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Remarks to the Exchequer Club
FHFA, Housing GSEs, and Housing Finance in a World of Uncertainty
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Thank you. It is an honor to be here today.

I would like to describe for you what the Federal Housing Finance Agency is doing today to contribute to the functioning of the housing finance system amidst the wreckage of the past several years while we await legislative action necessary to define the legal and institutional framework for the future.

As most of you know, my agency, the Federal Housing Finance Agency or FHFA, was created in July 2008 to oversee Fannie Mae and Freddie Mac as well as the 12 Federal Home Loan Banks. As you can see, FHFA came into being just as the financial crisis was beginning to crest.

Interestingly enough, most of the entities that FHFA oversees – specifically Fannie Mae and the Home Loan Banks – were themselves created by Congress in response to the housing finance crisis that emerged in the Great Depression.

Let me begin with a few thoughts on the Federal Home Loan Banks. The FHLBanks continue to be highly valued by their members, especially by small- and mid-sized banks and thrifts. They served a critical role during the recent financial crisis by providing much-needed liquidity to a wide range of depository institutions. Indeed, in 2007 and 2008, advances grew dramatically, peaking above $1 trillion in September and October of 2008. Advances have steadily declined since then, and now total close to $450 billion, a level not seen in the System since 2001.

The FHLBanks have managed both the increase and the decline in advances without a hitch. This is a key aspect of their cooperative ownership and their capital structure. Despite the failure of several hundred member institutions, the FHLBanks have not lost money on advances. They have, though, faced their share of challenges, and they continue to do so. In particular, investments in private-label mortgage-backed securities have led to sizeable investment losses at some FHLBanks.

The combination of substantial declines in advances and investment losses have caused some FHLBanks' balance sheets to get out of kilter, with a heavier reliance on investments than is appropriate in the long-term. I expect to see this corrected over time.

A positive development for the FHLBanks is that they are about to complete the payment of the REFCorp obligation they incurred back in 1989 with the enactment of the FIRREA legislation. Since then, the FHLBanks have directed 20 percent (and sometimes more) of their earnings to paying this obligation arising from the savings and loan debacle. With the last REFCorp payment expected in the next few months, the FHLBanks have collectively agreed to direct that 20 percent of earnings going forward into a restricted retained earnings account, which will enhance the safety and soundness and capital strength of the FHLBanks. FHFA is very supportive of the FHLBanks' System Voluntary Capital Initiative and we look forward to working with the FHLBanks to make the necessary changes to their capital plans to implement this Initiative.

When Congress takes up housing finance reform, I expect the FHLBs to be part of the discussion as they remain an important element in the housing finance infrastructure.

As I noted, my agency was created in mid-2008. In establishing FHFA, Congress combined two existing regulatory agencies, transferred some authorities from the Department of Housing and Urban Development, and gave this new regulator greater powers and responsibilities than existed across the predecessor agencies. While many of these new authorities and responsibilities were designed to curb excessive risk-taking and to give the new regulator more authority to act, the legislation came far too late to stem the housing crisis or the collapse of Fannie Mae and Freddie

Mac. Indeed, less than six weeks after being created, FHFA placed Fannie Mae and Freddie Mac into conservatorship. Since that time, FHFA has been both the conservator and regulator of Fannie Mae and Freddie Mac, or the Enterprises as I will refer to them from here on. These operations have been made possible by the financial backing of the U.S. Treasury, backing authorized by Congress in 2008 and implemented through Treasury's Senior Preferred Stock Purchase Agreements with each company. To-date, these agreements have resulted in more than $150 billion being drawn from Treasury by the Enterprises.

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

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

(i) necessary to put the regulated entity in a sound and solvent condition; and
(ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity."

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

Today, FHFA is balancing three responsibilities: preserve and conserve assets, ensure market stability and liquidity, and prepare the Enterprises for an uncertain future. While the long-term course of housing finance is being debated and ultimately determined, FHFA meets these responsibilities by overseeing the Enterprises' management of, and limiting the costs to taxpayers from, the Enterprises' $5.5 trillion position in the market.

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

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

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

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

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

FHFA is committed to improving the system for mortgage servicing compensation. This is necessary both to enhance the opportunity for local lenders to service mortgage loans they originate and to respond to the poor performance of the servicing industry the past few years. Part of the goal in undertaking this initiative is to consider changes to the compensation structure that would improve competition and liquidity in the market for mortgage servicing. We are taking a deliberative approach, and have invited wide participation in the discussion across the spectrum of housing finance stakeholders. At an appropriate time later this year, we will seek additional public comment on a more detailed proposal. For now, on our website you may find a paper we posted that illustrates some of the key issues under consideration.

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

Lastly, as I testified last week, enhancing loan-level disclosures on Enterprise mortgage-backed securities (MBS), both at the time of origination and throughout a security's life, is on our agenda. I believe that improving Enterprise MBS disclosures over time will help establish consistency and quality of such data. Moreover, it will contribute to an environment in which private capital has the information needed to efficiently measure and price mortgage credit risk, thereby facilitating the shifting of this risk away from the government and back into the private sector. This will take time to accomplish, but this is the direction in which we are heading.

Turning specifically to FHFA's responsibilities to conserve and preserve Enterprise assets, it is useful to think about the Enterprises' assets and property as having four broad categories:

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

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

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

What we do know is that the single-family mortgage market in the United States is roughly an $11 trillion market. The nation's housing finance structure depends on institutions capable of absorbing the flows that a market of that magnitude generates.   The coming debate will be about what those institutional arrangements look like, what degree of government support or subsidy will be involved, and what degree and role of government oversight is desired.

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

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

First, for the legacy book of business – the mortgages acquired or guaranteed pre-conservatorship – the key risk is further credit losses from delinquent mortgages. FHFA and the Enterprises' boards of directors, senior management teams, and staff are focused on effective loss mitigation strategies to avoid foreclosure where practical and to minimize further credit losses through loan modifications and other loss mitigation strategies. Since conservatorship, the two Enterprises have completed more than 1.5 million foreclosure alternatives for homeowners in trouble on their mortgage. Loan modifications make up more than half of this total.

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

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

For a company in conservatorship, and unlikely to continue to exist in its current form, thinking about whether and how to invest in and develop infrastructure and operations presents unique and difficult challenges.

Finally, how does one preserve and conserve the value of a company's human capital in the face of an uncertain future? Recruiting and retaining executives and staff is one of FHFA's principal risk management challenges as conservator.

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

I have just described for you how FHFA and the entities we oversee are helping to maintain the functioning of the nation's housing finance system today.

But the big question, the key source of uncertainty, is, what will that housing finance system look like in the future? In 2008, Treasury Secretary Paulson described conservatorship as a "timeout" so the incoming Administration and Congress could decide the ultimate resolution of the Enterprise and the legal and institutional framework to replace them.

I have said many times that conservatorship cannot go on indefinitely and that certain risks associated with conservatorship increase over time.

I also would note that the only resolution of the conservatorships available under law to FHFA is to reconstitute Fannie Mae and Freddie Mac as they were. Even if that were feasible seems to be the one option everyone can agree they don't want.

Since the start of this year, two developments have taken place that show some movement towards the needed legislative work to rebuild the country's housing finance infrastructure.

In February, the Treasury Department and the Department of Housing and Urban Development issued a white paper that outlined three broad paths for housing finance reform. Those paths varied chiefly in whether, and to what degree, an explicit government credit guarantee would be attached to mortgage securitizations in the future. The Administration paper also suggested a number of steps FHFA could be taking in the meantime to prepare for any of the proposed outcomes. Several of these we are already doing and I touched on some of them earlier in my remarks.

Since release of the Administration's paper, the House Financial Services Committee has introduced about eight bills tailored to some specific action meant to move toward some additional winding down of the Enterprises, and several of these bills would legislate the suggestions for wind down made in the Administration paper. Additional such bills are likely to be forthcoming shortly.

This is progress but we still have a long and uncertain path to giving the private sector what it really needs to re-enter the mortgage market in a meaningful way. Private capital needs to know what the long-term role of the government is going to be before substantial commitments of private capital emerge to replace the dominant role played by government-supported institutions.

As a final observation on this emerging debate, in an $11 trillion single-family mortgage market, there is a wide range of possible outcomes in which some large portion could be served with explicit government support and some large portion could be served completely with private at-risk capital. As a simple example, Ginnie Mae today provides an explicit guarantee of mortgages it securitizes and policymakers could consider expanding or contracting that role. Since 2008, Ginnie Mae securities have constituted roughly a quarter of MBS issuance. This share, of course, is much larger than it had been previously.

There are several proposals to replace much of what the Enterprises have traditionally had as market share with entities issuing MBS guaranteed first by the issuer and ultimately by the taxpayer. The government would presumably charge a fee for this explicit taxpayer support. In this model, mortgage credit risk measurement and pricing would be dependent on the work of regulators. This model would also require a rigorous regulatory regime for oversight of prudential operations and capital adequacy for the issuers of such securities.

Alternatively, securitization without government guarantees would require sufficient standardization and transparency for private actors to have the responsibility for measuring and pricing mortgage credit risk. There could be a role for government in establishing such standards and ensuring such transparency.

These may be difficult choices for elected officials but it is time to get moving in making them.

Thank you again for the opportunity to be here today and I would be glad to answer questions.