MORTGAGE BANKERS ASSOCIATION
Investing in communities

September 7, 2010

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General Counsel
Federal Housing Finance Agency
1700 G Street, NW
Fourth Floor
Washington, DC 20552

RE: RIN 2590-AA23 – Conservatorship and Receivership

Dear Mr. Pollard:

The Mortgage Bankers Association (MBA)[1] appreciates the opportunity to respond to the Federal Housing Finance Agency's (FHFA) proposal to establish a framework for conservatorship and receivership operations for Fannie Mae, Freddie Mac and the Federal Home Loan Banks (Proposal).[2]

Summary of MBA Position

MBA has three primary concerns regarding the Proposal. First, the Proposal appears overly theoretical in its approach. For example, it speaks in generalities about what FHFA would do in resolving claims among competing claimants. In the current situation with respect to the conservatorship of Fannie Mae and Freddie Mac, the claimants on their assets are known now. MBA suggests that FHFA revise the Proposal to include as much specificity as possible, such as identifying how the FHFA will deal with each specific class if the firms are put into receivership. Second, the rule sheds no light on what would ultimately trigger placing the firms into receivership. Fannie Mae and Freddie Mac have already moved well beyond the points where any other financial institution would have been put into receivership. FHFA should state clearly the degree to which the continued operation of the firms under an FHFA conservatorship benefits existing shareholders and/or increases costs to taxpayers and whether accelerating the timetable for putting the firms into receivership would reduce taxpayer expense. Third, FHFA should specify its goals in receivership. For example, the Federal Deposit

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

[2] 75 Fed. Reg. 131, 39462-39471 (July 9, 2010).

Insurance Corporation (FDIC) follows a receivership policy of least cost resolution in which the failed institution is sold whole or piecemeal. MBA believes FHFA should articulate its own receivership policy, such as whether it will follow a least-cost model or a different strategy whereby the direct return to the taxpayers might be lower, but that the overall benefit would come in using the assets of the two firms to promote the development of a new, competitive secondary market structure.

MBA's comments are not meant to promote any specific course of action for FHFA in receivership. Rather they are meant to illustrate the types of issues FHFA needs to address as openly and quickly as possible so that market participants can see what could potentially change in the near future. Past operating practices and norms do not provide an adequate guide for two reasons. First, this is a unique situation with little historical precedent. Second, nearly every action FHFA and the enterprises take would have a financial impact on counterparties and different creditors. For example, the market effects of the loan buy-back demands of the agencies, under the direction of FHFA, and the negative impact on mortgage lenders, demonstrate what happens when decisions are made to use the current market power of the regulator and the agencies to change fundamentally standard industry operating practices and assumptions with no input from those affected.

The Proposal Appears Overly Theoretical

Unlike other financial institution regulators, the advantage FHFA has in writing this Proposal is that it knows exactly what two firms need to be dealt with and exactly what their current condition is. Given the clear consensus on this, it is imperative that FHFA make it clear exactly how the various claimants will be treated once the firms are put into receivership. For example, the Proposal makes clear that the common and preferred stock holders are wiped out. Nothing is said, however, about the subordinated debt holders. Are they to be guaranteed payment in full? Similarly, are the claims of the senior debt holders going to be treated differently than the claims of the MBS holders? If they are equally guaranteed, are they guaranteed at par or market value? Is there a distinction between pre-receivership and post-receivership obligations as there would be with debtor-in-possession (DIP) financing? Is there a difference in pre-conservatorship and post-conservatorship financing?

In discussing the repudiation of contracts, FHFA states in the Proposal "The proposed regulation differs in some respects, however, from the FDIC regulations, because the GSEs are not depository institutions, and their important public missions differ from those of banks and thrifts." This statement is only partially true. Fannie Mae and Freddie Mace essentially run two separate businesses: a guarantee business for mortgage-backed securities (MBS) that are sold in the secondary market or were retained by originating banks and a portfolio business. The portfolio businesses are in effect large thrifts funded entirely with debt rather than consumer deposits. In some respects, they are analogous to thrifts funded with large brokered deposits. Regulators already have experience in liquidating these types of institutions. One step, therefore, that FHFA should consider in its receivership plan is to split the portfolio and guarantee businesses and liquidate them separately. The question this raises, however, is whether FHFA would follow practices similar to those of the FDIC and apply its powers of contract repudiation and determine whether it wishes to continue to pay the contracted interest rates on debt issued by the government sponsored enterprises (GSEs) or simply pay off the debt at par. The power to eliminate no-call provisions in debt contracts would appear to fall under the FHFA's authority to repudiate contracts. While FHFA could then seek cheaper short-term bridge financing to fund the portfolios during liquidation, it should lay out whether or not this is a possibility to current holders of GSE debt.

Once the liabilities have been dealt with, FHFA would be free to liquidate the portfolios in a fashion similar to what the FDIC follows in liquidating bank portfolios. FHFA, with the advice of the Department of Treasury (Treasury) and the Board of Governors of the Federal Reserve System (Federal Reserve), could determine to what extent any particular sale schedule could or would impact market prices for these securities. To the extent a longer term home is needed for them, either the Federal Reserve or Treasury could provide a home and the sale decision would no longer be a concern of FHFA's. The feasibility of such a strategy is evidenced by the fact that the combined on balance sheet portfolios of Fannie Mae and Freddie Mac currently amount to about $1.5 trillion. In comparison, between January 2009 and March 2010, the Federal Reserve and Treasury purchased a combined total of $1.47 trillion in MBS.

Under this scenario, FHFA would then be able to treat the guarantee business as a separate entity. This is important because liquidating the guarantee business will differ from the historical experience with bank and thrift liquidations. The asset that Fannie Mae and Freddie Mac hold based on their guarantee of the timely payment of principal and interest to holders of MBS is like an insurance policy. Fannie Mae and Freddie Mac receive cash flows from the monthly premiums paid by homeowners. In turn, these two entities hold the obligation for making good on any credit losses resulting from defaults on mortgages in that pool, as well as the administrative costs of managing passing through of payments to the security holders. If credit losses on a pool of loans and the administrative costs are less than the cash received from the guarantee fee (g-fee) payments, the guarantee has considerable positive value. If credit losses and administrative costs exceed the expected revenue from the guarantee fees, the guarantee is a liability.

FHFA will face a problem with any potential sale of the MBS guarantee because, unlike any potential sale of loans and securities from the GSEs' portfolios or similar FDIC asset sales, it is not necessarily a case of selling to the highest bidder. In the case of a bidder for the MBS guarantee asset, the bidder must be sufficiently capitalized to absorb any potential losses not covered by the g-fee stream, or where the timing of the g-fee cash flows and the credit losses are not matched and funds must be advanced to cover the credit losses. That implies that the best potential bidder would be highly capitalized, but high capital levels imply a lower return on equity and therefore a lower price that bidder is willing to pay. Conversely, a purchaser with lower capital levels would be less well-positioned to withstand large credit losses, but would enjoy a higher return on equity from the purchase. Therefore, the decision as to who is a qualified buyer for the MBS guarantee assets of Fannie Mae and Freddie Mac will be a difficult one that will not necessarily be based on who is the highest bidder.

What is paramount, however, is that FHFA protect all the cash flows associated with the MBS from the demands of any other class of claimants. This includes the pass through payments of principal and interest as well as the guarantee fee stream. It is vital to the continued value of the MBS and the potential role these securities might play in a new secondary market system, and to limit losses to the taxpayers, that the MBS remain economically viable and free from any other potential claims.

One issue associated with Fannie Mae's and Freddie Mac's whole loan portfolios and the MBS they issue is who owns the servicing and how will these assets be disposed of in receivership. Generally speaking, the servicing on the mortgages is owned by Fannie Mae and Freddie Mac, and mortgage servicers own the rights to service the loans. Although the servicing can be seized by Fannie Mae or Freddie Mac at any time, the servicer must be remunerated in some instances where the servicing contract was terminated without cause. For many reasons, FHFA should make clear that existing servicing arrangements and agreements will not be candidates for repudiation under receivership, and that keeping existing servicing rights in place would be a precondition of any sale or transfer of MBS guarantee assets to a qualified purchaser. In the same vein, FHFA needs to examine and reaffirm any shared risk arrangements, particularly those of multifamily lenders participating in Fannie Mae's Delegated Underwriting and Servicing (DUS) program. One approach for resolving this issue is for the FHFA to designate servicing and shared risk arrangements as "Qualified Financial Contracts" in order to receive the protections accorded such contracts in the Housing and Economic Recovery Act of 2008.[3]

Finally, FHFA should give an indication of what current operations and departments of the GSEs will be retained in receivership. There is a tremendous amount of talent and industry knowledge resident in the staffs of the GSEs. It is important to retain that talent to preserve the ongoing functioning of the industry and economic value of the enterprises' infrastructure and/or ongoing operations. For example, the operations, MBS accounting, technical support and credit management staff, among others, are crucial to daily operations. In contrast, various other functions would appear to become superfluous in receivership. These might include the staff devoted to compliance with Financial Accounting Standards Board and Securities Exchange Commission requirements, portfolio management, community outreach and strategic planning, among others. Still other functions of one firm could be merged with another under an FHFA receivership plan as a way to reduce expenses. While the risk-based capital regulations governing Fannie Mae and Freddie Mac anticipated a significant reduction in operating expenses during the stress event, it does not appear as though there has

[3] Pub. L. 110-289, 122 Stat. 2654, (July 23, 2008).

been a significant reduction in staff levels or operating expenses during the conservatorship of these two GSEs. FHFA should factor in these potential savings into its calculation of the impact of moving to receivership. More importantly, FHFA should give as much notice as possible to staffs of the GSEs who remain in their jobs upon receivership.

What Will Trigger Receivership

The only reason Fannie Mae and Freddie Mac have not yet been put into receivership is that the Treasury has made available sufficient funds to prevent the capital positions of these two GSEs from going negative. With all of the remaining capital in Fannie Mae and Freddie Mac already provided by the government, there is no clear or explicit trigger of what can or will eventually cause FHFA to put the firms into receivership. The current situation is not unlike a brain dead patient who is being kept alive indefinitely by artificial life support. Absent some unforeseen event, the timing of when the doctors finally pull the plug can seem somewhat arbitrary. Similarly, absent some objective and transparent criteria of when FHFA will pull the plug, the timing of any move to put Fannie Mae and Freddie Mac into receivership will appear to be arbitrary.

FHFA should discuss the criteria it will use in deciding when to finally put Fannie Mae and Freddie Mac into receivership, particularly because the ultimate costs to the taxpayers increase the longer a decision is postponed. Such triggering criteria might include:

- The form of the new secondary market entities has been agreed on;
- The transition plan for moving toward the new system has been agreed upon and the degree to which receivership factors into that plan; or
- The point at which the costs maintaining the conservatorship are greater than the costs of operating under a receivership plan, relative to the benefits of each structure.

The cost issue is of particular importance as the debate progresses over who pays the costs for Fannie Mae's and Freddie Mac's losses. Whether the costs are borne by taxpayers at large or future homebuyers, minimizing that ultimate cost should be a primary goal of FHFA in deciding the timing of receivership.

Competing Goals in Receivership

Similar to the issue of the need for FHFA to spell out the potential triggers of receivership is the need for FHFA to make explicit what its goals will be under receivership. The potential goals can be competing and it is important for those working on potential replacement for Fannie Mae and Freddie Mac to know whether the receivership goals of FHFA will assist in that transition or be one more transition hurdle that needs to be overcome. There appear to be a number of potential goals in receivership that might conflict with each other. These would include the need to seek a least-cost resolution of the entities similar to the guidelines used by banking regulators, the need to maintain ongoing support of the housing market by protecting the important personnel and technological resources of the GSEs, and using the assets of the GSEs to seed a new secondary market structure. These three potential goals are discussed below.

Banking regulators have traditionally followed a least-cost resolution rule in disposing of failed banks and thrifts. This principle gives regulators wide latitude in determining whether the assets of the institution are sold off piecemeal, whether the institution is sold as a whole to another bank with or without FDIC assistance, or whether the institution is operated by the FDIC for a period of time until a sale or liquidation plan can be put into place. The difference, however, is that the costs of each approach to resolution can be reasonably estimated. No single failed bank or thrift resolution in recent years carried with it any additional cost to the financial system or the economy beyond the value of that institution's assets and liabilities, nor were the staffs of those institutions unique to the industry. That is not the case with the GSEs. Therefore, FHFA should make it clear whether it intends to follow the bank regulator strategy of least-cost resolution or whether it will take into account other considerations.

One of the other possible considerations is the need to maintain the important personnel and systems of Fannie Mae and Freddie Mac throughout the process of putting these enterprises into receivership and launching a new secondary market structure for mortgages. As was stated earlier in this comment letter on a related topic, it is important to let the key personnel know their roles and how they would be treated in receivership. Maintaining a system of compensation and other benefits sufficient to keep these people in place during the transition would not necessarily be consistent with a least cost resolution approach, but could be critical for maintaining proper market functioning.

Finally, FHFA should consider the degree to which the assets of the GSEs are used to seed the firms that will compose the new secondary market structure. It is highly likely that the benefits of a new, stable and competitive structure will far outweigh the near-term benefits of a least-cost resolution. For example, assuming the new system consists of a number of firms, distributing the assets of the GSEs across these firms would give each a fair start on a level playing field. However, making the GSE technologies and systems available as something of a public good would diminish the potential amounts those systems would attract if sold to a single player. Similarly, selling the entire MBS guaranty book to a single player, if such a player even existed, would be extremely valuable because that player would see great value in having something of a monopoly position and certainly a major leg up over potential competitors. Allocating shares of the current book of business out to various successor entities would minimize the chance of one firm immediately becoming dominant.[4] Such logic also applies to the credit data of Fannie Mae and Freddie Mac. The performance data on loans purchased by these two entities over the years and through several credit

[4] It is also possible that the potential losses on Fannie Mae's and Freddie Mac's books of business as such that a single bidder would not want to take on the entire exposure without support of Treasury. In this case, spreading out the losses among a number of bidders might actually be the least cost resolution strategy.

cycles is a very valuable commodity. Selling this data to the highest bidder would likely maximize the near-term gain to the taxpayers but would come at the cost of having a noncompetitive market going forward. The long-term interests of the market would best be served by instead making the credit records available to potential new secondary market entities, lenders and other market participants so that the mistakes of the past can be studied by all.

Conclusion

MBA appreciates the opportunity to comment on this very important matter. We request that FHFA consider the issues mentioned above, and look forward to addressing any questions you may have.

Regards,

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