

**Embargoed Until 10:00 a.m. EST, March 23, 2010**

Secretary Timothy F. Geithner  
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## **Introduction**

Promoting and maintaining stability in the housing market is critical to achieving economic recovery and sustainable long term growth. The Administration's broad housing policies, including support for the ongoing functions of the Government Sponsored Enterprises (GSEs), Fannie Mae and Freddie Mac, together with Treasury's and the Federal Reserve's purchases of mortgage-backed securities, have been crucial to restoring stability in the housing market and to maintaining the availability of mortgage credit. Private capital has not yet returned to provide the amount of funding that would be needed to allow families to get a mortgage to buy a new home or to sensibly refinance the house they already live in. Without the continued activity of the GSEs and the Federal Housing Administration (FHA) in the current environment, mortgage rates would be higher and homeowners would have a significantly harder time obtaining credit. While conservatorship, undertaken by the Federal Housing Finance Agency (FHFA) during the Bush Administration, pursuant to Congressional authorization under the Housing and Economic Recovery Act (HERA), and continued under the Obama Administration, was necessary, together we must begin the process of fundamental reassessment and reform.

The failure of Fannie Mae and Freddie Mac was part of a broader crisis that revealed structural flaws in the entire housing finance system. Housing markets are subject to booms and busts – a key issue is whether the system of housing finance acts to dampen such cycles or to worsen them. In this case the verdict is woefully clear. For many years, the housing finance system provided credit to households in a reliable and stable manner, setting appropriate standards for mortgage origination, and attracting diverse sources of capital through securitization. However, insufficient regulation and enforcement was unable to check increasingly lax underwriting, irresponsible lending and excessive risk taking. Increasing usage of complex products led to a growing misalignment of incentives facing mortgage brokers, originators, credit investors and borrowers. This fueled unsustainable debt levels and house price appreciation. The risk of a fall in home prices was ignored by most and there was too much leverage in every part of the system. These problems were worst in the least regulated non-bank sectors that fed private-label securitizations. Over time, problems associated with the absence of prudent underwriting standards and effective consumer protection migrated from these sectors to the more highly regulated channels of mortgage origination, including the banking sector.

The performance of the GSEs was symptomatic of this larger regulatory and oversight failure. They were allowed to earn private gains for many years, but ultimately the taxpayer subsidized their losses. They were allowed to expand and manage their investment portfolios without regard to the risk they posed to the system. Over time, the GSEs were permitted to guarantee riskier

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mortgages and mortgage-backed securities. They were not required to hold adequate capital and employed inadequate risk management.

The housing finance system clearly cannot continue to operate as it has in the past. A broad reform process of the housing finance system must be undertaken to achieve comprehensive and effective reform that delivers a more stable housing market with stronger regulation, more effective consumer protections and a clearer role of government with less risk borne by the American taxpayer. Where guarantees or support is provided, it will be explicit and priced appropriately. There will be no ambiguity over the status or allowable activities of any private entity which enjoys any benefits or protections from the government.

Designing and implementing practical solutions to the problems in the housing finance system will not be simple. The residential housing market is one of the largest sectors in the US economy, and the US mortgage market is the second largest securities market in the world (after US Treasuries). For many American families, their home is their largest and most important financial investment. Over 67 percent of Americans live in their own home. The scale and complexity of the system and its problems require that reform be developed and implemented in a thoughtful and measured way to ensure that Americans have sustained access to affordable credit as the overall housing market continues to recover. Homebuilders, realtors, lenders and other market participants need stability in order to do their jobs.

As part of the reform process, the Administration intends to develop a comprehensive reform proposal for the GSEs role in the broader housing finance system through public consultation with a wide variety of constituents, market participants, academic experts, and consumer and community organizations. After reform, the GSEs will not exist in the same form as they did in the past. Private gains will no longer be subsidized by public losses, capital and underwriting standards will be appropriate, consumer protection will be strengthened and excessive risk-taking will be restrained.

While the form of the housing finance system will change, government has a key role to play in shaping the future of the nation's housing finance system and in setting housing policy goals. A new system must be designed to ensure that markets are more stable, consumers are protected, sustainable credit is widely accessible and important housing policies, such as affordable housing for low and moderate income families, are administered effectively and efficiently.

### **The Housing Crisis**

Prior to considering any reform to the GSEs and the broader housing finance system, it is important to understand the circumstances that contributed to the current housing crisis.

While the structural problems in the mortgage finance market had been building for decades, it was not until the early part of the last decade that a combination of factors came together in a manner that set the country on a path towards an unsustainable housing and credit bubble. The forces that produce such bubbles are often present, but our system enabled and amplified them.

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Beginning in the unregulated, non-bank sector, underwriting standards were greatly relaxed. Rather than lending primarily against the credit quality of the borrower and assessing ability to pay, lenders increasingly underwrote mortgages based on the current and future expected value of the home. Borrowers were able to buy homes with little or no down payment through the expanded use of private mortgage insurance and “piggyback” second-lien mortgages (second mortgages originated at the same time as a first-lien mortgage). In some cases, borrowers were sold complicated loans they did not understand and could not afford. Non-bank actors developed these strategies, but over time the banking sector quickly adopted these practices and took the system to scale. A race to the bottom ensued.

Lenders increasingly offered alternative, non-conforming or non-“prime” mortgages, such as Alt-A and subprime products. Although these products first became available in the 1980s and 1990s, their use in the conventional market ballooned in the decade that followed. Exotic products – pay-option ARMs, interest rate only loans, negative amortization, 2/28 “bullets” and other such products – left their niches and became widely used in the Alt-A and subprime markets. Higher fees, yield spread premiums and prepayment penalties and the expectation of quick sales or refinancings made these products economically attractive for lenders in ways they had not been in the past. Private label securitizations, driven by investors chasing yield, fueled increased supply of high-cost products. Opaque structures, inflated triple-A ratings by credit ratings agencies and lack of “skin in the game” in the “originate to distribute” model helped to foster bad lending practices. Combined subprime and Alt-A mortgage origination increased from \$125 billion in 2000 to over \$1 trillion in 2006. At their peak in 2005, subprime and Alt-A mortgages together represented 32 percent of total mortgage origination.

The rate of credit expansion and house price appreciation ultimately proved unsustainable and higher prices and interest rates undermined affordability. An unprecedented increase in residential construction outpaced demand. By the beginning of 2006, the cycle began to turn. As home prices began to fall, households struggled to refinance their adjustable rate loans before they reset. Subprime and Alt-A borrowers began to default in higher numbers – foreshadowing eventual failures in the prime market. Lenders and borrowers began to re-evaluate core assumptions.

No one in the mortgage origination chain was prepared for a meaningful decline in housing prices. Too much leverage had built up in the system and equity cushions at all levels (borrower, lender, securitizer, investor) were inadequate to absorb even modest amounts of losses. Leverage, and in many cases leverage on leverage, had been built on a flawed foundation of assumptions and a thin capital base that left little room for error in the case of market deterioration.

Rising interest rates most acutely affected subprime, Alt-A and other non-conforming loan products, as such products frequently carried variable rates or short-term teaser rates and payment terms that reset into more punitive levels. In many cases, the borrower’s ability to pay had not been evaluated by the lender on the basis of these higher rates, and many borrowers were simply never capable of affording the mortgages they had been sold.

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Securities backed by riskier mortgage products began to lose value as delinquency and default rates that had been historically low for many years began to increase, in some cases dramatically. When market values declined and these securities' ratings were downgraded, liquidations became commonplace and investors were often forced to sell these highly leveraged structured products. This further exacerbated the crisis.

According to FHFA/Haver Analytics, home prices that had risen by 85 percent in aggregate from 1997 to mid-2007, fell by 11 percent across the entire US by the end of 2009, of which three-fourths occurred in 2008 alone. In certain markets, home prices fell more than 25 percent. The subsequent contraction of credit across the financial system led to a further reduction of lending and liquidity and exacerbated home price declines.

The excess supply of housing stock fueled by the previous expansion continues to weigh on home prices. Lower home prices have contributed to tremendous loss of wealth and reduced consumer confidence and spending. Labor mobility has declined, as many homeowners owe nearly as much or often much more than their house is worth on the combination of their home mortgage and subsequent borrowing done through home equity loans (HELOCs), resulting in "home lock." Delinquencies and foreclosures have risen dramatically. Foreclosures have caused great harm to the social fabric of communities, particularly those in the most afflicted areas.

Vacant and foreclosed homes have a debilitating effect on neighborhoods and can lead to reduced property values, blight, and neighborhood decay. Studies have shown that spousal relationships, family unity, child behavior and academic performance all suffer in connection with home foreclosure. Furthermore, the lost stability of the ownership of a home and the stigma associated with home foreclosure in America is significant and can make recovering from a lost job, a divorce, an expensive medical event or another shock to an individual or family much harder. The housing crisis cannot be measured only in numbers and dollars, but must also take into account the real impact to Americans who are working hard to provide a better life for themselves and their families.

### **Origins of the Crisis**

There are a large number of factors that contributed to the housing and credit bubble that emerged over the last ten years.

*Macroeconomic Conditions Supportive of Home Price Appreciation.* Coming out of the 2001 recession, the macroeconomic environment was conducive to a natural appreciation of home prices in the US. Accommodative interest rate policy and global imbalances combined to reduce financing and home ownership costs to historic lows for American households. Demand for housing in general increased due to higher rates of household formation. The start of this past decade was also marked by a psychological shift, as the declines in the equity market accompanying the end of the technology boom gave rise to the view that residential housing as an "asset class" was safer than other investment alternatives.

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As home prices began to rise at an increasing pace at the start of this decade, a belief that prices would only go up and never come down became embedded in the minds of nearly all actors in the housing market – borrowers, lenders, brokers, investors, developers, regulators and policy-makers. Prior to late 2007, national housing prices in the United States had not declined on a sustained basis since the Great Depression. The lack of a meaningful contraction in home prices during the 2001 recession furthered the perception that housing was a lower volatility asset class, with limited downside risk.

*Flaws in the Securitization Market.* Two trends in financial innovation reinforced and intensified these fundamental macroeconomic factors. First, there was a rapid expansion of lending generally that allowed many borrowers to access greater amounts of credit than they could have previously. Lenders relied on increasingly complex underwriting tools that incorporated risk management scoring and pricing systems to lend to a broader range of households. Furthermore, issuers were able to shop the rating agencies for the best ratings on their securities – conflicts of interest helped drive ratings, and there were insufficient checks on rating agencies' behavior. In many cases profits realized from these subprime and Alt-A lending activities exceeded those derived from traditional consumer and business lending activities.

Second, the rapid growth of structured credit products provided mortgage brokers with more direct access to capital markets, reducing the traditional role of banks and thrifts as the primary originator of mortgages to consumers. Moreover, securitizers, originators and mortgage brokers had little incentive to police standards more aggressively or to maintain an ongoing relationship with the borrower since they were not required to retain substantial risk in the products they sold to investors. Securitization, which moved core functions of lending off the balance sheets of major banks, came to represent nearly 50 percent of credit formation in the United States at its peak, with residential mortgages by far the largest credit product in this system. This parallel credit system, however, proved to be much less robust, more prone to manipulation and substantially more leveraged than the banks it replaced. The lack of proper transparency and clear rules and standards in the private-label securities (PLS) market made tracking and recognizing risk in the system difficult.

Reforming this key credit channel is important. The Administration's broader regulatory reform proposals include important provisions that reform the regulation of credit rating agencies, align incentives and create the basis for the preservation of securitization as a vital channel of credit provision going forward. Securitization, with the right standards and guidelines, can be an effective and sound source of credit formation and a method to allow for the broader distribution of mortgage risk beyond the banking sector.

*Errors in Risk Management.* Market participants made grave errors in risk measurement and management. They relied too much on the assumption that if diverse pools of mortgages were aggregated from borrowers across the country, problems affecting any one group of borrowers or limited to one part of the country would only represent a small loss to the broader pool of mortgages. And market participants assumed that by slicing these mortgage pools into different priority tranches they could create nearly riskless securities. This situation was exacerbated by

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the faulty assumptions used by rating agencies, investors, and lenders to model and assess risk, in particular the correlation risk that arose due to lack of diversification. They assumed a period of nearly uninterrupted economic growth, rising home prices and increasing and continued access to credit for almost all borrowers. Investors and other market participants were too quick to assume that the positive performance of loan products during this period would continue going forward and that this stable environment would not end. Rating agencies also relied on models that were ill-equipped to assess risks or adjust for the lack of historical data on performance of many of these new types of loans. At a time when investors and ratings agencies should have increased their diligence with respect to the capacity and likelihood that borrowers could repay these loans, they did the opposite and condoned substantial reductions in underwriting and documentation standards. Even sophisticated market participants faced challenges assessing risk levels, as product complexity and several layers of intermediation obscured the full risks borne by lenders and investors.

*Failure of Regulatory Oversight.* Absent in most of this narrative was the involvement of effective regulatory oversight or supervision. Evidence of deteriorating underwriting standards and excessive risk-taking was present early in the housing boom. There were many organizations and institutions that had the authority to respond, but failed to act. The growth of the less regulated sectors of the housing finance system applied pressure on the regulated sector, which resulted in a race to the bottom. The level of regulation and its application was inconsistent among supervisors and permitted forum shopping by lenders. Securitizers and investors were essentially able to opt-out of the parts of the system with heavier regulation and use whatever underwriting they saw fit. Some federal regulators imposed different standards than others, so firms that were interested in offering some of the more exotic products, such as Option ARMs or low-documentation loans, generally structured themselves to take advantage of more permissive supervision regimes.

*Failures of Consumer Protection.* The system for protecting consumers in the mortgage market was, and remains, fundamentally flawed. Fragmented and uncoordinated regulation allowed bad practices to develop in the under-regulated nonbank sector of independent brokers and lenders. When banking agencies failed to respond in a coherent way, these bad practices spread to the banking sector, which in turn legitimized the practices of the independents. Supervision of bank mortgage lending was fragmented over four different agencies, slowing responses to problems and inviting regulatory arbitrage. These flaws remain in place and still need to be addressed.

*A Shift in Consumer Behavior.* Borrowers also bear responsibility for their decisions to take on more debt. Over the last 20 years, in part due to a generally stable macroeconomic environment, the American people became more comfortable maintaining larger balances of debt on their homes, cars and credit cards. Homes were refinanced more frequently, “equity extraction” products like home equity lines of credit were increasingly utilized and homes were purchased with little or no money down. While the liberalization of access to credit had many benefits, consumers’ desire to maximize spending power while minimizing monthly payments contributed to the crisis.

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## **The Role of the GSEs in the Housing Crisis**

Fannie Mae was established in 1938 to create a secondary market for FHA-insured loans. Fannie Mae raised money in the capital markets and purchased FHA-insured loans from banks. This was a response to the failure of the many institutions that had held mortgage risk prior to the devastation of the Great Depression. After a period of fairly rapid growth, in 1954, Congress changed Fannie Mae's charter, effectively ordering it to liquidate its mortgage portfolio and focus solely on being a conduit for loans to the secondary market. At that time, Congress established Fannie Mae as a mixed-ownership government corporation on a gradual path towards private ownership of its stock. In 1968, Congress established Fannie Mae as a government-sponsored enterprise: owned by private stockholders who elected a majority of the board of directors, but with a limited charter of activities that were mandated by Congress.

In 1970, Congress expanded the role and scope of the GSEs in the housing market by adjusting Fannie Mae's charter to allow it to purchase conventional mortgage loans (i.e., non-FHA, non-VA mortgages) and established Freddie Mac as a new government chartered entity within the Federal Home Loan Bank System to provide a second source of liquidity for conventional loans.

The two companies initially followed different business models: Fannie Mae focused on building a large portfolio of mortgage loans, while Freddie Mac focused principally on guaranteeing mortgages. In the mid-1980s, in response to large losses in its portfolio stemming from the same interest-rate exposures that led to the failure of many thrifts, Fannie Mae expanded its guarantee business. In 1992, Congress established the Office of Federal Housing Enterprise Oversight (OFHEO), set formal capital requirements for the GSEs for their guarantee and portfolio activities, and refined the missions of the GSEs, effectively equalizing their charters and range of business activities.

To some degree the role that the GSEs came to play was an extension of the original function of the FHA. However, their ability to properly serve this function was undermined over time by the unhealthy combination of their pursuit of profits and their misuse of the perception of government support, which was condoned by a wide range of regulators and oversight bodies.

For a long period of time, the GSEs supported a well-functioning, efficient mortgage market and the existence of their underwriting standards acted as a guideline for responsible underwriting by lenders. They played a central role in the development of securitization of conventional mortgages. They established appropriate benchmarks for conforming loans and brought transparency and standardization to the housing finance system. Borrowers, lenders and investors benefited from the deep, liquid markets which were formed.

However, the mortgage guarantee business, while profitable, did not provide the GSEs with the same ability to grow earnings as the retained portfolio business. The features of the government charters (e.g., line of credit with Treasury, public mission requirements, limited competition) and exemptions from certain tax and regulatory requirements created a perception of a special status conveyed by the US government on these companies. This perceived guarantee lowered funding

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costs substantially and made the portfolio business increasingly attractive relative to the guarantee business, particularly given the GSEs' statutory capital requirements, which were significantly lower than other private sector competitors. While the activities of the GSEs in theory should have resulted in lower borrowing costs for homeowners, a significant amount of the subsidy was not passed on to homeowners, but instead benefited GSE shareholders, managers, mortgage originators and other stakeholders.

As the housing boom picked up earlier in the decade and as private label securitization began to increase, the GSE's mortgage guarantee business continued to maintain reasonably strict underwriting standards. In some part, as a consequence, non-agency, or "private label", securitization took on a larger share of the market where standards were being relaxed, and, consequently, the market shares of the GSEs began to fall. With a smaller market share and less guarantee income, the GSEs sought to find a way to continue to provide attractive returns to shareholders. Rather than compete for market share with private securitizations in guaranteeing mortgages, the GSEs increasingly directed more of their capital and resources towards growing the more profitable retained portfolio business. As a result, they focused more intensively on portfolio growth and, as the housing bubble expanded, greatly increased their purchases of riskier assets for their portfolios, in part by using their affordable housing mission requirements to justify some of their subprime purchases. In 2000 the GSEs held very few private label securities backed by subprime or Alt-A loans; by 2007 these securities made up 23 percent of their combined mortgage security portfolios.

The GSE charters contained a fundamental misalignment of interests. As private companies, the GSEs had a fiduciary duty to maximize profits. However, at times this duty conflicted with their public mission, which was relegated to a subordinate role. As the private, unregulated market grew, the GSEs, driven by profit motivation and maintaining market share, followed the private market's exuberance and contributed to the broad trends that perpetuated the boom. The GSEs thus became a pro-cyclical source of capital to the housing market and contributed to the housing bubble.

For decades, the GSEs consistently lobbied for lenient oversight and lower capital requirements. Although there were several attempts to limit their scope and scale and risk profile, entrenched interests and aggressive lobbying thwarted these efforts and critical reforms were not instituted.

One such critical reform would have been requiring the GSEs to hold more capital to protect against losses. The GSEs were allowed to operate with significantly lower capital requirements than other private sector competitors. Federally-regulated banks are required to hold 4 percent capital against their mortgages. Fannie Mae and Freddie Mac, however, were only required to hold 2.5 percent capital against their on-balance sheet mortgage portfolio, and only 0.45 percent against mortgages they guaranteed. Furthermore, it became clear over time that the perception of federal backing enabled the GSEs to borrow at a thin spread over Treasury securities that did not reflect their inherent risk. These advantages entrenched the market positions of the GSEs and pushed out competition. These low capital requirements allowed Fannie Mae and Freddie Mac to use unsustainable amounts of leverage and resulted in severe under capitalization, making



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these enterprises extremely susceptible to shock, particularly given the undiversified nature of their business activities.

The bursting of the housing bubble was just such a shock. Similar to other market participants, the GSEs were unprepared for a fall in housing and mortgage-back securities prices. Even a credit event of this magnitude, however, would have been less disruptive to the GSEs if they had retained more of their profits and built up their capital base. However, the low statutory capital requirements had essentially allowed earnings to be distributed to shareholders and other stakeholders each year.

Many observers of the government's role in the housing finance sector rightly focus on the role of Fannie Mae and Freddie Mac, but a full perspective must also include an evaluation of the Federal Home Loan Bank System (FHLBs), FHA, and the Government National Mortgage Association (GNMA or Ginnie Mae). Each plays an important role in the housing finance market. While these institutions, not motivated by private profits, did do a better job of serving a counter-cyclical role, the crisis also exposed some of the flaws in these institutional structures. For example, some of the same incentive alignment issues became clear in the decisions by several of the FHLBs to make large investments in non-agency, subprime mortgage securities at the peak of the cycle. These decisions have greatly affected the health of several of the FHLBs.

The FHA (through GNMA) was largely driven out of the market during the credit boom due to its lower loan limits and stricter originator standards, and so the FHA's safer and more conservatively underwritten product for low down-payment borrowers—the 30 year fixed rate mortgage—was not used extensively. During this period, the FHA was adversely selected for loans to borrowers that included poor practices such as seller-financed down payments that resulted in no-money-down loans. Today, when the private market has pulled back from providing credit to the residential housing sector, FHA and GNMA (along with the GSEs in conservatorship) are playing an important countercyclical role. As broader reform is undertaken, it must be done with a view to the appropriate role of each of these institutions in the overall housing finance system.

### **The Collapse of Freddie Mac and Fannie Mae and Conservatorship**

By the time the housing market began its collapse, extreme leverage was pervasive throughout the housing finance system – at the banks, at the GSEs, and with the homeowner. Almost every actor along the housing finance chain was overextended.

As long as housing prices continued to rise, the GSEs' exposure to risky non-prime loans remained manageable. With the bursting of the bubble, however, the underlying weaknesses and flaws of Fannie Mae and Freddie Mac emerged with force. In 2007, the GSEs reported combined losses of over \$5 billion, the first full-year loss for Fannie Mae since 1985 and the first ever for Freddie Mac. The companies' share prices plummeted by 60 percent between July 2007 and July 2008. The GSEs ultimately reported combined 2008 losses in excess of \$108 billion.

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A collapse of Fannie Mae or Freddie Mac would have had devastating consequences for the housing finance system and the broader economy. These two entities are deeply interconnected with the broader global financial system, and the potential of their collapse would define the notion of systemic risk. Between the two entities, the GSEs guaranteed over \$5 trillion of residential mortgage-backed securities, which represented nearly 50 percent of the overall residential mortgage market. They had over \$1.7 trillion of debt securities outstanding, held equally among foreign and domestic investors. At a time when the foundations of the financial system were being deeply shaken by the broadening financial crisis, a collapse of either of these institutions would have caused a breakdown in the mortgage securities market, a significant worsening of the breakdown of confidence across the markets and a likely pull-back of foreign investment. In the end, as confidence eroded, the government was left with few viable policy alternatives.

As a result of the substantial deterioration in the housing markets, and Fannie Mae's and Freddie Mac's rapidly rising credit expenses and their growing inability to raise new capital and access debt markets, FHFA placed the GSEs into conservatorship on September 6, 2008 under the authority provided by HERA. In conjunction with that action, Treasury agreed to provide financial support to the GSEs through the establishment of Preferred Stock Purchase Agreements (PSPAs). While this action was undesirable, it was necessary and required. Both companies were severely undercapitalized and would not have been able to meet their obligations without the intervention and financial support of the government.

Prior to the actions taken in September 2008, investors in the GSEs had relied on the perception of backing by the government. Through the establishment of the PSPAs, the perception of government backing became explicit capital support, and as a result, the entities were stabilized sufficiently to play their current role in supporting recovery.

To continue the necessary support of the GSEs as the financial markets and economy recover, Treasury announced several changes in advance of HERA's expiration in December 2009. Treasury agreed to amend the cap on Treasury's funding commitment to each GSE, replacing the fixed \$200 billion cap with a formulaic cap that increases above \$200 billion by the amount of any losses, and reduces by any gains (but not below \$200 billion), over the next three years. The cap will become fixed at the end of three years and will represent the maximum Treasury exposure to either GSE going forward from that point. Fannie Mae and Freddie Mac were also provided some modest additional flexibility as they reduced their retained mortgage portfolios. Treasury also announced that it would end its program to purchase mortgage-backed securities (MBS) at the end of the 2009 and terminate a liquidity facility that had not been utilized.

Neither company was near the previous \$200 billion per institution limit in December and neither is likely to exceed those caps even under a range of very conservative assumptions. These actions, however, were intended to provide greater certainty to the market going forward that, even in conditions that seem unlikely based on current trends, the GSEs in conservatorship will be able to continue to meet their obligations and play the vital role they are continuing to play during this current crisis. The change also ensures that each firm will have a more appropriate

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cap given their specific facts and circumstances at the end of 2012. By providing certainty to market participants for these extreme conditions, these actions are designed to improve market stability today, making such adverse conditions even less likely.

Additional flexibility was also provided in meeting the requirement that the companies reduce their retained mortgage portfolios over time. Fannie Mae and Freddie Mac are not expected to be active buyers of securities to increase the size of their retained mortgage portfolios in this period, but neither is it expected that active selling will be necessary to meet the required targets. Treasury remains firmly committed to ensuring that the GSE's retained portfolios are substantially reduced.

Taken together, these actions represent the most effective way to protect financial stability and enable these institutions to continue to play a vital role in the housing market during this crisis, including by securing the benefits of historically low mortgage rates on economic recovery, while limiting the long-term cost of the housing market collapse to the taxpayer. Indeed, the economy and the taxpayers would be far worse off if Treasury had not taken action during the Bush Administration in 2008 or if it did not continue that support going forward under this Administration.

The need for this level of intervention is both unfortunate and undesirable. However, without the decisive actions taken by the government and the specific support for the GSEs, the mortgage market would have halted, making it nearly impossible for Americans to buy or sell their homes or to refinance the mortgage on their existing home. The result would have been a much more wrenching decline in housing prices, a more severe foreclosure crisis and a deeper economic downturn.

The GSEs' securitization and guarantee activities continue to play an important role in housing finance today, and they have helped to stabilize the housing market during this crisis. As a result of the near complete absence of private capital in the mortgage origination market, the GSEs financed or guaranteed over 70 percent of new single-family mortgage originations in 2009, as compared to just under 40 percent in 2006. The FHA, the Department of Veterans Affairs (VA), and the Department of Agriculture (USDA) accounted for another 25 percent of originations in 2009.

Treasury and the Federal Reserve have also supported the secondary market through direct purchases of agency MBS (with approximately \$200 billion and \$1.2 trillion of purchases, respectively, in 2009).

Supporting the GSEs' ability to support the funding of new home purchases and the refinancing of existing mortgages will provide an important and valuable bridge that should allow necessary reforms to be executed in a time of greater housing market stability, something the Administration believes is essential to a successful transition.

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## **Clear Need for Reform of Housing Finance System and the Role of Government**

The housing finance system cannot continue to operate as it has in the past. The Administration has already put forth important proposals for the broader financial system as part of financial regulatory reform, which will help address many of the problems in the private residential mortgage credit markets. These proposals substantially enhance supervision, establish an agency dedicated to ensuring clear rules of the road for consumer financial markets and create new rules for the securitization market including a requirement that all originators retain some risk in the mortgages they underwrite. These are necessary reforms that will make the financial system safer for all Americans.

More, however, must be done to address the specific flaws of the housing finance system. Action is needed to ensure that markets are more stable, consumers are protected, credit is widely accessible and important housing policy objectives, such as affordable housing for low and moderate income families, are administered effectively and efficiently.

Government has a key role to play in that new system, but its role, and the role of the GSEs in particular, will be fundamentally different from the role played in the past. Private gains can no longer be supported by the umbrella of public protection, capital standards must be higher and excessive risk-taking must be appropriately restrained.

When considering the future role of government in housing finance and its organizational design, it is important to remember that Fannie Mae and Freddie Mac are only one part of a whole set of institutions that support housing finance, which also includes FHA, VA, USDA and GNMA, the Federal Home Loan Banks, commercial banks, thrifts, community banks, community development financial institutions, credit unions, private issuers of mortgage-backed securities, mortgage brokers, and a wide range of other stakeholders and market participants. Any restructuring of Fannie Mae and Freddie Mac must be done as part of a reform of the wider housing finance system and placed within the context of broader housing policy objectives to ensure that the functioning of the whole system is advanced.

Furthermore, as part of any broad review of government's role in the housing finance system, one must consider how other government programs and policies support housing. A reformed housing finance system should reflect a consideration of how these different policies and institutions are balanced to achieve overall housing policy objectives.

The Administration has defined a framework of objectives for reform of the mortgage finance system. A reformed housing finance system should deliver stability and efficiency to the housing market, while minimizing the risks and costs borne by the American taxpayer.

### **Objectives of Reform**

In considering reform, the Administration will be guided by the view that a stable and well-functioning housing finance market should achieve the following objectives:

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- *Widely available mortgage credit.* Mortgage credit should be available and distributed on an efficient basis to a wide range of borrowers, including those with low and moderate incomes, to support the purchase of homes they can afford. This credit should be available even when markets may be under stress, at rates that are not excessively volatile.
- *Housing affordability.* A well-functioning housing market should provide affordable housing options, both ownership and rental, for low- and moderate-income households. The government has a role in promoting the development and occupancy of affordable single- and multi-family residences for these families.
- *Consumer protection.* Consumers should have access to mortgage products that are easily understood, such as the 30-year fixed rate mortgage and conventional variable rate mortgages with straightforward terms and pricing. Effective consumer financial protection should keep unfair, abusive or deceptive practices out of the marketplace and help to ensure that consumers have the information they need about the costs, terms, and conditions of their mortgages.
- *Financial stability.* The housing finance system should distribute the credit and interest rate risk that results from mortgage lending in an efficient and transparent manner that minimizes risk to the broader financial and economic system and does not generate excess volatility. The mortgage finance system should not contribute to systemic risk or overly increase interconnectedness from the failure of any one institution.

The housing finance system could be redesigned in a variety of ways to meet these objectives. However, the Administration believes that any system that achieves these goals should be characterized by:

- *Alignment of incentives.* A well functioning mortgage finance system should align incentives for all actors – issuers, originators, brokers, ratings agencies and insurers – so that mortgages are originated and securitized with the goal of long-term viability rather than short term gains.
- *Avoidance of privatized gains funded by public losses.* If there is government support provided, such as a guarantee, it should earn an appropriate return for taxpayers and ensure that private sector gains and profits do not come at the expense of public losses. Moreover, if government support is provided, the role and risks assumed must be clear and transparent to all market participants and the American people.
- *Strong regulation.* A strong regulatory regime should (i) ensure capital adequacy throughout the mortgage finance chain, (ii) enforce strict underwriting standards and (iii) protect borrowers from unfair, abusive or deceptive practices. Regulators should have the ability and incentive to identify and proactively respond to problems that may develop in the mortgage finance system.

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- *Standardization.* Standardization of mortgage products improves transparency and efficiency and should provide a sound basis in a reformed system for securitization that increases liquidity, helps to reduce rates for borrowers and promotes financial stability. The market should also have room for innovations to develop new products which can bring benefits for both lenders and borrowers.
- *Support for affordable single- and multifamily-housing.* Government support for multifamily housing is important and should continue in a future housing finance system to ensure that consumers have access to affordable rental options. The housing finance system must also support affordable and sustainable ownership options.
- *Diversified investor base and sources of funding.* Through securitization and other forms of intermediation, a well functioning mortgage finance system should be able to draw efficiently upon a wide variety of sources of capital and investment both to lower costs and to diversify risk.
- *Accurate and transparent pricing.* If government guarantees are provided, they should be priced appropriately to reflect risks across the instruments guaranteed. If there is cross-subsidization in the housing finance system, care must be exercised to insure that it is transparent and fully consistent with the appropriate pricing of the guarantee and at a minimal cost to the American taxpayer.
- *Secondary market liquidity.* Today, the US housing finance market is one of the most liquid markets in the world, and benefits from certain innovations like the “to be announced” (or TBA) market. This liquidity has provided a variety of benefits to both borrowers and lenders, including lower borrowing costs, the ability to “lock in” a mortgage rate prior to completing the purchase of a home, flexibility in refinancing, the ability to pre-pay a mortgage at the borrowers’ discretion and risk mitigation. This liquidity also further supports the goal of having well diversified sources of mortgage funding.
- *Clear mandates.* Institutions that have government support, charters or mandates should have clear goals and objectives. Affordable housing mandates and specific policy directives should be pursued directly and avoid commingling in general mandates, which are susceptible to distortion.

## **Key Policy Choices for a New Housing Finance System**

Since the 1930s, the U.S. government has played an important role in housing finance. Today, significant support for housing and homeownership is now common across many different countries. Intervention in this market has been generally defended on two grounds: (i) some government support, particularly through the provision of guarantees or insurance, can contribute to financial stability and help reduce booms and busts in home prices and (ii) direct subsidies can support the social benefits of home ownership and the availability of affordable housing to low

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and moderate income families. Federal support for housing finance in the current system has at times conflated these two objectives. As part of any reform, it is important to ensure that the objectives and goals of government support are clear and well defined. Financial stability arguments have two components. First, stable access to mortgage credit is important for households and the economy. The largest financial asset for many households is the equity in their home. The housing sector also plays an important role in the overall economy. Residential construction is more volatile than other parts of the economy and consequently plays an important role in economic cycles. Changes in the value of real estate are an important source of variance for household wealth and consumption.

Second, housing finance can be severely affected when the financial system is disrupted. Mortgage loans are relatively small idiosyncratic credits. Underwriting mortgage loans responsibly, and investing in them, involves collecting and evaluating a substantial amount of information. A well functioning mortgage market requires institutions that develop and maintain the capacity to carry out this sort of analysis. When financial stress undermines existing financial institutions engaged in mortgage finance it can be difficult and take time to recreate that capacity.

The case for providing direct government support to stabilize mortgage credit would thus rest on the judgment that mortgage credit is particularly important to households and the economy overall. Moreover, the relative size of the housing market and high correlation of losses it can experience in times of financial distress means that government may be best suited to serve as a source of stability in a responsible manner. In the current crisis, mortgage credit that was not supported by either the GSEs or government programs collapsed highlighting the vulnerability of mortgage credit to financial stress. It is noteworthy that other forms of financial intermediation have fared much better (for example, the corporate bond market has recovered strongly over the past year). As the recent crisis has shown all too painfully, fluctuations in the supply of mortgages over boom and bust credit cycles can have a major impact on the economy. By supporting the availability of and access to mortgage credit, the government can ease the adverse effects of stress in the financial system on the broader economy.

Assuming government continues to play a meaningful role in the housing market for any of the reasons described above, there are a variety of mechanisms which could be employed to promote stability or convey a subsidy if desired.

In considering the various systems around the world, it is apparent that one of the key choices is whether or not government should provide explicit support or guarantees for the issuance individual mortgages or mortgage-backed securities to provide such stability. Government's involvement provides certainty in the value of the guarantee and can promote a stable supply of mortgage credit. Guarantees, together with appropriate regulation, can also form the foundation for promoting good underwriting standards, consumer protections, and the management of broad macroeconomic credit risk.

If some form of guarantee is to be explicitly provided or supported, a series of important questions would need to be answered about how best to achieve these objectives. First, what

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should be the appropriate scale and scope of those guarantees and which borrowers and mortgage products should be eligible? Guarantees on mortgage-backed securities could be provided on a full or partial basis and there are a variety of criteria such as loan size, loan-to-value ratio, credit score and income-to-debt service ratio which could be used to set eligibility and provide benchmarks for standardization. Second, how should any guarantees that are to be provided be priced? In order to protect taxpayers, guarantees should be priced in a way that appropriately reflects the underlying risk assumed by the government. Third, where support or a guarantee are not available or are purposefully limited, how will the risk which is retained in the mortgage finance chain be managed and supervised?

Finally, how should any organization that provides such guarantees be structured and how should guarantees be distributed? Clearly the governance structure of the GSEs in the past, in particular the unhealthy combination of private ownership and implicit government support, proved to be a mistake. Careful choices are needed about organizational design to ensure that those providing any guarantees have the appropriate incentives and expertise.

Many countries provide significant government support for housing finance, but they do so in a variety of ways. Several countries have GSE-like entities that guarantee and/or hold mortgages, but in no other country are they as large as they are in the United States. In a number of countries governments underwrite mortgage insurance. In some cases countries governments provide a regulatory framework and set standards that promote liquid mortgage markets. Securitization does not play a major role in housing finance in all other high-income countries, and where it does exist, it takes different forms. Many European countries use so-called covered bonds to channel credit to housing. This diversity of international practice in housing finance can provide useful insights and examples to consider.

### **Transition to a New System**

Transition presents several important challenges. There is a large stock of investments on the balance sheets of the GSEs, and financial markets are depending on the ability of the GSEs, in their current form, to perform on their obligations. The GSEs and the federal government, through the FHA and GNMA, are playing a larger role in the housing finance market today than they have since the Great Depression. Conditions must be created so that private capital will return in a substantial manner to the housing market. There are important infrastructure, capabilities and human resources at the GSEs that have great value and should continue to serve the needs of the housing market as reform moves forward. Maintaining these capabilities and retaining these personnel through the transition is important.

In conjunction with the Treasury's commitment to supporting the GSEs while in conservatorship, it should be clear that the government is committed to ensuring that the GSEs have sufficient capital to perform under any guarantees issued now or in the future and the ability to meet any of their debt obligations. The Administration will take care not to pursue policies or reforms in a way that would threaten to disrupt the function or liquidity of these securities or the ability of the GSEs to honor their obligations. The Administration recognizes the central importance the



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mortgage finance market plays in the broader capital markets and will ensure that this market is not allowed to be disrupted. Recent amendments to the Preferred Stock Purchase Agreements should leave no uncertainty about Treasury's commitment to support Fannie Mae and Freddie Mac as they continue to play a vital role in the housing market during the current crisis. Maintaining the current securitization operational flow, TBA liquidity, secondary MBS market liquidity and the ability of the GSEs to issue debt during the transition will remain key priorities for the Administration.

Government's role in the housing finance system and level of direct involvement will change, however, and the Administration is committed to encouraging private capital to return to the housing finance market. The substantial direct support for the housing markets that has been put in place will be allowed to fade as the market recovers and fully stabilizes. In addition, through regulatory reform and other supervisory actions, the Administration is committed to clarifying the framework for new securitizations to restart these important markets. These steps should create the room necessary for private markets to re-emerge.

An effective transition plan will seek to maintain the extensive infrastructure, knowledge, personnel and systems of Fannie Mae and Freddie Mac. Designing an effective transition plan that leverages these resources and minimizes market disruption will be a critical component of reform.

### **Next Steps**

To achieve these goals, the Administration intends to develop a comprehensive reform proposal for delivery to Congress. To ensure that input is provided by all stakeholders, Treasury and HUD will submit a list of questions by April 15, 2010 for public comment and will seek responses from a wide variety of constituents, market participants, academic experts, and consumer and community organizations. These questions will ask participants to provide comment on their recommendations for, and comments on (i) the priorities for government housing policy, (ii) the role of government in the housing finance system, (iii) characteristics of mortgage products available to consumers, (iv) the best practices to ensure consumer protection, and (v) the most effective design of the housing finance system.

The Administration will seek to work closely with the Congress, on a bipartisan basis, prior to finalizing a comprehensive reform plan.

Given the importance of the long term stability of the housing market and the critical role the GSEs continue to play in the current financial circumstances, this approach to GSE reform, built upon significant input from various stakeholders, should form the basis for a strong bi-partisan solution, introduced, enacted and executed at a time of greater market stability.