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As prepared for delivery

Good morning, and thank you, Carsten, for that kind introduction. It's a pleasure to be with you today to engage on a very important issue for our country and our economy.

This morning, I want to discuss the state of housing finance reform and the path we see to a more sustainable mortgage finance system that meets President Obama's principles and creates a housing finance system that will promote stability in the housing market and the broader economy, and therefore, benefits the American people. First, I'd like to briefly explain why Treasury is devoting significant resources to helping market participants create a robust and responsible non-government-guaranteed securitization market and then discuss our thinking about how to move forward on GSE reform.

Private Label Securities Initiative

The Administration believes that private capital should be at the center of the housing finance system. To that end, Treasury has been working with the industry to develop the structural reforms necessary to help bring the private label securities, or PLS, market back, and get investors off the sidelines. A key component of this effort is rebuilding trust among market participants, and to this end, Treasury published the results of an exercise last month that would provide greater transparency around credit rating agency loss expectations for newly originated mortgage collateral. The goal of this exercise and the broader PLS initiative is to improve confidence in post-crisis practices and encourage investors to return to a reformed PLS market.

Treasury views a diverse housing finance system that features multiple execution channels as essential to promoting competition, market efficiency, and consumer choice. We see the development of a healthy and responsible PLS market as an important component of a sustainable housing finance system and a complement to a reformed government-supported channel, an objective I will discuss in the remainder of my speech.

GSE Reform

With that in mind, let me turn my attention to the GSEs. We are now well into the seventh year of Fannie Mae and Freddie Mac's conservatorship. We cannot forget that the actions taken in the wake of the financial crisis to backstop the GSEs stabilized the housing market, protected the capital markets, and supported the broader economy. But as I have said many times, the status quo is unsustainable. Taxpayers remain at risk, market participants are uncertain about the government's longer-term footprint in the mortgage market, and mortgage access and pricing decisions are not in the hands of market participants. The American people deserve better.

They deserve an efficient, sustainable, housing finance system that serves borrowers effectively and efficiently without leaving taxpayers on the hook for potential future bailouts. The critical flaws in the legacy system that allowed private shareholders and senior employees of the GSEs to reap substantial profits while leaving taxpayers to shoulder enormous losses cannot be fixed by a regulator or conservator because they are intrinsic to the GSEs' congressional charters. And these charters can only be changed by law. That is why we continue to believe that comprehensive housing finance reform is the only effective way forward, not narrowly crafted ad-hoc fixes.

We cannot forget about the important progress made in the Senate during the last Congress and hope that the new Congress will afford the opportunity to again advance bipartisan legislation meeting our principles, even if it is too soon to tell what the ultimate prospects will be. The Administration remains ready, willing, and able to work in good faith with members of both parties to complete this important but unfinished piece of financial reform. As memories of the financial crisis fade, we cannot become complacent. The best time to act is when the housing market is well along the path to recovery and credit markets are normalizing, not on the precipice of a new economic shock when there is little time to be thoughtful.

We do recognize the myriad of challenges to achieving a bipartisan legislative consensus. But as I will explain shortly, we believe that significant progress can be, and is being made, prior to legislation, to help move the housing finance system towards a more sustainable future. While this progress is not a substitute for legislative reform, it can, over time, reduce the challenges to achieving a desired legislative outcome that puts in place a durable and fair housing finance system by advancing us down the path of transition.

Progress under Conservatorship

To that end, I'd like to highlight the steps forward that have been made under the conservatorship – progress that needs to be built upon. Important gains have been and continue to be made in de-risking and preparing the Enterprises for transition. The GSEs' critical housing finance infrastructure and technology – which was allowed to obsolesce in the years preceding the financial crisis – is being renewed and enhanced.

Furthermore, their business practices are being reformed. Between 1995 and 2008, management grew the GSEs' retained investment portfolios, which are financed at government-subsidized borrowing costs, fourfold to a combined total of $1.6 trillion. Since entering conservatorship, those portfolios have been nearly halved, and they are required to shrink further to less than $500 billion in total by year-end 2018.

In addition to being a major source of GSE earnings, these portfolios remain a significant source of financial volatility and potential taxpayer risk. These portfolios, the pursuit of maximum earnings, and the drive to recapture market share through greater risk-taking left taxpayers holding the bag when the bets went wrong. In conservatorship, these practices have been replaced with a recommitment to more effective risk management, prudent underwriting, more appropriate pricing, and a greater emphasis on sustainable mortgage finance.

The Federal Housing Finance Agency (FHFA), as the independent regulator and conservator of the GSEs, is laying the groundwork for a future housing finance system based upon private capital taking the majority of credit risk in front of a government guarantee with greater taxpayer protections, broader access to credit for responsible borrowers, and improved transparency and efficiency. These measures include, among others, expanding and diversifying risk-taking among private actors, further focusing GSE businesses on meeting the mortgage finance needs of middle class households and those aspiring to join the middle class, and developing a securitization infrastructure that can serve as the backbone for the broader mortgage market over time. All of these initiatives are consistent with the long-term vision of providing secure homeownership opportunities for responsible middle-class families.

After the failure of both GSEs, FHFA's ability to stand in the shoes of their respective boards and senior management as conservator in order to set appropriate, statutorily-guided priorities and ensure follow-through has been good for the Enterprises and good for the American people. Preserving FHFA's role in the future housing finance system merits serious consideration.

Administrative Vision

With that history in mind, I want to expand upon our vision for reforms that would transition the GSEs further along a path toward a future housing finance system while they still benefit from Treasury's capital support. In turn, the progress we make today could serve both as a framework for, and reduce certain challenges associated with, achieving bipartisan legislative reform. Within the context of a continuing backstop, further de-risking the Enterprises is common-sense, prudent policy. Other actions that improve market efficiency and liquidity and develop infrastructure that would promote competition are consistent with the Administration's interest in a durable and fair housing finance system.

The first of these areas is in the shedding of GSE legacy risk, both in their retained portfolios and their guarantee book. Given the strengthened underwriting practices and high credit quality of their new guarantee book, this legacy risk represents the overwhelming majority of taxpayer risk exposure to the GSEs today. Despite asset sales and natural run-off, their retained portfolios remain substantial at over $400 billion each and still constitute a significant line of business. The size and complexity of the retained portfolios also necessitate active hedging, introducing considerable basis risk and earnings volatility and making the GSEs susceptible to potentially relying on a future draw of PSPA capital support.

In light of the strong demand for mortgage credit risk in the market today and the market success of Freddie Mac's first nonperforming loan (NPL) sale in July of last year, it would be both feasible and beneficial to taxpayers to responsibly accelerate the reduction of the most illiquid assets in the GSE portfolios. In particular, Treasury sees value in cultivating programmatic NPL sales at both Enterprises with a focus on market transparency, improving borrower outcomes, and community stabilization.

Similarly, in light of the GSEs' expertise in transferring credit risk on their new books of business and recognizing that the bulk of credit risk exposure on their guarantee books is tied to their pre-2009 legacy commitments, the potential for transferring credit risk on their legacy guarantee books also merits consideration despite the unique challenges it may entail.

Continuing with the theme of reducing taxpayer exposure to mortgage credit risk, the second area where we see room for progress is in transferring credit risk on new originations. As I said before, the Administration believes that a sustainable housing finance system must have private capital at its core, and in conservatorship, the GSEs have started down a path of transferring greater mortgage credit risk to private market participants.

As you are aware, beginning in 2013, the GSEs have cultivated their respective credit risk transfer programs. These programs and their effectiveness in transferring credit risk have grown substantially in under two years. The GSEs have also engaged in other innovative forms of risk transfers including reinsurance contracts and recourse agreements.

Although the GSEs are directionally on the right path, there is more to be done on this front. Despite issuing 16 credit risk transfer transactions since 2013 referencing $530 billion notional balance, this amounts to approximately 20 percent of the GSEs' combined guarantees over this time period and roughly 12 percent of the GSEs' combined books of business. And while recent transactions have made progress by selling first-loss exposure for the first time, these transactions still rely on a defined credit event and fixed severity schedule.

The closer the GSEs can come to transferring the majority of risk to private market participants, the better. Such credit risk transfer activities serve to field-test the role of government as a guarantor of catastrophic risk while private capital bears the risk of the majority of potential losses. We are also sensitive to existing constraints to rapidly expanding credit risk transfer activities today and are supportive of additional, measured efforts to foster this market sustainably over time.

This is why we support the conservator's efforts to responsibly expand credit risk transfer efforts through continued structural innovation and counterparty strengthening in order to broaden and diversify the investor base and optimize pricing efficiency and stability. Credit risk transfer activities should not be concentrated in any one mechanism or entity. Rather, they should seek to develop a variety of mechanisms and entities in order to improve pricing efficiency and transparency, provide the lowest cost to borrowers, and ultimately, inform the framework of the future housing finance system. We see great value in leveraging the unique investment needs and competencies of the broad spectrum of market participants in shaping a sustainable model for putting first loss mortgage credit risk in private hands.

Finally, under the direction of FHFA, the GSEs have embarked upon a cutting-edge project to develop a Common Securitization Platform (CSP) and a fungible To-Be-Announced, or TBA, contract. We are broadly supportive of these efforts, which in the immediate future will modernize the GSEs' collective securitization infrastructure and improve the liquidity and efficiency of the market.

However, given the CSP's joint ownership by the GSEs and scope narrowly focused on their businesses, the near-term CSP initiative would not succeed at separating the industry's critical securitization infrastructure from the GSEs' credit risk-taking activities. This separation is necessary to enhance the stability of the housing finance system. Nor will it use its full potential to reshape the broader housing finance landscape by facilitating standardization, transparency, and competition, and serving as a market gateway for both guaranteed and non-guaranteed securities.

This is why we would support opening up the CSP as early as it can be responsibly done to accommodate non-GSE users, which should be reflected not just in the Platform's functionality but also in its governance structure. Greater transparency, more concrete timelines, broader engagement with private stakeholders, and ultimately, expanded governance of the CSP joint venture to include non-GSE stakeholders are all in the interests of moving towards a more sustainable future housing finance system.

The nation's housing finance system is too critical to remain in a state of limbo without a clear, legislated vision for the future. However, the activities I outlined today are representative of the progress that can be made without legislation. By pursuing these and other activities that de-risk the Enterprises, we can put the housing finance system on a course aligned with the Administration's priorities that would promote greater stability for the housing market and broader economy.

Capital

With the recent release of the GSEs' 2014 fourth quarter earnings, there seems to be increased interest in the subject of GSE capital. But before we discuss this, it is worth taking a step back to review the purpose of the Senior Preferred Stock Purchase Agreements, commonly referred to as the PSPAs. The PSPAs were put in place as both companies were placed into conservatorship. These agreements were established to protect the solvency of the two companies and to allow them to continue to operate. This was necessary to protect financial stability and to ensure the continued flow of mortgage credit. The PSPAs gave market participants confidence in the GSEs' debt and MBS obligations through which they fund the majority of the mortgage credit in this country. Without this capital support, it is clear that both GSEs would have been insolvent and that mortgage credit would have dried up as a result.

With this as a backdrop, I want to frame for this group how we think about capital at the GSEs while they are in conservatorship and continue to rely on the PSPAs to support their activities.

Currently, the GSEs operate with a minimal amount of capital at each Enterprise. These capital reserve amounts were established in order to provide protection against unexpected losses related to their retained investment portfolios. This capital amount will amortize to zero by 2018 when we would expect the GSEs to have wound down their legacy investment business. And, from Treasury's standpoint, we would like to see these retained portfolios wound down even faster to further reduce risk.

Despite having only minimal retained capital levels at the GSEs, investors continue to have confidence in their securities due to the ongoing backstop the PSPAs provide each company. The substantial remaining capital support left under the PSPAs gives market participants the confidence to buy 30-year GSE securities on a day-in and day-out basis. This is despite the fact that the companies remain in conservatorship and have minimal capital levels.

However, as a result of the ongoing capital support through the PSPAs, taxpayers remain exposed to potential future losses at the GSEs. Let me remind you, both recapitalization of the GSEs and draws against the existing Treasury backstop due to potential future losses would come at taxpayers' expense.

Allowing the GSEs to exit conservatorship within the existing framework that includes their flawed charters, conflicting missions, and virtual monopolistic access to a government support through the PSPAs exposes taxpayers to great risk and is irresponsible. As we have said repeatedly, the only way to responsibly end the conservatorship of the GSEs is through legislation that puts in place a sustainable housing finance system with private capital at risk ahead of taxpayers, while preserving access to mortgage credit during severe downturns.

One final point for those who advocate a recapitalization of Fannie Mae and Freddie Mac while in conservatorship and subsequent privatization. If in the future the GSEs were to operate as they did prior to conservatorship, the GSEs' size and significance would certainly attract broad regulatory attention due to the financial stability implications of their possible failure. Given this and the associated economic and regulatory ramifications, simply returning these entities to the way they were before is not practical nor is it a realistic consideration.

Conclusion

In closing, I want to return to the issue of timing and the urgency of enacting housing finance reform legislation. We know from experience that mortgage credit will be broadly accessible until it's not; that capital markets will be liquid until they're not. When the next crisis hits, it is unlikely that we will have the benefit of advance warning, and at that point, it will be too late for thoughtful reform. Our options will be limited, our hands will be tied, and we will be destined to relive the mistakes of the past.

Reforming a system as complex and as far-reaching as housing finance in a sensible and sustainable way takes time to get things right and to ensure a smooth transition from the existing system to the new, safer, fairer system. The point I want to make today is that there is an enormous amount of very good work underway to de-risk the enterprises, enhance liquidity, and protect taxpayers in a direction aligned with the Administration's principles for long-term reform.

Nevertheless, institutionalizing these and other critical reforms in bipartisan legislation is by far the better course. Let's be prudent; let's have foresight; let's find a bipartisan pathway to preventing another GSE bailout, which continuation of the status quo guarantees. We can do this, and we must do this.

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