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The Five-Year Anniversary of the Conservatorships of Fannie Mae and Freddie Mac: No Time to Celebrate

Thank you for inviting me to speak this afternoon. On September 6, our Nation reached the five-year anniversary of the establishment of the conservatorships of Fannie Mae and Freddie Mac, or as I will refer to them, the Enterprises.

Over those five years much has been accomplished. The Nation's secondary mortgage market has continued to function. The Enterprises' financial positions have stabilized. We have made significant progress resolving the pre-conservatorship book of business. The Enterprises have played an important role in providing foreclosure prevention and refinancing options to borrowers. And through the Federal Housing Finance Agency (FHFA) Strategic Plan for Enterprise Conservatorships (Strategic Plan), we have begun the process of building for a future housing finance system.

However, even with those accomplishments, much remains to be done. The single-family mortgage market remains heavily supported by taxpayers. While there is progress on the legislative front, the timing of broader housing finance reform remains uncertain.

Today I will provide a brief review of the failure of the Fannie Mae and Freddie Mac GSE business model, the steps FHFA has taken in the intervening five-years, and provide a look ahead at what to expect in the coming years if we remain without a legislative solution.

The Fannie Mae and Freddie Mac GSE Business Model Failed

I think it will be useful to start with a brief review of what led to Fannie Mae and Freddie Mac being placed into conservatorships. Five years is a long time, and memories may begin to fade. As Fannie Mae and Freddie Mac have begun to report positive net income there may be a growing perception that the problems that led to conservatorship have been fixed. That is not the case.

The pre-conservatorship business model of Fannie Mae and Freddie Mac, often referred to generically as the Government Sponsored Enterprise or GSE model, was established to promote liquidity and provide stability in housing finance on a national basis. Fannie Mae and Freddie Mac accomplished this task by linking mortgage originators to capital markets. They did this by developing standards, guaranteeing mortgage-backed securities, and purchasing mortgages. They were established as unique entities chartered by Congress, owned by private shareholders, provided a specific set of benefits not available to other private companies, and given a public mission.

GSE status conveyed important benefits such as the ability to fund operations with much less capital and to borrow at lower interest rates than other private sector companies. Some of this benefit was passed on to borrowers in terms of lower borrowing rates. Over the years questions were raised as to how much of the benefit remained with management and shareholders. Also, to the extent a rate subsidy was passed on to borrowers, it surely resulted in higher house prices, thereby transmitting some portion of the subsidy to existing home owners, not home buyers.

Over time, other requirements were added to their mission, through mandates like the affordable housing goals, which were intended to recapture some of those benefits for a public purpose.

There was considerable debate about reforming portions of the Fannie Mae and Freddie Mac model prior to 2008. And there were concerns about just how much public benefit, rather than private benefit, Fannie Mae and Freddie Mac actually produced.

As the housing downturn worsened in 2008, it became evident that the Enterprises could no longer raise capital and by late summer were having difficulty issuing debt. This led to the enactment of the Housing and Economic Recovery Act of 2008, or HERA, on July 30, 2008. HERA created FHFA, addressed some of the shortcomings with Enterprise oversight, and provided explicit authority for the Treasury Department to provide financial support to the Enterprises.

Over the next month, as housing and financial market conditions deteriorated further, more questions were raised about the continued viability of the Enterprises. On September 6, 2008, FHFA placed the Enterprises into conservatorships and the Treasury Department agreed to provide financial support through the Senior Preferred Stock Purchase Agreements, or PSPAs. The PSPAs included a return to taxpayers on this investment.

There should be no doubt that this set of events and the billions of dollars in subsequent losses meant that Fannie Mae and Freddie Mac had failed. Holders of Enterprise debt and mortgage-backed securities were questioning the value of their investments, and with over $5 trillion of those securities outstanding, the consequences for the financial system and the economy could have been disastrous. Only the financial support provided by Treasury through the PSPAs allowed Fannie Mae and Freddie Mac to continue as operating entities. There were no private sector investors willing to invest any amount of equity capital into these companies at that time.

Employing a conservatorship structure to address a failed financial institution is a relatively rare occurrence. It may be used to address short-term managerial problems when there is franchise value in a company. It may also be used as a short-term bridge to prepare a company for further disposition options.

There was broad consensus at the time that not only did Fannie Mae and Freddie Mac fail, but the GSE model had failed, and that Congress had to reestablish a new housing finance market. This is why former Treasury Secretary Paulson referred to the conservatorships as a "time out" to allow future policymakers an opportunity to consider a new structure for housing finance. The Secretary went on to say:

> *Because the GSEs are Congressionally-chartered, only Congress can address the inherent conflict of attempting to serve both shareholders and a public mission. The new Congress and the next Administration must decide what role government in general, and these entities in particular, should play in the housing market. There is a consensus today that these enterprises pose a systemic risk and they cannot continue in their current form.*

> *…. We will make a grave error if we don't use this time out to permanently address the structural issues presented by the GSEs.*[1]

The Obama Administration has made clear that its preferred course of action is to wind down the Enterprises. The Administration has also offered three broad approaches to replacing the conservatorships.

Of the various legislative proposals that have been introduced in Congress, none of them envision the Enterprises exiting conservatorship in their current corporate form.

The recent quarterly earnings reports by the Enterprises show a return to profitability. To be sure this is good news compared to the previous years of losses. But we should keep the recent reports of positive net income in perspective. Much of it has been related to one-time adjustments, such as the reversal of the valuation allowance against the deferred tax asset, or releases of loan loss reserves related to improved housing market conditions. And the Enterprises' positive net incomes continue to benefit from their access to capital markets at close to Treasury rates, and their ability to operate without any capital.

There are several positive aspects to the Enterprises' current condition that are worth noting. For example, the credit quality of the post conservatorship book of business is quite good and the pricing of their credit guarantees in relation to risk has improved since the establishment of the conservatorships.

Another significant improvement is with the management and staff of the companies themselves. Virtually every member of each company's senior management team at the time of conservatorship is gone and their replacements represent substantial mortgage talent and notable dedication to the mission. Similarly, a large portion of the staff has joined since conservatorship and the boards, management teams and staff at each company are diligently working to ensure ongoing market liquidity while working through legacy challenges and building for the future. While there are still issues to work through, they deserve credit for their commitment in the face of the long-term uncertainty regarding the post-conservatorship future.

While the Enterprises' recent financial results and improved operations are positive developments, it does not alter the fact that the GSE business model remains broken. So, our challenge remains planning for a post-conservatorship world while awaiting legislative action to set forth certain policy parameters for that world. We expect that legislation to include provisions for how key business functions and activities at Fannie Mae and Freddie Mac will be repositioned back into the private market.

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[1] Text of Treasury Secretary Henry Paulson's remarks at the announcement of the Fannie Mae and Freddie Mac conservatorships, September 7, 2008.

Authority and Responsibilities of the Conservator

As conservator, FHFA is responsible for taking actions necessary to put the Enterprises in a sound and solvent condition, and preserving and conserving the assets of the Enterprises. FHFA has reported on numerous occasions that, with taxpayers providing the capital supporting Enterprise operations, this “preserve and conserve” mandate directs FHFA to minimize losses on behalf of taxpayers.

Although each Enterprise is in conservatorship, without statutory changes their mission of supporting a stable and liquid mortgage market remains the same as before the conservatorships. FHFA has a statutory responsibility to ensure each Enterprise “operates in a safe and sound manner”[2] and that “the operations and activities of each regulated entity foster liquid, efficient, competitive, and resilient national housing finance markets.”[3]

Under the Emergency Economic Stabilization Act of 2008 (EESA), FHFA has a statutory responsibility 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 … available programs to minimize foreclosures.”[4]

In my view FHFA has successfully balanced these responsibilities over the five years of conservatorship. Over these past five years, the near-term priorities have changed, giving rise to various phases of the conservatorships.

In 2008, the immediate objective or initial phase of the conservatorships was to stabilize the Enterprises’ operations and ensure that that the secondary mortgage market continued to function. Because the private mortgage securitization market had already retreated and there were no other effective secondary market mechanisms in place, the Enterprises’ continued operations were necessary for most Americans to obtain a mortgage or refinance an existing mortgage. Simply put, the government placed these two failed companies into conservatorships to keep them operating as going concerns for the benefit of the country’s housing market and financial system.

As markets stabilized, the second phase of the conservatorships focused on developing tools to assist troubled homeowners while reducing credit losses. FHFA also clarified that the Enterprises would not engage in any new business activities, and be limited to continuing their existing core business activities. This type of limitation on new business activities is consistent with the standard regulatory approach for addressing companies that are financially troubled.

As I noted earlier, conservatorship generally has been used to address short-term problems with financial institutions, but we are moving into even more uncharted waters as the duration of these government-run conservatorships grows.

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[2] 12 USC 4513(a)(1)(B)(i)

[3] 12 USC 4513(a)(1)(B)(ii)

[4] 12 USC 5220(b)(1)

The final resolution of the future state of the Enterprises must come from Congress. FHFA has strived to maintain the operations of the Enterprises and keep all options available for Congress. At the same time, as the length of the conservatorships increase, that task becomes more difficult, and FHFA will have to make decisions on future operations.

In determining our responsibility to direct the conservatorships going forward, the law again serves as our guide. The law establishes the appointment of a conservator or receiver of the Enterprises "for the purpose of reorganizing, rehabilitating, or winding up the affairs of a regulated entity."[5] In fact, we are doing all three of these things – reorganizing, rehabilitating, and winding up the affairs of Fannie and Freddie. This is exactly the path we set forth last year when FHFA issued its Strategic Plan.

More specifically, FHFA set forth three broad goals in the Strategic Plan:

1. **Build.** Build a new infrastructure for the secondary mortgage market.

2. **Contract.** Gradually contract the Enterprises' dominant presence in the marketplace while simplifying and shrinking their operations.

3. **Maintain.** Maintain foreclosure prevention activities and credit availability for new and refinanced mortgages.

We identified specific activities to achieve these goals in a Conservator's Scorecard in 2012 and 2013 and much progress on those goals has been achieved.

But as time moves on, the scale of the Enterprises' operations in conservatorship cannot remain static. As of December 31, 2012, the amount of taxpayer capital available to support the Enterprises' outstanding debt and mortgage-backed securities obligations is fixed. Limiting risk exposure is vital to maintaining the adequacy of the remaining capital support through the PSPAs.

Long-term, continued operation in a government-run conservatorship is not sustainable because each company lacks capital, cannot rebuild its capital base, and is operating on a remaining, finite line of capital from taxpayers. Furthermore, a taxpayer-backed conservatorship provides a significant subsidy to the mortgage market that crowds out private capital and underprices risk in the market. It also places long-term decision making in the hands of a government agency, decisions that should be made by private sector businesses based on reasonable returns on private capital.

At some point, lawmakers will need to decide on the appropriateness and level of a government credit subsidy for housing. Such a decision should include whether a government-owned corporation should undertake some or all of the business activities of Fannie Mae and Freddie Mac, or whether some or all of those functions should be repositioned in the private sector.

[5] Housing and Economic Recovery Act of 2008, Section 1367 (a)(2), amending the Federal Housing Enterprises Financial Safety and Soundness Act, 12 USC 4617(a)(2).

The Next Phase of Conservatorship

What seems clear is that Fannie Mae and Freddie Mac will cease to operate in their current corporate form at some future date – a date to be set by Congress. FHFA's conservatorship strategic plan is designed to prepare the companies and the market for that date, while maintaining market stability and liquidity from now to then. The strategic plan aims to move forward with a transition to a post-conservatorship market, thereby making the final transition from the conservatorships as simple and quick to execute as possible

To more clearly define this process, FHFA will soon establish multi-year targets for Fannie Mae and Freddie Mac to further achieve the three strategic goals of building for the future, contracting the footprint, and maintaining market liquidity and borrower assistance. In this next phase of conservatorship, we intend to build upon the accomplishments of the past two years while accelerating progress towards achieving each strategic goal.

In particular, we need to consider which Enterprise activities are likely to be part of the future secondary mortgage market. FHFA expects certain assets, functions, and employees at the two companies will be repositioned in the private sector by the end of the conservatorships. In the meantime, each company will need to enhance their core operations that are expected to operate in the marketplace and to gradually sell or wind down certain operations not expected to go forward. This is a difficult exercise with an unknown future structure, but the establishment of the Common Securitization Platform (CSP) is an example of a set of Enterprise activities that FHFA believes would be necessary in any future housing finance system.

We will also continue to look for ways to reduce risk exposure across all Enterprise lines of business, and we will look for ways to attract private capital back into the mortgage market.

Finally, we must be sure that the Enterprises continue to have the ability to manage their taxpayer-backed books of business as many of their existing credit guarantees will live on for many years.

So to provide further context around how this should evolve over the next few years in each line of business if we do not get a legislative path forward, let me offer the following initial thoughts. Bear in mind that we still have much planning ahead of us.

Single-Family Guarantee Business

With an uncertain future and a general desire for private capital to re-enter the market, the Enterprises market presence should be reduced gradually over time. We have three main tools to accomplish this objective.

First, risk-sharing transactions are important for reducing the taxpayers' long-term risk exposure. We set a 2013 Scorecard target for each Enterprise to achieve $30 billion in risk-sharing transactions using multiple types of structures. Freddie Mac completed a securities-based transaction earlier this year that was well received in the market and expects to complete another shortly. Fannie Mae recently completed a risk sharing transaction with a mortgage insurer, and just last week completed a securities-based transaction similar to the Freddie Mac structure. We are planning for the scope and depth of risk-sharing transactions to continue to expand.

While these transactions and structures are very positive, they do rely on the underlying infrastructure of the Enterprises. Going forward, I expect to see work done on other types of transactions such as senior/subordinated structures for certain portions of the Enterprises' mortgage guarantees. These alternative approaches will contribute to our efforts to build for the future by helping to develop a securitization infrastructure that is less reliant on the Enterprises' traditional GSE securitization model.

Second, guarantee fees on new mortgages average about 50 basis points; approximately double what they were prior to conservatorship. A key motivation behind increasing Enterprise guarantee fees is to bring their pricing for credit risk closer to what would be required by private sector providers. While that level is difficult to evaluate with precision, I believe we are getting closer to a level that would encourage more private sector participation, and we plan to continue pursuing gradual guarantee fee increases in the near future.

Third, one of the most direct ways to increase private sector participation and reduce taxpayer exposure is through a reduction in the maximum size of loans that the Enterprises guarantee. This summer the President specifically endorsed a gradual reduction in maximum loan size. I understand the potential timing issues associated with such a change given the other regulatory changes that are scheduled to take place in the mortgage market. FHFA will follow its practice of announcing the 2014 conforming loan limits in late November, at which time further information will be provided on potential reductions in the size of loans the Enterprises will guarantee going forward. We expect to give market participants at least six months' notice of any change. Any reduction would be across the board, not just in some parts of the country. And, consistent with our practice when increasing guarantee fees, any change would be measured and gradual so as not to disrupt markets.

While these steps are important and necessary to carry out our conservatorship responsibilities, our efforts also are focused on building towards a future infrastructure to support the single-family mortgage market. FHFA is looking to reposition the Enterprises activities in ways that would support multiple housing finance reform options. One of those efforts is tied to the CSP with the focus on functions that are routinely repeated across the secondary mortgage market, such as issuing securities, providing disclosures, paying investors, and disseminating data. These are all functions where standardization could have clear benefits to market participants. We recently announced the formation of Common Securitization Solutions (CSS) as an equally-owned subsidiary of Fannie Mae and Freddie Mac, the signing of a lease for office space for CSS, and the on-going recruitment for executive leadership of the CSS.

Multifamily

Fannie Mae and Freddie Mac's market share in the multifamily market is smaller than in the single-family market, and their current activities already involve credit risk sharing with private capital.

For 2013, FHFA established a goal that Fannie Mae and Freddie Mac would contract their multifamily activity by 10 percent from 2012 levels. The market appears to have absorbed this reduction without major disruption.

One of the fundamental problems with setting the course in the Enterprises' multifamily business is determining what is being repositioned for the future.

Without a clear legislative path forward on what FHFA is repositioning to, we will continue to take gradual steps to reduce the Enterprises' exposure in this market, while maintaining a market presence. FHFA recently requested public input on how to achieve that reduction, and we are evaluating those responses. We are also planning to articulate this goal with a multiyear framework that provides clarity to policymakers and market participants.

Retained Portfolio

Finally, the retained portfolios of the Enterprises have been steadily declining since 2009. The composition of the Enterprises' retained portfolios has also changed significantly. Prior to conservatorship, the retained portfolios were dominated by their own mortgage-backed securities and performing whole loans. As those securities have been paid down, and as the need to work through delinquent loans increased, the retained portfolios changed from being relatively liquid to being less liquid.

To address this issue and further reduce risk in the Enterprises' retained portfolios in 2013, we set a target of selling five percent of the less liquid portion of their retained portfolios, in other words their retained portfolios excluding agency securities. We have been pleased with the execution thus far on the 2013 Scorecard goal. Going forward, given that we are not repositioning the retained portfolio business of the Enterprises, we will look for additional ways to shrink this business line over an appropriate time horizon.

Conclusion

Let me conclude today with a few thoughts on the legislative path forward. Our current housing finance system has its roots in the Great Depression, and as a Nation we should look at this as an opportunity to build a new housing finance system not for the next few years, but a restructuring that could last for decades. This effort should not be about considering just what Fannie Mae and Freddie Mac do in the housing finance market, but considering the entire market, including the Federal Housing Administration (FHA) and other government programs that support housing finance.

I applaud the Bipartisan Policy Center for giving the legislative process a framework to consider. A key feature of the BPC's work is that private capital must return to the mortgage market, and that such capital must be sufficient to protect taxpayers' interests. The initial efforts in the Senate led by Senators Corker and Warner picked up on this theme by requiring 10 percent private sector exposure, in addition to down payment and mortgage insurance requirements, as protection for the Federal guarantee provided in their structure. If there is going to be a government guarantee of this type, it must have sufficient private capital standing in front of that guarantee, or we will be to some degree re-creating the failed GSE business model. One of the open issues with this approach is the role of FHA, and how FHA/Ginnie Mae and FMIC guaranteed securities would complement, or compete with, each other.

Through the PATH Act, the House has proposed a different course. This legislation restates the role and structure of FHA, and establishes a market infrastructure for the rest of the mortgage market. It is a different model, one that is based on developing standards and infrastructure that can help to bring liquidity and efficiency to the mortgage market, as opposed to establishing a new government guarantee. Both bills are worthy of serious consideration.

In closing I am very pleased that both legislative efforts have recognized the important work that FHFA has undertaken to develop a new secondary mortgage infrastructure. Both bills include the CSP as part of the new housing finance system. This is a positive step forward, but we need more progress because a government-run conservatorship is not a sustainable long-term operating structure. FHFA will continue to carry out its mandate as conservator, accelerating its efforts to ease the transition to a post-conservatorship market ultimately defined by lawmakers. And the employees at Fannie Mae and Freddie Mac will continue to ensure their companies bring stability and liquidity to the market while they contribute directly to building towards that post-conservatorship market.