S. HRG. 113–15

OVERSIGHT OF FEDERAL HOUSING FINANCE AGENCY: EVALUATING FHFA AS REGULATOR AND CONSERVATOR

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE OPERATIONS AND REGULATORY PRACTICES AT THE FEDERAL HOUSING FINANCE AGENCY

APRIL 18, 2013

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.fdsys.gov/

U.S. GOVERNMENT PRINTING OFFICE

80–775 PDF WASHINGTON : 2013

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

TIM JOHNSON, South Dakota, *Chairman*

JACK REED, Rhode Island
CHARLES E. SCHUMER, New York
ROBERT MENENDEZ, New Jersey
SHERROD BROWN, Ohio
JON TESTER, Montana
MARK R. WARNER, Virginia
JEFF MERKLEY, Oregon
KAY HAGAN, North Carolina
JOE MANCHIN III, West Virginia
ELIZABETH WARREN, Massachusetts
HEIDI HEITKAMP, North Dakota

MIKE CRAPO, Idaho
RICHARD C. SHELBY, Alabama
BOB CORKER, Tennessee
DAVID VITTER, Louisiana
MIKE JOHANNS, Nebraska
PATRICK J. TOOMEY, Pennsylvania
MARK KIRK, Illinois
JERRY MORAN, Kansas
TOM COBURN, Oklahoma
DEAN HELLER, Nevada

CHARLES YI, *Staff Director*
GREGG RICHARD, *Republican Staff Director*

LAURA SWANSON, *Deputy Staff Director*
ERIN BARRY FUHRER, *Professional Staff Member*
WILLIAM FIELDS, *Legislative Assistant*

GREG DEAN, *Republican Chief Counsel*
MIKE PIWOWAR, *Republican Senior Economist*
CHAD DAVIS, *Republican Professional Staff Member*

DAWN RATLIFF, *Chief Clerk*
KELLY WISMER, *Hearing Clerk*
SHELVIN SIMMONS, *IT Director*
JIM CROWELL, *Editor*

C O N T E N T S

THURSDAY, APRIL 18, 2013

WITNESSES

OVERSIGHT OF FEDERAL HOUSING FINANCE AGENCY: EVALUATING FHFA AS REGULATOR AND CONSERVATOR

THURSDAY, APRIL 18, 2013

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:02 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I call this hearing to order.

Before we turn to the hearing, I would like to express my condolences to the people of Boston and to Senator Warren. Our thoughts and prayers are with you all.

As Members of this Committee on both sides of the aisle noted during the debate of the Housing and Economic Recovery Act of 2008, one of the most important aspects of this bill was the establishment of the Federal Housing Finance Agency as an independent regulator. This ensures that it can operate without undue political interference and that the appropriations process cannot be used as a road block for regulations.

With this independence, the Banking Committee must exercise Congressional oversight to ensure that the agency is properly balancing its attention among the entities it regulates and its role as conservator of Fannie Mae and Freddie Mac. HERA also established the FHFA Office of Inspector General, and I am pleased that we have both Acting Director DeMarco and Inspector General Linick before the Committee today.

As we turn again to housing finance reform, let me be clear that a never-ending conservatorship of Fannie Mae and Freddie Mac is not an option. To help remove obstacles to housing financing reform, Senator Crapo and I, along with every Member of this Committee, offered an amendment that was unanimously adopted by the Senate to the budget resolution to prevent the GSEs from being used as a piggy bank. I will continue working with Ranking Member Crapo to find a bipartisan path forward on sensible long-term reforms. So, it is important we understand the current status of the conservatorships and how FHFA's proposed changes will expand or limit our options for reforming the housing finance system.

The FHFA has a large and important role in the housing market, regulating two of the largest entities in the market, Fannie Mae and Freddie Mac, as well as acting as their conservator to oversee business and management decisions to ensure stability in the housing market. I am concerned about continued reports that FHFA does not have adequate staff to perform examinations of the entities under its supervision and follow up on enforcement directives.

Under Mr. DeMarco's leadership, the FHFA has made significant changes to the operations of the GSEs by standardizing some of their operations and now seeking to streamline their securitization platforms. I look forward to hearing more about this proposal and other priorities described in the Conservatorship Strategic Plan as well as how the current enforcement challenges raised by the IG are being addressed. If the FHFA is going to undertake such a massive effort as streamlining the securitization platforms of the GSEs, we should be sure that it will also be able to supervise the new platform once it is operating.

I look forward to hearing from our witnesses on these issues, and with that, I will turn to Ranking Member Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you, Mr. Chairman.

This September will mark the 5-year anniversary of the Federal Housing Finance Agency taking Fannie Mae and Freddie Mac into conservatorship, and Mr. Chairman, I again appreciate working with you on this and particularly appreciate your comments just now that leaving Fannie Mae and Freddie Mac in conservatorship is not an option.

As I noted in a previous hearing, when FHFA Director James Lockhart and Treasury Secretary Henry Paulson announced this action, Secretary Paulson described the situation as a time out and stated, "We will make a grave error if we do not use this time out to permanently address the structural issues presented by the GSEs." In the weeks to come, I will describe my views on long-term reform. I look forward to engaging in that timely and necessary debate.

Instead of a time out, these conservatorships have been more akin to a perpetual state of limbo, which has no doubt created extraordinary challenges for their management.

Director DeMarco, you are to be commended for your performance in the extraordinarily difficult and complex role that you were given by President Obama nearly 4 years ago. Your success in leading FHFA to preserve the assets of Fannie Mae and Freddie Mac has put us into a position to begin making the hard decisions of what to do with these entities. You have developed a knowledge and expertise that is shared by very few people, having been involved in the conservatorships of these highly complex institutions from the very beginning. You have further proven yourself to be a technical policy expert rather than a political advocate. And for all of these reasons, I can think of no one more qualified and better situated than you to manage these conservatorships and assist the Congress in making the hard decisions that lie ahead of us.

Unfortunately, as we approach the 5-year mark of these conservatorships, they are beginning to report profits. I say unfortunately, not that they are beginning to report profits. That is good. But I fear that we may be in the midst of a closing window to make those decisions and enact a meaningful housing reform. Because of that, I thank you for your continued service during this pivotal moment, despite the many challenges that you continue to face.

Returning to the issue at hand for this hearing, there are a few areas that I would like to highlight for our continued oversight. The Annual Scorecard released by the FHFA indicates a focus on the creation of a single securitization platform, as the Chairman has mentioned. I look forward to hearing more details about this undertaking. Specifically, how does this platform fit with future entities in a financial world post-reform of our housing finance system?

The Scorecard also created a goal for the continued shrinking of the current footprint within the market for Fannie and Freddie. As I noted in a previous hearing, the FHFA's latest Conservator's Report showed that the Federal Government, through Fannie and Freddie and Ginnie Mae, accounted for an astounding 100 percent of the mortgage-backed securities issued during the first three quarters of last year. Obviously, this is extremely troubling. So I am interested to hear more details about how FHFA plans to address the domination of our mortgage market by the Federal Government.

The recent profits reported by Fannie and Freddie also present new questions. For example, do the profits help with challenges such as personnel recruitment and retention, or do they present new challenges given that the companies will remain in conservatorship no matter how they perform absent Congressional action?

I look forward to learning the answers to these and other questions during this hearing. However, I must reiterate that the most pressing question in this space is how will we reform our Nation's housing finance system? The greatest aid that we can give both prospective and current homeowners is to provide clarity for market participants in regard to future mortgage finance, and for that reason, I am hopeful that the Administration will engage with us on this important topic in the coming months to shed further light on their positions moving forward.

Mr. Chairman, I believe our work together during the recent budget process that you have mentioned showed that we have the ability to find common ground. Every one of us on this Committee came together and agreed that we needed to end the practice of using the GSEs as piggy banks to fund other parts of the Federal Government. In doing so, we were able to pass a budget point of order against it with unanimous support from this Committee. I am very glad that we are working together on these important issues and look forward to working with you and all of my colleagues on this Committee once again on a robust, bipartisan process to finally bring about an end to these conservatorships.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you, Senator Crapo.

Are there any other Members who wish to make a brief opening statement?

Senator SHELBY. Mr. Chairman.

Chairman JOHNSON. Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Mr. Chairman, I would ask that my written statement be made part of the record in its entirety and I just have a few brief remarks.

I think I would be remiss if I did not thank you, Mr. DeMarco, for your outstanding service. I applaud your work. You have been an extraordinary person in this job, despite what some people would say. You were given a tough job, a very tough job, during a critical time in our Nation's housing market. But your commitment to protecting both taxpayers and homeowners, I believe, have served our Nation well, and I look forward to hearing from you today. Again, I thank you for your work.

Mr. DEMARCO. Thank you, Senator.

Chairman JOHNSON. Anybody else?

Senator VITTER. Mr. Chairman.

Chairman JOHNSON. Yes.

STATEMENT OF SENATOR DAVID VITTER

Senator VITTER. Very briefly, I just want to thank Director DeMarco, as well, for his work, and it has been very, very able in very tough times.

And, Mr. Chairman, I want to echo your thoughts and thank you for the clear statement, which I think is a clear bipartisan consensus, that significant reform does have to happen to GSEs and now is really the time to focus on that.

And in that regard, I would just encourage all of us, again, there is an obvious place to start, I think, and that is with the solid bipartisan Jumpstart GSE Reform Act, which has very broad support in this Committee. And I would like to continue to encourage a markup of that. It could be the same day as a markup of the Menendez-Boxer bill. They could be on the same agenda. I think that would work fine. And I think that would be an important jumpstart, as the name of the bill implies, to this effort. We have not had a markup in this Committee since September 8, 2011. That is over a year and a half ago. And I think this would be a very, very appropriate and timely and solid markup to get us on this path.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you.

Senator Tester.

STATEMENT OF SENATOR JON TESTER

Senator TESTER. Thank you, Mr. Chairman.

I want to thank Mr. DeMarco, too. I appreciate your work. It has been stellar.

I want to express my appreciation for you holding this hearing today. I think that there are a lot of good signs. Property values are rising. The Enterprises are making some money, turning some profits. These are all good signs. But I appreciate the statement made by both the Chairman and the Ranking Member. I believe now is the time to move forward with solutions to restructure the finance system, housing finance system, long-term, to provide stability for the long haul. And I would hope that—I would hope that, because I think it is so critically important for our economy—I would hope that this becomes a top priority for this Committee to get this done, to get this out of conservatorship and get a program that is going to work for this country for the next generation.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you.

I want to remind my colleagues that the record will be open for the next 7 days for opening statements and any other materials you would like to submit.

Now, I would like to introduce our first witness. Mr. Edward DeMarco is the Acting Director of the Federal Housing Finance Agency. Mr. DeMarco has served in this capacity since 2009.

Mr. DeMarco, please begin your testimony.

STATEMENT OF EDWARD J. DEMARCO, ACTING DIRECTOR, FEDERAL HOUSING FINANCE AGENCY

Mr. DEMARCO. Thank you, Mr. Chairman. Chairman Johnson, Ranking Member Crapo, Committee Members, I am honored to be here and I am also grateful for the remarks in your opening statements.

September 2008 was one of the darkest months in our country's financial history. On September 7, FHFA placed Fannie Mae and Freddie Mac into conservatorship supported with financial agreements with the Treasury Department. Markets opened the next day and we held our breath to see how the employees, the country, and global investors would respond. Our first concern was ensuring ongoing liquidity in the mortgage market by ensuring Fannie and Freddie kept operating. They did, and the market kept functioning, but with a much-needed reassessment of risk.

As the depth of the housing downturn fully materialized, it was imperative to expand foreclosure prevention actions. We needed to limit losses to Fannie and Freddie by addressing the daunting challenge of homeowners' financial distress, compounded by declining house prices in a deep and prolonged recession. The Obama administration and FHFA and Fannie and Freddie worked to develop and implement what became known as HAMP. While HAMP brought some consistency to the loan modification process, we recognized that it was not going to help everyone in distress.

Experimenting with other ideas led to the Servicing Alignment Initiative and the development of the Standard Modification Program, where we simplified and aligned the loan mod protocols for Fannie and Freddie, making eligibility easier, payments lower, and the process simpler than those governing HAMP.

We kept working. Through a series of steps, we improved and lengthened forbearance programs for unemployed homeowners and others facing temporary setbacks. We simplified, expanded, and expedited short sales. We kept testing. We kept learning. Our focus was two-fold: Keep it simple and get the monthly payment down. The latest enhancement to our suite of programs, announced last month, adds a streamlined modification option that addresses the key remaining impediment, the challenges of the documentation process.

Economic distress did not always mean default, but it did produce hardship for families and greater risk to taxpayers. We developed a refinance program called HARP to assist homeowners with little or no equity who are unable to refinance. It was not perfect, so we talked with the industry, consumer groups, and Treasury, and we reinvented the program, dubbed HARP 2.0. Today, it is working so well and has so much potential to reduce losses and assist borrowers that I announced last week I was extending it for 2 more years.

Although we have not been able to help every homeowner, we have completed 1.3 million loan modifications and a total of 2.2 million foreclosure prevention transactions that have allowed delinquent borrowers to stay in their homes. We have helped nearly half-a-million families exit their homes gracefully without foreclosure. That is a total of 2.7 million foreclosure prevention actions.

We have also completed 2.3 million HARP refinances. Including HARP and all other re-fis, Fannie and Freddie have acquired 16 million refinance loans since 2009.

Along the way, we have been relentless in evaluating these programs, in reinventing them to fix design flaws. As you would expect for any complex operation of this scale, operational challenges abounded, servicers made mistakes, and borrowers did not always respond to offers of assistance. But when you add the foreclosure prevention actions we completed and the HARP refinances since conservatorship, that totals to some five million delinquent or at-risk families that have received help from these efforts.

The companies themselves have also made great progress. The need to draw more than $180 billion from taxpayers tells me the GSE model is broken beyond repair. But the people of the two companies, many of whom joined after the conservatorships, have worked hard to restore the market and their companies. Today, as a result of their efforts and improvements in the housing market, both companies have generated positive net income, which as taxpayers we should all applaud.

The first time I appeared before this Committee as Acting Director, Senator Corker asked me a question I could not answer. How do we transition away from this mess to a better system? Over the past 3½ years, I have thought about that question. My prepared statement provides my answer. Our strategic plan for the Enterprise conservatorships and the specific plans in the 2013 Scorecard set forth a transition path and FHFA's efforts to date to get that transition going.

But we cannot complete the transition until we know the final destination, and for that, the country needs the Congress to set that destination. I am thankful for recent action by this Committee toward that end, particularly the budget resolution that prevents further use of guarantee fees to fund the Government, and I am supportive of the bipartisan Jumpstart GSE Reform Act. But much more remains to be done.

Thank you for having me again and I look forward to our discussion this morning.

Chairman JOHNSON. Thank you, Mr. DeMarco, for your testimony.

As we begin questions, I will ask the Clerk to put 5 minutes on the clock for each Member.

Mr. DeMarco, one of your strategic plan's goals for 2013 includes developing risk transfer transactions that would share risk with private capital, such as Private Mortgage Insurance. During the recent housing crisis, was PMI able to cover all claims associated with loans purchased by the GSEs? If a mortgage insurer were not able to cover all of a claim, how would this impact the GSEs?

Mr. DEMARCO. Mr. Chairman, mortgage insurance did not cover—make good on all of the coverage that Fannie and Freddie thought they had, but they have made good on most of it. So when a mortgage insurance company fails to make good on an insurance claim, that loss, then, is accruing to Fannie and Freddie, which means it is accrued to the American taxpayer.

There have been a couple of mortgage insurance companies that have failed and they are now in runoff or some other kind of management by their State Insurance Commissioner in which we are getting partial payment of claims made to us. The final resolution of those insurance claims and how much we actually recover, whether it is 100 percent or something less, only time will tell. But the majority of the mortgage insurance companies have actually remained solvent and operating and are continuing to make good on their claims, and that certainly has reduced loss to Fannie and Freddie as a result of having that private capital protection standing in front of them.

Chairman JOHNSON. Since insurance is regulated at the State level, how do the GSEs and FHFA ensure that Private Mortgage Insurers are operating soundly, and would that oversight need to change if a mortgage insurer participates in the Risk Transfer Transaction Program?

Mr. DEMARCO. So, even if we do not have mortgage insurers participating in risk transfer, the system and mechanisms you mentioned do have to change. We are changing them, and we put that in our 2013 Scorecard as one of our priorities for this year. We are reexamining and reestablishing eligibility standards for mortgage insurers to be eligible to provide that sort of first loss coverage for loans Fannie and Freddie purchase. So we are reestablishing those. We are also updating the master policy under which mortgage insurance companies provide this protection to Fannie and Freddie. So those changes or improvements in the marketplace are being developed right now and those changes will be out there shortly.

With regard to your question about mortgage insurance being a participant in the sort of risk transfer transactions we are envisioning, yes, I do believe that there is a role for them and I look forward to their participation as one source of getting private capital more into the game in the mortgage credit risk area. But we want to make sure that the mortgage insurance companies that participate in that are, in fact, financially sound and capable of providing the credit protection that we are seeking to acquire.

Chairman JOHNSON. Mr. DeMarco, the FHFA recently announced its Streamlined Modification Program for borrowers that are 90 days delinquent. Under this program, would a borrower need to verify their income, receive an appraisal on the property, or provide other documentation for the modification? How does this benefit borrowers, taxpayers, and the GSEs?

Mr. DEMARCO. Under the Streamlined Program, they would not have to provide any of those things, Mr. Chairman. We have developed this after a good bit of learning from the challenges we have had getting borrowers successfully into loan modification programs. It has been a persistent aspect of the loan modification story that getting borrowers to be able to fully document their income and circumstances to qualify for a HAMP modification or a standard modification has been a challenge.

What we are now doing is this is sort of the last chance before the borrower gets referred to foreclosure, and in the communication to the borrower, we are making clear that if they would provide documentation, they would be assessed for what could be a better loan modification option for them. But at this point, we are looking at borrowers who are seriously delinquent, and we have learned from experience over these past several years, if you do not get a borrower into some kind of an assistance program in those first 3 or 4 months, the likelihood that you are going to get them into some kind of successful program goes down substantially.

And we have found that borrowers have responded positively to this request. It is simply: sign, agree that this is your new payment, and begin submitting the payment. So we believe, based upon the testing and work we have done, the experience we have developed, that this, in fact, will lower the losses to taxpayers and will help further enhance our efforts to help consumers avoid foreclosure.

Chairman JOHNSON. One last question. With these recently announced changes to the modification program, would you now support the income verification changes that Senators Boxer and Menendez are trying to implement in the Responsible Homeownership Refinancing Act for borrowers who are paying their mortgages and trying to refinance?

Mr. DEMARCO. I believe—so, slightly two different things here, Mr. Chairman. The Boxer-Menendez bill is referring to income verification having to do with refinances for HARP and it really goes to a particular point regarding how to get a cross-servicer to be able to do a HARP loan. I believe that we have addressed the issues that Senator Menendez has as I understand them. And I think that, in fact, the evidence is showing we are getting a good bit of cross-servicer participation in the HARP program. We are using the income collected there as much to make the underwriting system work and be able to transfer the information to the new servicer. It is the way the systems are set up, and we have spent time explaining that to Senator Menendez.

Chairman JOHNSON. Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman.

Mr. DeMarco, last fall, the FHFA and the Treasury Department agreed to a change in the structure of the dividend calculation, and as a part of that, under the new agreement, all profits except for a small amount retained for capital are remitted to the Treasury. Some have argued that this may have created incentives for Fannie and Freddie to assume either more or less risk in a given transaction because they do not possess normal business incentives.

You have been dealing with the unintended incentives within the GSE space since even before the conservatorships began, but are you anticipating any new steps that may be needed to ensure that the taxpayers remain protected?

Mr. DEMARCO. I am not, Senator. I am not concerned about that particular risk. I think that the management team and the boards at Fannie Mae and Freddie Mac are quite anxious to demonstrate to the American taxpayer that they have made great strides at each company and that they are operating these companies in conservatorship profitably and safely. They recognize their responsibility to the American taxpayer and I think they take that responsibility quite seriously. I do not think that they anticipate or have any vision of increasing the risk taking. And in any event, I have got a solid supervision team at FHFA monitoring the activities at each company, and we would be quite mindful of any increase in risk-taking activity at the companies.

Senator CRAPO. Well, thank you, and I appreciate your attention to that.

On another issue, in my opening statement, I reiterated concern about the massive stake the Federal Government has and continues to have within our mortgage markets. The obvious solution for this is for Congress to act on reform. In the absence of Congressional action, you have established a reduction in the footprint of the GSEs as a fundamental goal over the next year and I am very happy to see that. Please describe to us in more detail the risk sharing and portfolio reductions targets that you are establishing.

Mr. DEMARCO. Certainly. Fannie Mae and Freddie Mac have three principal lines of business: The single-family mortgage guarantee business, a multifamily business, and a retained portfolio in which they buy and hold mortgages and mortgage-related assets. What we have done in the 2013 Scorecard is set objective measures for each of these lines of business to fulfill the strategic goal of gradually shrinking their footprint in the mortgage market.

So with regard to single-family mortgages, what we have described is a goal of having $30 billion worth of unpaid principal balance of mortgages to see some kind of risk sharing or risk transfer transaction between Fannie and Freddie and private capital. This could be done on—accomplished a number of ways.

The Chairman asked about mortgage insurance, so one way to do it is to have mortgage insurance companies provide an insurance wrap on a mortgage-backed security.

Another way to do it is to issue something called a credit-linked note, some kind of credit-linked security in which there is a reference pool of mortgages and investors pay in money and that serves as sort of real equity backing the credit risk there. And they get a return on that from the guarantee fee, but that money sits there in trust to absorb losses in the mortgages.

And the third principal way is through a Senior Subordinated Security Structure. This is pretty standard in the asset-backed securities market. It is how Freddie Mac operates its multifamily business. And what you do is you issue—you take the pool of mortgage securities and you break it up into two separate pieces. One piece is unsecured, or, I am sorry, it is unguaranteed by Fannie or Freddie, and so if there are credit losses, those are absorbed by the holder of that security. So that is what we are doing in the single-family space.

In the multifamily space, Fannie and Freddie already do virtually all of their lending on a risk shared basis with private capital. So our approach to gradually stepping back their footprint there is to say, we want to see your size in the marketplace in 2013 be 10 percent smaller than it was in 2012. We actually expect the multifamily market to be a bit smaller in 2013 than in 2012, but I do not want to see their market share growing at a time that we are shrinking the companies and the market itself is shrinking.

The third area is the retained portfolio. With the retained portfolio, the Treasury agreement already calls for a reduction of 15 percent year over year in the retained portfolio. What we have done is said, look, we are going to be able to meet that target the next couple of years just through normal runoff. We can do more than that. So we are looking at the illiquid portion, the nonagency security portion of that portfolio, and we gave each company a target that they must sell 5 percent of the nonliquid assets that they had at the start of the year. They have to do that over the course of the year. How they do it, when they do it, which assets they do it, that is for management's judgment to make good business decisions in light of the market circumstances.

Senator CRAPO. Thank you.

Chairman JOHNSON. Senator Reed.

Senator REED. Mr. Chairman, thank you very much. Thank you, Mr. Director.

Last year, you declined to participate in Treasury's Principal Reduction Alternative Program, and you communicated to Congress. In part of the letter, you did indicate that FHFA has allowed the Enterprises to conduct short sales, deeds-in-lieu, which resulted in principal forgiveness, essentially, for the homes. And then in another part of the letter, you said that we cannot do any principal forgiveness—and I am paraphrasing—because it would be inconsistent with the mandate, it would promote, or fail to promote the stability and liquidity of the marketplace, and several other reasons.

So you seem to be saying that you have allowed the Enterprises to do it, but that it is contrary to your mandate and you could never allow them to do it. Can you try to reconcile those two positions?

Mr. DEMARCO. I will do my best, Senator. Not having the letter in front of me, my guess is it is all about context, because, in fact, short sales and deeds-in-lieu, to your point, result in principal forgiveness to the borrower. In a short sale, you are allowing the borrower to sell the house for whatever the market price is that they can get and you are writing off the rest of it after an assessment of whether the borrower has other assets that can be used to help pay the mortgage.

What we did in—but I did say, and my conclusion in that letter was that we carefully analyzed the HAMP Principal Reduction Alternative that the Treasury Department had as part of the HAMP program, and I concluded after careful analysis by the FHFA team that pursuing that program of principal forgiveness, in which you are doing a loan modification, writing down principal, and the borrower keeps the house, was inconsistent with our mandate as conservator. And I think we went to some good length to try to explain the analysis we did and how we came to that difficult judgment.

Senator REED. Well, one of the things I find troubling is that part of the HAMP was actually providing some resources to the Enterprises for undertaking this, that it would not be a complete write-down of their investment or their obligation, but, in fact, given HAMP resources, they would be receiving—I think you get up to a high of 60 cents on the dollar of forgiveness, which seemed to be the policy of the Treasury Department, which would be consistent with the law, which would be——

Mr. DEMARCO. Right.

Senator REED. ——there might be a conflict between your view, but it seemed to be, one, a decision inconsistent with what you have already admitted that you did, which is allow short sales and allow people to forgive principal.

So as a legal restriction, you seem to have violated that in the short sales. But more importantly, I think, in terms of what one expects and what I think you try to do, many private financial institutions have, without any assistance from the Federal Government directly, have undertaken loan modifications because it has been in the best interest of their shareholders and they are not fearful of some systemic reaction, even though they would be the first victims of such reaction if it took place.

So how do you reconcile the fact that this seems to be a commercially reasonable approach, together with the fact that it was substantially subsidized by legislation and policy approved by the Congress?

Mr. DEMARCO. I believe that the mandate the Congress gave me, and I tried to spell this out in my response to Congress last summer, I have a responsibility to consider the overall cost to the taxpayer as well as the benefit to the taxpayer and to the market. And the fact that some of these funds were coming from the Treasury Department still meant they were coming from the American taxpayer. And we were actually very careful in delineating our analysis to show where these different costs were coming from.

I did not say—I have never said that it is illegal for FHFA as conservator to allow principal forgiveness. What I have said is we have a mandate to balance the responsibility to prevent foreclosure with the mandate of doing so in a way that minimizes the cost to the taxpayer, and we went through in great detail how we came to the conclusion and judgment that we drew.

So it really—the other thing, Senator, is I really do think there is a difference between an individual financial institution doing this and Fannie Mae and Freddie Mac doing this in terms of the systemic market impact, because when an individual financial institution undertakes this for even the largest ones, they are getting to select who they do it for. They do not have to announce it to anybody else. They do not have to publish rules that a thousand or two thousand mortgage servicers all have to follow. When Fannie Mae and Freddie Mac undertake any of these kinds of programs, all these rules need to be spelled out publicly and there needs to be a compliance regime that goes along with it and I think that it is fundamentally different to have Fannie and Freddie doing it.

Senator REED. Well, I think there is a significant difference, and it may be a very positive difference, that very systematic and thoughtful loan modifications could have dramatically improved the overall market sooner rather than later, could have led longer term to savings to taxpayers, because properties that were foreclosed and with a loss to the investor and a terrible loss to the homeowner could have been avoided, and that did not seem to be part of your—at least a relevant part of your calculation. So we will agree to disagree on this issue. Thank you.

Mr. DEMARCO. I am afraid so, Senator, but I must say, as I tried to go through in my opening remarks, I am actually quite proud of the work that FHFA and the people at Fannie and Freddie have done to pursue loan modifications and to come up with constructive, effective tools to help borrowers in distress. And I went through the totals of this and I think that, in fact, over these last several years, we have demonstrated both a commitment and a leadership role with regard to pursuing loan modifications, with regard to trying to new things, trying to make the system work better.

We have a policy disagreement, I guess, on a particular tool, but it is not reflective of my lack of concern or desire to get effective loan modifications done to help people stay in their homes.

Senator REED. Well, just a final point. This is not just a particular tool. This is probably the most significant Federal initiative that the Treasury Department initiated to try to help people who were facing mortgage. Billions of dollars that were paid, authorized by Congress, directed by Congress——

Mr. DEMARCO. Right.

Senator REED. So this is, I do not think, sort of a disagreement on sort of a technical approach. This was a fundamental rejection of what we all thought was going to be one of the most significant—and potentially could have been—significant improvements not only to the housing market, but to the overall economy. So thank you very much.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you. Mr. Chairman, I have a number of questions I would like to submit for the record, if I could, and then I have a few that I would like to engage with Mr. DeMarco.

Chairman JOHNSON. Without objection.

Senator SHELBY. Mr. DeMarco, I think you rightly point out that there is a difference between a private financial institution and Fannie Mae and Freddie Mac right now. Freddie Mac and Fannie Mae are under a conservatorship of the U.S. Government, is that right?

Mr. DEMARCO. Yes, Senator.

Senator SHELBY. And so, in other words, they are sitting in the lap of the taxpayer.

Mr. DEMARCO. Yes, sir.

Senator SHELBY. As opposed to, say, JPMorgan Chase or any of these others that are stockholder-owned, which is good. Thank you for doing that.

Let us talk about securitization and the lack of it in the private sector. How do we get that jump started? I am not a securitizer, but I could see if you packaged a number of quality loans, and there was transparency there——

Mr. DEMARCO. Right.

Senator SHELBY. ——either single-family or multifamily, and people knew what they were getting, they would be rated very high. There would be a market there with no taxpayer guarantee. They would stand on their own. Is that not what we really want to do as much as we can in the country?

Mr. DEMARCO. That is my sense that that is what most people would like to do, Senator. Yes. I think that is achievable.

Senator SHELBY. Absolutely. But it seems to me that it makes no sense for Fannie and Freddie, in other words, the implied guarantee of the taxpayer, to have 100 percent, or close to it, of the mortgages in today's market. So that seems to be our number one challenge as far as getting the private sector back in the market. And would that entail, as I said, transparency, a different attitude and maybe a lot more due diligence by the buyer of the securities, due diligence that we have not seen in a long time by the rating agencies, all of those?

Mr. DEMARCO. I think we need all of that, yes, sir.

Senator SHELBY. All three. Now, how do we get to the first big tranche there? You know, we have got to go measured step by step.

Mr. DEMARCO. Right.

Senator SHELBY. I think that is important——

Mr. DEMARCO. Right.

Senator SHELBY. ——as far as Fannie and Freddie are concerned.

Mr. DEMARCO. Yes. Yes, sir, it is. And I think one of the ways we can start to draw this capital back in and start to demonstrate how this can work better is, in fact, through some of the steps that we are taking, both in terms of the Risk Transfer Transactions, where we say, look, private capital out there, here we come. Here are some mortgages. We would like you to take on this risk. We want you to partner with us in these transactions, and we think it is an economically viable opportunity for you to come in.

And we are going to also, in that process, demonstrate with much greater clarity than the markets saw before, especially out of Fannie and Freddie, much greater clarity about here is the loan level details about what it is you are buying. Here is clarity about the legal structure in which this trust will be managed and how your interests as an investor are going to be protected over the life of this security. So we are trying to develop that right now.

Senator SHELBY. Is it true—we have a record here—that there are fewer and fewer foreclosures in multifamily apartments as opposed to single——

Mr. DEMARCO. Yes, sir.

Senator SHELBY. Is that because there is more skin in the game, generally? Even loans that Freddie Mac or Fannie Mae buy, they want substantial equity in those loans, is that correct?

Mr. DEMARCO. That is certainly part of it, Senator.

Senator SHELBY. But I suppose there is a role out there for multifamily loans that do not have as much skin in the game, but should be made for different reasons.

Mr. DEMARCO. Or that may be a hard market to——

Senator SHELBY. Right.

Mr. DEMARCO. ——bring credit into that market and so forth. Yes, sir, I do believe there are roles to consider opportunities where the market may not work——

Senator SHELBY. Give us the shorthand rendition of where Fannie Mae and Freddie Mac are today compared to where they were, considering the loans you have put on the books, or actually they put on the books, in the last 4 years, and Ginnie Mae, too, as opposed to a lot of the other portfolio. How are the new loans doing as opposed to the old?

Mr. DEMARCO. The performance of the new loans is substantially better. The credit characteristics of the borrower are better. The downpayments are better. The insurance premium that they are charging for this is much more appropriate to the risk that is being undertaken. So in all aspects, I believe that the quality of the book is much sounder, which is very important in these since the American taxpayer is the one right now providing the capital to support those mortgage credit guarantees.

Senator SHELBY. And is your challenge, your basic challenge, among others, at Fannie and Freddie, as you look at it, in the old portfolio?

Mr. DEMARCO. Yes, sir.

Senator SHELBY. And how are you going to surmount that? I know rising housing prices and more payments into it help, but——

Mr. DEMARCO. Right. So, we are continuing to work through the legacy book. We are now starting to make some meaningful progress through the preconservatorship book of business.

One of the things that I set forth in the 2013 Scorecard is that by the end of this year, I want the loan quality reviews of that book examined and I want all repurchase requests to be made under those contracts, those requests to be made by the end of this year. And we are continuing with all our loss mitigation efforts on that book, as I described in my opening statement.

Senator SHELBY. Keep doing what you are doing. Thank you.

Mr. DEMARCO. Thank you, Senator.

Chairman JOHNSON. Senator Tester.

Senator TESTER. Yes. Thank you, Mr. Chairman, and thank you, once again, Mr. DeMarco.

I am going to follow up with initially some of the questions that the Ranking Member asked about the risk sharing, specifically in single-family. You talked about three different areas that you are going to be looking for capital, and I guess the question I would have is are you going to be evaluating how these work as they move forward, I would assume, on each approach——

Mr. DEMARCO. Absolutely.

Senator TESTER. And what kind of—do you have specific metrics in mind when doing the evaluation?

Mr. DEMARCO. First of all, the market is a wonderful thing, because, you know, in doing these sorts of transactions, you get clarity on how the market is pricing mortgage credit risk. So that is the first thing we are going to get, is we are going to get actual market signals about mortgage credit risk.

We will also be able to begin discerning market appetite or preference for one structure over another structure, which is why I have encouraged Fannie and Freddie in the Scorecard to try multiple approaches to doing these Risk Transfer Transactions, so that we can start to demonstrate to the market how we think about it and how we are going ahead with it, but then also be able to then get that market response of we prefer this structure over that structure or whatever the case may be. But those are the sorts of things we would be looking for.

Senator TESTER. OK. And so over the long haul, can you predict what successful risk sharing will look like?

Mr. DEMARCO. I believe that what I am looking for over the long haul is to demonstrate—to develop the mechanisms and to demonstrate the concept in 2013 with these various things, and in 2014 and beyond, as long as the companies are still operating in conservatorship, to have the Scorecard show an increasing share of business in the single-family space be transacted this way, because this is the other thing the market is going to want to know. If we are going to invest in learning what it is you are offering, we want to know that it is going to keep coming. So we expect to—consistent with the goal of gradually shrinking the footprint, I would envision gradually increasing the portion of the new mortgage flow for which we engaged in risk-sharing transactions.

Senator TESTER. Thank you. I want to talk about the single platform and the impacts of that. How do you envision community banks being able to access the single platform, once established?

Mr. DEMARCO. I think this is a really important area, because this is something I care a lot about, Senator Tester, is making sure that the country's mortgage market now and into the future remains something in which local lenders, whether it is a bank or a credit union or whatever it is, remains a viable option for a borrower to go to and get a mortgage to buy a home for their family.

And so I think that one of the key things—one of the real building blocks of what we are doing with the platform—it even started before the platform—and that is with data and with getting data standards and electronic reporting standards in place that would work for the whole marketplace. Because when you do it just one way, you develop an industry standard, it is far easier for a community bank to be able to acquire that technology from a vendor and be able to put it in their institution, even if they are a small institution.

And so that is what I think is really important and what we are doing, with the platform and with our data work, is to build a set of mortgage industry standards that the industry itself helps us develop, but you make it a set of single standards everybody works on, because that will lower cost and improve the ability of small institutions to——

Senator TESTER. So, not to put words in your mouth, do you think once a single platform is established, it is actually going to be easier for community banks to be able to access?

Mr. DEMARCO. That is my goal.

Senator TESTER. Good. What is the timing?

Mr. DEMARCO. I get that question. We are building as fast as we can. Let me put it this way. In response to a similar series of questions on the House side last month, I said that I thought that we needed to have this developed, up and running, working, over the course of the next 5 years. But I will say that I also appreciate that this is a big lift that we are doing. It is a big technology lift. It has got things that are going to be developed. We will roll it out incrementally. I am not trying to build a Cadillac as the first thing that drives off the lot. But we are going to develop this so it will be functional for some things initially and it will expand over time.

Senator TESTER. And not to put words in your mouth, but what I heard you say is fully functional in 5 years?

Mr. DEMARCO. I think that we want to have this thing up and running and working over that time period, is what it is we are doing to develop that. I do not know whether we will be done faster than that or slower than that. I am trying to give a sense of that this is a several-year project to be able to develop this and get it going, and that gives, in terms of a range of time, some order of magnitude, Senator. It is not really a specific timeline.

Senator TESTER. OK. Thank you. Thank you, Mr. DeMarco. Thank you, Mr. Chairman.

Just a real quick close, and that is that I am going to go back to my opening statement. I think the time is ripe to address this issue and move it forward. I think there are folks on both sides of the aisle that want to quit playing with this like a political football and get the job done. I would encourage you to move forward in that way. Thank you.

Chairman JOHNSON. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman.

I especially liked Mr. Tester's comments. Thank you. I agree with many of those.

Mr. DeMarco, I want to thank you for your tremendous public service. Of the people that I have met here in Washington in the last 6 years and 3 months, I do not know of anybody who has been a more stellar public servant. And I think you have been in the middle of a political football game that has been taking place. I think you have handled yourself extraordinarily well and I think you are creating this circuitry to really transition away from the system that we have now. So I just want to thank you for that. I want to thank you, the way you have worked with people on both sides of the aisle to come up with solutions.

I know you were sandbagging Senator Tester there, talking about 5 years. I hope you can do that in the next year-and-a-half.

[Laughter.]

Senator CORKER. In the next year-and-a-half, maximum, you could have this fully implemented if we would do what we need to do here, so I look forward to a much-shortened timeframe.

I do want to say, if—I know there have been discussions about a permanent replacement of some kind for you. I do not know why anybody would want to change something that is working so well. But I think that if that were to be the case, we certainly should hear from the Administration explicitly about what they want to happen with Fannie and Freddie before that occurs, and, hopefully, the Senate and House will take action to make that explicit, even very quickly, as Senator Tester was just mentioning.

Let us talk a little bit about what you are creating. I know there are three ways of getting some private sector cushion, if you will, in front of any kind of governmental guarantee. There is a credit-linked note, and I know we have discussed that extensively.

There is an A and B piece, subordinated piece. In both those cases, you have real capital, if you will, in front of losses.

I know the insurance piece is the third, and I know that is the easiest to do because it is very liquid right now. But would you agree, in a systemic failure like we have had in the past, if you have insurance, and these are monolines and they are under stress, you end up in a situation where you likely have no real capital up front, is that not true?

Mr. DEMARCO. Well, it is certainly true that the capital that was behind it in an insurance company is not sitting in a trust fund that you control or can direct, and that there are competing potential claims on that capital. So, yes, Senator, I take your point that it is a different—it has some differences in terms of how much you rely on that.

Senator CORKER. Well, if you had a systemic crisis like we have had and you did not have real money, like you would have with a senior subcomponent or credit-linked note, typically, I mean, a systemic failure, these entities and monolines would likely fail, too, or have extreme stress, and so you would end up in a situation where you think you have capital up front, but you may really not have capital up front, is that correct?

Mr. DEMARCO. That is correct. You certainly have a counterparty risk there that would have to be carefully managed in a systemic event that could be a concern.

Senator CORKER. So let me ask you this question. I mean, at a maximum, you would want to limit exposure to that piece, is that not correct?

Mr. DEMARCO. You would certainly want to manage it very carefully as a key counterparty credit risk.

Senator CORKER. So moving on down to some of the questions Senator Shelby asked, you know, there have been discussions about whether there should be any governmental piece. I know that I do think with a transparent TBA market and standards set, you could probably issue securities. But there is an issue of what happens when the market contracts and you have stress and all of those kinds of things and keeping liquidity there.

I do not think you are advocating that there be no Government role in housing, is that correct, from the standpoint——

Mr. DEMARCO. Yes. That is correct.

Senator CORKER. Would you expand on that a little bit? I would like for everybody to hear this.

Mr. DEMARCO. Yes. Well, I think that in a $10 trillion single-family mortgage market, the Government does not belong at zero or at ten. It belongs somewhere in between. Really, the Government can play a key role in terms of standards, rules, transparency, fairness in terms of how the market operates. That can go an awful long way to facilitating the effective role of private capital in funding and in bearing the credit risk in the mortgage market.

But in any event, I have no reason to believe that the FHA program, the VA program, Rural Housing are not going to be still an important part of the fabric of the country's housing finance system. Those are explicit Government guarantee programs. And what we do with the Fannie, Freddie part of the market is up to you all, and there are ways of having some amount of Government support for it——

Senator CORKER. And I think when you say "Government support," you are saying some Government guarantee at some low level to keep liquidity, is that correct?

Mr. DEMARCO. Yes, Senator. That is certainly a viable option. I believe that could work.

Senator CORKER. OK. So just in my last question—I see the Chairman reaching for the button—Senator Tester's comments about the community banking industry accessing, I think is very important, and we have had numbers of people in our office that question, let us say, if you had a 10-percent private sector component up front, whether it was senior sub or whether it was credit-linked note, some people are questioning, with $5 trillion today at Freddie and Fannie, whether you could actually have $500 billion worth of private capital and question what stress that might create for community banks. Of course, this would buildup over time, right? It would not happen overnight.

Mr. DEMARCO. Right.

Senator CORKER. And so it would not actually be $500 billion overnight. You have no concerns about, over time, having plenty of private capital up front and for some system to be accessed where the community banking system could actually basically link up to that private capital to make it easy for them to be a part of the market, do you?

Mr. DEMARCO. That is right. I have no concern with gradually moving in that direction and having that amount of capital come in, and I have no concern with community institutions having access to it and being real competitors in that marketplace going forward.

Senator CORKER. Well, thank you for outstanding public service. I hope that you are around to see this through, to work with all of us to continue to create the circuitry to create the right kind of residential mortgage finance in our country. And thank you for your extraordinary efforts.

Mr. DEMARCO. Thank you, Senator. I appreciate that. And if I just may, while I am very grateful for those remarks and that kindness, I would like to take a moment here and thank the staff at FHFA. I am really blessed to have 600 career employees at FHFA who are working incredibly hard as a team to accomplish the things that you were talking about. So thank you, Senator.

Chairman JOHNSON. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman, and thank you, Mr. DeMarco, for being here and your service.

I also want to pick up on something you mentioned in your opening comments, the fact that there are an awful lot of good folks at Fannie and Freddie still, both some who have stayed on—there were clear excesses, but a lot of the fact that there are a lot of new teams there that are performing quite well——

Mr. DEMARCO. I appreciate it.

Senator WARNER. ——and I appreciate your recognition of their activities, as well.

I am not going to relitigate the point that Senator Reed issued, but I do think there may have been a moment in time when the macro effect to the overall housing market of having a more aggressive standpoint in terms of principal reduction could have jumpstarted the housing recovery quicker. I mean, we can debate it back and forth——

Mr. DEMARCO. That is the point of view, Senator.

Senator WARNER. ——but I just want to try to express that. It would have had to have been targeted. It would have had to have been limited. Because I think for a while, we had this sense of, after the immediate crisis, that we, in a sense, said, do no more harm as legislators, and candidly, I think it took a lot longer for this issue to work through the system than any of us had hoped or anticipated, probably you, yourself, as well.

Mr. DEMARCO. Yes, we agree on that, Senator.

Senator WARNER. But I do want to really commend you, building on what Senator Tester and Senator Corker have said and our conversations, the lack of uniform servicing and pooling agreements, and this whole system was a series of—our whole housing finance is a series of contracts that were a complete mishmash——

Mr. DEMARCO. Right.

Senator WARNER. ——and I really want to commend you on your efforts there. And I do think, as well—I will echo Senator Corker's comment that you were sandbagging Senator Tester. Five years is way too long and we need—this is—and I think, again, I know Senator Tester has a great concern about our community banks. I think if we do this portal the right way, it can actually be an asset for community banks, and I hope——

Mr. DEMARCO. I agree.

Senator WARNER. ——as you look at those resource allocations, that you can keep us informed to make sure that we are giving you the tools you need.

I do want to get a couple questions in. One is on multifamily. I understand the need to shrink the portfolio, but the multifamily book really did not cause the crisis in the first place.

Mr. DEMARCO. Right.

Senator WARNER. And I do wonder whether this cutback right now on the 10 percent, whether you feel that may affect liquidity in the CMBS market.

Mr. DEMARCO. I do not have a particular concern about that, Senator. As I said, I think that the multifamily market is actually performing quite well. I think Fannie and Freddie did provide some added support to it back in 2009, 2010, when financial markets were pretty disrupted. It is a competitive market. It is one in which there is a great deal of private capital competing in that space and I think that it is—what we have outlined in our Scorecard is consistent with the theme set forth in the strategic plan of trying to undertake a responsible gradual shrinkage of the footprint of Fannie and Freddie. They will still have a substantial role to play in the multifamily market this year.

Senator WARNER. I just think it is—I think that we do need to remember, this is not where the problem originated.

Mr. DEMARCO. Right.

Senator WARNER. Having a healthy multifamily business is important.

I know there was one thing you had thought about, too, that you were at least, in terms of your 2012 Strategic Plan, looking at an analysis of multifamily to see what would happen if you could do a piece of this business, a larger piece of this business without any Government backstop. Have you finished that analysis and are you——

Mr. DEMARCO. We are actually completing our review of what was submitted to us and I will look forward to sharing it with you.

Senator WARNER. Yes. I look forward to seeing that.

One of the things that we have seen come up in the last—recently a lot is investor-owned purchases, some of these REOs. Some concerns, we continue to hear that we are glad to get these properties kind of out of the foreclosure process, but they are actually maybe retarding the neighborhoods' ability to come back and homeowners' ability to get back into the market in their neighborhoods. Can you give us kind of—I know it is a broad issue, but can you give us your sense on the good, the bad, the ugly, and what we should be conscious of in terms of some of these great movement back of investor purchases?

Mr. DEMARCO. Right. This is a tough issue, because, for one thing, you have got sort of different economic situations in different markets. Two, you have got anecdotes that are kind of driving sort of a sense of a larger picture thing, and the anecdotes can be very well true and there could be a good number of them, but when we are dealing with hundreds of thousands of REO, they still remain anecdotes.

I do believe that—you know, what we have tried from the beginning of the conservatorships, almost, with regard to REO disposition was to provide an opportunity in the initial marketing of REO properties to target local community groups and local housing authorities and purchase of homeowners, people who are going to live in the house, not investors. And so the properties were initially marketed just to that group, so there is a waiting period before an investor can purchase our REO properties.

Nonetheless, we are selling an awful lot to investors. Whether these things that we design, is this is the protocol and so forth, is in individual markets and circumstances not working exactly as planned or whether it is simply because the bids that we get are really much stronger from the investor and that is the way I am protecting the taxpayer, is something that we are still—I mean, we are doing REO disposition evaluations this year to look into some of this to see if we can get a better handle on these stories. But I think—my guess is, it is going to end up being a pretty complicated answer.

Senator WARNER. And I know my time is up. I just want to make two quick comments. One is, I think REOs have got to be one of your tools in the tool kit. But as we start to hear more and more concerns with the market coming back, trying to get us as much information and data as possible, and if there are bad actors, sorting through that, I think it is very important.

And I just want to add one more voice to the Chairman and the Ranking Member that we have got a window to get this done and I think there is much broader bipartisan consensus on this issue than many would suspect and look forward to continuing to work with you, Mr. DeMarco, to get it right.

Mr. DEMARCO. Thank you, Senator.

Senator WARNER. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Vitter.

Senator VITTER. Thank you, Mr. Chairman, and thank you, Mr. Administrator, very much again for all your work. And I think that work has been excellent, again, as most Members of the Committee do.

I want to really focus on our needed work here in Congress. In that regard, thank you for your very positive words for the Jumpstart GSE Reform Act. My question about that is pretty basic. What sort of signal do you think it would send the market if the Senate were able to pass a broad, bipartisan bill that clearly indicates Congress will take up mortgage finance reform?

Mr. DEMARCO. I think that is it right there, Senator. By indicating that the Congress of the United States has agreed it does not want to use Fannie and Freddie to be funding part of the Government, it then removes that as an issue or a barrier to actually doing something to bring these conservatorships to an end and rebuild the housing finance system. I think the markets would take that very seriously.

Senator VITTER. Great. And my second question is really on the other end of the spectrum. You know, hedge funds have been lobbying Congress to encourage the sale of Treasury's preferred shares, and to some extent, investors are already speculating that the companies will be returned to the marketplace. The price of the preferreds has doubled this year for Fannie. What do you think the consequences would be of Treasury selling the preferred shares before Congress acts in any way regarding mortgage finance reform?

Mr. DEMARCO. I am not even sure how that would work, Senator, but I think the Treasury, both in the previous Administration and in this Administration, as well as FHFA, have been clear and consistent that we view the way out of conservatorship is for the Congress of the United States and the Administration to get together on legislation that determines what the future looks like. I am not aware of any plan to sell the preferred, and again, I am not even sure how that would work in the market. That money—there is $180 billion owed back to the American taxpayer, and then you have to completely recapitalize the companies after that.

Senator VITTER. Well, let me restate it. What do you think the message would be or the reaction would be if the Congress were to propose some movement in that direction or allow some movement in that direction without significant reform like we are discussing?

Mr. DEMARCO. I think it would certainly generate confusion and question in the mortgage market about the role private capital would have in the future if there was a thought that there was some sort of reconstituting of Fannie and Freddie as they had been with the charters they had. It would certainly conflict with the notion that we are trying to bring private capital back into this marketplace.

Senator VITTER. OK. Well, again, I just want to end by thanking you again for your service, and in particular your refusal to bend to, quite frankly, political pressure to use Fannie and Freddie as a piggy bank for things that would be popular in some forums short-term but very, very expensive and counterproductive, including for the taxpayer. But thank you for your work.

Mr. DEMARCO. Thank you, Senator.

Chairman JOHNSON. I would like to thank Acting Director DeMarco for his testimony—Senator Corker.

Senator CORKER. Are you ready to go to the other panel?

Chairman JOHNSON. Yes.

Senator CORKER. May I ask one question?

Chairman JOHNSON. Just one.

Senator CORKER. OK.

[Laughter.]

Senator CORKER. I have a six-part question I would like to ask.

[Laughter.]

Senator CORKER. I will ask just one. There have been discussions about having private capital up top, and I know a number of our offices have been working together to try to have a bill to actually take action, and I think, candidly, we may be at a place to do that very, very soon. It sounds like everyone here that has spoken has said the timing is really good for that to occur, and I think you agree.

But there is—one of the components has been to get capital up front, say at the 10 percent level through credit-linked notes, senior sub, or other, but then, also, to have an FDIC-like mechanism where, in the event all of that fails, and the underwriting, which will be very stringent, would be in place first. What are your thoughts about having an FDIC-like structure for those involved in the mortgage industry to have as a catastrophic insurance fund at this time?

Mr. DEMARCO. I think that that could work, Senator. I would hope that if Congress legislated something like that, my thoughts would be to make sure that the law charges whatever Federal entity was responsible for the fund that, A, the entity was independent, had a clear mandate to set appropriate pricing for the risk it was taking and not to have that be set in law, but, in fact, give the entity a real mandate and responsibility to be appropriately charging for risk in managing that reserve fund, because some day, it will get called upon and it needs to be there and it needs to be sufficient if it got called upon.

Senator CORKER. Thank you, Mr. Chairman, and thank you.

Chairman JOHNSON. I would like to thank Acting Director DeMarco for his testimony and for being here with us today.

With that, I would like to call forward the second panel, Inspector General Linick, for this hearing.

[Pause.]

Chairman JOHNSON. I would now like to welcome our second witness for our hearing today. The Honorable Steve A. Linick is Inspector General of the Federal Housing Finance Agency. He has served in this position since September 2010.

Inspector General Linick, you may proceed with your testimony.

STATEMENT OF STEVE A. LINICK, INSPECTOR GENERAL, FEDERAL HOUSING FINANCE AGENCY

Mr. LINICK. Thank you, Chairman Johnson, Ranking Member Crapo, and Committee Members for inviting me here to testify today. I appreciate the opportunity to update the Committee on the work of the Federal Housing Finance Agency Office of Inspector General.

We began operations in October of 2010 in the midst of an unprecedented housing and financial crisis of historic proportions. Since our beginning, we have published 49 reports and have commenced multiple criminal and civil investigations leading to 156 indictments and 62 convictions.

Let me begin by noting that FHFA has made progress in its role as conservator and regulator. FHFA has launched a number of significant initiatives intended to address key objectives, such as aligning Enterprise practices, improving service to borrowers, and conserving and preserving Enterprise assets. FHFA has also accepted and begun to implement the vast majority of our recommendations and we continue to monitor their progress.

Although the agency has made progress, our work continues to show that FHFA can improve its role as regulator and conservator. We have identified instances in which FHFA has displayed undue deference to Enterprise decision making in its capacity as conservator. In its capacity as regulator, we have identified instances in which FHFA could be more proactive in risk management. We have observed that FHFA has had difficulties identifying new and emerging risks potentially affecting the GSEs, issuing guidance governing risk management at the GSEs, and providing consistent enforcement for policy violations. For example, in a recent report on consumer protection, we found that FHFA does not examine how the Enterprises monitor compliance with consumer protection laws.

Second, we determined that the Enterprises do not ensure that their counterparties from which they purchase loans comply with such laws. Similarly, in a report on consumer complaints, we found that mortgage servicers, Freddie Mac, and FHFA have not adequately fulfilled their respective responsibilities to address and resolve escalated cases, which are a type of more serious complaint.

The evidence suggests that most of Freddie Mac's servicers are not complying with the reporting requirements. Ninety-eight percent of Freddie Mac's servicers had not reported on any escalated cases, even though they manage 6.6 million mortgages for Freddie Mac. Of Freddie Mac's eight largest servicers, four did not report any escalated cases despite handling more than 20,000 of them.

Second, Freddie Mac's oversight of servicer compliance has been inadequate. It has not implemented procedures for testing servicer compliance, and Freddie Mac has neglected to establish penalties for servicers that do not report escalated cases.

Third, FHFA did not identify the problems through its own examination. Rather than independently testing servicers' compliance, the FHFA examination team relied exclusively on Freddie Mac's reports, which did not mention the problems.

In addition, in a 2011 report, we found that the agency had too few examiners to oversee the GSEs. As a result, FHFA had scaled back planned work during its examinations and examinations took much longer than expected to complete. Additionally, we identified shortfalls in the agency's examination coverage, particularly in the crucial area of Real Estate Owned property.

Although the agency has made progress since we issued this initial report, it is not clear that FHFA has achieved the examination resources necessary to address this issue. Many of our subsequent reports continue to recommend expanded or improved examination coverage, and we have initiated follow-up work in this area.

We are mindful that FHFA's long-term success is necessarily affected by the uncertainty surrounding the fate of the Enterprises and the housing finance system in general. In other words, FHFA must effectively direct the Enterprises' operations while fundamental questions about its role and theirs remain unanswered.

Given the Committee's interest, I also want to highlight some of our current projects. First, we are assessing a number of FHFA's new or expanded initiatives, including the Servicing Alignment Initiative, the Securitization Platform, the REO Pilot, and HARP 2. Additionally, we are conducting follow-up work on the consumer protection report I just mentioned.

My staff and I look forward to continuing to work with your Committee to provide independent, relevant, and objective assessments of FHFA's operations and programs, and I am happy to answer any questions that you may have at this time. Thank you.

Chairman JOHNSON. Thank you, Mr. Linick.

During your last appearance before this Committee, we discussed the inconsistent enforcement of directives by the FHFA. Is this still a problem? If so, does this lack of follow-through pose greater risk to the conservatorship and taxpayer dollars, in your opinion? What should the FHFA do to improve its enforcement?

Mr. LINICK. I am concerned about implementation and follow-through, especially of many of these initiatives that have been launched. We found in earlier reports that FHFA deferred a lot to the Enterprises for decision making in crucial areas, and FHFA is going to require strong involvement in these new initiatives. We are concerned that there may be crucial decision making by the Enterprises and not by the agency.

Second, a lot of the new initiatives going forward are going to require strong regulatory oversight and they will require the agency to effectively identify risk, manage risk, issue guidelines and directives to the Enterprises, and as you mentioned, enforcement when policies are not being followed. Yet we continue to identify shortfalls in all three of these areas and remain concerned that these may present a problem in the future.

Also, going forward these new initiatives will require examiners, and as I said in my opening remarks, we have concerns about FHFA's examination resources and their ability to engage in robust oversight of these complex programs.

Chairman JOHNSON. Could you put a number on that in terms of what is enough examiners?

Mr. LINICK. That is a difficult question, and I do not have a number for you. In our report, we found that examination teams for Fannie and Freddie were staffed at about half of what they needed to be. They scaled back planned work. They were not getting a lot of examinations done.

Since then, it is my understanding that the agency has beefed up its examination capacity somewhat. They have strong leadership. They have imposed discipline in their examination programs. But we continue to issue reports that suggest their examination coverage is still lacking and it is unclear to us whether that is a result of a lack of examiners. We have ongoing work now to find out exactly where we stand, and we are monitoring the issue and will report back to the Committee as soon as we get those reports done.

Chairman JOHNSON. Given the problems in enforcement, should the Committee be concerned about the FHFA's ability to implement and oversee programs that would expand the role of servicers and mortgage insurers? Without enhanced exams and additional examiners, would these programs pose a risk to the GSEs and potentially the taxpayers, in your opinion?

Mr. LINICK. Well, I can only speak from our work to date. We have done limited work in this area. We have about six reports covering the servicing area. By way of an example, the Servicing Alignment Initiative in concept is a good initiative because it aligns servicing standards, helps borrowers, and also increases borrower contact with servicers. In that instance, we recently did a report on consumer complaints. The Servicing Alignment Initiative, which was unfolded about a year-and-a-half ago, requires that servicers report complaints, serious complaints—improper foreclosure, for example, or if a borrower is not getting foreclosure options and they are not able to get the servicer to consider other alternatives apart from foreclosure, things like that. Servicers are also required to resolve these complaints within 30 days.

In our report, we found that while the Servicing Alignment Initiative is a good one, there was a lack of implementation of the initiative, and that is where our concern lies. Servicers were not reporting complaints as required by the rules. There were also instances when they were not resolving cases within the required 30 days. We also saw problems with Freddie Mac. They were not testing servicers' compliance and they pretty much missed the problem. And then on the FHFA side, FHFA's examinations relied on Freddie Mac's reports, which did not really describe the problem, and therefore FHFA's examinations did not catch the problem.

I use this by way of example to show how these initiatives are going to require a lot of oversight, and implementation and follow-through are going to be key.

Chairman JOHNSON. One last question. Mr. Linick, your office has been up and running for over 2 years. In that time, has the FHFA made progress implementing your recommendations?

Mr. LINICK. FHFA has made substantial progress implementing our recommendations. They have accepted the majority of our recommendations. We have about 140 at this point. About half of them are implemented and the other half are in various stages. And I commend the agency for the progress that they made.

We started our work looking at a variety of controls across a number of fronts at FHFA, and now having been at OIG for more than 2 years, we are starting to go back, like we are with examination capacity, to see where things stand, and that will be a part of our work going forward.

Chairman JOHNSON. Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman.

I just had a couple of quick questions. First of all, I want to thank you for your work, Mr. Linick. We appreciate the oversight that you provide and the assistance you provide in making sure that the FHFA operates properly.

My first question relates to the money paid to the Treasury by the GSEs. The recent news reports surrounding the profits made by Fannie and Freddie and then subsequently remitted to the taxpayer seem to present conflicting information surrounding these payments and the debt owed by Fannie and Freddie. Based upon your knowledge of the situation, I am hoping you can help to clarify this.

My question is, do these payments reduce the $187 billion figure owed under the Preferred Stock Purchase Agreement?

Mr. LINICK. The short answer is no. They do not pay down what is called the liquidation preference or Treasury's investments, and the way Treasury structured this is like an interest-only loan. In other words, the payments to Treasury are like interest payments, but they do not pay down the principal, the $187.5 billion. So the Enterprises could pay $200 billion in interest and that $187.5 billion would still not be paid down. This was set up by Treasury through the PSPAs, the Senior Preferred Stock Purchase Agreements.

Senator CRAPO. And if the amount that is remitted by the agency exceeds the amount of interest that has accrued, what happens in that circumstance?

Mr. LINICK. Again, it does not pay down the liquidation preference.

Senator CRAPO. It is just a deposit——

Mr. LINICK. It is just a deposit. It goes to Treasury. It goes to taxpayers. Ultimately, it is up to the Treasury, FHFA, and Congress to figure out what is going to happen in the future.

Senator CRAPO. And in what way could they pay down the outstanding principal obligation? Is there just no provision for that to happen——

Mr. LINICK. I am not aware of a provision like that in the PSPAs, but I would ask Treasury, obviously, how that would work. But based on my knowledge of it, there is no provision to pay that down.

Senator CRAPO. All right. Thank you.

My last question is really kind of an open-ended question. Both you and Director DeMarco have previously noted that the continued open-ended nature of the conservatorships creates challenges for the management of both FHFA and the conservatorships for Fannie and Freddie. And this is just a general question. Based upon your observations and your analysis, what do you see as the biggest challenges that are faced to date?

Mr. LINICK. There is no doubt that uncertainty is the single most important challenge. I think this has an effect on oversight, which is obviously my role. It affects the agency, the Enterprises, and from what I have heard, the market.

On the agency side, it affects the agency's ability to recruit examiners and others, retain staff, and also develop long-term resource allocations. We do not know the fate of the Enterprises and that makes it very difficult. The conservatorship, as you mentioned, was meant to be a time out, temporary, and no one anticipated—including the agency—that it would last this long. It also affects morale for the agency.

On the Enterprise side, it certainly affects morale for them, and I have heard from the marketplace that without a set of rules, people do not want to dip their toe into the water.

Senator CRAPO. So the lesson from that would seem to be that the sooner Congress can act, the better it would be in terms of the overall success for both the Enterprises and FHFA.

Mr. LINICK. I would agree with that.

Senator CRAPO. My last question related to this is are there any new challenges that you think might develop, or will the existing ones just continue to languish if we continue to—if Congress continues to linger in terms of resolving these issues?

Mr. LINICK. Well, I think, as I mentioned before, the other major challenges as we continue to linger are shortfalls in oversight. Taxpayers, at the end of the day, could suffer if things just go on the way they are. I have mentioned that there are shortfalls in the conservatorship oversight and there are shortfalls in the regulatory oversight with respect to identification of risk, management of risk, and enforcement. I see these things as problems going forward.

Senator CRAPO. All right. Thank you.

I have no further questions, Mr. Chairman.

Chairman JOHNSON. I would like to thank Inspector General Linick and Acting Director DeMarco for being here with us today. Oversight of the FHFA will continue to be a top priority of this Committee and we appreciate your insights.

This hearing is adjourned.

[Whereupon, at 11:31 a.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF SENATOR RICHARD C. SHELBY

Mr. DeMarco, I would like to start out today by thanking you for your strong leadership at FHFA.

You were given a tough job during a critical time for our Nation's housing market, and you should commended for your service.

Your commitment to protecting both taxpayers and homeowners has served our Nation well, and we are finally beginning to see signs of recovery.

Unfortunately, while you have done a superb job at FHFA, Congress has failed its task of reforming the GSEs.

We are more than 4½ years into the conservatorships for Fannie and Freddie. These conservatorships were never intended to last this long, yet there is still no end in sight.

It is my hope that this Committee will work together to pass bipartisan legislation that reforms our GSEs and prevents taxpayers from footing the bill for future housing bailouts.

PREPARED STATEMENT OF EDWARD J. DEMARCO

ACTING DIRECTOR, FEDERAL HOUSING FINANCE AGENCY

APRIL 18, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, I am pleased to be invited here today to discuss the Federal Housing Finance Agency's (FHFA) oversight of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks (FHLBanks).

In my testimony today I will focus mainly on FHFA's role as the conservator and regulator of Fannie Mae and Freddie Mac (together, the "Enterprises"). As this Committee is well aware, the Enterprises have been in conservatorship for more than 4½ years. These have been the largest and most complex conservatorships in history. Throughout this time FHFA has explained its approach to the conservatorships in light of the statutory responsibilities Congress placed on the agency as conservator. I have reported to Congress numerous times regarding FHFA's actions in light of these responsibilities, recognizing that the prolonged time in conservatorship has required us to adapt to changing circumstances, while remaining consistent with the fundamental responsibilities given us as regulator and conservator. I am pleased to provide you today with an update on what we have accomplished and where we are headed.

I would first like to take a moment to thank the Chairman and Ranking Member for their introduction of an amendment to the 2014 budget resolution that would prevent any additional Enterprise guarantee fees from being used to fund other budget items. And I would like to thank all the Members of the Committee for supporting that amendment, which the Senate adopted by unanimous consent. I was also glad to see the introduction by Senators Corker, Warner, Vitter, and Warren of S.563, the Jumpstart GSE Reform Act. I share the views of the sponsors of S.563 that now is the time to address reform of the housing finance system. I look forward to working with all of you as you move forward on that effort.

I will begin this prepared statement with a brief review of the goals of FHFA as Conservator. Then I will review FHFA's approach to preparing for increased private market participation in housing finance and describe the significant activities that FHFA has undertaken during the past year to further our conservatorship goals. Next I will touch on the financial condition and performance of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. And finally, I will close with some thoughts on the role of Government in housing finance.

Goals of Conservatorship

With the financial crisis unfolding, and after substantial consultation with the Department of the Treasury and the Federal Reserve, FHFA placed the Enterprises into conservatorship on September 6, 2008. The Housing and Economic Recovery Act of 2008 (HERA), which created FHFA, specified two conservator powers, stating that the Agency should "take such action as may be:

1. necessary to put the regulated entity in a sound and solvent condition; and
2. appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity."

From the outset, FHFA stated that the goals of the conservatorships were to help restore confidence in the companies, enhance their capacity to fulfill their mission, and mitigate the systemic risk that contributed directly to instability in financial markets. As supervisor, we have also taken steps to strengthen risk management, internal controls, and establish proper governance over all of the Enterprise's activities.

As the private mortgage securitization market had already vanished and there were no other effective secondary market mechanisms in place, the initial phase of the conservatorships was focused on stabilizing the Enterprises' operations to ensure the continued functioning of the mortgage market during the crisis. This phase has been successful; operations of the two Enterprises have largely stabilized and the origination market and secondary market for mortgage has continued to function throughout the financial crisis.

The second phase of the conservatorships has focused on foreclosure prevention efforts, which have been critical for helping homeowners in distress and essential to meeting the conservatorship mandate to preserve and conserve the Enterprises' assets. These continuing efforts also are consistent with FHFA's statutory responsibility under the Emergency Economic Stabilization Act to provide assistance to homeowners and minimize foreclosures. Nearly 2.7 million "foreclosure prevention" actions evidence the success of that effort to date.

FHFA also clarified that the Enterprises would be limited to continuing their existing core business activities. This type of limitation on new business activities is consistent with the standard regulatory approach for addressing companies that are financially troubled. And it is even more pertinent for the Enterprises given their uncertain future and reliance on taxpayer funds. While there still is legacy credit exposure to work through, the second phase of the conservatorships put in place the loss mitigation infrastructure to help borrowers and protect taxpayers. At the same time, the Enterprises' new books of business are much stronger than their old ones.

Today we have a mortgage market that relies heavily on taxpayer support, with very little private capital standing in front of the Federal Government's risk exposure. There seems to be broad consensus that Fannie Mae and Freddie Mac will not return to their previous corporate forms. The Administration has made clear that its preferred course of action is to wind down the Enterprises. Of the various legislative proposals that have been introduced in Congress, none of them envisions the Enterprises exiting conservatorship in their current corporate form. In addition, recent changes to the Preferred Stock Purchase Agreements (PSPAs), replacing the 10 percent dividend with a net worth sweep, reinforce the notion that the Enterprises will not be building capital as a potential step to regaining their former corporate status. The amount of funding, essentially the Enterprises' capital base, available under the PSPAs also has become fixed as the Enterprises recently reported year-end 2012 financial results.

Against this backdrop, FHFA has moved into a third phase of Enterprise conservatorship, embodied in its Strategic Plan for the Operation of the Enterprise Conservatorships.

FHFA's 2012 Strategic Plan for the Operation of the Enterprise Conservatorships

In early 2012, recognizing that the conservatorships were over 3 years along and not likely to end soon, FHFA developed and formally communicated to Congress a strategic plan for the companies to pursue while in conservatorship, pending legislative action. This Strategic Plan has three goals:

1. *Build.* Build a new infrastructure for the secondary mortgage market.
2. *Contract.* Gradually contract the Enterprises' dominant presence in the marketplace while simplifying and shrinking their operations.
3. *Maintain.* Maintain foreclosure prevention activities and credit availability for new and refinanced mortgages.

These goals satisfy our statutory mandate as conservator, are consistent with the Administration's call for a gradual wind down of the Enterprises, and preserve all options for Congress while establishing a stronger foundation on which Congress and market participants can build to replace the preconservatorship Government sponsored enterprise (GSE) model.

With a focus on transitioning to a more secure, sustainable and competitive model for the secondary mortgage market, FHFA established the 2012 Conservatorship Scorecard to provide a roadmap for the Enterprises to implement the Strategic Plan. The Scorecard had four focus areas all tied to the Strategic Plan and great progress has been made in all areas.

Building upon the 2012 Scorecard, last month FHFA published the Conservator's Scorecard for 2013, again setting forth annual performance targets adhering to the strategic goals of build, contract, and maintain. I would like to walk through each of these with you now while also highlighting some of the successes of 2012.

Maintain

Although it is the third strategic goal, I would like to start with Maintain. Maintaining foreclosure prevention activities and promoting market stability and liquidity so that there is credit availability for new and refinanced mortgages is an important aspect of our work as conservator. Foreclosure prevention efforts were extensive in 2012 as FHFA and the Enterprises continued to simplify, streamline, and improve existing programs. More than 540,000 foreclosure prevention actions were completed last year alone, bringing the total to nearly 2.7 million since the start of conservatorship in 2008.

Since the start of conservatorship, Fannie Mae and Freddie Mac's management teams have completed over 1.3 million permanent loan modifications, more than 665,000 repayment plans, and nearly 150,000 forbearance plans. Together they have enabled the Enterprises to help more than 2.2 million families who were having trouble paying their mortgages remain in their homes. Additionally, the Enterprises have made it possible for more than 445,000 other families to gracefully exit their home without going through a painful foreclosure process by facilitating short sales and deeds-in-lieu of foreclosure.

Last year the Enterprises also implemented changes to the Home Affordable Refinance Program (HARP) that we announced late in 2011. Those changes included: expanding the program to include homeowners with greater than 125 percent loan-to-value ratio; clarifying representation and warranty exposure; and incenting shorter-term refinance opportunities through reduced pricing. The results have been impressive:

- The nearly 1.1 million HARP refinances in 2012, almost equaled the number of HARP refinances over the prior 3 years. An additional 97,000 HARP refinances were completed in January of this year.
- HARP refinances with greater than 105 loan-to-value ratios made up 43 percent of total HARP refinances in 2012, compared to 15 percent in 2011. In January of this year, 47 percent of HARP refinances were for borrowers with a greater than 105 loan-to-value ratio.
- HARP refinances with greater than 125 percent loan-to-value ratios made up 21 percent of total HARP refinances in 2012 and nearly 25 percent of total refinances in January of this year.
- HARP refinances into a shorter-term mortgage made up 18 percent of total HARP refinances in 2012 for underwater borrowers, compared to 10 percent in 2011, and stand at 18 percent of total HARP refinances in January 2013.

We are very pleased with the success of HARP thus far and look forward to building on this success in 2013. We will soon be implementing a nationwide public relations campaign to educate consumers about HARP and its eligibility requirements. The goal of this campaign is to reach as many eligible homeowners as possible and educate them on HARP eligibility criteria and the value of refinancing under HARP, and motivate them to explore their options and utilize HARP before the program expires. HARP is a valuable risk reduction tool for the Enterprises, and I announced last week that we will be extending the HARP deadline by 2 years through December 2015. I feel confident that with the changes made to HARP in 2011, the increased consumer awareness through the HARP consumer education campaign and the extension of the HARP deadline, every eligible homeowner who wants to refinance through the HARP program will have the opportunity.

For those homeowners who are seeking a modification we also recently announced that the Enterprises will soon be offering a new, streamlined loan modification initiative to minimize Enterprise losses and help troubled homeowners avoid foreclosure and stay in their homes. Starting this July, servicers will be required to offer eligible homeowners who are at least 90 days delinquent on their mortgage an easy way to lower their monthly payments and modify their mortgage. This new option supplements our existing suite of loan modifications, including the Home Affordable Modification Program (HAMP) and the Enterprise's standard modification program.

A key element of this new program is that it is essentially automatic and seriously delinquent homeowners are eligible for the program even if they have not provided complete documentation. Since the beginning of the financial crisis a consistent hindrance to assisting troubled borrowers has involved documentation requirements. The Streamlined Modification Initiative should be especially helpful to those who are self-employed, part of a multigenerational household, or are simply overwhelmed with the document collection burden. All borrowers have to do to take advantage of the modification offer is make three on-time trial payments, after which their loan will be permanently modified. Servicers will continue to work with borrowers throughout the trial period to evaluate all their foreclosure prevention options, as documenting income and financial hardship could result in a modification with additional savings for the borrower. This program also fits within our safety and soundness goals.

This new program builds on the principles embodied in the Servicing Alignment Initiative that was launched in 2011. The Servicing Alignment Initiative was designed to establish consistent policies and processes for the servicing of delinquent loans owned or guaranteed by the Enterprises to make it easier for servicers to reach borrowers as early in the delinquency as possible. Early, effective borrower outreach and engagement is critical for successful modification solutions. We are excited about the prospects of this new program and look forward to tracking and reporting on its progress.

A priority since the onset of conservatorship and enumerated under the "maintain" goal is to continue to strengthen the credit risk management practices of the Enterprises, and provide more certainty and timely feedback to originators as they make decisions on extending credit. Pursuant to this end, last September FHFA and the Enterprises announced the start of fundamental changes to the representation and warranty framework for conventional loans sold or delivered on or after January 1, 2013. The objective of the new framework is to clarify lenders' repurchase exposure and liability and inject greater up-front monitoring by moving the focus of quality control reviews forward to the time the loan is delivered to the Enterprises instead of when it has defaulted. The priorities for 2013 are enhancing the post-delivery quality control practices and transparency associated with the new rep and warranty framework, and FHFA's on-site supervisory teams will continue to review the effectiveness of the new framework.

In addition to the efforts of FHFA, the progress that I have just discussed on foreclosure prevention, refinancing, and maintaining credit availability would not have been possible without the commitment of the boards, management, and employees of Fannie Mae and Freddie Mac. I am gratified that the leadership and staff at both companies remain committed to fixing what is broken and creatively addressing the challenging issues we face. I would add that other such examples of their commitment abound. For example, Fannie Mae undertook an important effort to develop a bulk approach to selling properties in their real estate owned portfolio, and Freddie Mac has been leading efforts to expand loan level disclosures.

Build

The first strategic goal is to build a new infrastructure for the secondary mortgage market. The Enterprises' existing proprietary infrastructures are not effective at adapting to market changes, issuing securities that attract private capital, aggregating data, or lowering barriers to market entry. These outmoded infrastructures must be maintained and updated. An investment of capital—capital that would come from taxpayers through the PSPAs—will be necessary for this effort. But to the extent possible, we should invest taxpayer dollars to this end once, not twice.

Hence, updating the Enterprises' outmoded infrastructures should provide enhanced value to the mortgage market with a common and more efficient securitization model. The ultimate goal is to develop a new securitization model that will have benefits beyond the current Enterprise business model. To achieve this, the new infrastructure must be operable across many platforms and operate in a cost effective manner so that it can be used by any issuer, servicer, agent, or other party that decides to participate.

In October 2012, FHFA issued a white paper designed to gather input from the industry and move this effort forward. The white paper discusses development of a common securitization platform, including the important issue of its scope and functionality. One approach we outlined is that the focus of the platform could be on functions that are routinely repeated across the secondary mortgage market, such as issuing securities, providing disclosures, paying investors, and disseminating data. These are all functions where standardization could have clear benefits to market participants.

Last month I announced as part of the 2013 Scorecard that a new business entity will be established between Fannie Mae and Freddie Mac. This does not mean we are consolidating the two Enterprises, but we believe that setting up a new structure, separate from the two companies, is important for building a new secondary mortgage market infrastructure. Our objective, as we stated last year, is for the platform to be able to function like a market utility, as opposed to rebuilding the proprietary infrastructures of Fannie Mae and Freddie Mac. To make this clear, I expect that the new venture will be headed by a CEO and Chairman of the Board that are independent from Fannie Mae and Freddie Mac. It will be physically located separate from Fannie Mae and Freddie Mac and will be overseen by FHFA.

Importantly, we plan on instituting a formal structure to allow for input from industry participants.

What I have just described is the governance and ownership structure for the near-term phase of the platform. It will be initially owned and funded by Fannie Mae and Freddie Mac, and its functions are designed to operate as a replacement for some of their legacy infrastructure. However, the overarching goal is to create something of value that would be a foundational element of the mortgage market of the future. We are designing the platform to be flexible so that the long-term ownership structure can be adjusted to meet the goals and direction that policy makers may set forth for housing finance reform.

The white paper issued last October also puts forth some broad ideas on creating a model contractual framework. Similar to the securitization infrastructure effort, the focus of this effort is to identify areas where greater standardization in the contractual framework would be valuable to the mortgage market of the future.

This is an optimal time to consider how best to address contractual shortcomings identified during the past few years. A great deal of work has already been done in this area by market participants and additional input will be exceptionally valuable. As the Enterprises move forward with risk sharing transactions such as those I will describe shortly, the development of transactional documents will provide a real time test of a new standardized contractual framework for transactions where the private sector is absorbing credit risk.

Another aspect of the build goal is the Uniform Mortgage Data Program or UMDP. This effort may get overlooked at times, but a solid foundation of data standards is vitally important regardless of the future direction of housing finance reform. I am very encouraged by this effort as the Enterprises have worked through an industry process set up through MISMO—the Mortgage Industry Standards Maintenance Organization—to move this process forward. Much has already been accomplished through the development of a Uniform Loan Delivery Dataset and a Uniform Appraisal Dataset. Work is beginning on the Uniform Mortgage Servicing Dataset. This latter effort will take time, but working through the process with a broad-based coalition of industry participants in MISMO should serve as a model for future efforts as we seek to rebuild the foundation of the mortgage market. In the end, the benefits are immense. Developing standard terms, definitions, and industry standard data reporting protocols will decrease costs for originators, servicers, and appraisers and reduce repurchase risk.

Contract

The second strategic goal is to contract the Enterprises' dominant presence in the marketplace while simplifying and shrinking their operations, thus de-risking both Fannie Mae and Freddie Mac's activities. With an uncertain future, limited capital resources, and a general desire for private capital to re-enter the market, the Enterprises' market presence should be reduced gradually over time.

To move the "contract" goal forward, we set forth three priorities in the 2013 Scorecard.

First, the 2013 Scorecard sets a target of $30 billion of unpaid principal balance in credit risk sharing transactions in the single-family credit guarantee business for both Fannie Mae and Freddie Mac. A considerable amount of preparatory work was done in 2012 to lay the groundwork for executing on risk sharing transactions this year, and we have specified that each Enterprise must conduct multiple types of risk sharing transactions to meet the 2013 target. The Scorecard encourages the Enterprises to consider transactions involving: expanded mortgage insurance with qualified counterparties; credit-linked securities; senior/subordinated securities; and perhaps other structures. The goal for 2013 is to move forward with these transactions and to evaluate the pricing and the potential for further execution in scale. What we learn in 2013 will set the stage for the targets for 2014, and I fully expect to move from a dollar target to a percentage of business target at some point in the future.

Also, while it is not a Scorecard item, we expect to continue increasing guarantee fees in 2013, and the execution of the single-family risk sharing transactions I just described should provide valuable information as to how market participants are pricing mortgage credit risk. As we have noted before, the financial crisis demonstrated that the Enterprises had not fully priced their credit risk. In 2012, guarantee fees were increased twice, bringing the average guarantee fee on new mortgages to around 50 basis points, approximately double what guarantee fees were prior to conservatorship. A key motivation behind increasing Enterprise guarantee fees is to bring their credit risk pricing closer to what would be required by private sector providers. However, I feel it is important to note that increasing guarantee fees is part of the goal of contracting the Enterprises' dominant presence in the marketplace. It is not designed primarily to increase their revenue. The hope is that at some point the increases in guarantee fees will encourage private capital back into the market. We are not there yet, but in conversations with market participants, I think we are getting closer.

Second, we are setting a target of a 10 percent reduction in new multifamily business acquisitions from 2012 levels. We expect that this reduction will be achieved through some combination of increased pricing, more limited product offerings, and tighter overall underwriting standards. The multifamily business differs significantly from the single-family credit guarantee business. The Enterprises have a smaller share of the multifamily market and there are other providers of credit in the market. The Enterprises' market share of new multifamily originations did increase during the financial downturn, but in 2012 it returned to a more normal position.

Another difference from the single-family business is that each Enterprise's multifamily business has weathered the housing crisis and generated positive cash flow. In contrast to their common approach to their single-family businesses, Fannie Mae and Freddie Mac do not take the same approach to their individual multifamily businesses. Each approach also already embeds some type of risk sharing. For a significant portion of its business, Fannie Mae shares multifamily credit risk with loan originators through its delegated underwriting program. Likewise, for a significant and increasing portion of its business, Freddie Mac shares multifamily credit risk with investors by issuing classes of securities backed by multifamily mortgages where the investor bears the credit risk.

Given that the multifamily market's reliance on the Enterprises has moved to a more normal range, reducing the Enterprises' footprint in this market is appropriate and aligns with the overall goal of contracting their dominant market presence.

Finally, we are setting a target of selling an additional 5 percent of the less liquid portion of the Enterprises' retained portfolios—primarily their retained portfolios excluding agency securities. The retained portfolios of Fannie Mae and Freddie Mac have been declining since 2009. The initial PSPAs required a 10 percent annual reduction, and the most recent changes to the PSPAs increased the annual reduction to 15 percent. The composition of the Enterprises' retained portfolios has also changed significantly since the establishment of the conservatorships. Prior to conservatorship, the retained portfolios were dominated by their own mortgage-backed securities and performing whole loans. As those securities have been paid down, and as the need to work through delinquent loans increased, the retained portfolios changed from being relatively liquid to being less liquid.

Given that natural run-off in the retained portfolios would have likely satisfied the PSPA reduction targets in the next few years, and that the Enterprises are not actively purchasing new assets for their retained portfolios, requiring them to sell from the less liquid portions of their retained portfolios should lead to an even faster reduction than is required under the PSPAs.

Additional Priorities for 2013

Let me close this review of the conservatorship strategic plan by highlighting a couple of other priorities we are working towards in 2013. One will be the near-term efforts regarding mortgage insurance. To better protect the interests of the Enterprises, we are updating mortgage insurance master policies by clarifying the role and responsibilities of insurance carriers, particularly when servicers pursue loss mitigation to help delinquent borrowers. Further, we intend to formulate new mortgage insurance eligibility standards, to ensure that all insurance carriers doing business with the Enterprises have the appropriate financial, operational, and management capacity to fulfill their obligations, particularly in the event of additional stress to the housing markets. These efforts will be an important and critical step for mortgage insurance to remain a viable risk transfer mechanism in the future.

Another policy project of note is the development of an aligned set of standards for so-called force placed, or lender-placed, insurance. The various concerns with lender-placed insurance are well-known, including the costs, limitations on coverage, and consumer protections. FHFA recently sent a Notice to the *Federal Register* setting forth an approach to address certain practices relating to lender-placed insurance that we consider contrary to prudent business practices, contrary to appropriate administration of Enterprise guaranteed loans, and which expose the Enterprises to potential losses and safety and soundness risks.

These practices include sales commissions received by sellers and servicers when placing coverage or maintaining placement with particular insurance providers, and remuneration received by sellers and servicers from insurance providers that cede premiums to a reinsurer that is owned by, affiliated with or controlled by the seller or servicer. After receiving input during the 60 day period provided for in the *Fed-*

eral Register Notice and after FHFA review, we would anticipate the Enterprises putting these change in practices into place over a several month period.

We also plan to pursue a broader approach to lender-placed insurance, bringing together both public and private sector parties to participate in a dialogue with us and with a wide range of stakeholders. Our goal is to establish a set of standards that could be adopted by a broader set of mortgage market participants, similar to what was done with the Servicing Alignment Initiative. This broadened approach will also enable greater regulatory coordination in an effort to consider the various issues associated with lender-placed insurance.

FHFA as Supervisor

While FHFA has outlined a plan for the next phase of conservatorship, we continue to fulfill our supervisory responsibilities at both the Enterprises and the Federal Home Loan Banks. Since FHFA was created in 2008, we have added more than 200 employees. Over the past 2 years, we have undertaken substantial restructuring, particularly with regard to our supervision program and have hired experienced examiners at the executive and staff levels. I anticipate a modest amount of additional hiring, but believe that FHFA now has the executive management team, the organizational structure, and the staff necessary to carry out our safety and soundness mission.

With respect to Fannie Mae and Freddie Mac, we have strengthened our supervision and oversight of their activities, including how they implement and comply with conservatorship and FHFA policies. FHFA has in the past year implemented several changes that will enable us to quickly and effectively respond to emerging risks and developments, and to put in place a framework for supervising the secondary housing market not only today but for the future. This includes issuing supervisory guidance, governing regulations, and establishing a new risk-based supervisory framework. FHFA's 2013 supervisory objectives include:

- Assess the risks posed by new initiatives to ensure that they are being implemented under a sound control framework. These initiatives include SAI, the common securitization platform, the contract harmonization project, multifamily bulk loan sales, and REO disposition programs.
- Maintain a full understanding of the Enterprise's overall risk profile, particularly for the incremental risk created by implementing the new initiatives while maintaining and upgrading information systems and internal controls.
- Determine if the board and management are taking appropriate steps to comply with conservatorship and supervisory directives.
- Develop a formalized process for the ongoing monitoring program.
- Implement the CAMELSO rating system.

Financial Condition and Performance of the Enterprises and FHLBanks

Before turning to options for the future, I will first address current market conditions and the financial condition and performance of the Enterprises and of the FHLBanks, which are also important components of the U.S. housing finance system.

Housing Market Conditions

- We are seeing signs of recovery in the housing market across a number of dimensions and, while the marketplace is by no means "normalized," conditions are promising in many ways.
- According to the latest data from the National Association of Realtors, the inventory of homes available for sale was only 1.9 million units in February. Given that the annualized rate of home sales during that month was nearly 5 million properties, this represented only about 4.7 months' worth of supply. Just a year earlier, the relative supply was a still modest 6.4 months. And at its peak—in July 2010—the supply was 12.1 months.
- According to the FHFA index, national home prices grew 5.5 percent between the fourth quarters of 2011 and 2012. For the 12 month period ending in January, home prices rose 6.5 percent.
- Census data from December 2011 estimated the seasonally adjusted annualized rate of housing starts to be about 700,000 units. By September 2012, that rate had grown to roughly 840,000 units and, in March, the rate was estimated at 1,036,000 units. This compares to a low of about 480,000 units in April 2009, and is 71 percent of the long-run average.
- The latest CoreLogic information, which includes data for October, indicates that shadow inventory dropped roughly 12.3 percent between October 2011 and

October 2012. This decline represented a reduction in the shadow inventory pool of about 300,000 units.

Freddie Mac

- Net income for the fourth quarter of 2012 totaled $4.5 billion, and represented the fifth consecutive quarter of positive earnings. Annual net income of $11 billion represented a record level of earnings for Freddie Mac and compares to a net loss of $5.3 billion in 2011.
- In 2012 Freddie Mac required $19 million of funding from Treasury bringing the cumulative Treasury draw to $71.3 billion. Through December 31, 2012, Freddie Mac has paid $23.8 billion in cash dividends to Treasury on the company's senior preferred stock. Under the PSPAs, the payment of dividends cannot be used to offset prior Treasury draws. This provision has remained unchanged since the PSPAs were established. So while $23.8 billion has been paid to Treasury in dividends, Treasury still maintains a liquidation preference of $72.3 billion on its senior preferred stock. Freddie Mac has $140.5 billion remaining in available support from Treasury.
- The credit quality of new single-family acquisitions remained high in the fourth quarter of 2012, with a weighted average FICO score of 756. The average loan-to-value (LTV) ratio for new business was 75 percent. This higher LTV ratio is due to the expansion of HARP eligibility to borrowers whose mortgages have LTV ratios above 125 percent and to relief provided to lenders for borrowers with LTV ratios above 105 percent. These high LTV refinances represented 43 percent of HARP loans in 2012.

Fannie Mae

- Net income for the fourth quarter of 2012 totaled $7.6 billion, and represented the fourth consecutive quarter of positive earnings. Annual net income of $17.2 billion represented a record level of earnings for Fannie Mae and compares with a net loss of $16.9 billion for 2011.
- Fannie Mae did not require funding from Treasury in 2012. Fannie Mae's cumulative Treasury draw remains at $116.1 billion. Through 2012, Fannie Mae has paid $35.6 billion in cash dividends to Treasury on the company's senior preferred stock. Under the PSPAs, the payment of dividends cannot be used to offset prior Treasury draws. This provision has remained unchanged since the PSPAs were established. So while $36.5 billion has been paid to Treasury in dividends, Treasury still maintains a liquidation preference of $117.1 billion on its senior preferred stock. Fannie Mae has $117.6 billion remaining in available support from Treasury.
- The credit quality of new single-family acquisitions was strong in 2012, with a weighted average FICO score of 761. The average LTV for new business was 75 percent in 2012, compared with 69 percent in 2011. The year-over-year increase in average LTV ratios is due to the expansion of HARP to borrowers with high LTV mortgages.

Federal Home Loan Banks

- The FHLBanks have emerged from the financial crisis in generally good condition. They are profitable and have strengthened capital positions. The FHLBank System reported net income of $2.6 billion in 2012, the highest annual earnings since 2007.
- Retained earnings have grown significantly in recent years and totaled $10.4 billion, or 1.37 percent of assets, as of year-end 2012. Retained earnings are at their highest level ever, and will continue to grow as a result of provisions included in each FHLBank's capital plan. The FHLBank System regulatory capital ratio of 6.8 percent exceeds the regulatory requirement of 4.0 percent. The market value of the FHLBanks is 124 percent of the par value of capital stock, the highest ratio in at least 11 years.
- The aggregate balance sheet of the FHLBanks has shrunk considerably in recent years, led primarily by declining advance volumes due to market liquidity and sluggish economic growth. Advances totaled $426 billion as of year-end 2012, down 58 percent from a peak of $1.01 trillion in the third quarter of 2008.
- Viewed over the past business cycle, the FHLBanks carried out their public purpose of providing credit when needed to support the mortgage investments of their members.

Role of the Government in Housing Finance

The key question in housing finance reform is what, and how large, should the role of the Federal Government be? While it is ultimately up to lawmakers to provide an answer, in my opinion the main purpose in addressing housing finance reform should be to promote the efficient provision of credit to finance mortgages for single-family and multifamily housing. An efficient market system for providing mortgage credit to people that want to buy a house should have certain core characteristics: (1) it should provide consumer choice, (2) it should provide consumer protections, (3) it should allow for innovation by market participants, and (4) it should facilitate transparency.

As lawmakers consider the extent of the Government's role in housing finance, it is useful to start with some basic market facts. As of the fourth quarter of 2012, there was about $9.9 trillion in single family mortgage debt outstanding. About 13 percent was guaranteed through direct Government programs, roughly 52 percent was guaranteed by Fannie Mae and Freddie Mac, and the remainder not guaranteed by the Federal Government.

On a flow basis, Inside Mortgage Finance reports that in the third quarter of 2012 new single family mortgage originations totaled approximately $510 billion. Of that total roughly 18 percent was guaranteed through direct Government programs, 66 percent through Fannie Mae and Freddie Mac, and 16 percent not guaranteed by the Federal Government.

Measured by securities issuance, the proportion supported by the Government is over 90 percent.

However measured, it should be clear that today's housing finance market is dominated by Government support.

The relevant question then appears to be more in the line of how we move from the housing finance market of today, where almost all new single-family mortgage originations have some type of Government support, to a future market far more reliant on the private provision of mortgage credit? And in particular, of the $5 trillion portion of the mortgage market currently served by the Enterprises, what share, if any, should have Government credit support in the future?

From the point of view of an economist, the answer to this question, and to the general question of how great a role the Government should ultimately play in the housing finance sector, begins with consideration of a potential market failure. A market failure may lead the private market to produce less of, or more of, a particular good than would be economically optimal. Broadly speaking, in housing finance there are at least two potential market failures that are often considered; each may lead to an under-provision of mortgage credit.

A potential market failure could arise in housing finance if market participants have undue or unnecessary concerns about the ongoing stability and liquidity of mortgage credit in a purely private market across various economic environments. If this view prevails in the housing market, less credit will be provided than would be the case in the absence of this type of uncertainty. The Government response to this type of potential market failure could take a number of approaches, ranging from establishing standards and greater transparency for the market; providing liquidity or credit support under certain market conditions; to providing a Government guarantee to largely eliminate uncertainty.

Another potential market failure is what is often thought of as the positive externality associated with home ownership. In this view, the benefits of home ownership extend beyond the individual household to the broader aspects of society, hence if left solely to the market the number of homeowners will be less than optimal. The broader societal benefits of home ownership that are often highlighted include things such as the propensity for homeowners to engage more in civic and political action; stronger neighborhood and social ties that accompany home ownership; the opportunity to build family wealth through home equity; and the willingness of homeowners to make improvements to their property, thereby increasing the value of their home and neighborhood. A common Government approach to increase market demand is to provide some type of subsidy or other assistance to encourage or facilitate such consumption. Direct subsidies to lower the cost of mortgage credit or easing the eligibility terms for a mortgage are methods of delivering subsidies through the housing finance market. Government policies beyond the housing finance market are also used to promote housing demand. Prominent among these is the mortgage interest tax deduction.

These policies demonstrate that as a Nation we are committed to providing opportunities for home ownership, and there may be other social goals where it is decided that Government support is warranted. The Federal Housing Administration (FHA) and other traditional Government credit programs are typically used to address credit market failures or to achieve public policy goals. If policy makers begin by defining the role FHA and other Government mortgage credit programs should play in the future in terms of which borrowers should have access to these programs, then it should be easier to consider the Government's role, if any, in the remainder of the mortgage market.

This is not dissimilar to the approach taken in other credit markets. Take business lending as an example. The Government provides support to address potential market failures or achieve other public policy goals through the Small Business Administration and through direct Government credit programs. The rest of the small business loan market is generally left to the private sector, and credit for larger businesses is generally provided without direct Government credit support. Other consumer credit markets, like auto loans, have little if any direct Government credit involvement at all.

However, a very important difference separates the single-family mortgage market from other consumer credit markets—the size of the overall market. As I mentioned earlier, there is currently around $9.9 trillion in single-family mortgage debt outstanding. A market of this size needs to draw on broader sources of capital to fund this level of activity. The single-family mortgage market has come to rely on the Enterprises as the mechanism for attracting capital.

With their statutory public mission of supporting a stable and liquid mortgage market, along with their low capital requirements, the Enterprises were long able to guarantee mortgage credit risk at a volume and price at which other market participants could not compete. They were also seen as having a public mission to promote the availability of mortgage credit, especially to support affordable housing.

Still, there seems to be relatively broad agreement that this Government-sponsored enterprise model of the past, where private sector companies were provided certain benefits and charged with achieving certain public policy goals, did not work. That model relied on investors providing funding for housing at preferential rates based on a perception of Government support, which ultimately turned out to be correct and has resulted in Enterprises' drawing $187.5 billion in funds from Treasury as of December 31, 2012.

Determining how to replace this flawed model—and developing an efficient secondary market that can access capital markets in order to serve that part of the single-family mortgage market that is not covered by traditional Government credit programs—is central to congressional consideration of ending the conservatorships of the Enterprises.

The options for consideration range from a market-oriented approach that would ensure broad minimum standards, to establishing a Federal backstop to provide liquidity when needed, to developing a Government guarantee structure to ensure stability in the flow of mortgage credit and limit market uncertainty. These options are not novel. They are essentially the three options that the Administration set forth in its white paper more than 2 years ago. Let me offer some thoughts on these three options.

Standard-Setting

This approach would replace some of the standard-setting that the Enterprises undertake today with a regulatory regime or a market utility that sets those standards and that are subject to rigorous supervision. This model would not rely on a Government guarantee to attract funding to the mortgage market, but would look to standardization and rules for enforcing contracts to provide a degree of certainty to investors. The focus in such an approach could be on setting standards around key features that investors need to know to be willing to price credit risk in the mortgage market. These include standards associated with underwriting, pooling and servicing, and disclosures.

Clearly, a standard-setting framework is much different than a framework that has a Government guarantee. Investors would be required to price the credit risk of mortgages. They also would be responsible for enforcing their rights under the standard contracts developed under this framework. Those requirements are consistent with the way that a private market functions. Arguably, this is part of the market oversight and investor protection regime that is already established in various securities laws overseen by the Securities and Exchange Commission.

Part of the question here is, given the size of the single family mortgage, and the unique characteristics of today's agency securities market, in particular the To-Be-Announced market, would additional standard-setting measures enhance liquidity and provide further structure to the market? An important question to consider is whether there are other areas in terms of monitoring or compliance that could potentially broaden the investor base while still achieving the primary function of having private markets price credit risk?

To establish a liquid non- government-guaranteed market there would seem to be a need to have greater homogeneity in borrower characteristics. I would think such a market would broadly cover the bulk of the business that the Enterprises undertake today, but such a market might not be available to all borrowers currently served by the Enterprises. With greater transparency in requirements, it would give borrowers a clear sense of the qualification requirements. Traditional Government guarantee programs would still exist to meet various policy goals. And finally, for borrower characteristics that do not fit neatly into the secondary market, we need to find a way to get banks, thrifts, and credit unions back into the business of funding mortgages. Understanding individual borrowers and special circumstances is at the heart of the financial intermediation function of insured depository institutions. Whatever changes are made to the secondary market, I hope we preserve the option for local banks to make mortgages in their communities, and hold those mortgages on the bank's balance sheet. I would also note that the Federal Home Loan Banks give banks and other depository institutions access to credit across the maturity spectrum to assist in funding such mortgages on depository institution balance sheets.

Federal Backstop

In a standard-setting approach without a Government guarantee, it would be important to consider how such a market would operate in a time of stress. Having clear standards and greater transparency would certainly improve market operations, but there still could be cyclical swings that could broadly be of concern to the Government. Two potential concerns are:

- Preserving the availability of credit in times of stress is an important function. Is there a role for the Government, perhaps through the Federal Housing Administration to take on this role if necessary? Or alternatively, with a more standardized market and infrastructure, would it be possible for an existing guarantor, like Ginnie Mae, to play such a temporary guarantee function?
- Preserving liquidity in the market and the financial system in this framework would be an important function. Is there a need for a backstop source of funding when financial markets become temporarily illiquid? For example, could the Treasury Department, the Federal Reserve, or the Federal Home Loan Banks play a role in a market that had this type of standardized structure?

Government Guarantee

Finally, the third option is a secondary mortgage market operating with some type of Government guarantee. This is somewhat similar to what we have today. Clearly if the securities offered in a reformed housing finance market have a Government guarantee, those securities will be priced favorably and have a high degree of liquidity to reflect that guarantee. However, pricing for those securities would not provide the benefit of market pricing for credit risk of the underlying mortgages. In such a structure, private sector capital through equity investment would stand in a first loss position, with a Government guarantee that was funded through an insurance premium being available to cover other losses (much like with deposit insurance in the banking system). This type of structure requires a significant amount of regulatory safety and soundness oversight to protect against the moral hazard associated with providing a Government guarantee.

While such an outcome has certain merit and some attractive features, the potential costs and risks associated with this type of framework should be fully explored. Simply put, replacing the Enterprises' implicit guarantee with an explicit one does not resolve all the shortcomings and inherent conflicts in that model, and it may produce its own problems. As I have in past testimony, I offer three observations in this regard.

First, the presumption behind the need for an explicit Federal guarantee is that the market cannot evaluate and price the tail risk of mortgage default, at least at any price that most would consider reasonable, or it cannot manage that amount of mortgage credit risk on its own. But we might ask whether there is reason to believe that the Government will do better? If the Government backstop is underpriced, taxpayers eventually may foot the bill again.

Second, if the Government provides explicit credit support for the vast majority of mortgages in this country, it would likely want a say with regard to the allocation or pricing of mortgage credit for particular groups or geographic areas. The potential for Government involvement to distort the pricing of credit risk may subject taxpayers to further involvement if things do not work out as planned.

Third, regardless of any particular Government allocation or pricing initiatives, explicit credit support for all but a small portion of mortgages, on top of the existing tax deductibility of mortgage interest, would further direct our Nation's investment dollars toward housing. It would also drive up the price of housing, other things being equal. A task for lawmakers is to weigh such incentives and outcomes against the alternative uses of such funds.

Fourth, what will be the breadth and depth of regulatory authority and how is it exercised? For example, just how much capital should be maintained by a major mortgage market enterprise.

Finally, what I have just discussed relates to the single-family mortgage market. A similar type of analysis could be performed for the multifamily market.

Conclusion

Few of us could have imagined in 2008 that we would be approaching the fifth anniversary of placing Fannie Mae and Freddie Mac in conservatorship and that we have made little meaningful progress to bring these Government conservatorships to an end. The conservatorships were never intended to be a long-term solution. They were meant primarily as a "time out" for the rapidly eroding mortgage market—an opportunity to provide some stability while Congress and the Administration could figure out how best to address future reforms to the housing finance system.

The U.S. housing finance system cannot really get going again until we remove this cloud of uncertainty and it will take legislation to do it. Fannie Mae and Freddie Mac were chartered by Congress and by law, only Congress can abolish or modify their charters and set forth a vision for a new secondary market structure. While FHFA is doing what it can to encourage private capital to return to the marketplace, so long as there are two Government-supported firms occupying this space, full private sector competition will be difficult, if not impossible, to achieve.

I have been observing a developing "consensus" among private market participants that the conforming conventional mortgage market cannot operate without the American taxpayer providing the ultimate credit guarantee for most of the market. As I have noted, that clearly is one policy outcome, but I do not believe it is the only outcome to be considered that can give our country a strong housing finance system. I believe that our country and our financial system are stronger than that. I believe it is possible to rebuild a secondary mortgage market that is deep, liquid, and competitive; that is subject to appropriate supervision and regulation, and will operate without an ongoing reliance on taxpayers or, at least, a greatly reduced reliance on taxpayers, if that is what we set our minds to accomplishing.

Where lawmakers identify particular market failures requiring direct Government involvement, there may be more targeted approaches to addressing those issues than a broad subsidy to credit. For example, if certain borrowers or communities are of concern, taxpayer support could be targeted directly to support the building or purchasing of housing rather than indirectly through credit subsidies. Individual communities have already undertaken this approach, developing their own comprehensive list of challenges and potential solutions and bringing these to all parties involved with their communities.

I have said before, however, that these choices are for elected officials to make, not me. I am committed to working with this Committee, its counterpart in the House, and the Administration to make these policy determinations and then set about ending these conservatorships and transitioning to a future housing finance system that can serve our children, grandchildren, and beyond.

Thank you again for inviting me here today. I look forward to discussing these important matters with all of you.

PREPARED STATEMENT OF STEVE A. LINICK

INSPECTOR GENERAL, FEDERAL HOUSING FINANCE AGENCY

APRIL 18, 2013

Thank you, Chairman Johnson and Ranking Member Crapo and Members of the Committee on Banking, Housing, and Urban Affairs, for inviting me to testify here today. I appreciate the opportunity to update the Committee on the work of the Federal Housing Finance Agency Office of Inspector General (OIG).

OIG began operations in October 2010, in the midst of an unprecedented housing and financial crisis of historic proportions. Since our beginning, we have published 49 reports and have commenced multiple criminal and civil investigations.

Today, I will discuss emerging trends based on our work to date, discuss the challenges associated with ongoing uncertainty about the future of Fannie Mae and Freddie Mac, describe our operations, and answer the Committee's questions.

About OIG

OIG oversees FHFA's operations and programs. This oversight includes the Agency's regulation of the housing Government-sponsored enterprises (GSEs)—Fannie Mae, Freddie Mac, and the 12 Federal Home Loan Banks (FHLBanks); the GSEs' approximately 12,000 employees; as well as the conservatorships of Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac currently own or guarantee $5 trillion in mortgages. To date, they have received $187.5 billion in taxpayer money in order to ensure their continuing solvency.

OIG's mission is to promote the economy, efficiency, and effectiveness of FHFA's programs and operations. To carry out its mission, OIG conducts and coordinates audits and evaluations of FHFA's programs and operations. OIG also works to prevent and detect fraud, waste, and abuse in those programs and operations through investigations involving FHFA, Fannie Mae, Freddie Mac, and the FHLBanks. Important features of OIG's work are the promotion of transparency in FHFA programs and GSE oversight, as well as public understanding of matters affecting FHFA, the GSEs, and housing policy.

A. Emerging Trends

Since I last testified, we have seen a turnaround in the profitability of the Enterprises. This is the first period since 2008 in which the Enterprises, still under FHFA conservatorships, have returned to profitability; in 2012, they earned record profits of more than $28 billion.

1. FHFA Is Making Progress

FHFA has made progress in its role as conservator and regulator of the Enterprises across a variety of fronts. For example, FHFA has launched a number of initiatives intended to address key objectives, such as aligning Enterprise practices, improving service to borrowers, and conserving and preserving Enterprise assets. These initiatives include the Servicing Alignment Initiative, Uniform Mortgage Data Program, Joint Servicing Initiative, and lawsuits that FHFA has filed against 18 investment banks to recover investment losses incurred on residential mortgage-backed securities issued by those firms.

FHFA has also accepted and begun to implement the vast majority of our audit and evaluation report recommendations. For example:

- In December 2010, FHFA approved a buyback settlement with Bank of America in which the bank agreed to pay $1.35 billion to settle loan repurchase claims asserted by Freddie Mac. A subsequent OIG report raised concerns about the adequacy of the review of nonperforming loans for repurchase claims. Freddie Mac has since acted on our concerns and expanded its loan review process; it now believes that the expanded process may produce additional revenues ranging from $2.2 to $3.4 billion over 3 years.
- Since OIG's March 2011 report, FHFA has taken action to enhance its oversight and control of executive compensation. For instance, FHFA revised certain aspects of the compensation program, which, in the case of the Fannie Mae and Freddie Mac CEOs, significantly reduced their annual pay.
- In the aftermath of reports that the LIBOR rate affecting financial transactions was improperly manipulated, OIG began examining the potential impact of this manipulation on Fannie Mae and Freddie Mac. We concluded in a memorandum to FHFA that it was possible the Enterprises had suffered sizable losses, and we offered recommendations for Agency action to recover any such losses on behalf of the Enterprises. Subsequently, Freddie Mac has sued to recover its losses.

2. As Conservator FHFA Needs To Be More Involved in Enterprise Decision Making

Although the Agency has made progress, our work continues to show that FHFA can improve its role as conservator and regulator. As conservator of the Enterprises, FHFA's mission is to preserve and conserve Enterprise assets. Throughout our body of work we have identified instances in which FHFA has displayed undue deference to Enterprise decision making in its capacity as conservator. Without adequately testing or validating data, FHFA has at times deferred to the Enterprises regarding key matters under the conservatorships. We believe the Agency's actions in these cases reflect its approach as conservator to delegate most business decisions to the Enterprises. In each case, it relied upon review and corporate governance processes already in place at the Enterprises. However, we have concluded that some matters are sufficiently important to warrant greater involvement and scrutiny by the Agency. In some cases, the deficiencies have been remediated, but in other cases they still persist. For example:

- *Conservatorship decision making.* In a September 2012 report, we found that FHFA unduly relied on information provided by Fannie Mae when it issued a "no objection" response to Fannie Mae's last minute request to make a financial investment of between $55 and $70 million. Fannie Mae requested the Agency's approval as conservator to make the investment; FHFA approved the request that same day but stated that given the complex nature of the transaction and the short time frame for its decision, the Agency could not assess the reasonableness of the proposal.
- *Conservatorship decision making.* In the same report, we also found that over a 3-year period Fannie Mae took over 4,500 actions to increase the Enterprise's counterparty risk limits without first obtaining conservator approval, even though such approval was required and Freddie Mac had submitted such counterparty risk limit increases for conservator approval. We also found that FHFA had not discovered Fannie Mae's lapses. FHFA has subsequently revised its policies and procedures surrounding requests for conservatorship approval.
- *Underwriting.* In a March 2012 audit, we found that the Agency's oversight of underwriting, along with the accompanying variances that effectively further loosen underwriting standards, was limited; FHFA relied on the Enterprises to oversee and establish underwriting standards and to grant variances. Subsequent to our audit recommendations, FHFA established a formal process to review the Enterprises' underwriting standards and variances.
- *Transaction testing/exam capacity.* Transaction testing includes reviewing files to test the veracity of statements made by the Enterprises to examiners. In a September 2011 evaluation of FHFA's capacity to examine the GSEs, we found that examiners too often accept assertions made by Enterprise managers rather than independently validating such assertions through appropriate transaction testing.
- *Buybacks.* In approving the buybacks settlement discussed above, FHFA relied on Freddie Mac's analysis of the settlement without testing the assumptions underlying the Enterprise's existing loan review process. OIG found in a subsequent report that implementation of our changes may generate additional recoveries of $2.2 to $3.4 billion.

3. As Regulator FHFA Can Be More Proactive in Managing Risk

In multiple reports we identified instances in which FHFA was not proactive in risk management. In general, we have observed that FHFA has difficulties identifying new and emerging risks potentially affecting the GSEs, issuing guidance and regulations governing risk management at the GSEs, and providing strong and consistent enforcement for violations of policy. Some instances of risk management shortfalls identified by OIG have been addressed, nevertheless, FHFA still needs to do more to identify and manage risks and take enforcement action where warranted.

Identification of Risk

Our work has shown that the Agency's ability to identify new and emerging risks has been limited. Here are some examples:

- *Advances to Insurance Companies.* In a March 2013 report, we found that during the past 8 years, FHLBanks' advances to insurance companies who are FHLBank members have more than quadrupled—from $11.5 billion in 2005 to $52.4 billion in 2012. Lending to insurance companies may present unique risks compared with lending to other FHLBank members. Yet, neither FHFA nor the FHLBanks obtain confidential supervisory or other regulatory information relating to insurance company members from State regulators or the National Association of Insurance Commissioners.
- *Default-Related Legal Services.* In a September 2011 report, we found that there were indicators as early as 2006 that could have led FHFA (and its predecessor) to identify the heightened risk posed by foreclosure abuses associated with Fannie Mae's default-related legal services network. The indicators included the rise in foreclosures accompanying the deterioration of the housing market, increased consumer complaints alleging improper foreclosures, contemporaneous media reports of foreclosure abuses, and public court filings in Florida and elsewhere critical of such abuses. Notwithstanding these indicators, FHFA did not devote attention to the foreclosure abuse issues until August 2010. The Agency is now implementing changes intended to rectify that oversight.

- *REO.* In a July 2012 report, we found that since 2008, FHFA has consistently listed the Enterprises' large inventories of real-estate owned (REO) properties acquired in the foreclosure process as contributing to "critical concern" ratings in their quarterly risk assessments. FHFA did not conduct targeted examinations or focused reviews of REO until 2011. FHFA's eventual targeted examinations in 2012 were positive supervisory steps, but expanding the scope of the assessments to evaluate more risks can help the Agency improve its supervision of real-estate owned.

Risk Management

The Agency has not always managed identified risks by establishing sufficient regulations or guidance.

- *Servicing.* In a September 2012 report, we found that FHFA has not timely addressed known risks presented by mortgage servicing contractors. For example, FHFA has not developed sufficient regulations or guidance governing the Enterprises' oversight and risk management of counterparties, such as servicers. Specifically, FHFA had not established and implemented effective Enterprise regulations or guidance for controlling the reporting of critical servicer information and establishing baseline requirements for mortgage servicing. Instead, FHFA relied on the Enterprises to monitor counterparty risk as part of their ongoing risk management activities. Although FHFA has made progress in this area, servicing remains an ongoing challenge.
- *High-Risk Seller/Servicers.* In a September 2012 report, we found that FHFA has not addressed known risks presented by mortgage seller/servicers by developing sufficient regulations or guidance governing the Enterprises' oversight and risk management of such counterparties. The Enterprises work with numerous seller/servicers for post-origination mortgage work, such as collecting mortgage payments. These seller/servicers represent a significant risk to the Enterprises. Specifically, FHFA has not published standards for the development of contingency plans related to failing or failed high-risk counterparties. Counterparty contingency plans will not eliminate losses, but they can serve as a road map to help reduce the Enterprises' risk exposure. Managing such seller/servicer risk is important, as the Enterprises have incurred losses of $6.1 billion from failures at just four of their counterparties since 2008. FHFA recently issued an advisory bulletin containing guidance and outlining criteria on written contingency plans.

Enforcement

Even when FHFA has identified risks and taken steps to manage those risks, the Agency has not consistently enforced its directives to ensure that identified risks are adequately addressed. As conservator and regulator, FHFA's authority over the Enterprises is broad and includes the ability to discipline or remove Enterprise personnel in order to ensure compliance with Agency mandates. OIG has reported that FHFA's supervision and regulation of the GSEs is strengthened by exercising this authority where warranted.

- *Operational Risk at Fannie Mae.* In a September 2011 report, we found that FHFA had not compelled Fannie Mae's compliance with directives requiring it to establish an effective operational risk management program. Fannie Mae's lack of an acceptable and effective program may have resulted in missed opportunities to strengthen oversight of law firms with which it contracts to process foreclosures.
- *Troubled FHLBanks.* Benefit of stronger FHFA enforcement also extends to FHLBanks. For example, since 2008 at least four FHLBanks have faced significant financial and operational difficulties which classified them as institutions with "supervisory concerns." In a January 2012 report, we determined that FHFA had not established a consistent and transparent written enforcement policy for troubled FHLBanks having such a classification. This contributed to instances in which FHFA may not have held such banks and their officers sufficiently accountable for engaging in questionable risk taking.
- *Unsecured FHLBank Lending.* In a June 2012 report, we identified FHFA's current regulation governing unsecured lending by the FHLBanks as possibly outdated and overly permissive, as well as noncompliant with the Agency's existing regulation. More specifically, FHFA did not initially pursue potential evidence of FHLBanks' violations of the existing regulatory limits and take supervisory and enforcement actions as warranted. OIG is currently conducting a follow-up report on this topic.

Recent Examples

Two recent OIG reports exemplify multiple aspects of FHFA's shortfalls in risk management:

- *Consumer Protection.* The Enterprises' seller/servicer counterparties contractually agree to comply with all Federal and State laws and regulations (including consumer protection statutes) applicable to originating, selling, and servicing loans. If a counterparty does not comply, the Enterprises can require it to repurchase the noncompliant loan. We found in a March 2013 report that FHFA does not examine how the Enterprises monitor compliance with consumer protection laws, and the Enterprises do not ensure that their counterparties from which they purchase loans comply with such laws. Because FHFA has not identified compliance as a risk, it has not issued any guidance to the Enterprises. Further, FHFA has not attempted to enforce compliance with contractual provisions. We recommended that FHFA develop a risk-based plan to monitor the Enterprises' oversight of their counterparties' contractual compliance with applicable laws and regulations. FHFA agreed with our recommendation.
- *Consumer Complaints.* The Enterprises pay mortgage servicers to collect payments, interact with borrowers, and handle their complaints. The more serious complaints are called "escalated cases" and include foreclosure actions that violate the Enterprises' guidelines, complaints that the borrower was not appropriately evaluated for a foreclosure alternative, and violations of the Enterprises' time frames for borrower outreach.

We found in another March 2013 report that between October 2011 and November 2012, Freddie Mac and its eight largest servicers received over 34,000 complaints that became escalated cases. A servicer's failure to quickly and accurately resolve these escalated cases can prevent foreclosure alternatives from being adequately explored with borrowers and may result in losses to the Enterprise.

In early 2011, FHFA announced its Servicing Alignment Initiative, which requires servicers to report on escalated cases they receive and resolve cases within 30 days of receiving them. We found that FHFA, Freddie Mac, and its servicers did not fulfill their respective responsibilities to address and resolve escalated cases. First, evidence suggests that most of Freddie Mac's servicers are not complying with reporting requirements for escalated cases. As of December 2012, 1,179 or 98 percent of Freddie Mac's servicers had not reported on any escalated cases even though they managed 6.6 million mortgages for Freddie Mac. Of Freddie Mac's eight largest servicers—which serviced nearly 70 percent of its loans—four did not report any information about escalated cases despite handling more than 20,000 such cases during the 14-month period between October 2011 and November 2012.

Further, of the 25,528 escalated cases resolved by the eight largest servicers during the 14-month period between October 2011 and November 2012, 5,372 or 21 percent were not timely resolved within 30 days. Additionally, Freddie Mac did identify this as a risk area yet did not implement independent testing procedures during its operational reviews of its largest national and regional servicers. As a result, it had findings related to escalated cases in only 1 of 38 reviews of its largest national and regional servicers that it conducted in 2012. Freddie Mac has also neglected to establish penalties (such as fines) for servicers that do not report escalated cases.

Finally, FHFA did not identify the foregoing problems through its own examination of Freddie Mac's implementation of the Servicing Alignment Initiative. Rather than independently testing servicers' compliance with complaint reporting requirements, the FHFA examination team relied exclusively on Freddie Mac's on-site operational review reports, which did not mention problems with servicer reporting. Thus, FHFA's examination of Freddie Mac's implementation of the Servicing Alignment Initiative did not identify servicers' failures to report escalated cases or resolve them in 30 days. Additionally, FHFA lacks guidance for examination teams to use when testing the implementation of directives, such as its Servicing Alignment Initiative.

To address and resolve escalated consumer complaints in a timely and consistent manner, we recommended that the Agency ensure Freddie Mac requires its servicers to report, timely resolve, and accurately categorize escalated cases; ensure that Freddie Mac enhances its oversight of the servicers through testing servicer performance and establishing fines for noncompliance; and improve its oversight of Freddie Mac by developing and implementing effective examination guidance. FHFA agreed with our recommendations.

4. FHFA May Not Have Enough Examiners

FHFA has critical regulatory responsibilities with respect to the GSEs and conservator responsibilities regarding the Enterprises. Nonetheless, in a 2011 report we found that the Agency had too few examiners to ensure the efficiency and effectiveness of its GSE oversight program; due to examiner shortages, FHFA had scaled back planned work during examinations, and examinations often took much longer than expected to complete. Additionally, we identified shortfalls in the Agency's examination coverage, particularly in the crucial area of REO. We also found that the majority of the Agency's examiners lacked the certification that is required at other Federal financial regulatory examination divisions. Although the Agency has made progress since we issued this initial report by reorganizing the examination function and hiring new staff, it is not clear that FHFA has achieved adequate resources. Many of our subsequent reports continue to recommend expanded or improved examination coverage. We have initiated follow-up work to determine FHFA's progress in staffing its examination teams.

B. Challenges Associated With Ongoing Uncertainty

We are mindful that FHFA's long-term success—and our ability to assess the enduring effectiveness, efficiency, and economy of the Agency's actions—is necessarily affected by the uncertainty surrounding the fate of the Enterprises and that of the housing finance system. In other words, FHFA must effectively direct the Enterprises' operations while fundamental questions about its role and theirs remain unanswered.

In September 2008, when Fannie Mae and Freddie Mac entered into conservatorships overseen by FHFA, it was generally assumed that FHFA's role as conservator would be temporary and short-lived. Yet, nearly 5 years later, Fannie Mae and Freddie Mac are still in conservatorships with no clear end in sight. Indeed, no one is sure how long the Enterprises will continue to exist in their current form or what their future roles, if any, will be. Thus, human resource issues have been and will remain a challenge for FHFA and the Enterprises. Not only does the uncertain future present a challenge in recruiting and retaining employees, the Agency and the Enterprises are hampered in making longer-term staffing allocations because their future roles remain uncertain.

Until the uncertainty is resolved, we will continue to focus on housing finance matters, such as managing risks and repaying taxpayers.

C. OIG Operations

1. OIG Audits and Evaluations

In addition to monitoring and reporting on FHFA's progress in implementing report recommendations, my office will continue to release new audits and evaluations covering key areas. OIG maintains an Audit and Evaluation Plan focused on the areas of FHFA's operations posing the greatest risks and providing the greatest potential benefits to FHFA, Congress, and the public. Originally developed with input from an independent, third-party risk assessment, the Audit and Evaluation Plan also takes into account the feedback we receive about our work from FHFA officials, members of Congress, and others. Broadly, OIG's audit and evaluation strategies include reviews of the following FHFA activities:

- Regulatory efforts and its management of the Fannie Mae and Freddie Mac conservatorships. The Enterprise conservatorships are particularly high-risk areas in which taxpayers have invested $187.5 billion to date. As conservator, FHFA must regulate and oversee the Enterprises in an efficient, effective, and transparent manner so as to minimize taxpayer costs, conserve and preserve Enterprise assets, and meet all statutory mandates.
- Oversight of the FHLBanks and their associated risks, including investment portfolio management and concentrations, credit underwriting, and administration.
- FHFA and GSE internal operations involving issues that relate to information security as well as allegations of fraud, waste, or abuse.

Given the Committee's interest, I want to highlight some of our projects that are currently underway. First, we are assessing a number of FHFA's new or expanded initiatives, including the Servicing Alignment Initiative, the proposed Common Securitization Platform for the Enterprises, the Fannie Mae REO pilot program, and HARP 2.0. Additionally, we are conducting further work to follow up on our December 2012 consumer protection report entitled "FHFA Should Develop and Implement a Risk-Based Plan to Monitor the Enterprises' Oversight of Their Counterparties' Compliance with Contractual Requirements Including Consumer Protection Laws". There, we assessed FHFA's oversight of the Enterprises' monitoring of seller/servicer compliance with their contractual agreements, with an emphasis on their compliance with Federal consumer protection laws. The next phase of our work will move from the Agency's oversight of the Enterprises to the Agency's oversight of servicers. However, I look forward to working with you and reporting our findings and recommendations in the coming months.

2. Investigations

Within OIG, the Office of Investigations is actively engaged in combating fraud, waste, and abuse. Thus far in FY2013 alone, the Office of Investigations' activities have led to 53 indictments and 26 convictions; since our work began the Office of Investigations' activities have led to 156 indictments and 62 convictions.

OIG works with law enforcement partners across the Nation, including other Federal agencies, U.S. Attorneys' Offices, and State and local agencies. While many cases remain confidential, we have released details about mortgage fraud investigations once public charges have been filed, as is the case with the prosecutions of Colonial Bank and Taylor, Bean & Whitaker Mortgage Corporation, American Mortgage Field Services LLC, and Home Owners Protection Economics, Inc.

The Office of Investigations currently has a variety of open criminal and civil investigations involving a wide variety of allegations of wrongdoing. The Office of Investigations focuses on FHFA and the GSEs, both internally and externally, concentrating on those individuals and organizations that have victimized either FHFA or the GSEs or borrowers with GSE loans. Many of the cases fall into one or more of the following seven categories:

- Fraud involving residential mortgage-backed securities
- Mortgage origination related frauds
- Mortgage modification frauds
- Fraud involving REO transactions
- Builder bailouts and condo conversions
- Fraud involving mortgage servicing contractors
- FHFA or GSE employee misconduct

Fraud involving mortgage-backed securities is a key area of focus. During the housing boom, the GSEs purchased and guaranteed hundreds of billions of dollars of residential mortgage-backed securities. Since the collapse of the housing market in 2007, those investments have declined precipitously in value. The GSEs may have been victims of fraud in instances when the quality and value of the underlying assets they purchased or guaranteed was misrepresented to them. OIG is an active member of the Mortgage Fraud Working Group formed last year, and has assisted in civil cases filed in the second half of 2012 against JPMorgan Chase and Credit Suisse.

Mortgage origination fraud includes cases when the GSEs have been defrauded as a result of misrepresentations relating to the quality of the loans sold. These misrepresentations occur at the time the loan is originated. For instance, OIG is assisting in a Federal civil case alleging that Countrywide in 2008 implemented a new loan origination process called the "Hustle," which was intentionally designed to process loans at high speed and without quality checkpoints, and which generated thousands of fraudulent and otherwise defective residential mortgage loans sold to Fannie Mae and Freddie Mac that later defaulted, causing over $1 billion dollars in losses and countless foreclosures.

Mortgage modification fraud targets financially distressed homeowners who are underwater or have fallen behind on their mortgage payments. Some frauds involve advance fee schemes that require the homeowner to pay a fee for participating in supposedly "official" programs that are in fact completely fictitious or improperly imply participation in a U.S. Government housing relief program. Other schemes are designed to force a distressed homeowner into default sooner than would otherwise be the case.

REO fraud may involve individuals connected to the foreclosure and subsequent resale of a property. For example, the Enterprises contract with asset managers to maintain and prepare the property for sale. But the asset managers may not maintain the properties and bill for fictitious maintenance expenses. REO fraud can also involve realtors who collude with investors or other realtors and appraisers to drive down the price of properties they are selling on behalf of the Enterprises.

Builder bailouts and condo conversions usually occur when a builder who obtained loans to build homes is unable to sell all the homes when built. To get rid of those unsold homes quickly, the builder may use a variety of illegal schemes, including using straw-buyers, paying undisclosed concessions to the buyer, or paying undisclosed marketing fees to brokers or real estate agents.

Fraud involving mortgage servicing contractors can include instances when a mortgage servicing contractor defrauds an Enterprise. For instance American Mortgage Field Services LLC was a property inspection company. From at least 2009 through March 2012, the president of American Mortgage Field Services and some of his employees submitted fraudulent reports describing numerous inspections of foreclosed properties that were paid for but never actually performed. Recently, American Mortgage Field Services' president was sentenced in Federal court to over 8 years in prison and ordered to pay over $12.7 million in restitution.

FHFA or GSE employee misconduct involves cases alleging misconduct by FHFA or GSE employees or contractors. For instance, in a recently filed Federal case, a Fannie Mae foreclosure specialist allegedly solicited $11,000 in payments from realtors in exchange for taking favorable actions.

Finally, I want to mention that the Office of Investigations operates the OIG Hotline, which allows concerned parties to report information directly and in confidence regarding possible fraud, waste, or abuse related to FHFA or the GSEs. OIG honors all applicable whistleblower protections. If anyone wishes to report allegations of fraud, waste, or abuse, the Hotline can be reached at 1-800-793-7724, by fax at (202) 318-0358, or through our Web site at *www.fhfaoig.gov.*

Conclusion

My staff and I look forward to continuing to work with your Committee to provide independent, relevant, and objective assessments of FHFA's operations and programs. The continuing fragility of our Nation's housing market remains a significant source of ongoing concern. Further, Fannie Mae, Freddie Mac, and the FHLBanks continue to be key market participants, and FHFA continues to face significant challenges. We are hopeful that our work will be of assistance in meeting those challenges.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM EDWARD J. DEMARCO

Q.1. You have begun building a securitization platform that will be jointly owned by Fannie Mae and Freddie Mac. Upon its completion you have stated that this platform will be built so that it may be used by not only Fannie and Freddie, but other entities wishing to securitize mortgages.

Please describe the circumstances that necessitated this project be undertaken at this time and the reasons why you believe it must be completed in a timely fashion.

A.1. The mortgage market today relies heavily on taxpayer support, with little private capital standing in front of the Government's risk exposure. Any transition from conservatorship will require a multiyear period, yet the Enterprises' outmoded proprietary infrastructures are in immediate need of being upgraded and maintained. An investment of capital—capital that would come from taxpayers through the Preferred Stock Purchase Agreements with the Department of Treasury—will be needed for this effort. To the extent possible, we are trying to ensure that taxpayer dollars are invested to this end once, not twice. The common securitization platform will allow the Enterprises to better adapt to market changes, issue nonguaranteed or partially guaranteed securities in scale that attract private capital (helping to reduce the Enterprises' dominant position in the market), more efficiently aggregate data, and lower barriers to market entry. Timely completion will facilitate the Enterprises' ability to meet critical goals outlined in FHFA's Strategic Plan for the Conservatorships, consistent with the Administration's call for a gradual wind down of the Enterprises. It will preserve policy options for Congress, while establishing a stronger foundation on which Congress and market participants can build to replace the preconservatorship GSE model.

Q.2. What is the legal authority under which this project was undertaken and under what statutory obligations must FHFA operate in completing the project?

A.2. This project is undertaken in FHFA's role as conservator for each enterprise; 12 U.S.C. section 4617.

Q.3. You have stated that the securitization platform will be owned by a company outside of Fannie Mae and Freddie Mac, but jointly owned by the two companies.

Please further describe the legal structure under which this company will be organized and ultimately operational.

A.3. The agency is considering a range of structures that would operate now as well as be available for future sale or other structural or operational changes.

Q.4. Did your legal obligations as Conservator play any role in determining how this entity would be constructed? If so, how and which obligations?

A.4. FHFA's role as conservator played a role. As the platform will be owned and operated by a company that is jointly held by the Enterprises, the company will be an asset of each enterprise and remain under the ongoing oversight of the FHFA.

Q.5. What other factors did you consider in determining this structure to be the best construct for the new platform?

A.5. We believe that setting up a new structure that is separate from the Enterprises is important for building a new secondary mortgage market infrastructure. Our objective is for the platform to be able to function like a market utility, as opposed to rebuilding the proprietary infrastructures of Fannie Mae and Freddie Mac. While the common securitization platform will serve initially as a replacement for some of the Enterprises' legacy infrastructure, its focus is on functions that are routinely repeated across the secondary mortgage market, where standardization has clear benefits to market participants. Being physically separate from the Enterprises, with an independent CEO and Chairman of the Board and a formal structure allowing for input from industry participants, should facilitate the platform's independence. This will help to meet the overarching goal of creating something of value that could either be sold or used by policy makers as a foundational element of the mortgage market of the future. In terms of the mechanics of how the common securitization platform will be built, we are using industry-standard data definitions and protocols and industry-standard technologies, leveraging existing industry software to the extent feasible.

Q.6. You have given a ballpark estimate of about 5 years for ultimate completion of the securitization platform project. You and I have both stated that we need to reform our housing finance markets and end the conservatorships of Fannie and Freddie long before that time.

If, however, Fannie, Freddie, and this new company remain in conservatorships after ultimate completion of the securitization platform project, what are the legal obligations of FHFA in the operation of the platform and the company who owns it?

A.6. The structure would continue to operate to the benefit of the enterprises and FHFA would continue its oversight.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM EDWARD J. DEMARCO

Q.1. The Inspector General's report noted that the "FHFA has displayed undue deference to Enterprise decision making . . . without adequately testing or validating data." You also stated in written testimony provided to the Senate Banking Committee on April 18, 2013, "that FHFA now has the executive management team, the organizational structure, and the staff necessary to carry out our safety and soundness mission." Is FHFA now in a position to test and verify enterprise reports and data so that it can spot issues before the IG brings them to FHFA's attention? Why or why not?

A.1. During 2012, we completed a realignment of our examination resources to strengthen our dedicated examination staff and to build upon our team of professionals who provide significant contribution to our examinations of the regulated entities. At the end of the March 2013, FHFA had a total of 194 employees who are devoted to the examination process at Fannie Mae, Freddie Mac (Enterprises), and the Federal Home Loan Banks and 120 of those examiners are dedicated full-time safety and soundness examiners.

FHFA is accomplishing its supervisory mission at the regulated entities, but is still evaluating the sufficiency of our staffing given the dynamic environment, and the significant amount of work that the Enterprises are doing to remediate their critical safety and soundness ratings as well as meet FHFA's expectations to meet our strategic goals. FHFA is continuing to attract and hire highly qualified examiners with the expertise needed to fill knowledge gaps.

FHFA has implemented a risk-based approach to examination planning to ensure that the regulated entities are identifying and mitigating key enterprise-wide business risks inherent in their business operations. We also modified our supervisory model to allow more flexibility for the examination teams to focus on key risk areas by requiring on-site examination teams at each Enterprise, and by implementing an ongoing monitoring approach to certain areas that require heightened supervisory attention throughout the examination cycle. While we cannot be certain that we will spot all issues, including some that the Inspector General may bring to FHFA's attention, we firmly believe that our supervisory program is focused on those risks that are critical to the safe and sound operations of the Enterprises.

Q.2. The IG noted in his testimony that: "Rather than independently testing servicers' compliance with complaint reporting requirements, the FHFA examination team relied exclusively on Freddie Mac's on-site operational review reports, which did not mention problems with servicer reporting. Thus, FHFA's examination of Freddie Mac's implementation of the Servicing Alignment Initiative did not identify servicers' failures to report escalated cases or resolve them in 30 days. Additionally, FHFA lacks guidance for examination teams to use when testing the implementation of directives, such as its Servicing Alignment Initiative."

Although the FHFA has agreed to the IG's recommendations to address these issues, what assurance can FHFA provide that when the recommendations are implemented, all major servicing issues will be sufficiently addressed at the enterprises?

A.2. FHFA is developing examination guidance for evaluating the Enterprises' compliance with FHFA-mandated initiatives such the Servicing Alignment Initiative. The guidance will provide instruction to plan and complete the independent examination work necessary to determine compliance with FHFA requirements that are the subject of examination activity. The guidance will also address steps to be taken should examiners identify instances of noncompliance.

FHFA's examination and supervisory efforts include on-site examinations at nonbank specialty servicers targeted to those with significantly sized loan portfolios that present higher risk to the regulated entities. The examinations are comprehensive and include evaluation of the compliance, audit, and risk management programs, including servicer eligibility, performance, and reporting.

Further, during 2012, FHFA directed the regulated entities to define new representations and warranties frameworks that include an enhanced quality control review process and enforcement of violations to credit policy. The representations and warranties framework sets forth clear and consistent standards and practices for the regulated entities to pursue certain remedies and, among other things, assigning remedy types and usage, including remedies for noncompliance. Mortgage servicers are critical counterparties and servicing activity, including the implementation of the new representations and warranties framework, is a priority focus of FHFA's examination program.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM EDWARD J. DEMARCO

Q.1. *On HARP and Menendez-Boxer Refi:* With the extension of HARP for an additional 2 years, which I applaud, is it not also time to reconsider administrative extension beyond the June 2009 borrower eligibility deadline? The deadline has already been changed once from March 2009 back to June 2009, and if you can indulge me, I would say that the program extension from 2012 to 2015, itself represents a substantive change that nullifies any perceived "Covenant with Investors." And to the extent there is a covenant, isn't your role within it to facilitate the best interest not only of investors, but of borrowers? Leaving the cut-off date as is, makes it appear that you weigh investors' interests above borrowers, who contractually are equals are they not?

A.1. FHFA has a strong commitment to keeping borrowers in their homes when possible. The overall intent of the Home Affordable Refinance Program (HARP) is to provide affordable refinancing opportunities for current eligible borrowers.

HARP has embedded certain programmatic flexibilities that are intended to benefit the borrower. For example, if a borrower has a loan-to-value ratio above 80 percent, the HARP flexibilities related to mortgage insurance (MI) allow the transfer of existing mortgage insurance to the newly refinanced loan or the servicer can waive the MI coverage requirement on the new loan when coverage was not placed on the original loan. Since program inception, these flexibilities have allowed more than 2 million borrowers the ability to refinance their loans (*See* May 2013 FHFA Refinance Report at *www.fhfa.gov/webfiles/25375/May2013RefiReport.pdf*). Absent these flexibilities, a borrower would be required to make a downpayment, often significant, in order to cure their negative equity position before refinancing or to pay for new MI coverage.

While FHFA recently extended HARP through 2015, this action does not increase the eligible population, but rather provides eligible borrowers with additional time to take advantage of historically low interest rates through refinance. The minor adjustment made earlier to the cut-off date was done to align Fannie Mae's and Freddie Mac's practices in order to reduce confusion among lenders. The fixed date is consistent with the Administration's and FHFA's intent that HARP reduce credit risk in the Enterprises' books of business. By mid-2009, house price declines were widespread and had already reached or were near their ultimate bottom in most markets. Furthermore, interest rate declines, facilitated by central bank actions, were already well underway. Therefore, we currently do not have plans to extend the borrower eligibility date beyond loans acquired by the Enterprises before May 31, 2009. Such an action would generate a fairly small increase in the number of eligible borrowers. Our position in keeping the borrower eligibility date at May 31, 2009, is a function of balancing the impact on the borrower and the taxpayer, market and investor. The current May 31, 2009, eligibility deadline provides a clear cut-off point which contributes to investor confidence. This level of certainty allows investors to estimate the likelihood of prepayment. If the May 31, 2009, eligibility date were to change, and prepayment confidence was reduced, investors may react in a way that results in higher borrowing costs to all future borrowers. Therefore, given the small size of the additional population that could be served, we do not believe that expanding the eligibility is in the best interest of homeowners in general or the taxpayer.

Q.2. Let me further enquire about the extension of the program eligibility. And maybe you can clear a few things up for me . . . but aren't borrowers who took out loans after June 2009, who had sufficient equity when they took out their loans, given a contractual option to prepay or refinance that due to this eligibility rule—they cannot now exercise? It would seem also that any savings they may have enjoyed through a HARP refinance are instead being transferred directly to investors through higher interest payments. Is it not true then, if the date is not extended, those investors bear neither credit nor prepayment risk, and the GSEs are left with all of the risk? Again, I must point out that the optics of the situation is one where investors are enriched while borrowers are diminished and taxpayers are exposed to unnecessarily high risk. What are your thoughts?

A.2. The program eligibility date of May 31, 2009, was originally established with President Obama's initial announcement of HARP as a component of the Making Home Affordable Program in February 2009. The program was designed as an exceptional response to exceptional circumstances. The program has not removed or restricted any contractual rights of borrowers, but has, on the contrary, provided them with unprecedented benefits by making it possible for millions of homeowners to refinance without new or additional mortgage insurance. The exceptional circumstances were that both interest rates and house prices had fallen sharply and housing markets were in crisis. Currently, markets have begun to recover and borrowers with loans originated in the past 4 years are much less vulnerable to market fluctuations with much lower interest rates than those with precrisis loans and have suffered relatively small house price declines or in some cases benefited from appreciation. Government-aided refinance in this environment risks investor alienation with long-run costs to borrowers outweighing short term benefits. In short, there appears to be no meaningful market-based obstacles to borrowers who first obtained their mortgages after May 31, 2009, from refinancing in the normal course.

Q.3. *On Principal Reduction:* As part of the Emergency Economic Stabilization Act of 2008, Congress directed FHFA to "maximize assistance for homeowners" and "to minimize foreclosures," and it granted explicit authority to modify mortgage loans through the "reduction of loan principal." Given this mandate, why has FHFA repeatedly decided against principal reduction? Why wouldn't you at least consider this policy for GSE portfolio loans?

A.3. FHFA has considered principal forgiveness in the context of loan modifications several times. We conducted and publicly posted thorough analyses that are available on the agency Web site, and which showed small savings to taxpayers in comparison to the significant cost of implementing a principal forgiveness program. These analyses did not specifically target portfolio loans versus those that were securitized. All of the Enterprise delinquent loans are serviced by the same set of servicers who would be expected to apply a new modification program in a unique manner. That said, FHFA and the Enterprises have spent a great deal of time developing standard loss mitigation solutions to ensure consistency for all struggling homeowners. A policy that provides a specific loss mitigation tool or strategy for borrowers based on whether a loan is held in portfolio or in a security creates disparate treatment based on factors outside a borrower's control and would be complicated for servicers to manage.

Separately, the Enterprises regularly forgive principal indebtedness in the context of short sales and deeds-in-lieu of foreclosure.

Q.4. One factor you have cited for your rejection of principal reduction modifications was "implementation costs," saying the modifications would present "operational challenges" and would be "costly and time consuming to implement." Those are germane managerial concerns, but can you provide Congress with the documentation supporting this analysis? If I enquire with GAO to substantially investigate the methodology used to come to your conclusion, would you be able to provide them with this documentation?

A.4. In conducting the latest analysis, FHFA took into consideration: current loss mitigation tools; costs and benefits of using principal forgiveness, including the economic benefit or costs to the Enterprises as well as to taxpayers; the impact on borrower behavior; direct and indirect implementation costs; and, the overall impact on the mortgage market. Included below is a link to the latest analysis conducted by FHFA, as well as links to the analysis performed by each of the Enterprises on the cost and time to implement such a program.

- *www.fhfa.gov/Default.aspx?Page=403*
- *www.fhfa.gov/webfiles/24107/PF__FannieMae71312.pdf*
- *www.fhfa.gov/webfiles/24109/PF__FreddieMac73112.pdf*

Q.5. *On Forced Place Insurance:* How and when does the FHFA expect its ban on insurer to bank commissions to translate to lower rates, since your plan only amends the current process? Wouldn't Fannie Mae's plan that was denied by the FHFA a few months ago, have done away with the issue by directly contracting for the insurance itself?

A.5. On March 29, 2013, FHFA published a notice in the Federal Register expressing the agency's reservation with these practices and solicited public input to expand our understanding. Forty-two comments were received on the notice from a broad range of stakeholders. FHFA has reviewed these comments and plans to take action by the end of the year. In fact, Fannie Mae's proposal would not have done away with the issue. One of the reasons that FHFA did not approve Fannie Mae's plan is because Fannie Mae lacked the infrastructure to execute that proposal.

It is important to understand that issues involving LPI extend well beyond Fannie Mae and Freddie Mac. By taking a more inclusive and comprehensive approach to these issues, FHFA hopes to provide leadership in reaching a broader set of solutions and best practices that may be adopted by other State and Federal regulators and more broadly by market participants than simply a Fannie Mae-only approach.

To address the concerns with LPI more broadly, in April, FHFA convened a regulatory working group composed of various Federal and State regulators. The working group recently met with stakeholders to discuss concerns and possible solutions about the force-placed insurance market. We are also exploring whether the Enterprises' should have access to contractual documents between the mortgage loan servicers and the force-placed insurance carriers, which would provide a better understanding of the various fees charged and paid and the contractual relationships between the parties. These projects are in their early stages and the regulatory working group is expected to complete its tasks in the third quarter of 2013.

Q.6. Would banks still be able to accept free tracking of services from insurers? As I understand it, insurers generally monitor bank loan portfolios for both lapses in property insurance coverage and other things, such as unpaid taxes—at a considerable subsidy for the banks. How might you deal with this issue?

A.6. FHFA is concerned that current industry practices may include a number of inappropriate financial incentives based on relationships between servicers and carriers that result in excessive premiums being charged to the borrower or investor. This issue is under discussion by the regulatory working group and may be subject to data reporting requirements now under development.

Q.7. It has been shown that within the bank-insurer business loop; that sometimes banks own the mortgage insurers they contract with, or reinsure them, potentially allowing them to make even more money off of inflated insurance premium commissions. What are you specifically doing about this? Why hasn't there been greater scrutiny and demand from the FHFA for more transparent insurance procurement and invoicing, something we understand the GSEs currently have no say or ability to manage?

A.7. FHFA is concerned that such reinsurance practices involving conflicts of interest pose risks to the Enterprises or run contrary to the duties of the conservator. Accordingly, on March 29, 2013, FHFA published a notice in the Federal Register expressing the agency's reservation with these practices and solicited public input to expand our understanding. Forty-two comments were received on the notice from a broad range of stakeholders. FHFA has reviewed these comments and plans to take action by the end of the year.

Q.8. What has the FHFA specifically done to concretely explore other changes to force-placed insurance? Who is guiding that process? When will they come up with conclusions?

A.8. As described above in response to other questions, FHFA is taking a multipronged approach to addressing the issues presented by LPI. The steps we are taking, led by our Office of Housing and Regulatory Policy in the Division of Housing Mission and Goals, include:

- Assessing and analyzing the costs and risks associated with LPI.
- Establishing an interagency working group of Federal financial institution regulators and State insurance regulators to learn from each other's experience on LPI and identify, align, and act on needed reforms and protections for taxpayers and borrowers.
- Publishing a Federal Register Notice requesting comments by May 28, 2013, on whether FHFA should direct the Enterprises to cease reimbursing lenders for two LPI practices, broker commissions and captive reinsurance.
- Reviewing of contracts between mortgage loan servicers and LPI carriers, to better understand fees charged and paid and the contractual relationships between the parties.

FHFA expects to have conclusions and next steps from all of these activities by the third quarter of this year.

Q.9. *On State-Level Guarantee Fee Adjustments:* Many servicers and third-party law firms were allowed to robo-sign foreclosures on GSE-guaranteed loans because they were being inadequately overseen by the Enterprises, and, in turn, FHFA as their regulator. Because these abuses occurred, many States passed reasonable laws to crack down on fraud. Rather than punishing new borrowers in these States by increasing g-fees, wouldn't it make more sense for the Enterprises, under your direction, to properly supervise servicers? If consumer protections are not your end goal, which is an assertion I do not support, but if they aren't—isn't it still your duty as a conservator to work with State and Federal regulators to ensure that consumer protections are adequately in place rather than shouldering that burden on future borrowers without a full review of the total costs versus benefits to taxpayers?

A.9. Serving consumer needs and providing appropriate consumer protections are essential to well-functioning mortgage markets. FHFA has required the Enterprises to take a lead role in ensuring major changes in servicing standards and practice. For example, FHFA and the Enterprises led the way in directing servicers to stop taking foreclosure actions at the same time that they were actively considering loan modifications and in penalizing servicers that don't seek early modifications where possible. We continue to work closely with other Federal regulators to make the servicing process work better. We also recognize that States have important roles and interests in consumer protection and in foreclosure processes. In some cases, the States make difficult decisions about what protections make sense and work well, and what measures raise costs without much corresponding benefit, as well as how much money to spend on courts with crowded calendars.

Foreclosure costs vary widely across States. As credit risk takers, the Enterprises incur those costs on the loans they own or guarantee. Under conservatorship, those costs are passed on to taxpayers unless the Enterprise prices reflect them. If the fees are the same in all States, consumers in some States are paying for the effects of laws and practices in other States. And while poor servicing practices may contribute to costs in all States, we have not seen evidence that servicing is systematically worse in some States than others.

Q.10. Primary factors cited in FHFA's proposal as increasing State foreclosure timelines are "regulatory or judicial actions," and "legal and operational expenses." Yet your Notice contained no analysis of whether the laws and ordinances in place in various States are actually causing the longer foreclosure timelines. What about the study and reduction in fees where State and local laws actually reduce investor and guarantor costs?

A.10. The fees discussed in the Notice are based on the actual costs experienced by the Enterprises, mainly because of longer foreclosure times. The fees were designed to offset unusually high costs in States that exceed the nationwide norms by large margins. They were not designed to target any particular actions or practices, just to insulate consumers in most States from the exceptional costs in a few other States. To put this in perspective, consider that four States that together have 19 percent of Enterprise loans and 20 percent of loans with relatively less serious delinquencies of between 30 and 89 days, have 52 percent of Enterprise loans delinquent more than a year. Many of those extend to multiple years. Whatever the particular configuration of consumer protection and investor protection laws in those States, there is no denying that those States are statistical outliers that are driving up credit losses for Federal taxpayers.

Q.11. *On the National Housing Trust Fund and GSE Profitability:* The National Housing Trust Fund was authorized by the Housing and Economic Recovery Act of 2008 (HERA). The law called for the Housing Trust Fund to be funded by contributions from the Government sponsored enterprises (GSEs) Fannie Mae and Freddie Mac. However, the GSEs went into conservatorship shortly after the Trust Fund was authorized, and FHFA temporarily suspended the contributions due to the financial conditions experienced by the GSEs at the time. The GSEs have reported profits for several consecutive quarters. Given this return to profitability, will FHFA be directing the GSEs to start making contributions to the National Housing Trust Fund? If not, why not? Do you have the legal authority to continue suspending the payments considering that the GSEs are now profitable?

A.11. The trust funds and other requirements of the Housing and Economic Recovery Act contemplate action by FHFA in line with all conservatorship policies. The conservatorship authorities of the Act authorize extraordinary actions by the Director and any activity undertaken under normal circumstances falls within the ambit of the Director for modification, suspension or other direction in line with the conservatorship goals and obligations of the Director.

FHFA as conservator has plenary authority to make all business decisions for each Enterprise, including whether to fund the Housing Trust Fund and Capital Magnet Fund set asides. Decisions of the Director as conservator not to set aside money for the funds are consistent with the obligations of the conservator to preserve and conserve enterprise assets, to protect the investments of the taxpayers and to stabilize the Enterprises and maintain their market presence.

The Enterprises are sustained only by the backstop provided by the taxpayers pursuant to the Preferred Stock Purchase Agreements with the Treasury Department. The Enterprises are required, in exchange for the backstop that keeps them out of receivership and operating as businesses, to pay to the taxpayers, through the Treasury Department, a quarterly dividend, initially computed as a percentage return on the amount invested. The dividend requirement has never changed, but because the computation of the dividend resulted in a perverse circular pattern of requiring more investment just to pay the dividend, the computation of the dividend changed. It now is computed as all net worth reported quarterly. The new method of computing the dividend payment is more in line with traditional dividends—contingent on positive earnings and determined by the amount of earnings. It does not change the fundamental situation facing the Enterprise. Further, if an Enterprise does not earn a profit or if an Enterprise suffers a loss, no dividend will be paid for that quarter and a draw on Treasury may be required.

The financial condition of the Enterprises remains poor and a matter of "critical concern." The statute governing the trust funds provides for nonpayment when such a transfer would lead an Enterprise to fall within the "undercapitalized" status. Today, both Enterprises will be "critically undercapitalized" immediately following their next dividend payments, a classification that would require receivership, and each would be seriously insolvent without massive taxpayer investments. Their current status is well below undercapitalized, the statutory standard for suspension of payments.

Conditions requiring conservatorship have continued and the capital weakness is readily apparent by Enterprise dependency on the taxpayers to avoid liquidation through receivership. Suspension of the set asides is expressly anticipated in these circumstances and the conservator's decision not to fund the set asides is fully consistent with the Director's obligations under the law. Because of the all of the above considerations, no change in FHFA policy on the Trust Fund has been made.

Q.12. How might the forthcoming "Jumpstart the GSE" reform bill being offered by my colleague Senator Corker, affect the current Senior Preferred Stock Purchase Agreements with Treasury? How does it affect any potential payments to the Housing Trust Fund?

A.12. S.563, "Jumpstart GSE Reform", does not have any effect on the current state of conservatorship or the terms of the Preferred Stock Purchase Agreements (PSPAs). The bill will ensure that the returns on investment that the taxpayers funded through the PSPAs with each Enterprise continue to benefit the taxpayers at least until and unless both the Legislative and Executive branches agree on reform of the secondary housing finance market and the role of Government support for that market. It will also require that the reform debate include discussion of whether and how to terminate the support provided by that investment and the agreements.

This bill does not appear to have any effect on payments to the Housing Trust Fund.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR HAGAN FROM EDWARD J. DEMARCO

Q.1. Since conservatorship began, the FHFA, Fannie Mae, and Freddie Mac have proposed or implemented several policy initiatives that could have short-term market implications and longer-term implications for secondary market reform. As conservator for Fannie Mae and Freddie Mac, and in light of their market dominance, what steps are being taken to ensure adequate transparency in the development and implementation of major policy initiatives at FHFA, Fannie Mae, and Freddie Mac?

A.1. FHFA considers transparency and public input an important element in developing policy that impacts the housing finance system and the stakeholders within it. When considering major policy initiatives, FHFA has made extensive use of industry outreach and formal requests for public input through *Federal Register* notices and other means. FHFA also meets with various industry participants as it develops and deploys new policy initiatives. For example, FHFA met with a large number of market and Government entities in working towards its servicing alignment initiative, in discussions around new mortgage insurance standards to enhance the quality of such coverage, and in developing a common securitization platform. FHFA continues to reach out to industry participants in meetings at the agency or at industry meetings to provide outlines of agency directions and plans with community groups and other interested parties.

FHFA also continues to make extensive use of *Federal Register* publications to alert interested parties in actions it anticipates taking. Through these notices, FHFA both explains its direction and the rationales and provides an opportunity for public input. By providing a clear direction, the public is better able to focus its input, rather than seeing a general set of options that might be considered. This improves the nature and quality of public input and generates better discussion of alternatives for agency consideration. Two major examples have been a notice relating to proposed increases in Enterprise guarantee fees and a notice on proposed actions regarding lender placed insurance.

Finally, FHFA has used public communications to Congress (letters, reports, testimonies), speeches, and public documents such as the Strategic Plan for Enterprise Conservatorships, to inform the public of the goals and priorities of the conservatorships.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM EDWARD J. DEMARCO

Q.1. Mr. DeMarco, one of the three pillars of the FHFA's strategic plan and a large component of 2013 Conservatorship Scorecard focuses on contracting the GSEs' dominant presence in the market.

What progress have Fannie and Freddie made in meeting this year's goals established in the Conservatorship Scorecard to shrink their presence?

A.1. Both Enterprises are on track or exceeding the targets for portfolio reduction that were accelerated by the amendments to the Treasury agreement late last summer. Further, the Enterprises have been working on deal structures and contractual framework for multiple avenues of credit risk transfer through the capital markets and insurance companies. To increase transparency and facilitate market analysis both Enterprises have released significant loan level historical data that would be of use to prospective investors. We will continue to monitor this activity closely and can provide an update later in the year if you would like.

Q.2. The $30 billion target you set in the Conservatorship Scorecard for risk-sharing of single-family guarantees is a small amount compared to the overall holdings of Fannie and Freddie.

What process do you hope this will initiate at the GSEs?

A.2. Currently, taxpayers bear the risk of default on roughly 90 percent of all new mortgages, with Fannie Mae and Freddie Mac accounting for most of that amount. The risk-sharing initiatives being undertaken at the Enterprises are designed to explore mechanisms that transfer some of that risk to the private sector. More experience with alternative transaction types likely will make possible improvements in transaction structures, while the private sector will be stimulated to expand its capacity to absorb such risk.

Gradually, the Enterprises should be able to transfer increasing portions of the credit risk away from taxpayers.

Q.3. What steps can be taken to ensure the risk-sharing practices that are prevalent in the multifamily housing are utilized in single-family housing?

A.3. Some of the mechanisms the Enterprises are exploring are similar to those used in multifamily transactions, but they are looking at others as well. The goal is to find those that work best in the single-family market.

Q.4. How do you anticipate growing this $30 billion target for next year?

A.4. With the experience gained this year, the Enterprises should be able to make improvements in both the products they offer and in their internal processes. Perhaps more importantly, as financial markets and institutions become more accustomed to such products, they will likely build capacity to absorb them. We intend to expand beyond the $30 billion target in 2014 but do not anticipate establishing those targets until later this year, after we review our initial results.

Q.5. You intended for the unified securitization platform to be built separately from the two companies so that it can utilized by both the GSEs and the private sector. Historically, however, the Government has a dismal track record in containing costs for technological improvements.

What measures are being implemented to ensure the development costs will be contained?

A.5. This project is not a Government technology project. We are currently leveraging the Enterprises as the "general contractor" on this project, and they in turn are using both subject matter experts from within their firms and third party specialist contractors to run the project. We are undertaking careful monitoring of the project schedule, scope, and budget to ensure it is executed successfully. In due course we plan to house the technology project in a joint venture to further ensure its independence, and it will operate as a "private sector" firm but with Federal oversight.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM EDWARD J. DEMARCO

Q.1. Mr. DeMarco, at the hearing you described to the Chairman that the FHFA has developed a streamlined modification program that does not require verification of employment or income. As you know Senators Menendez and Boxer are considering legislation to change FHFA's streamlined refinance program. Do you believe eliminating the income and employment verification for refinances makes sense also and please explain your reasoning?

A.1. The streamlined modification program targets delinquent borrowers (90 days or more). Servicers have learned from experience that it is difficult to connect with homeowners that far behind on payments to work out a modification. In these cases, the current servicer already has borrower information, including payment history. The servicer can send an offer for a modification directly to the homeowner if he or she qualifies for a streamlined modification.

In contrast, the Home Affordable Refinance Program (HARP) is available only to homeowners who are current on their mortgage and creates a brand new mortgage loan. HARP refinances can be completed by the current servicer or any lender who participates in the program (called cross-servicers).

I believe FHFA's recent changes to the HARP program have addressed the concerns Senator Menendez has about cross-servicer participation. Current HARP program data show more cross-servicer participation in HARP than in traditional refinances. To date, about 30 percent of HARP originations have been cross-servicer transactions. During the same time period, about 20 percent of non-HARP refinances were cross-servicer transactions.

All servicers—current servicers and cross-servicers—have the same requirements for income and employment verification. Only the process differs. The current servicer has access to borrower information in its own databases, including payment history, and completes employment and income verification using a verbal verification of employment. Cross-servicers do not have access to the same information, so they must verify employment and income with a pay stub. We believe it benefits consumers to have lenders verify that a borrower does have some income to make mortgage payments. If a borrower has no income or assets he or she may be better served through a modification.

More importantly, cross-servicers must have the borrower's income to use Fannie Mae's or Freddie Mac's automated underwriting systems (AUS), which simplify the loan origination process but require an income figure. The AUS tools transmit key eligibility data to cross-servicers, including: borrower payment history, loan delivery date, property value, and mortgage insurance coverage. Without the benefit of these AUS tools, cross-servicers would be required to collect this eligibility information elsewhere.

It would take at least 6 months of information technology development time to modify the automated underwriting tools to accommodate the changes the Menendez-Boxer bill would require. Servicers will also have to receive clear information about those new statutory requirements and implement the new system.

All of this would happen at a point in time when there is tremendous momentum with the HARP program. I am very concerned about impeding the substantial progress we are making through HARP if the bill should pass, because I do not believe the changes specified in the bill will increase the number of people we can help.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM STEVE A. LINICK

Q.1. There were several trends identified in your reports relating to deficiencies at the FHFA, most of which appear to fall within the category of the FHFA giving undue deference to the Enterprises' decision making in a variety of areas. What changes, if any, have been implemented by the FHFA that are geared towards breaking the cycle of reliance on the Enterprises' decision making? What additional changes need to be made?

A.1. As I noted in my testimony, although the Agency has made progress, throughout our body of work, we have identified instances in which FHFA has displayed undue deference to Enterprise decision making in its capacity as conservator. For example, without adequately testing or validating data, FHFA has at times deferred to the Enterprises regarding key matters under the conservatorships, and we have concluded that some matters are sufficiently important to warrant greater involvement and scrutiny by the Agency.

In September 2012, we released a report that found that FHFA can better accomplish its oversight mission by proactively exerting greater control over its conservator approval process. In that report we recommended that FHFA:

- Revisit the nondelegated authorities to ensure that significant Enterprise business decisions are sent to the conservator for approval;
- Guide the Enterprises to establish processes to ensure that actions requiring conservator approval are properly submitted for consideration;
- Properly analyze, document, and support conservator decisions; and

- Confirm compliance by the Enterprises with conservator decisions.

In response, FHFA reassessed and issued revised nondelegated authorities, expanding the number and type of actions that require conservatorship approval. FHFA also issued revised conservatorship policies and procedures covering a number of areas, including submitting items in a timely manner to allow sufficient time for FHFA review, using Acting Director recommendation memoranda to establish business case analyses and substantiate decisions, and requiring notification of material deviation from conservator decisions or important new information. FHFA has work underway to implement the remaining recommendations from the audit.

Overall, FHFA continues to make progress on a number of specific recommendations from our body of work, including other reports in which we have observed examples of undue deference. In some cases, recommendations have already been closed as completed, and in other cases, the Agency continues to work on implementation. In general, though, we continue to encourage FHFA to embrace more fully the philosophy behind our recommendations, which is that as conservator the Agency should engage in greater involvement with and scrutiny of matters that go to the heart of the conservatorships.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM STEVE A. LINICK

Q.1. *On Forced Place Insurance:* Fannie Mae recently approached the FHFA with a well-researched and well-defined proposal for taking over the solicitation and procurement of hazard insurance on its portfolio properties. This proposal, on its face, would have saved taxpayers and borrowers money while protecting the property assets. On what basis was this proposal rejected? How long did the FHFA consider this issue before making its determination?

A.1. As Acting Director DeMarco noted in his testimony, FHFA is currently working on a project to develop an aligned set of standards for lender-placed insurance to address certain practices. I would defer to Acting Director DeMarco to explain FHFA's ongoing project, as well as the basis for rejecting Fannie Mae's proposal and the consideration that went into making that determination.

Q.2. *On the Housing Trust Fund Payments From GSEs:* To the extent you are aware, can you discuss what your office has found to be administrative or legislative roadblocks to meeting the Section 1337 HERA requirements that the Housing Trust Fund be funded from new business at Fannie and Freddie Mac?

A.2. At this time, we have not undertaken work related to the housing trust fund, therefore I am unable to respond.

Q.3. The FHFA Director, outlined in Section 1337(b) of HERA, is only allowed to temporarily suspend payments to the HTF if the Director finds that three conditions are met: that the contributions would undermine the financial stability of the Enterprises, they would cause the Enterprises to be undercapitalized, or would prevent the Enterprises from completing a capital restoration plan.

Has your office explored this issue and if so, has it found that payments to the HTF would violate these provisions? With the Enterprises' financial support of the new Single Securitization Platform, and their new found profitability—I suspect that they wouldn't.

A.3. At this time, we have not undertaken work related to the housing trust fund, therefore I am unable to respond.

Q.4. A report from your office on March 20th, 2013, that analyzed the amendments to the Senior Preferred Stock Purchase Agreements between Treasury and FHFA, claimed that "the changes to the PSPAs help to safeguard policy makers' options to reform the role of the Enterprises in the Nation's secondary mortgage market." Could you elaborate on that opinion?

A.4. As we noted in our report, the announcement of the 2012 PSPA Amendments emphasized three overarching themes: (1) benefits to taxpayers; (2) the continued flow of mortgage credit; and (3) winding down the Enterprises.

To some extent, the 2012 Amendments provide the mechanisms to achieve these goals. For example, the replacement of the 10 percent dividend with the sweep of quarterly net worth may result in more money being returned to Treasury and hence to taxpayers. The elimination of the circularity of financing the dividend also reduces the erosion of Treasury's remaining commitment level, thus shoring up its reassurance to investors and promoting the continued flow of mortgage credit.

Additionally, the 2012 Amendments accelerate the wind down of the Enterprises' retained mortgage investment portfolios. However, they do not wind down the Enterprises' securitization business. Indeed, that side of their businesses may continue to prosper, at least in the near term, as a result of improvements in the mortgage markets and recent increases in guarantee fees.

Fundamentally, the 2012 Amendments position the Enterprises to function in a holding pattern, awaiting major policy decisions in the future. And because of that, policy makers continue to have open options.

Q.5. *On FHFA Commitment to Supporting Protection of Consumer Laws:* While from a purely legal basis, I can see the FHFA's perspective that they are not regulator of consumer protections, from a practical sense, they are part of the new consumer regulatory nexus that has been spawned in part by the Dodd-Frank Act. Can you describe your offices recommendations to FHFA on oversight of consumer protection laws? How will they work with the CFPB?

A.5. In our March 26, 2013, report on this matter, we found that FHFA does not thoroughly oversee how the Enterprises monitor counterparties' contractual compliance. Specifically, FHFA does not examine how the Enterprises monitor compliance with consumer protection laws, and, indeed, we determined that the Enterprises do not ensure that their counterparties' business practices follow all Federal and State laws and regulations designed to protect consumers from unlawful activities such as discrimination.

According to FHFA officials, the Agency relies upon other Federal regulators who are responsible for enforcing laws that protect mortgage borrowers. This reliance on other Federal regulators, such as CFPB, without active coordination or collaboration has meant that FHFA is not assured its interests and obligations, such as ensuring Enterprise contractual obligations are met by their sellers and servicers, are necessarily being fulfilled and protected by the other regulators. FHFA should become more involved in ensuring compliance with consumer protection laws and regulations, not to usurp the compliance and enforcement functions of CFPB and other regulators, but rather to ensure that:

1. The Enterprises preserve and conserve assets by exercising repurchase requests for nonperforming loans that do not comply with all contractual provisions. Both Enterprises have written selling and servicing guides that their counterparties contractually commit to follow. Among other things, the contractual agreements and the guides require counterparties to comply with all Federal and State laws and regulations—including consumer protection statutes—applicable to originating, selling, and servicing mortgage loans. If the Enterprises discover that a counterparty has not complied with any provision, then they can require the original lender to repurchase noncompliant loans, thereby mitigating credit losses. However, unlike limits on repurchases related to other forms of noncompliance, the Enterprises' authority to request repurchase extends over the life of the loan for violations of Federal, State, and local laws and regulations.
2. The Enterprises have confidence that the loans they bundle and sell as mortgage-backed securities do not have defects. Currently, both Enterprises rely primarily on counterparty self-certifications of contractual compliance and do not review the loans they buy at the time of purchase to assess whether counterparties are complying with applicable laws and regulations intended to protect consumers. Such noncompliance can reduce the value of the securities to investors.
3. Consumers are protected. FHFA has a statutory responsibility—under the Housing and Economic Recovery Act of 2008—to protect the public interest, which in this instance is at least partially defined by Federal and State consumer protection laws.

By becoming more involved at the beginning of the loan origination process, particularly by confirming that the Enterprises conduct appropriate quality assurance, FHFA can ensure that the Enterprises are not accepting loans with consumer protection defects. Therefore, we recommend that FHFA develop and implement a risk-based plan to monitor the Enterprises' oversight of their counterparties' compliance with contractual representations and warranties, including those related to Federal consumer protection laws. By "risk-based," we mean the avoidance of duplication of Federal oversight efforts and the implementation of cost-effective identification of noncompliant loans. For example, an element of FHFA's plan could include detailed agreements with other Federal regulators, such as CFPB, delineating what roles FHFA and the Enterprises will play in the identification of loans originated in violation of consumer protection laws and how violations will be communicated to the appropriate Federal regulator. The Agency's role in fostering compliance with consumer protection laws should complement that of other Federal regulators who share responsibilities for oversight of the lenders and servicers doing business with the Enterprises.

FHFA provided comments to our report stating the Agency is committed to the fair treatment of consumers and agreeing with our recommendation and stated that it would develop a specific plan focused on the effectiveness of the Enterprises' monitoring of the sellers' and servicers' compliance with consumer protection laws under the existing contractual terms.

Q.6. *On FHFA as a Steward of Taxpayer Funds When Acting as a Conservator:* Your written testimony recounts of how a review of the FHFA's buyback policy on troubled loans, yielded weak controls that could have materialized or will materialize into around $2.2 to $3.4 billion. How is that reconciled with the stringent actions the FHFA has taken in terms of issues such as principal reductions that have routinely been characterized as a vehicle toward taxpayer losses? Why hasn't this same rationale been applied to internal management attitudes and oversight over the GSEs? This level of overpayment on loans could have funded the Housing Trust Fund for 2–3 years, so how can the FHFA ignore its legal obligations to fund the Trust Fund when it can ostensibly afford to just "throw away" billions of dollars due to weak internal controls?

A.6. In its capacity as conservator, FHFA has various tools at its disposal to mitigate credit losses, thereby conserving and preserving assets. Loan modifications represent a key method of loss mitigation on troubled loans. Repurchase requests offer another important means for the reduction of credit losses. If a homeowner defaults on any loan that Fannie Mae or Freddie Mac owns or guarantees, the Enterprise is obligated to absorb or reimburse the unpaid balance of the mortgage. If, however, the seller of the mortgage loan in question violated representations and warranties provided to the Enterprise at the time of the loan sale, then Fannie Mae or Freddie Mac has the contractual right to demand that the loan seller buy back or repurchase the mortgage loan. For determining whether representations and warranties have been violated, Fannie Mae and Freddie Mac examine some, but not all, mortgages they own or guarantee once they have become seriously delinquent.

On September 27, 2011, we issued a report that highlighted a potentially significant flaw in Freddie Mac's process for reviewing defaulted loans for repurchase claims and noted that the flaw could be costing Freddie Mac a significant amount of money. Specifically, Freddie Mac's process primarily reviewed only those loans defaulting in the first 2 years after origination rather than in subsequent years—when many housing boom loans defaulted. Subsequently, Freddie Mac expanded its loan review methodology to look at additional years for possible repurchase requests. In a subsequent report, we estimated that the expanded loan review methodology could result in an additional $2.2 to $3.4 billion in repurchase requests, and we continue to monitor the matter.