WRITTEN STATEMENT OF

DANIEL H. MUDD

BEFORE THE

FINANCIAL CRISIS INQUIRY COMMISSION

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Mr. Chairman and members of the Commission, thank you for the opportunity to appear before you today. I joined Fannie Mae as Chief Operating Officer in 2000, following a decade as a general manager at GE. In December of 2004, I began serving as interim Chief Executive Officer, and in June of 2005, the Board of Directors, with the approval of our regulator, elected me CEO. Throughout my time at Fannie Mae, the company and the U.S. housing market faced many challenges. During the early part of my tenure as CEO, I worked to improve the relationship between Fannie Mae and its regulator, to return Fannie Mae to timely filing with the SEC, and with that, to reestablish the company with a sense of purpose, value, and newfound humility. After the completion of one of the largest restatements in history, the company emerged to face the housing depression and financial crisis that is the subject today. Maintaining the delicate balance between profitability as a private company and service to a public mission became impossible.

Fannie Mae and Freddie Mac were established as financial institutions, restricted by law to the housing market, and tasked to provide financial liquidity to the housing market even when others chose to retreat. In 2008, the companies had no refuge from the twin shocks of a housing crisis followed by a financial crisis. In hindsight, though, less credit exposure to new homeowners, non-traditional products and regions of the country in economic downturn might have reduced losses. The companies are currently experiencing broad losses across the nation, across many economic sectors, and across all classes of loans, not simply newer products or those counting toward mission requirements.

There are subjects where I respectfully differ with former Treasury Secretary Paulson, but I do agree with his ultimate assessment that the cause of the GSEs' troubles lies with their business model. A monoline GSE structure asked to perform multiple tasks cannot withstand a multiyear 30% home price decline on a national scale, even without the accompanying global financial turmoil. The model allowed a balance of business and mission when home prices were rising. When prices crashed far beyond the realm of historical experience, it became "The Pit and the Pendulum," a choice between horrible alternatives.

Let me review the business model briefly. The GSEs' role in the housing market is not to originate mortgages—their role is to acquire mortgages originated by others in order to provide liquidity, to increase stability, and to assist in providing affordable housing to the American people. I would emphasize that the model, as codified in the GSE Charter Act, specifically prohibited the companies from participating in any business outside the secondary market, for affordable mortgages, in the United States. The GSEs, unlike other financial institutions, could not diversify—though one cannot overlook the fact that for many years that single market was attractive, growing, and profitable.

In addition to the general structure of the Charter, Congress and the executive branch (under various administrations) required the GSEs to take increasingly larger roles in fostering homeownership and affordable housing for underserved populations. This goal increased sharply, to the point that in 2004, 50% of the GSEs' business was required to be below median income levels, and this number increased to 57% by 2008, despite a decline in the overall market. In addition, in the realm of public and political opinion, the companies were challenged to support a variety of initiatives intended to increase homeownership on a local basis. There have been suggestions that Fannie Mae subordinated its mission to the pursuit of higher profitability, but I beg to differ. There may have been no way to satisfy 100% of the myriad demands for Fannie Mae to support all manner of projects, housing goals which were set above the origination levels in the marketplace, or ultimately, the affordable housing fund passed by Congress, which required an additional levy on earnings to support state housing agencies. That said, I want to assure the Commission that in my observation, Fannie Mae devoted enormous time and resources in a good faith effort to meet its many mission requirements. I assumed no bias to mission or business—I assumed the two had to be well balanced through time.

That balance included a fiduciary responsibility to our investors—the shareholders to whom the government sold Fannie Mae in 1972, and the global bondholders who chose to invest their funds in U.S. housing finance. Without earnings, the GSEs would not have been able to attract capital, to post reserves, to finance affordable housing projects, or to perform the function of channeling global capital flows into U.S. homeownership.

In order to succeed in the global financial marketplace, while limited to a single segment of the domestic marketplace, the GSEs had to deal with the market as it was, not as they wished it to be. Certainly, the traditional sweet spot of the Agency business model was the 30-year fixed rate mortgage. Beginning in the late 1990s and increasing throughout 2007, however, the market moved away from traditional products and the GSEs. More and more homeowners no longer wanted traditional 20% down, 30-year amortizing loans. The market moved into, and beyond, innovative new structures. Fannie Mae's market share fell from its historical level of approximately 40% to nearly 20%, as the private sector, including banks, Wall Street and mortgage specialists, entered the market. In 2003, Fannie Mae's estimated market share of new single-family mortgage-related securities issuance was 45.0%. By 2006, it had fallen to 23.7%. It became clear that the movement towards nontraditional products was not a fad, but a growing and permanent change in the mortgage marketplace, which the GSEs (as companies specialized in and limited to, the mortgage market) could not ignore.

It was a continuous debate, and many within Fannie Mae hoped for the simpler transactions of the past. Others concluded that to ignore the needs of the evolving marketplace would have been to fail our mission and ignore the very purpose of our Charter. The middle course was to maintain a preference for, and a focus on, the 30-year mortgage, but to develop capabilities, models and understanding in the event our bread and butter became a relic of the past. Fannie Mae chose the middle course. Fannie Mae created specialty groups, including a subprime group led and staffed by experts in the field, to build structures and risk management controls to support our participation in this market.

This did not happen overnight. And, there was no one momentous decision to enter this market. Rather, this was a long-term, continuous, and measured move. Fannie Mae had participated in subprime and Alt-A products since at least as early as the 1990s. With the market growing in these areas, Fannie Mae's participation grew as well, but we felt it was time to build out specialized capabilities rather than to assume all mortgages would be alike.

Fannie Mae maintained high underwriting standards for these products. Fannie Mae did not accept every type of mortgage that was originated by the market. Wall Street and other private subprime and Alt-A mortgages have default rates that have significantly exceeded those of Fannie Mae-guaranteed subprime and Alt-A loans. As of August 2008, Fannie Mae's Alt-A guaranteed book of business had more favorable credit characteristics than the loans backing private label Alt-A securities and was performing better across all vintages. For example, private label Alt-A securities issued during the years 2005, 2006, and 2007 were defaulting in a cumulative rate of 2.8%, 3.04%, and 0.99%, respectively. By contrast, Fannie Mae's Alt-A guaranteed book of business had lower default rates of 1.26%, 1.29%, and 0.41%, respectively.

While the market was changing, Fannie Mae struggled to meet aggressively increasing HUD goals. The goals were extremely challenging, increased significantly every year, and permitted no leeway to account for the changing lending environment. For example, in years where low rates drove a surge of refinancings, the GSEs' goals denominator spiked, and the companies had to struggle to find goals loans to keep the denominator proportionate. Certain mortgages that may not have met our traditional standards could not be ignored. Fannie Mae attempted to acquire these prudently and with greater fees and credit enhancements to offset the added risk.

By 2006, Fannie Mae was engaged in a continual struggle to balance all of the requirements of the public mission, along with all of the duties owed to the shareholders. Fannie Mae was required to expand lending, to conserve capital while providing liquidity, to meet housing goals for the underserved, and to serve shareholders and homeowners alike. Perhaps we should have gone to the government and gotten a clear answer to the question: Do you want more capital or more lending? Yet, Fannie Mae, with the guidance of the Treasury, the Fed, and its regulator OFHEO/FHFA continued to struggle to operate a business model chained to a market that was in freefall.

Starting in 2007, with the turmoil in the monoline insurance industry, the failure of subprime mortgage originators, and the first nationwide decline in average U.S. home prices since the Great Depression, the financial sector grappled with what most observers view as the worst conditions ever seen in the modern capital markets. While Fannie Mae had made much progress in strengthening its controls, procedures, and practices before this tsunami hit, the business was not immune to the shocks of 2008. To be sure, no financial institution was. Firms that survived both World Wars and the Great Depression were swept under as market conditions continued to worsen. Bear Stearns was liquidated into JP Morgan. Countrywide was sold. Lehman filed for bankruptcy. Merrill was combined into Bank of America. AIG was downgraded. Washington Mutual failed. The Dow dropped 500 points in a single day. The Bank of England lowered rates to a level last seen in 1694. And, in 2008, the GSE model became, in hindsight, "The Pit and the Pendulum."

In the midst of turmoil, virtually every other investor fled the market, and the GSEs were specifically required to take up the slack. This role had survived several recessions, the Russian debt crisis of 1998, and the aftermath of 9/11. Through the spring and summer of 2008, my colleagues and I worked with government officials, regulators, our customers in the banking system, housing advocates, and others to maintain the excruciating balance between providing liquidity to keep the market functioning and protecting Fannie Mae's regulatory capital. Until the time that the government decided to impose conservatorship, OFHEO stated that Fannie Mae had maintained capital in accord with the relevant regulatory standards, and we were still—along with Freddie Mac—the principal source of lending to the mortgage market. Based on ongoing examinations and frequent, if not daily meetings, our regulator had declared us in full compliance with our capital requirements throughout the period. We were also balancing our HUD housing goals, our role in the global capital markets, our fiduciary responsibility to our shareholders, and critically, our need to help individual homeowners afford their mortgages, stay in their homes, and avoid unnecessary foreclosures. We sought this balance consistent with a strict interpretation of our Congressional Charter.

As crisis became havoc, Fannie Mae was called upon by the Administration and Congressional leaders from both sides of aisle to refinance subprime borrowers who could qualify for a fixed rate loan. The GSEs were asked to take the lead in providing modifications. They were asked to provide warehouse loans by lenders who had previously screamed "foul" at the idea of Fannie or Freddie entering that market. They were tasked with providing liquidity to the jumbo market. From other corners, Fannie and Freddie were variously pushed to raise capital, protect against losses, earn outsize returns, rescue more borrowers, and cut costs. The extremes—cutting off liquidity to protect our balance sheet or voiding our securities to rescue every homeowner—were not options. I sought to balance the fine points of mission and business, insofar as I understood them, with the support of regulators and policymakers. This was no longer the case by September 6, 2008.

I cannot comment on the events, status, or numbers for Fannie Mae since that time, because as all agree, the companies are now being operated to implement public policy. As I have tried to explain, a considerable portion of my energies went into balancing the increasingly conflicting demands of the business model. That notion of balance is now a thing of the past, as shortly after conservatorship, the regulator declared BOTH the housing goals AND the capital requirements invalid.

I believe that, in retrospect, there was overinvestment in housing. Origination standards slipped. There was too little skin in the game. Homeownership rates probably rose too high. Ultimately, homeowners became homebuyers. I wish I could have maintained the delicate balance of the roles assigned to Fannie Mae, and I am sorry that I could not. It is possible, in all this, to forget the positive achievements of my former colleagues. Fannie Mae financed tens of millions of homes for American families of low-to-moderate income. In the days when the yawning gap in homeownership between white and minorities was an issue of national concern, Fannie and Freddie narrowed the difference. Fannie Mae did this while earning a competitive return and providing a profitable and unique service to the mortgage market. And, in those years when the company did well, Fannie Mae was proud to support organizations that revitalized communities, helped the homeless, sheltered hurricane refugees, and provided our veterans with homes to return to. Most recently, the GSEs filled the vacuum left when the private sector fled the market in the face of this crisis. I hope the good that was done will not be forgotten as we weigh the lessons of 2008.

It is impossible to plot a future course for Fannie and Freddie without understanding what we want to accomplish in housing our citizens, and what we are willing to risk to achieve it. I hope there is an opportunity to engage in a debate about the future structure of the U.S. housing finance system. There was a lasting consensus going back to the Great Depression that homeownership was an unequivocal good for society, communities, and families. Absent some new consensus, there is little basis on which to decide whether we want GSEs or not. Government entities created to support homeownership as a social good will tend to socialize the risk to all taxpayers. Purely private companies will tend to exercise their fiduciary responsibility to pass the costs and the risks to homeowners. Hybrid organizations will be left to balance conflicts between taxpayers, homeowners, and shareholders. There are no simple answers. I appreciate the Commission's work to understand the causes of the current crisis. Thank you for your attention.