

**Statement of Melvin L. Watt
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“The Status of the Housing Finance System After Nine Years of Conservatorship”

Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs

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Chairman Crapo, Ranking Member Brown, and members of the Committee, thank you for your invitation for me to discuss the critically important and timely hearing subject “The Status of the Housing Finance System After Nine Years of Conservatorship” and to answer any questions you may have about the work we are doing at the Federal Housing Finance Agency (FHFA).

As the members of this Committee are well aware, since September 6, 2008, Fannie Mae and Freddie Mac (the Enterprises) have been operating in conservatorships under the direction and control of FHFA and with backing of the U.S. taxpayers with explicit dollar limits as set out in the Senior Preferred Stock Purchase Agreements (the PSPAs) with the U.S. Department of the Treasury. As a result of prior Enterprise draws totaling \$187.5 billion against the PSPA commitments, the PSPA commitment still available to Fannie Mae is now limited to \$117.6 billion and the commitment still available to Freddie Mac is \$140.5 billion. Additional draws will reduce these commitments further; however, dividend payments do not replenish or increase the commitments under the terms of the PSPAs.

September 6 of this year will mark the beginning of the tenth year that the Enterprises have been in conservatorships. These conservatorships have been unprecedented in scope, complexity, and duration, especially when you consider that the Enterprises support over \$5 trillion in mortgage loans and guarantees. Since January 6, 2014 when I was sworn in as Director of FHFA, the conservatorships of the Enterprises have been under my direction.

I pledged to the members of this Committee during my confirmation hearing that I would carry out my responsibilities as Director in accordance with the statutory mandates given to FHFA as regulator and conservator. I have consistently tried to do just that. I have found that FHFA and the Enterprises operate with responsibilities that make it impossible to satisfy everyone and sometimes make it impossible to satisfy anyone. However, I believe that most stakeholders would agree that we have responsibly balanced and met FHFA’s multiple statutory mandates to

manage the Enterprises' day to day operations in what I often refer to as "in the here and now." These statutory mandates obligate us to:

- Conserve and preserve the assets of the Enterprises while they are in conservatorship;
- Ensure that the Enterprises provided meaningful assistance to the millions of borrowers who struggled to save their homes in the midst of the economic and housing crisis, as required in the Emergency Economic Stabilization Act; and
- Oversee the prudential operations of the Enterprises and ensure that they continue to carry out their on-going statutory missions in a safe and sound manner; in a manner that fosters liquid, efficient, competitive, and resilient national housing finance markets; and in a manner that is consistent with the public interest.

Many Reforms of the Enterprises Have Taken Place Through Conservatorship

I have said repeatedly, and I want to reiterate, that these conservatorships are not sustainable and they need to end as soon as Congress can chart the way forward on housing finance reform. However, it is important for all of us to recognize that the conservatorships have led to numerous reforms of the Enterprises and their operations, practices, and protocols that have been extremely beneficial to the housing finance markets and have reduced exposure and risks to taxpayers.

It is critically important for the members of this Committee to be well aware of these reforms because you will have the responsibility to ensure that the reforms are not disregarded or discarded because of assertions some will make that the Enterprises now are the same or mirror images of the Enterprises that FHFA placed into conservatorship almost nine years ago. I can assure you that such assertions would be unfounded.

We have reported extensively on some of the important reforms we have made and on our conservatorship priorities in our [2014 Conservatorship Strategic Plan](#); in our annual scorecards, including the [2017 Scorecard](#); and in our regular status updates, including three reports released earlier this year – [2016 Scorecard Progress Report](#), [Credit Risk Transfer Progress Report](#), and [An Update on the Implementation of the Single Security and the Common Securitization Platform](#).

Let me highlight some of the most important changes and reforms that have taken place during the conservatorships.

- 1. Board leadership and management:** When the Enterprises were placed into conservatorship, FHFA replaced most members of their boards of directors and many senior managers. Both through conservatorship and through our on-site regulatory oversight of the

Enterprises, FHFA has required Fannie Mae and Freddie Mac to make a number of changes to improve risk management, update many of their legacy systems, prioritize information security and data management, and better address other areas of operational risk. FHFA has also taken steps to prohibit certain activities, such as lobbying, by either Enterprise. The Enterprises board of directors and senior management have taken great strides to implement these improvements in coordination with FHFA.

- 2. Alignment of certain Enterprise activities:** While some aspects of their pre-conservatorship competition resulted in negative consequences or in a race to the bottom, FHFA has aligned many practices and policies on which the Enterprises are no longer allowed to compete, such as loss mitigation standards and counterparty eligibility standards. However, based on expectations established in conservatorship and regularly emphasized by FHFA to the Enterprises' boards and managements, we expect them to compete vigorously to find and implement innovative ways to make the housing finance markets more efficient and liquid, on customer service provided to Enterprise seller/servicers, and on the quality of their business practices.
- 3. Sound underwriting practices:** The Enterprises are required to emphasize sound underwriting practices in their purchase guidelines, and these practices facilitate responsible access to credit and sustainable homeownership for creditworthy borrowers. The Enterprises' serious delinquency rate on single-family loans is at its lowest level since May 2008.
- 4. Appropriate guarantee fees:** Guarantee fees have been increased by two and a half times since 2009. The guarantee fees are set to reflect the cost of covering credit losses in the event of economic stress or a housing downturn and the administrative expenses of running the companies. While the Enterprises cannot retain capital under the PSPAs, we also set their guarantee fees under the assumption that they are earning an appropriate return on capital. FHFA regularly reviews the Enterprises' guarantee fees to ensure that they remain at appropriate levels.
- 5. Smaller portfolios for core business purposes:** The retained portfolios of the Enterprises have been reduced over sixty percent since 2009 and both Enterprises are ahead of schedule to meet the 2018 maximum portfolio limits established in the PSPAs. The Enterprises' multiyear retained portfolio plans to achieve these reductions have focused on selling less liquid assets and investment assets, in addition to prepayments that have occurred over time. Their retained portfolios are now focused on supporting the core business operations of the Enterprises, including aggregation of loans from small lenders to facilitate securitizations and holding delinquent loans in portfolio so investors can be made whole, servicers can facilitate loan modifications, and borrowers can stay in their homes whenever possible.

- 6. New single-family credit risk transfer programs share credit risk with private investors:** The Enterprises have developed and continue to refine credit risk transfer programs that transfer a meaningful amount of credit risk to private investors on at least 90 percent of their targeted, fixed-rate, single-family mortgage acquisitions. The Enterprises are also developing their single-family CRT programs with the objective of cultivating a mature and robust credit risk transfer market, including by building and expanding a diverse investor base that will increase the likelihood of having a stable CRT market through different housing and economic cycles.
- 7. New securitization infrastructure:** Through a joint venture formed by the Enterprises under FHFA's direction, the Common Securitization Platform (CSP) is now operating and all of Freddie Mac's existing single-family, fixed-rate securitizations are being processed using the CSP. All parties are now well down the multiyear path toward the CSP becoming the infrastructure used by both Enterprises to issue a common single mortgage backed security. When fully implemented, we believe these changes will facilitate deeper liquidity in the housing finance market, support the to-be-announced market, and eliminate costly trading differences between the Enterprises' securities. The Enterprises are developing the CSP with an open architecture such that it will be usable by other market participants.
- 8. Responsible access to credit supporting sustainable homeownership:** The Enterprises have worked closely with FHFA on a number of initiatives designed to support responsible access to credit and sustainable homeownership. For example, they undertook a multiyear process to revamp their Representation and Warranties Framework to reduce uncertainty and support access to credit throughout the Enterprises' existing credit boxes. We are also requiring the Enterprises to conduct analyses about access to credit barriers and to develop pilots and initiatives to improve access to credit in a safe and sound manner. Another recent area of focus has been implementing the Enterprises' statutory duty to serve three underserved markets – manufactured housing, affordable housing preservation, and rural housing. The Enterprises posted their first draft Duty to Serve Plans for public input just this week.
- 9. Multifamily market liquidity and affordable rental housing:** The Enterprises' multifamily programs, which performed well during the crisis while other parts of the housing market struggled, continue to share a substantial amount of credit risk with private investors and continue to provide needed liquidity for the multifamily market with major emphasis on affordable rental housing and underserved markets.
- 10. Loss mitigation, foreclosure prevention, and neighborhood stabilization:** The Enterprises have worked with FHFA to develop effective loss mitigation programs that minimize losses to the Enterprises and allow borrowers to avoid foreclosure whenever possible. This has included aligning the Enterprises loss mitigation standards and developing

updated loan modification and streamlined refinance products to follow the Home Affordable Modification Program (HAMP) and the Home Affordable Refinance Program (HARP). The Enterprises are also effectively pursuing efforts to stabilize neighborhoods, including through the Neighborhood Stabilization Initiative.

11. Level playing field for lenders of all sizes: The Enterprises have eliminated volume-based discounts for larger lenders, which has leveled the playing field for lenders of all sizes – small, medium and large. This new approach, along with supporting the ability of small lenders to purchase loans through the cash window, has significantly increased the percentage of Enterprise acquisitions from smaller lenders during conservatorship.

Congress Urgently Needs to Act on Housing Finance Reform

While many reforms of the Enterprises' business models and their operations have been accomplished through conservatorship, FHFA knows probably better than anyone that these conservatorships are not sustainable and we also know that housing finance reform will involve many tough decisions and steps that go well beyond the reforms made in conservatorship. So I want to reaffirm my strong belief that it is the role of Congress, not FHFA, to make these tough decisions that chart the path out of conservatorship and to the future housing finance system.

Among the important decisions Congress, not FHFA, will need to make as part of housing finance reform are the following:

- How much backing, if any, should the federal government provide and in what form?
- What process should be followed to transition to the new housing finance system and avoid disruption to the housing finance market, and who should lead or implement that process?
- What roles, if any, should the Enterprises play in the reformed housing finance system and what statutory changes to their organizational structures, purposes, ownership and operations will be needed to ensure that they play their assigned roles effectively?
- What regulatory and supervisory structure and authorities will be needed in a reformed system and who will have responsibility to exercise those authorities?

I reaffirm my belief that it is the role of Congress, not FHFA, to make those housing reform decisions and I encourage Congress to do so expeditiously.

FHFA Must Continue to Meet Its Obligations While Housing Finance Reform Takes Place

The final thing I want to discuss is the most significant challenge FHFA faces as conservator while Congress continues to move ahead on housing finance reform. I first discussed this challenge publicly in a speech I delivered at the Bipartisan Policy Center on February 18, 2016. The challenge is that additional draws of taxpayer support would reduce the amount of taxpayer backing available to the Enterprises under the PSPAs and the foreseeable risk that the uncertainty associated with such draws or from the reduction in committed taxpayer backing could adversely impact the housing finance market. Unfortunately, the challenge is significantly greater today than it was last year and will continue to increase unless it is addressed. Let me explain why that is so.

At the time I delivered my speech at the Bipartisan Policy Center in 2016, each Enterprise had a \$1.2 billion buffer under the terms of the PSPAs to protect the Enterprise against having to make additional draws of taxpayer support in the event of an operating loss in any quarter. Under the provisions of the PSPAs, on January 1, 2017 the amount of that buffer reduced to \$600 million and on January 1, 2018 the buffer will reduce to zero. At that point, neither Enterprise will have the ability to weather any loss it experiences in any quarter without drawing further on taxpayer support.

This is not a theoretical concern. GAAP accounting for any number of non-credit related factors in the ordinary course of business regularly results in large fluctuations in Enterprise gains or losses. Some of these non-credit related factors include interest rate volatility; the accounting treatment of derivatives used to hedge risks; reduced income from the Enterprises' declining retained portfolios; and the increasing volume of credit risk transfers which, while supporting our objective of transferring risk and opportunity to the private sector, also transfers current revenues away from the Enterprises. We also know that a short-term consequence of corporate tax reform would be a reduction in the value of the Enterprises' deferred tax assets, which would result in short-term, non-credit related losses to the Enterprises. The greater the reduction in the corporate tax rate, the greater the short-term losses to the Enterprises would be. In addition to the regular and on-going prospect of non-credit related losses, even minor housing market disruptions or short periods of distress in the economy could also cause credit-related losses to the Enterprises in a given quarter.

Like any business, the Enterprises need some kind of buffer to shield against short-term operating losses. In fact, it is especially irresponsible for the Enterprises not to have such a limited buffer because a loss in any quarter would result in an additional draw of taxpayer support and reduce the fixed dollar commitment the Treasury Department has made to support the Enterprises. We reasonably foresee that this could erode investor confidence. This could

stifle liquidity in the mortgage-backed securities market and could increase the cost of mortgage credit for borrowers.

FHFA has explicit statutory obligations to ensure that each Enterprise “operates in a safe and sound manner” and fosters “liquid, efficient, competitive, and resilient national housing finance markets.” To ensure that we meet these obligations, we cannot risk the loss of investor confidence. It would, therefore, be a serious misconception for members of this Committee, or for anyone else, to consider any actions FHFA may take as conservator to avoid additional draws of taxpayer support either as interference with the prerogatives of Congress, as an effort to influence the outcome of housing finance reform, or as a step toward recap and release. FHFA’s actions would be taken solely to avoid a draw during conservatorship.

Thank you again for the opportunity to address this Committee. Please be assured that FHFA and the Enterprises stand ready to assist the Committee in any ways we are asked to do so. I look forward to answering your questions.