Statement of

Edward J. DeMarco, Acting Director

Federal Housing Finance Agency

Before the U.S. House of Representatives Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

"Current State of the Government Sponsored Enterprises"

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Chairman Kanjorski, Ranking Member Garrett and members of the Subcommittee, thank you for inviting me to speak on the current state of the housing government sponsored enterprises (GSEs): Fannie Mae and Freddie Mac (the Enterprises) and the twelve Federal Home Loan Banks (FHLBanks). Given the exceptional reliance over the past two years on all of the housing GSEs, there has been considerable discussion about their role, performance, and future. I appreciate the opportunity to provide you with a report on the current state and condition of these entities, as well as a description of the responsibilities and activities of FHFA as both conservator and regulator. I hope that my comments will help to build the foundation for the upcoming Congressional consideration of the future structure of the housing finance system.

Today I will highlight:

1) the purpose and goals of FHFA's conservatorships of the Enterprises;
2) general findings from FHFA's oversight of the GSEs, as set forth in FHFA's 2009 Report to Congress; and
3) principles and issues that should be considered by Congress when contemplating the future of the GSEs.

Conservatorship Status

The Enterprises have been operating in conservatorship since September 2008. 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. FHFA continues to exercise oversight as safety and soundness regulator, and as conservator, holds the powers of the management, board, and shareholders of each Enterprise. However, the Enterprises themselves are responsible for normal business activities and day-to-day operations.

The conservatorships have been effective to date, instilling confidence in the market that the Enterprises are capable of fulfilling their statutory role. Their increased presence in the mortgage market over the last two years demonstrates that they continue to serve their intended purpose, despite their tenuous financial situation. The Enterprises' mortgage purchase and guarantee activity in 2009 represented more than 76 percent of total conforming single-family originations.

Although the Enterprises substantial market presence has been a key step to restoring market stability, neither company would be capable of serving the mortgage market today without the ongoing financial support provided by the U.S. Department of the Treasury. Including the draws requested at the end of the first quarter of 2010, Fannie Mae will have drawn $83.6 billion and Freddie Mac $61.3 billion in Treasury support from the Senior Preferred Stock Purchase Agreements, nearly $145 billion in total. To provide the public with clear information about the Enterprises, FHFA will soon begin posting to its web site on a regular basis data on the Enterprises' business activities and performance in conservatorship.

While reliance on the Treasury Department's backing will continue until legislation produces a final resolution of the Enterprises' future, FHFA is monitoring the activities of the Enterprises to: a) limit their risk exposure by avoiding new lines of business; b) ensure profitability in the new book of business without deterring market participation or hindering market recovery; and c) minimize losses on the mortgages already on their books.

Limiting Risk Exposure

In February, I communicated to Congress my position that, in conservatorship, the Enterprises will be limited to continuing their existing core business activities and taking actions necessary to advance the goals of the conservatorship. I have not authorized any new products to be developed by the Enterprises, due to the operational challenges inherent in new product offerings, the need to devote full attention to loss mitigation activities and remediating internal weaknesses, and efforts to aid in the market recovery. As I said at the time, this type of limitation on new business activities is consistent with the standard regulatory approach for addressing companies that are financially troubled. And it is even more pertinent for the Enterprises given their uncertain future and reliance on taxpayer funds.

Rather than developing and offering new products, the Enterprises must maintain their focus on mitigating credit losses and remediating internal operational weaknesses while employing prudent underwriting standards and guaranteeing proven mortgage products. For example, over the past year, both Fannie Mae and Freddie Mac have nearly eliminated their purchases of Alt-A and interest-only loans, two of the poorest performing mortgage products in the market. During the first quarter of 2010, less than 2 percent of Fannie Mae's purchases were interest-only loans and Freddie Mac purchased none. Similarly, Alt-A loans were less than 1 percent of acquisitions for both Enterprises. This is significant because interest-only loans previously purchased by the Enterprises have serious delinquency rates of more than 18 percent and Alt-A loans have serious delinquency rates of more than 12 percent. These products, which may be appropriate in limited circumstances, have produced substantial losses for the Enterprises. During the first quarter of 2010, Alt-A loans already on the books were responsible for 37 percent of Fannie Mae's losses for the quarter and 42 percent of Freddie Mac's.

In fact, the Enterprises have made significant progress in improving the quality of new mortgages they purchased in 2009. As the chart below demonstrates, the Enterprises have been able to focus on borrowers with higher credit scores and loans with higher loan-to-value (LTV) ratios, two factors that affect expected default rates. In 2009, there were improvements across the product, credit score, and LTV ratio spectrums, as 15-year fixed-rate mortgages grew as a share of total acquisitions, credit scores improved, and fewer loans with low down payments were acquired.

The Enterprise loans that have been refinanced through the Home Affordable Refinance Program (HARP) have also helped to improve the credit quality of their books of business. HARP refinance mortgages, which the Enterprises began to acquire in the second quarter of 2009, accounted for 4 percent of acquisitions for the year.

Enterprise Acquisition Profile, 2007-2009*
(share of total unpaid principal balance)

Product Type	**2007**	**2008**	**2009**	**Change from 2008**
Fixed-Rate 30-year Mortgages	83	80	80	1
Fixed-Rate 15-year Mortgages	5	10	14	4
Other Fixed-Rate Mortgages	3	3	4	1
Adjustable-Rate Mortgages	8	7	2	(5)
	100	100	100	0
Credit Score				
>=720	55	68	85	17
660-719	28	24	13	(11)
<660	17	8	2	(6)
	100	100	100	0
Loan-to-Value Ratio				
0-70 Percent	31	38	49	11
70.1-80 Percent	45	40	40	(0)
80.1 - 95 Percent	14	18	10	(9)
>95 Percent	10	3	1	(2)
	100	100	100	(0)

Source: FHFA, based on data from Fannie Mae and Freddie Mac
* Components may not add to totals due to rounding; these data exclude bulk purchases and some unusual loan types.

Due to the focus on improved purchase quality and underwriting standards, the loans that the Enterprises have purchased since conservatorship in late 2008 have had much lower rates of serious delinquency. Serious delinquencies for the 2009 vintage are a fraction of the serious delinquency rates for the 2006-2008 vintages at comparable periods after origination. Losses on the 2006 and 2007 vintages accounted for 65 percent of combined credit losses in the first quarter of 2010 for the Enterprises. Losses on the 2009 vintage are expected to be much lower.

Profitability of New Business

Each Enterprise has also made changes in their national guarantee fee pricing to correct for the under-pricing of credit risk in prior years and to reflect current risks in an environment of falling house prices and rising mortgage delinquencies. The Enterprises updated their pricing models several times in 2009, as they had in 2008, to reflect changes in the market environment.

FHFA expects to publish its annual report on Enterprise guarantee fees shortly. The report will show that both Enterprises have set their 2009 pricing at levels that are expected to cover future losses, operating expenses, and a reasonable return on their new loan guarantees.

Minimizing Credit Losses

Central to the goals of conservatorship is the mitigation of credit losses. The Enterprises' foreclosure prevention efforts – including loan modifications and refinances as well as short sales and deeds in lieu of foreclosure – fulfill the Emergency Economic Stabilization Act of 2008 mandate to "maximize assistance to homeowners" while minimizing losses to the Enterprises themselves. FHFA reports monthly to Congress on the full range of Enterprise foreclosure prevention activities through the Foreclosure Prevention / Federal Property Manager's Report, the latest edition of which can be found on the agency's web site.[1]

In pursuit of the goal of minimizing credit losses and fulfilling this statutory mandate, FHFA and the Enterprises worked with the Administration to design and implement the Making Home Affordable program (MHA). The Enterprises will continue to act as agents for Treasury in implementing this program. FHFA views this activity as consistent with the goals of the conservatorship and the EESA mandate. The program should have a significant positive impact on the Enterprises, simply because of the breadth of their business and the concentration of poorly-performing loans in declining markets. Between the influx of new business in 2009 and 2010 and the loans already on the books, the Enterprises own or guarantee about half the mortgages in the country today.

From program inception in the second quarter of 2009 through March 2010, the Enterprises have reported more than 584,000 active trial and permanent modifications under the Home Affordable Modification Program (HAMP). More than 136,000 were permanent modifications. In addition, over the same period, the Enterprises have modified more than 128,000 mortgages under their own programs for homeowners who did not qualify for HAMP. Modifications can help homeowners stay in their homes by lowering their monthly payments through interest rate reductions, term extensions, or

[1] http://www.fhfa.gov/webfiles/15736/FPMreport51910.pdf

principal forbearance. To prevent foreclosure when a modification is not appropriate, the Enterprises can work out a short sale or deed-in-lieu. They have completed 74,000 of these since the second quarter of 2009.

Refinancing can also lower a homeowner's payment. Since the beginning of 2009, the Enterprises have refinanced more than 4.9 million loans, including 291,000 loans through the Home Affordable Refinance Program (HARP). The Enterprises will work with homeowners through repayment plans and forbearance plans to help them catch up on their mortgage payments; more than 251,000 homeowners have been assisted in this way since the beginning of 2009.

FHFA's Regulatory Oversight of the Housing GSEs

Fiscal year 2009 was FHFA's first full year of operation and the agency made significant progress in establishing the infrastructure, policies, and processes necessary to regulate the two Enterprises, all of the 12 FHLBanks, and the FHLBanks' Office of Finance. In the midst of integrating staff and operating systems from three agencies into one and operating the conservatorships, FHFA carried out its responsibilities for oversight of the GSEs, conducting continuous supervision activities and targeted reviews at Fannie Mae and Freddie Mac and performing examinations of all 12 FHLBanks and the Office of Finance.

Enterprises

While housing finance continues to depend critically on the Enterprises, FHFA rates both Fannie Mae and Freddie Mac to be "critical supervisory concerns," mainly due to continuing credit losses associated with the 2006 and 2007 books of business, as well as forecasted losses yet to be realized. FHFA expects the high delinquency rates to continue for these older books of business due to uncertain house price paths, weak employment, and continued economic uncertainty.

The risk associated with continued house price declines is a difficult challenge faced by both Enterprises. Fannie Mae and Freddie Mac will continue to sustain credit losses on mortgages originated pre-conservatorship across the entire country but especially on loans originated in four states: California, Florida, Arizona, and Nevada. Each of these states has experienced significant house prices declines, with values dropping dramatically, as illustrated below. The concentration of loans in these declining markets has contributed to a growing number of defaults as well as higher severity of losses for the Enterprises. The Enterprises have been building their loan loss reserves to cover the future anticipated losses associated with this business.

State	Losses as a Percent of Total Credit Losses, 2009		Percent House Price Declines, Peak to Current*
	Fannie Mae	Freddie Mac	
Arizona	11	11	-37
California	24	32	-39
Florida	16	15	-37
Nevada	7	6	-50

*FHFA Purchase Only Index, seasonally adjusted, through 4Q2009.
Source: Fannie Mae Quarterly Credit Supplement; Freddie Mac Quarterly Financial Results Supplement

Another problem faced by both Enterprises relates to their high degree of operational risk and limits to their operational capacity. Constraints on operational capacity are not only a concern for the Enterprises but for mortgage servicers that generally were incented to keep costs low during the housing boom and thus have been strained by record mortgage defaults. Although both Enterprises recognize the need for "high-touch" servicing, such servicing is scarce, which is why management at both Enterprises have been working to develop alternative servicing solutions for high-risk mortgage portfolios. Operational issues also result from rapidly rising inventories of real estate owned. Not only do large volumes of foreclosed houses give rise to operational challenges, but these properties must be liquidated in a manner that does not further exacerbate weaknesses in housing markets.

Aside from the obvious credit and operational challenges, each Enterprise continues to fund over $750 billion in mortgage-related assets with their own debt. The interest rate risk of mortgage portfolios of this size is inherently large, but the challenges of managing this portfolio have become even larger due to difficulties in estimating prepayments, in part due to continued uncertainties relating to defaults, unemployment, and interest rates. The need to carefully manage the risk of these portfolios is heightened by the fact that many of the new mortgages in the Enterprise portfolios were originated at historically low rates, so that if we were to face an environment of rising interest rates, the average duration of these investments would extend significantly, which could create funding challenges if such risk is not properly managed today. FHFA remains committed to reducing the Enterprises' retained portfolios as set forth in the Treasury agreements. Still, the increased flexibility provided in last December's amendments to those agreements has given the Enterprises critical capacity to purchase delinquent mortgages out of guaranteed mortgage-backed security pools.

Now I would like to turn briefly to the FHLBanks, institutions that are also a key part of the nation's housing finance system.

Federal Home Loan Banks

FHFA is looking for the FHLBanks to return to more traditional operations and activities, with a focus on the advances (collateralized loans) to member institutions and a gradual reduction in investment portfolios, which are not needed to support core business activities and safety and soundness.

The FHLBanks' advance business continues to experience no credit losses, but FHFA has serious concerns with the quality of the FHLBanks' past investments in private-label mortgage-backed securities. The FHLBanks' private-label mortgage-backed securities contribute to safety and soundness concerns at certain FHLBanks even though, as of December 31, 2009, all 12 FHLBanks exceeded the minimum leverage ratio by having at least 4 percent capital-to-assets. The weighted average regulatory capital to assets ratio for the FHLBank System was 5.9 percent.

Material risk management deficiencies are present at some individual FHLBanks. Since October, 2007, for example, the FHLBank of Chicago has operated under a cease and desist consent order. In early 2009, the FHLBank of Seattle failed one of its capital requirements. Although it satisfied that requirement later in the year, FHFA used its discretionary authority to maintain the undercapitalized designation for that FHLBank. As a result of these circumstances, each of these FHLBanks is prohibited from paying dividends and redeeming and repurchasing stock. Each is also working through other supervisory requirements.

Beyond these two FHLBanks, other FHLBanks with substantial investments in private-label mortgage-backed securities have seen a the decline in their market value of equity compared to the par value of capital stock, which has resulted in a reduction or suspension of dividends and limits on their ability to repurchase or redeem stock.

Advances fell to $572 billion at March 31, 2010, which is down 9 percent from the previous quarter and 30 percent from a year ago. Advances are now down 44 percent from the peak in 2008 and are at the lowest level for the System since the third quarter of 2004. Advances are less than 60 percent of total assets for the first time since the first quarter of 1998. The decline in advances reflects (1) continuing deposit growth and tepid loan demand at members that results in reduced need for wholesale funding and (2) the continuing consolidation in the financial services industry in which some former large borrowers were acquired by firms with a lower historical use of advances.

The FHLBanks' Affordable Housing Program (AHP) continues to be a source of funds for national and local affordable housing initiatives supported by member institutions. However, the decline in FHLBank income has reduced AHP contributions from $331 million in 2007 to $258 million in 2009. FHFA continued to implement housing goals for the FHLBanks, which are mandated by HERA. To that end, FHFA just sent a proposed rulemaking on the FHLBanks' housing goals to the *Federal Register*.

In another important development pertaining to the FHLBank System, on April 27th FHFA sent to the *Federal Register* a final rule revamping the governance structure of FHLBank System's Office of Finance (OF). Specifically, the rule restructures the OF's board of directors and enhances the independence and responsibility of the OF board's audit committee for the System's combined financial reports. The OF is responsible for issuing consolidated obligations on behalf of the 12 FHLBanks, serves as their fiscal agent, and prepares disclosure materials associated with the marketing and sale of that debt, including the System's quarterly and annual combined financial reports. The changes made by this rule strengthen the breadth and independence of the OF Board and should enhance the usefulness of the FHLBank System's combined financial reports to investors.

Future of the GSEs

The decision to place the Enterprises into conservatorship proved to be appropriate, accomplishing the Federal government's primary objective of supporting the ongoing availability of mortgage financing during a period of severe market contraction. Despite the benefits derived from the Treasury support for Enterprises activities, conservatorship is not a long-term solution. Moreover, of the various options under consideration for a post-conservatorship construct, the only one that FHFA may implement under existing law is to reconstitute the two companies under their current charters.

The new legislation needed to effect important changes in the institutional framework must contemplate how to replace, without disruption to the system as a whole, the role and function of the Enterprises, which have served as the two leading conduits that connected capital markets to individual mortgage transactions. Given the extraordinary losses to these companies and the need for financial support from the federal government resulting from the present mortgage crisis, to say nothing of the toll on individual households and communities, we as a nation need to ask and answer some hard questions about what we want out of our housing finance system. As part of that consideration, policymakers should consider the important role played by the FHLBanks during the recent crisis and their role should also be considered as part of the future of the nation's housing finance system. To start, Congress and the Administration need to clearly define the proper public policy objectives and the degree and characteristics of government involvement in this housing finance system to best serve those objectives.

I offer to this committee the same ideas and objectives that I shared with the Senate Banking Committee this past October. Our main purpose in addressing housing finance reform should be to promote the efficient provision of credit to finance mortgages for single-family and multifamily housing. I believe that an efficient system of credit allocation should have certain core characteristics: allowing innovation, providing consumer choice, providing consumer protection, and facilitating transparency.
While these characteristics provide a broad framework for thinking about the future of the housing finance system, there are a number of specific areas related to the current activities of the housing GSEs that deserve special attention. In particular, some key decisions that policymakers will have to address include what role the federal government should have in the following areas of the housing finance system:

- ensuring that the mortgage market has adequate sources of liquidity;
- having the ability to avoid and if necessary absorb credit risk; and
- promoting the availability of mortgage credit.

While new legislation is needed to produce larger-scale restructuring of the housing finance system, FHFA is looking at possible changes in the way the Enterprises do business that may be desirable in the interim period, while Congress contemplates and debates the statutory options. For example, we announced on Monday a set of prospective improvements in the data submissions of loan sellers that will raise the quality and consistency of key information and improve the Enterprises' risk management capabilities. This type of change also improves the functioning of the mortgage market and would be beneficial regardless of what course the larger-scale restructuring of the housing finance system takes. In the coming months we will consider other initiatives that can provide value to the mortgage financing process now and in the future.

I would be happy to discuss any of these ideas with you and look forward to working with the Administration and Congress on legislative action to restructure the housing finance system, including an ultimate resolution of the Enterprises. I recognize you have difficult and important decisions to make in the coming months and FHFA looks forward to offering technical assistance to both the Administration and Congress in considering policy alternatives.