FHFA OVERSIGHT: CURRENT STATE OF THE HOUSING GOVERNMENT SPONSORED ENTERPRISES

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

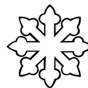
ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

MAY 26, 2010

Printed for the use of the Committee on Financial Services

Serial No. 111–142



U.S. GOVERNMENT PRINTING OFFICE

58–052 PDF WASHINGTON : 2010

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

HOUSE COMMITTEE ON FINANCIAL SERVICES

BARNEY FRANK, Massachusetts, *Chairman*

PAUL E. KANJORSKI, Pennsylvania
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIÉRREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
DENNIS MOORE, Kansas
MICHAEL E. CAPUANO, Massachusetts
RUBÉN HINOJOSA, Texas
WM. LACY CLAY, Missouri
CAROLYN McCARTHY, New York
JOE BACA, California
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
MELISSA L. BEAN, Illinois
GWEN MOORE, Wisconsin
PAUL W. HODES, New Hampshire
KEITH ELLISON, Minnesota
RON KLEIN, Florida
CHARLES A. WILSON, Ohio
ED PERLMUTTER, Colorado
JOE DONNELLY, Indiana
BILL FOSTER, Illinois
ANDRÉ CARSON, Indiana
JACKIE SPEIER, California
TRAVIS CHILDERS, Mississippi
WALT MINNICK, Idaho
JOHN ADLER, New Jersey
MARY JO KILROY, Ohio
STEVE DRIEHAUS, Ohio
SUZANNE KOSMAS, Florida
ALAN GRAYSON, Florida
JIM HIMES, Connecticut
GARY PETERS, Michigan
DAN MAFFEI, New York

SPENCER BACHUS, Alabama
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
RON PAUL, Texas
DONALD A. MANZULLO, Illinois
WALTER B. JONES, JR., North Carolina
JUDY BIGGERT, Illinois
GARY G. MILLER, California
SHELLEY MOORE CAPITO, West Virginia
JEB HENSARLING, Texas
SCOTT GARRETT, New Jersey
J. GRESHAM BARRETT, South Carolina
JIM GERLACH, Pennsylvania
RANDY NEUGEBAUER, Texas
TOM PRICE, Georgia
PATRICK T. McHENRY, North Carolina
JOHN CAMPBELL, California
ADAM PUTNAM, Florida
MICHELE BACHMANN, Minnesota
KENNY MARCHANT, Texas
THADDEUS G. McCOTTER, Michigan
KEVIN McCARTHY, California
BILL POSEY, Florida
LYNN JENKINS, Kansas
CHRISTOPHER LEE, New York
ERIK PAULSEN, Minnesota
LEONARD LANCE, New Jersey

JEANNE M. ROSLANOWICK, *Staff Director and Chief Counsel*

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

PAUL E. KANJORSKI, Pennsylvania, *Chairman*

GARY L. ACKERMAN, New York
BRAD SHERMAN, California
MICHAEL E. CAPUANO, Massachusetts
RUBÉN HINOJOSA, Texas
CAROLYN MCCARTHY, New York
JOE BACA, California
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
NYDIA M. VELÁZQUEZ, New York
CAROLYN B. MALONEY, New York
MELISSA L. BEAN, Illinois
GWEN MOORE, Wisconsin
PAUL W. HODES, New Hampshire
RON KLEIN, Florida
ED PERLMUTTER, Colorado
JOE DONNELLY, Indiana
ANDRÉ CARSON, Indiana
JACKIE SPEIER, California
TRAVIS CHILDERS, Mississippi
CHARLES A. WILSON, Ohio
BILL FOSTER, Illinois
WALT MINNICK, Idaho
JOHN ADLER, New Jersey
MARY JO KILROY, Ohio
SUZANNE KOSMAS, Florida
ALAN GRAYSON, Florida
JIM HIMES, Connecticut
GARY PETERS, Michigan

SCOTT GARRETT, New Jersey
TOM PRICE, Georgia
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
FRANK D. LUCAS, Oklahoma
DONALD A. MANZULLO, Illinois
EDWARD R. ROYCE, California
JUDY BIGGERT, Illinois
SHELLEY MOORE CAPITO, West Virginia
JEB HENSARLING, Texas
ADAM PUTNAM, Florida
J. GRESHAM BARRETT, South Carolina
JIM GERLACH, Pennsylvania
JOHN CAMPBELL, California
MICHELE BACHMANN, Minnesota
THADDEUS G. McCOTTER, Michigan
RANDY NEUGEBAUER, Texas
KEVIN McCARTHY, California
BILL POSEY, Florida
LYNN JENKINS, Kansas

CONTENTS

Page

Hearing held on:
May 26, 2010 1

Appendix:
May 26, 2010 41

WITNESSES

WEDNESDAY, MAY 26, 2010

DeMarco, Edward J., Acting Director, Federal Housing Finance Agency (FHFA) 10

APPENDIX

Prepared statements:
Kanjorski, Hon. Paul E. 42
Bachus, Hon. Spencer 44
Marchant, Hon. Kenny 45
DeMarco, Edward J. 47

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

DeMarco, Edward J.:
Written responses to questions submitted by Chairman Kanjorski 57

FHFA OVERSIGHT: CURRENT STATE OF THE HOUSING GOVERNMENT SPONSORED ENTERPRISES

Wednesday, May 26, 2010

U.S. House of Representatives,
Subcommittee on Capital Markets,
Insurance, and Government
Sponsored Enterprises,
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:02 p.m., in room 2128, Rayburn House Office Building, Hon. Paul Kanjorski [chairman of the subcommittee] presiding.

Members present: Representatives Kanjorski, Sherman, Lynch, Scott, Maloney, Donnelly, Childers, Adler, Himes; Garrett, Castle, Royce, Biggert, Capito, Hensarling, Gerlach, Campbell, Neugebauer, Posey, and Jenkins.

Also present: Representatives Watt and Marchant.

Chairman Kanjorski. Good afternoon. This hearing of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises will come to order.

Pursuant to committee rules and prior discussions with the ranking member, each side will have 15 minutes for opening statements. Without objection, all members' opening statements will be made a part of the record. I yield 5 minutes to myself for an opening statement.

We meet this afternoon to examine the Federal Housing Finance Agency in its oversight of Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System. This hearing is the fourth in a series the Capital Markets Subcommittee and the full Financial Services Committee have, so far, convened in this Congress to examine the future of housing finance.

The Housing and Economic Recovery Act of 2008 created the Federal Housing Finance Agency and gave the regulator many new powers. At the request of then-Secretary Paulson, the law also authorized the Treasury Department to provide emergency backstop liquidity for Fannie Mae and Freddie Mac. Within weeks of enactment, policymakers in the Bush Administration decided to place the two Enterprises into conservatorship and make available government support. Since then, the two Enterprises have worked to improve the quality of loans they buy and to end problematic programs.

The Treasury Department has also purchased $144.9 billion in senior preferred stock of Fannie Mae and Freddie Mac. In addition, the government has purchased more than $1.3 trillion of the Enterprises' mortgage-backed securities. Together, these sizable commitments have helped to preserve housing credit during tough economic times.

As our housing markets have begun to stabilize, the government has now started to scale back its efforts. Specifically, at the end of March, the Federal Reserve ended its program to purchase mortgage-backed securities. Going forward, we must continue to return to the private sector those functions that properly belong with the private sector. We need to closely monitor the mortgage rates and investor demand, as well.

Chairman Frank has noted that two important points of consensus have emerged from our two most recent hearings on the future of housing finance. First, the Enterprises' major losses have come from their pre-conservatorship activities. Second, the major players in our housing markets have agreed that we could cause considerable economic harm if we simply abolished Fannie Mae and Freddie Mac without putting something new in their place. I very much agree with both assessments.

We will, in the near future, complete our work on the Wall Street Reform bill. During these debates, some have regularly sought to use questions about the future of Fannie Mae and Freddie Mac as a toxic poison pill to forestall progress on this must-pass legislation. I find this situation very unfortunate, as the bill includes important provisions to alter the securitization process, impose risk retention requirements, and strengthen rating agency accountability. Once we resolve these baseline policy issues, we can turn our full attention to broader questions about how to reorganize our housing finance system.

Today's testimony will help us to determine how to move surgically and strategically on these important matters. It will help us to decide what elements of our housing finance system we need to keep and what aspects we should discard. In the months ahead, I plan to convene more hearings on these matters.

Before closing, I want to express my disappointment at the failure of our witness to respond to the request to address the issues related to the Home Valuation Code of Conduct in his written testimony. The House-passed Wall Street Reform bill contains my comprehensive appraisal independence and regulatory reforms, which many view as fixing the Code's implementation problems.

The bill also includes Congressmen Miller and Childers' amendment to sunset the Code. Because Congress is very focused on these issues, we need an update from the regulator.

In sum, today's hearing is part of a deliberative process that will ultimately lead to a new housing finance system. My goals in these debates are to limit taxpayer risk and establish a more stable, long-term funding source to help hardworking, responsible middle-class American families to buy a home with an affordable mortgage. I look forward to the testimony.

Now, I would like to recognize the ranking member, Mr. Garrett, for 3½ minutes.

Mr. GARRETT. I thank the chairman. And just as an aside, before I begin, I would just like to comment on the chairman's comments. There are those of us who say, yes, reform needs to be done, and we do support moving reform legislation through the House and the Senate. But we see no reason why it cannot include reform of GSEs at the same time.

But I do thank the chairman and I thank the witness who is here today. During normal times—well, actually, I should step back. When Congress passed the Housing and Economic Recovery Act, we created a new regulatory body for the GSEs called the FHFA. In that legislation, there is a requirement that the head of the FHFA comes before Congress once a year. And I was going to say during normal times, a once-a-year requirement for such an appearance might be reasonable. But under current circumstances, when, quarter after quarter, the American taxpayers are forced to hand out literally billions and billions and billions of dollars to keep Fannie and Freddie solvent, this requirement is really not sufficient.

Currently, Fannie and Freddie are costing us more than all the other bank bailouts combined. That is why I am pleased to cosponsor legislation that's being introduced today, I believe, by my good friend from Texas, Mr. Hensarling. And that would require the Director to come to Congress and testify every time Fannie and Freddie thinks they need an additional infusion of taxpayer bailout funds.

Too many times when this committee has been debating the problems with the GSEs, the focus has been on past mistakes instead of the future. Regardless of whose fault it was that these two entities encouraged the creation of the subprime housing crisis and the collapse of our financial sector and the economy, there is a litany of problems that need to be addressed by this body, and we need to do it today.

So, no matter how much my colleagues on the other side of the aisle attempt to ignore these problems, they really do persist.

And when the Administration and the Majority are faced with problems of Fannie and Freddie Mac and what are they going to do about it, it seems up until now, they turned a blind eye to it. We need to have more and more oversight hearings, and create an independent inspector general within the FHFA. They have turned a blind eye to those ideas.

When Fannie and Freddie need to be put on budget, so that taxpayers know what they are exactly on the hook for, as my bill would do, well, they have turned a blind eye to that, as well.

When we had an opportunity to stop the bailouts and end additional taxpayer losses, well, they turned a blind eye to that.

And when we have an opportunity to address the future of these entities in the regulatory reform bill, well, we have seen what has happened in the Senate; they have turned a blind eye to that, as well.

My friends in the Administration and the other side, the Majority, continue to ignore and delay dealing with these problems. But at some point in time, they are really going to have to open their eyes to reality. In fact, the only time that this Administration or Congress will do anything about the future of these two entities is

when they say they need an increase in the bailouts of the GSEs, and the fact that they're receiving them and receiving them from the taxpayers at further risk with their ineffectual mortgage modification programs. That's basically just throwing good money after bad.

So, when it's all said and done, the bailouts of Fannie Mae and Freddie Mac will go down as the most expensive bailouts of this crisis by wide margins. However, this Administration and this Congress just want to keep acting like there is really no problem, and keep turning a blind eye to it.

So, I look forward to today's hearing, and hope that this is a sign that this committee is starting to get serious about addressing the multitude of serious issues relating to Fannie and Freddie, and the future of housing finance in this country.

And with that, I yield back the balance of my time.

Chairman KANJORSKI. Thank you, Mr. Garrett. Next, we will hear from the gentleman from California, Mr. Sherman, for 3 minutes.

Mr. SHERMAN. Thank you, Mr. Chairman. I want to bring up two issues.

The first is this new predatory financial scheme called the private transfer fee covenants. Under these covenants, buried in the loan documents or sale documents is a requirement that for 99 years, whenever the house is sold, a percentage of the sale price needs to be mailed to some Wall Street investor. This is a new private real estate transfer tax with the money going to Wall Street.

It's my understanding that the FHFA has refused to participate in such transactions. I would hope that the Fannie and Freddie would do likewise. This is: first, a matter of consumer protection; second, a matter of avoiding undue complications in what is already a very complicated transaction; and third, a matter of the security of the GSE, in that this impairs the value of the home.

Second, we have a fragile recovery. Nothing could destroy this recovery more than a double-dip in home prices. We need to stabilize home prices. Home prices reflect and home values reflect transactions. Transactions have to be financed. And for middle-class people, all financing today goes through Fannie, Freddie, or FHFA.

What we will see at the end of the year is a dramatic decline in the size of transactions that Fannie, Freddie, and FHFA can deal with in high-cost areas. In Los Angeles, where it's 729, 750, that drops probably to 625, but perhaps into the 500's if Congress does not act this year. And that would devastate southern California. It would—nothing is more likely to push us into a double-dip recession.

I want to commend to my colleagues the Sherman-Miller bill that would say that we simply do not have a decline in these conforming loan limits. It is my understanding that the GSEs actually make a profit on those loans that are over $417,000 and as high as $729,000.

And second, I want to advise my colleagues that whereas in some rural parts—and even some urban parts—of this country, a home that sells for $417,000 is a mini-mansion. Even today, in Los Angeles, in New York, in San Francisco, working class people struggle and save and they have to buy a home for $500,000 or $600,000.

The economy of the area is built on that. And if we say, “No, your home is too lavish because it sells for more than $417,000,” that doesn't apply to my district, where such a home is certainly not lavish. I yield back.

Chairman KANJORSKI. Thank you. Now I will recognize the gentleman from California, Mr. Royce, for 2½ minutes.

Mr. ROYCE. Thank you, Mr. Chairman. Once upon a time, the GSEs were involved in securitization of loans here in the United States. They weren't involved in arbitrage, they weren't leveraged 100-to-1. They weren't buying massive amounts, trillions in subprime loans. But Congress did get in the act in 1992, passed the GSE Act, and changed a lot of that.

One of my more vivid memories is the Federal Reserve coming here and warning us that we faced systemic risk if Fannie and Freddie collapsed because of the subprime loans that were mandated on them by Congress—subprime and Alt-A had to be half of the loans—that this would be a systemic shock that would affect the financial system, and we would end up with a collapse in housing; in 2002, 2003, and 2004, we were warned by the Fed on this.

Because of the legislation that was passed, that is why the GSEs became the largest purchasers of junk mortgages. That is why, in those portfolios, they held those junk mortgages that they purchased at the end of every quarter. And this meant that, despite the low quality of the loans, millions of Americans—the perception at the time was, well, maybe a million Americans have a mortgage now that they otherwise could not afford, even though 30 percent of those transactions every year were people flipping homes within 6 weeks.

Well, pairing those affordable housing mandates with the GSE excessive leverage was a toxic combination that was at the heart of the housing bubble. When we tried to reign in the GSEs by decreasing those mortgage portfolios—that they held in their portfolios, our efforts were blocked because they were viewed, unfortunately, as a tax on subsidized housing. They weren't, but the argument went out, and the Democrats in the Senate were able to stop legislation from reaching the Floor. Chris Dodd played that role at the time. And my legislation here on the House Floor failed.

Going forward, we must reconsider the flawed notion that zero downpayment loans and subprime and because everybody has to own a house—you're going to create the moral hazard of a system like this that tries to trump economic reality. Because, in the end, the Fed is right. You will face that systemic risk, as we did here. And that is, I think, the one thing that we might glean out of this that would keep us from allowing an institution to so overleverage in the future. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mr. Royce. Now, we will hear from the gentleman from Georgia, Mr. Scott, for 3 minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman, and it's good to have this timely hearing.

I think one fact that certainly pervades our thinking today is this monumental loss of value in our homes—over the last 3 years, $9 trillion in value. Nothing has been more devastating to our homeowners than the fact—to see how their most basic investment for wealth building, that they have lost so much value in their homes.

And I think that is a challenge for us to look at, all of us that are involved in this, of how we can recover that and assist our homeowners in recovering the lost value. It's going to be difficult.

But we have come through a period where we have had these adjustable mortgage rates that have come through with teaser rates that were used that ballooned the payments up over the last 3 years. And we are paying the price for that now.

But we do have a rather structured oversight with the new supervision of the FHFA, and as we know, it was structured to regulate the operations of the GSEs and to ensure that another financial crisis like this does not happen on our watch.

And so, it's very important that we examine very carefully how we got into this situation. It's the best way of determining how you get out.

And in addition to this structured oversight, we have to continue to be alert to economic indicators—again, learn from our past experience in this financial system. For example, in my own home State of Georgia, we continue to lead the country in bank failures. And that must stop.

But I think we can learn from what happened in my State of Georgia, where 32 banks—32 banks—collapsed within the last 2 years alone, to see what we must not do, and to see what we can correct and also to see, as we move on, how we can help. These were small, these were basically largely community banks who make up 85 percent of lenders that hold stock in Fannie and in Freddie, and also worked to bring access to capital to many of my constituents.

It is a fact that we know—and maybe we can do something about the fact—when smaller banks would be so overleveraged. And the one fact we found out of a common characteristic of these small banks in Georgia was that most of them had nearly or over 80 percent of their loans, of their lending capacity, in real estate. And they really manifested the real estate bubble, and it burst on them.

We have some very serious questions that we need to take a look at. There is one question that I hope we can deal with, in terms of looking at the role that the Federal Home Loan Banks can play, which have done an admirable job in this crisis, and I think have a lot more that they can offer in the housing financial system. And I think we should use and look to them, and build on the good work that they have done.

And then, the overall question of what role should government play? What role should we play in this entire reform of the GSEs to make sure that they are adequate sources of liquidity? These are very important questions. Learn from the past. Look from the past, look how we're going forward.

This is a very timely hearing, Mr. Chairman, and I look forward to hearing from Mr. DeMarco.

Chairman KANJORSKI. Thank you very much, Mr. Scott. Now, we will hear from the gentlelady from Illinois, Mrs. Biggert, for 2½ minutes.

Mrs. BIGGERT. Thank you, Mr. Chairman. Since entering into conservatorship in the fall of 2008, U.S. taxpayers have propped up Fannie Mae and Freddie Mac to the tune of nearly $150 billion. And taxpayers are on the hook for $5 trillion in outstanding mort-

gage obligations. Let me repeat that number: Taxpayers are on the hook for $5 trillion.

Edging out private sector mortgage market participants, Fannie and Freddie guaranteed or financed over three-quarters of new single-family mortgages in 2009. And I have said it before and I will say it again. Taxpayers deserve to know where their dollars are going, what risk they are being exposed to, and how these institutions are being managed or mismanaged.

On May 6th, the Oversight and Investigations Subcommittee held a hearing entitled, "The End of Excess, Part One: Reversing Our Addiction to Debt and Leverage." During that hearing, we learned about our country's unsustainable levels of debt, a barrier to our future economic prosperity. High taxes, inflation, and higher unemployment rates will be the byproducts of the current Administration's fiscal irresponsibility.

Linked to this irresponsibility is the Administration's unlimited guarantee of the debt of Fannie and Freddie. During the O&I hearing, I cited a Wall Street Journal article that said that Fannie and Freddie were twice as leveraged as Bear Stearns. Yet the Administration has not appointed an inspector general to provide objective, independent oversight over the Federal employees who now control the GSEs.

It is inconceivable that the officials managing these liabilities would not be allowed to do so without proper transparency, independent oversight, and thorough reporting to Congress and the American people. Thus, I asked the GAO to expand their study on leverage, as mandated under EESA, to include a review of the balance sheets of the GSEs. We expect the GAO to produce that important study in the coming months.

A thorough examination by the GAO is critical in ensuring that Congress and taxpayers understand how the markets collapsed, what risk taxpayers are still being exposed to, and how to keep it from ever happening again. In the meantime, it is unacceptable that the Administration continue to kick the can down the road and still have no firm exit strategy to spare taxpayers from future losses associated with Fannie and Freddie.

Republicans are ready to address this problem and get taxpayers out of this mess. And with that, I yield back.

Chairman KANJORSKI. Thank you, Mrs. Biggert. We will now hear from the gentlelady from West Virginia, Mrs. Capito, for 2 minutes.

Mrs. CAPITO. Thank you, Mr. Chairman, for convening this hearing today. The committee will be having more hearings on the future of housing finance and the role of Government Sponsored Enterprises Fannie and Freddie, while we are sitting here today with the Director of the Federal Housing Finance Agency. And thank you for coming.

The future of regulatory reform is looming over Congress. The Senate has acted, and we are now headed to conference. Unfortunately, neither the House nor the Senate package addresses one of the most major causes of the financial downturn: the role of Fannie and Freddie in our mortgage markets. These entities now owe—as we have heard from several others—the taxpayers a total of $147 billion. And last Christmas Eve, it was announced that we were re-

moving any limits on the Federal funds to cover the losses of the GSEs.

This is a missed opportunity for our Nation. The troubles in the mortgage markets were at the root cause of the financial downturn. Yet the current Administration does not seem willing to acknowledge the serious need to start working on a plan for the future of housing finance.

House Republicans on the Financial Services Committee worked together on a list of goals and principles for GSE reform. We stand ready to work with our colleagues to properly reform the GSEs and create a system where the taxpayers are no longer on the hook for the losses of Fannie and Freddie.

Again, I thank the chairman, and I look forward to the testimony from Director DeMarco. Thank you.

Chairman KANJORSKI. Thank you very much, Mrs. Capito. Now, we will hear from the gentleman from Massachusetts, Mr. Lynch, for 2 minutes.

Mr. LYNCH. Thank you, Mr. Chairman, for holding this important hearing. I want to thank Mr. DeMarco for appearing as a witness and offering to help the committee with its work.

I think we have all learned much more about the mortgage securitization process since the financial crisis began, and just how central a role it played in the meltdown. Through investigative reports that we have received before this committee, as well as in the popular press, such as in in-depth accounts like Michael Lewis', "The Big Short," and Andrew Ross Sorkin's, "Too Big to Fail," we have seen just how much took place in the dark, without proper oversight from the regulators, and in some cases under morally suspect circumstances.

The way that mortgage-backed securities have been created, packaged, marketed, and managed has shed a great deal of light into how the system worked and how a lot of people made a lot of money from it. Unfortunately, Fannie Mae and Freddie Mac were not immune to this. They may have come late to the game, but we know that Fannie and Freddie began to enter the subprime and Alt-A markets just as the subprime market was tripling in size.

Rather than guaranteeing these less creditworthy loans, Fannie and Freddie increasingly purchased, and actually held in their portfolios, many securities backed by subprime and Alt-A loans. Fannie and Freddie should have never been allowed to purchase such dangerous and risky loans. I know they were concerned about losing a big part of the market, but the housing finance system that was created in the wake of the Depression to promote homeownership led to the rise of the middle class. But the mortgage markets have changed a great deal over the last 25 years, and it's clear that the change is needed, and new structures need to be established.

I agree with the decision to deal with Fannie and Freddie separately from the financial regulatory reform bill considered by this committee. However, as that process winds down with the appointment of a conference committee, I think the time has come to address this important issue.

I look forward to an informative discussion on the future of housing finance and the current state of the Government Sponsored Enterprises, and I thank the chairman for the time. I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Lynch. Now, we will hear from the gentleman from Texas for 2½ minutes. Mr. Hensarling?

Mr. HENSARLING. Thank you, Mr. Chairman. I can't help but notice that yesterday, the full Financial Services Committee had a hearing on a $350 million—with an "M"—housing proposal, and here we are today, at the subcommittee level, having a hearing on a program that has now cost taxpayers $147 billion and, as the gentlelady from Illinois so aptly pointed out, $5 trillion on the hook.

I have been informed that this is a required hearing under HERA. And if that is indeed correct, I lament the fact that we don't have greater participation, and are not doing this at the full committee level. This is something I don't understand, which, as our ranking member has pointed out, is one of the reasons I have introduced H.R. 5391, the Federal Housing Finance Oversight Board Increased Transparency Act, to ensure that any quarter that either of the Government Sponsored Enterprises requests more taxpayer bailout money, we will have testimony received at the full committee level.

If there are any two institutions that demand more accountability and more transparency, it's the Government Sponsored Enterprises and, as many of my colleagues have pointed out, the most polite term I can think of is "curious" that we would have major financial reform legislation—some of the most major legislation in decades—dealing with our financial crisis, and somehow Fannie and Freddie are left out of the mix. This I don't understand.

Now, the distinguished chairman of the Senate Banking Committee said, "Well, this system is very complex." And so the answer from the Senate side is that, "We will conduct a study." The answer from the Administration is, "We will monitor." And the answer from the House is, "We will exempt them from the purview of this legislation," and allow the taxpayer hemorrhage, unfortunately, to continue.

Mr. Chairman, that is simply unacceptable. Fannie and Freddie were at the ground zero of the economic crisis. This is the most expensive bailout—more than AIG, more than GM, more than Chrysler, more than any other bank—and here we are, again, having a hearing relegated to the subcommittee level. And these two financial Frankensteins that have wreaked so much havoc on our economy can no longer be ignored.

With that, I yield back the balance of my time.

Chairman KANJORSKI. Thank you, Mr. Hensarling. We will now hear from the gentleman from Texas, Mr. Neugebauer, for 2 minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. And like my other good friend from Texas, I am a little surprised, too, that we aren't having this hearing in the full committee when you look at the amount of risk that the taxpayers are already at, and what they have already put into this.

Twenty months and at least $145 billion later, taxpayers are asking what they're getting for their money that they put into Freddie Mac and Fannie Mae. They not only own 80 percent of these companies, but they continue to report quarterly losses in the billions of dollars. As long as these losses continue, the government has pledged unlimited supply and support of taxpayer dollars.

While Congress and the Administration continue to put off planning for the future of Fannie Mae and Freddie Mac, we can't afford to put off the oversight of the hundreds of millions of dollars that are already at risk and continue to climb. We need to understand how these entities are operating today, and what risks they are taking, and whether their losses are in the older mortgages or if they're in the newer mortgages, as well.

We need to know how the GSEs plan to manage the risk of their large portfolios, especially since the Treasury relaxed the benchmarks for portfolio reduction.

With Fannie Mae and Freddie Mac responsible for three-quarters of the mortgage market, and functioning as wards of the state, we need to know whether these companies are being run to minimize further losses to the taxpayer, or as tools to carry out the Administration's policy goals.

The GSEs can't be shut down overnight, but we can start phasing down the size now, until we get a plan in place. When is Congress going to put a limit on taxpayer support and set a deadline for winding these companies down?

With that, I yield back my time, Mr. Chairman.

Chairman KANJORSKI. I thank the gentleman from Texas. Are there any other requests for time on the Democratic side? I see none, so we are ready to take the testimony from our witness.

Today, we have Mr. Edward DeMarco, Acting Director of the Federal Housing Finance Agency. Thank you for appearing before the subcommittee today. Without objection, your written statement will be made a part of the record. You will be recognized for a 5-minute summary of your testimony.

Thank you, Mr. DeMarco. You have the floor.

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

Mr. DEMARCO. Thank you, Mr. Chairman. Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee, thank you for inviting me to speak on the current state of the housing GSEs: Fannie Mae; Freddie Mac; and the 12 Federal Home Loan Banks.

My written statement provides a detailed report. Yesterday, FHFA released its annual, "Report to Congress" which provides detailed summaries of our annual examination findings at each of the housing GSEs.

I will briefly summarize key points in three areas: the purpose and goals of FHFA's conservatorships; findings from FHFA's oversight of the GSEs; and principles and issues that may be considered by Congress when contemplating the future of the GSEs.

Beginning with conservatorship, the Enterprises have been in conservatorship since September 2008. The purpose of conservatorship is to preserve and conserve each company's assets to enable

them to fulfill their mission and mitigate the systemic risk that contributed to instability in financial markets. The conservatorships have been effective to date, instilling confidence in the market that the Enterprises are capable of fulfilling their statutory role.

Although the Enterprises' substantial market presence has been a key step to restoring market stability, neither company would be capable of serving the mortgage market today without the ongoing financial support provided by the Treasury Department. Including the amounts requested at the end of the first quarter, the Enterprises will have drawn nearly $145 billion.

While reliance on the Treasury Department's backing will continue until legislation produces a final resolution of the Enterprises' future, as conservator, FHFA is limiting the Enterprises' risk exposure by preventing them from entering new lines of business, ensuring that the new business they are taking on is profitable, and minimizing losses on mortgages originated pre-conservatorship by executing an aggressive program of loss mitigation that ranges from loan modifications to graceful options for homeowners to exit their homes, short of foreclosure.

Let me briefly summarize some key points from yesterday's annual report. While housing finance continues to depend critically on the Enterprises, FHFA rates both Fannie Mae and Freddie Mac to be critical supervisory concerns, mainly due to continuing credit losses associated with the 2006 and 2007 books of business, as well as forecasted losses yet to be realized. FHFA expects the high delinquency rates to continue for these older books of business, due to uncertain house price paths, weak employment, and continued economic uncertainty.

Another problem faced by both Enterprises relates to their high degree of operational risk and limits to their operational capacity.

With regard to the Federal Home Loan Banks, FHFA is looking for the Home Loan Banks to return to more traditional operations and activities, with a focus on advances to member institutions, and a gradual reduction in investment portfolios which are not needed to support core business activities and safety and soundness.

The Federal Home Loan Banks' advance business continues to experience no credit losses, but it is shrinking. Advances fell to $572 billion, as of the end of March, which is down 9 percent from the prior quarter, and 30 percent from a year ago. Advances are now down 44 percent from the peak in 2008, and are at the lowest level for the system since the third quarter of 2004.

The Federal Home Loan Banks face continued challenges from past investments and private-label mortgage-backed securities. At some banks, these investments have caused them, either voluntarily or as a result of supervisory action, to limit or suspend dividends, and to stop redemptions and repurchases of stock.

Before turning to the future of the GSEs, let me pause, Mr. Chairman, on one other topic you asked me to address—and I do apologize for it not being addressed directly in my written statement—as you know, in 2008, FHFA's predecessor agency entered into an agreement with the Enterprises and the State attorney

general of New York that resulted in the Home Valuation Code of Conduct, or HVCC.

The purpose of the HVCC was to enhance the standards for appraiser independence. The Code has improved the independence of the valuation process: a critical element in assuring homeowners pay a fair price for properties, and that investors have confidence in mortgages backing securities they purchase. The Code has also aided efforts to combat mortgage fraud, a leading contributor to the housing finance crisis.

Last week, I announced that, given the conservatorships, I did not deem it appropriate for the Enterprises to fund the independent valuation protection institute envisioned in the agreement. Instead, each enterprise will soon be announcing a complaint process.

When the Code expires in November, I expect its benefits to continue into the future, as the standards that developed from the agreement have been incorporated directly into the Enterprises' seller-servicer guides.

A word about the future. Despite the current benefits in the marketplace resulting from the Treasury's support for Enterprise activities, conservatorship is not a long-term solution. Legislation is needed to change the institutional framework for housing finance. Without disrupting the fragile recovery of our housing finance system, the role and the function of the Enterprises needs to be debated and decided upon.

To start, Congress and the Administration need to clearly define the proper public policy objectives and the degree and characteristics of government involvement in the housing finance system to best serve those objectives.

I look forward to working with the subcommittee and the full committee on legislative action to restructure the housing finance system, including an ultimate resolution of the Enterprises, and a consideration of the Federal Home Loan Banks.

Thank you for this opportunity, and I would be pleased to answer questions.

[The prepared statement of Mr. DeMarco can be found on page 47 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. DeMarco. I think we all have a few questions here, and I will yield the first 5 minutes to myself for some of those questions.

As I understand your oral testimony, it is your opinion that we cannot just dismiss the existence of Fannie and Freddie without major disruptions within the mortgage market?

Mr. DEMARCO. That's correct, Mr. Chairman. There needs to be a solution—a system that—on the other end, so that we can preserve ongoing liquidity and stability in the mortgage market.

Chairman KANJORSKI. Are you aware of the preliminary findings from the special commission appointed to determine the cause of the credit crunch that occurred some 18 months ago, where they indicated that it is not their opinion that Fannie and Freddie were major contributors?

Mr. DEMARCO. Mr. Chairman, I am familiar with some of the documents and reports they have put out. I do know that they have

not yet finalized any of their conclusions or recommendations, but they are rolling things out on an interim basis, yes.

Chairman KANJORSKI. Great. Would you agree with me and some in the Administration that before we take any final action on the existence of Fannie and Freddie, construct institutions to replace it, or provide procedures to make up for the deficit that would occur if those institutions were to disappear, that we should wait for the final approval of the commission or the final findings of the commission, so that we get the benefit of the best thinking on the subject?

Mr. DEMARCO. I understand that the commission is looking at the full range of involvement and causes of the crisis. How Congress and the Administration determine to wait for findings of that is up to them.

I think currently there is plenty that we can be talking about, and I am pleased that you have invited me here today, Mr. Chairman, to begin talking about the future of the housing finance system, because I do believe we need to take this up directly and get on with it. It will be a difficult challenge, but it is one that we need to be working on now.

Chairman KANJORSKI. In that regard, have you, yourself, concluded any particular recommendations that you could make to this subcommittee or the full committee, as to what can be done?

Mr. DEMARCO. Not a particular recommendation or form or structure, Mr. Chairman. In my written statement, I outlined several things that I believe are important for all policymakers to consider.

I think fundamentally—and one thing that I am pleased about as I listen to commentary, both from Members of Congress and from the Administration—is that what we're looking at here is not what to do with Fannie and Freddie. The question before us is what should be the future of the housing finance system in this country. And the place to start there is what are the government's public policy objectives, and given those objectives, what do policymakers conclude about the proper role of the government in our housing finance system?

Starting with the answers to those questions, one can then move into what are the institutional arrangements, the charters, and the regulatory structures that accomplish the objectives. But one first has to determine what are the objectives that we have in mind, and what's the proper role of the government to achieve those objectives. Those are challenging questions, right there.

Chairman KANJORSKI. Very fundamental questions.

Mr. DEMARCO. Yes, sir.

Chairman KANJORSKI. Do you suggest we go down to the fundamentals before we try to construct a rescue?

Mr. DEMARCO. Yes, sir. Because, my view—sometimes this is talked about as the reform of the GSEs. Whether it should be the reform or the complete changing of the model is really part of the question before us.

And I think that by having answers to those two fundamental questions I have, policymakers would be informed as to whether we're reforming Fannie and Freddie, or whether we are fundamentally changing the institutional structure—whether to have a gov-

ernment sponsored enterprise, as we have known those two to be, is what we want going forward is really part of the question. And I think it should be in that larger context.

Another thing I would note, Mr. Chairman, is the institutions that today are serving our housing finance system so critically—and it has been mentioned by a number of the members in their opening remarks—FHFA, Fannie Mae, and the Federal Home Loan Banks were all created in the 1930's as Congress' response in the 1930's to the Great Depression.

These are institutional arrangements and determinations about the role of government in housing finance that were decided upon by past Congresses. And here we are, 80 years later, and we are—those institutional arrangements, those structures are with us today and are holding up our housing financing system.

I do think that taking a careful consideration of what we are doing in defining the future of the housing finance system is important, because the decisions that, with all respect, that this body will be making in the coming months could be with us for many decades. And I think getting this right is an important thing.

Chairman KANJORSKI. Thank you, Mr. DeMarco. I see my time has expired. The gentleman from New Jersey is recognized for 5 minutes.

Mr. GARRETT. And I thank the chairman. Okay, so what I hear from your answers so far is that while the commission is out there and doing the studies and what-have-you, you apparently concur with the testimony we had from Chairman Bernanke who was here, saying that this was important enough and significant enough, as far as the cost that it's incurring to the taxpayers, and the risk going forward, that we need to be dealing with this situation today, as opposed to waiting until next year or any other time. Is that—

Mr. DEMARCO. I believe we should be discussing this now, and developing the models and the options that are out there. I believe that certain industry groups have actually come up with some thoughtful proposals, and academics and others have, as well. The GAO has presented them. And I think that the more we can be talking about and laying out what these options are and what the possible approach is—

Mr. GARRETT. Right.

Mr. DEMARCO. —with respect to these fundamental questions is—we should be doing it now.

Mr. GARRETT. Right. And just like with what's—the House has already moved, the Senate has already moved an entire financial reform piece of legislation that basically rewrites laws that have not been changed in 50, 60, 70 years. We did that without the benefit of waiting for any commission to come through, and I think we could probably do the same thing here.

Your opening remarks made—and I couldn't find it exactly just in here; I heard you say it, though, as far—is that the conservatorship has a measure of effectiveness. Right? I don't remember the exact term that you used.

Mr. DEMARCO. Yes.

Mr. GARRETT. But how do you measure effectiveness in the sense that we are spending close to $200 billion now, and if we do ask

you to come back every single time that they ask for more money, we will be seeing you frequently.

Mr. DEMARCO. Right.

Mr. GARRETT. So, how do you measure—I can be quite effective if I have—given an unlimited amount of money to spend in the housing market.

Mr. DEMARCO. When the conservatorships were announced, my predecessor, Director Lockhart, made clear—as did Secretary Paulson at the time of the announcement—that the conservatorship action was being taken because the Enterprises were in a situation in which they were going to be withdrawing from the housing finance market, and that given the state of the economy and the critical role that they played, where they were situated in the marketplace and where there were not other secondary market institutions, that by establishing the conservatorships and the Treasury backstop, there would continue to be a functioning mortgage market.

So, I think that the effectiveness, Congressman, comes in the fact that we do have a functioning mortgage market today, that nearly 5 million people were able to refinance their mortgages in the last 15 months or so. This would not be possible without conservatorship.

Mr. GARRETT. Let me get to that, the idea of the functioning of the marketplace.

Right now, the FHA is insuring—I don't know the numbers—around 30-some-odd percent or more of the new mortgage market, and there is a question by some people, why is so much going over there? And some people would say it's because, well, the rest of the investors are not really ready to enter the market right now because of all of the other factors.

But others suggested that it's because of actions actually by the GSEs. And I will just throw out one to you right now, and that's the loan level price adjustments, suggesting that by—and maybe you can walk me through this quickly, because I don't have much time—basically what that is doing is it's saying that with those—I'll just say it this way—higher costs of going into the GSEs, hey, then sure, we're going to push all the business into the 100 percent guarantee of the FHA.

Can you walk us through quickly as to why it is necessary that you still have that as a market—the Administration tells us things are being—leveling out in the marketplace.

Mr. DEMARCO. So one of the reasons that the Enterprises have drawn $145 billion from the Treasury is poor underwriting and poor pricing of credit risk. So credit risk by the Enterprises had been underpriced, prior to conservatorship. And, prior to conservatorship, the Enterprises began making adjustments to that in their pricing mechanisms, including through the use of loan-level price adjustments.

Those things are being reviewed and adjusted from time to time by the Enterprises, but it's a result of underpricing of credit risk—

Mr. GARRETT. But the credit risk going forward is better, right, because you have full underwriting, so you're just—

Mr. DEMARCO. Yes, sir. It is. And so, actually, when one looks at something like the average guarantee fees that the Enterprises

are collecting, they are not going up the way you might expect because the way the loan-level price adjustments work, they—it's higher prices on higher-risk mortgages. Because the Enterprises are, in fact, booking lower-risk mortgages than before, the lower prices are what's applying to that flow of business.

Mr. GARRETT. Yes, but you know, the Wall Street Journal just had a piece on this a day or so ago. And they point out, as far as that—the risk base that you're doing there is quite extensive or broad, I guess, would be the terminology, and so that—so what you're really doing is adding additional burden to a much wider spectrum than maybe you should be doing, just to pay off what you're telling me now is the bad loans in the past.

Mr. DEMARCO. All I can tell you, Congressman, is that we are aiming for the Enterprises to be pricing their business—first of all, that we have underwriting standards that are prudent and sounder than they were, and second, to be pricing their business so that they are covering their costs, their expected losses, and an appropriate rate of return.

Mr. GARRETT. Thank you.

Chairman KANJORSKI. The gentleman from California, Mr. Sherman, is recognized for 5 minutes.

Mr. SHERMAN. Thank you. First, I want to set the record straight. Chairman Oxley, the former Republican Chair of this committee, had an excellent bill to provide additional controls for the GSEs. It was passed through the House, supported by a bipartisan group, and then the Republican-controlled Senate refused to take up the bill. And there was no Democratic announcement of a filibuster threat. It was the Bush Administration that opposed that bill. And now, as former chairman of this committee, Mr. Oxley has made it plain his frustration at the time with the Republicans in the Senate and the Administration.

If only we had had a unicameral legislature, we might have avoided the problems we face in our economy today.

Now, it—the GSEs are criticized for being the largest purchaser of subprime mortgages. Being a Californian, I know how it feels to be the largest in every category. We have the most left-handed people, we have the most right-handed people. The GSEs are so large compared to anybody else, particularly now, that they're the largest in every category, which is a misleading statistic.

It's my understanding that the GSEs have $5 trillion of mortgage securities for which they are at risk, and that only 10 percent of that book is subprime or Alt-A. So 90 percent prime is better than just about any other real estate lender I am aware of.

Now, we face the risk that the conforming loan limit will drop precipitously at the end of this year if the bipartisan Sherman-Miller bill is not adopted, or some other legislation. And, not only would the conforming loan limit in high-cost areas drop from 729 down to 625, in many of those high-cost areas it would drop even lower, into the 500s. That would be a sudden, immediate shock to every attempt to sell real estate in a high-cost city, the 10 largest metropolitan areas, or the most expensive metropolitan areas.

And I would like to ask Mr. DeMarco, what effect would it have on the value of the risk that Fannie and Freddie takes guaranteeing $5 trillion in mortgage-backed securities, if there was a sud-

den precipitous January 1st decline in the value of properties, not only in my district but throughout the 10 largest metropolitan areas in the country?

Mr. DEMARCO. So, Mr. Sherman, certainly one of the things that affects their losses on defaulted loans is what's going on with house prices. And so I appreciate the concern that you have raised.

I would actually, though, like to provide you with a clarification I think would be helpful to you. It is true—it's certainly my understanding—that at the end of this year, that the way the law works, that the conforming loan limit going into 2011 would be governed by HERA. And so, the temporary increase that has allowed certain parts of California to have a conforming loan limit of $729,000 would reduce.

But FHFA has already announced and had the view, with respect to the conforming loan limit, that—in cases where it would go down, that the house price index goes down, the conforming loan limit would actually stay where it is, not go down. But before it could rise again, whatever that house price decline was that had taken place would need to have been recovered.

Mr. SHERMAN. I'm going to have to interrupt, because I have to sneak in one more question.

Mr. DEMARCO. Okay, so we're not—

Mr. SHERMAN. But it's my understanding the maximum would be $625,000, though.

Mr. DEMARCO. Yes, sir.

Mr. SHERMAN. Right?

Mr. DEMARCO. Yes, sir.

Mr. SHERMAN. So at least it would be a precipitous drop, $729,000 down by $100,000. And if that's just cut by 2 or 3 percent, the value of your $5 trillion portfolio, we would lose a whole lot of money.

Now let's move on to this predatory finance scheme, these transfer taxes.

Mr. DEMARCO. Right.

Mr. SHERMAN. I described them in my opening statement. They are a hidden burden on homeowners. And my question is, what do you expect Fannie or Freddie to do, as far as their policy? Will they accept mortgages which have this hidden provision that nails homeowners with this secret tax and impairs the value of the security? Will they be participants in such transactions?

Mr. DEMARCO. Congressman, we are actually looking at this right now very closely. I must tell you that I am very troubled by what I am seeing and learning about this. And I would expect that the Enterprises and the FHFA will have something to say about it in the near future.

In terms of coming out with a promulgation or a policy, I would like to know a little bit more about what it is we would be getting—what it is that is taking place, to know what the proper response is to it. But I am very concerned, and I think we will have a response shortly. Before I ban something, I would like to know what it is I am banning.

Mr. SHERMAN. Good.

Chairman KANJORSKI. The gentleman's time has expired. I will recognize the gentleman from California, Mr. Royce, for 5 minutes.

Mr. ROYCE. Yes, I appreciate that opportunity, because again, for those of us who wanted to save Fannie and Freddie, in terms of their securitization, I remember very well in 2005, the whole debate. We had the Federal Reserve up here. We had the Chairman of the Federal Reserve tell us at the time that this legislation that was in the House would increase—basically, would increase systemic risk.

Why? Because the legislation we were trying to pass out of the House would have prevented the regulators from touching the portfolios of Fannie or Freddie. They couldn't regulate them for systemic risk. It would have prevented them from raising their capital. It would have prevented the regulators from doing anything to threaten to place them into receivership, to get them back in line.

I remember Chris Shays sitting here and asking the hands to go up in the audience: "How many of you are lobbyists for Fannie and Freddie?" And as he said it, virtually every hand went up.

That was the bill we passed into the Senate, and that is why the Treasury opposed it, that's why the Fed opposed it, that's why the Senate Republicans opposed it. That's why they put an alternative bill out of committee in the Senate, in order to regulate Fannie for systemic risk.

And, sure enough, that's why, if you pick up Congressional Quarterly in 2005, you can see the Democrats in the Senate talking about preventing that bill from coming to the House Floor, filibustering that bill from coming to the Senate Floor.

So, for those of us who were here at the time, involved in that debate—I remember this very vividly—the reason it's important to me is because this collapse in housing, at least this element of what contributed to it, could have been handled, had we listened to the regulators.

So, I want to get back to a comment for our witness, our guest here. I wanted to ask you. Your predecessor, Mr. Lockhart, was of the belief that the separation of the two regulatory responsibilities—mission oversight on one hand and safety and soundness on the other—was problematic when it came to regulating the GSEs. As he put it, "A separation of such responsibilities among GSE regulators helped cause their downfall. You can't really separate that."

So, as you know, HUD was enforcing the affordable housing goals, akin to mission oversight. And FHFA's predecessor was focusing on safety and soundness. So, I was going to ask if you would agree, Mr. DeMarco, with Mr. Lockhart's testimony here before us in the House, did the model with competing regulators also help cause their downfall?

Mr. DEMARCO. Yes, sir.

Mr. ROYCE. Thank you. I raise this because Congress is on the brink of applying this failed model to the rest of the financial services sector, through the creation of a CFPA. It is not hard to imagine altruistic goals being pushed by this consumer financial product agency or bureau. You can see them, how they would push those goals, like the affordable housing goals, and how it could have unintended consequences.

If you take the provision in the House bill that requires equal access to all products without defining equal access, clearly language

like this enforced by an agency not focused on safety and soundness could raise issues down the road. And this is why regulators have told us, "It is better to allow the safety and soundness regulator preemption to regulate these institutions, rather than set up competing regulatory agencies." As we have done many times, I would caution this body against taking this approach.

I also wanted to ask you—today, it's widely understood that in order to grow and expand their profits, Fannie and Freddie dramatically grew their mortgage portfolios, which were funded implicitly by the government and by subsidized debt. Even then, it was understood that the retained portfolios did very little to promote affordable housing, but did a lot to benefit the shareholders and executives at the firms.

Looking at where they are today, what is the purpose of the GSEs' retained portfolios, other than the fact that they really can't be unloaded right now? Why would they continue in the future to build up a retained portfolio? If I could ask you, Mr. DeMarco?

Mr. DEMARCO. Certainly. So, in fact, they will not be building up their retained portfolio. We have them on a path to be reducing their retained portfolio at a rate of at least 10 percent per year, going forward.

What's going on with their retained portfolio today, sir, is when a mortgage is in a mortgage-backed security and it goes delinquent, in order to undertake a loan modification or some kind of foreclosure prevention action with that mortgage, or if the mortgage is delinquent past a certain amount of time, the mortgage needs to be removed from the security. And at that point, it does need to be put on the balance sheet of the Enterprises.

So, there is a legitimate purpose served there for that type of transaction. That is what we are doing with respect to the portfolio. And I have communicated that publicly and to the Enterprises, that the use of their portfolio, the growth in it, is actually to have capacity to bring these delinquent mortgages on to their balance sheet so that they can actually—to undertake foreclosure mitigation actions.

Beyond that, sir, our goal is for the portfolios to be gradually shrinking, as I say, at a rate of at least 10 percent per year, and that is in the preferred stock purchase agreement between us and the Treasury Department.

Mr. ROYCE. Thank you, Mr. DeMarco. Thank you, Mr. Chairman.

Chairman KANJORSKI. Now, I will recognize the gentleman from Massachusetts, Mr. Lynch, for 5 minutes.

Mr. LYNCH. Thank you, Mr. Chairman. Mr. DeMarco, do we look like we're going to make that 10 percent for the next year, the reduction of the portfolio?

Mr. DEMARCO. Sir, the way this works is that their portfolio for the end of 2010 is supposed to be 10 percent less than the maximum allowed for 2009. The maximum allowed in 2009 was $900 billion. So by the end of this year, it needs to be—

Mr. LYNCH. I don't have a lot of time. Could you tell me—

Mr. DEMARCO. The answer is it would be $810 billion or less, sir.

Mr. LYNCH. What's that?

Mr. DEMARCO. It will be $810 billion or less.

Mr. LYNCH. Is that 10 percent?

Mr. DEMARCO. That will be less than 10 percent of the prior year's cap.

Mr. LYNCH. Okay. Because I know right now, based on the numbers that we have, the GSEs remain the dominant source of funding in the secondary mortgage market. I think we're doing between 80 and 90 percent of all conforming loans.

So, in addition to that, I know the Treasury has pumped in—well, actually, the Fed and the Treasury have pumped in a total of $1.35 trillion in mortgage-backed securities. So, while we talk about reform, it's ironic that the GSEs sort of followed the private market into subprime and Alt-A because they were afraid of losing the market share. And now, we have all the market share.

And I am just wondering. If we are going to go to this—and I think we need to look at a different model. And I am wondering, how do we get there? With all you're doing right now, and with everything we have piled up here, how do we get to a better place where this is all—we have some private-label responsibility here, and everything is not on the GSEs. I just don't see how we can go from one to the other. I think we probably have to have a transition, some type of intermediate step or movement in some direction, so that we can move to that different model.

I know you talked earlier about—in your testimony—about different mortgage industry experts, academics who have talked about a different model, and you're looking at it. Do any of those models stand out as being more promising, in your mind?

Mr. DEMARCO. To take a slightly different tack on that, sir, I believe that the question about whether we can have a functioning and robust secondary mortgage market operated by and served by private firms is something that I believe we can have. And I think that there are models available that would allow for the future secondary mortgage market to be served by private firms operating with their own at-risk capital.

Mr. LYNCH. Even though, in the recent crisis, it was really the GSEs that followed the private label into the riskier market?

Mr. DEMARCO. An important thing to understand about the GSE model that we had, besides the subsidies and the excessive leverage that was in place, was that it was a system in which, by law, there were just two of them. We did not have entry and exit from the market. We did not have a more normal competitive marketplace in providing this function, because the government had provided a set of rather extraordinary benefits, but it had provided them just to two companies, and only two companies could have access to those benefits.

Mr. LYNCH. Are there any specifics, other than just saying, "Sure, we can build a system on"—with private entities here?

Mr. DEMARCO. You asked about the transition, sir. And the senior preferred stock purchase agreement that is in place today may be part of helping Congress to think through this transition. Because that support offered by the Treasury Department remains in place while these companies are operating in conservatorship.

So, new mortgage activity that is being undertaken by Fannie and Freddie is being supported with that backstop, which helps provide an element of stability, as one thinks about building a transition plan to the future.

Mr. LYNCH. Okay, thank you. I see my time has expired. Thank you, Mr. Chairman. I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Lynch. Now, we will hear from the gentleman from Texas, Mr. Hensarling, for 5 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman. Good afternoon, Mr. DeMarco. You were last here in February.

Mr. DEMARCO. Yes, sir.

Mr. HENSARLING. And when you were here, I shared with you a quote from Charles Haldeman, the CEO of Freddie Mac. He was quoted in the Wall Street Journal as saying, "We are making decisions on loan modifications and other issues without being guided solely by profitability that no purely private bank could ever make."

Knowing that, cumulatively, Fannie and Freddie have now cost—I believe, according to your testimony—$145 billion and counting, at the time I shared that with you, you said you were unaware of the quote, and that you would check with Mr. Haldeman and talk to him. I think you said, "I will have to check that quote and talk to Mr. Haldeman." I assume you did that. Can you report on your conversation with Mr. Haldeman?

Mr. DEMARCO. Yes, sir, thank you. I would be pleased to. I have followed up with Mr. Haldeman. And he explained to me what he had in mind.

First of all, the loan modifications in that quote is in brackets. So I am not sure what the reporter was putting in there. But what Mr. Haldeman reported to me was that the example that he had in mind, the issue he had in mind, had to do with low-income housing tax credits, of which Freddie Mac had roughly $3 billion worth. And we were, at that point, working with the Treasury Department regarding the disposition of those assets. And as has been made quite clear—

Mr. HENSARLING. Okay. So, Mr. DeMarco, essentially he was relaying to you that his comments were taken out of context. Is that a fair assessment?

Mr. DEMARCO. Whether it's out of—no, I don't believe that's a fair assessment, sir. But he had something specific in mind, which is if they were operating as a private company, they would have sold those $3 billion worth of tax credits. It was in the best interest of the taxpayers, determined by the Treasury Department, for them not to—

Mr. HENSARLING. Let me continue on this line of questioning. In your testimony, in defining your mission, you stated the purpose of conservatorship is to preserve and conserve each company's assets and mitigate the systemic risk that contributed to instability and financial markets. I am trying to figure out to what extent those are complementary goals, to what extent are those competing goals, particularly when I think in terms of what the Administration is doing on the HARP program.

The latest report that I have had on Fannie and Freddie—and you may have more up-to-date data—is that the redefault rates for their loans after 12 months after modification both exceed 50 percent. That may be a fourth quarter 2009 number. Do you have anything more recent? Is that at least a ballpark figure?

Mr. DEMARCO. Yes, sir. I do. Let me say, though, with respect to the systemic risk, you asked whether those were complementary or not. I believe they are, because Fannie and Freddie actually own or guarantee a little over half the mortgages in this country. Anything that brought stability to the housing finance system was certainly going to be a positive contribution—

Mr. HENSARLING. I guess, Mr. DeMarco—

Mr. DEMARCO. —to their assets.

Mr. HENSARLING. —what I'm trying to figure out, if more than half of these loans redefault after 12 months, how is that preserving the assets of Fannie and Freddie to where the taxpayer can ever expect to even receive pennies on the dollar?

Mr. DEMARCO. Let me give you some updated data, sir. I don't have 12-month redefault rates in front of me. I do have 3-month and 6-month after modification data in front of me.

And so, with respect to modified loans, 3 months after modification, in the fourth quarter of 2008, the percentage of modified loans that were still performing 3 months later was about half. It was 49 percent. At the end of 2009—so 1 year later—77 percent of modified loans were still performing 3 months after modification.

Mr. HENSARLING. Mr. DeMarco, if you could at some time, maybe—so we're comparing apples to apples—

Mr. DEMARCO. Sure, certainly, sir.

Mr. HENSARLING. —I would love, perhaps in writing, your latest data—

Mr. DEMARCO. I would be glad to do that, Mr. Hensarling.

Mr. HENSARLING. —on the 12-month—

Mr. DEMARCO. And I would add, as I noted in my written comments, I would like to, in response to concerns that have been raised, be making some of this information more clear on a regular basis by FHFA to Congress and to the public.

Mr. HENSARLING. Mr. DeMarco, some have maintained that all of Fannie's taxpayer hemorrhage, or problems resulting from the past, the most recent reports I have seen from the Congressional Budget Office show taxpayers will lose an additional $64 billion in the 10-year budget window that we are presently in on new mortgage originations.

Am I somehow misinterpreting what the Congressional Budget Office says, that also does not have the reputation for being overly pessimistic? Is this—indeed, are they predicting $64 billion of loss on new mortgage originations?

Mr. DEMARCO. I'm sorry, sir. Off the top of my head I'm not sure what the CBO's most recent projection is. I could certainly verify that and get right back to your office. I don't have that right in front of me.

Mr. HENSARLING. If you could, please, because it seems like the hemorrhaging is certainly not over, certainly not on old mortgages, but also on new mortgage originations, according to the Congressional Budget Office.

Mr. DEMARCO. Right, and I certainly make clear in my testimony that there are still losses to come with respect to the pre-conservatorship book of business at each—

Mr. HENSARLING. But this is post. Anyway, if you could check on that, I would—

Mr. DEMARCO. Certainly, sir.

Mr. HENSARLING. I see I'm out of time. Thank you, Mr. Chairman.

Mr. DEMARCO. I would be happy to do that, Mr. Hensarling.

Chairman KANJORSKI. The gentleman from Georgia, Mr. Scott, will be recognized for 5 minutes.

Mr. SCOTT. Thank you, Mr. Chairman. Mr. DeMarco, I want to get a clear picture of where we are now with these GSEs. In 1932, the first to come on board were the Federal Home Loan Banks to deal with the liquidity issue in the system through secured loans, and they used 12 regional banks. Then, in 1938, we brought on Fannie Mae to give credit to banks to secure loans for the middle class. In 1970, we brought on Freddie Mac to give credit and access to, basically, savings and loans operations.

Given where we are now, what is your vision for each of these three entities, going forward? And I am specifically concerned about what role do you see for the Federal Home Loan Banks going forward, and then following that, Fannie and Freddie.

Mr. DEMARCO. Thank you, sir. With respect to the Federal Home Loan Banks, I think, in fact, the Federal Home Loan Banks mission, which, as you noted, was given to them in 1932, has served them and the Nation's financial system very well during this housing crisis.

What we saw in the fall of 2007 and again in the fall of 2008, when there was a great deal of illiquidity in the marketplace, is that the Federal Home Loan Banks were able to provide, immediately, liquidity to their members. And so, their advances book grew from, let's say, $600 billion to $1 trillion in a very short period of time, and that was serving their mission, and it was very important to our financial system. It worked very well. The liquidity crisis has gone, and they have shrunk.

I believe, going forward, that they certainly remain a viable part of our financial system. It's something for Congress to consider as it takes up the future of housing finance, but their core business of advances seems to me to remain a viable and important contribution to the financial system.

With respect to Fannie Mae and Freddie Mac, I believe that there is a range of options available, post-conservatorship, that move away from the government sponsored enterprise model that we have had all these many years. There are a variety of options available, and I do believe that that's an important part of the discussion in the coming year.

As I have already mentioned, one of the things that I would hope to see is if any sort of a private sector model is followed, that there be greater freedom of entry and exit, so that there is more competition in the marketplace provided by securitizers of mortgages.

Mr. SCOTT. Fannie and Freddie continue to absorb additional losses as real estate prices keep dropping nationally, as I alluded to in my opening remarks. How much, if any, additional aid do you feel Fannie and Freddie will require to survive?

Mr. DEMARCO. That's a very difficult question to answer, Congressman. As we look at various ways this could turn out, three of the key factors are: first, what happens to house prices, particularly—and this is not just at a national level—what happens to

house prices in certain parts of the country, particularly, the harder-hit housing markets in the country; second, what happens to employment, because employment is, certainly at this point, a key factor in a household's ability to pay their mortgage; and third, what happens to interest rates.

And so, there is a variety of scenarios we look at. In my judgment, the more likely scenarios are that they will incur some additional losses based on their pre-conservatorship book of business, but that those losses will not exceed the original—the $200 billion that had been put in place through this senior preferred agreement.

But beyond that, I don't have a point estimate for you, sir.

Mr. SCOTT. One of the other things I do want to call to your attention, as I mentioned before, that I am very concerned with, is I don't think we are putting enough attention or trying to figure a way to deal with this very disheartening reality that so many of the American people are faced with, in seeing this extraordinary drop in the value of their home, which is the basic unit of wealth-building in this country.

What are your recommendations? What are your suggestions? Have you given any thought to what we can do? Even if it's from the standpoint of simply developing a stronger appeal system for a homeowner who receives word that his property has fallen this much in value, yet, at the same time, he is paying this huge mortgage on a value that was up here, and now it's down there. What can we do to address this phenomenon?

Mr. DEMARCO. I think that the start is sounder underwriting practices within our housing finance system. I actually think that is the place to start. In some of the States in which we have seen the most dramatic increase and then the most dramatic decline in house prices, there has been a great deal of speculation and investor activity that was riding this up, and has contributed to the collapse.

And so, I think that more prudential underwriting is certainly the place to start.

Mr. SCOTT. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mr. Scott. Now, we will hear from Mr. Neugebauer from Texas for 5 minutes.

Mr. NEUGEBAUER. Yes. Thank you, Mr. Chairman. I have been kind of trying to go through some of these charts. But I think—I'm looking at a Freddie Mac chart, on page 19, and it's talking about single-family credit guarantee portfolio characteristics, and it talks about book year.

And so, for the book year 2010, I guess 3 percent of the total portfolio was originated in 2010. And, if I'm reading this right, in 2009, 25 percent of the outstanding balance was originated in 2009. That's double what, when you look historically at what was even happening in 2008, 2007, 2006, 2005. And, in fact, it says, less originated before 2004—26 percent of the portfolio was originated before 2004.

And what I heard you say is you're charging a lower-risk premium on these loans that you're processing now because they are less risky, in your estimation, and so you are charging a lower-risk premium. The problem is that, at a very accelerating rate, we are

increasing the contingent liability of these two entities, because they are basically the major market for securitization right now.

I think the question is, what if you're wrong with this risk premium again?

Mr. DEMARCO. Sir, the earlier question had to do with loan-level price adjustments that had been put in place, essentially increasing the fees charged for mortgages. And this is a—sort of think about it as a matrix pricing that, as the risk characteristics of the mortgage go up, the greater is the added fee or risk premium that's attached.

Those loan-level price adjustments are still in place. The response I gave earlier had to do with relative to the mortgages that were being booked in 2006, 2007, the risk characteristics have improved. And hence, on average, the guarantee fee income is going down, because it's a higher quality book. But it's a risk-based pricing scheme that's there, it's not a reduction, per se, in the premiums that are being charged. In fact, it's an increase relative to where things were in 2006.

Mr. NEUGEBAUER. Well, I think I understood that perfectly, and I think my question still holds. What if your model is not correct, and we have, in one year, increased the exposure by—in that entity in 2009 for the first—I don't know if this is the first quarter. It's through March 31st, I assume you're on a fiscal year—that means it's 28 percent of—since this entity went into conservatorship, we have increased the exposure by 28 percent using this risk model, right?

Mr. DEMARCO. I see your question, Congressman. I can report that the early payment default on new mortgages, mortgages that had been originated since the start of 2009, the early payment default rates on those mortgages are equivalent to what we saw in 2003, which was a very strong performance vintage for the Enterprises. And it is dramatically less than was the case for the mortgages originated in the couple of years prior to conservatorship.

So, the early performance of these mortgages are, in fact, the way we would expect, based upon the modeling work that has been done and the improved underwriting of the mortgages.

Mr. NEUGEBAUER. And so, then the question I have is, do these entities—is anybody doing a budget for these entities? Do you have a budget?

Mr. DEMARCO. Each company prepares a budget, yes.

Mr. NEUGEBAUER. Could I have a copy of that, please?

Mr. DEMARCO. I will look into that, sir.

Mr. NEUGEBAUER. Yes. And then the next question is that if—is there an interest rate sensitivity analysis of the portfolio?

Because, at the rate that some of these rates that were originating now—what the potential—because you're taking a credit risk and an interest rate risk, particularly on your portfolio.

Mr. DEMARCO. Yes, sir. In fact, I discussed that in my written testimony, and also there is a discussion of it in the annual report that we sent up to Congress yesterday.

It is, in fact, the case that a great deal of mortgages are coming on at lower interest rates. And if there is a dramatic rise in interest rates going forward, that would extend the duration of these mortgages, and that's an important risk element for the companies

to be managing, with regard to how they fund and hedge their retained portfolio.

And as—not just as conservator, but as the regulator of the two companies, I have a staff of people who are paying attention to that on a daily basis, and observing the business decisions of the companies, and overseeing, as a prudential matter, how they are managing the interest rate risk of their retained portfolio.

Mr. NEUGEBAUER. I would like to see some more recent analysis.

And then just one final question. If you could, also furnish me with information on when you look at the losses. Is this—are these companies making a net operating profit? And if they are, fine. But in the credit losses, how much of those losses are coming from the portfolio, and how much of those losses are coming from the guaranteed portfolio?

Mr. DEMARCO. We will put that together. Of course, their quarterly statements are filed with the SEC. And what's driving the financial performance of the company are the credit losses on the mortgages. And the credit risk is there, whether it's guaranteed on an MBS, or whether that mortgage is retained in their portfolio. So that's the key driver of the financial—

Mr. NEUGEBAUER. But I think this committee—it would be beneficial for us to see where those losses came from, the guaranteed portion of the portfolio or from the portfolio that was retained.

Mr. DEMARCO. Very good, Congressman. I will see what we can do.

Chairman KANJORSKI. The gentleman's time has expired, and we will now recognize the gentlelady from New York, Mrs. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman, and welcome, Mr. DeMarco.

I represent New York City. And, as you know, New York City has a growing problem of overleveraged multi-family properties, including Stuyvesant Town and Peter Cooper Village, which is in the district that I am honored to represent. Stuyvesant Town and Peter Cooper Village are rent-stabilized developments, housing over 25,000 of my constituents.

As you may be aware, Stuyvesant Town and Peter Cooper Village was sold by Metropolitan Life to a private entrepreneur. And they were financed in the secondary market by Fannie and Freddie. The business model that came forward was that in order to make the payments, the loan-to-debt ratio was so high that the only way they could make it was for the entrepreneurs to aggressively turn over affordable housing to market rate units in order to increase the rental income.

What was surprising about this particular deal is that Fannie and Freddie received affordable housing goals credits for their investment into Stuyvesant Town and Peter Cooper Village, yet the business model was such that the only way it could survive was to evict the tenants and move it from affordable housing to market rate, which was totally opposite of the mission and goal of Fannie and Freddie.

What I find particularly onerous about it is that they received housing goals credits for this project, when the only way it could survive was to turn affordable housing into market rate, high-income housing units.

The tenants went to court, and they won. And the entrepreneurs were stopped from their proceeding with their eviction practices, and the project is moving forward.

I find this distressing, because Fannie and Freddie were used for the opposite goal of their mission. So I wanted to know, as you know, these GSEs invested in the secondary market on the Stuyvesant Town debt. Can you describe those transactions? Are you familiar with this case?

Mr. DEMARCO. A bit, Representative Maloney, I am. So, this was not a direct purchase or guarantee by Fannie or Freddie. They, in fact, purchased commercial mortgage-backed securities, senior tranches of commercial mortgage-backed securities, and in the pool of mortgages that underlied those securities were certain of the properties in Peter Cooper Village, and so forth.

And so, they had some interest in those properties as part of that pool. And yes, I do understand that HUD provided housing goals credit at the time of the purchase for them. I share your concern that, since the purpose of housing goals is to be providing affordable housing, it seems questionable to be providing housing goals credit when the intent is, in fact, to turn the property into something other than affordable housing that would meet the definition of the goals. And so that is something for us to be looking at.

With respect to housing goals currently, we have a proposed rule that we issued earlier this year—

Mrs. MALONEY. Before we get to that rule—

Mr. DEMARCO. Yes.

Mrs. MALONEY. —I am interested in this particular, specific project, because it really tells more about the goals and the activities and the success than talking about the goals in the future.

How much did Fannie and Freddie know about the deal underlying these transactions when it invested in the debt? Were they aware that the only way it could be successful was to evict the tenants that were there? How much did they know?

Mr. DEMARCO. I do not know what the business people at Fannie and Freddie, at the time they purchased these securities, knew or thought about the—

Mrs. MALONEY. Can you get that information to the committee?

Mr. DEMARCO. I will look—

Mrs. MALONEY. The paperwork involved.

Mr. DEMARCO. I will look into that, yes, ma'am.

Mrs. MALONEY. And one of the aspects of Fannie and Freddie's investment that I think shocked a number of people was that, although the owners knew that they would have to aggressively turn over affordable housing to market rate units in order to increase the rental income, Fannie and Freddie received affordable housing goal credits for their investments.

Can you elaborate on FHFA's process for providing affordable housing goal credits? What are the factors you use to decide what gets credit and what doesn't? Because, obviously, projects like this should not get credit in the future. And have you changed your processes any? How did they get affordable housing goal credits when, obviously, they had to turn it into high-income property to succeed?

Mr. DEMARCO. I would be happy to provide in writing for you how the goal credit is actually assessed on any property, not just this.

Mrs. MALONEY. Can you tell us?

Mr. DEMARCO. Generally, it has to do with—we collect data on, with respect to multi-family, what are the rents that are being charged in the units, and how do those rents compare to area median income?

Mrs. MALONEY. So, in other words, you take a snapshot of what's happening right then. You don't look at the whole project, the debt, and other things, of how it has to be done in the future?

Mr. DEMARCO. That is—

Mrs. MALONEY. So that process needs to be changed.

Mr. DEMARCO. That's correct.

Mrs. MALONEY. My time has expired?

Chairman KANJORSKI. The gentlelady's time has expired. I now recognize the gentlelady from Illinois, Mrs. Biggert, for 5 minutes.

Mrs. BIGGERT. Thank you, Mr. Chairman, and thank you, Mr. DeMarco, for being here. In February, my colleagues and I introduced H.R. 4581, the Fannie Mae and Freddie Mac Accountability and Transparency Act, and then requested you to take a look at it and give us a redline on the bill. I think that was in February, and it's almost June. Are you going to send us the redline on the bill, or have you looked at it?

Mr. DEMARCO. Congresswoman, we will get right back to you on that, because we certainly have. And forgive me if we have not responded in a timely fashion on that.

Mrs. BIGGERT. Thank you. Is it important for the FHFA, which now runs the GSEs, to have a watchdog or independent body reviewing the work?

Mr. DEMARCO. I believe, yes, it is helpful and appropriate for the FHFA to have an overseer, and that would be—as it would with any other Federal agency—the Inspector General. And, as the HERA act actually requires, not only that FHFA have an inspector general, but that that inspector general be a presidentially-appointed, Senate-confirmed individual.

We have been—the Administration did recently nominate an individual, a career official at the Justice Department, to be the inspector general. The gentleman's name is Steve Linnick. His paperwork has been forwarded to the Senate Banking Committee, and I look forward to the committee's quick action on his nomination.

Mrs. BIGGERT. Good. Have you talked to the Senate at all about it, or do you know when it will be scheduled?

Mr. DEMARCO. Yes, we have been in communication with the committee. I don't know the schedule; that's the committee's decision.

Mrs. BIGGERT. Okay. Actually, Fannie and Freddie and the FHA are essentially the only games in town on home mortgages today. And I guess you could say they constitute about 90 percent of the market. Is this helping the market, or is it subverting it?

And what steps has the Administration taken, or what steps did they plan to take to bring back the private sector capital back into the mortgage market?

Mr. DEMARCO. I think, in the near term, the actions that have been taken have brought an important measure of stability to the country's housing finance system. I think that folks are able to purchase more houses, to refinance their mortgages, and that has been the result of an array of government interventions to bring support to the housing finance system.

With respect to the Administration's plans to exit and to restore more normal order and greater private participation, I would have to defer to the Administration on that.

Mrs. BIGGERT. So you haven't discussed that with—

Mr. DEMARCO. No, ma'am. Secretary Geithner and other members of the Administration have certainly testified before Congress on their plans to bring forward a proposal, and they have published a document for public comment raising a series of questions about the future of the housing finance system, so they are gathering input. But I don't have any particular insight into their timing or particular plans.

Mrs. BIGGERT. Thank you. How leveraged were Fannie and Freddie?

Mr. DEMARCO. Excessively.

Mrs. BIGGERT. Okay.

Mr. DEMARCO. By statute—the Congress created OFHEO back in 1992. It hardwired into the statute the minimum capital requirements for Fannie and Freddie, setting it at 2.5 percent for on-balance sheet assets, and 45 basis points for mortgages that were guaranteed by the companies through mortgage-backed securities. This was an excessive degree of leverage. It's something that multiple Administrations had testified about, raising concerns about. It's certainly something that FHFA's predecessor agency, OFHEO, had testified repeatedly was problematic, and made it very difficult, if not impossible, for them to carry out their responsibility of assuring safety and soundness.

I would say that Congress has addressed that in the HERA legislation, giving FHFA far greater authority with respect to setting capital standards. Unfortunately, it came too late.

Mrs. BIGGERT. Thank you. Thank you, Mr. Chairman. I yield back.

Chairman KANJORSKI. Thank you very much, Mrs. Biggert. And now, we will hear from Mr. Childers of Mississippi for 5 minutes.

Mr. CHILDERS. Thank you, Mr. Chairman, and I appreciate you holding this hearing today. And, Mr. DeMarco, thank you for being here.

Mr. DEMARCO. Thank you, sir.

Mr. CHILDERS. I have been, between appointments, trying to watch what you had to say from our office, on the monitor, and I guess I just want to thank you for your leadership, first of all.

Mr. DEMARCO. Thank you, sir.

Mr. CHILDERS. I sit before you today as a veteran Realtor and a real estate appraiser for some 32 years. I have long been an advocate for the real estate industry and the—strengthening homeownership in rural America a long time before I came to Congress. And I have been here about 2 years, and I plan to be more so now.

I want to talk to you about HVCC, specifically. Since HVCC has been implemented, many—most rural appraisers—who, in my opin-

ion, are people who have the best and most accurate knowledge of their rural market area—are being replaced by appraisers, quite frankly, from usually an urban area, many times out-of-State, many times out of the area, and they are being replaced with appraisers who are not familiar with the market area.

I have talked to these appraisers all across my State and, quite frankly, because of my background in real estate, I think is why some across the country in rural areas chose to speak to me about it. I guess, in short, I just want to tell you I don't think it's working, and I think it is negatively affecting the real estate industry. I think it is negatively affecting small businesses being—appraisers, specifically. I have heard from appraisers. Basically, if they're not with one of these appraisal management companies, they're somewhat left out.

I have so many problems with the appraisal management companies themselves that I won't go into today for the sake of time. But I would just like to hear your thoughts about how the current and future changes to HVCC will affect rural appraisers, because I have a great concern for rural appraisers, not only in the State of Mississippi, but across this great country.

And I would also like to know, how would FHFA implement the HVCC sunset provisions in section 4312 of the Wall Street Reform and Consumer Protect Act, if the bill is passed, or if the upcoming conference report includes this provision?

Mr. DEMARCO. Fundamentally, the HVCC was about assuring a set of standards whereby the investor in a mortgage could be assured that the appraisal that went into the mortgage—the loan underwriting had been done independently. That's the fundamental premise here, is to be able to establish a set of processes whereby the appraiser is independent, and not subject to undue influence by an interested party in the transaction. I think that's an important goal, and it's one the HVCC was designed to address.

The HVCC was not designed to favor appraisal management companies versus other appraisers. The difficulty of doing appraisals in the kind of housing market that we have had cannot be overstated. When you have a market in which there are a great deal of delinquent loans, there are foreclosures, you have declining house prices, economic uncertainty. Coming up with appraised values on houses is difficult.

I am not aware of particular differences between rural and urban areas, and I would be glad to have my staff follow up with you to find out if there are particular things with regard to appraisals in rural areas that we should be more aware of. I would welcome that opportunity to follow up and get that information. But I think that what we are trying to achieve with the Code, and what I think will live on beyond the Code, is the importance of there being independence in the appraisal process.

One other thing I would say is that the Code does not address where the appraiser is from that is doing the appraisal, but it does, by reference, bring in the code of conduct for appraisals, which includes that any appraiser needs to be familiar with their local area. So bringing in an appraiser from many miles away who is unfamiliar with the local market is a problem with—of appraisal standards outside of the Code, and it is problematic, and should be a

concern. But it is not something that the Code itself deals with directly.

Mr. CHILDERS. Thank you. I would be less than a decent Representative if I didn't say that in the State of Mississippi, which is the people who hired me, my State was not a State with excessive foreclosures. And, quite frankly, I have to defend those appraisers. They didn't do anything wrong, in my opinion. And the law will take care of that. We have a fine real estate commission in our State that, if you don't do right, they will pull you out, make no mistake, and put you on the road doing something else.

And so, I just feel like they are being punished, and I just have some great concerns about it.

Mr. DEMARCO. Okay. Thank you, sir.

Chairman KANJORSKI. We will now hear from Mr. Posey for 5 minutes.

Mr. POSEY. Thank you, Mr. Chairman. Director DeMarco, I want to bring to your attention a recent policy change by Fannie Mae that, in my State, could affect borrowers who are in trouble.

Fannie Mae implemented spending cuts to contract borrowers going into foreclosure on May 1st. And I am informed that Fannie Mae officials have decreed that: one, no law firm can give more than 50 percent of its service of process business to one firm, no matter how well their firm performs, or what the cost is; and two, the new pricing structure is suitable for the lowest-cost firm, but obviously could adversely affect a borrower. And there are lots of ramifications to that, as you well know, probably better than me.

I just want to note that Florida is a judicial foreclosure State. That means in person. And recently, this committee passed a bipartisan amendment—it was the Marchant-Klein amendment—in the FHA Reform bill to devote more funds to in-person contact. The intention was twofold: number one, to reduce unnecessary foreclosures; and number two, to reduce FHA losses, which the American taxpayer ultimately has to foot the bill for.

Fannie Mae just announced an $11.5 billion first quarter loss, and asked the Treasury for another $8.4 billion infusion. So members of this committee surely recognize the need to reform Fannie Mae and stop the hemorrhaging as soon as possible.

That said, it doesn't seem to make sense to cut funds that helps borrowers, hopefully to reduce foreclosures and to reduce future Fannie Mae losses—particularly in Florida, which again, has the second highest foreclosure rate of all the States. My Florida colleagues—Congressman Klein and Congresswoman Kosmas—and I last week sent a letter to Chairman Frank and Ranking Member Bachus, and we requested a 120-day stay on the Fannie Mae policy change so that there would be time to review it and the ramifications that it might have more closely.

And the question I have now is, of course, whether or not you will support that stay.

Mr. DEMARCO. So, Congressman, I am going to have to get more familiar with the particulars of the policy change that you are describing to have an opinion.

Florida is perhaps—if I might turn it around, I could use some help here—because Florida, as you noted, is a judicial State. And this is a State that, as is noted in my written statement, represents

a considerable portion of the losses that Fannie Mae and Freddie Mac have been absorbing. And despite the tremendous efforts that each company is taking to find foreclosure alternatives for troubled borrowers, there is still a great deal of properties that need to go through foreclosure in Florida.

And because of various protections and the way the system works—and, frankly, that the court system is overwhelmed, the number of foreclosures coming through—this, I fear, is hurting neighborhoods in Florida because it is taking so long—

Mr. POSEY. Yes, it's destroying a lot of neighborhoods.

But my point is, where does FHA get off telling the people who are working the foreclosures—hopefully trying to stop them—that they can't use a particular firm?

It could be the low bidder. Let's suppose there is one that charges, hypothetically, $1, one that charges $2, and one that charges $3. And let's suppose they give all their business, 400 cases a year, to the firm that charges $1. That's $400. We have FHA saying, "No, there is no way. You have to pay at least 50 percent more than that." Actually, you have to pay 100 percent more for half of your cases if you're over the 300 mark. It just defies logic that you would try and—so minutely manage the process down there.

And I don't see any upside to it. I was thinking that maybe there was some logic behind it that would be good for the consumer, but I don't see that anywhere.

Mr. DEMARCO. Okay. Well, I would be happy to look into this. You have mentioned FHA several times, and that would be within HUD, so that's a different jurisdiction than me. If you're talking about a Fannie Mae or Freddie Mac policy—

Mr. POSEY. Right.

Mr. DEMARCO. I would be happy to look into it, sir, and find out what the particulars are. But I am—forgive me, I am not aware enough of the details of what you're describing for me to have a ready answer for you.

Mr. POSEY. Okay.

Mr. DEMARCO. But I will look into it.

Mr. POSEY. Thank you. And I guess you will mail a copy to the chairman, and the chairman will get it to us.

Fannie Mae, Freddie Mac, and FHA are essentially the only games in town right now, constituting over 90 percent of the market. And I was wondering if you think that's helping the market or hurting it. And I think I already know the answer, but I want to get your opinion.

And I want to know what steps the Administration plans to take to entice some private sector capital back into the mortgage market.

Mr. DEMARCO. In the near term, I believe that the role Fannie, Freddie, and the FHA have played has brought a great deal of stability to the country's housing system, so it has been a positive. Long-term, I believe we need to figure out what the future is, so that there can be much more of a return of private businesses and private capital to the housing market.

With regard to the Administration's plan, I am sorry, I'm a regulator, I'm not part of the Administration. I'm not an Administration

official. So I would have to defer to them in terms of what their plans and timeline are, sir.

Mr. POSEY. And that's a good answer, because nobody who has appeared before us yet in any sector has had any kind of a plan. So I guess that's fair enough.

Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mr. Posey. Now, the gentleman from Delaware, Mr. Castle, will have 5 minutes.

Mr. CASTLE. Thank you, Mr. Chairman. Mr. DeMarco, several questioners ago you indicated that Fannie—I think you said Fannie and Freddie would reduce their retained portfolios by 10 percent per year. Did I hear that correctly?

Mr. DEMARCO. Yes, sir.

Mr. CASTLE. How will they do that? I don't quite know what assets they are going to be reducing, and who wants them.

Mr. DEMARCO. It will generally be accomplished through the normal run-off of their mortgage books, so mortgage loans that are paying down.

Mr. CASTLE. So mortgage loans that are paying down and paying off, or somebody—or they're sold, or whatever it would be?

Mr. DEMARCO. Yes, sir.

Mr. CASTLE. Okay. What are Fannie and—I don't want specifics on this, but in general—Fannie and Freddie's requirements to accept mortgages, or to purchase mortgages into their portfolios?

You have indicated they are excessively leveraged. Others have said that the collapse of Fannie and Freddie was a failure of management. But at some point somebody has to make the decision that they are going to acquire a mortgage, or do whatever they are going to do. Is this just a failure of good decision-making? Or is it blamed on the collapse of the real estate market in this country?

It just seems to me that there were missteps that were made—and perhaps they're still being made, I have no idea how it's going today.

Mr. DEMARCO. In 2004, 2005, 2006, and so on, we saw the emergence of a private-label mortgage-backed security market, not just for subprime mortgages, but for other non-traditional mortgages, which are called Alt-A mortgages, low documentation mortgages.

So, as this emerged, as an alternative to the conforming conventional market, Fannie Mae and Freddie Mac, over time, did make management decisions to lower their underwriting standards, adjust their pricing so as to remain what they saw as competitive in the marketplace. They also became purchasers of the senior tranches of these private-label mortgage-backed securities, both for purposes of meeting certain housing goals, and for the purpose of profitability. They thought that they could make money on those investments.

These were, in fact, business decisions made over time. Like many other participants in the housing market, they under-estimated the credit risk that they were undertaking, and they certainly did not have enough capital to support it.

Post-conservatorship, they're not leveraged in the sense that the Treasury backstop is there to bring shareholder equity basically to zero, but they are operating in conservatorship with much tighter underwriting standards, and more appropriate risk-based pricing,

so that they are able to serve their statutory mission of providing a liquid and stable secondary mortgage market as we go along now, but do so in a way in which they are not adding to the losses that they incurred in their book of business, pre-conservatorship.

Mr. CASTLE. Thank you. This is going to have to be a little bit vague, because I don't quite understand it at all, but I am curious about the timeline for revamping the GSEs. And I ask that in conjunction with the financial regulatory bill that has been passed in the House and the Senate, and it's now going into conference, in which the statement has been made, "We just can't deal with the GSEs in this piece of legislation," which I thought we should have dealt with.

And the discussion has been from the Administration—and maybe you're not even involved in this, I don't know—but that there is going to be a redoing of Fannie and Freddie, in particular, recommended at some point. But it wouldn't be part of that bill, it would be some time in the future.

You can comment on that, but I would be curious as to what—whether or not there is a timeline for doing anything different with Fannie and Freddie, or just letting them work out their problems, such as the way you have just described in the previous answer.

Mr. DEMARCO. I can't speak for the Administration's timeline of coming before Congress with a specific proposal. They have said that they will.

I would say that, as I have said earlier, conservatorship is not a long-term option. And policymakers are going to have to deal with the future of the housing finance system. And, in that context, deal with the—what is the post-conservatorship world for the Enterprises and, more generally, for the secondary mortgage market.

But I don't have a specific timeline. That's for policymakers to develop and act upon.

Mr. CASTLE. Going back, what, 40 years ago or whenever Fannie Mae was created, and then Freddie Mac thereafter, as we all know, the U.S. housing finance market was basically funded by, I guess, demand deposits from banking institutions in this country. And then we got into this whole business of using Fannie Mae and Freddie Mac, which had some advantages, obviously, and some disadvantages.

But is there a better mortgage finance model than securitization, or does this securitization provide some sort of stability or liquidity to the banking institutions, and therefore should not and is not going to go away? Or could we revert to some sort of a just demand deposit circumstances?

Mr. DEMARCO. I would be awfully cautious about returning to a demand deposit-based system of financing housing. The thrift crisis in the late 1970's and into the 1980's demonstrated the considerable risk that can be realized if one if funding a 30-year asset with basically overnight money. The interest rate risk of trying to finance a 30-year mortgage with short-term deposits is considerable, and the costs of properly hedging that are very difficult.

What securitization does give the Nation's homeowners is the following. I think of it as that is the—those are the—that's like the plumbing that connects, on the one hand, individual housing transactions across the country, the average size of which is only

$200,000 per mortgage. But when you aggregate that across the United States, it's a single-family mortgage market of roughly $10 trillion.

And so, what securitization—the power of securitization is it's a way of aggregating all of these $200,000 transactions that add up to a cumulative amount of $10 trillion, and then securitization allows one to tap into global financial markets, to institutional investors, not just in this country but around the globe, that can deal with the interest rate risk of a 30-year fixed-rate mortgage, and have the capacity and have the capital to want to fund in that kind of volume.

And so, securitization can be a powerful element to enhancing our financial system and providing great benefit to homeowners because it provides a channel to connect from that individual transaction to the size of investment that institutional investors around the globe want.

The trick here, and what we have to improve upon, really, is how does one assure these global investors that are going to have no idea about the actual credit worthiness of any individual borrower of $200,00, what are the credit protections that are in place so that the owner of that mortgage-backed security can have confidence in the credit characteristics of the pool of mortgages?

Now, in the GSE model, that was looked upon as the backing of the GSEs. But we had this very awkward and unfortunate framework in which investors relied on not just the guarantee of Fannie and Freddie, but the implicit guarantee of the Federal Government if anything happened to Fannie and Freddie. And, quite to our regret, that implicit guarantee had ended up being realized.

I think what Congress is grappling with in the future of the housing finance system, is what is going to replace that model of a Fannie and Freddie GSE guarantee and an implicit government backstop behind it, so that in the future, we can continue to be able to tap into global capital markets to finance housing in this country, but do so in a way in which we have better managed who owns the credit risk, and how that credit risk is being managed, and what kind of private capital is supporting it.

Mr. CASTLE. Thank you. I yield back, Mr. Chairman.

Chairman KANJORSKI. I recognize the gentlelady from New York for several questions. Mrs. Maloney?

Mrs. MALONEY. Thank you so much, and that was a very good explanation, Director DeMarco. Thank you for your service.

I would like to get back to the rather startling example in Stuyvesant Town and Peter Cooper, where the financing from Fannie Mae and Freddie Mac enabled a situation where affordable housing was in the process of being converted to high-income housing, and many people were forced out of their homes, or evicted.

Looking back on it, do you believe Fannie and Freddie should have received housing goals credit for their investment in the Stuyvesant Town/Peter Cooper deal?

Mr. DEMARCO. To the best of my knowledge, the awarding of housing goal credit on the transaction was done in accordance with the rules and the policies that were in place at that time. So it was not inappropriate, given the way the housing goal framework and policies existed at that time. So, the answer then is no.

But I share with you the concern about transactions that are, in fact, aimed at turning affordable housing into something else, and whether there is a way of, whether through policy or regulation or legislation, avoiding that peculiar outcome, where one is awarding affordable housing goal credit on a transaction that is designed, in fact, to turn the housing into something other than affordable housing.

I would note that we have a proposed rule out—the comment period is closed and we are evaluating it—regarding the housing goal rules going forward. And in that we have raised the question as part of the comment period about whether commercial mortgage-backed securities, such as the ones Fannie and Freddie purchased in the instance you're referring to, should get housing goals credit at all, regardless of what the investor's intent with respect to the property is.

And so, that's a question that we raised in our proposal.

Mrs. MALONEY. I will look forward to commenting on it, and I believe many people will comment on it. And recently, Chairman Frank and I sent you and others a letter, urging you not to give credit for projects that are, in fact, converting affordable housing into market rate, high-income housing.

Last week, I introduced H.R. 5361, the Responsible GSE Affordable Housing Investment Act, and the goal of this bill is to take away the incentive for GSEs to invest in properties and projects that would lead to an aggressive turnover of affordable units to market rate. It does so by giving the FHFA authority to reduce credits for those investments that do not lead to an increase or preservation of affordable housing, and by requiring GSEs to do better due diligence when they are investing in the secondary market, and to obviously not just look at the snapshot of the day, but how the financing affects the overall project.

Simply put, if the rental income at the time the deal is done is not enough to satisfy the debt service, then the GSEs should not receive affordable housing goals credits for those investments.

The bill does not prohibit GSEs from investing in those properties. It merely says that they can't receive a housing goals credit for those investments.

Mr. DeMarco, what is your view of the bill, or the goals of the bill? Do you think it gives the FHFA the right authority to ensure that GSEs invest in properties that actually increase affordable housing?

Mr. DEMARCO. Mrs. Maloney, I appreciate that our staffs have had productive discussions about this. I am sorry I have not reviewed all of the provisions of the bill you introduced last week, so I don't have a particular response. But I do know that we have had some productive exchanges about it.

And, as I have already said, I certainly share the overriding principle here, which is awarding goals credit on properties that are designed, in fact, to turn affordable housing into not affordable housing is something that we need to figure out an appropriate way of fixing. And I look forward to us continuing that discussion, so that we can be constructive—

Mrs. MALONEY. Thank you, that's constructive.

Mr. DEMARCO. —in this area.

Mrs. MALONEY. I know the FHFA just issued its proposed housing goals for 2010 and 2011, and I believe the public comment period has ended. How did stakeholders respond to the proposed goals? Can you tell the committee what changes were made to the goals from the previous years?

Mr. DEMARCO. Because this is in a rule-making process, I can't comment on the decisions that we are in the midst of making in response to the comments. The comments that we received are available on our Web site.

As you did note, the comment period is closed, and we are looking to go through the comments and then make appropriate adjustments to our proposal, and then we will be publishing a final rule.

Mrs. MALONEY. Thank you very much, and I look forward to continuing to work with you for the housing goals of—and certainly the goal of more affordable housing. Thank you very much.

Mr. DEMARCO. Thank you.

Chairman KANJORSKI. Thank you, Mrs. Maloney. We will recognize the gentleman from New Jersey.

Mr. GARRETT. Just for one last question. Can you remind me—and we may have discussed this in the past—can you just sort of walk me through the methodology you use on hedging—on your interest rate risk? And who it is—the second half of that, I guess, would be who is on the other side of that?

Mr. DEMARCO. There are some big banks and financial institutions on the other side. And a lot of this is actually plain vanilla interest rate swaps that are undertaken by Fannie and Freddie to hedge the interest rate risk in their portfolio.

It's a matter of ongoing observation by us, as the regulator. We assure that each company has appropriate operating limits, with respect to the interest rate risk they take on. Those are both management limits and board limits we monitor that ensure the companies remain operating within those limits.

And we think that—the only thing that we have been encouraging germaine to your question is working with both Fannie and Freddie and the Federal Home Loan Banks to look at what derivatives activity they are undertaking that can be effectively moved to central clearing, so as to improve the transparency and the risk management in their hedging activity.

Mr. GARRETT. Wasn't this—

Mr. DEMARCO. So that's an ongoing issue we have right now.

Mr. GARRETT. Yes, wasn't there some work on that already, and that that was going to be—so that's not—is that done, as far as the transparency of—what's the word I'm looking for? Yes, well, as far as the clearing of them?

Mr. DEMARCO. They have not moved to central clearing, yes.

Mr. GARRETT. Shadow clearing?

Mr. DEMARCO. But it is being looked at. And this is a developing area right now that's involving not just us, but the CFTC and the other banking regulators with regard to moving various derivative transactions to central clearing.

Mr. GARRETT. Yes. Well, I understand that. So isn't it just like—correct me if I'm wrong—is there only just like maybe just four or five partners on the other side that we're really dealing with?

Mr. DEMARCO. There are a limited number of counterparties, as a general matter, which is part of the reason for wanting to see this moved to central clearing, to improve the counterparty risk management.

Mr. GARRETT. Because we were just discussing this up here. You're doing everything you can—I understand—that if interest rates tomorrow go like this, that you guys are all protected, and we don't have to call you back in and say that you did everything good.

Mr. DEMARCO. Yes, sir.

Mr. GARRETT. But we were just saying do we have to have another hearing to bring in the four or five guys on the other side?

Because now, because interest rates went through the roof and you have gotten rid of all your risk, but those three or four guys have to come in and say, "We picked up all that risk," is that something that we have to worry about or no?

Mr. DEMARCO. This gets into an area that is certainly beyond my expertise, but certainly—and this is being discussed a lot in the context of financial regulatory reform—is that derivatives can be a helpful thing for financial institutions to be managing risk. Derivatives themselves need to be properly overseen. We need to assure liquidity in the derivatives market. Derivatives activity is dominated by a relatively small number of large institutions. How they are laying off that risk or managing it on their end is something for their prudential regulators to be overseeing.

And so, with the major U.S. banks that are key derivative counterparties of Fannie Mae and Freddie Mac, the Federal banking agencies are overseeing that as part of their prudential oversight of those companies. Moving to central clearing would provide a different mechanism, a broadened mechanism, for that kind of oversight and risk management.

Chairman KANJORSKI. If I may just add on to that question, how is it that—take AIG Financial Products in London, why did it not come to anyone's attention that they did not have anywhere near the amount of equity necessary to support their derivative activity?

As a regulator, did you have an occasion to look at their capacity to be a counterparty or to take the risk on some of these transactions, or did anyone else in the field do that?

They had, as I understand, $2.8 trillion in derivatives without any actual physical support of funds out of AIG itself, until far down the line, when the market started deteriorating.

Why was this not examined, either by the regulators or by the parties involved?

Mr. DEMARCO. I'm sorry, Mr. Chairman, but I just don't feel that I'm expert enough to be able to respond to what is a very important question.

My limited understanding here involves things that—for example, some of the derivative transactions that—for which AIG had great difficulty were certain credit default swaps and other things that are of different characteristics than what the Enterprises used to hedge their interest rate risk on their retained portfolios.

But I would have to defer to the appropriate regulators for what was going on in the AIG case. That's outside my area of expertise.

Chairman KANJORSKI. Thank you very much. The Chair notes that some members may have additional questions for this panel, for this witness, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to this witness, and to place his responses in the record. Without objection, it is so ordered.

There are no statements to be submitted into the record. Therefore, the panel—or the witness—is dismissed, and this hearing is adjourned.

[Whereupon, at 4:09 p.m., the hearing was adjourned.]

A P P E N D I X

May 26, 2010

OPENING STATEMENT OF
CHAIRMAN PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON FHFA OVERSIGHT: CURRENT STATE OF THE HOUSING GOVERNMENT SPONSORED ENTERPRISES

MAY 26, 2010

We meet this afternoon to examine the Federal Housing Finance Agency and its oversight of Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System. This hearing is the fourth in a series that the Capital Markets Subcommittee and the full Committee have so far convened this Congress to examine the future of housing finance.

The Housing and Economic Recovery Act of 2008 created the Federal Housing Finance Agency and gave the regulator many new powers. At the request of then-Secretary Paulson, the law also authorized the Treasury Department to provide emergency backstop liquidity for Fannie Mae and Freddie Mac. Within weeks of enactment, policymakers in the Bush Administration decided to place the two enterprises into conservatorship and make available government support.

Since then, the two enterprises have worked to improve the quality of the loans they buy and end problematic programs. The Treasury Department has also purchased $144.9 billion in senior preferred stock of Fannie Mae and Freddie Mac. In addition, the government has acquired more than $1.3 trillion of the enterprises' mortgage-backed securities. Together, these sizable commitments have helped to preserve housing credit during tough economic times.

As our housing markets have begun to stabilize, the government has now started to scale back its efforts. Specifically, at the end of March the Federal Reserve ended its program to purchase mortgage-backed securities. Going forward, we must continue to return to the private sector those functions that properly belong with the private sector. We need to closely monitor mortgage rates and investor demand, as well.

Chairman Frank has noted that two important points of consensus have emerged from our two most recent hearings on the future of housing finance. First, the enterprises' major losses have come from their pre-conservatorship activities. Second, the major players in our housing markets have agreed that we could cause considerable economic harm if we simply abolished Fannie Mae and Freddie Mac without putting something new in their place. I very much agree with both assessments.

We will in the near future complete our work on the Wall Street reform bill. During these debates, some have regularly sought to use questions about the future of Fannie Mae and Freddie Mac as a toxic poison pill to forestall progress on this must-pass legislation. I find this situation very unfortunate as the bill includes important provisions to alter the securitization process, impose risk retention requirements, and strengthen rating agency accountability.

Once we resolve these baseline policy issues, we can turn our full attention to broader questions about how to reorganize our housing finance system. Today's testimony will help us to determine how to move surgically and strategically on these important matters. It will also

help us to decide what elements of our housing finance system we need to keep and what aspects we should discard. In the months ahead, I plan to convene more hearings on these matters.

Before closing, I want to express my disappointment at the failure of our witness to respond to the request to address issues related to the Home Valuation Code of Conduct in his written testimony. The House-passed Wall Street reform bill contains my comprehensive appraisal independence and regulatory reforms, which many view as fixing the code's implementation problems. The bill also includes Congressmen Miller and Childers' amendment to sunset the code. Because Congress is very focused on these issues, we need an update from the regulator.

In sum, today's hearing is part of a deliberative process that will ultimately lead to a new housing finance system. My goals in these debates are to limit taxpayer risk and establish a more stable, long-term funding source to help hardworking, responsible middle class American families to buy a home with an affordable mortgage. I look forward to the testimony.

Opening Statement for Ranking Member Spencer Bachus
Capital Markets Subcommittee Hearing on
"FHFA Oversight: Current State of the Housing Government Sponsored Enterprises"
May 26, 2010 2:00 p.m.

Thank you, Chairman Kanjorski.

During the last year and a half, House Republicans have introduced a number of measures to immediately address the failures of Fannie Mae and Freddie Mac. We have released a set a principles to protect taxpayers from further losses and future bailouts and have suggested ways to build a stable housing finance system based on private capital. The Democrats have offered nothing. They have done nothing. And they seem content to do nothing.

It is past time to deal with these bailed out companies which were at the center of the mortgage market meltdown that caused the financial crisis. They have already cost us more than $145 billion. We need to end these bailouts immediately.

And it is unacceptable that the financial regulatory reform bills that have passed the House and Senate do nothing with regard to Fannie Mae and Freddie Mac. Without leadership, this problem cannot be solved. Republicans are ready to lead.

With that, I yield back the balance of my time.

STATEMENT OF THE HONORABLE KENNY MARCHANT

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

MAY 26, 2010

Good afternoon. First, I would like to thank Chairman Kanjorski, Ranking Member Garrett, and Acting Director DeMarco.

Today we meet to discuss the future of Fannie Mae and Freddie Mac, the Government Sponsored Enterprises that have cost our taxpayers nearly $145 billion since entering conservatorship, and are on pace to cost us twice that amount over the next ten years. While I respect the job that Acting Director DeMarco has done in managing the GSEs through the conservatorship—effectively continuing on with the GSE's core business activities and gradually restoring confidence in the secondary mortgage market—we must not be satisfied with the status quo. A bold new course must be charted to navigate whatever remains of this economic downturn, and to guard against the next one that comes along.

In my estimation, our primary mission in moving forward is two-fold. First, we must repay the taxpayers and make them whole on their $145 billion investment in the GSEs; second, we must strip out the financially hazardous policies and practices that spurred on our current situation. While some on both sides of the aisle advocate simply shuttering the doors on Fannie Mae and Freddie Mac, others would prefer a reversion to the way the GSEs functioned before the financial crisis. I, on the other hand, would submit that neither of these extremes will effectively achieve our goals.

We must work to construct a plan that sets up a reasonable payment schedule for the GSEs to replenish federal coffers, whether through dividend payments on senior preferred stock currently owned by the Treasury, or through other channels. No matter the method, the repayment must be consistent with a viable business model, instead of the current 10% dividend arrangement that cripples balance sheets, boosts losses, and leads to further draws from the Treasury.

Our plan must find a way to divest the GSEs and, by extension, the federal government of the 40 percent portion of their portfolios made up of toxic subprime and alt-A mortgage loans, which are generating losses at an extraordinary rate. Furthermore, the size of the GSE's portfolios must be severely limited, at first to just include the generally-performing prime loans already on the books, and ideally even smaller over time.

Moving forward, our plan must limit the size and scope of the GSEs, moving them strictly into securitization and out of the activities that risked their fiscal viability in the first place. We must eliminate their ability to hold mortgages as investments in risky portfolios and gradually increase down payment requirements on the mortgages that they securitize. We should, to the best of our

abilities, allow for competition with the GSEs, for example by introducing a regulatory system for covered bonds.

Finally, although affordable housing goals are worthy expenditures, they must be brought on-budget, shifted into H.U.D. and out of the GSEs, subject to annual appropriations. While I support the mission of providing affordable housing to those in need, Congress must take responsibility for that mission and find a way to pay for it within the federal budget.

I look forward to hearing from Acting Director DeMarco this afternoon, and I hope to work with him soon in constructing a workable plan to repay the taxpayers and ensure the viability of the secondary mortgage market.

Statement of

Edward J. DeMarco, Acting Director

Federal Housing Finance Agency

Before the U.S. House of Representatives Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

"Current State of the Government Sponsored Enterprises"

May 26, 2010

Embargoed until 2:00 pm EDT

Statement of Edward J. DeMarco, Acting Director,
Federal Housing Finance Agency

Before the U.S. House of Representatives Subcommittee on Capital Markets,
Insurance and Government Sponsored Enterprises

"Current State of the Government Sponsored Enterprises"

May 26, 2010

Chairman Kanjorski, Ranking Member Garrett and members of the Subcommittee, thank you for inviting me to speak on the current state of the housing government sponsored enterprises (GSEs): Fannie Mae and Freddie Mac (the Enterprises) and the twelve Federal Home Loan Banks (FHLBanks). Given the exceptional reliance over the past two years on all of the housing GSEs, there has been considerable discussion about their role, performance, and future. I appreciate the opportunity to provide you with a report on the current state and condition of these entities, as well as a description of the responsibilities and activities of FHFA as both conservator and regulator. I hope that my comments will help to build the foundation for the upcoming Congressional consideration of the future structure of the housing finance system.

Today I will highlight:

1) the purpose and goals of FHFA's conservatorships of the Enterprises;
2) general findings from FHFA's oversight of the GSEs, as set forth in FHFA's 2009 Report to Congress; and
3) principles and issues that should be considered by Congress when contemplating the future of the GSEs.

Conservatorship Status

The Enterprises have been operating in conservatorship since September 2008. The purpose of conservatorship is to preserve and conserve each company's assets to enable them to fulfill their mission and mitigate the systemic risk that contributed to instability in financial markets. FHFA continues to exercise oversight as safety and soundness regulator, and as conservator, holds the powers of the management, board, and shareholders of each Enterprise. However, the Enterprises themselves are responsible for normal business activities and day-to-day operations.

The conservatorships have been effective to date, instilling confidence in the market that the Enterprises are capable of fulfilling their statutory role. Their increased presence in the mortgage market over the last two years demonstrates that they continue to serve their intended purpose, despite their tenuous financial situation. The Enterprises' mortgage purchase and guarantee activity in 2009 represented more than 76 percent of total conforming single-family originations.

Although the Enterprises substantial market presence has been a key step to restoring market stability, neither company would be capable of serving the mortgage market today without the ongoing financial support provided by the U.S. Department of the Treasury. Including the draws requested at the end of the first quarter of 2010, Fannie Mae will have drawn $83.6 billion and Freddie Mac $61.3 billion in Treasury support from the Senior Preferred Stock Purchase Agreements, nearly $145 billion in total. To provide the public with clear information about the Enterprises, FHFA will soon begin posting to its web site on a regular basis data on the Enterprises' business activities and performance in conservatorship.

While reliance on the Treasury Department's backing will continue until legislation produces a final resolution of the Enterprises' future, FHFA is monitoring the activities of the Enterprises to: a) limit their risk exposure by avoiding new lines of business; b) ensure profitability in the new book of business without deterring market participation or hindering market recovery; and c) minimize losses on the mortgages already on their books.

Limiting Risk Exposure

In February, I communicated to Congress my position that, in conservatorship, the Enterprises will be limited to continuing their existing core business activities and taking actions necessary to advance the goals of the conservatorship. I have not authorized any new products to be developed by the Enterprises, due to the operational challenges inherent in new product offerings, the need to devote full attention to loss mitigation activities and remediating internal weaknesses, and efforts to aid in the market recovery. As I said at the time, 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.

Rather than developing and offering new products, the Enterprises must maintain their focus on mitigating credit losses and remediating internal operational weaknesses while employing prudent underwriting standards and guaranteeing proven mortgage products. For example, over the past year, both Fannie Mae and Freddie Mac have nearly eliminated their purchases of Alt-A and interest-only loans, two of the poorest performing mortgage products in the market. During the first quarter of 2010, less than 2 percent of Fannie Mae's purchases were interest-only loans and Freddie Mac purchased none. Similarly, Alt-A loans were less than 1 percent of acquisitions for both Enterprises. This is significant because interest-only loans previously purchased by the Enterprises have serious delinquency rates of more than 18 percent and Alt-A loans have serious delinquency rates of more than 12 percent. These products, which may be appropriate in limited circumstances, have produced substantial losses for the Enterprises. During the first quarter of 2010, Alt-A loans already on the books were responsible for 37 percent of Fannie Mae's losses for the quarter and 42 percent of Freddie Mac's.

In fact, the Enterprises have made significant progress in improving the quality of new mortgages they purchased in 2009. As the chart below demonstrates, the Enterprises have been able to focus on borrowers with higher credit scores and loans with higher loan-to-value (LTV) ratios, two factors that affect expected default rates. In 2009, there were improvements across the product, credit score, and LTV ratio spectrums, as 15-year fixed-rate mortgages grew as a share of total acquisitions, credit scores improved, and fewer loans with low down payments were acquired.

The Enterprise loans that have been refinanced through the Home Affordable Refinance Program (HARP) have also helped to improve the credit quality of their books of business. HARP refinance mortgages, which the Enterprises began to acquire in the second quarter of 2009, accounted for 4 percent of acquisitions for the year.

Enterprise Acquisition Profile, 2007-2009*
(share of total unpaid principal balance)

Product Type	**2007**	**2008**	**2009**	**Change from 2008**
Fixed-Rate 30-year Mortgages	83	80	80	1
Fixed-Rate 15-year Mortgages	5	10	14	4
Other Fixed-Rate Mortgages	3	3	4	1
Adjustable-Rate Mortgages	8	7	2	(5)
	100	100	100	0
Credit Score				
>=720	55	68	85	17
660-719	28	24	13	(11)
<660	17	8	2	(6)
	100	100	100	0
Loan-to-Value Ratio				
0-70 Percent	31	38	49	11
70.1-80 Percent	45	40	40	(0)
80.1 - 95 Percent	14	18	10	(9)
>95 Percent	10	3	1	(2)
	100	100	100	(0)

Source: FHFA, based on data from Fannie Mae and Freddie Mac
* Components may not add to totals due to rounding; these data exclude bulk purchases and some unusual loan types.

Due to the focus on improved purchase quality and underwriting standards, the loans that the Enterprises have purchased since conservatorship in late 2008 have had much lower rates of serious delinquency. Serious delinquencies for the 2009 vintage are a fraction of the serious delinquency rates for the 2006-2008 vintages at comparable periods after origination. Losses on the 2006 and 2007 vintages accounted for 65 percent of combined

credit losses in the first quarter of 2010 for the Enterprises. Losses on the 2009 vintage are expected to be much lower.

Profitability of New Business

Each Enterprise has also made changes in their national guarantee fee pricing to correct for the under-pricing of credit risk in prior years and to reflect current risks in an environment of falling house prices and rising mortgage delinquencies. The Enterprises updated their pricing models several times in 2009, as they had in 2008, to reflect changes in the market environment.

FHFA expects to publish its annual report on Enterprise guarantee fees shortly. The report will show that both Enterprises have set their 2009 pricing at levels that are expected to cover future losses, operating expenses, and a reasonable return on their new loan guarantees.

Minimizing Credit Losses

Central to the goals of conservatorship is the mitigation of credit losses. The Enterprises' foreclosure prevention efforts – including loan modifications and refinances as well as short sales and deeds in lieu of foreclosure – fulfill the Emergency Economic Stabilization Act of 2008 mandate to "maximize assistance to homeowners" while minimizing losses to the Enterprises themselves. FHFA reports monthly to Congress on the full range of Enterprise foreclosure prevention activities through the Foreclosure Prevention / Federal Property Manager's Report, the latest edition of which can be found on the agency's web site.[1]

In pursuit of the goal of minimizing credit losses and fulfilling this statutory mandate, FHFA and the Enterprises worked with the Administration to design and implement the Making Home Affordable program (MHA). The Enterprises will continue to act as agents for Treasury in implementing this program. FHFA views this activity as consistent with the goals of the conservatorship and the EESA mandate. The program should have a significant positive impact on the Enterprises, simply because of the breadth of their business and the concentration of poorly-performing loans in declining markets. Between the influx of new business in 2009 and 2010 and the loans already on the books, the Enterprises own or guarantee about half the mortgages in the country today.

From program inception in the second quarter of 2009 through March 2010, the Enterprises have reported more than 584,000 active trial and permanent modifications under the Home Affordable Modification Program (HAMP). More than 136,000 were permanent modifications. In addition, over the same period, the Enterprises have modified more than 128,000 mortgages under their own programs for homeowners who did not qualify for HAMP. Modifications can help homeowners stay in their homes by lowering their monthly payments through interest rate reductions, term extensions, or

[1] http://www.fhfa.gov/webfiles/15736/FPMreport51910.pdf

principal forbearance. To prevent foreclosure when a modification is not appropriate, the Enterprises can work out a short sale or deed-in-lieu. They have completed 74,000 of these since the second quarter of 2009.

Refinancing can also lower a homeowner's payment. Since the beginning of 2009, the Enterprises have refinanced more than 4.9 million loans, including 291,000 loans through the Home Affordable Refinance Program (HARP). The Enterprises will work with homeowners through repayment plans and forbearance plans to help them catch up on their mortgage payments; more than 251,000 homeowners have been assisted in this way since the beginning of 2009.

FHFA's Regulatory Oversight of the Housing GSEs

Fiscal year 2009 was FHFA's first full year of operation and the agency made significant progress in establishing the infrastructure, policies, and processes necessary to regulate the two Enterprises, all of the 12 FHLBanks, and the FHLBanks' Office of Finance. In the midst of integrating staff and operating systems from three agencies into one and operating the conservatorships, FHFA carried out its responsibilities for oversight of the GSEs, conducting continuous supervision activities and targeted reviews at Fannie Mae and Freddie Mac and performing examinations of all 12 FHLBanks and the Office of Finance.

Enterprises

While housing finance continues to depend critically on the Enterprises, FHFA rates both Fannie Mae and Freddie Mac to be "critical supervisory concerns," mainly due to continuing credit losses associated with the 2006 and 2007 books of business, as well as forecasted losses yet to be realized. FHFA expects the high delinquency rates to continue for these older books of business due to uncertain house price paths, weak employment, and continued economic uncertainty.

The risk associated with continued house price declines is a difficult challenge faced by both Enterprises. Fannie Mae and Freddie Mac will continue to sustain credit losses on mortgages originated pre-conservatorship across the entire country but especially on loans originated in four states: California, Florida, Arizona, and Nevada. Each of these states has experienced significant house prices declines, with values dropping dramatically, as illustrated below. The concentration of loans in these declining markets has contributed to a growing number of defaults as well as higher severity of losses for the Enterprises. The Enterprises have been building their loan loss reserves to cover the future anticipated losses associated with this business.

State	Losses as a Percent of Total Credit Losses, 2009		Percent House Price Declines, Peak to Current*
	Fannie Mae	Freddie Mac	
Arizona	11	11	-37
California	24	32	-39
Florida	16	15	-37
Nevada	7	6	-50

*FHFA Purchase Only Index, seasonally adjusted, through 4Q2009.
Source: Fannie Mae Quarterly Credit Supplement; Freddie Mac Quarterly Financial Results Supplement

Another problem faced by both Enterprises relates to their high degree of operational risk and limits to their operational capacity. Constraints on operational capacity are not only a concern for the Enterprises but for mortgage servicers that generally were incented to keep costs low during the housing boom and thus have been strained by record mortgage defaults. Although both Enterprises recognize the need for "high-touch" servicing, such servicing is scarce, which is why management at both Enterprises have been working to develop alternative servicing solutions for high-risk mortgage portfolios. Operational issues also result from rapidly rising inventories of real estate owned. Not only do large volumes of foreclosed houses give rise to operational challenges, but these properties must be liquidated in a manner that does not further exacerbate weaknesses in housing markets.

Aside from the obvious credit and operational challenges, each Enterprise continues to fund over $750 billion in mortgage-related assets with their own debt. The interest rate risk of mortgage portfolios of this size is inherently large, but the challenges of managing this portfolio have become even larger due to difficulties in estimating prepayments, in part due to continued uncertainties relating to defaults, unemployment, and interest rates. The need to carefully manage the risk of these portfolios is heightened by the fact that many of the new mortgages in the Enterprise portfolios were originated at historically low rates, so that if we were to face an environment of rising interest rates, the average duration of these investments would extend significantly, which could create funding challenges if such risk is not properly managed today. FHFA remains committed to reducing the Enterprises' retained portfolios as set forth in the Treasury agreements. Still, the increased flexibility provided in last December's amendments to those agreements has given the Enterprises critical capacity to purchase delinquent mortgages out of guaranteed mortgage-backed security pools.

Now I would like to turn briefly to the FHLBanks, institutions that are also a key part of the nation's housing finance system.

Federal Home Loan Banks

FHFA is looking for the FHLBanks to return to more traditional operations and activities, with a focus on the advances (collateralized loans) to member institutions and a gradual reduction in investment portfolios, which are not needed to support core business activities and safety and soundness.

The FHLBanks' advance business continues to experience no credit losses, but FHFA has serious concerns with the quality of the FHLBanks' past investments in private-label mortgage-backed securities. The FHLBanks' private-label mortgage-backed securities contribute to safety and soundness concerns at certain FHLBanks even though, as of December 31, 2009, all 12 FHLBanks exceeded the minimum leverage ratio by having at least 4 percent capital-to-assets. The weighted average regulatory capital to assets ratio for the FHLBank System was 5.9 percent.

Material risk management deficiencies are present at some individual FHLBanks. Since October, 2007, for example, the FHLBank of Chicago has operated under a cease and desist consent order. In early 2009, the FHLBank of Seattle failed one of its capital requirements. Although it satisfied that requirement later in the year, FHFA used its discretionary authority to maintain the undercapitalized designation for that FHLBank. As a result of these circumstances, each of these FHLBanks is prohibited from paying dividends and redeeming and repurchasing stock. Each is also working through other supervisory requirements.

Beyond these two FHLBanks, other FHLBanks with substantial investments in private-label mortgage-backed securities have seen a the decline in their market value of equity compared to the par value of capital stock, which has resulted in a reduction or suspension of dividends and limits on their ability to repurchase or redeem stock.

Advances fell to $572 billion at March 31, 2010, which is down 9 percent from the previous quarter and 30 percent from a year ago. Advances are now down 44 percent from the peak in 2008 and are at the lowest level for the System since the third quarter of 2004. Advances are less than 60 percent of total assets for the first time since the first quarter of 1998. The decline in advances reflects (1) continuing deposit growth and tepid loan demand at members that results in reduced need for wholesale funding and (2) the continuing consolidation in the financial services industry in which some former large borrowers were acquired by firms with a lower historical use of advances.

The FHLBanks' Affordable Housing Program (AHP) continues to be a source of funds for national and local affordable housing initiatives supported by member institutions. However, the decline in FHLBank income has reduced AHP contributions from $331 million in 2007 to $258 million in 2009. FHFA continued to implement housing goals for the FHLBanks, which are mandated by HERA. To that end, FHFA just sent a proposed rulemaking on the FHLBanks' housing goals to the *Federal Register*.

In another important development pertaining to the FHLBank System, on April 27th FHFA sent to the *Federal Register* a final rule revamping the governance structure of FHLBank System's Office of Finance (OF). Specifically, the rule restructures the OF's board of directors and enhances the independence and responsibility of the OF board's audit committee for the System's combined financial reports. The OF is responsible for issuing consolidated obligations on behalf of the 12 FHLBanks, serves as their fiscal agent, and prepares disclosure materials associated with the marketing and sale of that

debt, including the System's quarterly and annual combined financial reports. The changes made by this rule strengthen the breadth and independence of the OF Board and should enhance the usefulness of the FHLBank System's combined financial reports to investors.

Future of the GSEs

The decision to place the Enterprises into conservatorship proved to be appropriate, accomplishing the Federal government's primary objective of supporting the ongoing availability of mortgage financing during a period of severe market contraction. Despite the benefits derived from the Treasury support for Enterprises activities, conservatorship is not a long-term solution. Moreover, of the various options under consideration for a post-conservatorship construct, the only one that FHFA may implement under existing law is to reconstitute the two companies under their current charters.

The new legislation needed to effect important changes in the institutional framework must contemplate how to replace, without disruption to the system as a whole, the role and function of the Enterprises, which have served as the two leading conduits that connected capital markets to individual mortgage transactions. Given the extraordinary losses to these companies and the need for financial support from the federal government resulting from the present mortgage crisis, to say nothing of the toll on individual households and communities, we as a nation need to ask and answer some hard questions about what we want out of our housing finance system. As part of that consideration, policymakers should consider the important role played by the FHLBanks during the recent crisis and their role should also be considered as part of the future of the nation's housing finance system. To start, Congress and the Administration need to clearly define the proper public policy objectives and the degree and characteristics of government involvement in this housing finance system to best serve those objectives.

I offer to this committee the same ideas and objectives that I shared with the Senate Banking Committee this past October. Our 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. I believe that an efficient system of credit allocation should have certain core characteristics: allowing innovation, providing consumer choice, providing consumer protection, and facilitating transparency.
While these characteristics provide a broad framework for thinking about the future of the housing finance system, there are a number of specific areas related to the current activities of the housing GSEs that deserve special attention. In particular, some key decisions that policymakers will have to address include what role the federal government should have in the following areas of the housing finance system:

- ensuring that the mortgage market has adequate sources of liquidity;
- having the ability to avoid and if necessary absorb credit risk; and
- promoting the availability of mortgage credit.

While new legislation is needed to produce larger-scale restructuring of the housing finance system, FHFA is looking at possible changes in the way the Enterprises do business that may be desirable in the interim period, while Congress contemplates and debates the statutory options. For example, we announced on Monday a set of prospective improvements in the data submissions of loan sellers that will raise the quality and consistency of key information and improve the Enterprises' risk management capabilities. This type of change also improves the functioning of the mortgage market and would be beneficial regardless of what course the larger-scale restructuring of the housing finance system takes. In the coming months we will consider other initiatives that can provide value to the mortgage financing process now and in the future.

I would be happy to discuss any of these ideas with you and look forward to working with the Administration and Congress on legislative action to restructure the housing finance system, including an ultimate resolution of the Enterprises. I recognize you have difficult and important decisions to make in the coming months and FHFA looks forward to offering technical assistance to both the Administration and Congress in considering policy alternatives.

Questions for the Hearing Record
U.S. House of Representatives Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
"Current State of the Government Sponsored Enterprises"
May 26, 2009

Questions for Mr. Edward J. DeMarco, Acting Director, Federal Housing Finance Agency, from Chairman Kanjorski:

1. Much of the discussion to-date of Fannie Mae and Freddie Mac has focused on the single-family housing market. The enterprises, however, also play a large role in the multifamily market. In contrast to the single-family business, first quarter SEC filings for multifamily mortgage programs showed net positive earnings in the amount of $321 million. Additionally, the enterprises' delinquency rates at the end of the quarter were among the lowest relative to other multi-family credit sources with 0.75 percent for Fannie Mae and 0.34 percent for Freddie Mac. Could you comment on the status of their multifamily portfolios?

A. While the delinquency numbers cited above for the enterprises' multifamily portfolios are better than the single-family numbers, these numbers are significantly worse than they were one year ago. Fannie Mae's rate of serious delinquency (defined as 60 days or more past due) was 0.79 percent for March 2010, which is more than double the March 2009 rate of 0.34 percent. Similarly, Freddie Mac's March 2010 serious delinquency rate of 0.24 percent was double its March 2009 rate of 0.12 percent.

Along with this rise in delinquencies, watch-list assets and REO inventories are increasing at both enterprises. While there is some good news in the multifamily market (the 20- to 34-year old segment of the population continues to grow, household formations are up, and vacancy levels stabilized in the first quarter of 2010), caution is warranted with respect to the jobs outlook and the continuing high supply of apartment units. If distressed properties begin entering the sales market, values could be further depressed.

2. Do you agree that Fannie Mae and Freddie Mac play a necessary role in providing market liquidity to the apartment market? What do you think would have been the situation without Fannie Mae and Freddie Mac to provide credit to the apartment industry during the last two years?

A. Although the Enterprises substantial market presence has been a key step to restoring market stability, neither company would be capable of serving the mortgage market today without the ongoing financial support provided by the U.S. Department of the Treasury. Since conservatorship, Fannie Mae and Freddie Mac (Enterprises) have played a key role in continuing to provide liquidity to the market to finance multifamily properties. The Enterprises' multifamily portfolios have grown during the recent financial crisis; for example, from year-end 2007 through year-end 2009, the balance of multifamily whole loans grew from $90.9 billion to $119.8 billion at Fannie Mae, and from $57.6 billion to $83.9 billion at Freddie Mac. Even today, the multifamily market faces high vacancy rates due to high unemployment.

3. Do you believe that there is adequate understanding of available credit capital sources serving the many segments of the multifamily industry, including seniors' housing, student housing and rural rental housing, among others? If not, would you support efforts to collect critical data that is otherwise unavailable from your agency and other regulators to increase this knowledge base?

A. FHFA is committed to provide transparency where possible to better inform stakeholders in the housing market. Both Fannie Mae and Freddie Mac publish a great deal of information on their multifamily investments in their 10Q and 10K filings with the SEC, available on their websites. FHFA publishes aggregated data on the Enterprises' multifamily holdings in its annual Report to Congress, available on its website. In addition, FHFA notes that the Dodd-Frank Wall Street Reform and Consumer Protection Act includes a provision to create an Office of Financial Research with broad authority to collect and compile data on financial markets, including the multifamily credit market.