June 4, 2010

Via Email

Mr. James B. Lockhart III
Vice Chairman
WL Ross & Co. LLC
1166 Avenue of the Americas
27th Floor
New York, NY 10036
jlockhart@wlross.com

Re: Financial Crisis Inquiry Commission Hearing on April 9, 2010

Dear Mr. Lockhart:

On April 12, 2010, Chairman Angelides and Vice Chairman Thomas sent you a letter thanking you for testifying at the April 9, 2010 hearing and informing you that the staff of the FCIC would be contacting you to follow up on certain areas of your testimony and to submit written questions and requests for information related to your testimony, which are listed below. Please provide your answers and any additional information by June 17, 2010.[1]

1. Prior to September of 2008, did you ever tell Fannie Mae that its increased purchase and guarantee of risky, non-traditional mortgages was unsafe and unsound? Why or why not? Was there internal discussion within OFHEO/FHFA that the company was operating in an unsafe and unsound manner?

The FCIC appreciates your cooperation in providing the information requested. Please do not hesitate to contact Jeff Smith at (202) 292-1398 or jsmithr@fcic.gov if you have any questions or concerns.

[1] The answers you provide to the questions in this letter are a continuation of your testimony and under the same oath you took before testifying on April 9, 2010. Further, please be advised that according to section 1001 of Title 18 of the United States Code, "Whoever, in any matter within the jurisdiction of any department or agency often United States knowingly and willfully falsifies, conceals or covers up by any trick, scheme, or device a material fact, or makes any false, fictitious or fraudulent statements or representations, or makes or uses any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry, shall be fined under this title or imprisoned not more than five years, or both."

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Sincerely,

Wendy Edelberg
Executive Director,
Financial Crisis Inquiry Commission

cc: Phil Angelides,
Chairman,
Financial Crisis Inquiry Commission

Bill Thomas,
Vice Chairman,
Financial Crisis Inquiry Commission

4843-5647-5398, v. 1

WL ROSS & CO. LLC

James B. Lockhart III
Vice Chairman

July 30, 2010

Ms. Wendy Edelberg
Executive Director
Financial Crisis Inquiry Commission
1717 Pennsylvania Avenue, NW, Suite 800
Washington DC 20006

Dear Ms. Edelberg,

Please find below the response to your question posed in your letter of June 4, 2010. The question was:

> "Prior to September of 2008, did you ever tell Fannie Mae that its increased purchase and guarantee of risky, non-traditional mortgages was unsafe and unsound? Why or why not? Was there internal discussion within OFHEO/FHFA that the company was operating in an unsafe and unsound manner?"

OFHEO communicated regularly in writing and in meetings to both Fannie Mae and Freddie Mac, starting in 2006, that we were concerned with their growing credit risk and encouraged them to conserve and raise capital to build cushions as housing prices began to fall. As I testified publicly, there was countervailing pressure to meet their affordable housing goals established by HUD, which many non-traditional mortgages supported.

As the safety and soundness regulator, OFHEO focused on the credit risk of non-traditional and traditional mortgages as well as market risk and operational risk. From 2006 through September 2008, we increasingly focused our efforts and attention on the growth in positions and risks in nontraditional loans and private-label securities. During this period, we described several aspects of their activities and risk management as imprudent or inadequate, and the level of credit risk as high and increasing.

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Based on these conclusions, we required them to take several corrective actions, including:

- limit the growth of their mortgage portfolios;
- limit or cease activities in private-label securities rated below AAA;
- meet the provisions of the Interagency Guidance for nontraditional loan products or cease the purchase or guaranty of loans covered in the Guidance (a move that had a significant and beneficial market impact);
- strengthen or generate policies, limits and controls; and,
- ensure levels of capital and loan loss reserves commensurate with the risks in nontraditional loans.

In 2005 and 2006, OFHEO noted the GSEs' growth in nontraditional mortgages as an emerging risk, and began discussions with the GSEs regarding the growth and risk management of nontraditional mortgages. As a result of these discussions and the portfolio restrictions, the rapid growth in private-label securities (PLS) ceased. OFHEO also limited and then closed down new activities such as the GSEs' requests to purchase PLS rated below AAA.

Throughout my time at OFHEO and FHFA, we held several meetings each week to discuss known and emerging issues at GSEs and the agency's actions to address those issues. The frequency of those meetings increased as the severity of the issues escalated. In addition, we met with other regulators of financial institutions with increasing frequency starting in 2006 to discuss the issues and determine a coordinated approach to reducing the risks generated by nontraditional mortgages. As the issues in nontraditional mortgages and PLS emerged, our internal discussions increasingly referred to several of the GSEs activities as imprudent or inadequate, noting that certain aspects of risk management were not commensurate with the GSEs' positions and activities in nontraditional mortgages.

I met monthly with the CEO's of both Fannie Mae and Freddie Mac. The growth in non-prime mortgages was a frequent topic as I continued to pressure them to strengthen their credit risk management and modeling. They acknowledged their credit risk was growing, but believed that it was manageable. These meetings also covered their thin capitalization structure and the need for regulatory reform. During this time, members of the OFHEO supervisory team also counseled the GSEs on their credit risk.

Evidence of these discussions within the agency and with the GSEs is noted in several documents and actions taken by OFHEO. This evidence includes a series of letters between OFHEO and the GSEs written between December 2006 and June 2008, and OFHEO's actions to limit positions and risk in PLS rated below AAA, and risk assessment letters sent to the CEOs of Fannie Mae and Freddie Mac.

Interagency Guidance on Nontraditional Mortgage Product Risks

On December 8, 2006, we wrote letters to Fannie Mae's and Freddie Mac's CEOs requiring the GSEs to immediately take action to implement practices consistent with the October 2006 Interagency Guidance on nontraditional mortgage products. We stated that the GSEs needed to implement these practices to "promote the safety and soundness" of the GSEs, and improve underwriting standards, risk management practices, and consumer protection throughout the mortgage market. The letter required the GSEs to address weaknesses in risk management by:

- developing and implementing stronger and clearer written policies;
- designing and implementing stronger and clearer internal controls;
- designing and implementing enhanced performance measures and management reporting;
- establishing appropriate loan loss allowance levels; and,
- maintaining capital commensurate with the risk characteristics of their nontraditional loan portfolios.

Our requirement of capital and loan loss allowance levels commensurate with the risk characteristics of their nontraditional loan portfolios demonstrates OFHEO's conclusions that the GSEs' activities represented significant risk to these entities.

On January 19, 2007, Freddie Mac responded to our December letter. On page two, within the section on "regulated customers," it states "Freddie Mac's safety and soundness would be protected by the continued requirement that lenders comply with Freddie Mac's own underwriting standards…" This statement indicates an understanding by the GSEs that OFHEO questioned the safety and soundness of their activities in nontraditional loans.

OFHEO's June 22, 2007 letters informed the GSEs that they needed to comply with the Interagency Statement on Subprime Mortgage Lending and Guidance on Non Traditional Mortgages*)* immediately. It also states that if the GSEs were not operationally capable to comply with the Interagency Guidance by September 30, 2007, they needed to adopt alternative controls or temporarily suspend the purchase and guaranty of loans subject to the Interagency Guidance. This action also indicates OFHEO's conclusion that certain aspects of the GSEs' activities in nontraditional loans represented a significant risk to the entities. We also went a step further than the bank regulators by telling the Enterprises that they had to apply the standards to the underlying mortgages that were in the PLS that they purchased. Therefore, OFHEO's action had a direct impact on the markets, making mandatory the guidance provided by the bank regulators.

PLS

During the first quarter of 2006, OFHEO informed Freddie Mac in a conclusion letter that "rapid expansion of the nonagency home equity asset-based security portfolio had outpaced the development of the attendant risk management infrastructure. OFHEO concluded that the governance and risk management framework was not adequate to support investments in nonagency ABS rated below AAA." Freddie Mac did not pursue investment in PLS rated below AAA.

During 2007, Fannie Mae launched a program to purchase up to $3 billion in PLS rated below AAA. OHFEO informed Fannie Mae's management that they had to limit their risk in this activity to no more that $500 million in these bonds, and then only after they implemented a satisfactory risk management infrastructure. Based on OFHEO's actions, Fannie Mae reversed its purchase of $2.4 billion in these bonds, and maintained a position below $500 million. Once they met the infrastructure requirements and began purchasing these bonds, OFHEO described some activities conducted by the traders as unsafe and unsound. The purchase activity ceased before they reached $500 million through OFHEO's direct intervention.

Risk Assessment Letters

Examples of OFHEO's concerns in 2006 of growing credit risk are below:

2Q2006 OFHEO Risk Assessment for Freddie Mac
"Credit exposures reflect moderately aggressive underwriting initiatives. Substantive exceptions or overrides to current underwriting standards exist. Enterprise Risk Oversight (ERO) has report to the Enterprise Risk Management Committee that the purchase and guarantee of higher risk mortgages from nontraditional sectors is expanding faster than the Enterprises' ability to develop requisite risk management and control capabilities. The credit policy function has not effectively and comprehensively defined existing credit risk policies and practices."

4Q2006 OFHEO Risk Assessment for Fannie Mae
"Credit risk is moderate and increasing due to purchase of untested or nontraditional mortgage products coupled with deficiencies in systems, reports, and risk measurement and management."

"Single Family credit risk is moderate due to risk management deficiencies, and increasing due to adverse trends in REO and losses, and plans for continued growth in higher risk products. Risk management requires improvement due to deficiencies noted in several departments which encompass policies, staffing, and report quality. Improvement is noted in Single Family Credit and several other departments, but full correction will require significant time and resources."

"Retained portfolio credit risk is low due to loss levels and products with favorable credit characteristics or sufficient credit enhancements. Systems limitations prevent or impede portfolio management, effective reports, and the securitization of most of the whole loan portfolio. Risk management for private label securities (PLS) improved but remained inadequate for PLS rated lower than AAA."

Supervisory Letters

Beginning in December 2006, OFHEO wrote supervisory letters, which served both to caution and direct Enterprise behavior, as the Enterprises began to fail the net income tests. Net income for the quarter ended September 30, 2006 was less than one-half of its average quarterly net income for the four-quarter periods ending June 30, 2006, March 31, 2006, December 31, 2005 and September 30, 2005.

In the November 2007 letters, we informed the Enterprises that their actions had been inadequate, their forecasts were optimistic and their dividends were excessive. We said that the Enterprises should consider a full range of options for restoring and protecting the capital surplus. Some options included:

- selling assets or not reinvesting runoff proceeds;
- limiting growth of the retained portfolio and/or credit guaranty business;
- reducing the common dividend;
- issuing preferred stock;

- issuing common stock; and,
- taking other remediation actions.

The April and June letters continued to push the Enterprises to raise capital. We also continued to require more extensive and realistic modeling of credit risk.

Summary

As I explained in my testimony, OFHEO and its successor agency, FHFA, were concerned about the growing credit risk and thin capital levels to support that risk. The Enterprises missions of providing stability, liquidity and affordability to the housing market was fatally compromised by the legislation that allowed them to be leveraged over 100 to 1. Without remedial legislation, which came too late, OFHEO used the tools available to constrain GSE growth, improve their internal controls and enhance risk management including credit, market and operational risk.

I would be happy to answer any other questions you may have. In particular, the future structure of the secondary mortgage market and the future of Fannie Mae and Freddie Mac must be addressed.

Sincerely,

JBLockhart

James B. Lockhart III

Cc: Phil Angelides
Chairman
Financial Crisis Inquiry Commission

Bill Thomas
Vice Chairman
Financial Crisis Inquiry Commission