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House of Representatives

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

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May 3, 2012

Mr. Edward DeMarco
Acting Director
Federal Housing Finance Agency
400 7th Street SW
Washington, DC 20024

Dear Mr. DeMarco:

In recent months, the Federal Housing Finance Agency (FHFA) has been evaluating the prospect of allowing Fannie Mae and Freddie Mac ("the Enterprises") to reduce the mortgage principal on home loans they own or guarantee. During this time, it appears you have been on the receiving end of undue and inappropriate political pressure designed to bully you into accepting a policy proposal favored by the Administration. As you consider the issue of mortgage principal reduction, we write to urge you to remain steadfast in your role as an independent regulator and to carefully evaluate all relevant information prior to making a decision that could have such a profound impact on American taxpayers.

Independence of the Federal Housing Finance Agency

The Housing and Economic Recovery Act (HERA) established FHFA as an independent agency to oversee the operations of Fannie Mae and Freddie Mac.[1] FHFA is statutorily charged with "preserv[ing] and conserv[ing] the assets and property" of the Enterprises during conservatorship.[2] Like all other independent agencies, FHFA occupies a unique position in our system of government in which its "independence [rests] upon the need for technical expertise" free from coercive influences.[3]

Several senior federal and state government officials, as well as some industry commentators, have recently intensified their *ad hominem* attacks on you for not allowing Fannie Mae and Freddie Mac to reduce mortgage principal. For doing so, you have been called the "single largest obstacle to meaningful economic recovery"[4] and the man who has "slowed the economic recovery with the stroke of a pen."[5] The Attorney General of the State of California

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[1] *See* Pub. L. 110-289 § 1101, 122 Stat. 2654, 2661 (2008) (codified at 12 U.S.C. § 4511).
[2] Pub. L. 110-289 § 1145, 122 Stat. at 2737 (codified at 12 U.S.C. § 4617).
[3] *Free Enterprise Fund v. Public Co. Accounting Oversight Bd.*, 130 S. Ct. 3138, 3174 (2010) (citing *Humphrey's Executor v. United States*, 295 U.S. 602, 624-26 (1935)).
[4] Peter S. Goodman, *Ed DeMarco's Refusal on Principal Reductions Grounds for Firing*, Huffington Post, Mar. 12, 2012.
[5] Katrina vanden Heuvel, *The Man Blocking America's Recovery*, Wash. Post, Mar. 19, 2012.

has suggested that you are not qualified for your position because of your reticence on principal reduction.[6] Some members of Congress have repeatedly suggested that you should resign for disagreeing with the Administration's preferred policy,[7] and the Administration itself has been vocal about its desire for a new FHFA Director who "shares [its] view."[8] Both Secretary of the Treasury Timothy Geithner and Secretary of Housing and Urban Development Shaun Donovan have publicly and repeatedly pressured you to support principal reduction.[9]

We regret that the tenor of the housing debate in this country has become increasingly politicized and that your integrity and the independence of your office have been directly challenged. The *National Journal* has opined that principal reduction has become more of a partisan issue because it would give your critics "an opportunity to claim credit for delivering on a major priority of their base as election season swings into high gear."[10] The *Wall Street Journal* likewise has called the idea of principal reduction an "election-year bailout."[11] As you continue to exercise the independence of your office, we strongly encourage you to resist this political pressure in favor of decision-making based on the data and expertise at your disposal.

Duty to Preserve and Conserve Taxpayer Funds

At a time when the sovereign debt of the United States exceeds its annual gross domestic product,[12] policymakers at all levels of government must work to eliminate wasteful and risky government spending. As the conservator of Fannie Mae and Freddie Mac, you have a unique obligation to "preserve and conserve the assets and property" of the Enterprises.[13] During recent remarks on the housing market, you elaborated on this statutory duty:

> We're approaching it as our responsibility is to conserve assets to the taxpayer, and so we're looking at what the costs would be to Fannie and Freddie. It can't help us but to be aware that we are conserving assets on behalf of the American taxpayer. And so if we engage in principal forgiveness because there's money being taken from another taxpayer pocket, we are trying to provide transparency . . . that that is the case. So while it may make Fannie and Freddie's losses lower, if it makes the overall cost to the taxpayer higher, we're trying to provide clarity to that point.[14]

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[6] Andrew S. Ross, *Edward DeMarco, Housing Finance Head, Catches Heat*, S.F. Chron., Feb. 28, 2012.
[7] *See* Joseph Williams, *Elijah Cummings Gets Help In Edward DeMarco Fight*, Politico, Mar. 1, 2012.
[8] Ross, *supra* note 6 (quote of Housing and Urban Development Secretary Shaun Donovan).
[9] Clea Benson & Cheyenne Hopkins, *DeMarco Says Principal Reduction Writedowns May Save FHFA $1.7 Billion*, Bloomberg, Apr. 10, 2012; *Treasury's Run Around DeMarco*, Wall St. J., Apr. 9, 2012.
[10] Stacy Kaper, *DeMarco's Principal Reduction Does More for Politicians than Homeowners*, Nat'l J., Apr. 10, 2012.
[11] *Treasury's Run Around DeMarco*, Wall St. J., Apr. 9, 2012.
[12] *See* Richard Wolf, *U.S. Debt Is Now Equal to Economy*, USA Today, Jan. 9, 2012.
[13] Pub. L. 110-289 § 1145, 122 Stat. at 2737 (codified at 12 U.S.C. § 4617).
[14] Edward DeMarco, Acting Director, Fed. Housing Finance Agency, Briefing at the Brookings Institution on the Housing Market (Apr. 10, 2012).

We appreciate your observation that although FHFA has the responsibility to conserve taxpayer assets with respect to the Enterprises, principal reduction funded through the U.S. Department of the Treasury ("Treasury Department") may result in greater overall losses to the U.S. taxpayer. As the conservator of Fannie and Freddie, with the fundamental mission to diminish the Enterprises' drain on the treasury, you are absolutely right to consider the larger federal budget implications of your decision on principal reduction.

It appears from the available data that principal reduction on Enterprise-owned mortgages – no matter how it is implemented – would require substantial taxpayer funds. In your letter to Ranking Member Cummings on January 20, 2012, you estimated that "principal forgiveness for all [first-lien underwater mortgages owed by the Enterprises] would require funding of almost $100 billion to pay down mortgages to the value of the homes securing them."[15] In your recent remarks on the housing market, you stated that even with the Treasury Department's newly proposed incentive payments, principal reduction would "imply a net cost to the taxpayer of $2.1 billion."[16] Under either scenario, principal reduction on Enterprise-owned mortgages appears to require substantial costs and to impose significant burdens on taxpayers. When considering the moral hazard concerns discussed below, however, the actual costs to American taxpayers could be substantially higher.

Private Sector Experiences with Principal Reduction Programs Have Not Added Benefit to Homeowners

Recent experiences with principal reduction pilot programs have not demonstrated added benefit to homeowners.[17] FHFA approved pilot programs for Citibank and Wells Fargo in 2009 and 2010 to "test[] principal reduction as a loss mitigation tool and evaluat[e] whether it would reach more homeowners facing financial difficulties, result in improved loan performance going forward or provide better loss outcomes for each Enterprise."[18] The Wells Fargo pilot program, conducted in conjunction with Fannie Mae, assumed that because negative equity is a factor in loan performance, "principal reduction would improve the success rate of high mark-to-market loan to value ratio (MTMLTV) loan modifications."[19] However, eight months after the program ended, the percentage of borrowers current in the principal reduction test group was "very similar" to the percentage of borrowers current in the control group.[20] Thus, the available evidence from the Wells Fargo pilot program suggests that principal reduction does not lead to more borrowers staying current relevant to alternative modifications.

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[15] Letter from Edward J. DeMarco, Acting Director, Fed. Housing Finance Agency, to Elijah E. Cummings, Ranking Member, Comm. on Oversight and Gov't Reform (Jan. 20, 2012).
[16] Edward DeMarco, Acting Director, Fed. Housing Finance Agency, Briefing at the Brookings Institution on the Housing Market (Apr. 10, 2012).
[17] *See* Letter from Alfred M. Pollard, General Counsel, Fed. Housing Finance Agency, to Elijah Cummings and John F. Tierney (Apr. 12, 2012).
[18] *Id.* at 1.
[19] *Id.* Att. at 2.
[20] *Id.* Att. at 3

These pilot programs also illuminated operational concerns associated with implementing principal reduction on a large scale.[21] As Alfred Pollard, FHFA's General Counsel, noted in a recent letter, "[t]hese pilot programs, to the extent they were begun, ended due to complex operational issues involving system changes, accounting considerations and the interest level of Fannie Mae's partners."[22] As you noted in your remarks on the housing market, these operational hurdles – including necessary accounting and technological modifications – are "not trivial" and could add significant costs to the overall taxpayer burden for any principal reduction program.[23]

Additional Enterprise research seems to indicate that a borrower's ability to repay an underwater loan is not closely related to the degree that his mortgage is underwater.[24] In fact, data show that a borrower with a current loan-to-value (LTV) ratio of greater than 190 percent – in other words, a borrower who is deeply underwater – has a 70 percent chance of remaining current with a loan modification, whereas a borrower with an LTV ratio of between 90 and 100 percent has a 71 percent chance of remaining current with a modification.[25] Instead, as you noted in your remarks, Enterprise data indicate that performance is more closely related to a change in payment on the loan.[26] This information, along with the Enterprises' experiences with principal reduction pilot programs, suggests that principal reduction may not help more borrowers remain current and would therefore only yield additional losses for American taxpayers. Given the amount of taxpayer dollars at risk under the Administration's principal reduction proposals, we trust that you will give great weight to this experience and data with these principal reduction pilot programs.

HAMP/TARP Funds for Principal Reduction

In addition to your duty to conserve the assets of the Enterprises, we strongly urge you to closely examine the nature and intent of the Treasury Department's newly proposed incentive payments to Fannie Mae and Freddie Mac. In an apparent attempt to entice you to accept the Administration's preferred policy, the Treasury Department has proposed expanding the Home Affordable Modification Program (HAMP) to increase incentive payments to the Enterprises if they perform principal reductions.[27] Under the proposal, the Treasury Department would pay the Enterprises up to 63 cents for every dollar of forgiven principal, which may add up to as much as $3.8 billion in incentive payments.[28] These funds would reportedly come from a larger

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[21] *Id.* Att. at 3-4.
[22] *Id.* at 2.
[23] Edward DeMarco, Acting Director, Fed. Housing Finance Agency, Briefing at the Brookings Institution on the Housing Market (Apr. 10, 2012).
[24] *Id.*
[25] *Id.* tbl.3 (remarks as prepared for delivery).
[26] Edward DeMarco, Acting Director, Fed. Housing Finance Agency, Briefing at the Brookings Institution on the Housing Market (Apr. 10, 2012).
[27] *See* Brian Collins, *Surprise: Treasury Offering New Incentives for Principal Writedowns*, Nat'l Mortgage News, Jan. 27, 2012.
[28] *See* Clea Benson & Cheyenne Hopkins, *DeMarco Says Principal Reduction Writedowns May Save FHFA $1.7 Billion*, Bloomberg, Apr. 10, 2012.

pool of $20.9 billion in unspent Troubled Asset Relief Program (TARP) funds, through which HAMP is funded.[29]

We have serious reservations about the use of HAMP funds to subsidize the performance of principal reductions. TARP was established "to purchase, and to make and fund commitments to purchase, troubled assets from any financial institution."[30] The proposed use of TARP funds for principal reduction goes well beyond that statutory mandate, and furthers the use of HAMP as a housing slush fund from which the Treasury Secretary may direct money to politically expedient uses. The proposal also contravenes congressional intent with respect to TARP and HAMP. The Dodd-Frank Wall Street Reform and Consumer Protection Act reduced TARP's authorization level and expressly barred the Secretary from undertaking any new program after June 25, 2010.[31] In addition, the House of Representatives passed a bill last year to terminate the Secretary's authority to provide new mortgage modification assistance under HAMP.[32]

Moreover, there is a strong likelihood that the use of HAMP funds to subsidize principal reductions could contribute to a "backdoor bailout" for banks holding second liens on Enterprise-owned or -guaranteed properties.[33] As you know, principal modification on a first-lien mortgage improves the position of a subordinate lien holder to the degree that the second lien is more likely to be repaid.[34] Even where the second lien is modified similar to the first lien, as in HAMP, the second lien holder benefits by sharing in any overall losses with the first lien holder.[35] Without a modification, the second lien holder would recover significantly less in the event of a default. Under the Treasury Department's proposal, however, banks holding second liens on Enterprise properties would be in a better position to recover their investments. With your estimate that about half of all underwater, seriously delinquent Enterprise loans have at least one subordinate lien, a HAMP-financed principal reduction program could amount to a large backdoor bailout to a number of banks.[36]

Given the clear congressional intent to reign in TARP and wind down HAMP, the Treasury Department's proposal to incentivize principal reductions with HAMP funds violates the spirit – if not the letter – of the law. It also doubles down on a program that has been the subject of widespread criticism. The former Special Inspector General for TARP, Neil Barofsky, testified before Congress that HAMP "benefits only a small portion of distressed homeowners, offers others little more than false hope, and in certain cases causes more harm than good."[37] As this Committee found over two years ago, "HAMP both hurts homeowners who might otherwise spend their trial-period mortgage payments on rent and also distorts the housing market, delaying

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[29] *Treasury's Run Around DeMarco*, Wall St. J., Apr. 9, 2012.
[30] Pub. L. 110-343 § 101(a)(1), 122 Stat. 3765, 3767 (2008).
[31] Pub. L. 111-203 § 1302, 124 Stat. 1376, 2133 (2010).
[32] H.R. 839, 112th Cong. (2011) (as passed and engrossed by the House).
[33] Gretchen Morgenson, *A Bailout by Another Name*, N.Y. Times, Mar. 24, 2012.
[34] *Id.*
[35] Edward DeMarco, Acting Director, Fed. Housing Finance Agency, Briefing at the Brookings Institution on the Housing Market (Apr. 10, 2012).
[36] *Id.*
[37] H. Rept. 112-31, 112th Cong. 3 (2011).

any recovery."[38] With these open questions about the legality and the wisdom of expanding the HAMP program, we hope you will carefully scrutinize the Treasury Department's proposal and consider the congressional intent behind the use of these TARP funds in making your decision.

Strategic Modification and "Moral Hazard" Associated With Principal Reductions

You recently noted there is the very real possibility that a broad principal reduction policy at the Enterprises would create a "moral hazard" problem that would encourage so-called "strategic modifiers." As you stated, "some percentage of borrowers who are current on their loans [would] be encouraged to either claim a hardship or actually go delinquent to capture the benefits of principal forgiveness."[39] Under your calculations, if 172,750 delinquent borrowers participate in principal reduction, only 20,000 current borrowers would need to strategically modify their mortgages and take advantage of these reductions to eliminate the savings to the Enterprises.[40] If 690,000 delinquent borrowers participate, 90,000 of these strategic modifiers would eliminate the savings.[41] Given that there are an estimated two million borrowers who are current on mortgage payments, but deeply "underwater," owing much more than what their homes are worth, these figures indicate that a strategic modification rate of one to 4.5 percent would completely eviscerate any technical savings to the Enterprises achieved through the use of $3.8 billion in taxpayer-financed HAMP funds.[42] Thus, given your duty as conservator, even ignoring other relevant factors, in order to accept the Treasury Department's proposal, you must conclude that the likely rate of strategic default would be less than one to 4.5 percent.

We recognize, as do you, that these figures are estimates of the potential "moral hazard" risk associated with principal reduction. Yet, data suggest that the likely figure is much higher. According to one study in 2011, an estimated 26 to 35 percent of mortgage defaults are strategic.[43] Another study from 2009 estimated that 18 percent of borrowers in default were strategic defaulters.[44] As you recognized in your remarks, the obligation of Fannie and Freddie to apply servicing standards transparently and uniformly would necessarily raise the risk of strategic modification by signaling to the public the precise criteria under which the Enterprises would forgive mortgage principal.[45] While some of your critics discount the degree of strategic modifications,[46] the truth is that no study can predict the precise strategic modification rate in a principal reduction program undertaken on such a large scale.

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[38] Comm. on Oversight and Gov't Reform, Treasury Department's Mortgage Modification Programs: A Failure Prolonging the Economic Crisis (Feb. 2010) (minority staff report).
[39] Edward DeMarco, Acting Director, Fed. Housing Finance Agency, Briefing at the Brookings Institution on the Housing Market (Apr. 10, 2012).
[40] *Id.*
[41] *Id.*
[42] *See* Nick Timiraos, *Boost for Loan Write-Downs*, Wall St. J., Apr. 11, 2012.
[43] *See* Luigi Guiso et al., The Determinants of Attitudes towards Strategic Default on Mortgages 14 (June 2011).
[44] *See* Oliver Wyman, Understanding Strategic Default in Mortgages Part I, at 10 (2009).
[45] *See* Edward DeMarco, Acting Director, Fed. Housing Finance Agency, Briefing at the Brookings Institution on the Housing Market (Apr. 10, 2012).
[46] *See* Nick Timiraos, *Boost for Loan Write-Downs*, Wall St. J., Apr. 11, 2012 (citing Secretary of Housing and Urban Development Shaun Donovan as stating that strategic default concerns are overstated).

The risks of potential strategic defaults associated with a broad-based principal reduction program for Enterprise loans are enormous. Even beyond the significant operational and indirect costs associated with such a program, one estimate calculates that a principal reduction program could induce strategic defaults that would add $128 billion in further losses for taxpayers.[47] Accordingly, because principal reduction could have costly consequences that would increase the Enterprises' drain on the treasury, we believe that it behooves you to proceed with the utmost caution in any consideration of adopting such a program.

Suggestions and Options for Consideration Other Than Principal Reductions

Given the massive risks to taxpayers associated with a potential Enterprise principal reduction program and the relative lack of evidence about its ability to benefit homeowners, we believe the most prudent course is for FHFA to solicit data and input from interested stakeholders on the issue of principal reduction. Several commentators, including Professor Anthony Sanders, have noted that little empirical evidence exists on whether principal reduction helps to alleviate foreclosures.[48] Your critics have likewise called for more information, with Ranking Member Cummings "saying for many months that we need to focus on data."[49] We suggest that you heed these calls and strive to obtain more information about the real-world effects of principal reduction on homeowners and taxpayers.

As the Committee has previously shown with respect to government intervention in the housing market, a well-intentioned government-run program could have disastrous unintended consequences.[50] Because the relevant data on principal reduction is sparse and anecdotal, it is important that you consider soliciting realistic data on the relative performance of bank-owned loans that have been modified using principal reduction. Further, in light of the significant economic risks associated with this issue, we recommend that you initiate dialogues with other stakeholders to obtain additional relevant information. Without this valuable information, you may be poised to undertake a course of action that could have substantial unintended consequences for homeowners, taxpayers, and the economy.

As you continue your deliberative process, we remind you that any FHFA action must conform to your conservatorship obligation to reduce taxpayer losses at Fannie and Freddie. In this spirit, we respectfully suggest that you focus on ways to mitigate the incentives for strategic default associated with all current and future modification options, including ensuring that modification recipients have a demonstrated financial hardship. As you have said, high-risk borrowers who are underwater but have remained current are "the much greater contingent risk to housing markets and to taxpayers."[51] Therefore, we suggest that you explore ways to

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[47] Daniel Indiviglio, *Fannie Generosity Could Cost Taxpayers $128 bln*, Reuters, Apr. 18, 2012.
[48] *See, e.g.*, FHFA's DeMarco: Several Weeks Before a Decision on Principal Reductions (Jurassic Park Alert!), Posting of Anthony B. Sanders to the Confounded Interest Blog (Apr. 10, 2012).
[49] Press Release, Cummings Issues Statement on DeMarco Speech on the Housing Market, Apr. 10, 2012.
[50] *See* Comm. on Oversight and Gov't Reform, The Role of Government Affordable Housing Policy in Creating the Global Financial Crisis of 2008 (updated May 2010) (minority staff report).
[51] Edward DeMarco, Acting Director, Fed. Housing Finance Agency, Briefing at the Brookings Institution on the Housing Market (Apr. 10, 2012).

encourage continued payment on these mortgages, including, if appropriate, targeted interest rate reductions, consistent with maximizing expected returns to taxpayers.

We also suggest that the Enterprises conduct aggressive and proactive outreach to identify those high-risk borrowers most in need of assistance and most at risk of default. For example, it is possible that targeted modifications for current but underwater borrowers with demonstrated financial hardships and particularly onerous mortgage structures – such as option ARM mortgages with balloon payments – could increase the likelihood of continued repayment and net return to taxpayers while helping the homeowner stay in the home. Finally, if continued repayment is impossible, we recommend that you consider alternatives – such as short sales and deeds-in-lieu – that would provide a dignified and expedient transition for homeowners to more affordable housing options.

In the meantime, as you consider the Treasury Department's new incentives proposal, we hope you will continue to focus your efforts on independently examining the merits of the proposed action. An issue as significant and as far-reaching as principal reduction on Enterprise-owned or -guaranteed mortgages demands nothing less than your thorough and expert examination. Any rush to judgment, no matter how well-intentioned, may have serious consequences for the health of our housing market and our overall economic recovery. We therefore hope that you will continue your efforts and address the issues raised in this letter before you make any final decisions. Thank you for your attention to these matters.

Sincerely,

Darrell Issa
Chairman

Patrick McHenry
Chairman
Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs

cc: The Honorable Elijah E. Cummings, Ranking Minority Member
Committee on Oversight and Government Reform

The Honorable Mike Quigley, Ranking Minority Member, Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs