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February 8, 2012

Mr. Edward DeMarco
Acting Director
Federal Housing Finance Agency
1700 G Street NW
Washington, D.C. 20551

Dear Acting Director DeMarco:

We are writing in response to your January 20, 2012, letter which discussed your refusal to authorize principal reduction programs for underwater mortgages owned or guaranteed by Fannie Mae and Freddie Mac, and which provided some of the analyses on which you claim to base your refusal.

The single most significant revelation in your letter is that—even based on your own questionable assumptions and data—your most up-to-date analysis demonstrates that principal reduction programs would serve taxpayer interests more effectively than any other alternative, including your preferred alternative of forbearance, particularly with respect to mortgages backed by Fannie Mae. This revelation directly contradicts your testimony before the Oversight Committee on November 16, in which you stated that principal reduction "is not going to be the least-cost approach for the taxpayer."

In addition, although we appreciate the information you provided, we have now become aware of new information that calls into serious question the accuracy and completeness of your response, as well as your motivation for continuing to oppose principal reduction programs even when they have the potential to save American taxpayers billions of dollars.

After reviewing the data and legal explanations set forth in your letter, a former employee of Fannie Mae has come forward with detailed information about a pilot program that was designed to offer principal reductions to borrowers with loans backed by Fannie Mae. The program was tentatively approved in 2010, but cancelled several months before the November elections in which Republicans took control of the House of Representatives.

According to this former employee, the pilot program had obtained appropriate internal legal and accounting approvals, as well as the participation of a prominent mortgage servicing company, but the program was terminated by senior officials at Fannie Mae who were "philosophically opposed" to the concept of reducing principal. The former employee also indicated that significant research had been conducted prior to initiating this pilot program, and that personnel from your office were directly involved in reviewing the program.

Your letter did not mention anything about this pilot program. Instead, you repeated the unfounded claim that you lack the statutory authority to proceed with principal reduction programs at this time, and you focused instead on new analyses that you began receiving in December 2010, one month after the congressional elections. If these allegations by the former employee are accurate, your response to Congress is seriously deficient and misleading.

Rather than highlighting these and other pertinent facts, you chose to begin your letter with a highly inflammatory statement that was quickly cited by the press—that it would cost American taxpayers $100 billion to reduce principal on all three million underwater mortgages owned or guaranteed by Fannie Mae and Freddie Mac. This was an answer to a question that was never asked and a flagrant distortion of the fundamental issue. A more relevant figure would have been an estimate of the costs of taking no action at all and allowing all three million underwater mortgages to default—an amount that vastly exceeds your $100 billion estimate.

In fact, your own calculations prove that principal reduction programs prevent losses from occurring. The data you provided indicate that implementing principal reduction programs for even a small subset of these underwater homeowners would save taxpayers an estimated $28 billion compared to the losses that would occur if no action were taken to prevent defaults.

Economists across the political spectrum have concluded that addressing the housing crisis is the key to improving our nation's economic recovery, and they believe principal reduction programs offer a sound approach to addressing this crisis responsibly while serving the interests of taxpayers.

Over the last several days, however, we have received troubling new reports that you are now blocking efforts to allow Fannie Mae and Freddie Mac to participate in principal reduction programs agreed to as part of the multi-state settlement under which the nation's five largest mortgage servicers will provide billions of dollars in compensation for their abuses and illegal actions against homeowners.

We understand that the Federal Housing Finance Agency (FHFA) is not part of the Obama Administration, and that you do not take direction from Administration officials, but it appears that your refusal to follow Congress' direction and allow principal reduction programs is based more on ideology and the fear of political backlash than on a straightforward analysis of the interests of American taxpayers.

Unlike almost any other official in the entire government, you have an historic opportunity to improve our nation's fragile economy, to provide real assistance to millions of struggling homeowners, and to save American taxpayers billions of dollars in the process. It is time for you either to seize this opportunity or to step aside.

BACKGROUND

During your testimony before the Oversight Committee on November 16, 2011, you made two assertions: that FHFA lacks the statutory authority to authorize principal reduction programs for Fannie Mae and Freddie Mac; and that after examining data and analyses, you determined that principal reduction programs do not serve the long-term interests of taxpayers.

Specifically, Rep. Tierney asked why FHFA refused to allow Fannie Mae and Freddie Mac to utilize principal reduction programs when the Emergency Economic Stabilization Act of 2008 specifically directs FHFA, Fannie Mae, and Freddie Mac to "implement a plan that seeks to maximize assistance for homeowners."[1]

In response, you stated: "I believe that the decisions that we've made with regard to principal forgiveness are consistent with our statutory mandate." You also stated: "I do not believe that I've been appropriated taxpayer funds for the purpose of providing general support to the housing market." During your testimony, however, you identified no specific statute that prohibits FHFA from allowing Fannie Mae and Freddie Mac from developing principal reduction programs in select cases that would serve the long-term interests of both taxpayers and homeowners.[2]

You also testified at the hearing that principal reduction programs do not serve the interests of taxpayers. You stated:

> We have been through the analytics of the underwater borrowers at Fannie and Freddie, and looked at the foreclosure alternative programs that are available, and we have concluded that the use of principal reduction within the context of a loan modification is not going to be the least-cost approach for the taxpayer.[3]

In contrast, many leading economists believe that principal reduction programs could fulfill this goal while also serving the long-term interests of the taxpayers. For example, appearing before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs, the President of the New York Federal Reserve Bank, William Dudley, testified:

> We think that you can devise a program that, for home buyers that have mortgages that are under water, to incent them to continue to pay on those mortgages by giving them some program of principal reduction. Obviously the devil's in the details, so you have to

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[1] Emergency Economic Stabilization Act of 2008 (P.L. 110-343).

[2] House Committee on Oversight and Government Reform, *Hearing on Pay for Performance: Should Fannie and Freddie Executives Be Receiving Millions in Bonuses?* (Nov. 16, 2011).

[3] *Id.*

> have good program design. But we are confident that one can design a program, which would be net beneficial—net positive—to the taxpayer.[4]

At the conclusion of Rep. Tierney's questioning, he asked you to provide both the statutory authority for your claim that you are prohibited from allowing principal reduction programs and the analysis you conducted demonstrating that principal reduction programs do not serve taxpayer interests. He stated:

> What you're telling me flies in the face of all these people who have come up with a quite different idea. ... I'd like you to do two things for the Committee if you would. First, I want you to identify anywhere in the statute that specifically prohibits you from developing principal reduction programs. ... [S]econd, I'd like you to submit whatever analysis you have done that shows why reducing the principal on some mortgages is worse for the United States taxpayer than foreclosure.[5]

In response, you committed under oath to provide these documents, stating: "We can provide that information as you suggested, Congressman."[6]

On November 30, 2011, all Democratic Members of the Committee wrote to follow-up on this request and to ask that you provide to the Committee "(1) the specific statutory provision you believe prohibits the Federal Housing Finance Agency (FHFA) from allowing Fannie Mae and Freddie Mac to reduce mortgage principal in all cases; and (2) the analysis you conducted, including the data you examined, demonstrating that principal reduction never serves the long-term interests of the taxpayer when compared to foreclosure."[7]

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[4] House Committee on Oversight and Government Reform, Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs, *Hearing on What the EuroCrisis Means for Taxpayers and the U.S. Economy* (Dec. 16, 2011) (online at http://democrats.oversight.house.gov/index.php?option=com_content&task=view&id=5556&Itemid=104).

[5] House Committee on Oversight and Government Reform, *Hearing on Pay for Performance: Should Fannie and Freddie Executives Be Receiving Millions in Bonuses?* (Nov. 16, 2011).

[6] *Id.*

[7] Letter from Rep. Elijah E. Cummings, Ranking Member, House Committee on Oversight and Government Reform, *et al.*, to Edward J. DeMarco, Acting Director, Federal Housing Finance Agency (Nov. 30, 2011) (online at http://democrats.oversight.house.gov/index.php?option=com_content&task=view&id=5525&Itemid=104).

After receiving no response, we sent a letter to Committee Chairman Darrell Issa requesting that he issue a subpoena compelling the production of the requested documents.[8]

CONCERNS WITH FHFA RESPONSE TO CONGRESS

On January 20, 2012, you sent a three-page response letter explaining your rationale for refusing to authorize principal reduction programs for mortgages owned or guaranteed by Fannie Mae and Freddie Mac and providing data you relied on in order to make your decision.[9] Although you did not include any original documents, you did include a summary of three sets of analyses you were provided in December 2010, June 2011, and December 2011. Based on consultations with experts in the government and private sector, as well as a thorough review of the information you provided, we have numerous concerns with your response, each of which is addressed below.

Claim That Principal Reduction Does Not Serve Taxpayer Interests

In our opinion, the single most significant revelation in your letter to Congress is that, even based on your own questionable assumptions and data, principal reduction programs serve the taxpayer interests even when compared to your preferred alternative of forbearance.

Your letter concedes that both principal reduction and principal forbearance programs serve taxpayer interests by reducing the rates of default and the numbers of foreclosures. Nevertheless, you argue that forbearance is preferable because it saves more money. As you testified at the hearing on November 16, principal reduction "is not going to be the least-cost approach for the taxpayer."

However, your letter and accompanying data demonstrate the opposite. The analyses from December 2010, June 2011, and December 2011 confirm that, in light of the significant uncertainty underlying your assumptions, there is no effective difference between the estimated savings from these two approaches. As the analyses concede, any perceived difference between the two is "negligible given the model risk."

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[8] Letter from Rep. Elijah E. Cummings, Ranking Member, House Committee on Oversight and Government Reform, and Rep. John Tierney, Member, House Committee on Oversight and Government Reform. to Rep. Darrell E. Issa, Chairman, House Committee on Oversight and Government Reform (Jan. 18, 2012) (online at http://democrats.oversight.house.gov/index.php?option=com_content&task=view&id=5562&Itemid=104).

[9] Letter from Edward J. DeMarco, Acting Director, Federal Housing Finance Agency, to Rep. Elijah E. Cummings, Ranking Member, House Committee on Oversight and Government Reform, and Rep. John Tierney, Member, House Committee on Oversight and Government Reform (Jan. 20, 2012).

In fact, according to the latest report you provided from December 2011, which is based on the most recent data and up-to-date analyses, principal reduction programs actually save more money than forbearance programs. Table 3 on page 19 of your letter indicates that Fannie Mae would save more money with principal reduction programs than with forbearance. It shows that implementing principal reduction programs for borrowers who are Net Present Value (NPV) positive would reduce overall losses by $28.3 billion, while principal forbearance programs for these borrowers would reduce overall losses by $27.9 billion compared to the cost of taking no action.

If your estimates truly guide your decisions, it appears that you are disserving the American taxpayers by subjecting them to unnecessary and avoidable costs because you refuse to approve principal reduction programs.

One explanation you provide in your letter for not approving principal reduction programs is that they would require "changes to the existing IT systems, which are outdated and inflexible." We do not believe this is a valid justification for inaction, particularly since you did not even ask Fannie Mae or Freddie Mac to estimate the costs of adjusting their IT systems.

Claim That Principal Reduction Programs Would Cost $100 Billion

Rather than acknowledging that principal reduction programs serve the interests of American taxpayers, the first paragraph of your letter under "FHFA Considerations" included a highly inflammatory assertion implying that principal reduction programs could cost American taxpayers $100 billion. You said this:

> Putting this determination in context, as of June 30, 2011, the Enterprises had nearly three million first lien mortgages with outstanding balances estimated to be greater than the value of the home. ... FHFA estimates that principal forgiveness for all of these mortgages would require funding of almost $100 billion to pay down mortgages to the value of homes securing them.

No Member of the Committee asked how much it would cost to pay down the mortgages of all three million mortgages backed by Fannie Mae and Freddie Mac that are currently underwater. Nevertheless, your statement apparently had its intended effect of diverting attention from the questions we posed as news outlets immediately ran provocative headlines like "Mortgage Writedowns Could Cost Taxpayers $100B."[10]

To the contrary, your own data show that principal reduction programs would save taxpayers billions of dollars. According to the data accompanying your letter, you examined borrowers with loan-to-value ratios exceeding 115% and concluded that taxpayers currently stand to lose an estimated $102 billion as a result of the defaults and foreclosures that will occur

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[10] *See, e.g., Mortgage Writedowns Could Cost Taxpayers $100B,* Bloomberg (Jan. 23, 2012) (online at www.bloomberg.com/news/2012-01-23/mortgage-writedowns-could-cost-taxpayers-100-billion-fhfa-says.html).

if no modification efforts are undertaken. Your December 2011 analysis shows that implementing principal reduction programs would reduce these losses by $28.3 billion.

We have not identified a single press account in which you corrected the misimpression you created by suggesting that principal reduction programs would cost taxpayers $100 billion. Beginning your letter with such a misleading statement trivializes the critical issues we are struggling to address and undermines your credibility and impartiality.

Statutory Authority Prohibiting Principal Reduction Programs

Your letter finally puts to rest the false argument that federal law prohibits FHFA from authorizing principal reduction programs for mortgages owned or guaranteed by Fannie Mae and Freddie Mac.

Your letter correctly references "three principal mandates set forth by Congress that direct FHFA's activities and decisions." Your letter also correctly acknowledges that under the Emergency Economic Stabilization Act of 2008, "FHFA has a statutory responsibility to maximize assistance for homeowners to minimize foreclosures." Finally, your letter concedes that "FHFA did not conclude that 'principal reduction never serves the long-term interest of the taxpayer'."

What remains unclear, however, is why you have refused to exercise the authority Congress gave you to implement principal reduction programs. As discussed above, your own data indicate that principal reduction programs would save taxpayers more money than forbearance programs in certain situations.

Your letter acknowledges that you might "reconsider" whether to authorize principal reduction programs "if other funds become available." This seems to be a reference to your ongoing efforts to seek additional taxpayer funds from the Treasury Department in order to provide incentives to mortgage servicing companies to conduct principal reduction programs.

Although additional incentives may be warranted in some cases, taxpayers have already provided $153 billion to Fannie Mae and Freddie Mac, and it is irresponsible and contrary to Congress' direction for you to refuse to authorize principal reduction programs when they serve taxpayer interests today, according to your own data.[11] In other words, if your own data show that principal reduction programs would serve the interests of taxpayers now, you should implement these programs immediately and aggressively rather than holding out for additional funds from the Treasury Department.

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[11] *U.S. Senate Adopts Measure to Ban Bonuses at Fannie, Freddie,* Businessweek (Feb. 7 2012) (online at www.businessweek.com/news/2012-02-07/u-s-senate-adopts-measure-to-ban-bonuses-at-fannie-freddie.html).

In addition, as discussed below, a former Fannie Mae employee has informed us that a pilot program to initiate a targeted principal reduction program was vetted by agency legal counsel prior to receiving preliminary approval, yet it was cancelled by Fannie Mae officials on ideological grounds. If this assertion is accurate, it suggests that the use of legal arguments to prevent principal reduction programs is misplaced and misleading.

Differences in Re-Default Rates

Based on input from numerous experts on housing policy, we have concerns about the assumptions used to estimate acceptance and re-default rates when comparing principal reduction programs to principal forbearance programs. In particular, the assumptions underlying your analysis may underestimate the benefits of principal reductions and overestimate the benefits of forbearance.

First, your letter observes correctly that borrowers are less likely to re-default when they receive principal reductions compared to when they receive principal forbearance. It states that the model you used "assumes that principal forgiveness reduces the rate of re-default on the loans to a greater extent than would forbearance."

Similarly, an August 2010 staff report from the Federal Reserve Bank of New York agreed with this approach and stated:

> We find that delinquent borrowers whose mortgages receive some modification have a strong tendency to re-default, but that different kinds of modifications have diverse effects on outcomes. ... [T]he re-default rate declines with the magnitude of the reduction in the monthly payment, but also that the re-default rate declines relatively more when the payment reduction is achieved through principal forgiveness as opposed to lower interest rates.[12]

The benefits of principal reductions may be understated in your analysis, however, since your hypothetical principal reduction program is not as sophisticated as programs proposed by experts or currently being implemented elsewhere. For example, a number of principal modification programs include shared equity features that enable lenders or investors to recover a portion of appreciation in the home's value. In such programs, the "loss" from principal reduction may be less than otherwise assumed if the home is later sold at a higher value.

In addition, credible principal reduction programs typically seek to restore borrowers to positive equity positions and are likely to be more successful in obtaining borrower acceptance and preventing re-defaults. According to your letter, however, you assumed only that principal would be reduced to 115% mark-to-market loan-to-value. No data were provided comparing

[12] *Second Chances: Subprime Mortgage Modification and Re-Default,* Federal Reserve Bank of New York Staff Reports, no. 417 (Dec. 2009; revised Aug. 2010) (online at www.newyorkfed.org/research/staff_reports/sr417.pdf).

loans with loan-to-value between 101% and 115%, and no data were provided comparing modifications that reduce loan-to-value to any level other than 115%.

On the other side of the equation, it appears that the model used by FHFA to estimate the re-default rate for borrowers who receive forbearances may be overly optimistic. In particular, the NPV tool appears to assume that if borrowers do not re-default within a given period of time (e.g., within one year), they will never re-default. Such an assumption is highly suspect given projections that housing prices are likely to remain depressed for many years. The failure to consider likely re-default rates over multiple years may skew your analysis to make forbearance appear more successful in preventing losses than it really is since many borrowers may be underwater for years.

Insufficient Detail to Evaluate Analyses

Your letter fails to provide any of the calculations made to generate the data presented in the tables that accompany the analyses. In addition, it fails to provide definitions of key terms or to enumerate specific assumptions built into the models used to conduct the analyses. The analyses appear to aggregate data from across 50 states and do not include any data on more narrow categories of borrowers, such as borrowers with loan-to-value between 115% and 125% or higher than 126%. As a result, it is impossible to conduct a thorough analysis of the findings you have presented or to understand whether certain sub-sets of borrowers might benefit more than other borrowers from principal reduction programs.

INFORMATION FROM FORMER FANNIE MAE EMPLOYEE

A former employee of Fannie Mae has come forward to express concerns to us about your blanket refusal to authorize any principal reduction programs, even when those programs have been fully vetted by agency legal counsel and have the potential to save the American taxpayers billions of dollars.

According to this former employee, Fannie Mae officials conducted a significant amount of work developing a pilot program to test different principal reduction approaches and determine the most effective models. As part of this effort, officials identified a major mortgage servicing company that was willing to become a partner in this program, analytical modeling was conducted by both Fannie Mae and the mortgage servicing company, consumer education materials were drafted, and a third-party counseling service was retained, according to the former employee.

This former employee has informed us that preliminary approvals for this pilot program were obtained from a variety of officials, including the Risk Subcommittee of Fannie Mae's Executive Committee, as well as officials at FHFA and the Office of the Comptroller of the Currency. The analytical teams at Fannie Mae and the mortgage servicing company also reportedly analyzed a host of factors, including the comparative risk of re-default with shared equity modification options.

According to the former employee, the purpose of the program was to develop "a responsible way to reduce principal balances for underwater mortgage borrowers without creating undue incremental moral hazard." As the former employee told us:

> The thesis was straightforward: the program would minimize losses for Fannie Mae versus conventional loss mitigation practices. The analytical modeling done by both Fannie Mae and its pilot program bank/servicer partner supported this thesis.

According to the former employee, after six months of development work, and two weeks prior to its launch, the pilot program was cancelled in mid-2010 by senior executives in loss mitigation at Fannie Mae who were "philosophically opposed to writing down principal balances."

The former employee informed us that dozens of officials were involved in this effort and that FHFA and Fannie Mae would have all of the documents relating to this pilot program, including all of the legal and analytical reviews that were conducted.

The former employee also explained to us the purpose of coming forward at this time, stating: "I believe that we could be saving tens of billions of dollars while also helping stabilize housing prices and stimulating economic growth."

If the allegations put forth by this former employee are accurate, it is unclear why you failed to include any of this information in your response to Congress. Even if you subsequently questioned the data or assumptions relied on for this pilot program, your failure to disclose this information calls into question the completeness and accuracy of your response, as well as your motivation for continuing to oppose principal reduction programs.

REQUESTS FOR RESPONSES, DOCUMENTS, AND INTERVIEWS

In order to address the numerous concerns raised about your response to Congress and the new information provided by the former Fannie Mae employee, we request that you provide the documents requested below:

(1) All documents relating to estimates of losses that would incur if all three million underwater mortgages owned or guaranteed by Fannie Mae and Freddie Mac were allowed to default without any modifications.

(2) All documents relating to specific default assumptions in the NPV model used by FHFA to compare modifications that include principal reduction with modifications that include principal forbearance.

(3) All documents relating to estimates of re-default rates for mortgages owned or guaranteed by Fannie Mae and Freddie Mac, including those that received modifications that include principal forbearance, disaggregated by loan-to-value level.

(4) All documents relating to estimates of specific costs that would be associated with information technology upgrades needed to implement principal reduction programs.

(5) All documents relating to analyses, if any, of the estimated consequences of reducing mark-to-market loan-to-value to levels other than 115%.

(6) All documents relating to assumptions and estimates of the potential consequences of offering loan modifications, including forbearance or principal reductions, to borrowers who have mortgage insurance.

(7) All documents relating to estimates of the number of mortgages owned or guaranteed by Fannie Mae and Freddie Mac that have mortgage insurance or second liens, as well as the share of potential gains from principal reduction programs that would go to unrelated beneficiaries as a result.

(8) All documents, whether in draft or final form, relating to any pilot program developed by Fannie Mae relating to principal reduction modifications, including but not limited to:

(a) records of communications, including emails, between and among officials at FHFA, Fannie Mae, the Office of the Comptroller of the Currency, and any outside parties including mortgage servicing companies and consulting firms, relating to such programs;

(b) legal analyses conducted before, during, or after consideration of such pilot programs;

(c) accounting or actuarial studies evaluating shared equity modeling or other aspects of such pilot programs, whether prepared by government entities or outside parties;

(e) consulting, analytic, or other contracts or memoranda or agreement relating to such programs, as well as any products prepared pursuant to such contracts or memoranda of agreement;

(f) consumer education materials prepared relating to such programs; and

(g) agendas, briefing papers, minutes, summaries, or other documents prepared by, on behalf of, or after consideration of such programs by the Executive Committee, including but not limited to its Risk Subcommittee.

Please provide the requested documents by February 29, 2012. To the extent that no documents exist that are responsive to these requests, we ask that you provide a substantive explanation in response to the specific issues raised in this letter. Thank you for your cooperation with this request.

Sincerely,

Elijah E. Cummings
Ranking Member

John F. Tierney
Member

cc: The Honorable Darrell E. Issa, Chairman
Committee on Oversight and Government Reform