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THE FUTURE OF FANNIE MAE AND FREDDIE MAC

A CONVERSATION WITH FEDERAL HOUSING FINANCE AGENCY DIRECTOR MEL WATT

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P R O C E E D I N G S

MR. GAYER: Good morning, everybody. Welcome. My name is Ted Gayer. I am the Vice President and Director of Economic Studies here at the Brookings Institution. I am very pleased today to introduce today's keynote speaker, Mel Watt, who is the director of the Federal Housing Finance Agency. We're thrilled to have Director Watt here today to give us his views on housing finance and the direction in which he's taking the FHFA. We're now approaching six years since Fannie Mae and Freddie Mac were placed into conservatorship. Much has changed since then including the profitability of the companies yet in many ways their fundamental structure is unchanged. While Congress actively debates whether and how to reform our housing finance systems the decisions that Director Watts and the FHFA make are critically important in determining credit availability for our housing market, housing affordability, and the degree that taxpayers will be a risk in the mortgage market. Director Watt has been in his current job for about four months now as the regulator and conservator of Fannie and Freddie and the regulator of the 12 federal home loan banks. Prior to that he was a member of the U.S. House of Representatives for over 20 years representing his home state of North Carolina after serving for 2 years in the State Senate. Before that he practiced law for over 20 years specializing in minority business and economic development law. Director Watts served on the sub-committees on capital markets and government sponsored enterprises and financial institutions and consumer credit on the House Financial Services Committee. Also while in the House he introduced anti-predatory lending legislation to combat abuses in the mortgage lending market.

With that short summary, I'm going to let Director Watt take it away. Just as a note after he speaks he and I will have a question and answer session and then we'll open it up to you for further questions, and then we're going to follow up with a panel of housing and consumer experts. That panel will be moderated by the *Wall Street Journal's* Nick Timiraos who is as I say going to be the moderator. They're going to discuss the state of the housing market, Fannie and Freddie's role in it as well as the current reforms pending in Congress.

So please join me in welcoming Director Watt. (Applause)

DIRECTOR WATT: Well, good morning. Good morning. That's good. Let me start by thanking the folks at Brookings for hosting us and thanking Ted for his kind introduction. I do understand that a number of you have been waiting to hear from me and that some of you have been expecting me to say something sooner than now. After all I was sworn in on January 6th and except for a speech last week about the federal home loan bank system you haven't heard a word from me, not a peep, not a press interview, not a speech, not a word. So some of you are probably wondering well, has this guy made a cold turkey transition from member of Congress, outspoken to policy wonk regulator? What's up with this guy? So I welcome you here this morning to talk for a little bit.

You haven't heard much from me but it does not mean that we have not been working. Since January FHFA has continued to carry out its day to day responsibilities as the regulator of the federal home loan banks and as the conservator and regulator of Fannie Mae and Freddie Mac. Many of these decisions and responsibilities are often considered routine and may go unnoticed but they are absolutely critical to the effective and efficient operation of the housing finance market. I can't touch on all of these responsibilities in my remarks today but I do want to give you a summary of what FHFA has been working on since I arrived and I hope this will provide you some insight into the direction we'll be headed in the future, particularly with reference to Fannie Mae and Freddie Mac.

In addition to overseeing our day to day operations my work has also involved an overall assessment of FHFA as well as Fannie and Freddie. During this time I've witnessed the dedication and expertise of FHFA staff at all levels as well as the tenacity and dedication of the employees of Fannie Mae and Freddie Mac who continue to stay the course during these most difficult and uncertain times. And I would be remiss not to acknowledge and thank the staffs for their hard work. There's been a constant urgency since the financial crisis. It's been a marathon but to these employees it's felt like a sprint. And the people have continued to excel at every step along the way.

I also want to publicly thank Ed DeMarco for his lifelong career in public service including the time as Acting Director of FHFA. In the face of general great economic collapse, the biggest one since the Great Depression, FHFA helped prevent an extremely bad situation from getting much worse. It's hard to imagine things being worse given the depth of the housing market collapse, but I very much believe that FHFA and Ed DeMarco's leadership prevented an even deeper financial collapse by stabilizing Fannie Mae and Freddie Mac. Throughout his time at FHFA Ed was instrumental in establishing the foundation for all that we will do going forward. So while you may notice from my comments today certain changes in focus you should know that I firmly believe that we will be building on a very solid foundation.

As part of an overall assessment of the Agency we have been very focused on the numerous policy decisions that were and are in the pipeline. In making decisions about the future strategic direction of the enterprise conservatorships the principle we are following is how best to fulfill our current obligations under current law. This means first and foremost that we must ensure that Fannie and Freddie operate in a safe and sound manner. It means that we'll work to preserve and conserve Fannie and Freddie's assets. And it means that we'll work to ensure a liquid and efficient national housing finance market. Our job at FHFA is to balance these obligations and that's a message I'll come back to throughout today's remarks. Another way of stating the principle that will be guiding us is that FHFA is focused on how we manage the present. The present conservatorships of the enterprises and the present housing finance market under the present statutory mandates. Let me say that again, the role of FHFA is to manage Fannie and Freddie in the present under current statutory mandates. As a result one topic that is not FHFA's agenda because it's not part of our statutory mandate is housing finance reform legislation. My guess is that there are many people who expected that I would start talking about GSE reform legislation the minute I got to FHFA. I am well aware and regularly express my belief that conservatorship should never be viewed as a permanent condition or as a desirable end state and that housing finance reform is necessary. However Congress and the Administration have the important job on deciding on housing finance reform legislation, not FHFA. Instead our task is to continue to fulfill our statutory mandates to execute our strategic plan and to manage the present status of Fannie and Freddie.

So today we are releasing a new strategic plan for the conservatorships of Fannie and Freddie along with their 2014 conservatorship scorecard. Both documents are built around three strategic goals, maintain, reduce, and build. I'd like to walk through each of these goals and discuss how they build upon and in some cases reformulate FHFA's past conservatorship goals. Strategic goal number one, maintain in a safe and sound manner foreclosure prevention activities and credit availability for new and refinanced mortgages to foster liquid efficient competitive and resilient national housing finance markets. Our first strategic goal, maintain, requires Fannie and Freddie to carry out and strengthen where possible three aspects of their core operations. First, we expect Fannie and Freddie to take actions that improve liquidity in the present single family housing finance market; second, we believe they should continue to improve servicing standards and foreclosure prevention actions; and, third, we think they have a critical ongoing role in the multi-family sector, particularly for affordable multi-family properties. Across these three areas our overriding objective is to ensure that there is broad liquidity in the housing finance market and to do so in a way that is safe and sound. The maintain goal is not a new one for the Agency but we are placing an increased emphasis on it. We are leading with maintain as the first goal in our strategic plan and score card. We have doubled the score card weight to this goal from 20 percent to 40 percent.

Let me begin my remarks about single family liquidity by discussing representation and warranty standards and when these trigger repurchase demands. I know that repurchase risk remains a top concern for the mortgage industry. Lenders believe that there is still too much uncertainty in this area for them to ease their credit overlays, and ultimately this undermines the goal of improving access for mortgage credit for credit worthy borrowers. After extensive discussions with Fannie, Freddie, and lenders over the past several months we are making a number of refinements to address some of these concerns. As we authorized and as Fannie and Freddie announced yesterday they are going to relax the payment history requirement for granting representation and warranty relief by allowing two delinquent payments in the first 36 months after acquisition. Lenders will also get loan level confirmations when mortgages meet performance benchmark and when they pass a quality control review. The enterprises will also eliminate automatic repurchases when a loan's primary mortgage insurance is rescinded. These refinements build on FHFA's work in 2013 and demonstrate our continuing commitment to making the representation and warranty process work better for everyone. However, we know that more improvements are needed to provide additional clarity. One area we are prioritizing is addressing the scope of life of loan exemptions. We know that lenders are concerned about how these exemptions apply to loans that have passed quality control reviews or have met the 36 month benchmark, and we will work toward clarity on this issue. Over the course of this year we will also explore the following: establishing an independent dispute resolution program when lenders believe a repurchase is unwarranted, developing cure mechanisms for loan defects rather than relying solely on repurchases, and providing additional clarity on Fannie and Freddie underwriting rules.

There are two other issues I want to comment on that relate to the overall scope of single family mortgages guaranteed by Fannie and Freddie. The first one involves loans with debt to income ratios above 43 percent. Current Fannie and Freddie guidelines make some of these loans eligible for purchase when the borrower has other compensating strengths. FHFA will continue to permit these compensating factors in each company's underwriting standards. As part of our ongoing safety and soundness obligations we will of course continue to monitor performance data relating to these factors. The second disuse involves loan limits. As market participants are already aware FHFA released a proposal last year suggesting that the Agency might use its conservatorship authority to lower the mortgage amounts eligible for guarantee by Fannie and Freddie. Many groups and individuals submitted feedback in response to the request for input and FHFA has thoroughly reviewed and evaluated those responses. I am announcing today that FHFA will not use its authority as conservator to reduce current loan limits. This decision is motivated by concerns about how such a reduction would adversely impact the current health of the housing finance market.

The next part of our maintain goal involves continuing to refine and improve servicing and foreclosure prevention standards. Experiences in recent years have revealed serious weaknesses in the servicing industry and in the foreclosure prevention alternatives offered to borrowers. Substantial work has been done to get things right but there is still much room for improvement. As part of FHFA's focus in this area or at least part of FHFA's focus in this area is working to stabilize communities hardest hit by the foreclosure crisis. As a result we are launching a neighborhood stabilization initiative with Fannie, Freddie, and the National Community Stabilization Trust. Phase one of this initiative is a pilot program in Detroit, Michigan. We are pursuing pre-foreclosure and post-foreclosure strategies that include deeper loan modifications and partnering with non profits earlier in the real estate owned sales process. FHFA expects to use the experience in Detroit to expand this initiative to other parts of the country. We believe this will be a win-win for hardest hit communities and for our conservatorship objectives. We've also receive a number of inquiries about changing the eligibility requirements for HARP. Because the number of borrowers we could add by extending the eligibility date or by changing performance requirements is relatively small we have decided not to alter HARP eligibility parameters. FHFA is however working to retarget our HARP outreach efforts to the approximately 750,000 borrowers who already qualify and would financially benefit from refinancing under HARP. We are exploring outreach efforts designed to gain the trust of these in the money borrowers so they will take action to refinance. It's already in their financial interest to do so.

FHFA's maintain strategic goal also extends to Fannie and Freddie's multi-family loan businesses. This is a critical part of the 2014 strategic plan particularly in light of the increasing number of households who are renting instead of owning in recent years and the fact that affordability continues to be a significant concern for many households. Consequently our 2014 strategic plan does not require a reduction in Fannie and Freddie's multi-family production levels and it provides additional capacity for affordable multi-family projects. Consistent with safety and soundness our affordability focus will include multi-family lending for small properties and manufactured housing rental communities, much of which takes place in rural communities. We expect market competition in 2014 to actually result in lower multi-family levels for the enterprises, but FHFA will not mandate that the enterprises prematurely shrink their multi-family footprint.

I'm onto the second goal. Strategic goal number two, reduce taxpayer risk through increasing the role of private capital in the mortgage market, reduce taxpayer risk through increasing the role of private capital in the mortgage market. FHFA's second strategic goal, reduce, is focused on ways to bring additional private capital into the system in order to reduce taxpayer risk. We have reformulated this goal so that it no longer involves specific steps to contract the enterprise's market presence which could have an adverse impact on liquidity. Instead the reduce goal focuses on ways to scale back Fannie and Freddie's overall risk exposure. This approach allows us to meet our mandates of upholding safety and soundness and ensuring broad market liquidity. While FHFA has reformulated this strategic goal our strategy is to reduce taxpayer risk, build on much of FHFA's past work in this area. This includes having Fannie and Freddie conduct additional credit risk transfers for their single family guarantee business. These transactions have opened up private capital to share in credit losses which protects taxpayers from bearing all of the potential losses. Our 2014 score card requires each enterprise to triple the amount of risk transfers in 2014. This will be an increase from $30 billion of unpaid principle transfers last year to approximately $90 billion in 2014. On top of increasing the amount of credit risk transferred we also expect each enterprise to try new risk transfer structures to assess sustainability in different market conditions. All of this is consistent with the commitments I made to the Senate Banking Committee during my confirmation process. In addition we are requiring ongoing reductions in the enterprises retained portfolios. The senior preferred stock purchase agreements with the Treasury Department require the enterprises to reduce their portfolios to no more than $250 billion each by 2018. Fannie and Freddie must develop plans to meet this target even under adverse market conditions. We are also requiring them to prioritize selling their less liquid assets to reduce risk and take advantage of current investor interests. As their portfolios continued to decline the effect is to transfer interest rate risk and liquidity risk from these portfolios to the private sector. On multi-family purchases we are requiring the enterprises to continue sharing risk with the private sector which Freddie Mac does through a capital market structure and Fannie Mae does through a risk sharing model. Both approaches transfer significant risk to the private market and have had strong performance even through the economic crisis. We expect these models to continue. Finally, another risk reduction priority in 2014 involves private mortgage insurance counterparties. This work will strengthen master policies and eligibility standards for private mortgage insurers. Mortgage insurance is a critical source of private capital in the mortgage finance markets. However as we all know the crisis revealed severe weaknesses in this system. FHFA's objective is to ensure that private mortgage insurer counterparties to Fannie and Freddie are able to provide adequate credit loss prevention in times of market stress.

On to strategic goal number three. Strategic goal number three, build a new single family securitization infrastructure for use by the enterprises and adaptable for use by other participants in the secondary market in the future, build a new single family securitization infrastructure for use by the enterprises and adaptable for use by other participants in the secondary market in the future. FHFA's final strategic goal is to build a new infrastructure for the enterprises securitization functions. The core of this effort is the common securitization platform and I want to talk about two aspects of this today.

First, after extensive discussion within FHFA and with the enterprises we have clarified that the Agency's top objection for the common securitization platform is to make sure that it works for the benefit of Fannie and Freddie. Over the last four months we have identified the risks involved in transitioning to a common securitization platform and reviewed how to manage those risks. We found that because of the many variables involved the main danger to the CSP effort would be pursuing too many objectives at the same time. Since any stumbles along the way could have ripple effects in the $10 trillion finance market there's a lot at stake in getting this right. As a result our decision has been to de-risk this project. Moving forward we will focus our efforts on creating a common securitization platform that can undertake Fannie and Freddie's current securitization operations. A successful outcome will be a seamless transition from the current in-house systems that issue new securities for each enterprise to a future joint venture owned by Fannie and Freddie that operates one system with updated technology. Defining the scope in this way acknowledges that building a CSP for a future housing finance system that is not yet defined is extremely risky and could add needless costs. This scope does not mean that our CSP efforts will be at odds with the future housing finance system or that our process will take place in a vacuum. To the contrary, we are requiring that the CSP leverage the systems, software, and standards used in the private sector whenever possible. This will ensure that the CSP will be adaptable for use by other secondary market actors including private label securities issuers when the future state is more defined.

Our second objective for the common securitization platform is to move the enterprises toward a single common security which we believe will improve liquidity in the housing finance markets. It would also reduce cost to the enterprises, particularly Freddie Mac since Freddie's securities have historically traded at a disadvantage compared to Fannie Mae's. Adding a common single security component to the CSP's scope will require FHFA and the enterprises to define the securities parameters along with shared contractual and disclosure requirements. FHFA along with Fannie and Freddie have made great progress on developing the common securitization platform, but all the components of the CSP, including the common single security, will require a multi-year effort before final implementation. Having defined the CSP's parameters as I have described today we are well positioned to move forward. Throughout this process we will provide opportunities for stakeholder input about our decisions along the way.

In releasing FHFA's 2014 strategic plan my goal today has been to provide a clear sense of direction for the enterprises' ongoing conservatorships. Implementing these objectives will require ongoing analysis, evaluation and input. FHFA will proceed with these steps in a transparent way that incorporates the feedback and input of the public and stakeholder groups whenever possible. One example of this approach is our upcoming request for input on the guarantee fees charged by Fannie and Freddie which we will release very soon. As many of you know on my second day as Director of FHFA I issued a directive to Fannie and Freddie that they delay the G fee increase announced in December of last year. In our request for input we will pose a number of questions the Agency is considering and we solicit and encourage your feedback. We'll review your responses and we'll announce a decision later this year that is consistent with the goals that we have outlined in our strategic plan.

This concludes my remarks. I want to thank you for your time today and I look forward to working with all of you as we implement our strategic plan and as Fannie and Freddie and FHFA implement the 2014 score card. Thank you. (Applause)

MR. GAYER: Well, thank you again, Director Watt. That was a perfect speech and there was lots in there constrained by time. I feel like we can spend hours on each of the goals.

DIRECTOR WATT: That's right.

MR. GAYER: So we'll do our best and then we'll some questions from the crowd as well. So I want to start by first saying I'm going to respect what you started with which is you don't want to talk about housing finance legislation which I can understand. But there's something you said that intrigued me right after that. You said that conservatorships should never be viewed as permanent. So I guess my question is I think increasingly likely we might not have a housing finance legislation, or at least not for a number of years, and so then my question is what happens to conservatorship? We're now approaching six years; you're saying it shouldn't be permanent. Do you have the authority to end conservatorship and if so what does that look like? At what point do we say, you know, it's over and what conditions have to be met?

DIRECTOR WATT: Well, clearly we have the authority to end the conservatorship; it's in the statute. The statute gave us the authority to start it and it goes with that the authority to end it. But the alternatives would not be desirable alternatives so I think our role and the reason we've worked so hard in the current space is to make sure that we have a solid plan for continuing the operations of Fannie and Freddie and the federal home loan banks so that there will be liquidity and efficiency in the housing market and that we continue to operate as we have operated without interrupting housing finance in this country because housing finance is such a critical part of the economy. To stop or stand in place is just simply not an option. So we'll continue it and I think our goals are consistent with continuing the operation of Fannie and Freddie in the here and the now and we'll do that until there is legislation passed.

MR. GAYER: So I guess -- I think maybe you've already answered this then, so the end of conservatorship you can see the different things obviously being debated on the Hill, but two outcomes if it happens -- if it's not going to be indefinite, two outcomes is one, they get -- Fannie and Freddie get wound down, and another is they essentially get -- they exist as they currently are as private -- or they become wholly private entities outside of the conservatorship. I shouldn't say wholly private because the government has a large share there. That kind of final outcome, this is -- at this point you don't -- if -- you don't see how the end of conservatorship looks or so you?

DIRECTOR WATT: Well, I haven't contemplated that. I mean I think all of my focus for the last four months has been in the present and doing what we're doing in the short term and letting the Congress run its course there and we'll see what happens after that.

MR. GAYER: So as I said there was a lot in your speech but I do want to -- I think -- unless I missed it -- there was one thing you didn't mention and so I don't know -- I'd love to get your feeling son that and that's principal reduction. So as I think everybody here knows FHFA previously said that principal reduction, the potential benefit was too small relative to the known and unknown costs and risks. Is there a sense of is this an issue that has passed? Is this something that FHFA is still considering? Where do we stand on this?

DIRECTOR WATT: I don't know that it's passed. We've evaluated in the short term and found that there are other things that we need to focus on at the present. We continue to study not only that issue but a number of other issues that I did not talk about in today's speech. I told one of the reporters earlier that it would be interesting that all of the things that we talk about today the focus would be on the things we didn't talk about.

MR. GAYER: Yeah.

DIRECTOR WATT: You know --

MR. GAYER: That's my second question in other words.

DIRECTOR WATT: I keep this running list of issues that I call my water hose issues. They started out coming at me as one big fire hose and we've separated them into individual water hoses. They are a bunch of them on the list --

MR. GAYER: Yeah.

DIRECTOR WATT: -- that I didn't talk about today and principal reduction is one of those. Doesn't mean that we won't -- that we are not considering it, it just means that we're not ready to talk about it at this point. And that's the same category that a lot of other issues fall into.

MR. GAYER: Okay. So let me pivot back to something that you did talk about, which were the multi-family caps. I'd like to just get your sense of -- this seems to me like a -- you started your speech by acknowledging your predecessor and also mentioning a shift in focus or maybe priorities. Is this -- does this constitute one of the shifts in focus? Not lowering the cap and giving additional flexibility and I guess if so what's your thinking on the kind of the role that Fannie and Freddie play for affordable housing?

DIRECTOR WATT: You know, I haven't thought about this whole focus issue. I think we've tried to make good reason decisions. We tried to understand the history of how every decision was made and why it was made. And so I'm not focusing on whether --

MR. GAYER: It's a shift.

DIRECTOR WATT: -- we've shifted focus or didn't shift focus. Everything that has taken place in the past has created the foundation that allows us the flexibility to make good decisions in the present. We actually think that competition in the multi-family sector will decrease the role of Fannie and Freddie in that space over time.

And we think it will mean that they won't reach the caps possibly this year. The more important part of it is that there seems to be a lot less competition in the affordable space and we want to incentivize Fannie and Freddie to continue to play that role in the affordable space because people need housing and they have played the role successfully and with minimal risk through a very difficult time in the economy. So it's not as if we are increasing risk. But for us to arbitrarily say decrease your footprint without knowing that somebody is stepping into this space was not something that we thought was prudent thing to do.

MR. GAYER: So in your strategic plan you lay out a lot of kind of your statutory responsibilities, and there are many. So I don't envy the task of trying to achieve all of them. One of them is that you're responsible to ensure that Fannie and Freddie maintain adequate capital. Now of course that's a little bit of a challenge given that all their profits now are being swept into the Treasury. I'm curious what your thoughts on that. Is this something that you've spoken to Treasury about or is this just -- an indefinite feature going to be current policy and how do they build their capital base?

DIRECTOR WATT: Well, I can't control that I don't think. You know, the taxpayers in effect providing significant capital to back Fannie and Freddie at this point. And so capital has not been an issue that we have had to focus on for a period of time. Obviously it was a major issue because both Fannie and Freddie were making draws. Their financial conditions have stabilized and while a lot of their income in the last two or three years has been big recoveries, financial recoveries, tax adjustments that won't be sustainable in the future, we want them to continue to operate in a sound way and we'll -- we're focused on that. But we don't spend time vexing about things that we really can't control. And I'm sure -- I would think that the Treasury would feel the same way but I haven't had any discussions about that with them.

MR. GAYER: With them. Okay, thank you. And so another thing you said that intrigued me -- I think I'm going to get the quote correct or at least close enough -- you said that your goal is -- I think this was goal number two -- "reduce taxpayer risk through increasing the role of private capital." But then right after that you rejected the goal of contracting the enterprises' market presence. So you want to increase the role of private capital but not contract enterprises which I'm trying to figure out kind of how you square those two and maybe -- and I don't -- you -- and then said that this is a decision to come. So I know you're not going to announce it now but in my view you could look at an increase in the guarantees fees as either of those, as a contracting of their market presence or as an entering of private capital. Is that -- how does that fit in those two criteria?

DIRECTOR WATT: Well, we are balancing in a number of instances sometimes what appear to be contradictory mandates. You know, but I don't think it's FHFA's role to contract the footprint of Fannie and Freddie. Our role is to maintain an efficient credit market and as private capital demonstrates that it will come into this market it think it will be clear that Fannie and Freddie will step back. But to arbitrarily say that the footprint should be reduced without assuring that there's a responsible way to make the transition to private capital stepping into the space would do serious damage potentially to the housing finance part of our economy. And I think that would be irresponsible. So we're not into doing anything that's irresponsible. I hope everybody picked that up from my comments this morning.

MR. GAYER: So just so I understand. So if the enterprises' market presence contracts due to kind of market forces and kind of a revitalized private sector that's fine but FHFA as a regulator --

DIRECTOR WATT: That's exactly what I said --

MR. GAYER: I see.

DIRECTOR WATT: -- in the multi-family space.

MR. GAYER: Okay.

DIRECTOR WATT: We didn't arbitrarily contract them but actually we think this year the private sector will step into the multi-family space at least in the non affordable multi-affordable space in a big way. They're already doing it and there's no reason for us to think that they will stop. But there are some things that we could do arbitrarily that I think we're not intending to do.

MR. GAYER: I'm just getting a signal. I'm going to take questions from the crowd. I've got -- if you guys need help I've got plenty more but I'll take questions from the crowd. How about in the -- let's start in the back corner. Is there a mic? Wait for the mic so -- the rules of the game, please wait for the mic, state your name and affiliation, and keep it to a question.

MS. BENSON: Hi, Clea Benson with Bloomberg News. Following up a little on the discussion of the role of FHFA. How does the fact that Fannie Mae and Freddie Mac are not posting record profits factor into your thinking about how much they should be helping troubled borrowers and undertaking initiatives to stabilize the mortgage? Is that something that's guiding some of your policy decisions now?

DIRECTOR WATT: You know, I haven't looked a lot at profits as a driving force in any of our decisions. I think as I've indicated already the record level of profits that you have seen are not sustainable. It's clear that -- and we've said that over and over. They made substantial tax adjustments and they are releasing those now. And we've had substantial major recoveries in litigation that won't be repeated over time. In fact we are nearing the end of those kinds of recoveries. So I don't think we should let the profits drive decisions that we make. We're trying to make responsible decisions, we're trying to increase the availability of credit to credit worthy borrowers, we're trying to do it in a safe and sound way, and not be irresponsible. And I just -- I don't think looking at the bottom line is a productive way to try to evaluate how we proceed on that front.

MR. GAYER: And while we're in the back, also in the back right over here. Wait for the mic again.

: Hi, Judy Kennedy, Affordable Housing Lenders. Thank you so much for the focus on targeted rental and small rental properties because that's the 90 percent of the market that Fannie and Freddie haven't been present in. But I wanted to follow up on one thing you didn't talk about. The same law in 2008 that enabled the conservatorship also tried to focus Fannie and Freddie on affordable rental housing in a meaningful way and that just hasn't happened. Whether it's Fannie Mae trying to count the blanket loan on the Dakota property on Central Park West, the Yoko Ono property, as affordable rental housing or other devices that they've developed. So I'd like you to speak to how you intend to change or maybe better enforce the mission related part of Housing and Economic Recovery Act.

DIRECTOR WATT: Well, I think the first step you just heard this morning is changing our focus to pay some more attention to it. The affordable housing goals we are looking at aggressively, they are already in place for 2014, will be issuing new affordable housing goals for 2015. So there's a lot of focus on that issue and it is part of the statutory mandate and the charter mandates of both Fannie and Freddie. So we take those mandates seriously and obviously we think that Congress took them seriously otherwise they wouldn't have written them into the law. So we're going to treat them as seriously as we treat every other aspect of Fannie and Freddie's and FHFA's statutory mandates.

MR. GAYER: Other questions? How about right here?

MR. MILLS: Director Watt, Ed Mills with FBR. I had a question about servicing. One of the issues that we hear a lot from originators about contraction of credit is not only on reps and warranties when you sell the loan but also when you service the loan. Recently JP Morgan's CEO, Jamie Dimon, said he would never want to service a defaulted loan. We've seen a lot of servicing transfers come out of Fannie and Freddie over to non bank servicers and in recent months we've seen a lot of scrutiny on those servicers. I was wondering if you could comment on some of the transfers, what we might be able to expect in terms of regulation on those non bank servicers and what can be done to give originators and servicers some certainty that if the loan defaults they're going to be able to appropriately service that product?

DIRECTOR WATT: Well, this has been a topical and difficult issue for us because there are multiple things at play here. Jamie Dimon is right when he says it's difficult to service a defaulted mortgage. Easy to service a current mortgage because all it is is collecting and remitting. But when somebody defaults it gets to be a lot more complicated and there's a growing industry that has built up around that that some of whom have more expertise in this area than the lenders themselves who tend to focus more on the lending side than on the servicing side. And Bozel Three has taken a lot of the capital requirements have maybe led to some of the lenders actually wanting to get out of this space. So servicers are not regulated by FHFA. They are regulated by CFPB but not on a capital basis so there's a shortcoming there. We can control their relationships with Fannie and Freddie, right. That's the space in which we operate. And we have looked very carefully in some cases much, much longer and more carefully than a lot of people would like for us to look at evaluating when these requests for transfers are made to see are these people responsible to whom -- are the companies responsible to whom the transferring servicing rights are being transferred. What is their expertise?

What is their history in this space? What kind of capital do they have if things start going back? What kind of backup will the lender provide to take the servicing back if necessary if the servicers don't? So all of those are factors and we look at them very carefully in making our evaluations, but -- and then sometimes there are short term versus long term competing considerations. Short term the servicer actually might do the servicing better. The longer terms concerns you're worried about, can they sustain it over a long period of time. And we have to balance those and I think we've been responsible in that space and we're doing a lot of work to try to develop standards so it's clear to Fannie and Freddie what we expect when it comes to transferring servicing rights. And then they can communicate that to the lenders that they are dealing with so that they know what to expect when they're transferring. So I think you'll find that we'll be doing a lot of work going forward in that area trying to refine what the expectations and standards are. Yeah?

MR. GAYER: Can I just -- I want to just piggy back a quick question off of that. It's hard to write a punchy title with the phrase reps and warrants in it but they seem like significant changes. Do you have an expectation of what impact it will have on credit overlays?

DIRECTOR WATT: I have a hope that it will substantially reduce credit overlays and that lenders will start operating more inside the credit box that Fannie or Freddie have said they will purchase loans in or guarantee loans in that space. And based on conversations that we have had with industry participants my hope is a positive hope. I don't know when you transfer from a hope to an expectation but some of them have assured me that if we can smooth out some of these uncertainties that exist in their space it would translate into a reduction in overlays and it would translate into more availability of credit to people who can afford to repay the loans. And that's what we are very much interested in having happen.

MR. GAYER: Like I said we have -- I'm sure both me and the crowd have a lot more questions we'd love to ask but we are past our limit so I just would like everybody to join me in thanking you once again for coming here today. (Applause)

And if I could ask everyone to just remain in their seat while Director Watt exits the auditorium and then we'll have the other panel set up while he's doing so.

DIRECTOR WATT: Thank you all so much.

MR. GAYER: Thank you very much, Mr. Watt. Thank you.

(INTERRUPTION)

MR. TIMIRAOS: Good morning, everybody. My name is Nick Timiraos. I cover housing and economics for the *Wall Street Journal*. Pleased to get into this panel. Starting at far stage right is Phil Swagel with the University of Maryland, worked at the Treasury Department in the George W. Bush Administration. Next to him we have Mike Malloy, an executive in mortgage from Bank of America, Mike Calhoun, President of the Center for Responsible Lending and Self Help Credit Union, and finally, Mark Fleming is Chief Economist of CoreLogic. I'm sure they're very familiar faces to all of you in this room.

So with that we'll go ahead and get started. I want to get the panelists reactions to Director Watt's speech. Obviously there was a lot of pretty interesting meat on the bone in there and, Mike, Malloy, I want to ask you first what you think of the changes that were announced late yesterday on rep and warrant. Do you think those changes on representations and warranties are going to make a lender like Bank of America any more comfortable in removing credit overlays?

MR. MALLOY: Well, I wouldn't comment on the specifics of, you know, what we would do on credit, we're still reviewing the announcements. I think it's a very positive step. The Director said two things about the reps and warrants. First, he announced three specific items that are in the announcements yesterday from Fannie and Freddie. Those were very positive first steps here. He also announced that they're going to continue working on the things that have been issued. He mentioned particularly the life of loan extension as well as dispute resolution. Those are also very important steps. So I think of it -- and I think the Director said these are the first steps toward this issue and they're continuing to work. And I think that commitment from the Director is a very, very positive step in this space.

MR. TIMIRAOS: So we hear a lot, you know, different policy makers or the Fed, the senior loan officers surveyed have said that credit overlays are a key contributor to tight lending standards. Would you agree or disagree with that premise right now?

MR. MALLOY: Well, at Bank of America we focus on making sustainable loans to credit worth borrowers. And we're out there doing that in the market today. That's what we focus on. And so I think when we talk about that, that's what we're looking at. The Director talked as well, sustainable homeownership, that's where we're looking today, that's how we focus our lending, on our customers, making it sustainable for them. And so I think as we move down this path, you know -- you know, Mark would be better to talk to the data on this than I would but, you know, we are all out there in the market with all of our loan officers making, you know, good loans to credit worthy borrowers today and we're going to continue doing that.

MR. TIMIRAOS: So, Mark, I will ask you, I mean some people will hear make credit easier and they'll hear it, you know, coming from someone like Director Watt who was a, you know, more liberal member of Congress and they'll say, oh my, gosh, this is -- you know, we're going back to the races here. This is terrible. Should we -- is that the wrong way to think about this? Kind of how d you walk through that balancing act that policy makers are facing right now?

MR. FLEMING: I'll start I guess by saying as an economist I have to start with a joke, on the one hand, then on the other. We evaluate the credit box and we have to be a little bit careful in terms of we're looking at the loans that actually got originated. We evaluate the credit box and along with a number of dimensions. And so the problem is, you know, credit worthiness is defined by -- well, let's start with the simple things, the three Cs right, collateral, capacity and credit worthiness? And we look at them, collateral and capacity, and actually that's the DTI calculations and the LTV calculations actually at or beyond what we would consider more normal. The other thing is when someone says it needs to be tighter, it needs to be looser, that there's an implied relative point, right? Relative to what? Well, if anyone says relative to 2006, run, right because we clearly know that it was probably too loose then. But we really have a hard time knowing. Now what I can say is when we look across the boxes and sort of look at the early 2000s that LTVs are actually -- were more lax in you will in that dimension, in LTV space. We're at about the right space. The market has really sort of moved to the CFPB definition 43 and in fact if you think about it traditional underwriting practices would put it back in ratio well below 43 even in the old days, right. So that's actually a very loose standard by historical lending practices. But it's in the credit score; that's where things are really tight. So in the early 2000s about 12 percent of all purchase origination loans in any given month had credit scores of 620 or less. So a 12 percent share at 620 or less. Today it's .3 percent. Now the credit box is defined by the grid that Fannie and Freddie put out. For Fannie at least they'll go down to 620, right, they'll lend to 620. But clearly we're not doing very much lending at that space or even below it. And the reason really gets back to what we started with Mike is well if there's this uncertainty about repurchase risk one of the best ways to avoid a repurchase is to avoid a default. And one of the best ways to avoid a default is make sure you have a credit worthy borrower. And so there's that play there that I think is the natural tension that we're all realizing is this expansion of removal of uncertainly will create more comfort to delve further down that credit curve. But we have to be careful in terms of knowing what is or isn't the right level and what's normal or not because that's a very complex question to actually answer.

MR. TIMIRAOS: So on capacity and collateral we're tighter than we were even in kind of a pre-bubble era?

MR. FLEMING: We evaluate it and say we're about where we were in the early 2000s. LTV we're actually a little bit looser. If you think about it, you know, collateral is one of the -- you know, we lost all that equity in the house price downturn. If we weren't loose in collateral space then, you know, that credit box would be very, very tight.

MR. TIMIRAOS: Right. Mike Calhoun, same question that I posed to Mark. I mean the people hear some of these things and they think oh, no, there we go again. FHFA wants to try to rejoice the market. You know, I have a feeling you're going to say that's the wrong way to think about this. And so why is that the wrong way to think about this?

MR. CALHOUN: So for people who haven't had that much contact with Director Watt before, I think what you saw today was vintage Watt if you will. I mean people don't remember as much but through his time in Congress his first real involvement with housing was trying to tighten lending standards. And for that he was roundly criticized ironically for constricting credit too much. He was the first sponsor of legislation for example to impose predatory lending standards on some of the practices that ultimately led to the crisis. And then at the same time he has been for broad access but only sustainable access. He very much believes that high rates of foreclosure are a disaster for families, communities and the overall economy. So I think one of the things that made him well suited for this job is that kind of middle of the road approach that you heard here today. But I think you nailed in on -- the problem right now is it's hard to make economic sense for lenders to make loans that have a substantial risk of default if there is not only the uncertainty but in fact the practices of the GOCs to be quite frankly overly aggressive on buy backs. Now they were sold lots of junk that very much correctly was put back through the crisis. So let's distinguish between those. But mortgage underwriting is challenging and at times they have publicly taken the position that a loan file with any defect whatsoever regardless of whether it had an impact at all on the performance of the loan is a legal basis for them to put the loan back on the lender and force him to eat the whole cost of a default. And particularly it's a challenge for large lenders but it's a near impossibility for small lenders. If you're making 100 loans and you've got a risk that three or four of them can come back to you and you eat half of the loan amount you've lost the entire profitability for that business. So I think it is an appropriate place for him to focus at the outset. I think it was one of the main bottlenecks. It's not the only one but it was one of the main ones and I'm very pleased to see him address that today.

MR. TIMIRAOS: And, Phil, I want to bring you in here but one of the shifts that I found interesting in the speech was, you know, he took that build and maintain and contract framework that the FHFA had had before and preserved it but kind of changed or toggled -- the contract is now reduce. So instead of contracting the footprint we're reducing the taxpayer risk. What do you think of that move given that over the past five years we really haven't seen any kind of resurgence of private -- either private mortgage-back securities or even in the jumbo market, you know, fairly limited to kind of the cream of the crop mortgages?

MR. SWAGEL: Right. So I mean I thought that symbolically the most important thing he said was the change, the doubling the emphasis on maintain. And there's a sense in which the, you know, the regulator was pushing the enterprises in a certain direction to get them ready for the future system. And in a variety of ways we saw that. Either slow down so, you know, my mental image is shifting from fourth gear to first or second gear, or maybe into reverse, right, to use the car metaphor. So certainly the multi-family reverse conforming loan limit -- not reverse but close to it. The G fees of course on hold. And so symbolically that's what we're seeing, much more of an emphasis on maintain. You can even see that in the CSFs, right, in the common securitization platform out in Bethesda where that's going to be the benefit of Fannie and Freddie which of course makes sense as a joint venture, but rather than setting the stage for a future system with competition and entry. And the second part of the resurgence of private label securitization or balance sheet lending, I think that goes very well with the credit box issue that everyone's discussed, right. Until there's the certainty on, you know, the reps and warranties and then also on the fair housing lawsuits and the sort of State Attorney Generals, all the variety of factors that is inhibiting the resurgence of private lending it is going to be tough to restart that and it is necessary to have a better system.

MR. TIMIRAOS: Mark?

MR. FLEMING: I just think -- I mean to leverage that point one of the most interesting things about what he presented today was in that reduced or contract comment. Whether you call it reduce or contract I think we always leapt to the assumption that that meant that the GSEs would not be involved in the origination and securitization of the loan and there would be this resurgence private capital, right, but -- private label market. And he actually twisted or changed that to mean I'm going to reduce the credit risk held by the government, but that doesn't necessarily mean that I'm still not going to participate very heavily in the production of the loan, right. You go back to the idea of the market maker on Wall Street. You know for every stock there's a market maker that just makes sure that there is liquidity in that stock. We'll figure out how to buy that even when the bid spreads get big. And he's really taking that approach now which is I'm going to reduce the credit risk held by the GSEs but I'm not necessarily going to pull myself out of the market and allow private label capital to actually participate in the securitization investor process. And I think that's a change, maybe for the good, maybe for the better because actually at this point there doesn't seem to be a lot of private label or private market interest in actually participating in the old way. And even if we thought about the sheer size and scale of the market some have suggested that there may not even be enough capital out there to do it. So I mean that's a big shift that we've seen is this concept of like the GSEs acting more like a liquidity market maker and the goal is to reduce credit risk through these, you know, credit risk transfer type processes.

MR. TIMIRAOS: Well, and so on that point -- and I want to ask you about this Mike Calhoun -- but on that point a few years ago there was an assumption that, you know, private label would come back quickly. There was also an assumption that at some point down the road Congress would perhaps more easily than what has proven to be the case advance some kind of bipartisan legislation. The Senate Banking Committee looks like it's going to pass the Bill, the Johnson Crapo Bill this week but not with enough of a majority to propel it through the Senate this year. And so if, you know, if that first one is true that we're not seeing much of a return in the private label market, we're also not seeing enough of a bipartisan consensus to push through a reform bill this year or even maybe in the next term of Congress where do you think that leaves the FHFA in terms of possibly advancing administratively some type of housing finance overhaul? I know Director Watt said today he wasn't really going to address legislation but where do you think he could take this if Congress chooses not to act?

MR. CALHOUN: Well, I think first of all his remarks today were a little pressing and as you said the vote is coming up on GSE reform but it looks like that's going to be a longer process rather than shorter. And I think that's just part of the landscape and he's saying my job is not to tilt that landscape but to provide a stable housing system while Congress sorts it out. He is a creature of Congress for more than two decades and I think he has great deference to the role of Congress to make those policy decisions rather than himself. I think it also recognizes though two things. One, the public role in housing finance has been large even through the peak of the PLS, private label securities. People think that while it's at abnormally high levels now it has even through normal market cycles been how most people get their home mortgages. Private label securities even at their peak were not dominant in the market compared to the role the government played in providing that just foundation that our system operates under. And then furthermore as people had alluded to with the tightness of the credit market right now, the credit market is not just affecting some home buyers it's affecting the broad economic recovery here and holding it back as housing starts are still very much depressed compared to normal levels, not compared to the boom years of the mid 2000s. And credit is most constricted for those first time homebuyers who would be buying those starter homes but are also essential to making the whole pipeline of the housing finance system work. If there are not those new first time homebuyers people moving up or people trying to retire don't have a good market to sell their houses into and it impacts the whole economy. So I think his approach is spot on in terms of what is the role of FHFA and what is needed right now in the housing economy and our overall economy.

MR. TIMIRAOS: Mike Malloy, I want to ask you about Johnson Crap because kind of the conceit behind Johnson Crap is we will replace many of the functions currently performed by Fannie and Freddie with new privately capitalized either guarantors or this kind of securities execution. Some folks have suggested maybe you could get to the same place simply by restructuring Fannie and Freddie as a seller servicer to the GSEs. How do you think about, you know, the benefits or disadvantages of one over the other?

MR. MALLOY: Well, I think trying to predict the end state or what Congress might do is a very difficult game and so, you know, I think instead of looking at, you know, what might an end state be here versus there I think you have to move back to sort of the base principles. You know, and the base principles -- the director talked about base principles of Johnson Crap of, you know, getting private capital back into the market, you know, in the first loss position ahead of the tax payer, right. I think that sort of first principle is critical. And then saying how do we deal with the risk of, you know, catastrophic risk beyond that, right, is another principle that you have to say, okay, how does the government play there, what is that role, you know, how does that role play itself out. I think those are the items that, you know, back to what the Director is doing, back to, you know, Johnson Crapo, what they were trying to do, back to any of the things. You know, rather than what is one end state or the other you ah veto move back to those principles and say are we moving, you know, are we talking about the right principles. And that's where I think the debate has gone. But I think that concept of private capital coming back in is critical and that, you know, and so I think looking for what are the solutions that look like that.

MR. TIMIRAOS: Yeah. Phil, I mean you were involved initially I know in some of the discussions around the Corker-Warner Bill. If that idea has kind of reached its maximum level of support, you know, is it worthwhile to say all right, well let's look at how we can do this utilizing the GSEs or the reasons why you don't want to go down that road.

MR. SWAGEL: No, no, I think that is the natural next step. I would say the next step really is to let the firms build capital. And so Jim Millstein, who's here, and I have an op-ed together in *The Washington Post* from like a year and a half ago -- just making sure he doesn't leave. So I mean we have an op-ed from December --

MR. MILLSTEIN: I almost got out.

MR. SWAGEL: Exactly. We have an op-ed from December 2012 which said look, the firm should build capital. That's what insurance companies do, they build capital, they pay claims and they're not able to do it now. So, you know, all the other questions about the Third Amendment aside the firms should be building capital; they're profitable. So I mean Jim and I said the profit sweep doesn't make sense. Looking at the -- how does the system evolve, right. So hopefully more capital both internally and through the credit link notes. You know, going from 30 to 90 is triple but it's -- you know 90 is very close to 0 on a $5 trillion balance sheet. So that was -- that seemed like a pretty modest step taken today when the risk transfer transactions are so successful so far. But more private capital. The two firms will continue to be regulated and the retained portfolios, the internal hedge fund will wind down. You know, that's not as far a reform as Johnson Crap but it's much better than the system before the financial crisis, that's for sure.

MR. TIMIRAOS: So do we need Congress to do legislation or could FHFA -- how much of this could FHFA advance unilaterally, administratively?

MR. SWAGEL: Yes. I mean a lot of what I just said FHFA could do. I mean again that's why the 90 billion number today was so disappointing. You know, it really is downshifting into first gear or maybe gear or something. But the reset they could do. I mean the worry I have still is the competition, right. That was the -- you know, they're too big to fail in competition, right. If there's going to be two firms they have market power and of course in the old system they used their market power, right, in the same way that Amazon today is using its market power against publishers, you know, as well read a couple of days ago. That's the concern. You know, can a regulator get at that? I don't know.

MR. TIMIRAOS: But there's also -- I mean there have been great benefits to what the GSEs have down, market power and concentration of involvement and concentration of risk honestly to the tax payer and to the government aside, you know, the GSEs have provided a, you know, created a very liquid and amazingly efficient and standardized market. I mean you contrast the GSE world of the two securities and DU and LP and how a loan is done in the old days versus the wild, wild west of the private label capital markets and we kind of see what happened, right? So those --

MR. SWAGEL: Yeah. No, in the future we want to keep the good and address the bad. So the good is exactly, exactly that. The bad is the use of market power, the 50 basis points skimmed off from 5 trillion for shareholders and management. I mean that's the part we want to address. That's what I worry about if we go back to the old system, we'll go back to the slush fund days and all that and I don't think so. Look, we've got a good regulator but that's the concern.

MR. TIMIRAOS: Well, so I want to ask the panel then, and anybody can jump in here, how do you deal then with the ownership structure of whatever this, you know, new or reformed model looks like? And I want to read a quote from - this is from Dan Mudd who is the former CEO of Fannie Mae before it was taken through conservatorship, and when he testified before the financial crisis inquiry commission he said that, "By 2006 Fannie Mae was engaged in a continual struggle to balance all the requirements of public mission, all the duties, and all the duties owed to shareholders. Fannie was required to expand lending, conserve capital, provide liquidity, meet housing goals for the underserved, serve shareholders and homeowners alike. Perhaps we should have gone to the government and gotten a clear answer to the question, do you want more capital, more lending." He said, "There are subjects where I respectfully differ with former Treasury Secretary Paulson but I do agree with his ultimate assessment that the cause of the GSE's trouble lies with their business model, a monoline GSE structure asked to perform multiple tasks cannot withstand a multiyear 30 percent decline on a national scale even without the accompanying global turmoil." And so he went on to talk about the horrible choices that the company faced in 2006. How do you, you know, to the extent -- hopefully we're never in a situation of course like 2006 again, but if we are in that environment where there's been a lot of procyclical lending and you have an entity that's supposed to be countercyclical how -- is there a way you can address the ownership structure to remove some of those pressures from, you know, somebody in that position?

MR. CALHOUN: I'll jump in and say, yes, in a couple of regards. First of all it's sort of back to the future. I mean Freddie started as mutual. You could send the structure back to that. That's what's used by the federal home loan banks where they're mutually owned by all the participating lenders so you remove that conflict of maximizing shareholder return. And quite frankly I think it's important to realize how much reform has already been implemented, not just at the GSEs with more transparency with a fully empowered regulator, but what really was the core of the problem in that was the unsustainable mortgages that brought down the housing finance system, and there the reforms of full documentation, of determining ability to repay, of discouraging the riskiest features on loan. If you take just QM loans for example, just the product features you would have reduced the default rate through the crisis with the 2000-2008 book of business to a little over 5 percent which the system would have readily handled. That's not even putting in the debt to income limit. And so by making loans more predictable and safer it is fundamentally a better system. We need -- there's still risks there that need to be addressed but we securitize subprime car loans, we securitize, you know, credit cards. We had more transparency. The problem was we had lack of transparency in that market where investors did not know what they were buying and did not get what they thought they were buying and you had volatility that you could not match. Our markets are actually quite good at pricing and managing risk when it's transparent and when the volatility is predictable.

MR. FLEMING: I would actually tweak that comment a little bit. It's not necessarily that they didn't now although there was a limited amount of availability of information and transparency and transfer of information, symmetric information is very important and good. But I think there was also this grand -- and we'll use Director Watt's statement, "expectation". There was one clear expectation that house prices would always go up. So I didn't really care --

QUESTIONER: Right.

MR. FLEMING: -- what I bought, right. And that was ultimately obviously a big mistake. But it's the one thing that really explains all this behavior. Give someone with poor credit a high LTV, low no doc loan with all the funky features, we'll call them financial innovations to be nice here, right, and say that's okay because, you know, the value of the asset backing it today will be worth more tomorrow than it was today and so I'm good. And we sort of learned -- we never expected -- there's a famous Lehman Brothers prospectus on a bond and in the back of the bond they go through the details of their house price simulations and they say well, there's this one possible path of prices going down by three to four percent negative and they showed that if that happened basically most of the tranches of that bond would get wiped out because it was a really terrible subprime pool of loans. And then they assigned a probability of say one or less than one percent to that likelihood happening, so we're all good, right. And, you know, so you get back to these conversations, like the black swan conversation. We had what we now know, you know, once you have a black swan it sort of becomes white because it's now known. And so what's the next black swan? Is it a, you know, a 60 percent decline in house prices or something else that we'll do to ourselves on the seven year cycle.

QUESTIONER: Interest rate shock?

MR. FLEMING: Interest rate shock. Yeah, something like that, but so, you know we have to -- you know we sort of look at these things and say, you know, we should own collectively, you know, the mortgage industry, the consumer, everybody, we should own this problem ourselves because we all had a role to play. We made bad decisions around our expectations. We won't make that mistake again but as all of us sitting in this room definitely know I'm sure we'll make another mistake again.

MR. TIMIRAOS: And on that sober note, I'll --

MR. FLEMING: I don't want to end it. Come on, that's what we're --

MR. TIMIRAOS: I want to see if the audience has any questions. If you do please state your name and ask a question. Yes, in the back?

MR. WALLACH: Hi. Phil Wallach from Brookings. I'm just wondering, the private shareholders have gone entirely unmentioned up to this point and obviously they're bringing cases in various courts trying to assert that the Third Amendments are illegal and we don't know how Congressional action might affect them but I just wanted to throw that to there and see if any of the panelists want to comment on what's the likely state of those lawsuits and of the private shareholders.

MR. TIMIRAOS: Any lawyers up here? Phil?

MR. SWAGEL: I mean I -- look, I don't know, that's up to the courts. I mean the government has effectively told the firms' shareholders you still own your car but you never to get to drive it again, we the government get to drive it forever in the future. I don't see how that's legal at least in English instead of Russian. So, you know, look we saw in the auto bankruptcies that it's tough for a federal judge to go against the government in this situation so we'll have to see how that goes. You know, again it think it's just bad policy. So forget the legal part, it was bad policy. The Third Amendment was not necessary, right. The ostensible reason for putting it on to avoid the 100 billion caps didn't make sense at the time, it doesn't make sense today. It would be better as a policy matter for the firms to build capital.

MR. TIMIRAOS: Was it a mistake to not take a 100 percent of Fannie and Freddie given that the tax payers had all of the downside. I mean people cited that 188 billion number as if that was the maximum the U.S. had agreed to inject when of course the truth is that the U.S. was willing to put in $400-500 billion. I mean 188 billion isn't really where the clock stops.

MR. SWAGEL: Right. Yes, I have a paper that was written for a conference here at Brookings in April 2009 that goes through in more detail. So if you Google, "Swagel Financial Crisis" you'll get many things but that's one of them. So my fans are there too. But, right, I mean the structure of the PSPAs was put in place to avoid having the assets and the liabilities coming in under the government balance sheet at that time. And I think no one envisioned that the administration would take so long to move forward on housing finance reform. You know, the support for the government as

Nick said was unlimited, right. There's a payment in kind provision as usual in the stock agreements and so the government could have put in an unlimited amount at a 12 percent rate rather than a 10 percent rate. So again for many reasons the Third Amendment is baffling. But again I start with it's poor policy.

MR. TIMIRAOS: Any other questions from the audience? Uh, yes, Rob.

MR. ZIMMER: Thank you. Rob Zimmer, Community Mortgage Lenders of America. The co-op idea is interesting to me but representing mortgage bankers which are relatively thinly capitalized, they don't have deposit insurance, don't have (inaudible) to didn't get TARP money, they have their warehouse lines. And so help me think this through. How would that work that the mortgage bankers, would they be required to inject equity into the new entity? They're not members of the home loan banks probably for the same reason. How can we make sure that the future system still serves mortgage bankers appropriately? So non depositories in general?

MR. TIMIRAOS: I'll ask you, Mike.

MR. CALHOUN: Sure. I think those bankers are a critical part of the system so they need to be served in any successful reform here. And I think there are a couple of ways. One of course is the cash window. It's one of the things that the current GSEs provide that is very popular with small lenders in general. There are also correspondent arrangements that mortgage bankers could do that would feed into the mutual structure. But both of those I think are ways to address it but in any event I would agree with you totally, it's critical that they be addressed. And one concern we have about some of the possible reforms is the mortgage market has concentrated more post crisis and we think that is an unfortunate trend and that we more competition among mortgage originations. You know, I think it's good to step back. Everyone in the room here is deep in all the intricacies, but all of this is pretty much a black box for the average home buyer/home seller. They want to be able to get a mortgage at a good rate, they want credit to be there through the cycle, and I think we really need to think about how that interface works. We need to make sure the back room if you will of it is stable and sound and responsible, but ultimately it needs to serve the customers on the street.

MR. TIMIRAOS: And with that you utility or I guess the kind of co-op model would you envision there being just one? Would you have multiple, you know, secondary market guarantors or do you need -- you really only need just one?

MR. CALHOUN: There would be various options there. There are different functions of the aggregating of the loans to bring them together for the pooling and then the guarantee. I think there is a consensus on a lot of things about GSE reform, that we want more private capital. So I think any system will have more private capital in front of it. There will be deeper insurance, more capital required by the guarantors. You know, the people differ about exactly where to set that but at far, far higher levels. People are talking about near multiples of 10 times as much capital as what was there before. And you could do that various ways. So you could combine the aggregator and the guarantor in the co-op model or you could have multiple guarantors. I think all these systems envision a continuization of the private mortgage insurance companies with, as Dr. Watt referred to, greater scrutiny at to their capitalization and their operation to make sure that they are there in fact in a crisis.

MR. TIMIRAOS: Phil?

MR. SWAGEL: I would just, you know, say -- and I'm going to disagree here but, you know, it's -- you know, different people can disagree on this stuff. I mean I look at co-op model and say it has a number of problems. I mean it doesn't get at the too big to fail problems; if anything it enshrines it. I think ultimately it will turn in -- so I think a synonym for co-op is Wells Fargo, JP Morgan joint venture, right. I think those are synonymous terms. And I just don't -- you know, I don't think it's what we need for the system. I would say failure should be catastrophic, right. If there's another failure of the system the officers should be fired, the shareholders should go to zero or nearly to zero and so on. And with a co-op you can't have that, right, it has to stand there. So my criticism is actually from the left which I know is going to be ironic, that if the future -- if someone says we should have a co-op I would say no, no, no, don't stop there, have a single utility. Run it by the government, call it what it is and don't have a co-op. So that's my -- anyway, that's my disagreement.

MR. TIMIRAOS: We have time for one more question. Yes, straight in the back here.

MR. GABRIEL: Yes, thank you. Chuck Gabriel at Capital Alpha. Just a question maybe for Mike with regard to the Fannie/Freddie rep and warrant language that was released yesterday. A lot of us didn't have a chance to peruse that very closely. There had been a lot of ideas out there, for instance in moving to a narrower sunset window on the loans going forward. This didn't seem to go there. I was just wondering, you know, how the notion of allowing up to two delinquent payments in a 36 month period and the other changes that the Director mentioned, you know, how far did that go towards satisfying the issue or, you know or might -- do you think they might consider additional changes going forward?

MR. MALLOY: Right. Well, that's what I was getting at with my first comment which is these are a very important first step, very positive. And when you do study them there's also in addition to the payment issue there's some, you know, requirements around if a QC review is done then there can't be a subsequent repurchase demand. Also the rescission of mortgage insurance doesn't result in an automatic repurchase. And those are significant steps. But what I believe is equally important, perhaps even more important than those positive steps is the fact that the Director said they are committed to working on these things and, you know, we haven't yet seen the strategic plan but, you know, I have the impression that some of those items that he was mentioning from the podium today will be in the strategic plan to keep working on those items. And so I think like many things it's an iterative process but Director making it such a point in his speech and talking about the commitment to keep working on it I think is as important as what words are on the page in the announcements yesterday.

MR. CALHOUN: And if I can add I think, you know, the two key components are ultimately going to be materiality. There's a requirement that you show that some defect, you know, had some causation with the mortgage actually defaulting. Which today there is astonishingly no requirement of that. And then to add to that you have that the GSEs currently, unilaterally essentially get to decide do you have to buy back. I mean people can fight it but they are the ultimate deciders on that in some dispute resolution system for that. But right now it's got a long ways to go to be in a good place. I would certainly agree with that part of your comment.

MR. MALLOY: There's not -- there's also not -- this is not something just that the secondary market, the GSEs, or even the private label market, whatever this is in terms of repurchase rep and warrants has to do with is that the mortgage industry itself I think bears some responsibility in doing a better job of manufacturing the loans in the first place, right. I mean you know the lemon laws for cars, well if you think the mortgage industry in many instances it's like we roll lots of cars off that production line missing lug nuts on wheels and sometimes the whole steering wheel, you know. And that's not acceptable from the car making acceptable and it's not really - -shouldn't be acceptable from the mortgage industry's perspective. And we're going and doing a lot -- even the GSEs are doing a lot to try and ensure that the information that is important and material to the credit risk on a loan is correctly captured and documented and put in the loan files and originate through the process. And that's sort of a -- that will in many ways help with the repurchase issue along with the way with the concept of materiality. We know the information up front. If it's bad going in the loan won't get originated, that information will usually get fixed and provided appropriately. I'm talking about credit scores, LTVs, DTIs, the important attributes, such that the risk of repurchase will be much lower because of the improvement in the manufacturing process itself.

MR. TIMIRAOS: Great. I think we're going to leave it at that. Thank you all very much for attending and we'll see you at the next one. (Applause)

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