie Mac."

Homeownership is a core American value and our members are proud of the role that credit unions have come to play in recent years - in conjunction, with Fannie Mae and Freddie Mac - in helping an ever increasing number of Americans achieve the dream of owning their own home. As you are well aware, credit unions were not the cause of the subprime crisis and the economic downturn that it caused.

GSEs such as Fannie Mae and Freddie Mac allow credit unions to obtain the necessary liquidity to create new mortgages for their member-owners by utilizing the secondary market. Despite their conservatorship, Fannie Mae and Freddie Mac remain an important tool for credit unions to help them free up funds to make more loans to members in the current economic environment.

We realize that Fannie Mae and Freddie Mac will ultimately transition out of their current conservatorship, into a new model. We believe it is important that Congress should ensure that there are safeguards in place to make for a smooth transition, and that the important roles that Fannie Mae and Freddie Mac play for credit unions and the secondary market not be compromised. As credit unions can only raise capital from their membership, having additional sources of liquidity is of key concern to our members. We look forward to working with the Subcommittee on this issue.

E-mail: fbecker@nafcu.org • **Web site:** www.nafcu.org

The Honorable Paul Kanjorski
The Honorable Scott Garrett
June 3, 2009
Page 2

Thank you for the opportunity to share NAFCU's views on these important issues. If you have any questions or if we can be of further assistance to you or your colleagues in the consideration of matters related to Fannie Mae and Freddie Mac please do not hesitate to contact me or NAFCU's Director of Legislative Affairs, Brad Thaler at (703) 522-4770.

Sincerely,

Fred R. Becker, Jr.
President and CEO

Mr. Chairman - Thanks for recognizing the credit union role both Fannie and Freddie play in credit union mortgage financing!

cc: Members of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

DONALD A. MANZULLO
16TH DISTRICT, ILLINOIS

COMMITTEE ON FOREIGN AFFAIRS

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SUBCOMMITTEE ON ASIA, THE PACIFIC, AND THE GLOBAL ENVIRONMENT

SUBCOMMITTEE ON TERRORISM, NONPROLIFERATION, AND TRADE

Congress of the United States
House of Representatives
Washington, DC 20515-1316

COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

SUBCOMMITTEE ON INTERNATIONAL MONETARY POLICY AND TRADE

HOUSE MANUFACTURING CAUCUS
FOUNDER AND CO-CHAIRMAN

April 30, 2009

The Honorable James B. Lockhart, III
Director
Federal Housing Finance Authority
1700 G Street, NW
Washington, DC 20552

Dear Director Lockhart:

I would like to thank you for your efforts to create a solution to the issue of fraud in the home appraisal process. I truly appreciate the time and effort you have given this undertaking, and I believe your intentions for a code of conduct comport with industry's recognition that such action is necessary. I agree with you that the housing industry needs to commit itself to greater professional standards and practices. However, I continue to hold reservations about the practicality of the Home Valuation Code of Conduct (HVCC).

I am writing in one last attempt to convince you that as drafted, the Housing Valuation Code of Conduct, an agreement which you have entered into with New York Attorney General Cuomo and the Enterprises, is not a workable product at this time. I urge you to consider a one year moratorium so you may bring together the industry professionals who will be affected by the HVCC agreement and work on a solution to combat fraud together.

Real-World Practicality
I have been involved in thousands of real estate closings, and as written I do not believe this agreement will accomplish your intended goals. The agreement cannot be put into practice without causing major disruptions to the housing market and increasing consumers' costs to purchase homes. This agreement simply adds layers to the home-buying process. I am very concerned that under this agreement, appraisers without the requisite experience in certain markets may be dispatched to value homes causing a level of uncertainty that the housing market cannot handle at this time.

Collusion
Also, I fear this agreement will actually invite collusion instead of prevent it. The agreement appears to come full circle. It essentially removes the traditional role mortgage brokers played in the appraisal process and replaces them with lenders. I do not believe this change actually addresses the issues of fraud at its core. While I am very confident that the bad actors are now out of the industry, who is to say that 5, or 10, or 20 years from now the bad actors will not return?

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http://manzullo.house.gov

DISTRICT OFFICES:
☐ 415 SOUTH MULFORD ROAD, ROCKFORD, IL 61108 • 815/394-1231 • FAX: 815/394-3930
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The very small percentage of individuals who were involved in fraudulent business practices were found to exist across the housing industry, not simply confined to one sector of the industry. If we truly want to prevent fraud, we should make every effort to make the appraisal process more independent from the other layers in the home-buying process, not more dependent on a different sector. This agreement maintains the conflict of interest as long as lenders and banks are allowed to wholly own AMCs and use home valuations from their own AMC to conduct business. Moreover, there is little if any state regulation and no Federal regulation of AMCs, a fact that would have arisen in any meaningful vetting of the proposal utilizing the Federal regulatory review process. The bottom line is, AMCs are not regulated and they are going to dominate about 90% of the appraisal market.

Flexibility
The act of buying a home is not a cookie cutter process. What works for one home buyer may not work for the next. This agreement is too inflexible and will not adapt for the many special circumstances that often arise in the home buying process. For example, there is no avenue to address unique situations where homes may, for any number of reasons, be undervalued as is the case in my neighborhood. Any HVCC agreement implemented in the industry must be flexible if we want to keep home sales moving.

Unanswered Questions
Additionally, the inflexibility and limitations set forth in the agreement raise a number of questions for which the document has no answer. For example:

- What remedies are available under the HVCC agreement for sellers in situations involving anomaly sales (e.g. an estate that offloads a property below market value for the sake of expediency)?
- How does the HVCC agreement protect against property devaluation as a result of implementation of this agreement?
- Can a buyer or seller order a second appraisal if they are unhappy with the first appraisal?
- Would dissatisfaction with the appraisal or the appraiser be grounds for ordering a second appraisal (e.g. an appraiser from a metropolitan area assessing a rural property)?
- Would an appraised value assigned well below the assessed tax value of the property be grounds for a second appraisal?
- What is available under the agreement for appraisers to adjust appraisal comparables based on radical swings in a neighborhood?
- Will this agreement increase the costs of purchasing a home by requiring a buyer to purchase multiple appraisals on the same property in order to shop for the best loan rate?
- Given the assumption that the majority of AMCs are located in urban population centers, what impact will this agreement have on rural, independent appraisers' businesses?
- Have you studied the cost-impact this agreement will have on appraisers, mortgage brokers, lenders, and consumers? If so, please share that impact study with me. If not, please explain, why not?
- How will this agreement prevent collusion between lenders and appraisers?

Finally, please furnish me with a list of AMCs expected to be included under this agreement and the contact information for that AMC. Also, please indicate which of the AMCs on that list are owned by lenders and by which lender.

This agreement has the potential to severely devalue housing prices in the market. We need to have firm solutions to deal with these issues on an as-needed basis, but this agreement does not afford that flexibility. Given the many questions these examples expose, I believe a one year moratorium is necessary so the industry, Enterprises, and Federal Housing Finance Agency can come together on a solution that will allow for flexibility, protect consumers, and address the core issues surrounding fraud in the appraisal process. I would also encourage this group to consider ways to make the appraisal process more independent.

Again, I thank you for your efforts to emphasize a greater standard of honesty in the housing market. I encourage you to reach out to those industry participants impacted by the HVCC who are best equipped to discuss a more workable solution to address fraud and create industry practices that promote more transparency and protection for all parties involved in a real estate transaction. If there is any way I can be of assistance to you in this endeavor, please do not hesitate to contact me.

Sincerely,

Donald A. Manzullo

Donald A. Manzullo
Member of Congress

FEDERAL HOUSING FINANCE AGENCY
Office of the Director

May 8, 2009

The Honorable Donald Manzullo
United States House of Representatives
2228 Rayburn House Office Building
Washington DC, 20515

Dear Representative Manzullo:

Thank you for your letter regarding the Home Valuation Code of Conduct deployed by Fannie Mae and Freddie Mac to reduce coercion of appraisers, to protect the safe and sound operations of the Enterprises and to provide greater assurance to investors in mortgage backed securities of the quality of such products. You have expressed your strong support for these goals as well, though you have reservations about the new code.

Appraiser Competence
Appraiser competence remains a matter for federal authorities, in terms of setting forth industry guidance under Uniform Standards of Professional Appraisal Practice (USPAP), and state authorities, in terms of licensing and certification as well as enforcement. I believe the code may assist this effort as it mandates enhanced quality testing of appraisals received by the Enterprises and this may result in improved analysis of appraiser performance.

Collusion
The code does not replace brokers with lenders. The code does not provide any new authority to lenders that they do not already possess under banking law. The code focuses on certification of adherence to best practices to avoid collusion and this would apply not only to regulated entities but as well to any lender selling mortgages to the Enterprises. Collusion has been a major problem and no group, including mortgage brokers, have been blameless in such improper practices.

The code does not foster appraisal management firms, such firms pre-exist the code and their utility has been based on factors such as assisting banks in markets with which they are unfamiliar and in removing appraisals from within the bank itself. The code applies to such companies, whether they are regulated or not, and that should assist in reducing any collusive practices. As to regulation of such firms, some are regulated and Congress has before it legislation that would create regulation for all such firms.

Undervalued Housing
The code does not address the appraisal process as to valuation of properties in line with USPAP standards. Appraisers must abide by such standards under the code—which includes familiarity with local markets— and lenders may reject appraisals not performed correctly as an unprofessional practice -- but the actual valuation of a property is governed by appraisal industry standards and state regulators.

Unanswered Questions
You raise a number of questions about the operation of the code. Many of these questions, as noted above, are unrelated to the code. The code is not intended to protect against property devaluation, but rather to assure that property valuations are accurate. Other questions as to how the code affects markets will be the subject of ongoing oversight by FHFA. Finally, other operational questions will be subject to review and reply by the Enterprises as a normal business practice.

I trust this provide a response to your inquiry. Our office will maintain a dialogue with you as we move forward and I appreciate your commitment to a housing market marked by honesty and protection for all parties.

Sincerely,

James B. Lockhart III
Director, Federal Housing Finance Agency
Chairman, FHF Oversight Board

Single Family Guaranty Business

Facing Strategic Crossroads
June 27, 2005

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As of 6/22/2005

FannieMae

1. Is the housing market overheated?
2. Are consumer changes in preference for adjustable rate vs. fixed rate mortgages cyclical or secular?
3. Does Fannie Mae have a role/responsibility to stabilize the housing market?
4. Does Fannie Mae have an obligation to protect consumers?

The risk in the environment has accelerated dramatically.

- Proliferation of higher risk alternative mortgage products
- Growing concern about housing bubbles
- Growing concerns about borrowers taking on increased risks and higher debt
- Aggressive risk layering

Growth in adjustable rate mortgages (ARMs) continues at an aggressive pace.

- Extensive menu of alternatives / options
- Increasing affordability concerns
- Emphasis on lowest possible payment
- Home being utilized more like an ATM

Our competitive advantages today are in fixed rate mortgages.

We are at a strategic crossroad....

We face two stark choices:

1. Stay the Course
2. Meet the Market Where the Market Is

Stay the Course

- Maintain our strong credit discipline
- Protect the quality of our book
- Intensify our public voice on concerns
- Refrain from offering specific guidelines
- Preserve capital
- Test cyclical vs. secular

Alternatively, we could seek to ....

Meet the Market Where the Market Is

- Meet current consumer and customer demands
- Participate in volume and revenue opportunity / current growth areas
- Accept higher risk and higher volatility of earnings

Possible Implications

Stay the Course

- Lower volumes / revenues
- Slower book growth
- Continued market share decline
- Lower earnings
- Impact on key customer relationship

Meet the Market

- Higher volume / revenues
- Faster book growth
- Slow down decline in market share
- Higher credit losses
- Increased exposure to unknown risks
- Potential increased earnings volatility

Significant obstacles block our ability to pursue a "Meet the Market" strategy.

- Lack of capabilities and infrastructure
- Lack of knowledge of the credit risks
- Lack of willingness to compete with the market on price
- Lack of a value proposition for subprime
- Lack of a conduit capacity and Regulatory concerns

Realistically, we are not in a position to "Meet the Market" today.

Therefore, we recommend that we:

- Pursue a "Stay the Course" strategy and test whether current market changes are cyclical vs. secular:
  - Advocate public position
  - Be selectively opportunistic in pursuing business
  - See if consumer sentiment changes with flatter yield curve

While we:

- Dedicate resources and funding to "underground" efforts to:
  - Develop a subprime infrastructure
  - Develop modeling capabilities for alternative markets
  - Develop a conduit capability

Is there an opportunity to drive the market back to the 30-year FRM?

If we do not seriously invest in these "underground" type efforts and the market changes prove to be secular, we risk:

- Becoming a niche player
- Becoming less of a market leader
- Becoming less relevant to the secondary market

Management Team Discussion

Single Family Facts and Data

First Half Performance and Observations

Single Family Performance

Corporate Objective Goals Scorecard
Monthly Progress Report - May 2005

Maintain leadership and retain or grow our key accounts	▽	Satisfactory progress with customer retention. Holding our own against FRE
Address key competitive issues and maintain 30% MDO share	▽	Leakage to subprime and private label continues. We lack a value proposition to stem the tide in today's market
Implement products and exceed target book growth of 1.75%	⬢	Book growth negative year-to-date. Negative growth is expected for the full year
Increase participation in subprime	⬢	Continue to work on value proposition and proposal to enter the subprime flow market
Use technology tools for process improvement and delivery preference	●	On track
Achieve the HUD goals	●	On track
Lead the market in minority lending and achieve targets	⬢	Loss of market share to subprime, interest only, option ARMS, attracting mission borrowers relative to our "core" products

Single Family Performance

2005 Divisional Goals ($Bil)	
Lender Channel	$383.2
Investor Channel	100.0
Dedicated Channel	16.0
Total Business Volume	**$499.2**
Book Growth	1.75%
Gross Charged Fee	27.3 bps
Credit Losses	$198 mil

Inclusive of eBusiness.

2005 HOUSING GOALS		MAY 2005 YTD ACTUAL
Low Mod (Affordable)	52.0%	55.5%
Special Affordable	22.0%	26.7%
Underserved	37.0%	41.3%
2005 SF PMM Sub Goal		
Low Mod (Affordable)	45.0%	45.48%
Special Affordable	17.0%	18.92%
Underserved	32.0%	32.49%
2005 MINORITY LENDING GOALS		
African American	5.4%	5.51%
Hispanic	11.6%	10.99%
Total Minority	24.7%	23.78%

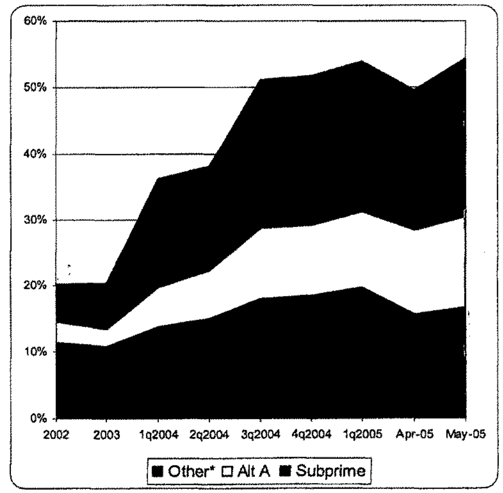
- Volume through May totaled $188 billion and was $11 billion (5.5%) behind plan
  - Full year estimate: $491 billion (Q2 forecast)
- YTD book growth (estimated): minus 1.7 percent
  - Full year estimate: minus 0.6 percent
- YTD gross charge fee vs. plan: 26.2 bps vs. 26.8 bps
- YTD credit losses vs. plan: $95.5 million vs. $55.1 million
  - Current full year estimate (6/05): $253 million

- On the housing goals front we remain ahead of targets against all goal categories
- Our minority lending results through May are behind goal for Hispanic (10.99%) and total minority (23.78%)

We continue to lose goals rich products to private label

- Much of the leakage to the private label market is from products with high minority concentrations
- The two product lines that are driving the majority of leakage to private label are Alt-A and Subprime
- In 2004, these product lines scored high relative to Fannie Mae's core products
  - Alt A: 30% total minority score
  - Subprime: 52% total minority score
- In addition, much of the Option ARM production is securitized in the private label market
  - Option ARMs: 37% estimated total minority score

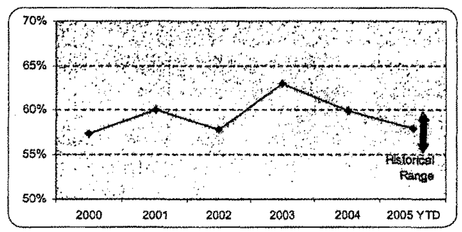
Private Label Market Shares of MBS Issuance



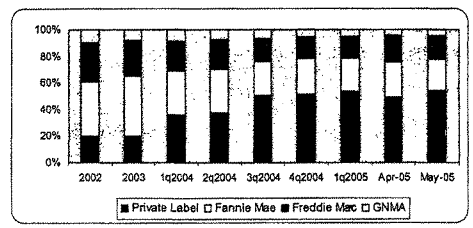
* Other includes Option Arms

Even with tough competition and widening MBS/PC price spreads, Fannie Mae has still maintained share levels versus Freddie Mac in the historical range (55% - 60%)

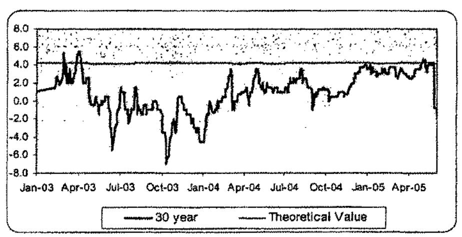
Fannie vs. Freddie



Entire Securities Market



MBS/PC Price Spreads



- Despite Fannie/Freddie price spreads being at high levels during the past 6 months, the Fannie/Freddie share has remained in the historical range
- However, both GSE's continue to see significant share loss to the private label market

Our competitive advantages in our core competencies continue to erode

1 YEAR AGO.... ⇨ TODAY....

Core Competencies

- Credit risk management
- Capital advantage
- Low cost producer
- Customized value approach
- Liquidity premium
- DU/DO Technology

TODAY....

- Our insular view prevents us from taking credit risks in areas unfamiliar to us.
- Our capital advantage has been lost to collateralized debt obligation issuers and hedge funds. Basel II will further erode our advantage.
- Our pricing is uncompetitive. According to our models, market participants today are not pricing legitimately for risks.
- We don't have a value proposition to compete in today's market (lack of conduit capability).
- Premium still exists with respect to our 30-year TBA security; No liquidity premium for non-fixed rate product.
- DU/DO remain the leading automated underwriting systems in the market. Continued investment is required to ensure we do not lose our competitive advantages in this area.

Our public position on risk concerns has been gaining momentum

5/3/05
Tom Lund
-- MBA Secondary
Remarks captured
in numerous articles.

5/16/05
OCC & Fed
-- Issue guidance letters
-- Feds warn lenders

6/1/05
OFHEO
-- Releases home price data
-- Expresses concerns

6/9/05
Greenspan
-- Froth/Bubble

Articles of Interest *Source: Google*	**# of Articles:** (Jan – April)	**# of Articles:** (May – June 22, 2005)
■ Housing Bubble	932	1,248
■ Interest Only	315	1,213
■ Housing Affordability Concerns	86	746
■ Greenspan and Housing Concerns	187	598
■ OFHEO and Housing Concerns	12	28
■ OCC and Housing Concerns	18	17
■ Option ARMs	20	10

Since early May, we estimate that over 3,500 articles have appeared in various publications on the topics listed above. This compares with an estimated 1,200 articles on these topics in the four months prior.

Our customer's and other market participant's attitudes towards layered featured products varies across a broad spectrum

Cautious Longer Term View Constrained	Slower to Move Reluctant Follower Tighter Credit Box	Production Focused Meet the Market Move Fast
Wells Citi ABN Suntrust Wachovia HSBC USAA Irwin Community Banks Credit Unions	Chase PHH First Horizon BofA GMAC Flagstar OSB Builder Mtg Corps	CHL WaMu World Greenpoint Indy Mac Street Aggregators Independent Mtg Bankers Brokers Realtors Subprime Originators

The market outlook for the year continues to change, driven by lower than expected interest rates and other market dynamics

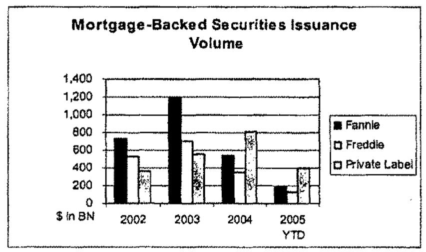
	2005 Plan	Q2 2005 Forecast
30-Year FRM	6.00%	5.64%
FRM-ARM Spread	1.35%	1.22%
SF Mortgage Originations ($Bil)	2,146	2,671
Refinance Share (% of volume)	39.5%	47.4%
ARM Share	29.2%	31.4%
SF 1st Lien MDO ($Bil)	7,704	7,923
SF 1st Lien MDO Growth	8.3%	9.8%
FNM HPI (% change from year ago)	3.4%	6.5%

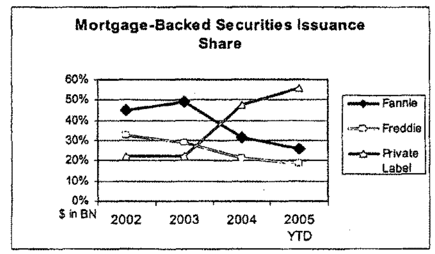
Fannie Mae 2005 Plan and Q2 2005 Forecast

Single Family Facts and Data

Private Label and Subprime Market Trends

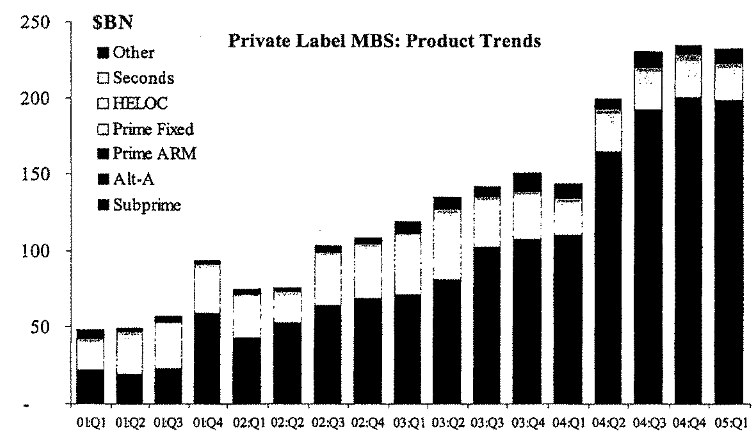
Private Label Trends





- Private label market continues to be a significant source of liquidity to lenders. $401 billion of private label securities have been issued in 2005 through May.
- In 2004, Private Label volume surpassed Fannie Mae volume for the first time, with total Private Label issuance of $809 billion versus Fannie Mae issuance of $537 billion.
- Fannie Mae is still the largest single issuer of MBS. Freddie Mac was the second largest issuer with $358 billion, and Countrywide ranked third at $114.5 billion.

Private Label Trends



Source: Corporate Development, Inside MBS & ABS

- Growth in PL has been driven by increases in:
  - Subprime
  - Alt-A
  - ARM production
- Common theme across these products: housing affordability and flexible guidelines

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As of 6/22/2005

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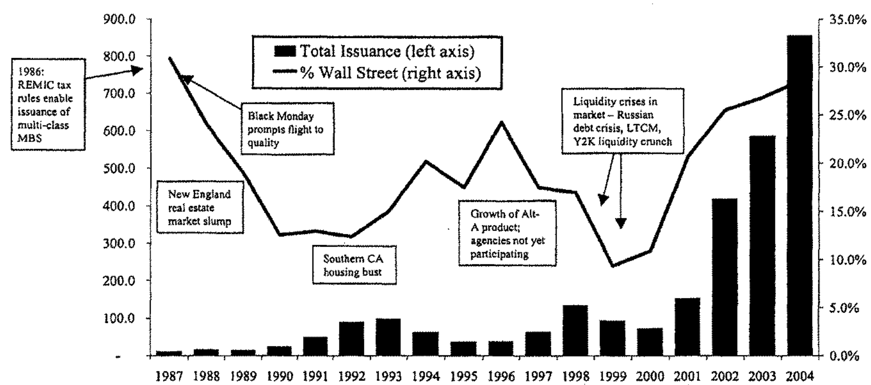
FannieMae

Private Label Trends – Wall Street Presence

- Wall Street firms playing an increasingly large role as aggregators of mortgage product.
- Wall Street share of private label issuance has doubled in the past three years (as of 2004 year-end).
- Many Wall Street players are pursuing vertical integration to develop consistent source of product:
  - Lehman originated $43B in Correspondent and Broker originations in 2004.
  - Bear Stearns launched a Broker division in early 2005.
  - Firms making significant front end technology investments, including developing proprietary AU systems.

Wall Street Issuance Trends – Cyclical or Secular?



- 1999-2001 – Wall Street presence in Private Label Issuance declines during (a) the consolidation of many subprime lenders, and (b) the increased presence of the Agencies in the Alt-A market.
- 2002-2005 – Wall Street participation increases measurably; and the street indicates that they are intent on having a lasting presence.
  - "They all want to be like Lehman Brothers... Lehman has a huge pipeline and everyone's coveting it." – Subprime Lender
  - CSFB has ambitious 2005 goals and is positioning itself to continue integrating downstream – exploring acquiring a servicer in 2005. (5/05 - CSFB 9th Private Label Issuers Conference)
  - Morgan Stanley is seeking "to build a brand and a reputation" for their securitization program and to show that they are "not just an opportunistic bond shop." (4/05 – Origination News)
  - On Bear's new broker platform:"Our pitch [is] that the broker's getting capital market execution because he's dealing direct with Wall Street."

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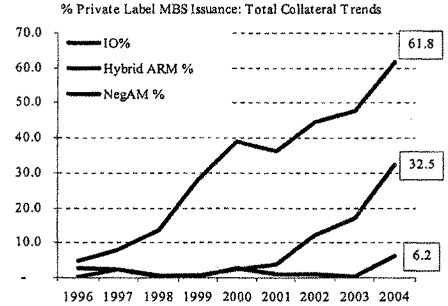
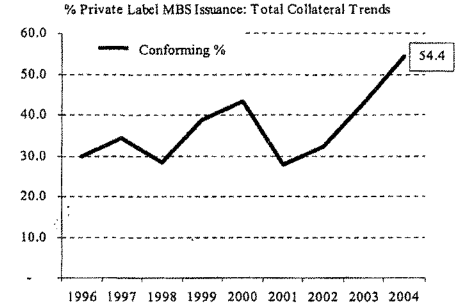
Private Label Trends – Products and Risk Appetite

- Primary market originations of products outside Fannie Mae's traditional risk appetite are on the rise. This means lenders have to turn to aggregators / private label as an outlet.





Source: UBS Mortgage Research: *Market Strategist, May 31, 2005*

- Strong growth of innovative products (Interest Only ARMs, "Pay Option" ARMs)
- Steady growth in share of Private Label market with conforming loan balances

Private Label Trends – Products and Risk Appetite

- Private label securities increasingly include a significant amount of conforming balance product. Reasons include:
  - Our tough anti-predatory lending guidelines preclude us from taking certain loans
  - Our risk appetite is tighter than the market's, especially regarding IO's and Option ARMs
  - Pricing / All-in execution
  - "Spillover" effect – lenders may prefer to sell product all in one place for convenience or execution reasons
  - Difficulty of hedging spread risk on ARMs: Many smaller lenders need best efforts flow execution and servicing released bids, which we don't offer with Alt-A and IO

Private Label Trends – Products and Risk Appetite

Private Label Securities Collateral Characteristics
Deals Issued April 2004 - Jan 2005

Prime Fixed & Prime ARM Deals --> *These two categories represented 27% of all private label securitizations in 2004*

	$ UPB (BB)	% Total UPB	Avg Loan Size	WA FICO	% FICO < 620	WA LTV	WA CLTV	% Investor	% Cashout	% CA	% Low/No Doc	% IO	% Option ARM
Total Collateral	116.1	100%	433,987	733	0.6%	69.1	85.6	2%	22%	48%	48%	48%	13%
Conforming Balance	22.1	19%	215,269	728	1.1%	73.3	92.5	7%	22%	26%	42%	73%	6%
Within FM Risk Appetite	20.0	17%	214,355	732	0.2%	73.1	92.4	7%	2%	25%	40%	79%	0%
Outside FM Risk Appetite	2.1	2%	225,742	683	10%	75.5	94.1	12%	42%	37%	55%	13%	60%

Alt-A Deals --> *This category represented 20% of all private label securitizations in 2004*

	$ UPB (BB)	% Total UPB	Avg Loan Size	WA FICO	% FICO < 620	WA LTV	WA CLTV	% Investor	% Cashout	% CA	% Low/No Doc	% IO	% Option ARM
Total Collateral	109.3	100%	252,548	711	1.2%	74.8	93.3	18%	30%	45%	67%	51%	12%
Conforming Balance	63.1	58%	182,392	710	1.5%	76.4	95.6	24%	28%	32%	63%	48%	11%
Within FM Risk Appetite	39.6	36%	181,273	723	0.6%	75.7	95.8	24%	21%	31%	56%	60%	0%
Outside FM Risk Appetite	23.5	22%	184,307	688	3.2%	77.5	95.3	24%	40%	34%	75%	28%	28%

Notes:
Data Source: Loan Performance database.
"Prime FRM" "Prime ARM" and "Alt-A" deal classifications are defined by the issuer as reflected in LP database.
"FM Current Risk Appetite" reflects typical FM eligiblity criteria on bulk deal business for an average customer.
Loans without reported FICO scores were excluded from the data set.
All loans are in first lien position; WA CLTV = weighted average combined LTV of first lien plus any subordinate lien(s)

Fannie Mae vs. Market View: IO & Option ARM

Countrywide Recent Bid Profile
Interest Only and Option ARMs

Collateral Profile	WAC	WAM	LTV	FICO	ACI	% Low Doc
IO ARM (Std MI)	6.00	359	79.5	727	622	79.6
Pay Option ARM (Std MI)	1.60	359	75.8	721	626	65.1

Fannie Mae vs. Rating Agencies

	IO ARM		Pay Option ARM		
	FM	S&P	FM	S&P - Old	S&P - New
AA Sizing (Fannie Stress)	7.5	3.7	8.5	5.5	6.7
B Sizing (Expected Loss)	1.8	0.4	2.2	0.6	0.8

Fannie Mae vs. MI Companies

	IO ARM	Pay Option ARM
Fannie Mae Value of CE	31.3	44.1
MI Cost for CE	18.7	28.9
MI Execution Benefit	12.6	15.2
Enhancement Levels	2.35% stop-loss, 0.55% deductible	3.85% stop-loss, 0.65% deductible

Market Pricing

	With Credit Enhancement		No Credit Enhancement	
	IO	Pay Option	IO	Pay Option
Competitive Gfee (Charge Fee)	54.0	55.0	54.0	55.0
Gross Model Fee (includes CE cost)	54.5	63.4	105.9	110.2
GAP	-0.5	-8.4	-51.9	-55.2

Notes:
Average Investor Channel charge fee for IO product is 49 bps
Pay Option charge fees reflect recent Countrywide bids vs. private label market.
Freddie Mac recently offered WAMU a mid-30's gfee for high quality Option ARMs

- Fannie Mae's view of risk is significantly different than other market participants
- S&P recently came out with more punitive criteria for Option ARMs
- MI companies price the expected and stress loss levels differently than Fannie Mae
- We need to obtain credit enhancement on the entire loan pool in order to achieve relatively gap neutral mode fees

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FannieMae

Fannie Mae vs. Market View: Subprime

Countrywide Recent Bid Profile
Subprime Market

Collateral Profile	WAC	WAM	LTV	FICO	ACI	DTI
ARM (Charter MI)	7.1	359	78.3	604	561	41.1

Fannie Mae v.s. Rating Agencies

	Subprime	
	FM	S&P
AA Sizing (Fannie Stress)	12.0	12.6
B Sizing (Expected Loss)	3.1	2.0

Fannie Mae v.s. MI Company

	Subprime with Deep CE
Fannie Mae Value of CE	176.0
MI Cost for CE	101.0
MI Execution Benefit	75.0
Enhancement Levels	15.0% stop-loss, 1.50% deductible, Charter Primary

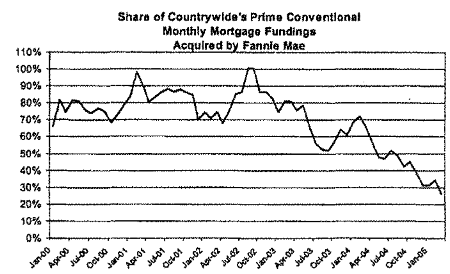
Competitive Alternatives

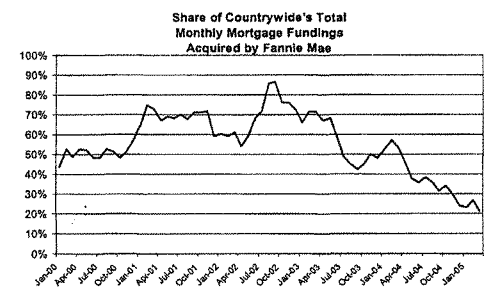
	Subprime	
	With Deep CE	With Charter Min MI Only
Competitive Gfee	130.0	130.0
Gross Model Fee (includes CE cost)	195.0	277.0
GAP	-65.0	-147.0

- Our view of risk for subprime product is more in line with Rating Agencies
- MI companies price the expected and stress loss levels differently than Fannie Mae
- Our execution still significantly off current market levels – market competitive g-fees would result in significant negative gap, even with credit enhancement

Private Label Trends – Products and Risk Appetite

- This trend is increasingly costing us business with our largest customer:





Private Label Trends – Products and Risk Appetite

Countrywide Loan Production
Q1-2005
$ in millions

PRODUCT	Total Countrywide Loan Production	% Total Production	$ UPB Sold to Fannie	% Sold to Fannie
30 FRM	$11,218	38.9%	$5,354	47.7%
15 FRM	2,985	10.3%	2,379	79.7%
FRM ALT-A	4,340	15.0%	646	14.9%
AMORTIZING ARM ALT-A	600	2.1%	403	67.2%
INTEREST ONLY ARM	2,811	9.7%	1,920	68.3%
PAY OPTION ARM	6,889	23.9%	-	0.0%
TOTAL PRODUCTION	$28,843	100.0%	$10,702	37.1%

Pay Option ARM Drill Down
Potential Eligibility Criteria

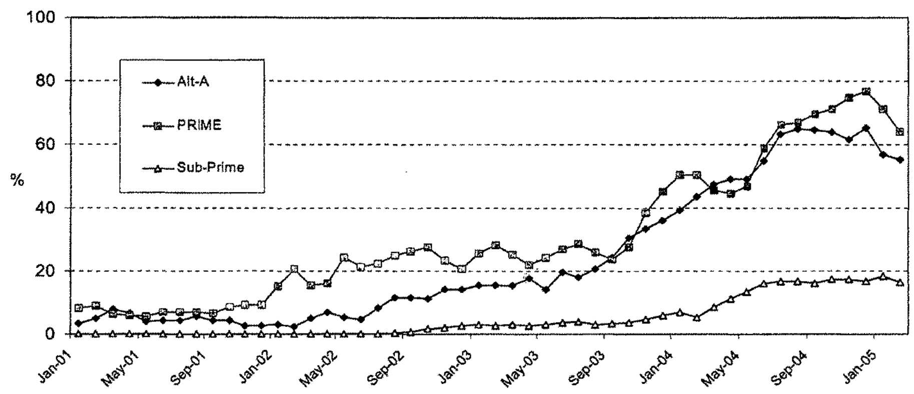
Pay Option	Tight Eligibility Bucket	Broader Eligibility Bucket	Not Eligible
Total UPB	$2,412	$5,670	$1,219
% Investor	22.1	21.6	30.3
% Cashout	38.9	41.8	44.1
% Single-Family	79.8	79.7	69.3
% Full Doc	46.1	36.1	33.6
% with Subordinate Liens	21.2	23.3	27.6
wa Debt Ratio	35.4	35.6	45.0
wa FICO	744.1	721.4	669.1
wa MTMLTV	70.7	73.1	78.3
CreditWorks Model Fee	76	101	219
Gross Model If Credit Enhanced	52	62	n/a
Est Market Price (Charge Fee)	25	50	55

Notes:

- Does not include subprime, second, or government loans.
- Eligibility buckets reflect potential offering to Countrywide for Option ARM product under a forward commitment.
- Tight eligibility bucket could be extended to other lenders on a bulk basis.
- "Not Eligible" category on Option ARMs reflects loans outside our credit risk appetite and/or borrower appropriateness framework.
- Debt ratio (back ratio) estimated from a one-month sample and only includes Full Doc loans.
- Countrywide data file did not include loans sold to Freddie; figures are grossed up assuming a 20% FR share based on Q1 actuals.

Interest Only / Option ARMs Dominate Prime & Alt-A Private Label Deals

IO/ Option ARM Share of Private Label Deals



Source: UBS Mortgage Research 6-7-05 Mortgage Strategist

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Many of the current products in the market today provide for a low payment with increased payment shock over time

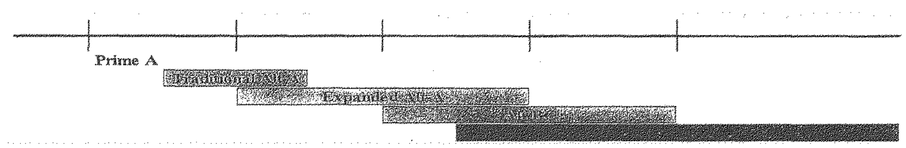
Loan Type	Start Rate	P & I Payment (Initial)	P & I Payment (First Adjustment)	P & I Payment (Maximum Adjustment)	Qualifying Max. Loan Amount
Option ARM (w/ Neg. Amortization)	1.00%	$125	$876	$1,912	$285,714
3/1 IO ARM	5.00%	$625	$904	$1,436	$300,000
5/1 IO ARM	5.13%	$641	$992	$1,376	$292,683
30-Yr. Fixed Rate (w/ 2/1 buydown)	4.25%	$738	$826	$916	$254,096
30-Yr. IO Fixed Rate	6.00%	$750	$1,266	$1,266	$250,000
5/30 IO (35-Yr.)	6.13%	$766	$911	$911	$244,898
40-Yr. Fixed Rate	5.75%	$799	$799	$799	$234,571
5/1 ARM	5.00%	$805	$900	$1,252	$232,852
30-Yr. Fixed Rate (Approve)	5.63%	$863	$863	$863	$217,143

Assumptions: a) $150K loan amount. b) Start Rates based on posted lender pricing. Rates at adjustment assume current index value for the loan type. Option ARM teaser rate of 1% on IO fixed for one year, then moves to 5.25% until first rate adjustment. c) Qualifying max loan amount for all loan types assumes the borrower made $60K and utilizes a 25% qualifying ratio. d) Option ARM qualifying rate of 5.25%. All other loan types qualified at starting payment rate.

Subprime Market Trends

- Market is evolving into a product continuum

($ in Millions)



- Trends towards integration of prime and subprime players:
  - New Century/RBC Acquisition in May 2005
  - Countrywide #1 issuer of subprime and Alt A; #3 issuer in Prime ARM securities in 2004
  - Ameriquest making significant marketing efforts aimed at broad customer base
  - To date, we have not seen any players integrate platform and sales process
- Profit margins in subprime shrinking but are still significantly higher than for prime mortgages

Subprime Market Trends

<u>Key Drivers of Growth in Subprime:</u>

- Broker driven sales process:
  - Subprime generates higher margins and more approvals
- Greater flexibility results in borrower ability to qualify for larger loan:
  - Calculation of income (subprime more flexible on income sources)
  - Higher debt ratios
  - Appraisal values (subprime typically exhibits higher appraisal bias)
- Mortgage Insurance Avoidance:
  - Subprime lenders moving up the credit spectrum results in higher LTV's
  - For marginal borrowers, a subprime loan often costs less than a conventional loan once the MI payment is factored in
- Ability of lenders to transfer risk to capital markets / monetize entire cash flow stream:
  - Strong CDO demand for subordinate bonds means lenders have a steady investor source for riskiest credit
  - Ability to sell off residual cash flows in form of Net Interest Margin (NIM) bonds means lenders can realize more proceeds upfront and reduce exposure to future income fluctuations

Single Family Facts and Data

Home Price Growth and Credit Concerns

Home Price Growth Remains Strong

Region	Annualized HP Growth from TB-RTI* up to 2005Q1		
	Last 1 yr	Last 2 yrs	Last 5 yrs
West South Central	4.7%	3.7%	3.4%
West North Central	6.4%	6.3%	7.3%
East South Central	6.6%	5.3%	3.7%
East North Central	6.8%	5.9%	5.4%
New England	10.9%	10.9%	12.3%
Middle Atlantic	14.6%	13.9%	12.3%
Mountain	22.5%	16.8%	9.4%
South Atlantic	22.7%	17.7%	11.8%
Pacific	22.8%	21.3%	15.5%
US	14.6%	12.7%	9.9%

*TB-RTI: A new home price index estimation methodology that uses data only from purchase transactions.

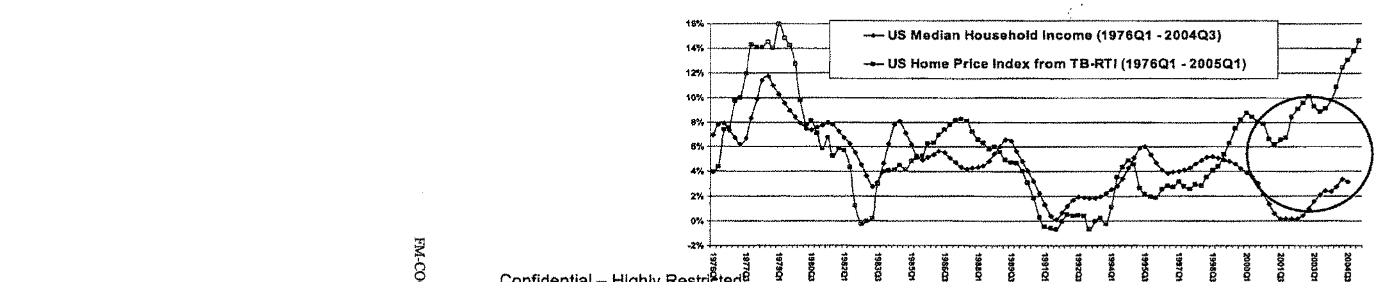
US Housing Market continues with its recent trend:

- High growth rate and high dispersion across geographic locations
- Some observed slowing of growth rates (Southern CA, Las Vegas), but most remain above long-term trend

Home price growth has significantly outpaced income growth:

- Affordability is at historical lows in some markets

US Income Growth vs. Home Price Growth



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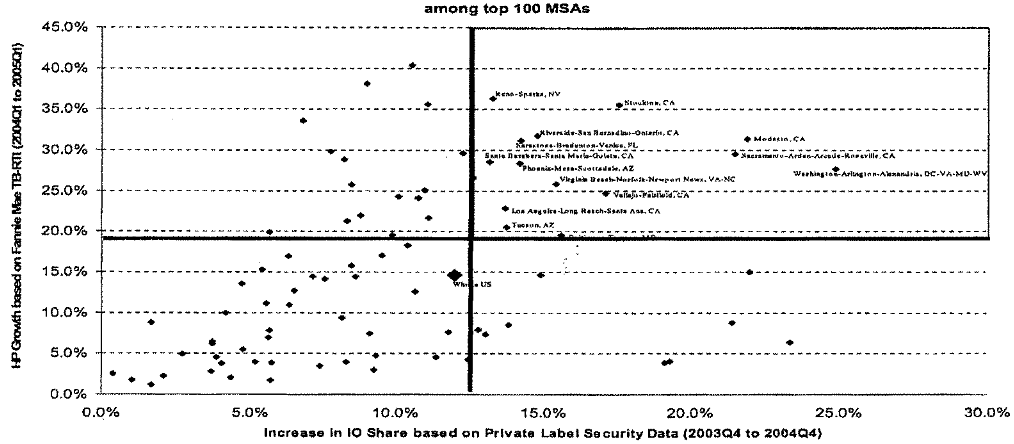
Local Market Focus – I/O Share

- Many of the MSAs that experienced a high annual IO share increase (in excess of 13%) were MSAs that also experienced high home price growth (in excess of 19%) in the last year.

Increase in Interest-Only (IO) Share Vs. HP Growth
among top 100 MSAs



Source: Private Label Purchase Loan Dataset (Economics and Mortgage Market Analysis) & Credit Finance

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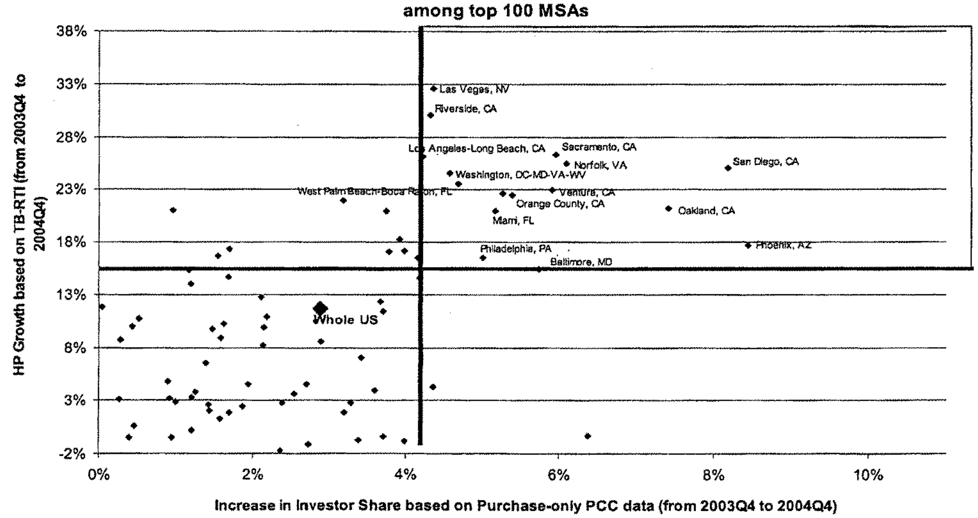
Local Market Focus – Investor Share

- During the last year, many of the MSAs that experienced a high annual increase in investor share (in excess of 4%) were MSAs that also experienced high home price growth (in excess of 15%).

Increase in Investor Share vs. HP Growth among top 100 MSAs



Source: Purchase only PCC data (Economics and Mortgage Market Analysis) & Credit Finance

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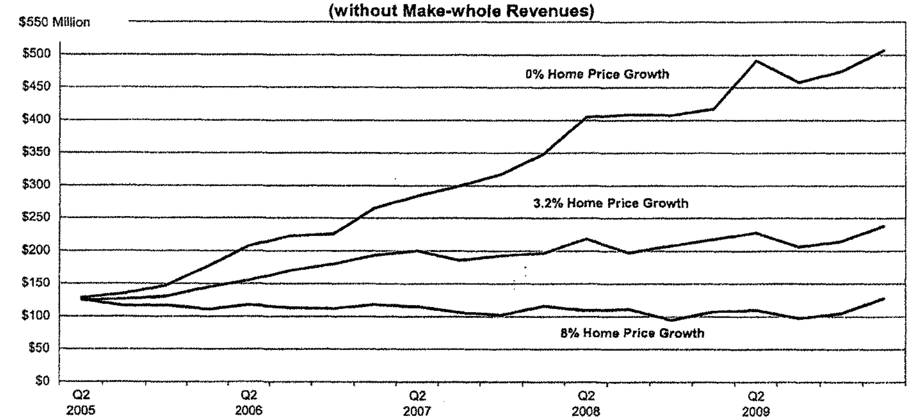
High home price growth tends to reduce credit losses

Forecasted Credit Losses Under Alternative National Home Price Growth Scenarios (without Make-whole Revenues)

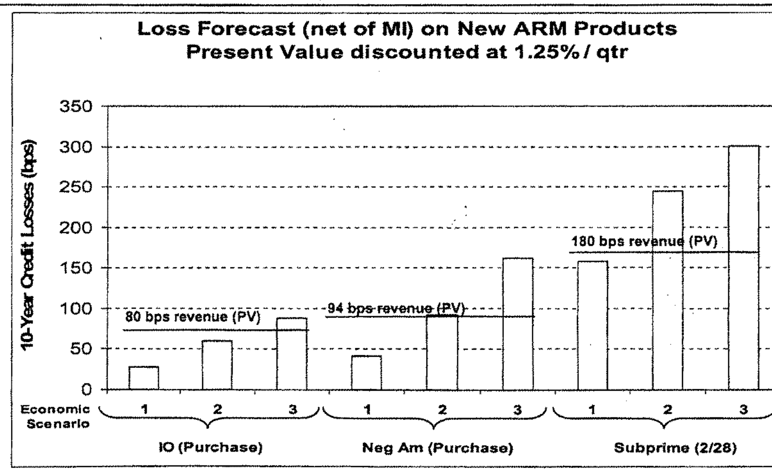


Source: 2005Q2 Loss Forecast Model (LFM) production runs.
All loss figures are as of default date and include charge-off, foreclosed property expense, and foregone interest.

Credit losses on new ARM products would vary under different economic scenarios

Losses were forecast on new ARMs in three different economic scenarios:

1. Corporate Forecast: House prices up 3-4% annually, interest rates up 1% in 1st 5-years
2. Housing Recession in overpriced regions, interest rates increase 1.1% in 1st 5-years
3. Housing Recession in overpriced regions, interest rates increase 5% in 1st 5-years



Single Family Facts and Data

Emerging Products and Product Definitions

Emerging Products: Market View and Fannie Mae Participation

	2003				
	ARM	Low & No Doc	Investor	2nd Home	IO ARMs
	(Share of $ Volume)	(Share of $ Volume)	(Share of $ Volume)	(Share of $ Volume)	(Share of $ Volume)
Prime Conventional Conforming	18.2%	16.7%	6.5%	5.1%	NA
Subprime	80.6%	42.8%	7.2%	1.3%	9.1%
Alt-A	44.0%	65.0%	18.1%	3.9%	25.1%
FNM Participation	13.9%	8.5%	5.5%	5.5%	**1.1%**
% FNM Participation via Inv. Chan	28.7%	77.7%	26.2%	9.0%	47.7%

In 2003, IO ARMs accounted for just 1.1% of FNM's purchase money mortgage acquisitions. In 2004, they accounted for 7.6%

	2004				
	ARM	Low & No Doc	Investor	2nd Home	IO ARMs
	(Share of $ Volume)	(Share of $ Volume)	(Share of $ Volume)	(Share of $ Volume)	(Share of $ Volume)
Prime Conventional Conforming	30.8%	22.3%	8.1%	6.5%	NA
Subprime	88.1%	44.8%	7.5%	1.5%	23.9%
Alt-A	71.1%	57.6%	18.2%	4.7%	50.3%
FNM Participation	24.9%	10.1%	5.6%	7.0%	**7.6%**
% FNM Participation via Inv. Chan	33.6%	80.6%	40.9%	14.8%	71.7%

Source: Economics and Mortgage Market Analysis using Loan Performance.

- Shares of ARMs, Investor and Low Doc products have increased from 2003 to 2004 as measured by purchase money mortgage originations.
  - FNM product shares of ARM, I/O, Low Doc are trailing behind market share.
  - Investor Channel is driving I/O and Low Doc volume.
- Alt A and Subprime are more concentrated in these products.

Product Definitions

- **Interest Only** - A mortgage in which the borrower makes monthly payments for a specified period that cover only the interest due on the loan. During the Interest Only period, the outstanding principal balance of the loan does not decline. After the initial interest only period, the monthly payment is increased to an amount sufficient to fully amortize the outstanding balance over the remaining term of the loan.

- **Hybrid ARM** - A mortgage loan that has an initial fixed rate period, after which the mortgage loan converts to an adjustable rate. An example of a Hybrid ARM is a 2/28 mortgage loan. This is a 30 year adjustable mortgage program, except that the first interest rate adjustment does not occur until 2 years into the loan. Once the loan converts to an ARM, the interest rate adjusts periodically (typically monthly, semi-annually or annually) based on a particular interest rate index (e.g., LIBOR, 1-Yr Treasury).

- **Negative Amortization Adjustable-Rate Mortgage (Neg Am)** - An adjustable rate mortgage that provides for a fixed monthly payment even if the interest rate on the loan changes. Typically, the interest rate on a neg am loan adjust monthly, while the payment stays fixed for a year. If the interest rate increases in a given month such that the monthly payment is insufficient to cover both principal and interest then due, the interest shortage is added to the unpaid principal balance of the mortgage to create "negative" amortization. Most neg am loans have a cap on the maximum amount that can be added to the loan balance over the life of the loan.

- **Option ARM** - An adjustable rate mortgage that gives the borrower various payment options each month. In a typical Option ARM, borrowers have the option to make a minimum payment, which could result in negative amortization if the minimum payment is not enough to cover interest due (similar to the minimum payment on a credit card). They also have the option to make interest-only payments or fully amortizing payments. The expanded payment options give the borrower more leeway to qualify for a mortgage. The 12 month Treasury Average (MTA) is the most common index used with option ARM loans; however, some lenders also offer LIBOR, the 1-Year Treasury Bill, and the 11th District Cost of Funds (COFI) as indices.

From: David A Andrukonis
Sent: Wednesday, September 8, 2004 9:26 AM
To: Mike May
Subject: Re: No Income/No Asset(NINA) Mortgages

Mike,

At last week's risk management meeting I mentioned that I had reached my own conclusion on this product from a reputation risk perspective. I said that I thought you and/or Bob Tsien had the responsibility to bring the business recommendation to Dick, who was going to make the decision. Marty and Patti asked me what it meant that I opposed this product. I said that my job was to speak out to Dick and then to the Board if I thought we were in the wrong place on business or reputation risk. I think of this letter as comparable to the one Don B sent Paul. What I want Dick to know is that he can approve of us doing these loans, but it will be against my recommendation. I wouldn't be surprised if he disagrees with my conclusion. The "as soon as practicable" phrase was to reflect the fact that business realities may dictate the timing of our action, even if you agree with my position. I think I would wait for the business if it were a line we were contemplating entering. But since we've been in this one for some time, I think I should speak as soon as I reach a conclusion. In writing it I actually felt more like I was late. Let's talk.

DA

Mike May
09/07/2004 06:43 PM
To: David A Andrukonis[redacted]
cc:
Subject: Re: No Income/No Asset(NINA) Mortgages

Wow.

This seems a bit premature. I am not sure what you are trying to accomplish......I would have expected you to wait until we had made a decision and a firm recommendation and then perform an oversight role on that decision.

I will call you and discuss this when we both have a chance.

Mike May
Mortgage Sourcing, Operations and Funding
Committed to Integration and Execution
Office: [redacted]
Fax: [redacted]
Cell: [redacted]

David A Andrukonis
Sent by: Donna L Cogswell

09/07/2004 04:41 PM
To: Dick Syron[redacted] Mike May[redacted] Robert Tsien[redacted] Patricia Cook[redacted] Clarke D Campe[redacted] Susan W Gates[redacted]
cc: David A Andrukonis[redacted]
Subject: No Income/No Asset(NINA) Mortgages

The purpose of this e-mail is to document my recommendation regarding NINA mortgages. I've come to my conclusion after studying data from three major lenders and comparing notes with other risk managers in the industry. Mike May and Bob Tsien are working to get this issue before you formally in the near future.

Recommendation

Freddie Mac should withdraw from the NINA market as soon as practicable. Our presence in this market is inconsistent with a mission-centered company and creates too much reputation risk for the firm.

Background

The NINA mortgage was created over 20 years ago as a way of serving borrowers with inconsistent income patterns (actors, the self employed, etc.) but strong credit profiles and downpayments. In addition, the product served borrowers who, for whatever reason, did not want to report their income. Over time, other mortgage products and underwriting practices evolved, making NINA mortgages less common. Specifically, Freddie Mac's Loan Prospector and other automated underwriting services began to recognize that income was less predictive of default than previously thought, and consequently traditional guidelines around housing expense to income ratios were eased. Other mortgage products, such as stated income/stated asset (SISA) mortgages, arose that accommodated borrowers who didn't want to be hassled with providing their income.

The NINA product we are being sold today differs substantially in the niche it is trying to reach. Today's NINA appears to target borrowers who would have trouble qualifying for a mortgage if their financial position were adequately disclosed. The best evidence of this is the first year delinquency rates on these mortgages, which range from 8 to 13%, depending on the lender. We conducted a quality control review of NINA loan files and found that nearly two-thirds of the time a spouse was dropped from the note. This means that the borrower with the weaker credit score was probably not adequately considered in the underwriting process. Our underwriting system uses credit data from both spouses, when available, because we have found the weaker borrower to be predictive of default. Typically, borderline borrowers need both incomes to meet minimum income thresholds. However, since, by definition, NINA mortgage underwriting ignores income, originators can advise spouses with weaker credit to only include the stronger of the two borrowers on the application.

An additional problem with these mortgages is that it appears they are disproportionately targeted towards Hispanics. The potential for the perception and the reality of predatory lending with this product is great. In 2003, 5.5% of Freddie Mac single-family loans were made to Hispanics. This compares with 18% of the NINA type loans we sampled that went to Hispanics.

The HMDA data paint a similar picture with 16% of no income documentation loans going to Hispanics, versus 10% of total conforming mortgages.

Exiting the NINA market would be difficult and expensive, but there is also an opportunity. Certainly lenders would criticize us because our withdrawal might affect their margins on this business. Freddie Mac would also stand to lose $25 to 50 million in annual profits. Finally, since NINA loans are minority rich, it will make it even more difficult to match the private market level of minority and underserved mortgage production.

On the other hand, what better way to highlight our sense of mission than to walk away from profitable business because it hurts the borrowers we are trying to serve? What better way to highlight the problem with linking the assessment of our progress to hitting the HMDA data? In my judgment, matching the market's production of underserved and minority borrowers will require us to engage in market practices that are at odds with our charter if it requires us to make a market in NINA mortgages.

From: Mudd, Daniel H [redacted]
Sent: Tuesday, July 17, 2007 6:57 AM
To: Dallavecchia, Enrico [redacted]
Subject: RE: Budget 2008 and strategic investments

My experience is that email is not a very good venue for conversation, venting, or negotiating. If you feel you have been dealt with in bad faith, address it man to man, unless you really want me to be the one to carry messages for you to your peers--- and they are peers. If you feel the process is not working, you know my door, telephone and house are open to you. I am not aware that you have sought to do so on this topic.

If there is any data in the company, you as a senior person, who is supposed to be able to see the top risks and goals of the company, are not privy to, let me know, you will have it--- to make decisions, but not to negotiate for your group or against any other. And of course, you may say anything you believe to be true, at any time, to anyone on the Board or anywhere else. And I believe it is innacouate for you to suggest anyone expressed a view that there are enough resources for anyone to do everything necessary for the plan. Resources are tight. Everyone has cuts.

Please come and see me today face to face.

-----Original Message-----
From: Dallavecchia, Enrico
Sent: Monday, July 16, 2007 10:15 PM
To: Mudd, Daniel H
Subject: Budget 2008 and strategic investments

Dan, see the email below to Mike.

In a nutshell, I am very upset as I had to stand at the Board meeting today and hear that we have the will and the money to change our culture and support taking more credit risk. This is not evidenced in the proposal to cut my budget in 2008 by 16pct (sixteen) after in 2007 with reorganizations and consolidation I cut headcount by 25pct (and budget probably over 20pct).

My main concerns are:

1. I am given a number from Steve without any consultation with me or my people on what we did this year and what we need next year (indipendent from the new strategic plan). I wasn't treated like this even when I was three level downs from the CEO.

2. I have no visibility on the rest of the company, on the trends in the last 3 years (CRO is about 33mm additional budgets, who else is spending the other 470mm from three years ago when revenues have been growing single digit, and in some business they have been down for the past 3 yrs). if I am a member of the management team I should have a say (not only visibility, which I also don't ave) on how and where we cut, otherwise it is a travesty that I work for you, I may as well work for Rob or Mike.

3. It was inappropriate what was said today to the Board as if I had all the necessary means and budget to act on the strategic plan. I do not even think that with what I was given for 2008 is adequate for the current risk, considering how far we already are from adequate market practices. I had no part in some Board members asking questions on having the means to execute, but I cannot let the impression stand, as my credibility and reputation with them will be at stake.

4. I am more than anything very upset because I thought I had joined a team and I realize I am in the usual place where people smile and act nicely but they keep running the company as they always did. I can only infer malice from some of your directs when we come from the control history we have as a company, and when they are fully aware that CRO is in full build up mode, that I took leadership not only in cutting expenses for CRO but for the whole risk discipline this year, and that I have been saying that we are not even close to have proper control processes for credit, market and operational risk. I get a 16pct budget cut. Do I look so stupid? And if they didn't act with malice, I would propose that maybe they don't get how you run budget custs.

please tell your directs (Mike, and Rob) to spare me the story about 'this is only the first cut, it is a proposal, tell us what you need by all means'. I went through many cost cutting and I did many too, I have been in some of the most politicized companies in banking, I did cutthroath merger, tell them to spare me the story, they already lost much of my respect, they don't want to lose all of it.

For the two of us we need a heart to heart conversation when we meet on Thursday. I am sure you have not seen these figures or approved them and that you would never hand me a budget cut, even minimal, without sitting down with me and discussing what I think is necessary to run CRO and risk ingeneral for the company.

In the meantime I ask that you make sure we stay way clear from the comments made today about having the budget and the will to execute this strategic plan, because the last think I want is to be forced to say that I disagree and embarass you in front of the Board.

Enrico Dallavecchia
[redacted]

-----Original Message-----
From: Dallavecchia, Enrico
Sent: Monday, July 16, 2007 09:33 PM Eastern Standard Time
To: Williams, Michael (COO)
Subject: RE:

Mike, I got no say and no input in building of the budget I was given. And I can only assume tha those that built it were knowledgeable of the build up state of CRO and of the fact that last year CRO took a 25pct headcount reduction, when the company avererage 10pct (and I am not even counting Andy Leonard reductions or those done in Single Family, all work that we took to increase efficiency).

Doing the budget for nxt year off my forecast and with a 16pct further reduction in budget is at best being ill informed or maybe I sdue to malice. I find it offesive to my intelligence and that of my staff

The company has one of the weakest control processes I ever witness in my career. We have barely started to work on it, we took significant costs out of the company while during our job and we still get a 16pct reduction this year?

This tells me that people don't care about the function or they don't get it. I sat tight today at the Board meeting when representations were made after some Board members asked about the funding of the new strategy that we have it. This is inconsistent with the cuts I did last year and the cuts I am asked to make. And we have not even address taking more credit risk.

I can't let the Board think that CRO is showered with money, not with what we spent this year and certainly not with what I have got as budget for next year. This is even before we consider what needs to be done to take more credit risk. What do you think it is going to be, adding 3 people in CRO and run up a fee billions of revenues?

This company really doesn't get it, we are not even current and we are already back to the old days of scraping on controls and people can can set up proper controls to reduce expenses.

And giving me a number to ask for pushback it is treating me liike a child or a second class citizen.

I cannot convey in writing my disappointment on this whole situation, I expected better from this company. This is a very sad day.

Enrico Dallavecchia
[redacted]

-----Original Message-----
From: Williams, Michael (COO)
Sent: Monday, July 16, 2007 09:01 PM Eastern Standard Time

To: Dallavecchia, Enrico
Subject:

Enrico:

You should assume that the team built the budget targets off of your current forecast. Given the importance of the CRO function, we would expect you to push back and tell us where you need to be next year. The team, absent your inputs, is (or can) only make assumptions about what makes sense to you given your current rate of spend. Steve (and the team) shared your concerns with me and I have said that I would expect we will need to up the number but Enrico should opine.

Separately, this does not include any "initiative" money that you need for 2008.

Mike

From: Mudd, Daniel H [redacted]
Sent: Sunday, October 29, 2006 12:42 PM
To: Dallavecchia, Enrico [redacted]
Subject: RE: Subprime

This is a serious matter and if the facts are supportive, we (you and I) will come down hard.

Daniel Mudd

-----Original Message-----
From: Dallavecchia, Enrico
Sent: Saturday, October 28, 2006 01:39 PM Eastern Standard Time
To: Mudd, Daniel H
Subject: Subprime

Dan, I have a serious problem with the control process around subprime limits.

The business actions in terms of ramping up business much faster than what would be consistent with the $5bn limit for year end we agreed upon less than two months ago is de facto preventing me to exercize my reserved authority to determine limits without damaging relationships with customers.

This is on top of the recent lack of process on the Chase deal (also a limit excess on concentration and debt to income ratios), and after we approved twice (in March and in June) to buy subprime loans without having completed the new business initiative.

There is a pattern emerging of inadequate regard for the control process.

We need to talk on Monday.

Enrico Dallavecchia
Fannie Mae
[redacted]

-----Original Message-----
From: Levin, Robert
Sent: Friday, October 27, 2006 03:55 PM Eastern Standard Time
To: Mirras, Sal; Lund, Thomas A; Dallavecchia, Enrico; Johnson, Pamela; Shaw, Michael A
Subject: RE: REQUEST

I'd like Tom L. to tell us what the business is going to do consistent with today's direction.

R.

From: Mirran, Sal
Sent: Friday, October 27, 2006 3:46 PM
To: Levin, Robert; Lund, Thomas A; Dallavecchia, Enrico; Johnson, Pamela; Shaw, Michael A
Subject: REQUEST

All,

We had a 3pm call re Chase to decipher exactly what it was Chase wanted and we would want to attempt to deliver.

There is a $600-$800mm tape of current production coming Monday. That is the deal they really want us to look at and tell them if we have general appetite [vs an immediate actual bid] by COB today, and bid next week.

Separately, they have sent over a $3.6bn tape of seasoned paper, that to them is lesser priority, but we are invited to pick through for goals if we'd like.

The spirit of the limit memo we wrote really only envisioned the incremental $600-$800mm to get to the proposed $7bn. We have been given the go-ahead, I believe, to proceed on a deal-by-deal basis.

However, there was also some direction at Alignment to pursue goals.

Thus, the question is: knowing there are other non-Chase deals likely coming, shall we now proceed with the $600-$800mm on the new deal-by-deal protocol, AS WELL AS a selection [of roughly about $750mm-$1.25bn] from the $3.6bn, or only the former?

Sal

Purchase of AA and A-Rated Sub Prime Private Label Securities

New Business Initiative presented to
Credit Risk and Market Risk Committees

May 2, 2007

FannieMae

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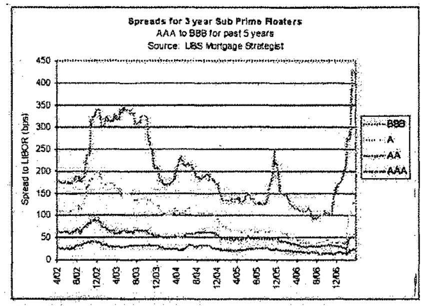
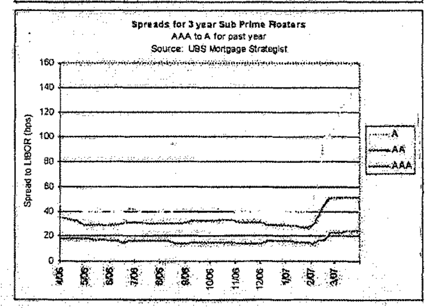
Business Opportunity

- Buying PLS below AAA is a corporate objective
  - We are experienced investors in AAA
  - We want to go down the credit spectrum for both value and mission purposes
- **Sub prime spreads have widened dramatically to their widest level in years**
- We do not feel there is much risk in going down to AA and A
  - We have developed new metrics and processes to assess where to find value
  - We feel our current credit analytics, pre-purchase due diligence, and surveillance process are adequate down to AA and A
  - We don't expect to take losses at the AA and A level
  - Eventually we want to go to BBB, and this will give us a chance to learn
- **We anticipate being able to buy $2 billion in AA and A over the next year (with a proposed purchase limit of up to $3 billion)**
- Project Value of $82 million (calculated by BA&D)
- **We want to move quickly while the opportunity is still there**





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Credit Analysis

Risk of losses in AA and A is low…

Bond Cumulative Expected Loss								
Rating Class		Aaa	Aa1	Aa2	Aa3	A1	A2	A3
No. of Bonds Included		113	81	112	88	81	111	107
Average		0.0004%	0.001%	0.048%	0.118%	0.17%	0.63%	1.43%
Stdev		0.0046%	0.006%	0.119%	0.267%	0.16%	0.87%	2.03%
Min		0.0000%	0.000%	0.000%	0.000%	0.00%	0.00%	0.00%
Max		0.0487%	0.048%	0.850%	2.176%	0.87%	4.45%	10.29%

…but credit analysis is required for security selection.

Deal Name: SASC07-WF1					Servicer / Originator: Wells Fargo	
Settlement Date: 20070328					2,000 Simulations as of Q4 2006. All Loss Discounted at Libor, off Original HPA Distribution	
Tranches	Original Support	Rating	Discount Margin	Price	Expected Loss (as % of face amount)	Individual Bond Stress (99.5%) Loss
A1	18.35	Aaa	21	100	0.00%	0.00%
A6	18.35	Aaa	21	100	0.00%	0.00%
A2	53.03	Aaa	9	100	0.00%	0.00%
A3	45.02	Aaa	18	100	0.00%	0.00%
A4	25.88	Aaa	20	100	0.00%	0.00%
A5	18.35	Aaa	31	100	0.00%	0.00%
M1	14.65	Aa1	44	100	0.00%	0.00%
M2	12.30	Aa2	49	100	0.00%	0.00%
M3	10.70	Aa3	67	100	0.00%	0.00%
M4	9.15	A1	100	100	0.01%	0.00%
M5	7.65	A2	115	100	0.07%	0.00%
M6	6.55	A3	150	100	0.17%	0.00%

Deal Name: FFMER07-WF1					Servicer / Originator: First Franklin (HLS)	
Settlement Date: 20070327					2,000 Simulations as of Q4 2006. All Loss Discounted at Libor, off Original HPA Distribution	
Tranches	Original Support	Rating	Discount Margin	Price	Expected Loss (as % of face amount)	Individual Bond Stress (99.5%) Loss
A1	16.20	Aaa	14	100	0.00%	0.00%
A2A	16.20	Aaa	12	100	0.00%	0.00%
A2B	16.20	Aaa	17	100	0.00%	0.00%
A2C	16.20	Aaa	25	100	0.00%	0.00%
A2D	16.20	Aaa	34	100	0.00%	0.00%
M1	13.10	Aa1	38	100	0.00%	0.00%
M2	10.40	Aa2	50	100	0.00%	0.00%
M3	8.75	Aa3	70	100	0.01%	0.00%
M4	7.30	A1	125	100	0.05%	0.00%
M5	5.90	A2	135	100	0.14%	0.00%
M6	4.85	A3	150	100	0.30%	14.94%

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Low Risk of Loss with AA and A

Past sub prime stress analyses show sub prime AA and A bonds are very resilient

	CRO Stress Scenario			
Moody's Rating	No. of Bonds in Deals in our PLS Book	No. of Bonds Projected to Take Loss	Average Magnitude of Projected Loss	Bond's Expected Loss (% of face amount)
Aaa	274	0	0.00%	0.00%
Aa1	210	0	0.00%	0.00%
Aa2	291	0	0.00%	0.00%
Aa3	229	0	0.00%	0.00%
A1	221	0	0.00%	0.00%
A2	290	0	0.00%	0.00%
A3	267	1	100.00%	0.37%

Stress Scenario

	Year 1	Year 2	Year 3
Interest Rates	+200	Flat	Flat
House Price Appreci-ation	-5%	-5%	Flat

	CRO Super Stress Scenario			
Moody's Rating	No. of Bonds in Deals in our PLS Book	No. of Bonds Projected to Take Loss	Average Magnitude of Projected Loss	Bond's Expected Loss (% of face amount)
Aaa	274	0	0.00%	0.00%
Aa1	210	1	26.33%	0.13%
Aa2	291	2	77.52%	0.53%
Aa3	229	10	49.30%	2.15%
A1	221	26	60.78%	7.15%
A2	290	78	61.84%	16.63%
A3	267	142	71.24%	37.89%

Super Stress Scenario

	Year 1	Year 2	Year 3
Interest Rates	+200	+200	Flat
House Price Appreci-ation	-10%	-10%	Flat

Enhanced Risk Management

Our enhanced pre-purchase credit analysis and due diligence process and will enable us to identify value

Prepurchase Analytics

- Pre-purchase review (not essential for AA and A, but useful) will include:
  - Loan level collateral performance projections
  - Loss coverage multiples
  - Bond losses
  - Housing goals
  - Collateral composition benchmarking, including multivariate stratifications
  - Counterparty approval
  - Analyst commentary
  - Credit recommendation
- Will employ Economic Capital framework for valuing AA and A
- Working with outside counsel to draft a Pooling and Servicing Agreement to further protect our interests
- Will also perform loan level diligence on a select deal for learning/ preparation for BBB

Ongoing surveillance

- Current system and processes (with minor changes) will be sufficient for AA and A
- Will engage OfficeTiger (outsourced surveillance provider) on one of the first deals for learning/ preparation for BBB

Implementation Plan

We plan to implement the required changes to our processes and policies in an accelerated manner

Step	Target Date
Credit models in place	Complete
CMS credit model implementation approved	Working with CRO
Calibrate models (house price path)	Before first deal
Implement pre-purchase analytics form	Complete
Update PLS Risk Policy	Upon NBI approval
Tape cracking process in place	Before first deal
Economic Capital Framework in place	Before first deal
Work with dealers to create the structures we want	Upon first deal
Use OfficeTiger for surveillance	One of first deals
Loan level due diligence executed on selected deal	One of first deals
Update procedures	June 30
Update surveillance metrics for Watch List	June 30
Hire additional CMS staff	TBD
Identify PSA best practices	In preparation for BBB

New Business Initiative Assessment Questionnaire
Purchase of Sub Prime PLS rated AA and A

GENERAL RISK/RETURN DESCRIPTION

Why is the business initiative being undertaken? (Describe the initiative, key objectives and how it fits into the Business' strategic plan.)

Capital Markets is seeking to invest in private label securities (PLS) rated AA and A (i.e. between AA+ and A-) and backed by sub prime conforming loans. Capital Markets wishes to prudently participate in this market as an extension of Fannie Mae's mission to bring liquidity to the mortgage market, to support affordable housing, and to profit from attractive returns when available. Recent spread widening in the sub prime market has made investments in these securities especially attractive from a risk/return perspective. Furthermore, as a result of the widening spreads, credit standards appear to be returning to the sector, making the bonds safer.

This New Business Initiative (NBI) is the first phase of a two-phase process. The second phase will entail investing in sub prime PLS down to the BBB level. Capital Markets will decide on the appropriate time to submit the second phase for approval as an NBI.

This NBI is a key part of both the corporation's and Capital Market's strategic plans of becoming sophisticated investors in lower-rated tranches (below AAA) of structured securities as well as in sub prime collateral. As the company becomes experienced in managing the risk of these lower-rated tranches and collateral, we will earn commensurately higher returns. As a result of the well publicised subprime shakeout, the investor base for this product has dried up. CDOs, which were once the most aggressive bid, have gone away. Thus, this NBI directly supports one of Fannie Mae's corporate objectives this year to grow the business while at the same time it supports the company's mission to provide liquidity to this market.

Capital Markets considers this to be a Corporate NBI because the company has not previously invested in PLS securities at the AA and A level (although it has at the AAA level). Moving in this direction increases the level of credit risk and sub prime exposure that we face as a company. Capital Markets wants to ensure that there is adequate support, approval and oversight from across the company as we move in this direction.

What are the major credit, market, operational, or other risks associated with the proposed business initiative? (Qualitatively assess the significance of these risks to the success of the initiative and performance of the business.)

Credit risk
Investments in lower-rated tranches generally are correlated with a higher probability of downgrade or credit losses. However, we believe that by performing pre-purchase due diligence and credit analysis we can mitigate the chance of downgrade or losses.

- We plan to employ Fannie Mae's credit models and expertise in this space to select investments that either do not experience losses or are priced so as to compensate for any losses.
- Furthermore, we recognize that these securities are complex financial instruments with structured cash flow rules which can be affected by servicer practices. We plan to work more closely than we have in the past with servicers of these PLS in order to mitigate losses post-purchase.
- We also plan to draw upon resources in other parts of Fannie Mae, such as the Automated Valuation Model and Servicing Scorecard developed by the Single Family business, and where appropriate use them in the evaluation process for these securities.
- In addition, we plan to employ the services of third party pre-purchase due diligence and/or bond surveillance providers when appropriate in order to enhance our own due diligence process.
- There is also significant credit risk associated with buying PLS of an originator who is facing

bankruptcy. These pools are more likely to contain fraud. We will be selective in choosing well-capitalized counterparties.

Market risk
These securities are generally less liquid than AAA securities, but a liquid secondary market does exist. We will limit the size of the PLS portfolio rated below AAA so as to not reduce the overall liquidity of Fannie Mae's PLS portfolio.

Operational risk
In the past we have not performed the type of loan level diligence we are proposing for purchases below AAA. As a consequence, we will likely encounter some challenges in establishing our due diligence processes.

Other challenges may include:

- Securities will have to be constructed by the dealer community in order to meet Fannie Mae's conforming loan requirements. It is not certain that the dealers will do so.
- There may also be accounting items as well as housing goals issues to be resolved.
- Executing and managing these investments requires an extensive, ongoing coordination across multiple business units.

The business units involved in pricing the securities and managing the risk will continue to work closely through both formal and informal relationships in order to execute effectively. Committees such as the Credit Risk Committee and the Private Label Advisory Team will continue to provide forums for coordination and oversight of the activities related to this portfolio. We will also develop PSAs that will contain industry best practices proven to mitigate operational risk.

What is the risk/return strategy associated with the proposed business initiative?

Capital Markets and Business Analytics and Decisions (BA&D) are jointly developing a return on economic capital framework to assess risk and return for investing in subprime PLS rated below AAA. Due to the nature of the capital structure of the AA and A bonds, we anticipate that regulatory capital will be higher than economic capital for these PLS, implying a higher return on economic capital than the AAA subprime PLS and most other investment opportunities available to Fannie Mae.

SPECIFIC RISK ISSUES

Does the existing management and organizational infrastructure support the proposed business initiative and required operations? (If not/if not now, describe the changes required and the plans to address the gaps.)

The technical skills and tools are largely in place to support the proposed NBI. With the implementation of the Capital Markets Strategy (CMS) PLS Prepurchase Analytics Process (including a form to be completed by the CMS PLS team), the required analytics are already in place. We believe that the current surveillance process is sufficient for PLS rated down to A (but not for PLS rated below A). The largest operational issue with respect to assessing the risk is that the CMS PLS team does not currently have access to any corporate-approved implementation of BA&D's credit risk models. CMS PLS will seek temporary approval from the Model Validation team of Market Risk Oversight to implement for their own purposes a version of the approved credit risk models.

Will existing (credit, market, operational) policies, standards, tolerances and procedures provide sufficient guidance for the management of the risks associated with the proposed business initiative? (If not, describe the changes required and the plans to address the gaps.)

The Private Label Advisory Team (PLAT) requests to CRO as part of this NBI process that the Private Label Securities Risk Policy be updated to allow for purchases of PLS below AAA. Furthermore, the team requests that we introduce a PLS purchase limit of $3 billion in new acquisitions through May 31, 2008 for sub prime securities rated between AA+ and A-.

Will the existing systems/technology infrastructure effectively support the proposed business initiative? (If not/if not now, describe the key requirements and the plans to address the gaps.)

Yes, with the aforementioned caveat that the CMS PLS team does not have access to the corporate-approved implementations of BA&D's credit models and that CMS PLS will have to implement a version of the approved credit risk models for the purpose of evaluating sub prime PLS.

Are there any reputation risk issues, laws and/or regulations affecting the proposed business initiative that pose special concerns?

There are possibly some reputation risk issues related to investing in sub prime, but Fannie Mae already has made a decision to participate in this market and to manage the related reputation risk. We currently have approximately $46 billion of sub prime PLS securities in our portfolio, so investing below AAA would only mean that Fannie Mae is participating in another portion of the security structure.

The Housing Goals Steering Committee is currently considering how these securities will count towards regulatory housing goals as determined by Fannie Mae's mission regulator, the Department of Housing and Urban Development (HUD).

Do we understand the appropriate accounting, financial reporting, and tax treatment for this business initiative, and do we have the ability to execute those requirements (including any impact on the allowance for loan losses, as appropriate)?

Yes. The accounting, financial reporting, and tax treatment for these securities is similar (if not identical) to the treatment for AAA-rated securities. We will notify Impairment Accounting that Capital Markets intends to begin making investments in these securities. While we anticipate no immediate impact, we nevertheless want Impairment Accounting to be aware of the higher credit risk of the securities.

PERFORMANCE MONITORING

What specific limits, constraints and review points should be associated with the proposed business initiative?

Capital Markets requests a PLS purchase limit of $3 billion in new acquisitions through May 31, 2008 for sub prime securities rated between AA+ and A-. The PLAT will report quarterly to the Credit Risk Committee (as part of the regularly scheduled Private Label Securities Update) the status of PLS purchases below AAA. Capital Markets will notify the VP – Credit Risk Oversight, Capital Markets for the first few purchases of PLS rated below AAA. The VP – Credit Risk Oversight, Capital Markets currently attends the bi-weekly PLAT meeting, at which Capital Markets apprises the PLAT of developments in this sector. We anticipate that the VP – Credit Risk Oversight, Capital Markets will provide close and extensive oversight of this NBI.

How will we monitor the performance of the proposed business initiative and the implementation

of business and risk management requirements that have been defined in this assessment – e.g., organizational infrastructure, policies/procedures and technology/processes? (Describe the key requirements of and the plan to implement the monitoring/reporting process.)

Capital Markets will appoint a project manager to track implementation of following items:

Business and risk management
- Tracking and reporting of size of portfolio rated below AAA.
- Tracking and reporting of losses on the PLS portfolio.

Organizational infrastructure
- Appointment of individual(s) to perform AAA to A pre-purchase analytics.
- Appointment of individual(s) to perform AAA to A surveillance.

Policies
- Completion of policy changes.

Technology/processes
- Approval for implementation of credit models.
- Implementation of pre-purchase analytics form.
- Completion of procedures documenting the pre-purchase process.

EXIT STRATEGY

What is the exit strategy for this proposed business initiative if, after monitoring, it appears that the risks are no longer acceptable to the company or the business initiative does not meet return or other business expectations, and what are the appropriate criteria to determine if we should exit?

Capital Markets may at any time choose to cease purchasing these securities and/or conduct sales of purchased securities.

New Business Initiative Checklist

Sponsoring business unit and lead:	Sponsoring Unit: Capital Markets Leads: Ramon de Castro, David Gussmann	
Product Description: (including purpose, dependencies, description of any key attributes, etc.)	Investments in tranches of sub prime private label structured securities rated AA and A	
Risk Limits: (e.g. term, volume, # lenders/issuers)	• $3 billion purchase limit on PLS rated below AAA until May 31, 2008 • Only tranches backed by sub prime collateral and rated between AA+ and A- will be purchased	
Signature (or designee)	Approval	Approval Conditions/Comments (attach if needed)
Ramon de Castro **Date** **SVP – Capital Markets Mortgage Assets** **(Initiative Leader)** **(PLAT Voting Member)**	Yes ☐ No ☐	
David Gussmann **Date** **VP – Capital Markets Strategy** **(Initiative Leader)** **(PLAT Voting Member)**	Yes ☐ No ☐	
Peter Niculescu **Date** **EVP – Capital Markets** **(Business Unit Head)** **(Capital Markets Business)**	Yes ☐ No ☐	
Bill Quinn **Date** **SVP – Capital Markets Strategy** **(Business Unit Risk Officer)** **(PLAT Voting Member)**	Yes ☐ No ☐	
Steven Shen **Date** **VP – Capital Markets Mortgage Assets** **(PLAT Voting Member)**	Yes ☐ No ☐	
Kin Chung **Date** **Director – Capital Markets Strategy, PLS** **(PLAT Voting Member)**	Yes ☐ No ☐	

New Business Initiative Checklist

Paul Weech **Date** **VP – Housing Goals** **(Housing Goals Office)**	Yes ☐ No ☐	Note: Contact person is Sara Feder.
Mark Winer **Date** **SVP – Business Analysis and Decisions** **(Business Analysis and Decisions)**	Yes ☐ No ☐	Note: Contact person is Tarun Chopra.
Scott Lesmes **Date** **SVP – Deputy General Counsel** **(Legal)**	Yes ☐ No ☐	
Bill Senhauser **Date** **SVP – Chief Compliance Officer** **(Compliance and Ethics)**	Yes ☐ No ☐	
Monte Shapiro **Date** **SVP, Capital Markets/CRO Technology** **(Technology: BU Technology)**	Yes ☐ No ☐	
Brian Cobb **Date** **SVP, Enterprise Systems Management** **(Technology: Enterprise Systems Management)**	Yes ☐ No ☐	
Rich McGhee **Date** **SVP, Corporate Systems** **(Technology: General Business Systems)**	Copy Only No signoff required	Note: Signature not required because this initiative does not affect administrative systems (PeopleSoft, HR related systems, etc.)
Luiz de Toledo **Date** **SVP and CAO, Technology** **(Technology)**	Yes ☐ No ☐	
Scott Blackley **Date** **SVP and CFO – Capital Markets** **(Chief Financial Officer)**	Yes ☐ No ☐	
Greg Kozich **Date** **SVP – Accounting Operations** **(Controller)**	Yes ☐ No ☐	

New Business Initiative Checklist

Greg Ramsey — Date **VP – Accounting Policy (Accounting Policy)**	Yes ☐ No ☐	
John Gibson — Date **VP – Policy, Communications (Corporate Communications)**	Yes ☐ No ☐	
Sharon Canavan — Date **Director, Government Relations (Government & Industry Relations)**	Yes ☐ No ☐	
Mary Doyle — Date **SVP – Finance (Tax)**	Yes ☐ No ☐	
Caroline Herron — Date **VP, SOX Strategy & Execution (SOX)**	Yes ☐ No ☐	
Maria Schultz — Date **VP, MBS Program Office (MBS Program Office)**	Yes ☐ No ☐	
Lesia Bates Moss — Date **VP – SF Counterparty Risk Management (PLAT Voting Member)**	Yes ☐ No ☐	
Jon Roman — Date **VP – Counterparty Risk Oversight (Corporate Counterparty Risk Oversight)**	Yes ☐ No ☐	
Mike Shaw — Date **SVP – Credit Risk Oversight (Credit Risk Oversight, Loss Allowance)**	Yes ☐ No ☐	Note: Contact persons are Robert Bowes and Ben Perlman.

New Business Initiative Checklist

Clinton Lively — Date **SVP – Market Risk Oversight** **(Market Risk Oversight, Model Oversight and Capital Methodology)**	Yes ☐ No ☐	Note: Contact person is Scott Chastain.
David Sykes — Date **VP – Model Review** **(Market Risk Oversight, Model Oversight)**	Yes ☐ No ☐	
Angela Isaac — Date **SVP – Operational Risk Oversight** **(Operations Risk Oversight)**	Yes ☐ No ☐	Note: Contact person is TBD.
Betsy Ashburn — Date **Chief Audit Executive** **(Internal Audit)**	Copy Only No signoff required	
Mary Lou Christy — Date **SVP – Investor Relations** **(Investor Relations)**	Copy Only No signoff required	Note: Contact person is Catherine Constantinou.
Enrico Dallavecchia — Date **EVP – Chief Risk Officer** **(Chief Risk Officer)**	Yes ☐ No ☐	
Carolyn Groobey/Mercy Jimenez — Date **SVP – Corporate Strategy** **(Office of Corporate Strategy)**	Yes ☐ No ☐	

Changes to Private Label Securities Risk Policy for New Business Initiative
"Purchases of Sub Prime MBS rated AA and A"

Added to **Responsibilities for SVP – Capital Markets Mortgage Assets, or designee:**

- For PLS rated below AAA, receive approval from SVP – Capital Markets Strategy or designee before purchase.

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Added to **Responsibilities for SVP – Capital Markets Strategy, or designee:**

- For PLS rated below AAA, perform a pre-purchase review and credit analysis of the PLS.
- For PLS rated below AAA, provide a memo to the SVP – Capital Markets Mortgage Assets or designee before commitment indicating whether Capital Markets Strategy approves or declines the purchase.

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Changes to **Tolerance and Limits**:

Limit	Description	Value
Minimum ratings for purchases or wraps	PLS purchased or wrapped by Fannie Mae must have a minimum rating at the time of purchase or wrap of A-/A3. In the event the security has two or more ratings that differ (split rating) the lowest rating will apply.	A-/A3
AA/Aa and A handle (i.e. between AA+/Aa1 and A-/A3) portfolio limit	Purchased or wrapped PLS rated AA/Aa or A are limited to a percentage of the total PLS portfolio outstanding. MH PLS are not included in the calculations for this limit. (There are no haircuts for bonds rated below AAA, so this limit applies on a gross basis.)	5%
Purchase Limit for sub prime PLS rated AA and A handle (i.e. between AA+/Aa1 and A-/A3)	Purchases of sub prime PLS rated between AA+/Aa1 and A-/A3 are limited to **$3 billion** for the period May 2, 2007 to May 31, 2008.	**$3 billion**

Deleted: AAA/
Aaa

Deleted: AAA/Aaa

Deleted: (AA/Aa PLS may be in the portfolio either due to migration from AAA/Aaa or because they were purchased/wrapped before the AAA/Aaa minimum rating was in effect.)

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Added to **Implementation Plan**:

ID	Action Item	Group(s)	Deadline
21.	Update procedures for pre-purchase review and surveillance (including Watch List criteria) for purchases of PLS rated below AAA.	CMS	August 2, 2007

Deleted: Interest Only Subprime Conditions

Deleted: Subprime securities containing interest-only loans are subject to the additional eligibility requirements approved by the Risk Policy Committee (predecessor to Corporate Risk Management Committee) on August 25, 2004 and as updated from time to time.

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Added to **Change Control Log**:

ID	Source	Date	Issue	Notes	Results	Status
48	P. AT.	5/21/2007	Changes for purchases below AAA	• Updated responsibilities for CMS and CMMA. • Added limit for purchases below AAA.	CMS must approve purchases for below AAA. Limit of $3 billion in purchases over the next year.	Pending review

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Questions for the Record
House committee on Financial Services, Capital Market Subcommittee
June 3, 2009 Hearing

__Congressman Driehaus__

1. **How many pension funds (public, union and private) are investors in Fannie Mae and Freddie Mac?**

The largest pension fund investments in Fannie Mae and Freddie Mac are in debt instruments of these Enterprises. Most pension funds of any size in the United States invest in either corporate debt issued by or mortgage-backed securities guaranteed by the Enterprises. It would be a practical impossibility to determine how many pension funds this would be as funds routinely re-balance their portfolios. A fair expectation would be that the numbers are in the thousands.

Data are available to estimate the extent of pension fund investments in equity securities of the Enterprises. Using third-party data providers considered fairly reliable, but by no means definitive, Fannie Mae and Freddie Mac have compiled the following information on pension fund ownership of Enterprises common shares.

Fannie Mae. The most recent report indicates that as of June 1st 2009, ten of the 75 largest equity shareholders of Fannie Mae were U.S. pension funds (one additional German shareholder is identified as a "Gesellschaft," which sometimes indicates a pension structure). In aggregate, the ten pension funds identified in the report owned approximately 21.5 million shares of Fannie Mae.

Freddie Mac. As of March 31st 2009, data indicate 17 firms classified as pension funds held Freddie Mac shares (one additional German shareholder pension fund). In aggregate, the eighteen pension funds owned 14.5 million shares of Freddie Mac.

It is difficult to assure a full statement of total pension ownership of the Enterprise shares. Even the largest pensions, with capabilities to manage their assets in house, invest a significant portion of their assets through external money managers. This practice would be even more prevalent at smaller pensions lacking in-house expertise. Pension investments at money managers (like BlackRock, Capital Research, Fidelity, *etc.*) are held indirectly for the benefit of the pensions and would therefore be reported as shares owned by the external money manger. The ownership in these money managers could be extensive.

These data provide a best estimate based on a combination of public data (self reporting of largest holdings by institutional investors), custodial account reporting and other sources. The data should be considered a generally accurate, though imprecise, assessment of institutional ownership.

2. **How many active and retired policeman, firemen, teachers, public safety workers and other public service employees do those pension funds represent?**

FHFA has no way of determining the number of individuals represented by pension funds that own GSE shares. This information would have to be self-reported by individual pension funds.

3. **Have you taken into consideration the fact that most of these pension funds have lost billions in their investments in Fannie Mae and Freddie Mac because the focus is too weighted toward fulfilling the public housing missions and there is no focus on improving shareholder value for those pension funds that own stock of Fannie and Freddie?**

As explained above, the vast majority of pension fund investments in the Enterprise securities are bonds. These securities have not lost investors a penny to date, due to the massive intervention of the Federal government by, among other extraordinary measures, effectively providing a $400 billion guarantee to support those securities.

Losses incurred by Fannie Mae and Freddie Mac occurred, in some large measure, because of the focus on shareholder returns, leverage required to achieve those returns, and inadequate attention to the mission of maintaining a robust secondary market. As revealed in FHFA Special Examinations (conducted by the predecessor agency OFHEO), risks were taken with the goal of increasing the value of the companies to shareholders that were inconsistent with the safe and sound operation of systemically important financial institutions. Those risks proved costly to the Enterprises and ultimately shareholders lost money as have taxpayers.

4. **Why is the Conservator still spending large sums of U.S. taxpayer and U.S. Treasury money to defend the 2004 Fannie Mae securities class action when the Conservator issued two reports after months of extensive investigation confirming the wrongdoing alleged in the lawsuit?**

The court case against Fannie Mae pre-dates the conservatorship. The case remains before D.C. District Court and under the supervision of Judge Richard Leon. It will be for the Court to determine the outcome of the case. The amount of money that Fannie Mae is expending to defend this class action is a small fraction of the amount that plaintiffs are seeking. Also worthy of note is that prior to the conservatorship FHFA's predecessor agency, the Office of Housing Enterprise Oversight, negotiated settlements of enforcement actions against both the company and individual defendants which yielded approximately $400 million, all of which has been paid out or is being paid out to shareholders who incurred losses.

Congressman Grayson

1. **Is Fannie Mae currently paying the legal defense fees against shareholder actions for former Chairman and CEO Franklin Raines, former Vice-Chair and CFO Timothy Howard, and former Controller Leanne Spencer?**

Yes.

2. **If so, how much has Fannie Mae, and by extension the taxpayers, paid since the end of their employment to defend each of these individuals? Please break out costs by year.**

Year*	Raines	Howard	Spencer
Post-Conservatorship (9/6/2008) 2008	$ .67 million	$ 0.46 million	$ 1.22 million
2009	$1.76 million	$ 0.89 million	$ 1.3 million

*As reported by Fannie Mae, based on the date that Fannie Mae received an indemnification invoice. Includes all invoices received after the date of the Conservatorship, when the Treasury began providing financial assistance to Fannie Mae (and prior to July 21, 2009), even if they relate to fees and expenses incurred prior to the Conservatorship. The amounts include fees and expenses incurred in connection with the defense of derivative, securities, and ERISA claims pending in the U.S. District Court for the District of Columbia. The amounts above do not include invoices for expenses totaling $ 0.4 million incurred in connection with government investigations prior to the Conservatorship.

3. **What is the total cost to the company and government for shareholder actions against the company and the management?**

Approximately $23.1 million during the conservatorship. This amount includes all fees and costs for outside counsel to defend the Office of Federal Housing Enterprise Oversight and FHFA and their employees and former employees in the multidistrict litigation involving Raines, Howard and Spencer. It also includes all such fees and expenses expended by Fannie Mae since the Conservatorship was imposed in September 2008, and includes the figures provide in answer to question 2. It includes nothing for OFHEO, FHFA and Fannie Mae in-house employee costs, which have been substantial, but not accounted for separately, but probably exceed $1 million.

4. **Could these costs to the taxpayers have been avoided if the company had gone into receivership instead of conservatorship?**

Whether these costs could have been avoided would depend on the facts and circumstances surrounding any receivership. It is possible that receiverships might have reduced the costs of the litigation, but by no means certain. Costs might have been deferred longer, because HERA provides for a 90-day mandatory stay of litigation in receiverships, but only a 45-day stay in conservatorships. Receivership raises numerous additional legal issues that would eventually need to be litigated.

5. **How many depositions has the government paid for to defend Raines, Howard and Spencer subsequent to their removal from their positions with Fannie Mae?**

Raines, Howard and Spencer have not yet been deposed in any of the shareholder actions. Since the Conservatorship (and prior to July 21, 2009), 33 depositions of other parties have taken place in the consolidated shareholder, derivative, and ERISA actions pending before the U.S. District Court for the District of Columbia. These defendants have had counsel at all or most of those depositions.

Congressman Manzullo

1. **What remedies are available under the HVCC agreement for sellers in situations involving anomaly sales (e.g. an estate that offloads a property below market value for the sake of expediency)?**

Under the Uniform Standards of Professional Appraisal Practice ("USPAP"), the appraiser must identify the particular definition of "market value" that is being applied in the appraisal. See USPAP Definition of Market Value. In cases of loans sold to the enterprises, the definition of "market value" to be applied is the same as required by the Federal banking agencies' regulation implementing Title XI of FIRREA. See Fannie Mae Seller Guide B4-1.2-02 at 432-34; Freddie Mac Selling Guide 44.3(c). It defines "market value" as "[t]he most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller, each acting prudently, knowledgeably and assuming the price is not affected by undue stimulus."

To the extent USPAP or state laws regarding appraisals may have been violated where an appraiser is alleged to have misapplied the definition of market value or used inappropriate comparable sales, the seller may file a complaint with the appropriate state licensing agency.

In addition, under the Code, an enterprise seller may, as a remedy for a flawed initial appraisal, obtain a second subsequent appraisal, provided that there is a reasonable basis to believe that the initial appraisal was flawed. The enterprise seller may also perform a second appraisal pursuant to written, pre-established bona fide appraisal review or quality control policies or underwriting guidelines. In any event, the lender must adhere to a policy of selecting the most reliable appraisal, rather than the valuation most favorable to the transaction at hand.

2. How does the HVCC agreement protect against property devaluation as a result of the implementation of this agreement?

The Code protects against property devaluation by improving market confidence in residential property valuation.

The Code's purpose is to ensure appraiser independence from conflicts of interest and improper influence from parties with an interest in the mortgage loan transaction. Appraisals resulting from improved appraiser independence would not be tainted by the same inflation bias that previously infected appraisals procured with appraiser conflict of interest. The appraisal serves as an independent valuation estimate of the underlying collateral. As such, when an appraisal process is working properly, the appraisal that is produced should neither inflate nor depress property valuation. It should be noted that the Code does not address what properties should be used as comparables. Furthermore, in the context of using foreclosures as comparables, the enterprises noted that appraisers should use such properties as comparables only where "appropriate" or where foreclosures or short sales are "representative" of the properties available to typical purchasers for the market. See Fannie Mae FAQs Q. 34; Freddie Mac FAQs Q. 28.

Ultimately, increasing market demand counters property devaluation. By improving market confidence in valuation, the Code serves to improve market demand and hence property valuation.

3. Can a buyer or seller order a second appraisal if they are unhappy with the first appraisal?

No, with respect to a buyer or seller of a house. Federal law prohibits a lender from accepting an appraisal ordered by a buyer or seller of a home for purposes of originating a mortgage loan, because that appraisal is considered tainted by conflict of interest. See, e.g., 12 CFR 323.5(b) (FDIC interagency appraisal regulation requires that "... the appraiser shall be engaged directly by the regulated institution or its agent..."); 55 Fed. Reg. 33879, 33886 (Aug. 20, 1990) ("To further the goal of appraisal independence, the FDIC requires that fee appraisers ... be hired by a regulated institution or its agent rather than the borrower"). This is because a buyer or seller is an interested party in the mortgage loan transaction, and have an interest in seeing the loan approved. However, the Code does not prohibit a home buyer or seller from raising any errors or appraisal quality problems with the lender's quality control personnel.

Yes, with respect to an enterprise seller (i.e., lender) under limited circumstances as noted in the Code. See Fannie Mae FAQs (updated March 2009) at Q. 9; Freddie Mac FAQs on Code at Q. 25. An enterprise seller has to balance between the potential benefits of originating the loan and the risks that originating the loan carries, such as the risk the borrower may default. In doing such balancing, an enterprise seller may, under the Code, perform a second appraisal where there is a reasonable basis to believe that the initial appraisal was flawed. An enterprise seller may also perform a second appraisal pursuant to pre-established written, bona fide appraisal review or quality control policies or underwriting guidelines. In instances where a second appraisal is performed, the enterprise seller must also adhere to a policy of selecting the most reliable appraisal, rather than selecting the appraisal most favorable to the transaction.

4. Would dissatisfaction with the appraisal or the appraiser be grounds for ordering a second appraisal (e.g. an appraiser from a metropolitan area assessing a rural property)?

Enterprise sellers must have controls in place to ensure that appraisals are performed competently by appraisers with knowledge and experience.

USPAP requires an appraisal to be performed competently by an appraiser with knowledge and experience. See USPAP Competency Rule (an appraiser must "have the knowledge and experience to complete the assignment competently" or, alternatively, to disclose the lack of knowledge and/or experience, take all steps necessary or appropriate to complete the appraisal assignment, and document in the appraisal report the lack of knowledge and steps to complete the assignment competently; USPAP comment provides that competency factors includes appraiser's familiarity with a market or geographic area).

In addition, enterprise guidance contains similar requirements for appraiser knowledge and experience. See Fannie Mae Seller Guide, Sec. B4-1.1-03 (Lender must use appraisers who "have the requisite knowledge required to perform a professional quality appraisal for the specific geographical location"); Fannie Mae Guidance for Lenders and Appraisers (April 2009) at 3 ("Fannie Mae believes that it is important for a lender to use an appraiser who has the appropriate knowledge and experience, rather than taking advantage of this [USPAP alternative] flexibility"); Freddie Mac Seller Guide, Chap. 44.4 ("At a minimum, the appraiser must be a State-certified or State-licensed real estate appraiser eligible to perform appraisals in the State in which the property is located and be experienced in the appraisal of properties similar to the property being appraised or inspected. . . . The Seller should be particularly attentive to selecting an appraiser who is knowledgeable of the subject area when ordering appraisal or inspection reports in central city neighborhoods and rural areas"); Freddie Mac Bulletin No. 2009-18 (July 10, 2009) at 5-7 ("Appraisers must be familiar with the local market in which the property is located, and must be competent to appraise the subject property type, and must have access to the data sources needed to develop a credible appraisal").

Assuming that the enterprise seller has ensured that its appraisals comply with the competency requirement, an enterprise seller may, under the Code, perform a second appraisal, provided that there is a reasonable basis to believe that the initial appraisal was flawed. An enterprise seller may also perform a second appraisal pursuant to written, pre-established bona fide appraisal review or quality control policies, or underwriting guidelines. Where a lender performs a second appraisal, the lender must adhere to a policy of selecting the most reliable appraisal.

5. Would an appraised value assigned well below the assessed tax value of the property be grounds for a second appraisal?

Not necessarily, because an appraisal performed for purposes of a property tax assessment may have a different scope of work, value definition, or intended use from an appraisal providing collateral valuation supporting a loan sold to the enterprises. Appraisals supporting loans sold to the enterprises have specific appraisal requirements, which may not be met by appraisals performed for purposes of property tax assessments. See USPAP; Fannie Mae Seller Guide appraisal requirements; Freddie Mac Seller Guide appraisal requirements. The tax assessment valuation may also not have been performed by a qualified appraiser sufficiently recently as may be required by enterprise underwriting requirements. See Fannie Mae Seller Guide at B4-1.2-01; Freddie Mac Seller Guide at sec. 44.7(d). A divergence of value, by itself, would not be sufficient grounds to conclude that the appraisal is flawed.

6. What is available under the agreement for appraisers to adjust appraisal comparables based on radical swings in a neighborhood?

The Code does not affect the obligation of appraisers to comply with USPAP and enterprise appraisal requirements with respect to appraisal practices and standards for determining appropriate adjustments of comparables sales. Where there is a reasonable basis to believe that an appraisal is flawed under professional appraisal standards, the violation may be reported to the appropriate state appraiser licensing agency and a second appraisal may be performed under certain limited circumstances. See Nos. 8 and 9 above.

In addition, current enterprise requirements outside of the Code include appraiser reporting of market conditions to improve transparency of appraiser conclusions of market trends and conditions. See Fannie Mae Announcement 08-30 (Nov. 14, 2008); Appraisal and Property Report Policies and Forms - FAQs (updated March 2009); Freddie Mac Bulletin No. 2009-18 (July 10, 2009) at 7.

7. Will this agreement increase the costs of purchasing a home by requiring a buyer to purchase multiple appraisals on the same property in order to shop for the best loan rate?

No, the Code does not require a buyer to purchase multiple appraisals. Rather, the Code permits lenders to transfer appraisals and accept transferred appraisals. However, whether particular lenders take advantage of that opportunity is up to the individual lender. Lenders have been taking steps to improve the quality of their loans, including tightening their underwriting standards and, by doing so, shutting down their indirect channels. If lenders choose to be more conservative in their underwriting standards and refuse to accept transferred appraisals because they want tighter controls over the appraisal process, that market process may require a borrower to pay for a new appraisal.

8. Given the assumption that the majority of AMCs are located in urban population centers, what impact will this agreement have on rural, independent appraisers' businesses?

The Code affects from whom appraisers receive their appraisal assignments. This effect is not dependent on the geographical area in which an appraiser is located. Formerly, an appraiser may have received their appraisal assignments from loan product personnel, such as loan officers or mortgage brokers. The Code requires that personnel independent of the loan production process manage the appraisal assignments. Thus, fee appraisers will experience changes to the way they previously received appraisal assignments.

It should also be noted that the Code does not require that lenders employ any particular entity to manage their appraisal functions; lenders are permitted under the Code to directly engage fee appraisers to perform appraisals, so long as those employees engaging the appraisers or otherwise managing the appraisal process for the lender are independent from loan production.

9. Have you studied the cost-impact this agreement will have on appraisers, mortgage brokers, lenders and consumers? If so, please share that impact study with me. If not, please explain why not?

No, FHFA addressed this issue as a supervisory matter to improve the enterprises' safety and soundness, which is one of FHFA's primary missions, and strengthen the quality of mortgage loans purchased by the enterprises. However, a cost of previously inflated appraisals and undue influence by a minority of bad actors may be found in the general erosion of market confidence in the credibility of appraisal valuations supporting loans purchased by the enterprises, and in losses sustained by homebuyers or homeowners who unknowingly bought or refinanced based on inflated appraisals.

10. How will this agreement prevent collusion between lenders and appraisers?

By insulating appraisers from a lender's loan officers and other loan origination personnel, including wholesale channel mortgage brokers, the Code prevents appraisers from being placed in a position of bias and conflict of interest. By requiring that a lender's quality control or risk management function manage the appraisal function, the Code prevents the appraisals from being skewed by systematic bias which results when appraisers are selected, hired, and paid by a lender's loan sales personnel or third parties who have an interest in the outcome and size of the loan.

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