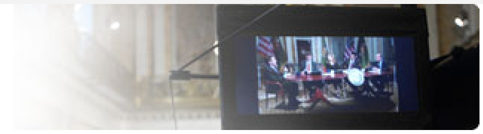
1-7-2009

Remarks by Treasury Secretary Henry M. Paulson, Jr.

Henry M. Paulson Jr.

U.S. DEPARTMENT OF THE TREASURY

Press Center



Remarks by Treasury Secretary Henry M. Paulson, Jr.

1/7/2009

HP-1345

On The Role of the GSEs in Supporting the Housing Recovery before the Economic Club of Washington

Washington – ***Good afternoon. Thank you, David and thanks to the Washington Economic Club for this opportunity to provide my thoughts on long-term reform of the housing Government Sponsored Enterprises, the GSEs, Fannie Mae and Freddie Mac.***

Good afternoon. Thank you, David and thanks to the Washington Economic Club for this opportunity to provide my thoughts on long-term reform of the housing Government Sponsored Enterprises, the GSEs, Fannie Mae and Freddie Mac.

Debate over the role and function of these entities has raged for years. Congress established Fannie and Freddie decades ago to meet a public policy goal – to increase the funding available for home mortgage financing. The GSEs achieve this through providing liquidity to the secondary market for a limited range of home mortgages, either through credit guarantees on mortgage-backed securities (MBS) or by directly investing in mortgages and mortgage-related securities through their retained mortgage portfolios. To further this mission, their congressional charters grant the GSEs several benefits which together created a perception that the GSEs were backed by the U.S. government, even though this was not the case. This "implicit" government guarantee provided the GSEs with a funding advantage over other mortgage market participants.

The inherent conflict in this structure is obvious – the GSEs served both a public mission and private shareholders – they received public support but operated for private shareholder gain. While policymakers of every ideological stripe have acknowledged the risks created by this conflict, entrenched debate, often with little recognition of market realities, prevented reform. Over time, the GSEs' advantages enabled them to grow at a phenomenal pace, so that today they have $5.4 trillion in obligations outstanding, held by investors in the U.S. and around the world. As a comparison, that is almost 40 percent the size of the entire $14 trillion U.S. economy. The systemic risk posed by such size was heightened by the fact that investors assumed that GSE securities were backed by the U.S. government and therefore virtually risk-free, despite repeated statements by consecutive U.S. administrations to the contrary. These debt-holders would be the largest, but not the only, conduits of systemic impact should either GSE fail. Derivative counterparties, for example, would also be overwhelmed by a default of either GSE.

For some time market participants had questioned whether the GSEs were adequately capitalized for the risk they were taking, and therefore able to withstand losses without triggering a systemic event. Policymakers acknowledged that the GSE regulator did not have the authorities to address these risks, yet they could not reach consensus to improve it, and instead left a clearly inadequate regulatory structure in place. When I came to Washington, I saw an opportunity to improve the regulatory structure, even if it wouldn't be perfect. I set to work in the fall of 2006 to broker progress in the House, and we did begin to solve some of the seemingly intractable differences.

Even as Washington debated GSE oversight, there was little debate over the extent to which government should subsidize homeownership, and whether such government support was contributing to a housing bubble. The U.S. government has many policies that subsidize homeownership – it would be oversimplifying and wrong to blame Fannie and Freddie for the bubble, but they clearly are part of the public policy bias that contributed to it.

In sum, the GSE reform debate was largely frozen in place, or moving at glacial speed. Then suddenly, the unprecedented housing correction shifted the ground under that debate and forced action.

Today I will review the actions we have taken and their effect, and address two issues before us. First, in the short-term, how do we use the GSEs to mitigate the current credit crisis and housing downturn? Second, given the temporary nature of their current status, how might we address the appropriate long-term structure?

Prelude to Recent Actions Regarding Fannie Mae and Freddie Mac

As we progressed through the current housing market downturn, investors fled mortgages that carried any credit risk. But because the GSEs take the credit risk on the mortgages they guarantee and because investors believed there was implicit government backing, the conforming loan market continued to function relatively well. As a result, the GSE share of new mortgage business rose from 46 percent in the second quarter of 2007 to 84 percent in the second quarter of 2008. Without the GSEs to finance mortgages, it was very clear that mortgage finance would essentially dry up.

However, as the extraordinary housing correction deepened, weaknesses in these entities became apparent. In July 2008, investors lost confidence as they became increasingly uncertain about Fannie and Freddie's capital position. The GSEs' already depressed stock prices plummeted further. Shareholder losses did not pose a public policy concern, but the share price drop further weakened confidence among the holders of the $5.4 trillion of GSE debt and MBS. Investors at home and abroad were reducing purchases and even selling from their holdings of GSE debt. The consequences of either GSE failing would be catastrophic. We couldn't wait for a failure; we had to act preemptively to shore up confidence in these enterprises.

In July, I requested that Congress quickly complete work on long-sought GSE regulatory reform and also provide Treasury with expanded authority to support Fannie, Freddie and the Federal Home Loan Banks. Congress did so – giving us enormous temporary authorities to inject capital if the GSEs asked for it, and to create a back up liquidity facility for GSE debt.

Immediately after passage of the legislation, in coordination with the Federal Reserve, the newly-constituted GSE regulator, FHFA, and our advisor Morgan Stanley, we began a comprehensive financial review of the GSEs. At the same time, mortgage market conditions continued to deteriorate. Negative earnings announcements by Fannie and Freddie in August reflected those worsening conditions, and further roiled markets. Neither company appeared to have any reasonable prospect of raising private capital to allay those concerns in the foreseeable future, and our examination found capital to be inadequate – in terms of both the quality of capital and the embedded losses stemming from worsening mortgage market conditions.

Confidence in the GSE model was largely shattered. It was clear to me that simply injecting even a great deal of equity into their business model would not create the market confidence necessary to fund these enterprises going forward and to bolster confidence in the $5.4 trillion of extant GSE obligations, which posed the greatest systemic risk. Market fragility and the GSEs' deteriorating balance sheets required that we take responsibility for the GSE structural ambiguities that U.S. policymakers had let fester for decades. If we had asked Congress for, and received, the power to explicitly guarantee the GSEs' obligations, we would have done so. But without that authority, we had to be creative and find a way to effectively guarantee the GSEs' obligations.

We had to stabilize the situation immediately. We knew that markets were exceptionally fragile and would be further threatened in September when we expected that a number of large financial institutions, including Lehman Brothers, would post disappointing earnings. Chairman Bernanke, FHFA Director Lockhart and I met almost daily, over a 10 day period, to work toward a comprehensive action plan. As I made clear at the time, we sought a temporary solution that would achieve three goals: (1) stabilize markets, (2) promote mortgage availability, and (3) protect the taxpayer.

In comprehensive action taken on September 7th, FHFA placed Fannie and Freddie into conservatorship, enabling Treasury to take creative steps to support their obligations. We moved quickly to do what was necessary. Our actions would have been impossible to implement were it not for the GSE reform legislation that gave FHFA the expanded power to make qualitative and quantitative judgments about capital and also gave Treasury the financial authorities necessary to make conservatorship a stabilizing, as opposed to a destabilizing, event. We devised Preferred Stock Purchase Agreements to effectively guarantee the GSEs' obligations by ensuring Fannie and Freddie would maintain a positive net worth. This commitment ensures that they can fulfill their financial obligations, even after the temporary authorities expire in December 2009. Additionally, Treasury established a new secured lending credit facility intended to serve as an ultimate liquidity backstop. To further support the availability of mortgage financing, Treasury initiated a program to purchase GSE MBS and has purchased over $50 billion thus far.

We took these actions first, to avert the financial market meltdown that would ensue from the collapse of these institutions and, second, to allow the GSEs to continue, in the midst of overall market stress, to perform their essential role of providing mortgage finance. This conservatorship, with the explicit backing of the federal government, is temporary and must be resolved for the long-term. In the meantime, the GSEs must serve the taxpayers' interest by assisting in turning the corner on the housing correction, which is critical to return normalcy to the capital markets and resume U.S. economic growth. The GSEs can facilitate progress through the housing correction by keeping mortgage rates low and by mitigating foreclosures.

Keeping Mortgage Rates Low

Lower mortgage rates enable more potential homebuyers to return to the market and help put a floor under home prices. Initially, following our September actions, mortgage rates did fall. Market turmoil subsequently increased and mortgage rates rose, but not nearly as much as the cost of other forms of credit. Still, neither the taxpayers nor the economy were getting the full benefit of the agreements put in place to effectively guarantee GSE debt. We could have gone back to Congress to ask for authority to directly guarantee GSE debt, however this would have been difficult to achieve. While a simple, direct government guarantee of GSE MBS might have reduced rates further – given the extraordinary strains in today's markets it probably would still have failed to produce all of the desired mortgage rate reductions. Therefore, we examined other means of deploying our authorities that could reduce mortgage rates.

We immediately noted that, given the effective government guarantee and the spread between Treasury rates and those of the GSEs, the taxpayers would profit if the government simply issued Treasuries to buy GSE securities. And in fact, we have funded the purchase of GSE securities with the issuance of Treasury bonds. But to make an impact on mortgage rates, such an initiative would have to be very large and those Treasury issuances would count against the debt limit.

On November 25, the Federal Reserve announced a new program to purchase up to $100 billion in GSE debt securities and $500 billion in GSE MBS. This Federal Reserve program had a significant impact. The 30-year fixed rate has fallen from an average of 6.04 percent the week before the policy was announced to a record low 5.10 percent last week, accomplishing a vitally important step in addressing this housing correction – lower mortgage rates that may bring additional credit-worthy buyers into the housing market.

Foreclosure Mitigation Efforts

While the GSEs are in this temporary form, we have also worked to increase their impact on foreclosure mitigation. In November, FHFA, the GSEs, Treasury and the HOPE NOW Alliance announced a major streamlined loan modification program (SMP) to move struggling homeowners into affordable mortgages. The new protocol relies heavily on the "IndyMac model" developed by the FDIC and creates sustainable monthly mortgage payments by targeting a benchmark ratio of housing payments to monthly gross income. Together with the IndyMac/FDIC protocol, the SMP creates a powerful new model that should help ensure that no borrower who wants to stay in their home and can make a reasonable monthly payment will fall into foreclosure.

The SMP will directly and immediately apply to the 50 percent of homeowners with loans serviced under the GSEs' auspices. Fannie and Freddie announced that they would suspend foreclosure sales and cease evictions of owner-occupied homes until January 9th to allow time for implementation of the modification program. The timing of this initiative is especially important as prime loans now account for almost 50 percent of new delinquencies, and delinquencies are increasingly the result of overall economic factors rather than the loan features and underwriting practices associated with Alt-A and subprime products.

And the impact of the SMP will go much further. The vast majority of servicing contracts for non-GSE mortgages reference the GSEs' practices, and we therefore expect the SMP to be widely adopted and quickly move hundreds of thousands of struggling borrowers into sustainable, affordable mortgages. Further, this streamlined protocol frees up servicing industry resources that can be redirected to providing case-by-case assistance to more difficult cases that fall outside the SMP protocol.

Impact of Temporary Authorities to Stabilize the GSEs

Given the authority granted by Congress last summer, we have gone about as far as we can to avert systemic risk and to use the GSEs to speed progress through the housing correction that lies at the heart of our economic downturn. Although the effective guarantee of GSE debt and MBS has brought some degree of stabilization, it is not the most efficient way to remove the ambiguity inherent in the GSE structure, even temporarily.

To the extent that the Congress and the next Administration wish to use the GSEs as a tool to further reduce mortgage rates, they could, under existing authorities, make large purchases of mortgages made at a target rate of, say, 4 percent – although very large volumes of Treasury issuances would be required for such a program to be effective. A targeted program such as one that purchases only new mortgages made for home purchases, as opposed to refinancing, for a one year period would require less but still substantial funding. Separately, the next Administration could pursue legislative authority to directly guarantee GSE debt for the remainder of the conservatorship period.

Long-Term Policy Recommendations

The GSEs are playing a necessary role supporting the mortgage availability which is essential to eventually turning the corner on the housing correction, reducing the stress in our capital markets and returning to growth in our economy. This must continue to be our first priority. But we will make a grave error if we don't use this period to decide what role government in general, and these entities in particular, should play in the housing market.

The public debate over the long-term structure of the GSEs is dramatically changed today – no one any longer doubts the systemic risk these entities posed. It is clear to all conservatorship is a temporary form, and that returning the GSEs to their pre-conservatorship form is not an option.

The debate about the future of Fannie and Freddie requires answering the much larger and more important question of the federal government's role in the mortgage market and in housing policy, generally. Given the bubble we have experienced, policymakers must ask what amount of homeownership subsidies are appropriate. Numerous long-standing indirect subsidies already exist, including the mortgage interest deduction, subsidized FHA mortgages, and the variety of other HUD programs that expand homeownership opportunities.

Is that enough? Or should government also reduce mortgage rates for a larger group of homebuyers? Policymakers must decide if the GSE subsidy is a public policy priority. If the GSEs are to play a role, then, the debate is clearly framed: Government support needs to be either explicit or non-existent, and structured to resolve the conflict between public and private purposes. Any middle ground is a recipe for another crisis. Although there are strong differences of opinion over the government's role in supporting housing, under any course policymakers choose, there are structures and choices that can resolve the long-term conflict of purposes issues.

And it is clear that to protect against systemic risk in the future, the GSEs should be constituted with a portfolio no larger than what is minimally necessary for warehousing purposes. Without portfolios of significant size, the enterprises' management of interest rate risk would remain a vital function for the safety and soundness of the enterprises, but would no longer present the same potential systemic risk.

As a public policy tool to expand homeownership, the GSEs, like FHA-Ginnie Mae, reduce mortgage rates for borrowers by taking on the credit risk that mortgage investors would otherwise bear and guaranteeing that mortgage investors will be paid in full should the mortgage borrower default. As Congress considers the future role and structure of the GSEs, it must consider how much credit risk the Federal government should take.

Addressing Credit Risk

In today's stressed mortgage market, between FHA-Ginnie Mae, Fannie Mae, and Freddie Mac, almost all new mortgage market originations have federal government credit support. This is not sustainable over the long-run. It will lead to inefficiency, less innovation and higher costs. It also contradicts basic U.S. market principles. We must have some degree of private sector involvement in the evaluation of credit risk if we are going to have a mortgage market that allocates resources with efficiency.

In the mortgage market of the future, I clearly see a role for the FHA and Ginnie Mae for first-time and low income homebuyers. Beyond the explicit guarantee provided to FHA and Ginnie Mae policymakers must decide how much to further subsidize mortgage credit risk, if at all, and must decide the role of private capital in any subsidy plan. Depending on the degree of subsidy policymakers choose, there are a variety of options for structures to replace the GSEs, including:

(1) Expanded FHA/Ginnie Mae. Some advocate that beyond the current credit crisis the U.S. government's long-term policy should make the implicit, explicit. Explicitly guaranteeing Fannie and Freddie's obligations would essentially nationalize this significant portion of the U.S. housing finance market. Under this model, the GSEs could become a government entity, or their functions could be absorbed by FHA/Ginnie Mae . In either case, the GSEs would no longer have private shareholders. The size of the eligible population of homebuyers would determine how large a share of mortgage credit exposure the government would own.

Some advocate that beyond the current credit crisis the U.S. government's long-term policy should make the implicit, explicit. Explicitly guaranteeing Fannie and Freddie's obligations would essentially nationalize this significant portion of the U.S. housing finance market. Under this model, the GSEs could become a government entity, or their functions could be absorbed by FHA/Ginnie Mae . In either case, the GSEs would no longer have private shareholders. The size of the eligible population of homebuyers would determine how large a share of mortgage credit exposure the government would own.

I view the permanent nationalization of the GSEs, essentially expanding the role of FHA and Ginnie Mae, as a less-than optimal model. While it offers the perceived advantage of explicit government support, it eliminates the necessary private sector evaluations of credit risk and the private market stimulus to innovation.

(2) Partial Guarantee. A hybrid of this would be to create a Ginnie Mae-like entity for non-FHA mortgages, structured as a partial guarantee mechanism. The new entity could operate on a similar basis as Ginnie Mae, but provide only partial guarantees for MBS. Investors would then have a floor under potential MBS losses, but would still evaluate the credit risk associated with individual issuers. While such a hybrid program would clearly define the extent of the government's guarantee, developing risk sharing parameters compatible with profit incentives would be as problematic, and potentially as inefficient, as in the current GSE structure.

A hybrid of this would be to create a Ginnie Mae-like entity for non-FHA mortgages, structured as a partial guarantee mechanism. The new entity could operate on a similar basis as Ginnie Mae, but provide only partial guarantees for MBS. Investors would then have a floor under potential MBS losses, but would still evaluate the credit risk associated with individual issuers. While such a hybrid program would clearly define the extent of the government's guarantee, developing risk sharing parameters compatible with profit incentives would be as problematic, and potentially as inefficient, as in the current GSE structure.

(3) Privatization. A third alternative would be to remove all direct or indirect government support, completely privatizing these companies while breaking them up to minimize systemic risk. As appealing as this alternative sounds, it is difficult to envision a sound, practical, private sector mortgage insurance business of any significant size that does not require large amounts of capital, and consequently generates only a modest return on capital. The recent problems encountered by monoline insurers, which ventured into guaranteeing mortgage product as well as the experience of the GSEs, underscores this point. Moreover, a break up scenario does not look particularly promising, as reverse economies of scale would take hold. It is also worth noting that a regional mortgage insurer would lack diversity as a risk mitigant. Perhaps a consortium of banks would find it advantageous to own a national mortgage insurer to wrap their product, or some other good private sector business model may emerge. But I am skeptical that the "break it up and privatize it" option will prove to be a robust or even viable model of any substantial scale, without some sort of government support or protection. However, should policymakers choose to scale back public policy bias toward homeownership, we will eventually find out what business model the free market would support.

A third alternative would be to remove all direct or indirect government support, completely privatizing these companies while breaking them up to minimize systemic risk. As appealing as this alternative sounds, it is difficult to envision a sound, practical, private sector mortgage insurance business of any significant size that does not require large amounts of capital, and consequently generates only a modest return on capital. The recent problems encountered by monoline insurers, which ventured into guaranteeing mortgage product as well as the experience of the GSEs, underscores this point. Moreover, a break up scenario does not look particularly promising, as reverse economies of scale would take hold. It is also worth noting that a regional mortgage insurer would lack diversity as a risk mitigant. Perhaps a consortium of banks would find it advantageous to own a national mortgage insurer to wrap their product, or some other good private sector business model may emerge. But I am skeptical that the "break it up and privatize it" option will prove to be a robust or even viable model of any substantial scale, without some sort of government support or protection. However, should policymakers choose to scale back public policy bias toward homeownership, we will eventually find out what business model the free market would support.

(4) Housing Utility. Finally, given traditional U.S. public policy support for marshalling private capital to expand homeownership, establishing a public utility-like mortgage credit guarantor could be the best way to resolve the inherent conflict between public purpose and private gain. Under a utility model, Congress would replace Fannie Mae and Freddie Mac with one or two private sector entities. The entities would purchase and securitize mortgages with a credit guarantee backed by the federal government, and would not have

investment portfolios. These entities would be privately-owned, but governed by a rate setting commission that would establish a targeted rate of return, thereby addressing the inherent conflicts between private ownership and public purpose that are unresolved in the current GSE structure. This commission would also approve mortgage product and underwriting innovations to continually improve the availability of mortgage finance for a population to be defined by the Congress. In this model, continued safety and soundness regulation would be essential.

Finally, given traditional U.S. public policy support for marshalling private capital to expand homeownership, establishing a public utility-like mortgage credit guarantor could be the best way to resolve the inherent conflict between public purpose and private gain. Under a utility model, Congress would replace Fannie Mae and Freddie Mac with one or two private sector entities. The entities would purchase and securitize mortgages with a credit guarantee backed by the federal government, and would not have investment portfolios. These entities would be privately-owned, but governed by a rate setting commission that would establish a targeted rate of return, thereby addressing the inherent conflicts between private ownership and public purpose that are unresolved in the current GSE structure. This commission would also approve mortgage product and underwriting innovations to continually improve the availability of mortgage finance for a population to be defined by the Congress. In this model, continued safety and soundness regulation would be essential.

Need to Support Vibrant Private Market

If we are to maintain a private-sector secondary mortgage market – which I believe serves the taxpayer and the homebuyer equally well – then we must enhance the ability of depository institutions to fund mortgages, either as competitors to a newly-established government structure or as a substitute for government funding. One way to do this is for the government to receive some compensation for its guarantee. The current GSE Preferred Stock Purchase Agreements take a small step in this direction, in that as of 2010 the GSEs must pay the government a fee for the taxpayer backstop on their guarantees. Of course, if this rate perfectly reflected the risk versus the cost of the guarantee, there would be no subsidy to mortgage availability. It is obviously inherently difficult to reach an exactly correct price, yet a long-term fee-like structure in exchange for explicit government backing would help to reduce advantages over private institutions. Over time, another approach might be to offer other financial institutions the opportunity to pay a fee for government backing on securitized, conforming loans, a structural transformation that would lower entry barriers, and increase competition and innovation in housing finance.

Covered bonds are another private sector alternative worth exploring. The FDIC has made regulatory changes to support the emergence of covered bonds, which could provide enhanced opportunities for depository institutions to fund and manage mortgage credit risk. There is strong interest in developing a U.S. covered bond market, but we will have to work through the credit crisis before a new market is likely to take hold. Some have advocated dedicated covered bond legislation, which could be helpful to establishing this market, and should be considered in the context of broader housing finance reforms.

Additionally, the President's Working Group on Financial Markets has recommended extensive reforms in the mortgage securitization process by investors, ratings agencies, underwriters and regulators, especially with respect to mortgage origination oversight. When these reforms are in place, we expect private label securitization to return with greater oversight and market discipline.

Conclusion

My thoughts today are intended to inform the necessary debate over the future structure of the housing GSEs. By allowing the GSE structural ambiguities to persist for too long, U.S. policymakers have created an untenable situation. Today, Fannie Mae and Freddie Mac are in a temporary form that, while stable, cannot efficiently serve their Congressionally-chartered mission and protect the taxpayers' investment over the long-term. We took the right actions to meet a specific need at a specific time.

The GSEs are critical to getting us through this current period, and this is our first priority. More may need to be done to clarify and simplify their structure and to increase their effectiveness in curbing further housing price correction. But we cannot look only at this short-term need; policymakers must resolve the question of long-term structure because the pre-conservatorship model has been disproven.

The first step must be for policymakers to decide – in light of the recent housing bubble and the severe financial and economic penalty it has imposed on our nation – the role government should play in supporting home ownership. We cannot allow a repeat of the devastation this housing correction has wreaked on families and communities across the United States. Once that decision is made, the GSEs should be restructured to meet that public policy choice and satisfy three objectives: First, there must be no ambiguity as to government backing. It must be explicit or non-existent. Second, there must be a clear means of managing the conflict between public support and private profit. Third, there must be strong regulatory oversight of the resulting institutions.

As I have outlined, whatever role the U.S. government chooses to play in subsidizing mortgage finance, there is a structure that can meet the objectives. With the knowledge of recent experience, we have a responsibility to begin work now on a long-term GSE structure which avoids the dangerous mix of policy and market distortions created by the former flawed GSE model. Thank you.

-30-