Statement by

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INTRODUCTION

Chairman Johnson, Ranking Member Crapo, members of the Committee, thank you for the opportunity to testify on the development of an effective transition plan for the US housing finance system.

I have spent the entirety of my thirty year professional career—as a lawyer, banker and public servant—in the corporate restructuring business. I have restructured companies as diverse as American Airlines, WorldCom and Charter Communications in the United States, Cadillac Fairview in Canada, United Pan European Communications, EuroDisney and Marconi in Europe, and Daewoo Corporation in Korea. During the recent financial crisis, I served as the Chief Restructuring Officer of the US Department of the Treasury. In that role, my primary responsibilities were managing, restructuring and designing the exit from the Department's substantial investments in AIG and Ally Financial.

I am here today because embedded in the task of reforming our nation's housing finance system is a restructuring of the two largest players in that system: Freddie Mac and Fannie Mae. These companies now operate in conservatorship under the control and direction of the Federal Housing Finance Agency. Because they are central to mortgage credit formation in the United States today, "winding them down" as some members of Congress and the Administration suggest is certain to have significant and adverse consequences for mortgage credit availability and for the nascent housing and economic recovery. Rather than wind down, I urge you to consider a restructuring alternative that addresses the fundamental causes of the companies' insolvency, eliminates the private gain/public loss nature of their current government sponsorship, generates a significant profit to Treasury for supporting their solvency, and, most importantly, ensures a smooth transition to a new housing finance system that better protects taxpayers against future losses while providing for the continuing availability of credit to the credit-worthy.

There appears to be a growing consensus in the policy community around the basic architecture of that new housing finance system. A federal guarantee on qualified mortgage products is required to ensure the widespread availability of a thirty-year fixed-rate product, and to sustain the deep and liquid mortgage securities funding markets that have developed over the past thirty years to complement balance sheet lending from the US banking system. The guarantee should be explicit and structured as reinsurance, available to reimburse investor losses only after a layer of private "first-loss" insurance provided by well-capitalized mortgage insurers or subordinated capital provided through structured product markets has been exhausted. The reinsurance should be priced at arm's length by an independent agency required to use its reinsurance fees to build a reserve fund to protect taxpayers against future loss should that reinsurance ever be called. Finally, in contrast to the system prevailing before 2008, the government reinsurer also needs to be a strong regulator with authority over all issuers, guarantors and servicers with whom it interacts in the new system. In this regard, I commend Senators Corker and Warner and the coalition of other members of this panel behind S. 1217 for putting out a bill with all of these elements in it.

However, the transition to this new system contemplated by S.1217 is fraught with difficulty and needs serious re-thinking to mitigate three significant risks that any credible transition plan must address. First, our fragile economic recovery cannot afford the risk of a significant disruption in mortgage credit. Borrowing rates will need to rise in the new system to reflect the cost of the first-loss capital and new reserves required to protect taxpayers on their guarantee. At the same time we need to protect against a significant contraction in the availability of housing credit that would push us back into recession. Second, the government must end its ongoing backstop of Fannie Mae and Freddie Mac in conservatorship in a way that minimizes the likelihood that Treasury will need to cover future losses on their $5.5 trillion of liabilities. While the substantial guarantee fees and net interest margin which the companies are currently earning and paying over to Treasury may look like an asset to be seized by taxpayers as the quid pro quo for their bailout, it could easily turn out to be a substantial liability if there were another significant housing downturn. Managing that liability in a responsible way to avoid future taxpayer losses is a critical challenge of the transition. Third, there must be a credible path toward the development of the substantial layer of private "first loss" capital on which the functioning of the new system will depend. If you build the new Government reinsurer but the required layer of first-loss capital doesn't come in the size or at the pace of your contemplated wind down of Fannie and Freddie, the whole system will shut down before it has a chance to start. The idea that "if you build it, they will come", may work in the movies, but you are playing with the nation's housing finance system. Hope is not a credible strategy.

You have to make a fundamental choice in meeting these challenges in the transition: Restructure Fannie and Freddie and use their assets and operations to create a well-capitalized set of private market players who can ensure that the new system functions as contemplated, or wind them down on the bet that if you build the new reinsurance system, new private players with the sizeable capital required to make the new system function will come. My concern with both S.1217 and the Protecting American Taxpayers and Homeowners Act introduced in the House of Representatives is that each is based on the bet that to-be-named new players with capital yet to be raised will show up right on queue as the two institutions at the center of the current system are mechanically wound down. As I hope to demonstrate in the following testimony, we don't have to gamble with the future of the housing market. There is a better alternative.

EVOLUTION OF THE GOVERNMENT'S ROLE IN THE CONFORMING MORTGAGE MARKET

A responsible transition begins with a clear understanding of the status quo and how it arose.

In the late 19th and early 20th centuries, there were various attempts to use bond markets to fund housing and commercial real estate. But the lack of adequate securities law and insurance company regulation, the absence of uniform contractual investor protections, poor underwriting, and outright fraud led to repeated funding market collapses, subjecting the US economy to painful downturns. The 1870s and 1880s featured a permutation of covered bonds, where mortgage originators issued debt to the public collateralized by pools of the mortgages they had originated. While this market functioned for a time and funneled investor dollars into housing finance, it eventually collapsed because the originators violated their purported underwriting standards and packed the pools with non-conforming collateral. In the 1900s, New York title guarantee companies originated mortgages, insured them, and sold participation certificates

backed by them (an early form of mortgage-backed securities). These title insurance companies eventually failed, and the mortgage securities markets they supported collapsed, because of poor underwriting, thin capitalization and weak state insurance regulation. The 1920s featured the issuance of single-property real estate bonds, each governed by a separate set of indenture provisions, the proceeds of which were used to finance large construction projects. Poor underwriting and weak investor protections led to its eventual collapse. The same decade (the roaring 20s) also saw bank and thrift failures at an average rate of 600 per year (in a banking system with approximately 10,000 banks and thrifts), a crisis by today's standards and significantly disruptive to home lending and local economic activity. The pace of bank and thrift failures peaked five years after the Crash of 1929 when, in 1933, roughly 4,000 banks and thrifts failed, resulting in widespread foreclosure and a severe contraction of housing finance credit.

In response to the housing and banking crisis of the 1930s, the federal government restructured the banking system and significantly expanded its role in housing finance. Among other things, the Banking Act of 1933 created and Banking Act of 1935 expanded the authority of the Federal Deposit Insurance Corporation (FDIC), an independent agency of the Government chartered to provide federal deposit insurance to banks to prevent the bank runs that forced the Roosevelt Administration to impose a national two-month long bank holiday in early 1933. The acts also provided the FDIC with regulatory authority over its member banks, initially funding its reserve fund with loans from the Treasury and Federal Reserve. Those loans were repaid with interest after member bank insurance fees began to accumulate. When faced with widespread bank failures during the recent financial crisis, the FDIC's Deposit Insurance Fund also fell into deficit. However, instead of drawing on its line of credit with Treasury to replenish its coffers, the FDIC pulled forward insurance assessments and imposed additional fees on its member banks. The Dodd-Frank Act of 2010 requires the FDIC's Deposit Insurance Fund to reach 1.35 percent of insured deposits by 2020.

In the 1930s, Congress also addressed mortgage finance directly. In 1932 it created and capitalized the Reconstruction Finance Corporation (RFC), which made loans to, among others, banks and mortgage associations.[1] In 1932, Congress established the Federal Home Loan Bank System in order to create additional funding for home loans originated by savings and loan institutions. Federal Home Loan Banks (FHLBanks) make loans to member institutions secured against eligible collateral—typically mortgages—and issue debt to the public to fund such lending activity. The cost of that funding is generally lower than an individual member can obtain because the debt is the joint and several obligation of all FHLBanks, which operate under government-sponsored charters. The FHLBanks are capitalized by their members, whose borrowing limits are proportionate to their respective capital contributions. The FHLBanks are regulated by the Federal Housing Finance Agency and have a minimum capital requirement of four percent of assets. In exchange for their federal charters and exemption from state taxation, FHLBanks pay an assessment of 10 percent of annual earnings for affordable housing programs.

These efforts helped stabilize banks and other mortgage providers in the 1930s. But many would-be homebuyers in the 1930s remained shut out of the mortgage market, and home

[1] The RFC funded various relief projects during the Depression and authorized loans and investments to support the government's efforts during World War II. It also established multiple companies to carry out its mission. The RFC was ultimately disbanded in 1957.

construction remained muted. The average mortgage required a large down payment, had a maturity of three to five years, and featured large balloon payments at maturity. Although most loans were renewable at maturity the interest rate would reset, subjecting borrowers to the risk of significant interest rate movement over the short life of the mortgage loan, with no ability to hedge that risk.

The National Housing Act of 1934 established the Federal Housing Administration (FHA) to address this problem and facilitate credit for home construction and repairs to a broader swath of borrowers. By offering insurance in exchange for a fee and assuming a first layer of risk, the FHA made possible the issuance of fixed-rate, long-term mortgage with regular monthly payments.[2] The act authorized the creation of a reserve fund to support claims made on the government's insurance: the Mutual Mortgage Insurance Fund (MMI Fund). The act also provided initial capital for the fund, and it has since been funded through premiums on insured mortgage loans. Today the MMI Fund is required to maintain a reserve of two percent of insured loans based on projected losses over a 30-year horizon. During most of its history, a portion of premiums collected in excess of that reserve minimum have been transferred to Treasury. Between 2001 and 2007, for example, the program transferred approximately $14 billion to Treasury. Earlier this year, for the first time in FHA's history, it borrowed $1.7 billion from Treasury to bring the MMI Fund reserve up to its congressionally-mandated minimum level. The FHA single-family mortgage insurance program generally targets first-time and lower-income homebuyers, although during the recent crisis, when other private mortgage insurers failed or became undercapitalized, the FHA significantly expanded its footprint to ensure credit availability.

The same act that created the FHA also authorized the agency to create "national mortgage associations" to purchase and sell FHA-insured mortgages. The objective was to create additional liquidity for housing credit beyond the then FDIC-guaranteed deposit-based funding available in the banking system or though the discounting of mortgages at the FHLBanks. Similar to the FHLBanks, the national mortgage associations would tap capital markets to fund FHA-insured mortgage originations. Unlike the FHLBanks, they would not be cooperatives. Instead, it was contemplated that they would have a broad base of private equity investors. However, four years after passage of the National Housing Act in 1934, no national mortgage association charters were ever taken out by the private sector. As a result, at the urging of the Roosevelt Administration, the government-owned RFC began buying FHA-insured loans and in 1938 formed a subsidiary that became the only chartered national mortgage association: the Federal National Mortgage Association (Fannie Mae).

Fannie provided a secondary mortgage market into which originators could sell loans, which freed capital and provided funding so that those originators could recycle the funds and extend additional mortgage credit. In 1954, after 16 years as a purely government entity, the Federal National Mortgage Association Charter Act converted Fannie into a mixed-ownership corporation, where the government held preferred stock and private investors held its common stock. In 1968, in order to remove its growing balance sheet liabilities from the federal budget, Congress split the company in two, leaving behind the Government National Mortgage Association (Ginnie Mae), a government entity that began guaranteeing passthrough securities

[2] As opposed to short-term balloon payment mortgages that were more traditionally available.

backed by mortgages insured by FHA, the Department of Veterans Affairs, and Farmers Home Administration and fully privatized the ownership of Fannie Mae. However, the government charter remained with the privatized Fannie, and with that charter came the obligations to serve the public policy ends of increasing home ownership and supporting low- and moderate-income housing. This original policy error in the 1968 privatization created a private shareholder-owned company with a public mission, allowing Republican and Democrat Administrations alike to pressure Fannie to increase credit availability to serve political ends. It also allowed Fannie to use its public mission as political ammunition to fend off challenges from banks to its market power and to its relatively lax regulatory oversight.

In 1970 Congress created the Federal Home Loan Mortgage Corporation (Freddie Mac) to compete with Fannie, expand the secondary market for mortgages, and help thrifts manage interest rate risk. Freddie had the same charter and implied government guarantee as Fannie, but it was initially capitalized and owned by the FHLBanks. In 1971 Freddie issued its first mortgage backed security (MBS). Securitizing mortgages purchased from thrifts defined the company's business model over the next few decades, while Fannie continued primarily to purchase and hold mortgage loans in its portfolio funded with balance sheet borrowing from the capital markets. Both government-sponsored enterprises (GSEs) were permitted to purchase non-FHA-insured loans.

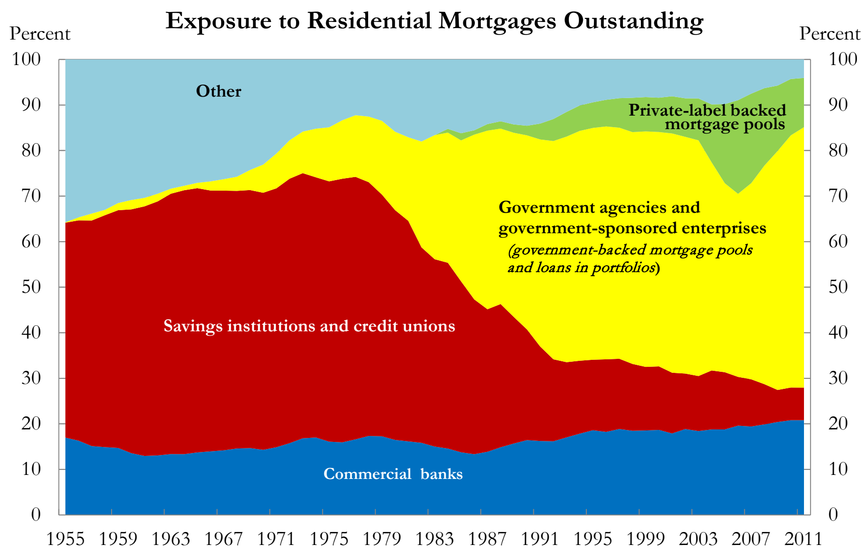
Inflation, interest rate volatility, economic downturns, and the beginning of a thirty-year wave of bank deregulation in the late 1970s and early 1980s wreaked havoc on savings and loan associations, also known as "thrifts", as well as on Fannie. Thrifts funded most of the long-term mortgages they held with short-term obligations, largely deposits. Until the 1980s regulators imposed ceilings on the rates of interest on savings and time deposits that thrifts could pay. The Depository Institutions Deregulation and Monetary Control Act of 1980 phased out those limits.[3] Meanwhile the then relatively-new money market funds began to grow rapidly with little regulatory impediment, competing with thrifts for deposits. As a result, the rates paid on deposits increased, and the thrifts faced a mismatch between their funding costs (deposits) and the earnings on their primary assets. Fannie, as a balance sheet lender, was exposed to similar risks, although it funded itself in the capital markets, largely through long-term debt, rather than with deposits. To try to help thrifts mitigate losses from the mismatch between their deposit funding costs and the interest rates on their long-term mortgage assets, the Garn-St. Germain Depository Institutions Act of 1982 permitted them to expand into corporate lending, an area for which they had little underwriting experience. In relatively short order, thrifts experienced significant losses during the recession that occurred during the mid-1980s, and the sector virtually collapsed by the late 1980s, simultaneously putting the FHLBanks under pressure. The same act also authorized banks to provide adjustable-rate mortgages.

Regulatory forbearance and a rapid change in its funding profile away from long-term debt toward short-term debt permitted Fannie to weather that particular storm, and by the early 1990s it began to shift away from a long-term buy and hold strategy to the Freddie securitization model. Meanwhile, in 1989 Congress reorganized and privatized Freddie, and it opened

[3] This was the first in a series of legislative deregulatory initiatives for the financial sector over a 30-year period, which culminated in the repeal of the separation of commercial and investment banking that had been provided by the Banking Act of 1933.

membership in the FHLBanks to commercial banks. The latter action more than offset the losses suffered by the FHLBanks during the savings and loan crisis of the late 1980s. As a result of the expansion of FHLBank membership to include commercial banks, FHLBank assets increased by a factor of six to roughly $1 trillion.

During the 1980s, as the savings and loan crisis intensified and many thrifts failed and withdrew from the mortgage funding markets, the GSEs, FHA, VA, Ginnie and the FHLBanks—filled the void and increased their respective share of credit exposure to the residential mortgage market. The figure to the right illustrates that between 1982 and the mid-1990s, as the dominant savings and loan share of the market shrank, the GSEs and government agencies went from less than 10 percent of the market to roughly 50 percent of it.



Source: Federal Reserve Board.
Notes: Other includes life insurance companies, finance companies, real estate investment companies, private pension funds, state and local government retirement funds, households and nonprofit institutions, and non-financial corporate and non-corporate businesses.

After the collapse of the savings and loan associations in the 1980s, and the concomitant rise of the GSEs and government agencies in the market, the only other significant change in mortgage funding was the creation and growth of the private-label mortgage backed security (PLS) market. Like MBS issued by the GSEs, PLS facilitated the pass through of funds from security investors to mortgage originators. However, instead of leaving the credit risk with the government or one of its government sponsored proxies, the PLS market passed credit risk onto private investors. Regulators and rating agencies facilitated the growth of this market by lowering capital charges imposed on banks to hold PLS, especially certain highly-rated allegedly riskless tranches of them, and by permitting their use as collateral in short-term funding markets. While the single-family residential mortgage market roughly doubled in size between 2000 and 2007 to over $10 trillion, PLS outstanding in that market more than quadrupled, increasing from approximately $400 billion to $2.3 trillion. A significant portion of that increase represented PLS composed of subprime and Alt-A mortgages, PLS which proved, we now know, to be rife with poor underwriting, misrepresentations and outright fraud.

Encouraged by legislated charter amendments in 1992 imposing new affordability goals, growing competition from issuance in the PLS markets, and private shareholder return expectations, Fannie and Freddie used their government-subsidized balance sheets to purchase riskier assets, including PLS backed by subprime and Alt-A mortgages. By contrast, the conforming loans bundled in MBS which the enterprises guaranteed were quite conservatively underwritten and exhibited default rates and loss severities modest by comparison to the default rates and loss severities exhibited by the PLS which they bought. But weak regulation of the

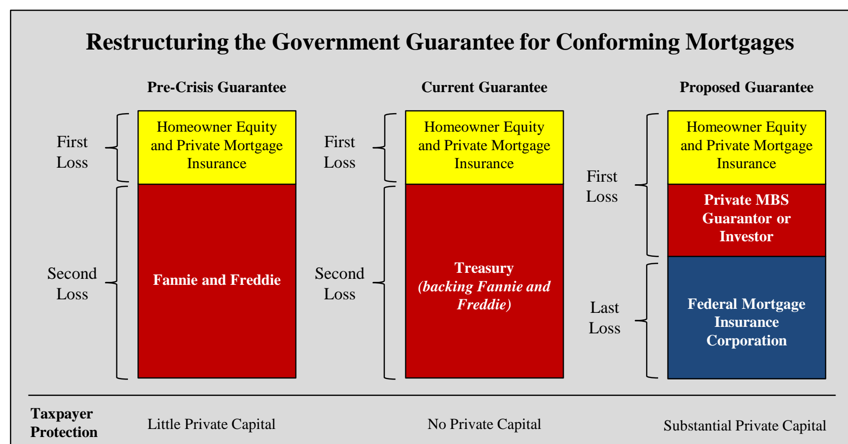
enterprises failed to deter them from what would prove to be a path toward self-destruction. And regulatory arbitrage encouraged banks to purchase large volumes of PLS as well, effectively setting them on the same path as Fannie and Freddie.

House prices began to collapse in 2006. PLS investors fled the market and MBS issuance other than what the GSEs supported came to a complete halt by the middle of 2008. In addition, banks cut back sharply on balance sheet lending. The entire sector of private mortgage insurers, who had conceptually provided credit enhancement for banks and the enterprises, became insolvent. The thin layers of capital at Fannie and Freddie proved woefully inadequate to absorb losses from the risky assets they had acquired in their portfolios.

And so it was, in the summer of 2008, that the federal government found the economy spiraling deep into recession with the continuing collapse in home prices and mortgage credit formation adding weight to that fall. No one was left to take credit risk in mortgages except for government agencies and the GSEs. And by early September, it seemed that the GSEs might be on the brink of failing.

Treasury intervened. It sought and obtained legislation that created a new regulator, the Federal Housing Finance Authority (FHFA), over the entities with authority to place Fannie and Freddie into a government supervised conservatorship or receivership. Treasury had hoped that the mere existence of that resolution authority would assure markets that the government would ultimately make good on what had been an implicit guarantee of the enterprises' liabilities, and that Fannie and Freddie would be able to fund themselves in private markets without the need for formal federal government support.

However, as financial conditions continued to deteriorate, in September 2008 the FHFA placed Fannie and Freddie into federal conservatorships. To ensure that they would remain solvent and continue to provide funding to the mortgage markets, Treasury entered into Preferred Stock Purchase Agreements through which it committed to inject fresh capital into the companies. Treasury also took a warrant on 79.9% of each company's common stock. This investment structure allowed Treasury to achieve its goals without taking the liabilities of the enterprises onto the federal balance sheet.[4] This Treasury backstop convinced agency MBS and debt investors that they were not at risk of default, and they continued to buy GSE MBS and funded debt throughout the crisis.



Through the mechanism of the Preferred Stock Purchase Agreements, Treasury transformed what had previously been an implicit guarantee of two private companies into an explicit guarantee of their balance sheet solvency. Rather than extending the guarantee

[4] Accounting rules could require consolidation if the government owns 80 percent or more of a private company.

directly to their liabilities, however, Treasury guaranteed each entities' ability to pay their obligations when due by committing to an open ended purchase of sufficient preferred stock to cover the entities' losses.

Between the fall of 2008 and the end of 2011, to cover both accounting reserves and allowances and real cash credit losses at the enterprises, as well as a mandatory 10 percent dividend on the amount of its outstanding senior preferred stock, Treasury p rovided $187 billion to Fannie and Freddie. However, as the housing market stabilized in 2011, the enterprises' losses abated, and they started to become extraordinarily profitable. Prices of securities in their portfolios were rallying, guarantee fees had increased, and large reversals in reserves and allowances seemed likely. In August of 2012, Treasury and FHFA amended the terms of the PSPAs, changing the fixed 10 percent dividend on the outstanding preferred to a variable dividend equal to 100 percent of the enterprises' earnings in any quarter. As a result, by the end of this year—six quarters after the amendment—Fannie and Freddie will have returned to taxpayers almost the entirety of the $187 billion that Treasury invested in them.[5]

Nevertheless, more than five years after Fannie and Freddie were placed into conservatorship, the PLS market is moribund, balance sheet lending by banks remains weak, and those private mortgage insurers that have survived only as a result of regulatory forbearance and continuing fee streams related to MBS guaranteed by the GSEs. As a result, Fannie and Freddie, together with FHA, VA, and Ginnie, underwrite the credit risk on and facilitate funding for nine out of every 10 new mortgages written in the United States today. After five years of conservatorship, the GSEs remain liable for $4.4 trillion securities backed by single-family mortgages—nearly half of the outstanding mortgage debt on single-family residences in the United States—as well as $1.1 trillion of on-balance-sheet funded debt. But, as a result of the August 2012 amendment, and the sweep of all of their earnings to the Treasury Department, neither company has any material capital standing between the taxpayers and potential future losses on those $5.5 trillion of liabilities.

LESSONS FROM EVOLUTION FOR THE TRANSITION

One of the most important lessons from the evolution of the mortgage markets in the United States is that the willingness of private investors to take on mortgage credit risk is quite volatile, subject to huge swings in appetite between irrational exuberance and fear. After the turn of the century, PLS investors piled into a loosely supervised, poorly underwritten market with securities whose underlying collateral support was both opaque and riddled with fraud and misrepresentation. In this respect, the PLS market of the 2000s was not at all unlike the private mortgage markets that briefly flowered in the 1870s and 1880s and then again in the 1910s and 1920s. They were robust for a time and then floundered on their own excesses.

Today, institutional investors remain wary of doing business with any of the previous participants in the underwriting chain. And it is safe to assume that it will be a long time before

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[5] Treasury invested $187 trillion in the two companies. Through the end of the third quarter of 2013, they had returned $146 billion through dividends on Treasury's preferred securities. In their recent earnings releases, the companies announced that they would send another $39 billion in dividends by the end of December 2013. That will bring total dividends to $185 billion.

investors trust any of the mortgage brokers and bank aggregators that managed to survive the crisis, or the ratings agencies that were complicit in their flawed offerings. The few PLS deals that have been done in the last few years are being done almost entirely by new non-bank finance companies against mortgages of high credit quality with huge layers of "first loss" protection ahead of the investors.

The thrift industry has all but disappeared as a source of mortgage funding and overall bank portfolio lending is down 20 percent from 2008. Although banks have worked through the majority of their troubled residential mortgages, capital requirements have increased, making it more expensive to hold mortgage loans on balance sheet. And while deposits at banks have expanded slowly since the crisis, they would need to allocate their entire deposit base to fund the existing mortgage market. That means that banks would have to stop all commercial and consumer lending, grinding our economy to a halt, and the fate of the sector would be tied to a single asset class.

Private mortgage insurers have begun to add to their aggregate credit risk and capital over the past two years. But they still have only half the $17 billion in capital they had at their peak—well short of the capital that would be required to adequately support the likely $750 billion to $1 trillion in annual demand for conforming mortgage loans over the next five years.

Another important lesson from history is that change is slow. It took 25 years and a major change in the regulatory landscape governing the thrift industry for the GSEs and government agencies to obtain a majority of the credit risk in the US mortgage market. Assuming that an objective is to prevent the mortgage credit market from shrinking dramatically, it will likely take an equally long time to shift a material amount of that credit risk back into private hands. That is because Fannie and Freddie are the central pipes of the current mortgage funding system. Everyone participating in the origination, aggregation, securitization and servicing of mortgage credit risk in America connects to them. They are the only standard setters with any market credibility. They own nearly half the credit risk in the mortgage market. Banks depend on them to move risk off their balance sheets while capturing profits from the spread between the primary and secondary market. Private mortgage insurers depend on credit enhancement requirements that Fannie and Freddie impose on conforming mortgages. Rate investors rely on their guarantees to funnel investment funds into the housing market. And, without their participation, the so-called To-Be-Announced market would shrink considerably (only Ginnie securities would remain), and rate locks for consumers on conforming mortgages would disappear. They have done more mortgage modifications and workouts than any other lender in the system. In short, while it could be done, winding Fannie and Freddie down will entail a massive restructuring of the entire infrastructure of the mortgage funding system. It is not going to be as simple as flipping a light switch or clearing a field and building a baseball diamond.

A final takeaway is that the now express government guarantee of Fannie and Freddie's solvency has left the government with a rather complicated liability management problem. The credit investor most at risk from a botched transition, in which mortgage credit availability contracts, house prices decline and delinquencies and defaults spike again, is the Treasury Department. Treasury now effectively stands behind those $5.5 trillion in liabilities, with virtually no capital

in front of it.[6] What now looks like a huge asset could quickly turn into a massive liability for taxpayers if a "wind down" throws the mortgage funding markets into disarray.

A Smooth Transition: Transforming the Government Guarantee and Managing Existing Liabilities

Given that history and the current state of the housing market, I see one viable path to the end state envisioned in S.1217 that does not put the economy or taxpayers at risk: restructure, recapitalize, and privatize the single-family and multifamily guarantee businesses of Fannie and Freddie. Doing so would solve the thorniest problem in the transition: ensuring the creation of a durable layer of private capital ahead of the FMIC backstop.

Note that I am not proposing that you reinstate the pre-crisis GSE model. On the contrary, I suggest that you tear it down. Eliminate the "national mortgage association" charters dating back to 1934 that enabled Fannie and Freddie to operate government-sponsored hedge funds, using government-subsidized cost of funds to purchase risky mortgage assets on a highly levered basis. Wind those portfolios down to levels necessary to operate a cash window to facilitate the purchase of mortgage loans from small banks and credit unions and to manage the workout of troubled mortgages that they guarantee. Fully privatize their single-family and multifamily businesses separately, and subject them to strong safety and soundness and capital adequacy regulation. Create conditions for competition among private sector participants, while establishing a credible resolution regime for all participants, including those who may otherwise be deemed too big to fail. Substitute their existing access and affordability requirements with FMIC regulatory authority and dedicated federal vehicles subject to congressional oversight and funded through fees on all securities issued in the conforming market. In short, I propose fixing the problems with these businesses and using what remains to bridge to your new system.

Below I provide a framework for evaluating any transition plan, followed by a more detailed explanation of what I propose. Finally, I evaluate the transition plan in S.1217.

Framework for Transition

Any responsible transition plan for reforming the government's role in housing finance should satisfy the following 10 criteria:

1. Avoid a sharp contraction in mortgage credit that would depress house prices and risk another recession;
2. Avoid saddling Treasury with losses from the remaining liabilities at Fannie and Freddie to which it is currently exposed;
3. Establish an adequate and durable layer of private capital ahead of the FMIC and taxpayers;
4. Preserve liquidity between the old and new systems, including through the TBA market
5. Maintain secondary market access for small and community banks without forcing them to go through large US banks;

[6] Under the terms of the PSPAs, each company currently has a capital reserve of $3 billion, which is required to decline to $0 in 2018.

6. Prevent concentration of mortgage risk in large US banks;
7. Facilitate competition among private loss providers on FMIC-reinsured MBS;
8. Avoid consolidating GSE obligations onto the federal balance sheet;
9. Contribute to deficit reduction; and
10. Respect the rule of law.

A REALISTIC WAY FORWARD

Again, I urge you to use the two companies currently under your control and central to the current mortgage system to transition smoothly to a new, safer system.

Use them to build capital cushions at each issuer adequate to protect the government on the $4.4 trillion in outstanding MBS that the government has backstopped through the conservatorships. To build that capital, FHFA should immediately direct the enterprises to increase their guarantee fees to market levels, reflecting a return on capital that other private insurers have to factor into their fees. And Treasury should suspend its profit sweep and allow the companies to retain their earnings. Building capital to restore the companies' solvency is one of the express mandates of the statute authorizing the creation of the conservatorships, a mandate that has been entirely ignored during the past five years.

Meanwhile, begin building reserves at the new Mortgage Insurance Fund to protect the Federal Mortgage Insurance Corporation when the new system is turned on. Ten basis points of guarantee fees on the existing GSE MBS books should be re-allocated to start building the FMIC reserve fund. In exchange, once the FMIC is up and running, it could reinsure the outstanding $4.4 trillion of legacy Fannie and Freddie MBS. This would relieve Treasury of any further obligation to backstop future losses on those securities through the PSPAs. It would also create continuity between the securities issued under the old regime and securities issued in the new regime, ensuring that securities in the new regime are issued into a deep and liquid market based on the same reinsurance. Without this bridge, legacy GSE MBS will be orphaned from the new market, and FMIC securities will suffer in pricing during the transition.

The personnel, assets and operations associated with the single-family and multifamily businesses in each enterprise should be separated. Each separated business should be licensed to purchase FMIC reinsurance. And when they attain adequate capitalization levels, those businesses should be re-chartered under state insurance and corporate charter statutes. Equity in each of the separately-capitalized businesses should be sold to the highest bidder or in an initial public offering. This separation would promote focused management and reduce consolidated market power that could squeeze out competition. The privatized single-family businesses should be permitted to maintain portfolios of sufficient size to operate a cash window for small banks, credit unions and other originators, to manage troubled mortgages which they have guaranteed, and to conduct basic Treasury operations.

None of these private companies would have special privileges—no implicit or explicit guarantee of their liabilities that Fannie and Freddie enjoy today as a result of their "national mortgage association" charters and the express backstop from Treasury of their solvency in conservatorship. They will not have the ability to issue government guaranteed debt to fund

expansive on-balance-sheet mortgage portfolio investments, which Fannie and Freddie had the ability to do under the government-sponsorship model. And each of the separated businesses and new entrants should be subject to a resolution regime that could facilitate their failure without wrecking mortgage credit formation or the functioning of the mortgage market generally. In the case of future failure, shareholders can be wiped out and any mortgage guarantee infrastructure transferred to new ownership. That regime should be modeled on the FDIC's orderly liquidation authority for banks and financial institutions deemed systemically important by the FSOC.

Finally, conduct the ritual slaughter that so many are demanding. The highly-levered investment portfolios each firm ran before the crisis—in effect, their government-sponsored hedge funds—should continue to be wound down under federal supervision. The public charters that allowed private shareholders to benefit on the backs of taxpayers should be terminated. Affordability and access requirements that have been suspended by the FHFA in conservatorship will end with the termination of the charters. Fannie and Freddie should ultimately be placed into receivership and liquidated.

I appreciate the trepidation of re-creating two dominant players in the mortgage market by releasing parts of Fannie and Freddie back into the wild, however they may have been restructured. Therefore, an important element of both the transition and the end-state is to ensure that there is a competitive marketplace for conforming mortgage credit risk.

There are at least six concrete, mutually-reinforcing steps that the FHFA and FMIC can take during the transition to promote a more competitive market structure while ensuring continuity through the recapitalization and privatization of the mortgage guarantee businesses:

1. **Common MBS Security:** The FMIC could work with private market participants to establish a common To-Be-Announced market for securities eligible for FMIC insurance and facilitate options for multi-lender pools of eligible single-family mortgages. A single FMIC security could remove the largest barrier to entry for new issuers to compete with Fannie and Freddie. The difference in liquidity between Fannie and Freddie securities has given Fannie a more competitive position in the MBS market over Freddie. To combat Fannie's advantage over Freddie and both companies' advantages over any new issuer, a common TBA market through which a single FMIC security could be issued would defeat the competitive advantages the privatized mortgage guarantee businesses would otherwise have over any new issuer or guarantor. Establishing a single security and extending it to legacy GSE MBS could be accomplished in two to three years.

2. **Capital Surcharges:** Legislation could require the FMIC to impose heightened capital and other heightened prudential requirements on any issuer or bond guarantor that establishes a dominant market position. This would be similar to the heightened requirements being debated for large banks and other financial institutions designated by the Financial Stability Oversight Council. New entrants with lower capital requirements should then be able to offer the same first loss protection to taxpayers on better terms while achieving comparable return on equity for their investors. S.1217 imposes a hard limit on market share, which risks discontinuities and inefficiencies that will translate

into unnecessarily higher mortgage pricing. Adverse capital charges rely on economic incentives to achieve the same desired outcome, while providing flexibility to the regulator to preserve efficiencies in the market. If the consensus is to impose a hard limit on market share, I urge you to base that limit on some empirical analysis of the benefits and costs of the market structure which that hard limit will dictate.

3. **Infrastructure Licensing:** At least during the transition, the FMIC could coordinate with the FHFA to allow new MBS guarantors to use the issuance infrastructure of the enterprises and/or the common securitization platform in exchange for a fee to help establish and grow their market share. This could eliminate or at least mitigate another substantial barrier to entry, and ensure that there are existing, viable competitors when the restructured single-family and multifamily businesses of Fannie and Freddie are privatized.

4. **Common Securitization Platform:** Meanwhile, efforts to establish a common securitization platform (CSP) that could serve as a market utility should continue. However, it is important to recognize that the platform will take several years to reach its first milestone—bond administration functions—and as currently envisioned even in its final phase it will support only a quarter of the aggregation and issuance chain necessary to generate FMIC-reinsured MBS. It is more realistic during the transition to expect that the FMIC will rely on a combination of issuers (similar to Ginnie Mae) and whatever is available at the CSP, which will continue to evolve. The FMIC need not wait on the CSP to reach a particular level of maturity to begin offering reinsurance. The FMIC should supervise the CSP, but its operations could be managed by private market participants.

5. **Pricing:** Raising guarantee fees at the enterprises to take into account a proper return on capital charge will also have the collateral benefit of creating a pricing umbrella under which new private investors and insurers can compete.

6. **Equal Access:** In all events, the FMIC should offer reinsurance to all new entrant first-loss providers who meet its capital and other eligibility requirements.

With respect to minimum capital requirements, it would be a mistake to set capital requirements at arbitrarily high levels. Doing so will increase borrowing costs with little to no incremental improvement in the safety of the system. It will trap capital that could otherwise be used productively in our economy. And it may impair returns on MBS guarantee businesses to such a degree that you will deter the investment necessary to capitalize new entrants. It would also be a mistake to set capital standards for first-loss providers or for a subordinated layer of first-loss capital in reform legislation that are substantially higher or lower than those required of other providers of mortgage credit, such as banks. To do so would create a type of regulatory arbitrage between the capital required for mortgages held in whole loan form on balance sheet versus mortgages held in MBS form with FMIC reinsurance, an arbitrage that was partially responsible for the flight of mortgage credit out of the banking system and into the previously-undercapitalized GSE system historically. Forcing mortgage credit back into the banking system by having substantially higher capital requirements for FMIC first-loss providers is not only inconsistent with heightened capital standards coming out of the crisis for banks going forward.

It would also exacerbate the Too Big To Fail problem with our largest banks if in fact better returns on balance sheet mortgage lending leads to accelerated asset growth at the largest banks.

Based on recent experience with the largest mortgage credit shock in any of our lifetimes, and consistent with what banking regulators are targeting, a total capital requirement between four and five percent would be adequate to protect the FMIC against loss. Such a level would be consistent with the 10 percent capital standard that S.1217 calls for, assuming a relatively conservative risk-weighting for conforming mortgages. I warn against expanding the set of eligible capital beyond the definition accepted by banking regulators. Regarding the capitalization level for the MIF, we believe that a reserve balance of 1.5 percent is appropriate and achievable within an acceptable timeframe without imposing undue costs on the conforming market. This is greater than the 1.35 percent minimum level that the FDIC is targeting for the Deposit Insurance Fund, and behind four to five percent of first-loss capital, it would have been more than adequate to protect taxpayers against loss during the recent crisis.

Allowing the single-family and multifamily businesses at the heart of today's conforming market to be recapitalized and privatized rather than liquidated would provide continuity in the transition. Meanwhile, the six tools identified above could be used to ensure that a more diversified set of first-loss providers could enter the market and provide a check on the perpetuation of the dangerous duopoly that now exist under the conservatorships. In addition, when the new system is switched on and the FMIC begins to offer reinsurance on new conforming MBS, there would be at least two issuers/guarantors with sufficient capital and capacity to provide small banks and credit unions an effective conduit to the secondary market without having to sell their customer relationships to the countries' largest banks. And those two issuer/guarantors would be able to provide a counterweight to the large banks in the mortgage market generally. In turn, mortgage risk would not become concentrated in the banking sector. Legacy MBS obligations would follow the privatized companies, not be absorbed onto the federal government's balance sheet. Privatization proceeds would flow to the government and generate over $100 billion in deficit reduction.[7]

AIG PRECEDENT

During my recent tenure as the Chief Restructuring Officer at Treasury, I had primary responsibility for the oversight of the government's capital commitments to AIG, which rivaled in size the amount of capital invested to date in Fannie and Freddie. After a series of restructurings of that $182 billion commitment, we designed and implemented a recapitalization plan for AIG that involved (i) selling off almost half of its insurance businesses to generate sufficient proceeds to repay its debt to the Federal Reserve and (ii) exchanging Treasury's $50 billion of preferred stock into 92 percent of the common equity of the company. Treasury then sold the common stock into the public markets in a series of secondary offerings in 2011 and

[7] Since Fannie and Freddie were put into federal conservatorships, the Congressional Budget Office (CBO) has treated them as consolidated entities of the government that confer a subsidy (budget cost) to the market because CBO estimates that the price the companies charge to guarantee mortgages against default is lower than a private entity would charge. Severing the single-family and multifamily businesses' special relationship with the government and divesting the government's financial interests in those businesses subsequently in the market would eliminate the guarantee-fee subsidy and generate cash proceeds from sales that CBO could score as a substantial negative subsidy (budget benefit) over the budget window.

2012, which fully eliminated government ownership of AIG. In the end, taxpayers made almost $23 billion on an investment that the OMB initially projected would result in $50 billion of losses for the government.

As with Fannie and Freddie, at the height of the financial crisis regulators determined that the potential failure of AIG could threaten the stability of the financial system. Failures in management and regulation were blamed for allowing the company to reach that point. However, once taxpayer capital was committed, Treasury and the Federal Reserve Bank of New York went to work figuring out how to fix the company and recover the taxpayer support, all while protecting broader financial stability. Approximately $2 trillion of notional derivatives at AIG Financial Products were wound down and substantially de-risked before the recapitalization was consummated in early 2011. Operating businesses were sold as going concerns in value-maximizing transactions in order to reduce the company's complexity, shrink its balance sheet and repay its government support. Financial leverage was reduced to responsible levels. Management refocused on AIG's core property and casualty and life insurance businesses, which remain today important cornerstones of the global insurance landscape and integral parts of the daily risk management realities for countless policyholders.

The key lesson from this process is that tried and true methods of corporate reorganization within our existing rule of law can be used to move forward with reform. Privatizing recapitalized and newly state-chartered mortgage-guarantee businesses would enable Treasury to recover its substantial investment in the companies and begin moving toward a safer housing finance system driven by market incentives, with private capital first in line for losses. Taxpayers deserve both outcomes. Once the companies have enough capital to cover their "first loss" insurance exposure, Treasury should outline a detailed privatization plan in consultation with various stakeholders. The firms could then be released from government control and Treasury's ownership stakes in the restructured entities sold to private investors over time.

Maximizing the asset value of what the government controls today and selling it off over time to ensure the new system has at least two well capitalized first-loss providers is a far safer bet in transition than hoping that new capital sources and avenues for funding mortgages will arrive in appropriate size to support the market according to an arbitrary wind-down timeline. Moreover, it would provide a clear roadmap to the desired end state that all private market participants can plan for and invest around.

THE TRANSITION PROPOSED BY S.1217

The transition suggested in S.1217 has elements of the above proposal but ultimately rests on a leap of faith, faith that if we build a new system, new private capital will come in sufficient size and speed to allow the new system to meet the future demand for mortgage funding currently being channeled through Fannie and Freddie. If it does not, the new system will shut down before it ever has a chance to get off the ground. As a result, the implementation of the new system contemplated in S.1217 carries significant execution risk, depending on capital yet to be raised by players yet to be named. It also puts taxpayers at risk, not only from potential shocks resulting from the contemplated break-up of the two largest players in today's mortgage market, but also from the $4.4 trillion of MBS liabilities which the bill puts on the Federal Government's

balance sheet. Further, by imposing capital requirements on first-loss providers in the new system higher than those are imposed on regulated depositary institutions, S. 1217 ignores the lessons of the recent crisis which suggest that capital will flow to that part of the financial system where permitted leverage is the greatest and leveraged returns are the highest.

S.1217 requires that Fannie and Freddie cease doing any new MBS business and wind their portfolios down to $0 by the FMIC certification date; that is within five years after the bill's enactment. This arbitrary deadline risks significant dislocation in mortgage credit formation if private capital is not raised in sufficient amounts to substitute for Fannie and Freddie on that timetable.

The bill would consolidate $4.4 trillion of GSE MBS liabilities onto the balance sheet of the Federal Government. This poses two problems. It will create discontinuities in the trading markets for those legacy MBS and the new FMIC-reinsured MBS, orphaning the existing securities and creating significant liquidity constraints on the new FMIC MBS which will negatively affect mortgage pricing during the transition. Separately, putting the full faith and credit behind those contingent liabilities could balloon the federal debt. This would complicate an already difficult debate over the sustainability of US debt and austerity measures.

S.1217 provides that Fannie and Freddie be repurposed in three ways. First, parts of their businesses are to be sold to a mutual with small bank members. I am sympathetic to the desire to provide small banks with access to the secondary mortgage market away from large banks. Fannie and Freddie do that today. Why create execution risk of trying to recreate Freddie out of spare parts from both companies? The bill is also unclear how the mutual would be capitalized, governed, or established to compete on pricing with large banks. Second, the bill takes the multifamily businesses "at no cost" and puts them inside the FMIC. Although it may be a placeholder for a better plan, in its current form, it is neither legal nor workable. Third, the bill would allow certain businesses to be sold as going concerns. But here too, it would strip them of assets and purport to sell them without any capital. A financial institution without capital is like a widget factory with no assembly line: you can sell the building but you are not going to get going-concern value for the business that it houses. As a drafting matter, if this is the path you want to pursue, S.1217 needs to be redrafted to expressly override HERA's provisions that obligate the conservator or receiver to maximize the sale proceeds of the assets it seeks to liquidate.

More generally, S.1217 requires 10 percent capital at first-loss providers. Assuming the conforming market is $5 trillion in seven to ten years after a significant portion of the legacy books have rolled over, and assuming that the bill means for that capital to be defined as a percentage of total assets, a 10 percent capital requirement means that $500 billion of first-loss capital needs to be raised to backstop the conforming MBS market. That is a gargantuan sum relative to the existing equity capital in the banking and insurance sectors. On top of this, the bill requires another 2.5 percent, or $125 billion, in the MIF to be raised within 15 years. Again, the bill provides no direction of how either such capital level will be reached. But each is critical to the functioning of the new system. In short, the bill is based on a leap of faith that such a substantial amount of capital will be raised by players yet to be named.

CONCLUSION

By highlighting the important role that the mortgage guarantee businesses of Fannie and Freddie play in today's mortgage funding markets, and by taking on the politically charged idea that the safest and surest path to raising the significant amount of new capital on which the new system depends and ensuring continuity in mortgage credit formation during the transition is to recapitalize and privatize those businesses, I hope that my testimony today will stimulate a frank conversation about how to handle the transition. I do not envy you the task ahead: To say that housing finance reform is the most complicated policy, economic and corporate finance challenge I've seen in my 30 years in the restructuring business would be a gross understatement.

As I noted previously, you have a fundamental choice in meeting the challenges in transition: Fix what you have and use it to move to a better-capitalized system of mortgage funding, or destroy what is working today and make a leap of faith that new capital will be raised by players to be named. For the sake of the federal budget, the stability of the mortgage funding markets and the value of the single-most important asset for most Americans, I hope that I have persuaded you that the choice is clear.