The Roles of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks in Stabilizing the Mortgage Market

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National Association of Real Estate Editors
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It is a pleasure to speak to the National Association of Real Estate Editors. Real estate and mortgages have been at the heart of the financial crisis for the last two years. Two years ago, it was just thought to be a subprime crisis. I remember giving a speech at a conference which had as a theme Broadway musicals. My presentation was entitled, "Mighty Python's Subprimealot." **(SLIDE 2)** At least I was right in the featured song, "He's Not Dead Yet." As it turned out, there was much more than just subprime to swallow. As this slide shows, **(SLIDE 3)** over the past two years, serious delinquencies of 90 days or more have risen across the board to record levels. For subprime mortgages, serious delinquencies are almost 25 percent, and those subprime ARMs are more than 36 percent seriously delinquent. Serious delinquencies are far lower at Fannie Mae and Freddie Mac at about 3 percent, which is even lower than the prime market at 4.7 percent or the whole market at 7.2 percent. Serious delinquencies across all categories are continuing to rise rapidly.

There have certainly been a lot of bad stories written about real estate, housing, and mortgages. Hopefully, we may see more positive stories as we are starting to see a bottom process. Certainly, that is FHFA's big goal as we implement our strategies for stabilizing the mortgage market.

FHFA Stabilization Strategy

Stabilizing the mortgage market is our biggest challenge. At FHFA, we have devised a four-pronged strategy **(SLIDE 4)** to help stabilize the mortgage market. First, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks must support the market in a safe and sound manner. Second, we are working with our government partners to get mortgage interest rates down. Third, we are working with the Enterprises and other groups to set best practices for the whole mortgage market. We are all keenly aware of how badly underwriting and other practices slipped from 2005 to 2007. Finally, we are actively working with the Administration, U.S. Department of the Treasury, the Department of Housing and Urban Development (HUD), the Federal Deposit Insurance Corporation (FDIC), and the GSEs on foreclosure prevention to help homeowners in trouble.

The Current State of the Markets

On a combined basis, the housing GSEs have $6.6 trillion in debt and MBS outstanding. **(SLIDE 5)** This slide shows the history of the mortgage market over the past 12 years with the Enterprises in gold, FHA/VA in green, and others in blue. From 1997-2003, Fannie Mae's and Freddie Mac's market share of mortgage originations—that top line—gradually grew to almost 55 percent. From 2004-2006, the private mortgage market predominated, and Fannie's and Freddie's business sank pretty dramatically, with their market share dropping below 35 percent because of their accounting problems and our resulting extra 30 percent capital requirement and portfolio caps. Then as the private market started to freeze up in 2007, Fannie's and Freddie's market share took off—up to nearly 73 percent in 2008 and the first quarter of 2009. However, you can see that is simply a larger share of a much smaller market.

(SLIDE 6) The Federal Home Loan Banks also play an important role in the mortgage market by providing secured advances to banks, credit unions, and insurance companies. Federal Home Loan Bank advances hit the trillion-dollar mark in October 2008. Advances have declined to $817 billion at the end of March. Advances have continued to fall since then, and now are 25 percent off the top. Only 5 percent is in private-label mortgage-backed securities, but these have turned out to be very high risk, even though they were originally rated triple-A.

During the boom times of the so-called "housing bubble," virtually everyone involved in home mortgage lending—builders, borrowers, brokers, Realtors®, lenders, mortgage insurers, credit rating agencies, the Enterprises, other secondary market investors, and yes, we regulators—failed to fully appreciate the likelihood of a severe house price correction.

Well, prices did not rise forever, as this chart shows. **(SLIDE 7)** From January of 2000 through July 2006 (peak), the more volatile S&P/Case-Shiller house price index rose by more than 106 percent only to fall by more than 32 percent since then. FHFA's index, which has a much broader geographic span than the S&P 20-city index but only covers conventional conforming and so has fewer lower- and higher-priced houses, is much less volatile, as it peaked later at 63 percent and has only declined 11 percent from that peak. It now appears to be bottoming, but it is too early to make that call. If you take the five worst states—California, Florida, Nevada, Arizona, and Michigan from the FHFA index, we can get a line pretty close to the S&P/Case-Shiller index **(SLIDE 8)**, peaking at 90 percent and falling by 35 percent. These states, not surprisingly, have also been the major source of Fannie Mae's and Freddie Mac's credit losses. **(SLIDE 9)** California alone represents more than a quarter of their losses. In total, the five states represent about two-thirds of their first quarter 2008 losses.

<u>Federal Support for the Housing GSEs</u>

The Housing and Economic Recovery Act of 2008, or HERA, which created FHFA, came much too late to save the Enterprises, but it did pave the way for the Treasury Department to provide financial support to the GSEs so they could continue to support the housing market through this turmoil. **(SLIDE 10)** Treasury's $200 billion Senior Preferred Stock facility for each company provides *an effective guarantee* of the Enterprises' debt and mortgage-backed securities by ensuring each Enterprise has a positive net worth. Two additional facilities were also implemented when the conservatorships began. Under the first, Treasury has purchased $168 billion of their mortgage-backed securities and has made it clear it will continue to be an active buyer. The third facility is a liquidity facility for Fannie, Freddie, and the FHLBanks, but it has never been tapped.

The Federal Reserve Board also is building upon the Treasury's support to reduce mortgage rates. In November last year, the Fed announced it would purchase up to $500 billion in Fannie Mae, Freddie Mac, and Ginnie Mae MBS—and this was upped to $1.25 trillion in March. It has purchased $576 billion. In a second program, the Federal Reserve had originally announced a commitment to purchase up to $100 billion in Fannie Mae, Freddie Mac, and Federal Home Loan Bank debt. That was raised to $200 billion, and to date, the Federal Reserve has purchased $89 billion in Fannie, Freddie, and Federal Home Loan Bank notes.

(SLIDE 11) These efforts have, for the most part, had a very positive impact on mortgage rates. Rates on 30-year mortgages dropped below 5 percent for nearly three months but are now back up to nearly 5.4 percent**.** Obviously, this bounce-back will slow the refinance boom dramatically.

Foreclosure Prevention and the Homeowner Affordability and Stability Plan

I began today by telling you our biggest challenge is to stabilize the housing market. Keeping people in their homes has to be the cornerstone of all efforts to stabilize the housing markets. It is clear that the more empty foreclosed homes, the more damage to neighborhoods, business, and the markets. **(SLIDE 12)** We believe the Administration's new Home Affordable modification and refinance programs are a major step in reducing preventable foreclosures and stabilizing the housing market. FHFA staff spent months working with Treasury on developing these programs—I'm very proud of the work my staff has done on this. It also aggressively builds on FDIC's foreclosure prevention efforts. Lower mortgage rates already helped spark a miniature boom in refinancings this spring.

In the Home Affordable Refinance program (HARP), Fannie Mae and Freddie Mac will provide access to low-cost refinancing for responsible homeowners with loans the Enterprises already own or guarantee. Up to 4 to 5 million homeowners could see their monthly payments reduced. Borrowers will be eligible for a refinanced mortgage with a current loan-to-value (LTV) of 80 percent to 105 percent. Because Fannie Mae or Freddie Mac already hold the credit risk on these mortgages, no additional credit enhancements, such as mortgage insurance, will be required. Existing mortgage insurance will be rolled into the new mortgage. Servicers should already have most of the needed documentation. In many cases, appraisals will not be needed. The idea is to make the refinancing process quick, relatively easy, and cheaper for both the homeowner and the mortgage lender and reduce delinquencies and foreclosures. For the Enterprises, that will reduce their credit risk, and in many cases, increase their guarantee fees. Over the last three months, they have done 1.8 million refinancings. The HARP refis, just starting, are 80,000, a quarter of which are over 80 percent LTV.

The Home Affordable Modification initiative is a comprehensive $75 billion loan modification plan designed to reach up to 3 to 4 million at-risk homeowners. It will be paired with the expanded and improved FHA Hope for Homeowners plan. It will reduce a borrower's monthly housing expense to 31 percent of his/her gross income through a combination of capitalization of past due payments, interest rate reductions, term extensions, principal forbearance, and/or principal forgiveness. Servicers can lower rates to as little as 2 percent, and extend loan maturities to 40 years. After five years of reduction, payments will increase gradually—at no more than 1 percentage point per year up to the Freddie Mac rate at the time of the mortgage origination. This program includes performance incentives for borrowers, servicers, lenders, and investors to encourage the willingness of all industry participants to engage in aggressively modifying mortgages to assist borrowers at risk and to encourage those borrowers to keep their accounts current.

(SLIDE 13) Fannie and Freddie are making good progress on loan modifications. The big challenge is mortgages held in private-label securities. As you can see in these pie charts, while Fannie Mae and Freddie Mac own or guarantee almost 31 million single-family mortgages, about

57 percent of all single-family mortgages. The mortgages they own or guarantee only represent 22 percent of serious delinquencies. On the other hand, private-label mortgage-backed securities represent only 13 percent of the mortgages but 42 percent of the serious delinquencies.

Let me pause on these pie charts for a moment, because they represent the problem we face in foreclosure prevention. If we are going to stabilize the housing market, we have to address that 42 percent in private-label securities. Fannie Mae and Freddie Mac have to return to their previous status as leaders in setting, promoting, and enforcing industry standards and best practices for all mortgages.

Even before the implementation of the Home Affordable refinance and modification programs, our push to increase loan modifications as a means of reducing preventable foreclosures had been really picking up steam. In the first quarter of this year, the number of loan modifications increased by nearly 14,000 from the last quarter of 2008. Very importantly, the type of loan modification has changed dramatically. **(SLIDE 14)** Some 52 percent of modifications during the first quarter of this year reduced the borrowers' monthly payments by more than 20 percent, while a year ago, it was only 2 percent. With only 16 percent receiving any reduction last year, versus 83 percent last quarter, no wonder there was so high a redefault rate.

On April 28, Treasury announced the Second Lien Program component of the Making Home Affordable programs to make it possible for people with second mortgages to modify or refinance. Statistics show that about half of all at-risk mortgages have second liens—some have more than one additional lien. Now when a modification is initiated on a first lien, participating servicers in the second lien program will automatically reduce the second lien's payments.

As agents of the Treasury, both Fannie Mae and Freddie Mac are playing major roles in and assume responsibilities in the implementation and ongoing oversight of the modification program. Those responsibilities include transaction processing, distribution of cash flows, payment of incentives, and program compliance oversight and on-site reviews.

Although the Home Affordable programs are still in their early stages, the Enterprises have reached some key milestones already. The Enterprises have signed up 16 servicers representing 75 percent of the market to participate in the programs. A special Internet portal has been set up for servicers to help them find information easily.

Before leaving the topic of mortgage modifications, I want to make one point that seems to be lost. Although these programs may have a short-term cost from an accounting standpoint to the Enterprises, foreclosures are much more costly directly and indirectly. With a $5.4 trillion mortgage book, stabilizing the mortgage market is critical to the long-term profitability of Fannie Mae and Freddie Mac. With the adoption of the Financial Accounting Standards Board's 166 and 167 in January, which will consolidate their mortgage-backed securities on their balance sheets, even the short-term adverse accounting impact of loan modifications will disappear.

The Future of Fannie Mae and Freddie Mac

These new foreclosure prevention programs depend on Fannie Mae and Freddie Mac for success, a clear sign that the Obama administration is serious in its intent that the Enterprises will continue having a key role in the nation's economy as we go forward. As yesterday's Financial Regulatory Reform proposal said, "We need to maintain the continued stability of the GSEs during these difficult financial times." There is no shortage of ideas. I would venture to guess that everyone in this room has an opinion about what should happen to Fannie Mae and Freddie Mac. Congress and the Administration ultimately have to figure out the answer. In yesterday's Financial Reform agenda, it was announced that the Administration will have a proposal at the time of the President's 2011 budget release.

Before deciding among the wide variety of possible legal and ownership structures for the Enterprises, I believe the first decision is what do we want the mortgage market to look like. Then we must establish some very basic principles that will guide evaluation of the options and the choice among them. **(SLIDE 15)**

The first principle is that the Enterprises or any successors should have a well-defined and internally consistent mission based on their fundamental role in the mortgage market. Their mission activities should not require excessive risk taking.

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. 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. What roles are best played by the federal government and private firms? How can we best harness the strengths of market capitalism, while reducing the risks and avoiding unintended consequences?

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

The fourth principle is to create a regulatory and governance structure that ensures risk taking is prudent. Clearly, it was folly to allow the Enterprises to legally leverage their mortgage credit by well over 100 to 1. HERA gave FHFA greater flexibility to establish capital and other prudential standards for the housing GSEs. 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 also 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 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. FHFA's membership on the Financial Services Oversight Council will be an important step.

Potential Structures

With those principles in mind, we can consider issues related to the structure of the Enterprises or successor institutions. Whatever option is chosen, the U.S. financial system will continue to require a vibrant secondary mortgage market, including the functions currently performed by the Enterprises.

(SLIDE 16) There are three basic options for the future structure of Fannie Mae and Freddie Mac: government agency, improved GSE, or fully private firms. 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. My career has included work with several private-sector insurance companies and several government insurance programs. What I have seen is that government insurance programs are high risk, and inviting the private sector to shift risk to the government. It is often difficult in a political environment to calculate or charge an actuarially fair price, avoid mission creep, and keep federal risks from increasing. Nonetheless, government has an important role to play in providing certain types of insurance, especially reinsurance against catastrophic risks. One possibility, for example, would be for the government to provide catastrophic reinsurance to the secondary mortgage market funded by premiums paid by participating companies. The present difficulties do not provide a sound rationale for permanently nationalizing the $11 trillion mortgage market.

The second alternative would be to keep the Enterprises as improved GSEs, building upon HERA. They could continue with Treasury net worth protection or government reinsurance for catastrophic risk. A public utility model could be established. A cooperative ownership similar to that of the Federal Home Loan Banks 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 profit and public purpose.

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.

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. We believe that the approach taken to funding the Federal Home Loan Banks' affordable housing mission, which is essentially a flat tax that directly subsidizes 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, conflicts between safety and soundness and mission will arise and will require tough decisions.

To summarize, our critical job, and that of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks is to help stabilize the housing market and thereby the U.S. economy. Markets and the Enterprises will stabilize, and as they do, top policymakers in Congress and the Administration will have to address the complex issues I have outlined for you today. It is crucial that we get the restructuring done right for the U.S. and world economies and all present and future homeowners and renters.

Thank you. I will be happy to answer any questions you may have in the time we have left.

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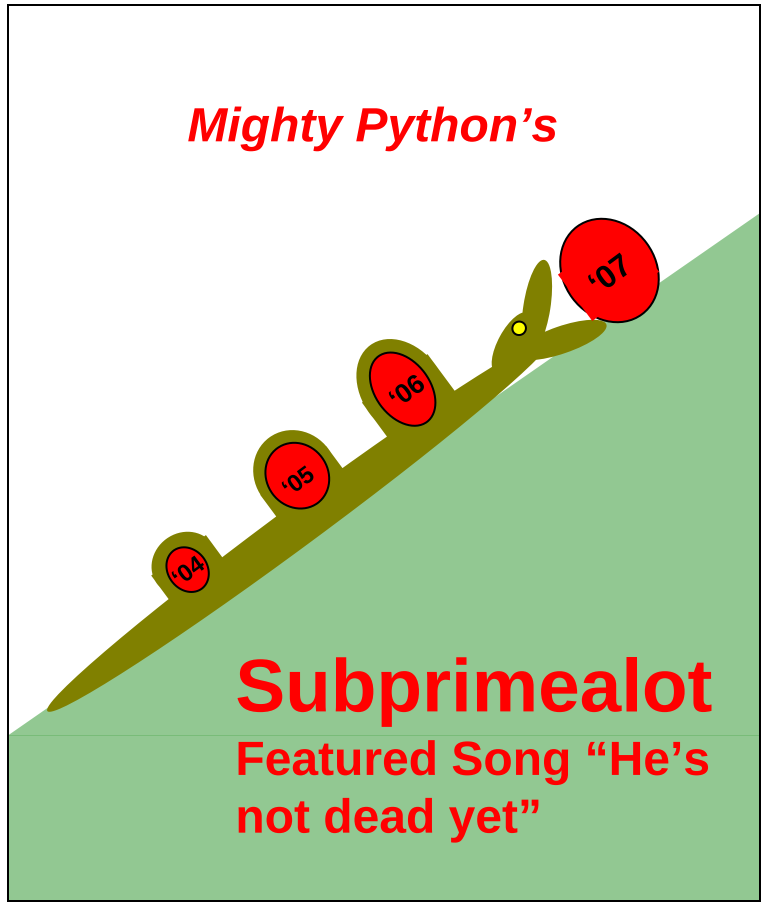
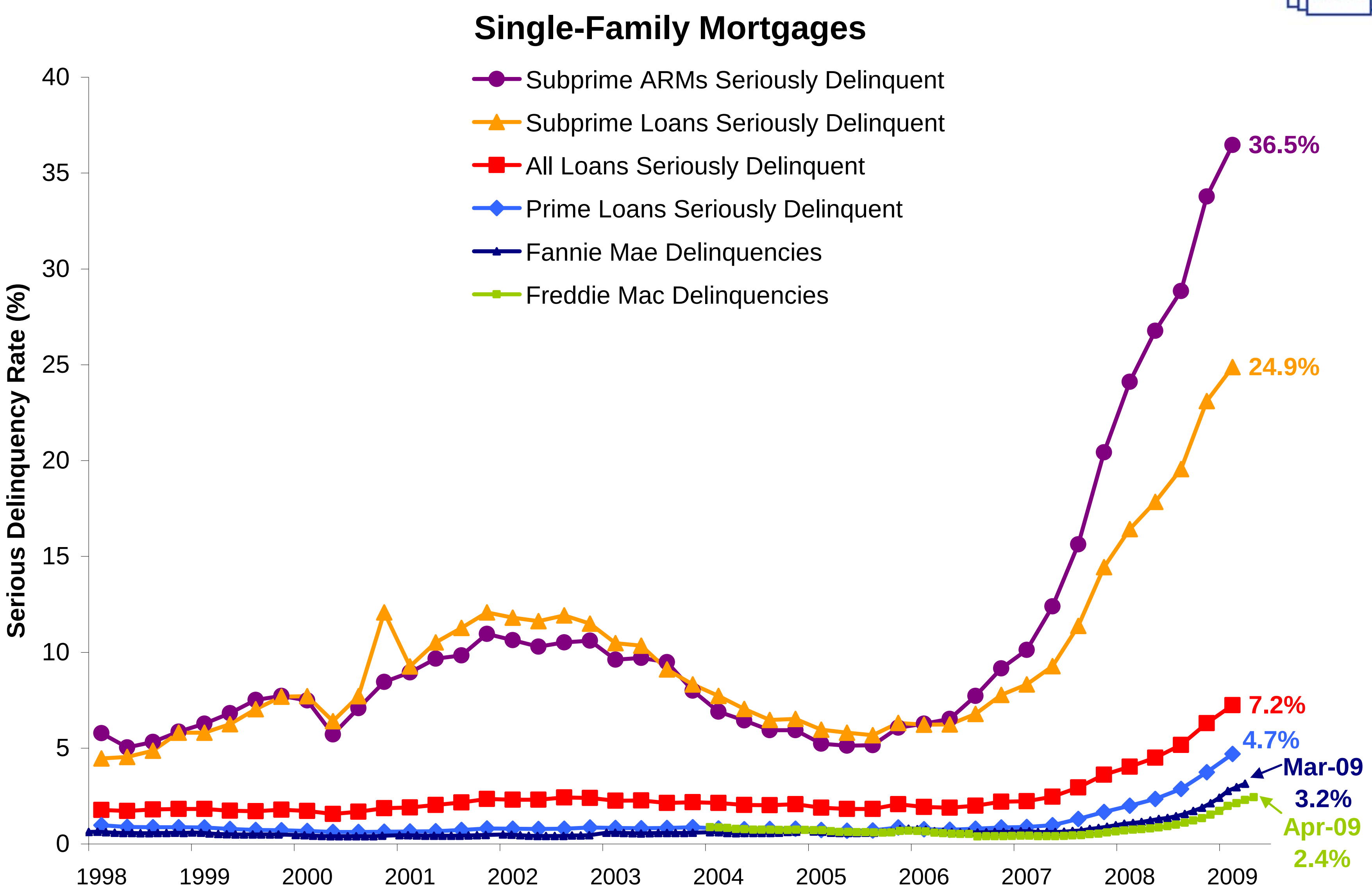
Broadway



June 30, 2007

Serious Delinquencies Rising Rapidly



Sources: Mortgage Bankers Association, Fannie Mae, Freddie Mac.

FHFA's Four Stabilization Strategies

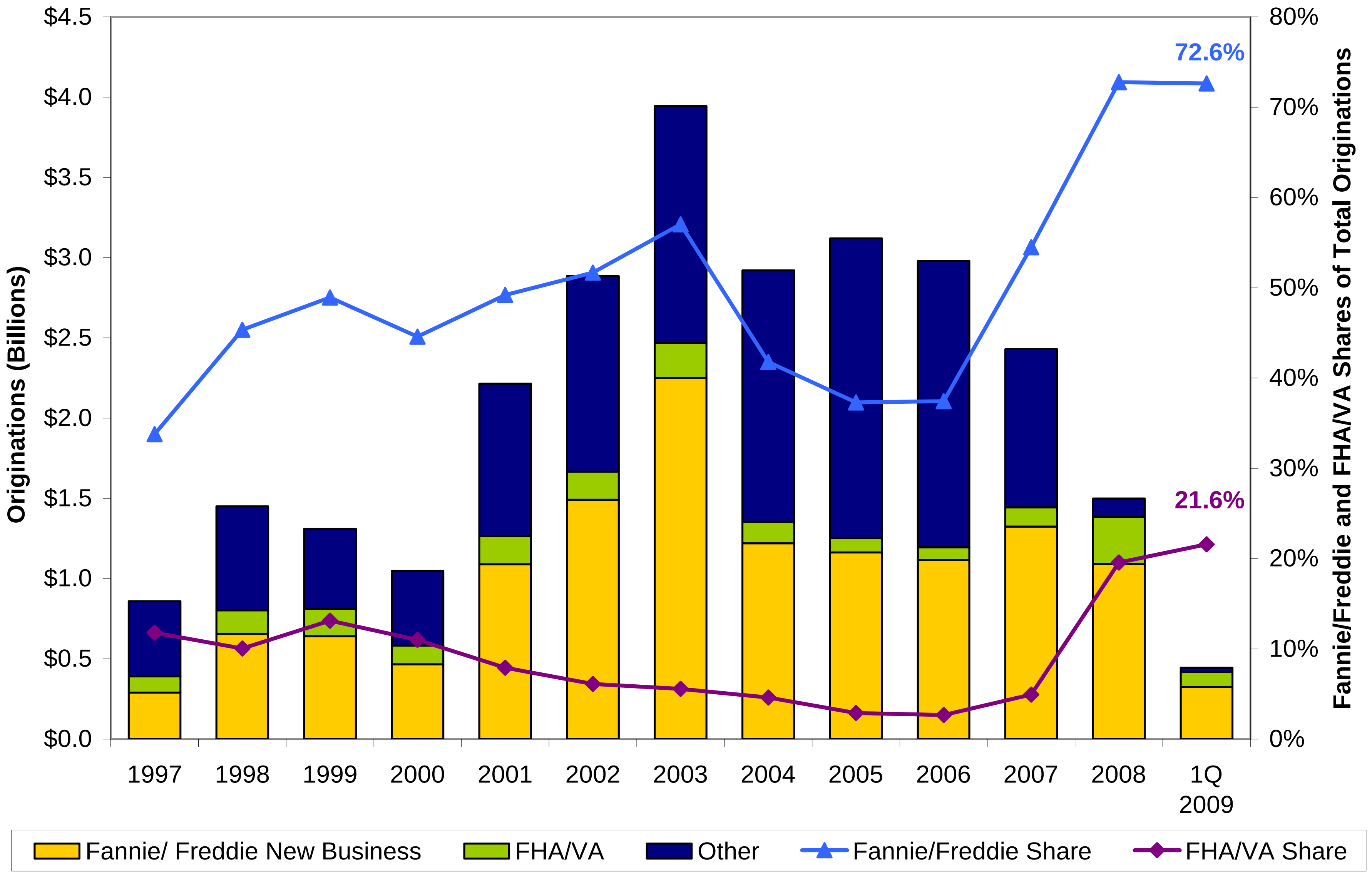
1. Ensure Fannie Mae, Freddie Mac, and the Federal Home Loan Banks provide liquidity, stability, and affordability to the housing market in a safe and sound manner

2. Work with government partners to reduce mortgage rates

3. Work with the Enterprises to set best practices for the mortgage market

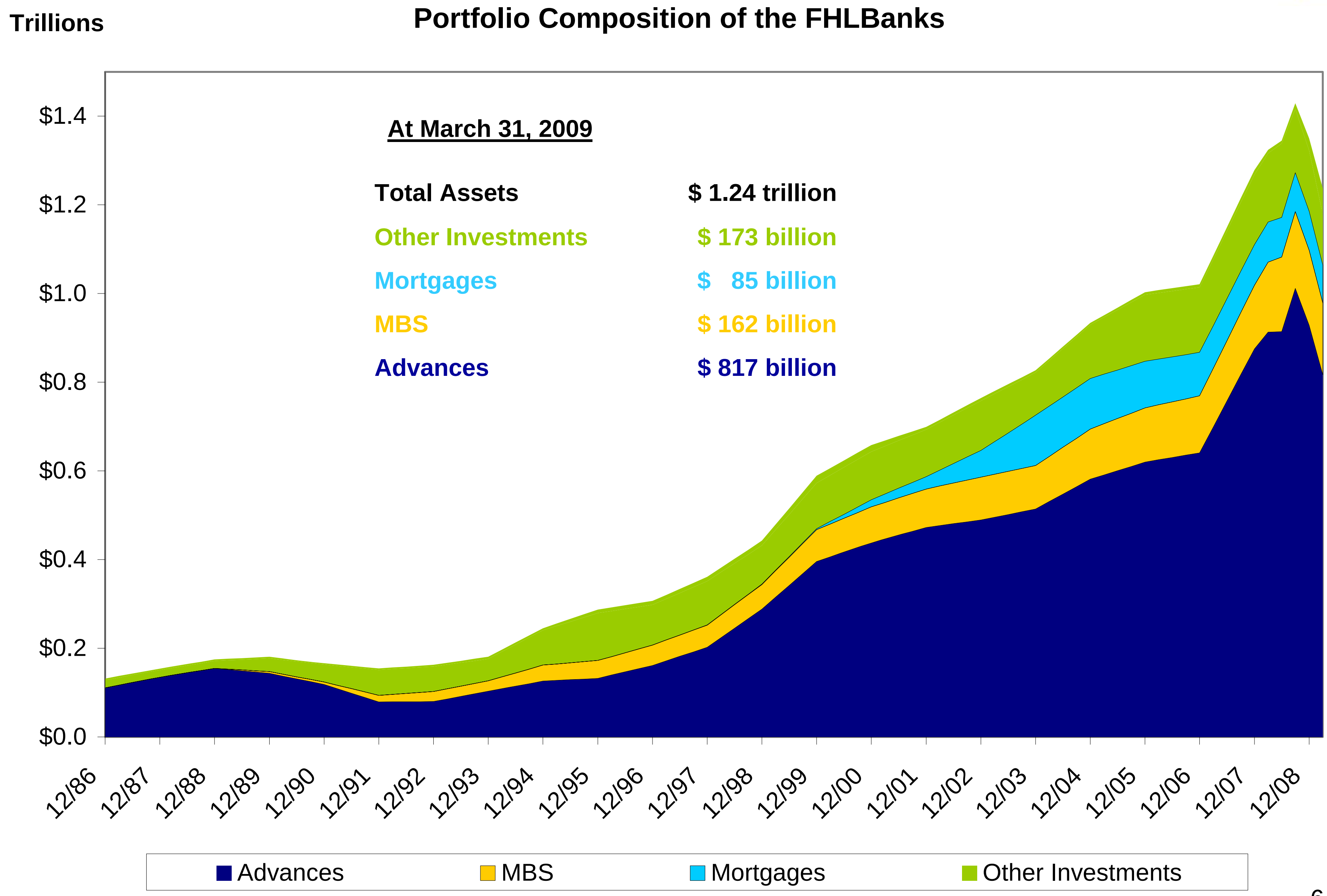
4. Prevent foreclosures through affordable modifications and refinancings

Enterprise and FHA/VA Shares of Originations

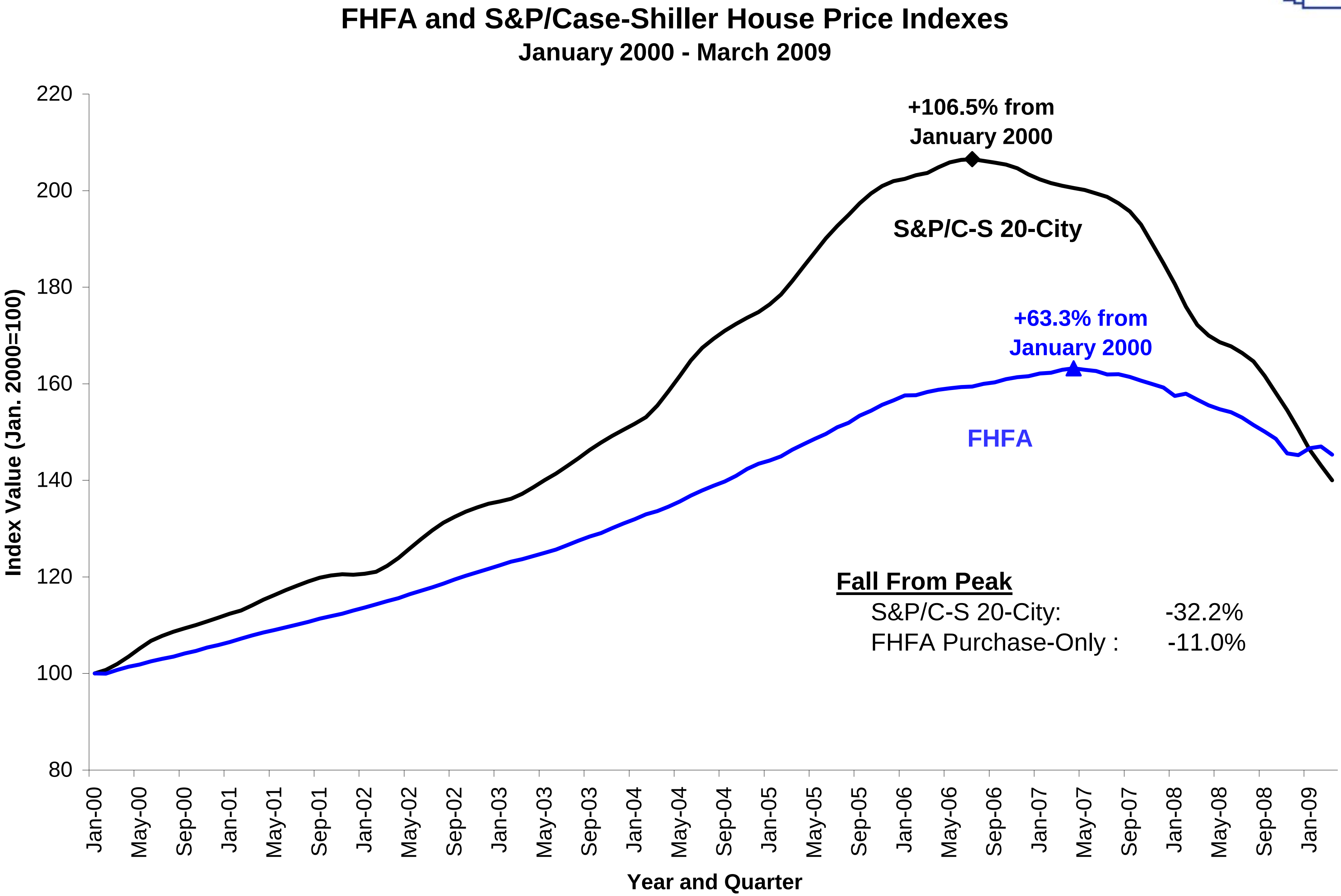


Sources: Inside Mortgage Finance, Enterprise Monthly Volume Summaries.

FHLBank Advances Peak in Third Quarter 2008

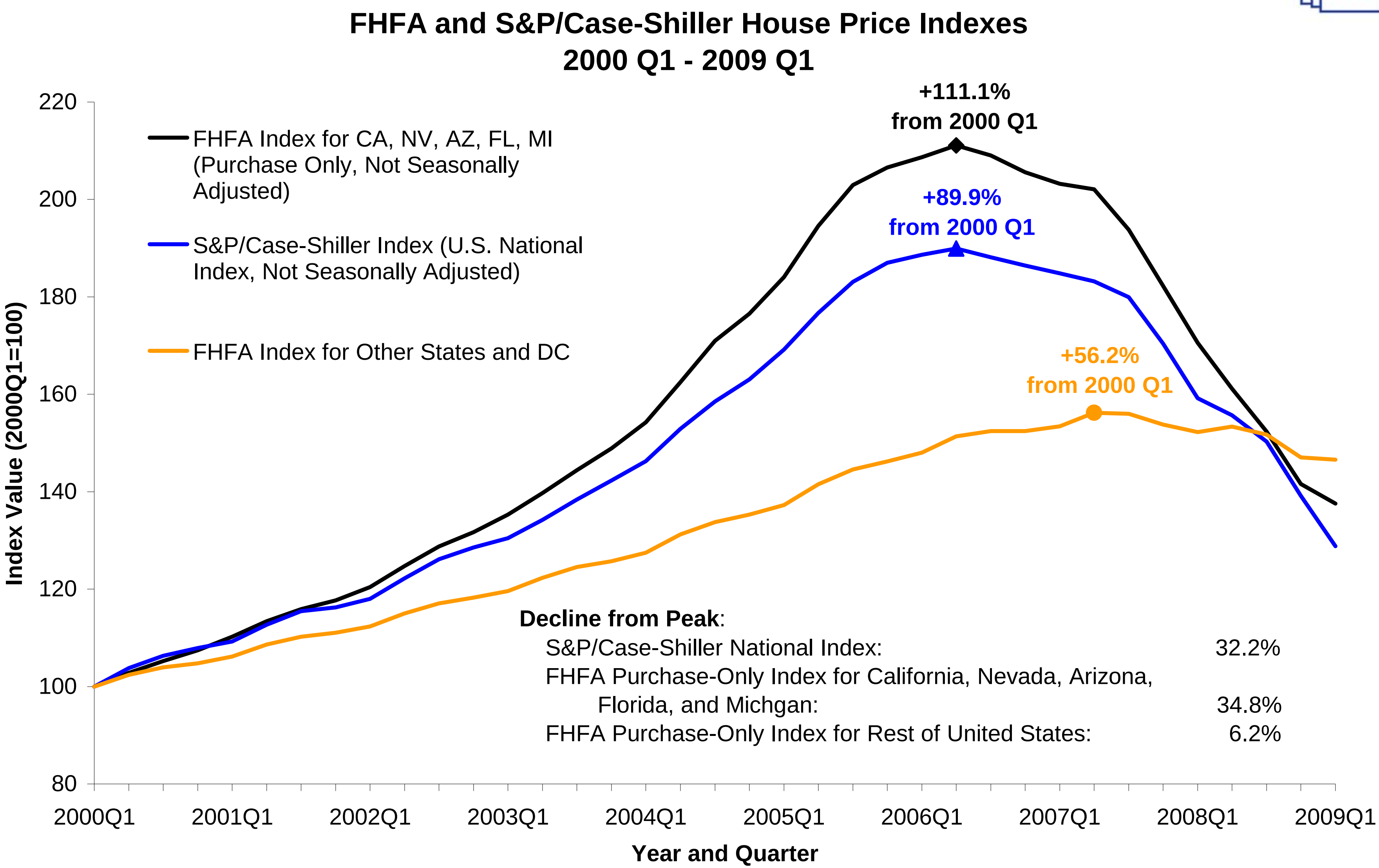


House Prices Continue to Fall



Note: For purposes of comparison, the FHFA purchase-only index has been re-based to January 2000=100 (the standard series is set so that January 1991=100)

House Prices Continue to Fall

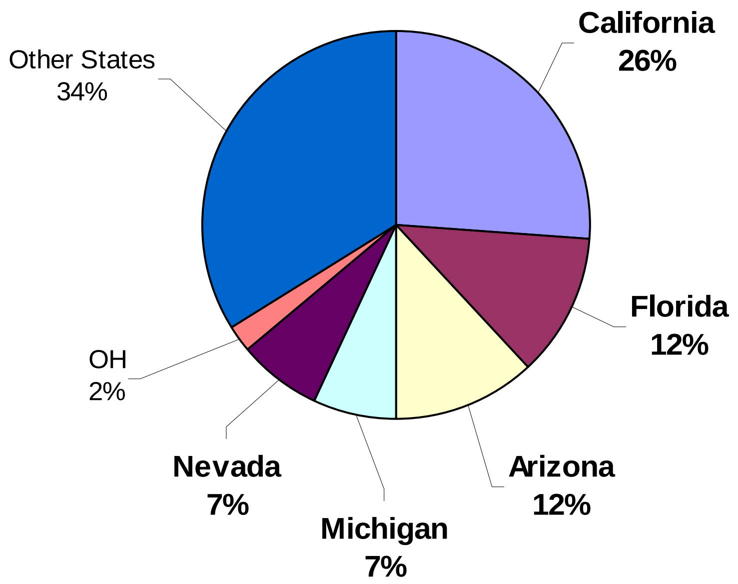


Sources: FHFA National House Price Index and S&P/Case-Shiller National Index.

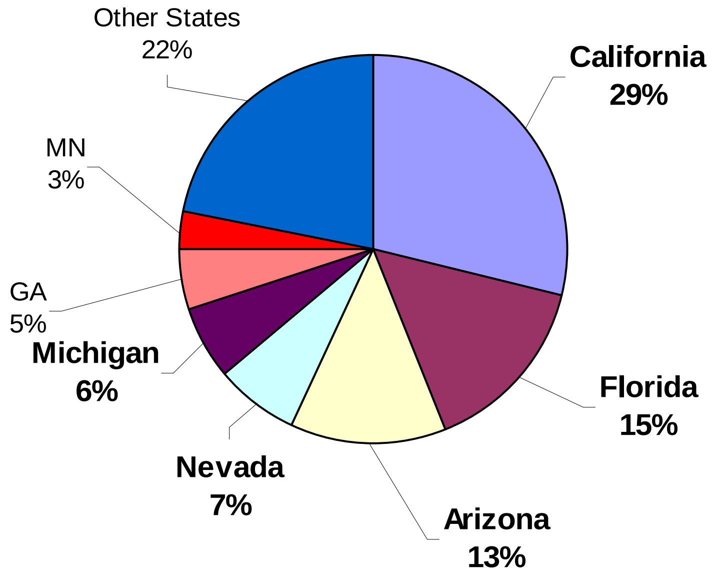
Note: For purposes of comparison, the FHFA purchase-only indexes have been re-based to January 2000=100 (the standard series is set so that January 1991=100)

Five States Account for Two-thirds of Credit Losses

Credit Losses by State 1Q09
Fannie Mae



Credit Losses by State - 1Q09
Freddie Mac



Treasury and Fed Support Is Strong

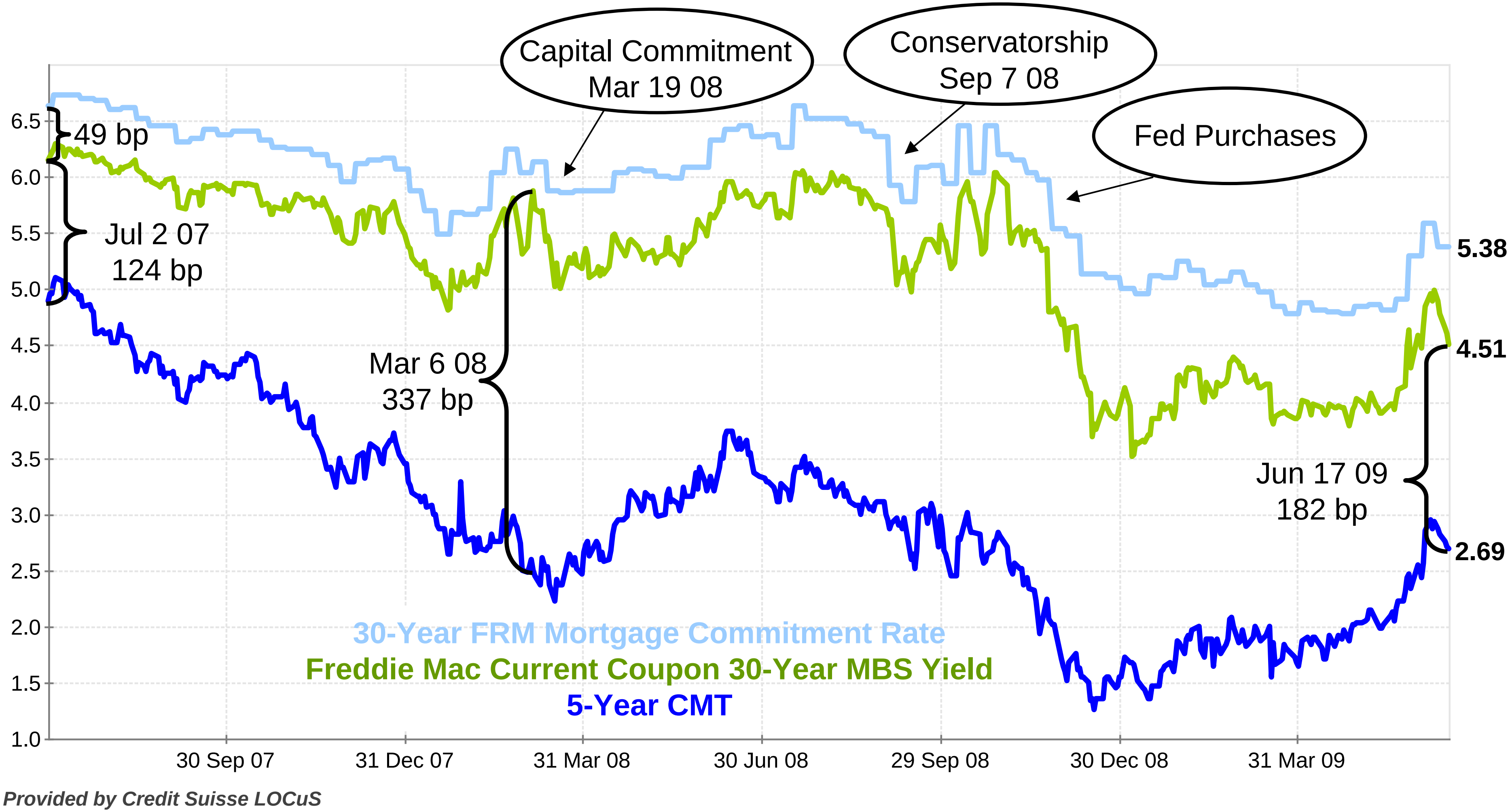
(in Billions)

	Available	Used	
Treasury:			
Senior Preferred	$400	$85	
Enterprise MBS	no limit	168	*
GSE Liquidity Facility	no limit	0	
Federal Reserve:			
Agency MBS	$1,250	$576	
GSE Debt	200	89	
Total:	**$2,018+**	**$918**	

data as of 6/18/2009

** included in available*

Mortgage Rates Falling, but Spreads Are Wide



Sources: Credit Suisse, Freddie Mac, and Federal Reserve Board H15.

Homeowner Affordability and Stability Plan

Home Affordable Refinance Plan

- Fannie Mae and Freddie Mac refinance responsible homeowners — 4 to 5 million eligible
  - Currently paying homeowners can refinance mortgages up to 105 percent loan-to-value to reduce payments

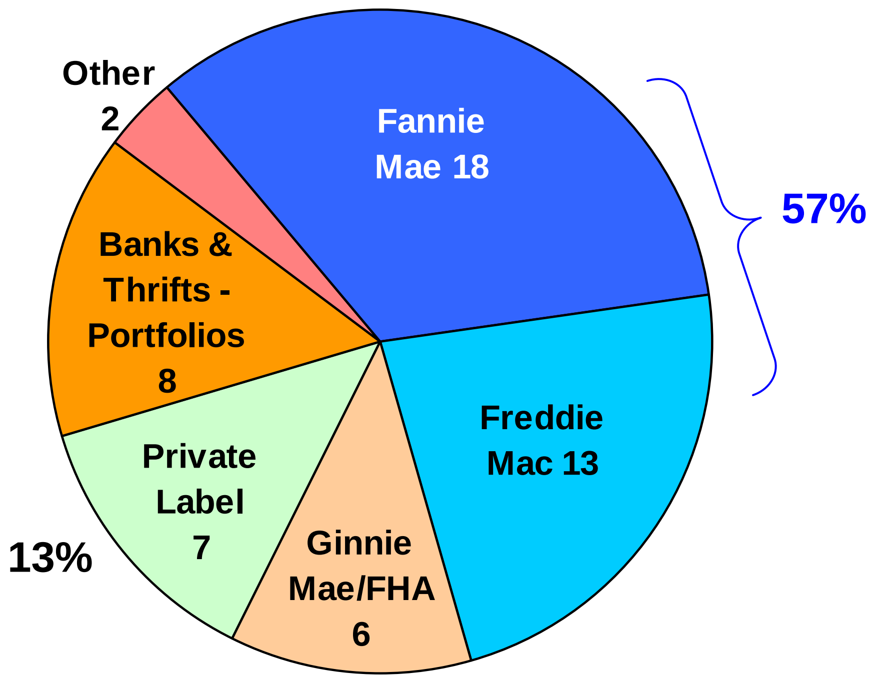
Home Affordable Modification Plan

- $75 billion Aggressive Loan Modification Program — 3 to 4 million eligible
  - Imminent or in-default homeowners can get mortgage payments reduced to 31 percent of gross income

PLS Modifications Key to Foreclosure Prevention

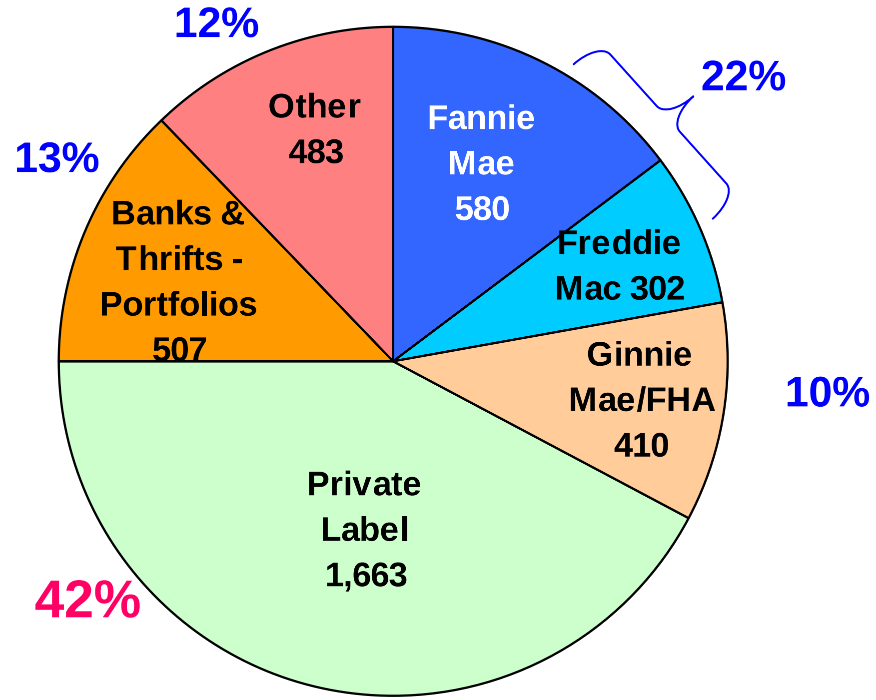
Q1 2009

Mortgages Outstanding (millions)



Total: 54.5 million

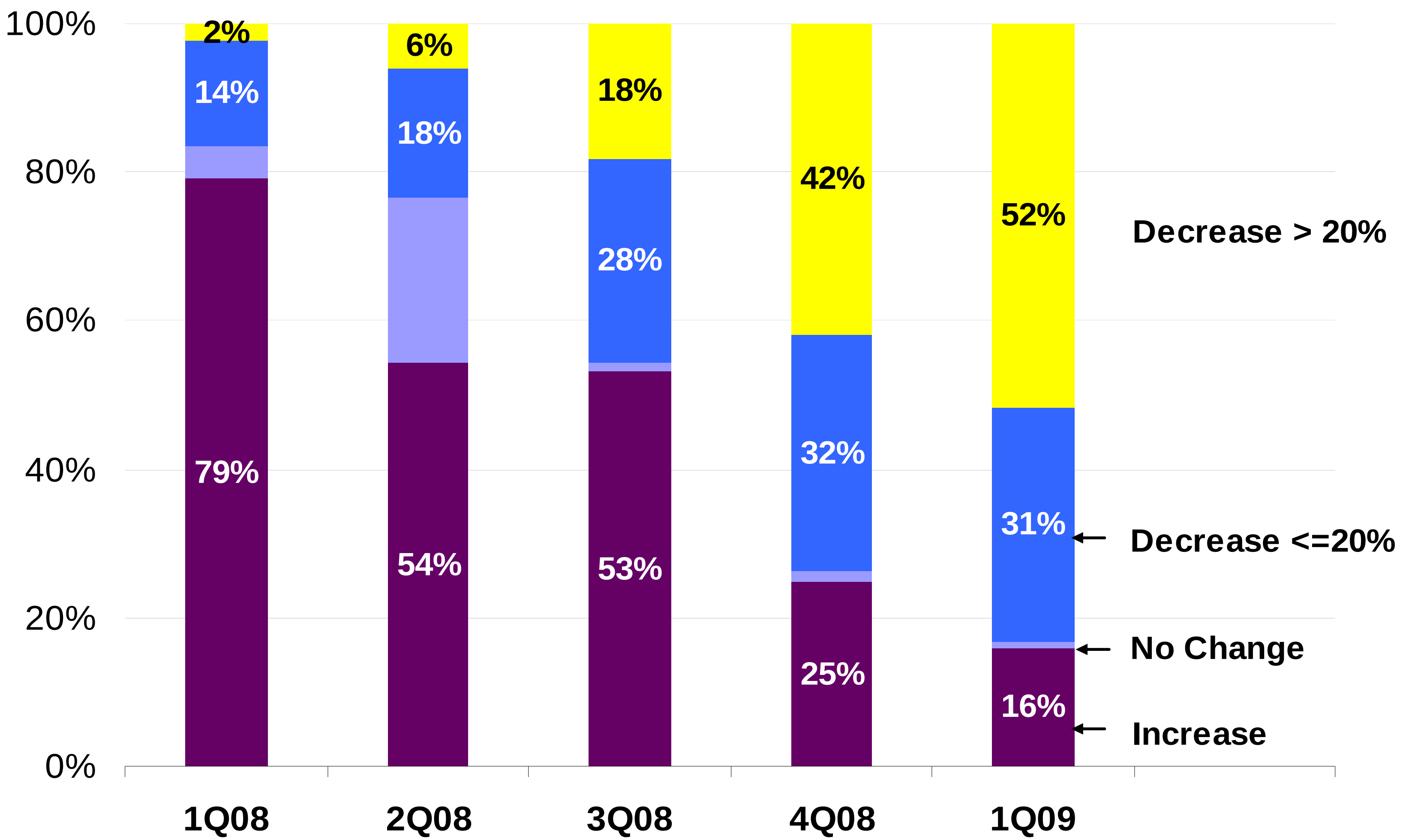
Seriously Delinquent Mortgages (thousands)



Total: 3.9 million

Sources: FHFA, Freddie Mac.

Enterprise Loan Modifications Are Changing



# of Loan Modifications	15,655	15,387	13,488	23,777	37,328

Principles for the Future of the Enterprises

1. Well-defined and consistent mission based on fundamental role in secondary mortgage market

2. Clear demarcation of private and public sector roles

3. Base on strong insurance principles

4. Regulatory and governance structure to ensure prudent risk taking

5. Systemically prudent supervision that incorporates countercyclical capital to limit booms and busts

Options for the Future of the Enterprises

- Nationalize or merge Enterprises with FHA or Ginnie Mae
  - Moral hazards of government insurance programs

- Improved GSE model building upon HERA
  - Variations include public utility model, government insurance for catastrophic risks, reduction in retained portfolios, and cooperative ownership

- Establish private-sector firms to supply liquidity to mortgage markets
  - With or without government catastrophic insurance of MBS credit risk

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