Edward J. DeMarco
Acting Director
Federal Housing Finance Agency

Second Annual Best Practices in Loss Mitigation Conference
Dallas, Texas
July 21, 2010

Thank you. I am very pleased to join you today for the 2nd Annual Best Practices in Loss Mitigation conference.

Today I want to briefly discuss some of the key challenges and near-term issues facing FHFA and the current state and future of loss mitigation activities, and to look ahead to some of the issues and opportunities that will arise in housing finance reform. During its short existence, FHFA has been deeply involved in many of the federal government's efforts to respond to the crisis in the nation's housing and housing finance markets. While we are far from "out of the woods," we are starting to draw important lessons from the financial and housing crisis, reexamine the hybrid structure of Fannie Mae and Freddie Mac, and understand the causes and consequences of the recent housing boom and bust. Certainly, there is a great deal more to learn, but we are developing key questions and thoughts about the future structure of mortgage markets, secondary markets, and the role of government.

One clear message that emerges from the housing boom and bust is that, irrespective of what roles we ask the government to play in housing finance, we should not repeat a structure where public mission and private motive are commingled, as was the case at Fannie Mae and Freddie Mac. The misaligned incentives created by such a structure undoubtedly contributed to excessive risk taking and a lack of market discipline, both of which directly contributed to the substantial losses for Fannie Mae and Freddie Mac—and by extension, taxpayers. As we evaluate proposals for the future, we must consider what safeguards and authorities are needed when government subsidies are used to support those portions of the market that cannot operate efficiently in their absence or to promote some portion of the market to achieve a public purpose.

FHFA and the State of the Enterprises

Fannie Mae and Freddie Mac are well-known entities to all of you, but let me briefly define terms and provide some background on them. Fannie Mae and Freddie Mac are described as government-sponsored enterprises (GSEs). In my remarks today, I will refer to them jointly as the Enterprises. Each Enterprise was established and chartered by Congress and operated as a private company owned by private shareholders. Their congressional charters gave them benefits not available to other private firms but also imposed unique requirements and expectations to carry out a public purpose.

For those of you who aren't familiar with FHFA, let me explain the role of the organization. FHFA—the Federal Housing Finance Agency—is a young agency. Created in 2008, upon enactment of the Housing and Economic Recovery Act of 2008, also known as HERA, FHFA was formed by merging the former Office of Federal Housing Enterprise Oversight (OFHEO), the Federal Housing Finance Board (FHFB), and the GSE oversight team from the Department of Housing and Urban Development. FHFA was given safety and soundness and mission oversight responsibilities for the housing GSEs (Fannie Mae, Freddie Mac, and the Federal Home Loan Banks), including safety and soundness authorities that had been lacking at OFHEO.

When the housing bubble burst, the Enterprises' financial situation deteriorated rapidly, driven by credit losses on mortgages they owned or guaranteed and by the rapid decline in the value of private-label mortgage-backed securities held on their balance sheets. These losses quickly overwhelmed the relatively low levels of capital the Enterprises were required by statute to hold against potential losses and the additional amounts OFHEO required because of their previous accounting problems. Ultimately, intervention was required because of the inability of the Enterprises to raise new capital and access debt markets in their customary way. The Enterprises' ability to fulfill their mission was compromised by their financial condition, and their collapse would have had devastating consequences for the housing finance system and the broader economy because they were interconnected. Without action, Fannie Mae and Freddie Mac would have been unable to fulfill their statutory mission of providing liquidity and stability to the housing market.

Just five weeks after the creation of FHFA in September 2008, we placed Fannie Mae and Freddie Mac into conservatorship. The purpose of conservatorship is to preserve and conserve each company's assets to enable them to fulfill their mission and mitigate the systemic risk that contributed to instability in financial markets.

At the same time, the Treasury Department agreed to provide financial support to the Enterprises through the Senior Preferred Stock Purchase Agreements. These agreements are structured to provide ongoing financial support to the Enterprises to ensure they remain active participants in the marketplace. They are ongoing, explicit, and irreversible contractual commitments by the federal government to ensure Fannie Mae and Freddie Mac can meet their financial obligations. They work by ensuring the Enterprises maintain a positive net worth. Since the initial establishment of the agreements, the Treasury Department has increased its financial commitment twice to maintain market confidence in the Enterprises.

As a result of the Treasury support, the Enterprises have been able to fulfill their mission, providing liquidity to an otherwise constrained mortgage market. Meanwhile, investors have gained an understanding of and confidence in the U.S. government's commitment to honor its obligations under the Treasury agreements, and they continue to back the housing finance sector through investment in Enterprise securities. In turn, the Enterprises' ability to effectively carry out their mission translates into a direct benefit to homeowners, home buyers, local communities, lenders, and pension funds, among others. To see this benefit, consider that roughly three-quarters of mortgages originated last year were guaranteed by the Enterprises, with most of the remainder guaranteed by the Federal Housing Administration or the Veterans Administration.

Given the substantial need for the Enterprises to continue to support the market in the face of their significant credit losses, FHFA's role as conservator is as critical today as it was back in 2008. From July 2007 through the first quarter of 2010, combined losses at the Enterprises totaled $229 billion. During 2009 and the first quarter of 2010 alone, the Enterprises reported net losses of $111 billion. Make no mistake, the Enterprises' poor financial performance is attributed to credit-related expenses and losses stemming from purchases and guarantees of mortgages originated principally in 2006 and 2007. Since the establishment of the conservatorships, the combined losses at the two Enterprises depleted all their capital and required them to draw nearly $145 billion from the Treasury Department under the agreements.

With these substantial losses already on the books, it may seem simplistic to say that FHFA's primary goals are to minimize additional losses through loss mitigation efforts and to ensure the Enterprises' new business is profitable, but we are concentrating all of our efforts on these fronts, to positive effect, I believe. We've seen a significant improvement in the quality of new business as a result of tighter underwriting standards, and we're seeing better performance on the loss mitigation side as a result of more aggressive modifications and other foreclosure prevention activities. Let me say a bit about the improvements in loss mitigation.

Loss Mitigation—Yesterday and Today

The Enterprises have long had programs to mitigate losses in place. These programs typically consisted of repayment plans and modest changes to loan terms, rather than any substantial modification to reduce the borrowers' monthly payments to an affordable level. As the housing crisis took shape, it was clear that a more aggressive and broader approach to loss mitigation—one that included mortgages securitized in private-label securities, mortgages held as whole loans in bank portfolios, and mortgages owned or guaranteed by the Enterprises—was needed. This led to the Enterprises' participation in the Administration's Making Home Affordable (MHA) program in a number of ways, including the Home Affordable Modification Program (HAMP) and the Home Affordable Refinance Program (HARP). We oversee Fannie Mae's and Freddie Mac's participation as financial agents for HAMP, as well as their efforts to carry out these and other loss mitigation strategies.

Loan modifications and other loss mitigation activities are a key focus for FHFA as the Enterprises' conservator, not only because these strategies are consistent with the Enterprises' public mission, but because these activities are central to the purpose and goals of the conservatorships. In the current environment, conserving the assets of the Enterprises requires, first and foremost, minimizing their credit losses from delinquent mortgages. It is appropriate that Fannie Mae and Freddie Mac have played a key role in the development and implementation of HAMP because a well-designed loan modification is often a lower cost resolution to a delinquent mortgage than foreclosure, and these alternatives to foreclosure save the Enterprises' and taxpayers' money. These programs have benefits beyond reducing losses directly on the Enterprises' resolutions of their delinquent loans. Since the Enterprises own or guarantee about half the mortgages in the country, the successful widespread adoption of HAMP by others, which is improving the modification process, benefits the Enterprises by improving stability in housing markets and reducing credit exposure.

Impact of HAMP

HAMP was designed around three core concepts:

- **Affordability.** Every modification under the program must lower the borrower's monthly mortgage payment to 31 percent of the borrower's monthly gross income.

- **Pay-for-Success Structure.** This structure aligns the interests of servicers, investors, and borrowers in ways that encourage loan modifications to be both affordable for borrowers over the long term and cost-effective for taxpayers. Servicer, homeowner, and investor incentives are paid only while a modified loan is performing. This structure limits the downside risk to the taxpayer of modifications that redefault.

- **Transparency and Consistency.** Participating servicers are required to evaluate every eligible loan using a standard set of criteria, including a net present value (NPV) test. If the test is positive, the servicer must modify the loan.

HAMP, while certainly challenging to implement, has provided borrowers with improved opportunities to find a resolution to their mortgage difficulties. The most recent public report indicates more than 1.5 million trial modification plan offers extended to at-risk borrowers and more than 1.24 million trial modifications started. Of those started, nearly 400,000 have converted to permanent modifications, 364,000 remain in trial period, and more than 500,000 modifications have been cancelled or terminated. The most common causes of trial cancellations are missing documentation, a debt-to-income ratio below 31 percent, or a negative NPV result when evaluated using documented income. Importantly, most borrowers whose HAMP modifications have been cancelled have received an alternative modification or foreclosure alternative. In fact, an outcome other than foreclosure or bankruptcy resulted in 80 percent of cancelled modification cases. The program is clearly helping homeowners.

Another benefit that must be mentioned is that HAMP has provided a level of uniformity and focus to modification practices that did not exist previously. When the volume of delinquent mortgages threatened to overwhelm servicers, having a single, consistent approach to loan modifications reduced their operating costs. It also provided a measure of fairness to citizens as to how this loan modification program would work, without regard to how their individual mortgage had been financed.

Taking Fannie Mae and Freddie Mac as an example, we see that comparing the fourth quarter of 2008 to the first quarter of 2010, the number of completed modifications has increased dramatically—from 24,000 to 138,000, driven in part by standardization and increased emphasis on the consistent outreach and evaluation required by HAMP. The *OCC and OTS Mortgage Metrics Report*—covering Enterprise, private-label securities and portfolio loans—shows this is a general trend. In the first quarter of 2009, there were 242,000 modification actions, including trial plans but excluding payment plans. In the first quarter of 2010, this more than doubled to 510,000.

Just as strikingly, we see that the form of loan modifications has changed—the emphasis on improving affordability has become an industry standard. In the fourth quarter of 2008, 34 percent of Fannie and Freddie modifications decreased monthly payments by 20 percent or more, and more than a quarter of modification actions resulted in no change or an increase in monthly payment. In the first quarter of 2010, 67 percent of modifications resulted in payment decreases of more than 20 percent, and only 12 percent of modifications resulted in increased or unchanged payments. Again, the *OCC and OTS Mortgage Metrics Report* shows this is a general trend. In the first quarter of 2009, only 29 percent of modifications reduced monthly principal and interest payments by 20 percent or more, and nearly half (46 percent) of modification actions resulted in no change or an increase in monthly payment. In the first quarter of 2010, more than half of modifications resulted in payment decreases of more than 20 percent, and only 12 percent of modifications resulted in increased or unchanged payments.

These innovations are resulting in stronger postmodification performance. The share of Enterprise modified loans current and performing three months after modification jumped dramatically from 59 percent to 78 percent from the third quarter of 2009 to the fourth quarter of 2009 as HAMP trial modifications converted to permanent status. During the same period, 60-day delinquency rates at three months after modification fell from 21 percent to 10 percent. In a similar vein, the OCC and OTS report shows the 60-plus days delinquency rate on modified loans measured three and six months after modification—that is, what share of modified loans are 60-plus days delinquent three and six months after modification—has been falling steadily between loans modified in the first quarter of 2009 and those modified in the fourth quarter of 2009. In fact, the 60-plus days redefault rate for loans modified in the fourth quarter of 2009 is roughly one-third of the redefault rate for loans modified in the first quarter of 2009. The OCC and OTS report also shows early indications that permanent HAMP modifications are outperforming non-HAMP modifications.

The June HAMP performance report offers a new look at modified loan performance. Measured three months after permanent modification, only 4.5 percent are 60-plus days delinquent. Measured six months after permanent modification, only 5.9 percent are 60-plus days delinquent. While these measures are somewhat skewed by the presence of the trial modification period, which sorts out many unsustainable modifications before the permanent modification starts and any incentive payments are made, only a small percentage of cancelled trial modifications have been the result of payment performance or delinquency.

Other MHA and HAMP Initiatives

Of course, HAMP is evolving, and there are other critical programs under the MHA umbrella. As HAMP innovations and other MHA programs are developed, we review the programs to ensure that Fannie Mae's and Freddie Mac's participation is consistent with both safety and soundness and the purpose and goals of conservatorship. Obviously we are evaluating programs in terms of whether direct credit losses are likely to be lower if a program is adopted. Some less obvious criteria include the resource burden, operational risk, and managerial requirements associated with any new loss mitigation strategies.

The Enterprises are actively implementing the Home Affordable Foreclosure Alternatives program to provide increased incentives and a clearer structure that should increase the use of foreclosure alternatives such as short sales and deeds in lieu. As the HAMP temporary assistance program for unemployed homeowners is implemented by others, Fannie Mae and Freddie Mac will continue to offer similar unemployment-related forbearance programs.

It is clear that loss mitigation strategies will be critical to limiting losses at Fannie Mae and Freddie Mac over the coming months and years. Although this is a loss mitigation conference, I mentioned at the outset that I'll also share some of my thoughts on the future of the housing finance system.

GSE Reform and the Future of the Mortgage Finance System

Given my role as the acting director of FHFA, I'm frequently asked my views about the future of the mortgage market and the role of the GSEs. My answer starts with the following three observations:

1. Whatever we do, we should be sure not to repeat the mistake of establishing the hybrid structure of private gain and public risk-bearing that Fannie Mae and Freddie Mac represented.

2. Whatever set of reforms we decide on is going to require a period of transition. The mortgage market—all $10-plus trillion of it—requires a tremendous amount of infrastructure and plumbing. That plumbing can—and probably should—be changed, but we need to recognize that the transition will take time.

3. I don't have a silver bullet—a single plan that solves all the problems of the past and satisfies the wants of every constituency, and I don't think such a plan exists. Every way forward will include some hard choices.

As we review the conditions and decisions that led to the ultimate downturn in the market, I am repeatedly reminded of the power of very basic financial incentives and how easily pricing and profit can motivate all of the key stakeholders in any transaction—from borrowers to originators to investors.

The lesson I take away is that, irrespective of what roles we ask the government to play in housing finance, we must not fall into the trap of repeating the same misaligned incentives. Every proposal for future structure must be carefully evaluated to determine whether the proposal creates an implicit or explicit federal guarantee or backstop.

Previously, I've suggested this simple purpose statement to guide policy in the area of mortgage finance, "To promote the efficient provision of credit to finance mortgages for single-family and multifamily housing." An efficient system of credit allocation would typically have a number of characteristics, which I think there is broad agreement about among participants in the policy debate. These include:

- **Allows Innovation**. An efficient housing finance system should be constantly striving to innovate, and regulation should encourage innovation while protecting consumers, taxpayers and the financial system.

- **Provides Consumer Choice**. A robust housing finance system should be able to cater to varying demands and to suitably customize its product offerings.

- **Provides Consumer Protection**. Even for households with a substantial degree of financial sophistication, mortgage transactions are not an everyday occurrence, and for many homeowners, their house is their largest asset.

- **Facilitates Transparency**. Investors in and guarantors of mortgages and mortgage-related securities need clear, timely information on the mortgages they invest in to make optimal investment decisions and to properly manage the risks of those investments.

These all are worthy goals, although clearly there will be differences of opinion about how each is defined and the specifics of how each are achieved.

Where there is considerably less agreement is the question of the appropriate role of the federal government in ensuring the mortgage market has adequate sources of liquidity and an adequate ability to absorb credit risk. Why is this credit market different from other markets that appear to operate reasonably well without federally-sponsored liquidity facilities and guarantees? One consideration could be the importance of housing in household finances. Using the Survey of Consumer Finances, we estimate that in 2005 for households with a nonzero net worth, the value of the primary residence as a share of total assets was more than 65 percent for households in the second quartile of net worth, more than 60 percent for households in the third quartile, and more than 40 percent for households between the 75th percentile and the 90th percentile. Another consideration is the perceived externality of homeownership, the widespread view that homeowners make better citizens and stronger communities.

There is a concern that periods of economic volatility or of severe illiquidity in financial markets could have severe short-term consequences for housing. In particular, such events may make it much harder for people to buy and sell homes or obtain a mortgage. In the recent financial crisis, were it not for government support programs, there would have been severe disruptions in the flow of mortgage credit. If these are sufficient concerns, there are various government interventions that could address them. But having the government stand ready to provide liquidity or play the role of "balance sheet of last resort," does not imply or require an ongoing guarantee on mortgages when markets are operating effectively or during noncrisis periods.

Another area of debate is likely to center on using the housing finance system to promote the availability of credit for low- and moderate-income homeowners and renters. In the past, the many subsidies granted the Enterprises were exchanged for various requirements, including housing goals. Going forward, policymakers may consider alternative approaches to defining and targeting subsidies to achieve public policy objectives. For instance, subsidies intended to support the financing of affordable rental units or to assist first-time homebuyers could be more efficiently targeted through direct payment assistance.

While I am hopeful that policymakers will move quickly to enact legislation for a large-scale restructuring of the housing finance system, in the interim, FHFA will continue to study potential changes in the way the Enterprises do business that may be desirable both to conserve assets and to establish positive market standards. We recently announced a set of prospective improvements in the data submissions of loan sellers that will raise the quality and consistency of key mortgage information and improve the Enterprises' risk management capabilities. In the coming months, we will consider other initiatives that can provide value to the mortgage financing process now and in the future.

Thank you for the opportunity to speak with you today.