Testimony

# The Conservatorship of Fannie Mae and Freddie Mac

**9/25/2008**

*Correction Notice:*
*The following information was corrected in this document on September 26, 2008, at 5 p.m.*

*"For Fannie Mae, roughly 28 percent of new business in the first half of 2007 was in Alt-A and interest-only products versus 26 percent in 2005."*

*The sentence previously included a figure of 40 percent, which was in error.*

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Statement of The Honorable James B. Lockhart III, Director
Federal Housing Finance Agency
Before the House Committee on Financial Services
September 25, 2008

Chairman Frank, Ranking Minority Member Bachus, and members of the Committee, thank you for the opportunity to testify on the Federal Housing Finance Agency's (FHFA) decision to place Fannie Mae and Freddie Mac into conservatorship and the plans of the conservator for the ongoing operations of these companies. But before doing so, I would like to thank this Committee in for its efforts to pass the government sponsored enterprise (GSE) reform legislation, the Housing and Economic Recovery Act of 2008 (HERA).

Fannie Mae and Freddie Mac share the critical mission of providing stability, liquidity, and affordability to the housing market. Between them, these Enterprises have $5.3 trillion of guaranteed mortgage-backed securities (MBS) and debt outstanding, which is equal to the publicly held debt of the United States. Their market share of all new mortgages was 76 percent during the first half of this year. During the turmoil that started last year, they have played a very important role in providing liquidity to the conforming mortgage market. That required capital to support a careful and delicate balance of mission with safety and soundness. A key component of this balance has been their ability to raise and maintain capital. Because of recent market conditions, that balance was upset. Unfortunately, as house prices, earnings and capital have continued to deteriorate, their ability to fulfill their mission has deteriorated. In particular, the capacity to raise capital to absorb further losses without Treasury Department support vanished. That left both Enterprises unable to provide counter-cyclical market support. Worse, it threatened to further damage the mortgage and housing markets if they had to sell assets.

In retrospect and despite OFHEO's surplus capital requirements, the caps on the growth of their portfolios, and repeated warnings about credit risk, the credit profile at both Enterprises followed the market down in 2006 and 2007. They bought or guaranteed many more low documentation, low verification and non-standard ARM mortgages than they had in the past. For example, for the first half of 2007, roughly one-third of the Enterprises' new business was composed of Alt-A (less than standard documentation), interest-only, or Option ARM products, and mortgages with layered (multiple) risk characteristics versus 14 percent in 2005. For Fannie Mae, roughly 28 percent of new business in the first half of 2007 was in Alt-A and interest-only products versus 26 percent in 2005. The quality of their holdings of private-label mortgage securities (PLS) issued by others also deteriorated. The portfolio caps restrained the size of their PLS books, but maturing subprime and Alt-A PLS were replaced by PLS from the much riskier 2006 and 2007origination years. As house prices turned down, delinquencies, foreclosures, losses on real-estate owned and reserves against future losses soared.

Over the last several years OFHEO, now FHFA, worked hard to encourage the Enterprises to rectify their accounting, internal controls systems and risk management issues. Both Enterprises and their dedicated managers and employees made good progress in many areas, but market conditions overwhelmed that progress. Their antiquated capital structures even with the OFHEO additional requirement were not adequate for this market.

The result was that the Enterprises were unable to provide needed stability to the market. They also found themselves unable to meet their affordable housing mission.

Rather than letting these conditions worsen and put the markets in further jeopardy, FHFA decided to take action. The goal of these dual conservatorships is to help restore confidence in Fannie Mae and Freddie Mac, enhance their capacity to fulfill their mission, reduce the systemic risk and make more mortgages available at a lower cost for the American people.

## The Determination to Appoint a Conservator

FHFA based its determination on five key areas, which worsened significantly over the past several months:

1. Accelerating safety and soundness weaknesses, especially with regard to credit risk, earnings outlook, and capitalization;
2. Continued and substantial deterioration in equity, debt, and MBS market conditions;
3. The current and projected financial performance and condition of each company as reflected in its second quarter financial reports and our ongoing examinations;
4. The inability of the companies to raise capital or to issue debt according to normal practices and prices; and
5. The critical importance of each company in supporting the country's residential mortgage market.

It became apparent during on intense supervisory review, beginning in July, that market conditions were deteriorating more quickly than the companies had anticipated. In anticipation of the late-July enactment of the Housing and Economic Recovery Act of 2008 (HERA), we supplemented our own examination activity with consultations with senior mortgage credit examiners from the Federal Reserve and the Office of the Comptroller of the Currency. These examiners corroborated our own analysis of the deteriorating credit environment and its threat to capital.

During the last part of July and in August, FHFA was completing its confidential semi-annual examination ratings. FHFA's rating system is called GSE Enterprise Risk or G-Seer. It stands for Governance, Solvency, Earnings and

Enterprise Risk which includes credit, market and operational risk. There were significant and critical weaknesses across the board.

The Enterprises themselves disclosed in their second quarter filing how the rapidly changing credit environment in July was very negatively affecting their outlook and ability to raise capital. Freddie Mac reported losses of $4.7 billion over the last year and Fannie Mae reported losses of $9.7 billion.

The internal supervisory reviews and market evidence led us to conclude that the companies each presented critical safety and soundness concerns pertaining to credit risk and to continued deterioration in the market environment. Importantly, key developments in July and August demonstrated market recognition of these heightened credit concerns and the effect of the deteriorating market environment on the Enterprises. New equity capital in any meaningful size became unavailable, and yields on Enterprise debt and MBS rose relative to other benchmarks. These developments convinced us that the time to act was now.

During the July and August period, there were a wide variety of published reports speculating on the Enterprises' solvency, the need to raise more capital, their accounting practices, their ability to continue to borrow and even government bailouts. The rating agencies continued to dramatically lower all ratings except the AAA senior debt ratings. Their stock prices fell rapidly and their borrowing costs increased. Conditions in the mortgage market continued to deteriorate with much higher delinquencies and foreclosures. Housing prices continued to fall.

Central banks ceased buying and began selling Enterprise securities. Relatively small sales triggered large price moves. Despite financing 30-year mortgages, the Enterprises had to rely on short-term discount notes, with only a few fixed-rate debt securities issued, none with maturity greater than three years. Yet they had $89 billion in long-term debt maturing in the second half of 2008.

After substantial effort and communication with market participants, each company reported to FHFA and to Treasury that it was unable to access capital markets to bolster its capital position without Treasury financing. FHFA's and Treasury's own discussions with investment bankers and investors corroborated this conclusion. In the absence of access to new capital, the only alternative left to the firms was to cease new business and shed assets in a weak market. That would have been disastrous for the mortgage markets as mortgage rates would have continued to move higher and, in turn, disastrous for the Enterprises as the prices of their securities would have fallen and credit losses would have increased.

Therefore, in order to restore the balance between safety and soundness and mission, FHFA placed Fannie Mae and Freddie Mac into conservatorship. That is a statutory process designed to stabilize a troubled institution with the objective of maintaining normal business operations and restoring its safety and soundness. It was the most prudent regulatory action to take.

FHFA did not undertake this action lightly. We consulted with the Chairman of the Board of Governors of the Federal Reserve System, Ben Bernanke, who was made a consultant to FHFA under the new legislation. We also consulted with the Secretary of the Treasury, not only as an FHFA Oversight Board member, but also in line with his ability under the law to provide financing to the GSEs. They both concurred with me that conservatorship needed to be undertaken.

FHFA will act as the conservator of the Enterprises until they are stabilized. The Treasury's financial commitments, authorized by the new law, were critical to creating a workable conservatorship structure.

Let me now turn to the conservatorships. First signs are that the conservatorships are positive. A lack of confidence had resulted in continued widening of the spread between yields of their MBS and yields of Treasury securities, which meant that virtually none of the large drop in Treasury interest rates over the past year had been passed on to the mortgage markets. On top of that, Freddie Mac and Fannie Mae, in order to try to build capital, may have raised prices and tightened credit standards beyond what was necessary for sound underwriting. I am pleased to say that the Enterprises' funding costs and the spreads on MBS have declined. As denoted in the attached chart, yields on Freddie Mac guaranteed mortgage securities have declined relative to Treasury debt yields by a third of a percentage point since the Friday before the conservatorship. This lower cost has been passed on to homebuyers, with 30-year fixed-rate mortgage rates below 6 percent for the first time since January.

On the first day, businesses opened as normal, but with stronger backing for the holders of MBS, senior debt and subordinated debt. Consistent with the terms of the Treasury's financial assistance, over the next 15 months, we will allow each company to increase its portfolio, up to $850 billion, before requiring gradual declines in the portfolios of 10 percent per year. The Enterprises will also continue to grow their guarantee MBS books.

As the conservator, FHFA assumed the power of the board and management. Highly qualified, new Chief Executive Officers have been appointed. The new CEOs are Herb Allison of Fannie Mae and David Moffett of Freddie Mac. Herb has served as President and Chief Operating Officer of Merrill Lynch and for the last six years Chairman and CEO of TIAA-CREF. David had previously served as the Vice Chairman and CFO of US Bancorp. I appreciate the willingness of these two men to take on these tough jobs during these challenging times. In addition, their compensation will be significantly lower than the outgoing CEOs.

Although it is not necessary in a conservatorship, new boards are being formed as a matter of good governance. New non-executive Chairmen were announced last week. Philip Laskawy, former Chairman and CEO of Ernst and Young, has agreed to be the Chairman of Fannie Mae. John Koskinen, former President and CEO of Palmieri Company, a corporate turnaround management company, and former Deputy Director for Management at OMB, has agreed to be the Chairman of Freddie Mac.

As part of the conservatorship, the CEOs of Fannie Mae and Freddie Mac were asked to leave after a transition period. Under the new legislation's "golden parachute" language, and existing regulations, FHFA directed that severance payments not be made to the CEOs. As appropriate for senior executive officers, their pay over their years at the Enterprises was also at risk, as a major portion of their bonuses were in stock. Their actual pay based on today's stock price was about a third of what was reported in the press at the time.

FHFA worked with the new CEOs to establish employee retention programs. They agree with me that it is very important to work with the current management teams and employees to encourage them to stay and to continue to make important improvements to the Enterprises.

All political activities—including all lobbying—were halted immediately. We will review the charitable activities to ensure that these reflect their mission and their conservatorship status.

In order to conserve over $2 billion in annual capital, the common stock and preferred stock dividends were eliminated. I recognize that the loss of dividend income may have an adverse effect on some investors, including depository institutions. Before taking our action, we consulted with the bank regulators and I understand that they are working with individual institutions under their jurisdiction that may have capital invested in Enterprise preferred stock. As you know, any preferred stock is part of the issuing firm's equity account and is issued to absorb losses ahead of debt holders. Subordinated debt interest and principal payments will continue to be made, even if the capital test is breached.

Finally and very importantly, the liquidity, MBS investment, and senior preferred stock facilities with the U.S. Treasury, are all in place. These facilities will provide critically needed support to Freddie Mac and Fannie Mae to fulfill their mission over the long term, while giving a potential upside for the taxpayer. The key facility is the senior preferred stock agreement, which ensures that each Enterprise maintains a positive net worth. This measure adds to market stability by providing additional security to GSE debt holders—senior and subordinated—and adds to mortgage affordability by providing additional confidence to investors in GSE MBS. The senior preferred facility supports all past and future debt and MBS issuances, until the terms of the facility are completely satisfied. In light of this facility the existing regulatory capital requirements will not be binding during the conservatorship. As SEC registrants, the Enterprises will continue to report their financial results quarterly.

The second facility is a secured credit facility that is not only for Fannie Mae and Freddie Mac, but also for the 12 Federal Home Loan Banks that FHFA also regulates. The Federal Home Loan Banks have performed remarkably well over the last year as they have a different business model than Fannie Mae and Freddie Mac and a different capital structure that grows as their lending activity grows. They are jointly and severally liable for the Bank System's debt obligations and all but one of the 12 are profitable. Therefore, it is very unlikely that they will use the facility.

Another element of Treasury's financing plan is to hire investment managers to purchase Fannie Mae and Freddie Mac MBS. The goal is to provide additional liquidity to the MBS and lower the costs of mortgages. FHFA helped originate this approach. As such, we are pleased that Treasury has decided to implement these purchases quickly and on a larger scale than originally planned.

We also support other recent actions and proposals of the Bush Administration, Secretary Paulson and Chairman Bernanke designed to take a comprehensive approach to relieving the stress on our financial institutions and markets. Among these actions are:

- Requesting authority from Congress to purchase troubled mortgage assets from financial institutions; and
- Protecting investors in money market funds.

These actions are designed to get at the root cause of financial market turmoil which is the liquidity in the nation's mortgage market.

Let me now bring you up-to-date on our actions since September 7. The new CEOs were introduced to Enterprise senior management at separate meetings at FHFA offices on Sunday, September 7.

To reassure financial counterparties, later that day FHFA posted a statement on its website emphasizing that all existing contracts with the Enterprises remain in effect, that the Enterprises have the authority to enter into new contracts, and that the enforceability of such new contracts is not affected by the appointment of the conservator. I also sent a statement to employees at both Enterprises explaining the conservatorships, and that the purposes of the action are to help restore confidence in the Enterprises, enhance their ability to fulfill their mission, and mitigate systemic risk.

Since the Enterprises opened for business on September 8, FHFA personnel have been continuously on site, both at the Enterprises' headquarters and locations of other key operations to ensure a smooth transition and continued business operations. FHFA personnel include examiners, attorneys and other experts to provide for timely communications between the GSE, the conservator, and the examination team. As a conservatorship team, the FHFA representatives are there to reassure Enterprise employees about the continued business operations objective of the conservatorship, to support the needs of the new CEOs as they become familiar with their new organizations, and to act as a conduit and communicate any questions and issues that need resolution back to me.

FHFA will continue to work expeditiously on the many regulations needed to implement the new law. Some of the key regulations will be minimum capital standards, prudential safety and soundness standards and portfolio limits. Importantly, the new legislation adds affordable housing and mission enforcement to the responsibilities of the safety and soundness regulator.

While FHFA has had these responsibilities for only a matter of weeks, we are placing a high priority on them. A key reason for moving quickly to conservatorship was that the companies' abilities to serve their mission had been impaired.

As the companies operate in conservatorship, I have already instructed each new CEO to examine the underwriting standards and pricing. They have begun to do so, and I expect any changes to reflect both safe and sound business strategy and attentiveness to the Enterprise's mission.

Fannie Mae and Freddie Mac are important to the secondary market for multifamily loans, and multifamily lending is critical to the affordable housing mission of the Enterprises. I am determined to ensure that, in conservatorship, both Enterprises remain dedicated to, and actively involved in, multifamily lending. I released a statement to this effect so that market participants may have assurance that the Enterprises will continue to be a source of underwriting and financing for multifamily loans. That statement acknowledged the importance of all aspects of the Enterprises' multifamily businesses—including the LIHTC (low-income housing tax credit) area and liquidity facilities for remarketed mortgage revenue bonds.

Over the last year, we have actively challenged Fannie Mae and Freddie Mac to be more creative on foreclosure prevention. They have responded, but more has to be done. We have worked with them to publicly report their loan modification activities, but that work was slowed by the many other actions we were undertaking. Yesterday we did publish our first quarterly report on their foreclosure prevention activities. We will publish a second quarter update next week.

Going forward, we will work with the CEOs to modify business practices, such as the lengthy delay before pulling delinquent loans from securitized pools. Practices such as this were motivated by capital concerns, but undermined efforts to help distressed borrowers. If we are to address the problem of mortgage delinquencies, a systematic approach to loan modification is essential. Well before last week's actions, we had already asked the Enterprises to facilitate the loan modification program the FDIC has undertaken with IndyMac Federal. I expect the ongoing work on loan modifications being done there, and with other seller servicers, to continue to be a high priority for the conservatorships, both as a matter of good business and as a matter of supporting the Enterprises' mission.

The new legislation established a Housing Trust Fund to increase and preserve the supply of rental housing for extremely low and very low income families, including homeless families, and to increase homeownership for extremely low and very low income families. I recognize the importance of the Housing Trust Fund to many members of Congress. Under the law, the principal duty of FHFA involves the approval of funds paid by each Enterprise equal to 4.2 basis points for each dollar of unpaid principal balance of its total new business purchases. In the near-term, these funds will be used to fund a key component of the new law, the FHA HOPE for Homeowners Program, which will be funded by Treasury if the Enterprises do not. Enterprise funds are to be used to reimburse Treasury for the cost of the Hope Bonds. My understanding is that Treasury has already issued $29.5 million in Hope Bonds to fund the program's start-up costs.

Congress also required that the FHFA Director consider circumstances in which such allocations would be suspended. The Director is required to temporarily suspend such allocations upon a finding that they are contributing, or would contribute, to the financial instability of the Enterprise, are causing, or would cause, the Enterprise to be classified as undercapitalized, or are preventing, or would prevent, an Enterprise from successfully completing a capital restoration plan described in the legislation. Accordingly, I intend to make that determination only after a careful and thorough review of existing conditions including their third quarter results. Treasury has provided assurances that a temporary suspension of Enterprise contributions would not impede issuance of Hope Bonds, so the Hope for Homeowners program will not be harmed, even if Enterprises contributions are temporarily suspended

Enforcement of the affordable housing goals established for the Enterprises by the Congress, once HUD's responsibility, is now up to FHFA. While ensuring liquidity in the mortgage marketplace has necessarily been a primary focus in recent weeks and months, ensuring that low and moderate income persons and underserved areas have ready access to affordable mortgage loans remains a critical responsibility of the Enterprises. In the near-term, the Enterprises are charged with meeting the very ambitious goals set by HUD back in 2004, a year in which the mortgage marketplace looked far different than it does today. In 2007, they missed two subgoals. Based on our discussions with the Enterprises, the miss will be larger in 2008.

The market turmoil of this year resulted in a tightening of underwriting criteria for the purchase of new, unseasoned loans used by individual lenders—the entities that actually originate loans sold to the GSEs—and private mortgage insurers, thereby reducing the availability of traditionally goal rich high loan-to-value home purchase loans. In addition, the collapse of the private label, secondary mortgage market further reduced the share of home purchase loans qualifying for goals. Finally, the rise of FHA as a market force means fewer high-LTV, goal-rich borrowers for Fannie Mae and Freddie Mac. Even if some or all of these goals are found to be unattainable, I will expect each Enterprise to develop and implement ambitious plans to support the borrowers and markets targeted by the goals.

We have begun to meet with affordable housing advocates, seeking their perspective on implementation of the new goals structure.

Finally, I am pleased to report that FHFA expects to have a regulation in place by October 1 to implement Section 1218 of HERA, which provides temporary authority for the Federal Home Loan Banks to use a portion of the subsidy money in Affordable Housing Program to refinance mortgages for families at or below 80 percent of area median income. In broad terms, we intend to issue a regulation implementing this program so that it supports the refinance program in HERA's Hope for Homeowners program by permitting AHP funding of additional principal write-downs or payment of closing costs. We've discussed this initiative with the FHA, which is very supportive of the prospect of added support on this initiative.

## Conclusion

The decision to appoint a conservator for each Enterprise was a tough, but necessary one. They can now play their correct role of being part of the solution and not part of the problem. Unfortunately, all the good and hard work put in by the FHFA and the Enterprises was not sufficient to offset the consequences of the antiquated capital requirements and the turmoil in housing markets. Conservatorship will give the Enterprises time to restore the balances between safety and soundness and their missions. I want to thank the FHFA employees for their work during this intense regulatory process. They represent the best in public service.

I also recognize that many employees at each company have been working extremely hard through years of remediation and through the past year of market volatility. Employees have lost personal savings as a result of the plummet in their company's stock price and they have been working, and continue to work, long hours in the face of uncertainty. To them, I say thank you and pledge that, as conservator, we share the common goal of stabilizing your company while ensuring it continues to serve its public purpose of providing stability, liquidity, and affordability to the mortgage market.

Working together we can finish the job of restoring confidence in the Enterprises and with the new legislation you provided, build a stronger and safer future for the mortgage markets, homeowners and renters in America.

Thank you. I would be pleased to answer any questions you may have.

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