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Prepared Remarks of Melvin L. Watt
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At the Brookings Institution Forum on the Future of Fannie Mae and Freddie Mac

Managing the Present: The 2014 Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac

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Thank you to the Brookings Institution for hosting this event and thank you for that introduction.

Let me begin my remarks today by talking about the Federal Housing Finance Agency's (FHFA) work over the last four months. Since January, the agency 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 (the Enterprises). 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 provides you with 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 Mae and Freddie Mac. 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 these staffs for their hard work. There's been a constant urgency since the financial crisis. It has been a marathon, but I'm sure it has felt like a sprint. And everyone has 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 his time as Acting Director of FHFA. In the face of the greatest economic collapse 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 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 obligations under current law. This means, first and foremost, that we must ensure that Fannie Mae and Freddie Mac operate in a safe and sound manner. It means that we'll work to preserve and conserve Fannie Mae and Freddie Mac'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 my 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.

As a result, one topic that is not on FHFA's agenda, because it's not part of our statutory mandate, is housing finance reform legislation. My guess is that there were many people who expected that I would start talking about reform legislation the minute I got to FHFA. I am well aware, and regularly express my belief, that conservatorship should never be viewed as permanent or as a desirable end state and that housing finance reform is necessary. However, Congress and the Administration have the important job of 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 Mae and Freddie Mac.

Today, we are releasing a new Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac 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 1: 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 Mae and Freddie Mac to carry out and strengthen, where possible, three aspects of their core business operations. First, we expect them 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. Third, we think they have a critical ongoing role in the multifamily sector, particularly for affordable multifamily 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 Scorecard. We have also doubled the Scorecard weight given to this goal, from 20 percent to 40 percent.

I want to 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 too much uncertainty still exists in this area for them to ease their credit overlays. Ultimately, this undermines the goal of improving access to mortgage credit for creditworthy borrowers.

After extensive discussions with Fannie Mae, Freddie Mac and lenders over the past several months, we are making a number of refinements to address some of these concerns. As the Enterprises 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 this 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 the agency's work in 2013 and demonstrate our 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 Mae and Freddie Mac 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 Mae and Freddie Mac. The first one involves loans with debt-to-income ratios above 43 percent. Current Fannie Mae and Freddie Mac 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 issue involves loan limits. As market participants are already aware, FHFA released a proposal last year suggesting that the agency would use its conservatorship authority to lower the mortgage amounts eligible for guarantee by Fannie Mae or Freddie Mac. 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 could adversely impact the health of the current 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 room for improvement.

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 Mae, Freddie Mac and the National Community Stabilization Trust. Phase one of this initiative is a pilot program in Detroit, Michigan. We're pursuing pre-foreclosure and post-foreclosure strategies that include deeper loan modifications and partnering with nonprofits earlier in the REO sales process. FHFA expects to use the experiences 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 have also received a number of inquiries about changing the eligibility requirements for the Home Affordable Refinance Program (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. We are exploring outreach efforts designed to gain the trust of these "in-the-money" borrowers so they act in their own financial interest.

FHFA's MAINTAIN strategic goal also extends to Fannie Mae and Freddie Mac's multifamily loan purchases. 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 their multifamily production levels and it provides additional capacity for affordable multifamily projects. Consistent with safety and soundness, our affordability focus will include multifamily lending for small properties and manufactured housing rental communities, much of which takes place in rural communities.

We do expect market competition in 2014 to result in lower multifamily levels for the Enterprises, but FHFA will not mandate that the Enterprises prematurely shrink their multifamily footprint.

Strategic Goal 2: 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 Enterprises' market presence, which could have an adverse impact on liquidity. Instead, the REDUCE goal focuses on ways to scale back Fannie Mae and Freddie Mac'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 strategies to reduce taxpayer risk build on much of FHFA's past work in this area. This includes having Fannie Mae and Freddie Mac conduct additional credit risk transfers for their single-family credit 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 Scorecard requires each Enterprise to triple the amount of risk transfers in 2014. This will be an increase from $30 billion of unpaid principal balance 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.

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 Mae and Freddie Mac 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 interest. As their portfolios continue to decline, they are transferring interest rate risk and liquidity risk from these portfolios to the private sector.

On multifamily purchases, we are requiring the companies to continue sharing risk with the private sector, which Freddie Mac does through a capital markets 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 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 Mae and Freddie Mac are able to provide adequate credit loss protection in times of market stress.

Strategic Goal 3: <u>BUILD</u> 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 objective for the Common Securitization Platform is to make sure that it works for the benefit of Fannie Mae and Freddie Mac. 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 all at the same time.

Since any stumbles along the way could have ripple effects in the $10 trillion housing 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 Mae and Freddie Mac's current securitization operations.

A successful outcome will be a seamless transition from the current in-house systems that issue new securities at each Enterprise to a future joint venture owned by Fannie Mae and Freddie Mac that operates one system with updated technology.

Defining the scope in this way acknowledges that building a CSP for a future housing finance reform 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 a future 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 wherever 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 CSP 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 costs to the Enterprises, particularly Freddie Mac, since Freddie's securities have historically traded at a disadvantage compared to Fannie Mae. Adding a common single security component to the CSP's scope will require FHFA and the Enterprises to define the security's parameters along with shared contractual and disclosure requirements.

FHFA, along with Fannie Mae and Freddie Mac, has made great progress on developing the Common Securitization Platform. But all 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 here, we are well positioned to move forward. Throughout this process, we will provide opportunities for stakeholder input about our decisions along the way.

Conclusion

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 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 Mae and Freddie Mac, which we will release very soon. As many of you know, I issued a directive to the Enterprises that they delay the guarantee 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 announce a decision later this year that is consistent with the goals that we have outlined in our Strategic Plan.

Thank you for your time today. I look forward to working with all of you as we implement our Strategic Plan and 2014 Scorecard.