American Bankers Association
Building Success. Together.

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The Honorable Timothy Geithner
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Shaun Donovan
Secretary
U.S. Department of Housing and Urban Development
451 7th Street S.W
Washington, DC 20410

Dear Secretary Geithner and Secretary Donovan:

With the Administration expected to release policy recommendations for dealing with the conservatorship of Fannie Mae and Freddie Mac in the near future, I wanted to share with you the American Bankers Association's latest recommendations and attached principles regarding the future of the Government Sponsored Enterprises (GSE).

These recommendations have been developed by ABA's GSE Policy Committee and endorsed by ABA's Government Relations Council and Board of Directors. They reflect views across the spectrum of ABA's membership, and include hands-on input from community and regional banks as well as some of the largest banks in the country. Over the course of the last six months in particular, ABA has been pleased to engage in discussions with some of your staff to share and refine our views. Now, as the Administration and Congress begin the next phase in shaping the future of the mortgage markets and the government's role in them, I hope that you will find these summary recommendations useful.

ABA has focused on three broad policy questions: What is the desired end point? How do we get there? What are the costs and how might these costs be mitigated? The following paragraphs will discuss each of these questions in turn.

What is the desired end point?

ABA believes that the role of the government in housing finance should be dramatically reduced from its current level. A private market for the vast majority of housing finance should be fostered and encouraged with an ultimate goal of a much smaller governmental role. That role should be limited to ensuring stability and accessibility of the capital markets in the event of market failure. We expect that direct government involvement may be necessary and desirable for the creation of affordable rental housing and to assist first-time borrowers or others who may not readily qualify for conventional financing. A well regulated private market should be the desired financing source for the bulk of borrowers whose income and credit rating qualify them for conventional financing. We do strongly urge the continued federal guarantee of *existing* GSE debt and securities to ensure stability as the process moves forward.

Because of the trauma suffered by the financial markets and the borrowers they served during the recent financial crisis, it will be necessary to move toward a substantially private market in a cautious and well-considered fashion. A transition period taking a number of years will be necessary.

ABA has not endorsed a specific structure for the GSEs going forward, but instead has considered the mechanisms to be employed to reduce governmental involvement and to foster private sector financing – and to ensure that such financing can involve private sector banks of all sizes. (These specific mechanisms are discussed in the next section under "How do we get there?"). Possible structures for a transition vehicle (and potential end point) include a well-regulated and controlled cooperative structure owned by the financing entities or a similarly controlled secondary market public utility that is publically owned. Whatever structure is chosen will require significant control and direction of guarantee fees, mission, investor returns and potential taxpayer liability. Activities under the structure will need to be confined to a controlled mission intended, among other things, to foster and accommodate development and expansion of private sector mortgage financing alternatives.

It is also our view that rather than developing a single "silver bullet" solution to housing finance, it may be desirable to develop several sources which aid in the reestablishment of a private market. Thus, in addition to the creation of a successor entity or entities to the GSEs, policy makers may want to consider the creation of a well-regulated covered bond market, as well as enhancements to the Federal Home Loan Banks which better help them continue to meet and capitalize their mission of providing advances to private market portfolio lenders with minimal taxpayer exposure. It is also important to ensure that any actions taken with regard to Fannie Mae and Freddie Mac do not harm or destabilize the Federal Home Loan Banks, which provide a key source of liquidity to our nation’s banks, especially community banks. Multiple of sources of liquidity for private market (and especially portfolio) lenders will lead to a more diverse and ultimately safer housing financing system.

How do we get there?

ABA recommends that the primary mechanism for reducing government involvement (and for compensating the government for its ongoing support) is through adjustments to the guarantee fees (G fees) paid to the GSEs (or their successors). The current G fees are too low – the compensation being paid for what amounts to full government backing is simply not priced correctly. Raising the G fee can do much to encourage development of the private market and to begin to repay the government for its current support. By "dialing up" the G fees in an orderly and well-detailed manner, eventually the private market will find itself in a position where it is better able to compete with the GSEs for business. With a high enough G fee, the private market will be able to price for risk in a fashion that allows for safe and sound investment and lending at a rate that is comparable (and eventually better) than the rate charged by the GSEs. In the meantime, the increased rates for G fees will help to offset losses and assist in the repayment of the government's investment in Fannie Mae and Freddie Mac. This approach also allows for flexibility in the setting of guarantee fees, thereby ensuring a safety valve for housing finance in the event of private market disruptions.

The other key mechanism for transition to a private market will be setting more reasonable loan limits for GSE purchases. The current maximum loan limit of $729,750 in high cost areas and $417,000 in all other regions is dramatically higher than necessary for the purchase of a moderately priced home, especially in light of housing price declines nationwide. While some high-cost areas persist (and a recovery of the housing market will entail a hoped for stabilization and recovery in home values), the conforming loan limits for most of the nation can be reduced. This will assist the development of a private market for loans outside of the conforming loan limits as a step to a more fully private market for all loans.

Underwriting will also be an important mechanism, but given the significant new underwriting requirements required by the banking regulators and by the Dodd/Frank Act, it would seem that the most important role played by the GSEs in this area for the foreseeable future is to ensure that uniform underwriting requirements are followed by all market participants selling to the GSEs or their successors. Under the Dodd/Frank Act the current GSE regulator, the Federal Housing Finance Authority, will be among the regulators establishing underwriting standards and "safe harbors," so they will remain heavily involved with setting underwriting standards.

What are the costs, and how can they be mitigated?

This may be the most critical question, at least in terms of the ability to move forward from the current situation and establish a phased movement to successor entities for the secondary market GSEs. Any successor entity must contribute necessary market stability and liquidity, and have adequate capital. It is reasonable to expect that the users of that entity will contribute to capital or at least pay the full value and cost of any government guarantee, explicit or implicit. Similarly, any assumption of the hard resources of the existing GSEs by a private entity must occur in a manner in which the government recovers fair value for the assets acquired. In other words, the taxpayer should not subsidize formation of privately owned successors.

It is not realistic, however, to imagine that there is capacity within the financial services industry to fully capitalize a new entity in the near term, or to take on the debt of the existing GSEs. It is our recommendation that income from increased G fees be used to begin building capital, to repay the Treasury and to better protect taxpayers. This could be facilitated by cordoning off the troubled assets of Fannie Mae and Freddie Mac into a segment of the enterprises which would remain in need of federal support while being wound down. Ultimately, the troubled assets of the GSEs may have to be separated into a "bad bank" structure and losses realized. However, as the economy recovers some troubled assets may yet be salvaged and loses recovered. The new book of G-fee business, which would consist of guarantees for securitized pools of high quality mortgages – with higher G fees going forward – should provide healthy returns that support government payments and absorb some of the potential bad asset losses.

The resulting healthy guarantee businesses should be managed and regulated in a manner intended to dramatically shrink their market share, and also to establish incentives for growth of purely private mortgage finance alternatives to fill that market share. This most likely will require that the successors initially be managed under a public utility model as previously discussed and while under government control. Subsequently, the government can exit its controlling interest by spinning the successors to private ownership as cooperatives or through public offerings, further recouping its investment. If these private successors retain some form of government guarantee, which we believe likely, a continuation of the public utility regulatory model will be necessary to ensure capital requirements and G-fee pricing necessary to compensate the government, protect taxpayers and prevent leveraging of the government guarantee in a manner that discourages growth of private sector, non-guaranteed mortgage markets.

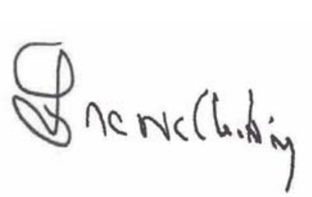
The end goal we envision is a housing finance market in which more than half of mortgage finance occurs without federal secondary market guarantees of any type. Perhaps the mix eventually might be 10 percent in direct government guarantees like FHA and VA, 30 percent in well-regulated and mission-directed businesses that are privately owned and operated with a government backstop, and 60 percent that is without government guarantees. That vision may take years to attain, and goals can be better calibrated as we proceed. However, it is essential that we start taking incremental steps toward these goals, and trust in our ability to make mid-course corrections as we progress.

Further, we would note that to fully protect taxpayers from additional losses, it will be necessary to impose similar reforms on the Farm Credit System, which continues to follow the discredited model of privatized gains and public losses which failed so badly in the housing sector. Without similar reforms to the Farm Credit System, it is only a matter of time until taxpayers again are put at risk.

Conclusion

The task ahead will not be easy. Fannie Mae, Freddie Mac and the Federal Housing Administration currently constitute the vast bulk of available financing for the American mortgage market. It is therefore imperative that reform must be cautious so as not to inflict further harm on an already fragile housing economy, but reform must be deliberate, as the current situation of full federal support is not viable for the long term. I hope that these recommendations and the 11 Principles for Reform which are attached to this letter are helpful to you in this process. The American Bankers Association stands ready to assist in any way possible.

Sincerely,



Frank Keating

Cc: The Honorable Spencer Bachus, Chairman, House Financial Services Committee
The Honorable Barney Frank, Ranking Member, House Financial Services Committee
The Honorable Tim Johnson, Chairman, Senate Banking Committee
The Honorable Richard C. Shelby, Ranking Member, Senate Banking Committee

Attachment

PRINCIPLES GOVERNING GSE REFORM AS PROPOSED BY THE AMERICAN BANKERS ASSOCIATION'S GSE POLICY COMMITTEE AND RATIFIED BY THE GOVERNMENT RELATIONS COUNCIL

1. The primary goal of any government-sponsored enterprise in the area of mortgage finance should be to provide stability and liquidity to facilitate the ability of the primary mortgage market to provide credit for borrowers who have the credit and skill sets required to maintain homeownership.

2. In return for the GSE status and any benefits conveyed by that status, these entities must agree to maintain their mission in all economic environments.

3. Strong regulation, examination and authority for prompt corrective action of any future GSE must be a key element of reform. Regulation also must include review and control for systemic risk.

4. Any GSE involved in the mortgage markets must be strictly confined to a well-defined and regulated secondary market role and should not be allowed to compete with the private, primary market.

5. Any reform of the secondary mortgage market must recognize the vital role played by the Federal Home Loan Banks and must in no way harm the traditional advance businesses of FHLBanks or access to advances by their members, particularly for community banks which play a vital role in providing mortgage finance and economic development.

6. GSEs must be allowed to pursue reasonable risks and rewards, but the risk/reward equation must be transparent and more rigorously defined and regulated.

7. GSEs must operate within a framework of market procedures and regulation governing the securitization of all mortgage assets.

8. Strong minimum regulatory standards are necessary to ensure sound underwriting for all mortgages. Insured depositories already comply with strong underwriting standards and are subject to vigorous examination. Comparable standards should be established for all loan originators with comparable levels of effective regulatory oversight.

9. True sales treatment and regulatory capital charges should appropriately reflect the reality of true risk-shifting activities, as well as balance sheet exposures. Accounting and regulatory changes should reflect and align the risks of mortgage securities and their underlying assets.

10. Affordable housing goals or efforts undertaken to broaden housing affordability are more suited to other programs and entities than the GSEs – whose principal focus should be on providing stability and liquidity to the primary market. Any affordable housing goals required of the GSEs should be in furtherance of their primary goals of promoting primary market stability and liquidity and should be delivered through and driven by the primary market, and should be structured in the form of affordable housing funds available to provide subsidies for affordable projects.

11. GSEs must provide for fair and equitable access to all primary market lenders selling into the secondary market through the GSEs