MEMORANDUM FOR THE RECORD

Event: Interview with FHFA Director Ed DeMarco re: GSEs

Type of Event: Interview

Date of Event: March 18, 2010, 2:30-3:45 p.m.

Team Leader: Chris Seefer

Location: FHFA

Participants - Non-Commission: Alfred Pollard, FHFA General Counsel; Ed DeMarco, FHFA Director

Participants - Commission: Chris Seefer; Tom Stanton; Al Crego; Sarah Knaus

Date of MFR: March 24, 2010

This is a paraphrasing of the interview dialogue and is not a transcript and should not be quoted except where clearly indicated as such.

Summary of the Interview or Submission:

Chris Seefer opened the interview by thanking Mr. DeMarco for taking time to speak with the FCIC. He explained that the FCIC was established in May 2009 by the Fraud Enforcement and Recovery Act. This statute explicitly directs the FCIC to look into the role of the GSEs in the financial crisis. Chris Seefer continued, informing Mr. DeMarco about the FCIC hearing on April 9, which will focus on Fannie Mae and include testimony by former Fannie CEO Dan Mudd and former FHFA Director Jim Lockhart. Additional FHFA employees could be asked to testify. The FCIC is generally interested in discovering what OFHEO/FHFA knew about internal operations at the GSEs.

Mr. DeMarco asked for a detailed explanation of the scope and period the FCIC is interested in, as well as information about the FCIC's process. Chris Seefer replied that the FCIC is interested in the GSEs' role in the housing market, going back to the early 1990s. The Commission is trying to understand the GSEs role in the growth of the housing market and non-traditional products in that period. The investigation has focused on the post-restatement change in culture and approach during the Mudd reign. At the same time, Fannie lost market share as non-traditional portions of the market are growing. However, the FCIC would be interested in earlier information, to the extent that this can provide contextual details. The focus of the investigation is on Fannie probably because it is the larger of the two GSEs. Mr. DeMarco recommended expanding the scope of the investigation, and going further into the past to obtain a fuller context.

Background

Mr. DeMarco explained that he joined OFHEO on October 30, 2006 as the Deputy Director and COO. When Mr. DeMarco arrived at OFHEO, he thought it was “a bit of a Rip van Winkle.” He was a little surprised by the things that had taken place in the country’s housing system during the previous three years, when he served as the head of Policy and Research at the Social Security Administration.

Mr. Demarco began his government career with GAO, where he worked from 1989 to early 1994. In1989 Congress enacted FIRREA, which dealt with the savings and loans debacle. In this legislation, Congress required the General Accounting Office (GAO) and Treasury Department to produce research on the GSEs. At the time, Mr. DeMarco was a young economist at the GAO, who was struck by the risk-filled characteristics of this “strange set of institutions.” Through his research, Mr. DeMarco met Tom Stanton of the FCIC and some Treasury officials. Both Treasury and the GAO produced studies in 1990 and 1991 examining all GSEs, including the Home Loan Banks and Farm Credit System. Mr. DeMarco recalled that the first report to Congress he was involved with was on the risks of the GSEs. Additional reports were produced by the GAO and Treasury between 1990 and 2003, detailing the risks and challenges facing the GSEs. Mr. DeMarco left the GAO in early 1994, after working on a report published the previous year about the Home Loan Banking System. This report recommended the merging of OFHEO and the Federal Housing Finance Board to avoid the bifurcation of regulation, safety and soundness.

Mr. DeMarco joined the Treasury Department in 1994. In late 1999, Larry Summers caused controversy by using systemic risk in the same sentence as Fannie and Freddie. Treasury Department Under -Secretary [Gary] Gensler testified before the House Banking subcommittee about a bill introduced multiple times by Rep. Richard Baker (R-LA) on reforming GSE regulation. The Treasury Department “funnily enough” supported a number of the provisions in Rep. Baker’s bill. Mr. DeMarco was personally involved in everything to do with this testimony. After the hearing, Treasury was subjected to a great deal of backlash from supporters of the GSEs, including press clippings, GSE statements, and any number of their supporters in the world including on Capital Hill.

Mr. DeMarco remarked that the issues facing the GSEs in the late 2000s were not a new phenomenon. The entities were unstable and perversely incented institutions that just happened to collapse in 2007-2008. Mr. DeMarco found no pleasure in the fact that he spent a career warning about the potential for GSE collapse, only to arrive at OFHEO months before things imploded. Chris Seefer asked Mr. DeMarco if he was saying he predicted the GSE collapse, to which Mr. DeMarco replied using a saying from his father: even if you have the right of way, if that truck hits you you are still dead. He meant that there is no satisfaction from the collapse. Mr. DeMarco did not join OFHEO with the expectation that there would be such a severe problem, or that he would be a conservator eighteen months later. It is no secret that the battle and public policy tension over the GSEs has been going on for years.

In 1991, while Mr. DeMarco worked for the GAO, he recommended a single prominent regulator for all seven GSEs. He thought that the new regulator's wide range of authorities could attract a prominent official. A single regulator would also reduce the risk of being distracted by the demands of a single entity. Mr. DeMarco has authored reports and testimonies making all different recommendation for Congressional action to improve the GSEs.

Mr. DeMarco began at OFHEO as the COO, dealing primarily with daily operations, concentrating on the issues facing the agency after its rapid growth during the Special Exam period. Growing from a static 20-40 people, the agency infrastructure had not kept up with the expansion. He was already at OFHEO when Director Jim Lockhart joined in May 2006. The Special Exam Report of Fannie was released three weeks into Mr. Lockhart's tenure. Around this time, Mr. DeMarco said that a great deal of work was being done on the special exam, and follow-on work subsequent to the exam was underway in terms of legal and supervisory matters. This included putting Consent Orders, caps, and capital add-ons into place, all of which were tied to remediation. When Mr. DeMarco arrived at OFHEO, he said the focus of the agency was on the remediation of the financial and accounting systems at Fannie. These led to the restatements, which was a huge job for both Fannie and OFHEO. Until the completion of this process, questions were raised about the financial and accounting data during these years.

Although his timing may be off, Mr. DeMarco recollected that shortly before he began with OFHEO the banking agencies released their non-traditional guidance. In December 2006, OFHEO directed Fannie and Freddie to comply with all of the guidance terms, which greatly expanded the scope of the guidance by including the secondary mortgage market. Mr. DeMarco then jumped back in time in his narrative, to issues he warned he has not looked at for ten years. He said that HUD and Treasury published a report on subprime lending concerns in 1998. Mr. DeMarco was involved in it, but could not recall much about the report's details, other than that it reviewed the concerns of the day. However, according to Mr. DeMarco, subprime lending in 1998 was different from 2005. An OFHEO taskforce was put together to examine the issues of the non-traditional mortgage report, which Mr. DeMarco was not involved in. In 2007, he started to see the first wave of the financial crisis, and the need to deal with the subprime realm.

Tom Stanton explained that one of the FHFA employees previously interviewed stated that he was a former bank examiner and when he joined OFHEO and looked at Fannie, he realized it was the worst run financial institution he had seen in the career. Mr. DeMarco could not remark on Fannie's condition from the same perspective, because he does not have a bank examination background. However, during his tenure with OFHEO he observed that neither Fannie nor Freddie has the infrastructure, systems, control mechanisms, operational rigor and review one would expect from a major financial institution. One cause for this situation is the beneficial institutional arrangement and leverage the GSEs had through their charter, which offered Congressional protections including barriers to entrance. Over time, these protections affected corporate governance and discipline, and the lack of competition reduced the competitive imperative to be innovative to attract business investors for long-term business propositions. Mr. DeMarco remarked that the protection of Fannie's charter is an issue.

FHFA and OFHEO regularly pointed out the limitations in the GSE infrastructure. For example, Citibank, with its global operations and businesses, and for all of its troubles, ordered its financials for 2009 on January 19, 2010. Fannie and Freddie were nowhere close to ordering financials, which indicated they did not know where they were. Fannie also does not have the ability to report where they are at the end of every business day, as most other financial institutions can. Although the GSEs' remediation work for the restatement was a great improvement for the GSES, they still have a long way to go. According to Mr. DeMarco, the restatement raised questions about the quality of the operational employees at Fannie.

Tom Stanton interjected, asking for a ranking of the performance of various divisions of Fannie, including the MBS swap business, capital markets, political realm, across PR. Rather than speculating on a ranking for these businesses, Mr. DeMarco suggested that Tom Stanton look at the exam reports. OFHEO is unique because its exam reports and reports to Congress are public. The last seven Reports of Examination point to the deficiencies within Fannie's business divisions. In the April 2008 Report, Fannie was rated as having significant supervisory concerns, with particular questions about operational risk. The reports also detail concerns about IT infrastructure, excessive end-user computing, and too few controls. A lot of the remediation work addressed these concerns. Referring to the earlier interview again, Tom Stanton next asked whether any of the quality levels dropped to where it was unsafe or unsound for Fannie to do business. He also asked what was going on and why there were no cease and desist orders for the company. During Mr. DeMarco's time with OFHEO/FHFA, he did not recall a supervision team coming forward to say that transacting business would be unsafe or unsound for Fannie. There were particular transactions that the regulator was concerned the GSEs were running with too quickly, but these were not stopped. For example, Mr. DeMarco recalled taking one look at Fannie's purchase of AA private label securities, and realizing that the company was going outside of their written program of what they do.

Responding to a question from Chris Seefer, Mr. DeMarco affirmed that he reported to OFHEO Director Lockhart. Although both Mr. Lockhart and Mr. DeMarco came to OFHEO from the SSA, the latter was hired through a competitive process and interviewed by a panel.

Mr. DeMarco was involved with the regulation of Fannie while serving as COO. His focus turned to supervisory issues in summer 2007 when things began to melt down. A newly hired Director of Supervision had joined OFHEO in early 2006, prior to Mr. DeMarco's arrival. Mr. DeMarco shared a memory from a visit to Fannie during the first week of the crash in early

2007. He recalled that Mr. Lockhart was out of town. The meeting was held in a big room with Fannie's senior management, who were "apoplectic" that the market was becoming illiquid. They blamed OFHEO's caps and other regulations for putting the brakes on their efforts to provide liquidity. Fannie wanted to provide liquidity, because it was their purpose in life. Mr. DeMarco remembered these being heated discussions, which ended with OFHEO telling Fannie no. In late July or early August 2007, Fannie asked for caps modifications to allow them to purchase more loans for their own portfolio. OFHEO also rejected this request. According to Mr. DeMarco, in the following weeks and months there were a large number of Congressional inquiries and a great deal of pressure to allow Fannie to increase their involvement in and support of the mortgage market. OFHEO held off on granting the increase, because Fannie needed to complete mediation work to allow investors the ability to rely on timely audit statements. This was the story until March 2008.

Tom Stanton asked whether there was a summary of the number of Fannie employees and funding allocated to the remediation. Mr. Pollard recalled "something" at "some point" detailing the remediation costs.

At this point, Mr. Pollard reminded the room that the interview was scheduled from 2-3:30 and that both Mr. DeMarco and himself had events they needed to attend at four. The FCIC staff apologized for having their time written down incorrectly.

Tom Stanton continued the questioning, asking Mr. DeMarco about the Strategic off-site retreat for Fannie's Vice Presidents, which was documented in House Oversight documents. During one of these, there was a presentation on whether Fannie should stay the course with loan standards. The 2007-2011 Strategic Plan approved by CEO Dan Mudd states that Fannie had avoided taking risks, but now needed to learn how to manage greater risk. Stanton asked Mr. DeMarco whether he knew of this mindset at Fannie and whether OFHEO plugged into the process to make suggestions. This did not "ring any bells" for Mr. DeMarco.

Chris Seefer questioned Mr. DeMarco about disjunction between his earlier comments surrounding the "apoplectic" Fannie executives and the OFHEO press release documenting more flexible portfolio caps. According to Mr. DeMarco, this release was focused on a change in the basis for the portfolio cap. Although he was uncertain about the details, Mr. DeMarco explained that OFHEO changed the portfolio measure from GAAP numbers to the more stable UPB numbers. Mr. DeMarco considered this a technical change to reduce the amount of volatility in loans. The change also rebased Fannie and Freddie at the same place. Mr. DeMarco said that these changes were modest.

Chris Seefer explained that the FCIC had seen documentation of Fannie executive meetings with HUD, Treasury, and OFHEO about liquidity shock in July and August. He asked if this was something from OFHEO or if other government agencies were calling for OFHEO to let Fannie do business. Mr. DeMarco thought that it was an OFHEO and Fannie remediation issue.

OFHEO was being mindful that Fannie had a mission to provide liquidity to the marketplace, and this seemed to be an appropriate and prudent response to the conditions at the time. According to Mr. DeMarco, the Federal Reserve and Treasury were holding discussions with Fannie on the March 19, 2008 deal to reduce caps and lower capital requirements. Under the consent order, capital and portfolio limits would be reduced as Fannie progressed on these actions. In March 2008, events caused questions about whether the consent order requirements were too stringent. OFHEO decided to say that the announcement was tied to the completion of the remediation process. The regulator did not want the capital levels to decrease, which is why there was an agreement announced, which included the gradual stepping down of the capital add-on in exchange for the commitment and follow through to raise new capital and operate well above the capital limits. This was an acknowledgement to the marketplace that the consent order was completed, but that the entities needed to raise capital. Responding to a question from Chris Seefer, Mr. DeMarco stated that Mr. Lockhart was always careful to make sure that he had worked with the legal and supervision teams to ensure this was the action to take. He was concerned about getting the right balance and taking prudential actions to stay within the terms of loss, agreements, conditions within the marketplace, and comments from the Hill and other regulators. Mr. DeMarco also stated that Freddie went from 30 to 20 at the time, and to get below 20 they would have had to raise capital.

Chris Seefer next informed Mr. DeMarco that it had been reported that towards the end July and into August 2008, folks from the Federal Reserve and OCC came in to take a hard look at the GSEs. According to Mr. DeMarco, Morgan Stanley did not come in. The FRB and OCC were invited in to assist in an ongoing evaluation of the adequacy of the entities' reserves. FRB and OCC came in because they were looking at similar issues. Because banking standards and their rules of reserving were different, OFHEO benefitted from the comparison between what banking regulators were doing and what OFHEO was doing. Mr. DeMarco said that OFHEO realized they needed to improve their accounting department. The only differences Mr. DeMarco remembered were variances in loss recognition. He said that the important thing was not that they came in with differences, but that they emerged with a consensus about the criticality of the credit condition of these institutions and whether this constituted an action for conservatorship.

Chris Seefer next discussed the large increase in the level of credit risk that is prevalent in documents from October 2006 through the conservatorship. He asked if OFHEO/FHFA knew the level of non-traditional mortgage products. Mr. DeMarco said that the Director was reporting in speeches and testimony that Fannie's underwriting standards had lowered, and that the book of business was shifting. Mr. Lockhart also offered testimony and reports to Congress.

Mr. DeMarco stopped the questioning to inform the FCIC staff that he recently asked Mr. Pollard to initiate a systematic process of pulling relevant data and presenting it in the most helpful way. He would like to walk out of the interview with a better sense of what the FCIC is looking for. As Mr. DeMarco stated, the documents are going to say what they say. No one comes out of the financial crisis looking good, because everybody made mistakes. Mr. DeMarco wants to get it all out there.

Chris Seefer responded by asking what were the mistakes made in terms of the regulation of the GSEs. Mr. DeMarco answered that he like most everyone else recognized that underwriting standards were deteriorating, there were higher risk mortgages being booked, and the GSEs did not sufficiently acknowledge the risk they had. While it is easier to focus on the mortgage market, what was really happening was that household balance sheets were being overleveraged and the risk that this presented was not sufficiently appreciated by examiners. The prevalence of second mortgages, equity extractions, and the unsecured debt obligations of households essentially made the credit and default models useless. OFHEO and a lot of people did not recognize this.

Chris Seefer next asked Mr. DeMarco about a December 2008 a hearing on the GSEs and the roles in the financial crisis. In the testimony of Mr. Raines and Mr. Mudd, as well as what the FCIC is hearing from people currently being interviewed, the models assumed 10% declines in housing prices in 2008 and 2009 and spit out results that said it was not going to be good, but not make Fannie insolvent. However, these models did not feed in scenarios of 30-40% housing declines in certain parts of the country that significantly hurt the GSEs. What the FCIC is hearing is that the housing market's drop caused the collapse of the GSEs, not the undue credit risk and lousy models. Mr. DeMarco replied that he had just said that the GSEs were taking on riskier loans, their models were lousy, there was not enough capital, and the underwriting was worsening. From late 2007 until the conservatorship, Director Lockhart was making speeches and pleas to improve the supervisory tools available to OFHEO, including raising capital levels. Mr. Lockhart became quite well known for his PowerPoint deck detailing the elaborate risk taken by the GSEs. In fact, Mr. DeMarco stated that OFHEO had been saying this before Mr. Lockhart started. Perhaps OFHEO should have started warning earlier than it did, but it does have a record of it.

Tom Stanton next asked about the extent the restatement caused the GSEs and/or OFHEO to take their "eye off the ball" of the emerging market conditions. Although Mr. DeMarco cannot reply for the time before he joined OFHEO, he has thought a lot about the question. It would pass the reasonable test to say that it could have impacted the regulatory focus. There was a tremendous focus on the restatement. Fannie brought in thousands of outside contractors to work on the remediation. It is fair to say that the opportunity cost for the restatement was that they did not spend as much time looking at other things including the changing markets.

Chris Seefer asked whether OFHEO had the power to increase the capital limits for the GSE, which Mr. Pollard was to answer. Seefer continued by questioning whether OFHEO had the supervisory authority to limit growth in a certain type of product. Mr. DeMarco imagined they had the authority to say that. OFHEO had authorities and said repeatedly that Fannie's risk standards were inadequate. However, prudential authorities similar to the FDIC and OCC were not established until the conservatorship. This is part of the reason to fix the enabling statute that created OFHEO. Chris Seefer requested a verbal interrogatory listing of the regulatory authorities' bank regulators possessed different from OFHEO. Tom Stanton replied that Rep. Baker generated a similar list, as did GAO.

Housing Goals

Responding to a question from Chris Seefer about Fannie's mission, including meeting HUD's housing goals, Mr. DeMarco replied that these contributed to, but in no way excused GSE management for running the companies into the ground. At end of the day, managers and the Board of Directors have the responsibility to run the company. Fannie took on higher risk goals and riskier business, which was somewhat driven by housing goals. However, it is too simplistic to blame the whole collapse on them. For example, one of the books of business that contributed to the losses were the Alt-A loans, but Fannie could not use the low-doc or no-doc loans to meet housing goal because they did not know the background of the buyer. These loans could contribute to an underserved area goal but none of the others. This demonstrates that there is more going on than just the goals. Mr. DeMarco commented that when looking at 2004 housing goals, in some sense what HUD wrote speaks for itself. He also stated that no one at the GSEs ever told him they reduced underwriting standards to meet affordable housing goals.

Wrap-up

The discussion turned to the materials Mr. DeMarco's team would prepare for the FCIC. Chris Seefer stated that the best thing would be to go through the timeline and the documents that show what the concerns were and when. The FCIC is interested in the bigger picture questions going back to the early 1990s. Tom Stanton asked for details about governance, and how information traveled at Fannie, what the Board of Directors or others knew about the issues. He also said it would be helpful to understand how OFHEO was looking at these issues at that time. Another topic would be who at the company was looking at a book of business and saying here is how much capital we have to allocate to this book of business.

Mr. DeMarco stated that in the larger context as the situation is broken down, it becomes obvious that it is not easy in this town to say that the regulation of the GSEs was not working. He thinks that this is evidenced in the history of OFHEO, Treasury, GAO, and FRB saying there is not enough capital here and the response from Fannie and Congress is a waving of hands. Chris Seefer also asked for a timeline on these developments.

Tom Stanton asked about the 30% surcharge on the GSEs, to which Mr. DeMarco replied that when Mr. Lockhart arrived at OFHEO, neither the regulator nor the GSEs had adequate economic modeling. Mr. DeMarco added that he was quite insistent that work on this include a far more empirical, model-based approach to operational risk. Mr. Lockhart began an initiative to insist that the enterprises record operational risk. OFHEO tried to get into the Boston Fed's operational risk database, but had access issues. He was also pushing OFHEO to enhance economic modeling, which is not a fast change. The regulator started too late.

Tom Stanton finished with a question for next time, about the change in relationships when Mudd started at Fannie and how easy it was to regulate.

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