



**Statement of**

**Edward J. DeMarco**

**Acting Director**

**Federal Housing Finance Agency**

**Before the U.S. Senate Finance Committee on the**

**President's Proposed Fee on Financial Institutions Regarding TARP**

**May 11, 2010**

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Chairman Baucus, Ranking Member Grassley, and members of the Committee, thank you for the opportunity for the Federal Housing Finance Agency (FHFA) to testify on the Financial Crisis Responsibility Fee and the nation's housing government-sponsored enterprises (GSEs) – the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal Home Loan Banks (FHLBs).

The Emergency Economic Stabilization Act of 2008, the statute that created the Troubled Asset Relief Program (TARP), requires the President put forward a plan “that recoups from the financial industry an amount equal to the shortfall in order to ensure that the Troubled Asset Relief Program does not add to the deficit or national debt.” In January, President Obama proposed a Financial Crisis Responsibility Fee that will be levied on the liabilities of the largest financial firms. The purpose of the fee is both to raise sufficient revenue to offset any budget cost of TARP and, by levying a fee on the liabilities of the largest financial firms, to provide a deterrent against excessive leverage.

The Administration proposal has the following key features:

- The fee would be applied to banks, thrifts, bank and thrift holding companies, brokers, and securities dealers that were eligible for the emergency assistance program put in place to resolve the crisis. Firms with consolidated assets of less than \$50 billion would not be subject to the fee for the period when their assets are below this threshold.
- The assessable base of the fee would include the worldwide consolidated liabilities of U.S. financial firms. The fee base would include a broad set of liabilities with a few

designated exceptions including Federal Deposit Insurance Corporation-assessed deposits and, for insurance companies, certain policy-related reserves. In addition, adjustments would be provided to prevent avoidance and to appropriately treat less risky activities, such as lending against certain high quality collateral.

- The fee rate would be approximately 15 basis points.

We understand that the Administration does not intend for Fannie Mae and Freddie Mac (the Enterprises) to be covered by the proposal. And as I will explain, given the Enterprises' current financial condition and financial support from the Treasury Department, subjecting the Enterprises to the fee would not increase revenue to the Federal government. While Fannie Mae and Freddie Mac are not TARP recipients, they are the recipients of substantial government support.

When the housing bubble burst, the Enterprises' financial situation deteriorated rapidly, driven by credit losses and other than temporary impairments on mortgage-backed securities held on their balance sheets. These losses quickly overwhelmed the relatively low levels of capital that the Enterprises were required to hold against potential losses. Ultimately intervention was required because of the inability of the Enterprises to raise new capital and access debt markets in their customary way. These actions were necessary because 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 due to their interconnectedness.

Therefore, in September 2008, FHFA placed Fannie Mae and Freddie Mac into conservatorships – a statutory process designed to stabilize the troubled institutions. In conjunction with that action, the Treasury Department agreed to provide financial support to the Enterprises through the Senior Preferred Stock Purchase Agreements (PSPAs). The PSPAs are structured to provide ongoing financial support to the Enterprises to ensure they remain active participants in the marketplace. The PSPAs are ongoing, explicit and irreversible contractual commitments by the Federal government to ensure that Fannie Mae and Freddie Mac can meet their obligations. The PSPAs work by ensuring that the Enterprises maintain a positive net worth. Since the initial

establishment of the PSPAs, the Treasury Department twice has increased its financial commitment to maintain market confidence in the Enterprises.

The PSPAs have worked as intended. Investors have confidence in the U.S. government's commitment to honor these obligations. As a result, investors have continued to support U.S. housing finance through investment in Enterprise securities. This has been of tremendous 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. Further, more than four million households last year lowered their monthly mortgage payment or moved to a more stable mortgage by refinancing their mortgages with the involvement of the Enterprises. And, while serious delinquencies continue to rise, we have begun to see some signs of improvement, however fragile, in house prices and mortgage performance.

In the first two full years of this housing crisis, from July 2007 through 2009, combined losses at the Enterprises totaled \$207 billion. During 2009 alone, the Enterprises reported net losses of \$94 billion. The Enterprises' financial performance continues to be dominated by credit-related expenses and losses stemming principally from purchases and guarantees of mortgages originated 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 over \$125 billion from the Treasury Department under the PSPAs. As conservator and regulator, FHFA is acting aggressively to assure that Fannie Mae and Freddie Mac are fully supervised for safety and soundness, are acting to reduce losses, and are undertaking only activities tied to their core responsibilities. Nevertheless, with continuing uncertainty regarding economic conditions, employment, house prices, and mortgage delinquency rates, the short-term outlook for the Enterprises remains uncertain and they are likely to require additional draws under the PSPAs.

More detailed information on the purpose and status of the conservatorships, as well as FHFA's views on the future direction of the Enterprises' business activities while they are in

conservatorship, is detailed in a letter I sent to Chairmen Frank and Dodd and Ranking Members Bachus and Shelby in February 2010. This letter is available on the FHFA website ([link](#)).

Today the financial state of the Enterprises makes them poor candidates for inclusion in a fee proposal because the Enterprises are projected to have continuing losses that will be funded by the PSPAs. Any additional fee assessments will add to those losses, resulting in increased draws through the PSPAs. Applying the fee to the Enterprises would be an exercise in moving money between government accounts.

Let me make two related observations. First, the Enterprises already have the obligation to pay a ten percent dividend to Treasury on draws made under the PSPAs. Today, this quarterly obligation exceeds \$1 billion for each company and those dividends are effectively being “paid” by further draws on the PSPA. So, we are already moving money from one government account to another. Second, the Housing and Economic Recovery Act of 2008 required each Enterprise to allocate 4.2 basis points of the principal balance of new business purchases to support the Housing Trust Fund established by the legislation. In view of the condition of the Enterprises, FHFA has used its authority to suspend these contributions. Had FHFA allowed these payments, they would have been funded entirely by Treasury draws.

Looking ahead, the Enterprises’ operating in conservatorship cannot be a long-term solution. We are in the midst of a “time-out” to allow careful consideration of the role of the Federal government in housing finance and the ultimate resolution of the Enterprises. I believe we are in the midst of an important national discussion about this issue. As the new roles, responsibilities, form, and structure of the Enterprises or their successors emerge from this debate, it may be appropriate to consider subjecting these institutions to a Financial Crisis Responsibility Fee just as part of the debate will undoubtedly touch on repayment of taxpayer funds used to provide financial support to the Enterprises. However, in the absence of concluding the debate on fundamental reform, it would be premature to subject the Enterprises to the Financial Crisis Responsibility Fee. As I stated earlier, given the Enterprises’ current financial condition and financial support from the Treasury Department, subjecting the Enterprises to the fee would not increase revenue to the Federal government.

Before closing, let me turn to the Federal Home Loan Banks (FHLBanks). While the Administration did not propose applying the fee to the FHLBanks, I would like to make some observations about the potential impact of such a fee. As member-owned cooperatives, the FHLBanks are owned by two groups of financial institutions: those that would be subject to the proposed fee and those explicitly not subject to the proposed fee. Consequently, assessing the fee on FHLBanks would result in some combination of further increasing the fee that would be assessed on large institutions and imposing the fee on smaller institutions that the Administration had sought not to assess. Beyond this, there are numerous questions of how such a fee would affect the FHLBanks, including equity within the System, the availability of System funding, and the weak financial state of several FHLBanks. In addition, if advances are included in the fee assessment base for other financial institutions, the current operation and structure of some FHLBanks could be materially affected. These are important issues that should be fully considered in the context of overall housing finance reform.

Thank you for the opportunity to appear here today. I would be glad to answer any questions.



FEDERAL HOUSING FINANCE AGENCY  
Office of the Director

February 2, 2010

Honorable Christopher Dodd  
Chairman  
Committee on Banking, Housing,  
and Urban Affairs  
United States Senate  
Washington, DC 20510

Honorable Richard C. Shelby  
Ranking Minority Member  
Committee on Banking, Housing,  
and Urban Affairs  
United States Senate  
Washington, DC 20510

The Honorable Barney Frank  
Chairman  
Committee on Financial Services  
United States House of Representatives  
Washington, DC 20515

Honorable Spencer Bachus  
Ranking Minority Member  
Committee on Financial Services  
United States House of Representatives  
Washington, DC 20515

Dear Chairmen and Ranking Members:

I am writing to update you on the conservatorships of Fannie Mae and Freddie Mac (the Enterprises). Recently there has been considerable speculation regarding how the future direction of the Enterprises' business activities interacts with their status in conservatorship. A key motivation for this letter is to provide greater clarity to policymakers and market participants on the Federal Housing Finance Agency's (FHFA) plans for the Enterprises' business activities while they operate in conservatorship.

The first part of the letter will review the establishment and purposes of the conservatorships, and how the conservatorships are operating. FHFA is focused on conserving the Enterprises' assets and meeting the goals of the conservatorship. The second part of the letter describes FHFA's views on the future direction of the Enterprises' business activities while they are in conservatorship, particularly: loan modifications and mitigating credit losses; retained portfolio; new products; and affordable housing mission.

## **Background**

### ***Establishment and Purposes of the Conservatorships***

After careful analysis and in consultation with the Secretary of the Treasury and the Chairman of the Board of Governors of the Federal Reserve System, FHFA placed each Enterprise into conservatorship on September 6, 2008. At that time and pursuant to the statute, FHFA set forth the purpose and goals of conservatorship as follows:

The purpose of appointing the Conservator is to preserve and conserve the Company's assets and property and to put the Company in a sound and solvent condition. The goals of the conservatorship are to help restore confidence in the Company, enhance its capacity to fulfill its mission, and mitigate the systemic risk that has contributed directly to the instability in the current market.

Critical to the establishment of the conservatorships were the actions taken at the same time by Treasury, consistent with its authority granted in the Housing and Economic Recovery Act of 2008 (HERA), to establish three funding facilities. Two of these – the liquidity facility and the mortgage-backed securities purchase facility – expired as scheduled at the end of last year. The third facility – the Senior Preferred Stock Purchase Agreements (PSPAs) – was structured to provide ongoing financial support to the Enterprises to ensure they remain active participants in the marketplace. The PSPAs work by ensuring that the Enterprises maintain a positive net worth, and Treasury's initial financial commitment was up to \$100 billion per company. As explained at the time of the conservatorships by Treasury Secretary Paulson:

These agreements support market stability by providing additional security and clarity to GSE debt holders – senior and subordinated – and support mortgage availability by providing additional confidence to investors in GSE mortgage backed securities. This commitment will eliminate any mandatory triggering of receivership and will ensure that the conserved entities have the ability to fulfill their financial obligations. It is more efficient than a one-time equity injection, because it will be used only as needed and on terms that Treasury has set.

In the face of a potentially catastrophic failure of our nation's housing finance system, these actions, along with the Federal Reserve's decision a few months later to purchase Enterprise debt and mortgage-backed securities, succeeded in maintaining an important measure of stability in the housing finance market. As nearly all other non-governmental participants in housing finance abandoned the market, the Enterprises in conservatorship, operating with the benefit of the PSPAs, have ensured that credit continues to flow to housing. As evidence of this, the Enterprises' share in financing or guaranteeing new single-family mortgage production rose from 54 percent in 2006 to 73 percent in 2008 and 78 percent in 2009 through September. The Enterprises have also played a significant role in multifamily housing finance with their market share growing from 33 percent in 2006 to 79 percent in 2008 and 64 percent in 2009 through September.



In February 2009, the Obama Administration reiterated the importance of the PSPAs in maintaining market confidence in the Enterprises by announcing an increase in the financial commitment to each company from \$100 billion to \$200 billion. The importance of maintaining market confidence in the Enterprises was further reiterated with a final adjustment to the financial commitment under the PSPAs on December 24, 2009. That adjustment increased the Treasury's financial commitment to each company to the greater of \$200 billion or \$200 billion plus cumulative net worth deficits experienced during 2010, 2011, and 2012, less any net worth surplus remaining as of December 31, 2012.

Since the establishment of the conservatorships, Fannie Mae has realized losses of \$111 billion, and Freddie Mac has realized losses of \$63 billion. These losses have exhausted the value of each company's shareholder equity and resulted in considerable draws from Treasury under the PSPAs. To date, Fannie Mae has drawn \$59.9 billion and Freddie Mac has drawn \$50.7 billion. These calls on taxpayer funds are troubling to all of us.

The PSPAs continue to serve their original intent – providing assurance to capital market investors in Enterprise debt and mortgage-backed securities that continued investments in such securities are sound. In that way, the Enterprises remain a stable source of funds for new home purchases and refinancings of existing mortgages. However, given the existing taxpayer outlays and the extraordinary public backing now in place, I believe that FHFA owes your committees and taxpayers a clear view on how the conservatorships are operating to limit losses and maximize recoveries in the future. I will turn to those issues next.

### *Conservatorship Operations*

As conservator, FHFA has the powers of the management, boards, and shareholders of the Enterprises. However, the Enterprises continue to operate as business corporations. For example, they have chief executive officers and boards of directors, and must follow the laws and regulations governing financial disclosure, including requirements of the Securities and Exchange Commission. Like other corporate executives, the Enterprises' executive officers are subject to the legal responsibility to use sound and prudent business judgment in their stewardship of their companies.

At the inception of the conservatorships, FHFA made clear that the Enterprises would continue to be responsible for normal business activities and day-to-day operations. FHFA continues to exercise oversight as safety and soundness regulator and has a more active role as conservator. While FHFA has very broad authority, the focus of the conservatorships is not to manage every aspect of the Enterprises' operations. Instead, FHFA reconstituted the boards of directors at each Enterprise and charged the boards with ensuring normal corporate governance practices and procedures are in place. The new boards are responsible for carrying out normal board functions, but they remain subject to review and approval on critical matters by FHFA as

conservator. The Enterprises are large, complex companies, and this division of responsibilities represents the most efficient structure for carrying out FHFA's responsibilities as conservator.

The reconstituted boards at each company oversee their respective management teams and are functioning as boards should. Like FHFA, the boards are focused on conserving assets, minimizing corporate losses, ensuring the Enterprises continue to serve their mission, overseeing remediation of identified weaknesses in corporate operations and risk management, and ensuring that sound corporate governance principles are followed.

In my view, maintaining and, where needed, strengthening these important private sector disciplines associated with each Enterprise's corporate infrastructure promotes the goals of the conservatorships and maximizes the government's options in a post-conservatorship world, including the opportunity to gain some return for taxpayers in a resolution of these companies. Any preservation of value in the Enterprises is directly related to maintaining the value of the intangible assets of these companies, including their human resources and business platforms.

There has been substantial executive management turnover at each Enterprise since the establishment of the conservatorships, starting with the replacement of each Enterprise's Chief Executive Officer (CEO) at the time the conservatorships were announced. At Fannie Mae, since conservatorship began, there have been two CEOs and new executives appointed to head almost every key business unit. Eight of the eleven highest paid employees pre-conservatorship are no longer with the company. At Freddie Mac, since conservatorship, there have been two CEOs and an Interim CEO. In just the past five months, after lengthy searches by the board, Freddie Mac has added a new Chief Operating Officer and a new Chief Financial Officer. The four highest paid employees at Freddie Mac pre-conservatorship are no longer with the company.

In short, the directors and senior executives tied to the financial collapse at each Enterprise are no longer with the companies. The senior executives who remain as well as those that were recently hired are essential to the Enterprises fulfilling the important goals of the conservatorships. As FHFA has stated since the outset of the conservatorships, it is critical to retain existing staff, including many senior managers, and critical to attract new executive management to fill the vacancies. The challenge of meeting this goal with companies in conservatorship is immense. The Enterprises operate with an uncertain future that will be the source of much public debate. As conservator, I believe it is critical to protect the taxpayer interests in the Enterprises by ensuring that each company has experienced, qualified people managing the day-to-day business operations in the midst of this uncertainty. Any other approach puts at risk the management of more than \$5 trillion in mortgage holdings and guarantees that are supported by taxpayers through the PSPAs.

I will now turn to specific actions and issues pertinent to accomplishing the important goals of the conservatorships.

## **Accomplishing Conservatorship Goals Going Forward**

### ***Loan Modifications and Mitigating Credit Losses***

Conserving the assets of the Enterprises requires, first and foremost, minimizing their credit losses from delinquent mortgages. This is and will remain the central goal of FHFA and the Enterprises.

Furthermore, FHFA operates under a statutory mandate in the Emergency Economic Stabilization Act of 2008 (EESA), Section 110, to “implement a plan that seeks to maximize assistance for homeowners and use its authority to encourage the servicers of the underlying mortgages, and considering net present value to the taxpayer, to take advantage of the HOPE for Homeowners Program ... or other available programs to minimize foreclosures.” This provision specifies loan modifications and tenant protections as part of the mandate and establishes a monthly reporting requirement for FHFA. Our monthly reports pursuant to this requirement are sent to each of you and are on our website under Federal Property Managers Reports at <http://www.fhfa.gov/Default.aspx?Page=172>.

In pursuit of the goal of minimizing credit losses and fulfilling this statutory mandate, FHFA and the Enterprises worked with the Administration a year ago to help develop and implement the Making Home Affordable program (MHA). The Enterprises’ participation in MHA is a critical step to minimizing their credit losses. Loan modifications are often a lower cost resolution to a delinquent mortgage than is foreclosure. Similarly, providing opportunities for borrowers to refinance into a more affordable mortgage helps mitigate future credit losses. Since the Enterprises own or guarantee about half the mortgages in the country, efforts like MHA that provide stability to borrowers also serve to restore stability to housing markets, which directly benefits the Enterprises by reducing credit exposure. The Enterprises also will continue to act as agents for Treasury in implementing the MHA loan modification program. FHFA views this activity as consistent with the goals of the conservatorship and the EESA mandate.

FHFA will continue to ensure the Enterprises look to foreclosure alternatives, starting with loan modifications, to minimize credit losses. I have communicated to each Enterprise the need for rigorous analytics in considering different forms of loss mitigation to ensure credit losses are being minimized. Such analysis will also guide the Enterprises’ participation in any potential new Administration efforts regarding foreclosure prevention. The Enterprises’ current and future efforts surrounding foreclosure prevention will focus on mitigating losses, which is fundamental to the FHFA’s mandate to conserve assets. And where there is no available, lower-cost alternative to foreclosure for a particular defaulted mortgage, my expectation is that the Enterprises will move to foreclose expeditiously.

### ***Retained Portfolios***

The December amendments to the PSPAs included a change to the Enterprises' retained portfolio limits. Briefly, the change preserves the original PSPA requirement that the Enterprises begin shrinking their retained portfolios by ten percent per year, beginning this year. But, rather than starting the reduction from the Enterprises' year-end 2009 balances, the reduction now begins from their maximum allowed balances (\$900 billion) as of year-end 2009. This means that each Enterprise may have a retained portfolio no greater than \$810 billion by December 31, 2010. Currently, each Enterprise is below that amount.

FHFA remains committed to the principle of reducing the retained portfolios as set forth in the PSPAs. Consistent with the goals of conservatorship and in accord with the recent Treasury announcement, FHFA does not expect the Enterprises to be substantial buyers or sellers of mortgages, with an important exception. As I stated in December, the increased flexibility provided with the retained portfolio amendment may be important for maintaining the Enterprises' capacity to purchase delinquent mortgages out of guaranteed mortgage-backed security pools.

Given the size of the Enterprises' current outstanding retained portfolios, and the potential volume of delinquent mortgages to be purchased out of guaranteed mortgage-backed security pools, it is my expectation that any net additions to their retained mortgage portfolios would be related to this activity. I also expect that other private parties will begin to invest in new Enterprise mortgage-backed securities as the Federal Reserve gradually withdraws its purchase activity. To aid in complying with the requirements of the PSPA portfolio limitations in light of these factors, I am instructing each Enterprise to develop a detailed plan for how it will manage its portfolio to stay within those limitations.

### ***New Products***

HERA established a requirement that FHFA implement a public review process for new products that may be undertaken by the Enterprises. In July 2009, FHFA published an interim final rule implementing this provision. To date, no new product submission has gone through this process.

After considering the statutory requirement and the goals of conservatorship, I have concluded that permitting the Enterprises to engage in new products is inconsistent with the goals of conservatorship. Therefore, I am instructing the Enterprises not to submit such requests under the rule.

In view of the critical and substantial resource requirements of conserving assets and restoring financial health, combined with a recognition that the Enterprises operate today only with the support of taxpayers, I believe the Enterprises should concentrate on their existing core businesses, including minimizing credit losses. I reach this conclusion as various proposals seek

Enterprise involvement that, even if within charter limitations, could require large expenditures of funds, entry into new business lines with little prior experience, or dedication of personnel already operating in a stressed environment. New products could also require new risk measuring tools, compliance procedures, and additional oversight from FHFA.

In short, the Enterprises will be limited to continuing their existing core business activities and taking actions necessary to advance the goals of the conservatorship. 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.

### ***Affordable Housing Mission***

While the Enterprises are in conservatorship, FHFA expects them to continue to fulfill their core statutory purposes and that includes their support for affordable housing. One set of measures of the Enterprises' support for affordable housing comes through the housing goals, which Congress revised significantly in HERA.

Shortly, FHFA will publish for public comment a proposed rule setting the housing goals for 2010 and 2011. In that rule, FHFA will establish the framework for ensuring that the Enterprises' participation in the mortgage market includes support for the affordable housing segments of the market, consistent with their mission and with safety and soundness.

FHFA does not intend for the Enterprises to undertake uneconomic or high-risk activities in support of the goals nor does it intend for the state of conservatorship to be a justification for withdrawing support from these market segments. Under the conservatorships, the Enterprises have tightened their underwriting standards to avoid the poor quality mortgages that have contributed so much to their losses. Maintaining this type of sound underwriting discipline going forward is important for conserving assets and supporting the Enterprises' mission in a sustainable manner.

### **Concluding Thoughts**

The Enterprises' operating in conservatorship cannot be a long-term solution. When the conservatorships and Treasury's financial commitment were established in 2008, Secretary Paulson described the arrangement as a "time-out" to allow policymakers to further consider the role of the Federal government and the Enterprises in the future system of housing finance. There are a variety of options available for post-conservatorship outcomes, but the only one that FHFA may implement today under existing law is to reconstitute the two companies under their current charters.

I recognize that the Administration and Congress have difficult and important decisions to make in the coming months on the future structure of the housing finance system. In my testimony before the Senate Banking Committee last October, I offered some of my own views on this subject. Going forward, FHFA looks forward to offering its technical assistance to both the Administration and Congress in considering policy alternatives.

The purpose of this letter has been to clarify the goals of the conservatorships and how FHFA is striving to achieve these goals. I also hope that this letter has helped to set the framework for how the Enterprises are operating in conservatorship as Congress considers the future structure of the housing finance system. I welcome the opportunity to meet with you personally to further discuss the matters covered here. As I believe the information contained here is also important to an improved public understanding of the conservatorships, I will be releasing this letter this afternoon.

Yours truly,

A handwritten signature in blue ink that reads "Edward J. DeMarco". The signature is written in a cursive, slightly slanted style.

Edward J. DeMarco  
Acting Director