THE FINANCIAL CRISIS INQUIRY COMMISSION

Official Transcript

Commission Hearing

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COMMISSIONERS

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Pages 1 - 262

C O N T E N T S

SESSION 2:

OFFICE OF THE FEDERAL HOUSING ENTERPRISE OVERSIGHT

P R O C E D I N G S

CHAIRMAN ANGELIDES: Good morning. The meeting of the financial crisis inquiry division will come to order. For those of you who have watched over the past two days we have been examining the issues of subprime lending and securitization and how they might have affected the financial crisis and contributed to the financial crisis that has gripped our country.

Today we will be examining what occurred at Fannie Mae and its regulator, OFHEO, the Office of Federal Housing -- Federal Housing Enterprise Oversight, and its successor agency, the FHFA, the Federal Housing Finance Agency.

This morning we will be hearing from Mr. Daniel Mudd and Mr. Robert Levin, who were with Fannie Mae, and so thank you very much, gentlemen, for joining us this morning.

I'm going to start off by asking you to do what we have customarily done with all witnesses to date, and we will do with all witnesses from here on forward, and that is to ask you both to stand so I can administer the oath to you.

Do you solemnly swear or affirm, under penalty of perjury, that the testimony you're about to provide the Commission will be the truth, the whole truth, and nothing but the truth to the best of your knowledge?

MR. MUDD: Yes, I do.

MR. LEVIN: I do.

CHAIRMAN ANGELIDES: Thank you very, very much.

Now, we are going to start this morning by asking each of you to give an oral opening statement. We have your testimony in hand, and we thank you for that. We'd like you each to take no more than ten minutes for your oral statement.

And, Mr. Levin, we're going to start with you today. And so we're ready for your testimony.

Before I start, though, Mr. Vice Chairman, would you like to make any opening remarks this morning?

VICE CHAIRMAN THOMAS: No, thank you, Mr. Chairman. But I would take the opportunity, as is usual with me, to ask you that if over the rest of the Commission's existence we have reason to continue discussion over the material that you presented, would you be willing to respond to written questions in a timely fashion and in an ongoing way?

MR. MUDD: Yes, sir.

MR. LEVIN: Yes.

VICE CHAIRMAN THOMAS: Thank you. Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: All right. Mr. Levin, proceed.

MR. LEVIN: Thank you.

CHAIRMAN ANGELIDES: Oh, and by the way, one last item. You'll see a light in front of you, and when it gets to one minute, if you see these little lights on the table, it will move to yellow with one minute to go and red when time is up.

MR. LEVIN: Thank you.

VICE CHAIRMAN THOMAS: And that just flip them to off.

MR. LEVIN: Thank you. Mr. Chairman, Mr. Vice Chairman and distinguished commissioners, thank you for providing me the opportunity to appear before you today to assist the Commission in examining the causes of the financial crisis.

As you know, I submitted to the Commission a written statement in advance of this hearing, and I will not repeat the more detailed explanation, but I thought I would highlight a few of my thoughts now. I'm happy to provide whatever assistance I can.

VICE CHAIRMAN THOMAS: Mr. Levin, if you would move the mic a little closer, they're very sensitive and directional, is the light on --

CHAIRMAN ANGELIDES: Is the light on?

VICE CHAIRMAN THOMAS: Is the light on, on the mic?

MR. LEVIN: There's a green light.

VICE CHAIRMAN THOMAS: Yeah, it just needs to be a little closer.

CHAIRMAN ANGELIDES: Good.

MR. LEVIN: Okay, thank you.

CHAIRMAN ANGELIDES: We'll start your time over. Good, sir.

MR. LEVIN: Okay. Oh, I'm sorry.

CHAIRMAN ANGELIDES: Good, now, yes.

VICE CHAIRMAN THOMAS: It sounds better.

CHAIRMAN ANGELIDES: It sounded like a very weak mic. All right.

MR. LEVIN: It's now -- it's now --

CHAIRMAN ANGELIDES: We'll start over. Good morning, Mr. Levin.

MR. LEVIN: Yes, thank you.

CHAIRMAN ANGELIDES: Let's go ahead and -- and start over and let's go.

MR. LEVIN: Okay. Start over, from scratch, sir?

VICE CHAIRMAN THOMAS: Sure.

MR. LEVIN: Okay. Mr. Chairman, Mr. Vice Chairman and distinguished commissioners, thank you for providing me the opportunity to appear before you today to assist the Commission in examining the causes of the financial crisis.

As you know, I submitted to the Commission a written statement in advance of the hearing, and I will not repeat the more detailed explanation, but I thought I would highlight a few of my thoughts now.

I'm happy to provide whatever assistance I can and will do my best to answer all of your questions to the best of my ability.

I was at Fannie Mae for 27 years until my retirement in August 2008. And while I left Fannie Mae prior to the takeover and the imposition of conservatorship, I continued to work as an advisor to senior management for about six months at the request of the new CEO.

At Fannie Mae I was privileged to work with many fine individuals and organizations, including mortgage lenders, community groups, housing organizations, and other stakeholders to help Americans achieve the dream of homeownership and affordable rental housing.

My pride at the contributions of Fannie Mae has understandably been overshadowed by the events that give rise to this hearing.

From my perspective, Fannie Mae was engulfed by an unprecedented decline in home prices and resulting dislocations in the housing markets. And these were truly catastrophic.

While some people foresaw a correction, few, if any, predicted the unusually rapid and devastating destruction of real estate values that occurred.

In hindsight, if we, in the industry, as a whole, had been able to anticipate the nature and extent of the crisis that engulfed the market, it is clear that we all would have conducted our business differently during this period. But we, like everyone else, were surprised by the unprecedented extent of the economic crisis.

However, Fannie Mae, unlike other financial institutions, was res- -- was restricted to one class of assets because of the charter, and thus we took the brunt of the crisis head on.

At the same time, the global economy was in the middle of a liquidity and credit crisis that damaged the capital markets. Shortly thereafter, unemployment rose.

This extraordinary upheaval in the economy and in the mortgage market in particular, challenged Fannie Mae in ways that would have been difficult to overcome regardless of any business decisions that preceded the crisis.

As the Commission is aware, Congress created Fannie Mae as a government-sponsored enterprise and, as such, we had a variety of important stakeholders, which included the Congress, our mission and safety and soundness regulators, private shareholders, debt and MBS investors, mortgage lenders, housing organizations and others.

As a private company, Fannie Mae raised capital from investors and sought to provide them with a competitive rate of return.

As a company with a public purpose, Fannie Mae sought to ensure the liquidity of the mortgage market, its only permissible line of business, and to promote affordable housing, which also included meeting government-mandated housing goals.

The housing goals were set forth in Fannie Mae's charter act. Some of the goals related to our single-family business, some related to multi-family.

In general, certain goals required that a specified percentage of our business be for families at lower income levels, and other goals required that a specified percentage of our business be in -- be located in certain places in the country that were considered underserved.

HUD increased these goals from time to time, frequently requiring levels of affordable housing in underserved market business that were higher than what our market naturally produced.

In response, the company engaged in efforts to create business to help us meet the goals. These efforts included outreach programs and the application of different underwriting and pricing standards.

Part of Fannie Mae's business in the secondary mortgage market was to purchase and securitize mortgage loans created by lenders. Fannie Mae's influence on the type of loans that lenders originated often changed depending upon market conditions and the availability of alternative sources of capital for lenders.

When Fannie Mae was one of the principal sources of capital in the mortgage market Fannie Mae's influence was greater. When other sources of capital were more plentiful, as in the period prior to the crisis, Fannie Mae's influence was diminished.

Fannie Mae and the other GSEs were unique.

We took our duties to our shareholders and our public missions very seriously.

Throughout most of my 27 years at Fannie Mae, the company was able to balance successfully its potentially conflicting objectives. However, this was more difficult when the markets experienced significant change and during periods of great stress in the system.

The growth in the last decade of the private label mortgage-backed securities market is one such change that had a significant impact on the mortgage markets and Fannie Mae.

Private label securities, or PLS for short, are mortgage-backed securities issued by entities other than Fannie Mae, Freddie Mac, and Ginnie Mae. PLS financed three main types of mortgage products, subprime mortgages, Alt-A mortgages, and jumbo loans.

In 2003, which was also a year of heavy refinance activity, the size of the PLS market was about half of the size of Fannie Mae's security issuances. In 2004, that changed dramatically. The PLS market increased and Fannie Mae decreased. Dollar volumes of PLS exceeded that of Fannie Mae MBS and almost reached the levels of Fannie Mae and Freddie Mac combined. In 2005 and early in 2006, that trend continued with the dollar volume of PLS issued exceeding the MBS issue by Fannie Mae, Freddie Mac, and Ginnie Mae combined.

The effects of PLS on Fannie Mae's business were significant. Our business activity relative to the overall market declined dramatically during this period of time.

Secondly, many of the new products funded by PLS have features that attracted low income borrowers, which threatened our ability to meet our mandated housing goals. Fannie Mae had never previously experienced market changes of the magnitude that we were seeing during this period.

There was an article in 2006, in a publication called Mortgage Banking, which I quote in my written statement, which summarized the significance of these trends. And to briefly quote it here, quote, a change in the mortgage-backed securities market that began more than two years ago appears to have completely reshuffled the industry's deck of cards.

Now issuer -- issuers of PLS are holding the aces that were once held by the government-sponsored enterprises, Fannie Mae and Freddie Mac. Once a junior, the powerful player in the market, PLS are now the leading force driving product innovation and net overall volume of mortgage origination. Further, it appears that the new, dominant role for private securities may be here to stay, unquote.

The PLS phenomenon and the resulting consequences for our business confronted Fannie Mae with critical strategic questions. First, were the changes temporary or were they permanent, and second, would we best be able to deliver competitive returns to shareholders, stay relevant to customers, and meet our mission requirements by doing nothing new or by increasing our participation in these markets to some degree.

These and related questions were the subject of continuous and serious discussion and in-depth analysis by the Fannie Mae management team and the board of directors over the last decade.

We address these issues in a series of dedicated strategic planning sessions as well as -- as well as day-to-day discussions. We consider the credit risks and the new markets, our capabilities to manage business, and the impact on our achievement of housing goals, our financial results, and our strategic positioning in the marketplace.

These considerations led management to expand Fannie Mae's already existing Alt-A business incrementally over time. In implementing these decisions, management continued to mitigate risk by applying underwriting standards that were more conservative than the standards prevalent in the market at the time.

Although Fannie Mae's Alt-A books sustained disproportionate losses, it did perform better than the market and sustained smaller losses than otherwise might have occurred.

Our involvement in the subprime market was minimal. It primarily consisted of the purchase of the Triple-A-rated private label securities secured by subprime loans, and these purchases contributed greatly to housing goal objectives.

With the benefit of hindsight, had we anticipated the extraordinary market meltdown, we would have been far less likely to expand our involvement in these nontraditional products.

We began to reduce our participation in the Alt-A market in 2007 as the market and our business took a turn for the worse. We tried to balance the pace of our withdrawal with our public mission to provide liquidity, a critical function, as the PLS market had dried up.

CHAIRMAN ANGELIDES: Can you wrap up, Mr. Levin, please?

MR. LEVIN: Yes, sir.

In closing, an unprecedented decline in home prices, a high unemployment rate, a global liquidity and credit crisis engulfed Fannie Mae and its only line of business, the secondary market from mortgages.

These crises were centered on our market and our asset class, and we took the full brunt of the market crisis head on, which would have been difficult for the company -- company to deal with under any circumstances.

Thank you. I'm pleased to answer any questions that you have.

CHAIRMAN ANGELIDES: Thank you very much. Mr. Mudd?

MR. MUDD: Thank you, Mr. Chair, Mr. Vice Chairman. I've had the opportunity to watch some of the Commission's proceedings this week, and having submitted remarks which cover a broad array of topics, I'm going to try a little bit to tailor my remarks to some of the issues that you've been pursuing. And thank you for the opportunity to appear today.

I joined Fannie Mae as the chief operating officer in 2000, following a decade at GE in December of `04, I served as interim chief executive officer. In June of `05 the board of directors, with the approval of our regulator, named me the CEO.

During my time at Fannie Mae, the company and the U.S. housing market faced many challenges. During the early part of my tenure, I worked to reinvent the company and move forward with a sense of purpose and value and humility.

I worked to improve the relationship between Fannie Mae and its regulator, the former OFHEO, and to return Fannie Mae to timely filing status with the SEC.

After the completion of that, one of the most complicated restatements in recent history, the company emerged to face the housing depression and the financial crisis, and it did not survive.

I want to be clear, I was the CEO of the company and I accept responsibility for everything that happened on my watch.

Over the past couple of days I've heard Mr. Greenspan assign himself a 70/30 rating, and I believe the Chairman gave himself a 51/49 rating. I am envious. My experience was that during the crisis of 2007 and 2008, at the GSEs it was virtually impossible to get on the positive side of that ratio because so many decisions were a choice between unsavory alternatives.

Certainly Fannie Mae endeavored to be best in class and to continuously improve our business. We hired talented executives to build world-class risk management, modeling capabilities, maintain strong controls, and comply with regulations.

I did the best that I knew how to consider alternatives, to develop processes, to listen to critical voices, and ultimately to try to predict the perilous path of the housing market.

I could not do what a private firm could do, leave the market, close the window, or short mortgages. The GSEs have to stay in the market, provide liquidity, and obviously were structured to be long-only mortgages.

The GSE structure required the companies to maintain a fine balance between financial goals and what we call the mission goals. On one hand, without revenue and profits and growth, the company could not attract global capital to the U.S. housing market, and on the other hand, without meeting the mission goals for affordable housing and liquidity, the GSEs could not meet the requirements of their congressional charter.

Thus I agree with former Treasury Secretary Paulson's ultimate assessment that the root cause of the GSE's troubles lies with their business model. A mono-line -- GE -- GSE, asked to perform multiple tasks, cannot withstand a multi-year 30 percent home price decline, on a national scale, even had it been without the accompanying global financial turmoil.

The government-sponsored enterprises were able to balance business and mission when home prices were rising. They could perform when home prices were flat. They could survive a 30-year flood, but not 2008.

As you know, the GSEs acquire mortgages in the secondary market to promote liquidity, stability, and affordable housing for the American people.

The congressionally created GSE businesses were specifically prohibited by law from participating in any business outside the secondary market for mortgages in the United States.

Unlike other financial institutions, this left the GSEs unable to diversify and, therefore, to avoid losses stemming from any U.S. housing finance crisis, and 2007 to 2010 was not merely a housing crisis, we witnessed a market collapse, a collapse of the only market that the GSEs were in.

Starting in 2007, the financial sector grappled with what most observers view as the worst conditions ever seen in the modern capital markets. In the midst of turmoil, virtually every other housing sector investor fled the market and the GSEs were specifically required to take up the slack.

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 the liquidity to keep the market functioning and protecting Fannie Mae's regulatory capital.

Until the time the government imposed a 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 into late August 2008, our regulator continued to declare us in full compliance with our capital requirements.

We were also balancing against our HUD housing goals, our role in the global capital markets, our fiduciary responsibility to our shareholders and, critically, the need to help individual homeowners afford their mortgages, stay in their homes, and avoid unnecessary foreclosures. And we sought this balance consistent with a very strict interpretation of our congressional charter.

As the crisis became havoc, Fannie Mae was called upon by the administration to refinance subprime borrowers who could qualify for a fixed rate loan.

The GSEs were asked to provide the lead in providing modifications. They were asked to provide warehouse loans by lenders who had previously resisted the idea of Fannie or Freddie entering that market. From other corners, Fannie and Freddie were variously pushed to raise capital, earn returns, rescue more borrowers and cut costs.

I sought to balance the fine points of mission and business, insofar as I could understand them, with the support of regulators and policy makers. That was no longer possible by September 6th, 2008, and I am sorry for that.

Since that time, as all agree, the companies have been operated to implement public policy. As I've tried to explain, a considerable portion of my energies went into balancing the increasingly conflicting demands of operating an enterprise sponsored by the government. That notion of balance is now a thing of the past.

Shortly after conservatorship the regulator declared both the housing goals and the capital standards invalid.

I believe, in retrospect, that there was overinvestment in housing. I believe, in retrospect, origination standards slipped. There was too much intermediation. There were too many middlemen. Homeownership rates probably rose too high.

The GSEs were chartered to expand and increase homeownership while operating as private companies. In doing so, they contributed to the crisis but they did not precipitate it.

Let me end by suggesting that homeownership remains essential dream for many Americans. I believe that once this crisis is behind us, the fundamental and solid economics of homeownership will reassert themselves. And I hope, in that, there's an opportunity to engage in the future structure of the housing finance system.

There was a lasting consensus in this country, really going all the way back to the Great Depression, that homeownership was a net good for individuals, for communities, and for the country at large.

Absent some new consensus, I fear it will be difficult to choose between competing models for a new housing finance system. Government entities created to support homeownership as a social good will tend to socialize the risk to all taxpayers.

Purely private companies will exercise their fiduciary responsibility to pass the costs and the risks to homeowners.

Hybrid organizations, such as a GSE, will be left to balance conflicts between taxpayers and homeowners and shareholders. There are no simple answers.

I appreciate the Commissions' work to understand the causes of the crisis and I thank you very much.

CHAIRMAN ANGELIDES: Thank you very much, Mr. Mudd and Mr. Levin. We will now proceed to questioning by Commissioners. I will start with some questions today before we move on, and so let me just move into this.

EXAMINATION BY CHAIRMAN ANGELIDES

CHAIRMAN ANGELIDES: So, really, to either one of you or both of you, in each of these questions I'm going to put some facts on the table for the public and for you. According to your SEC reports, the 2009 Form 10-Ks, Fannie Mae reported about 134 billion dollars of net losses in `08 and `09, most of which were driven by credit-related expenses, loan losses, which totaled more than 104 billion dollars in credit losses, which totaled more than 40 billion dollars.

If you look at the losses, very significantly, they come from loans with higher risk product features, Alt-A, subprime, interest-only, loan-to-value of 90 percent-plus, loans with FICO scores of less than 620, that were originated in 2006 and 2007.

At the heart of it, looking back on that business decision, would you kind of go to the thinking behind the -- your thinking behind, as leaders of this organization, that really the dramatic expansion in these higher risk products in that 2006, `7 period, what was at the core of the decision to move more dramatically into that arena?

And just for the edification of you and others I guess, as you look at losses, for example, in losses in `07, all loans, the selected higher risk product features constitute, I believe, 29 percent of the loans with 58 percent of the losses; in `08, 28 percent of the loans, 75 percent of the losses; 19 -- 2009, 24 percent of the loans and 69 percent of the losses.

MR. MUDD: Mr. Chairman, certainly the -- the -- the higher risk loans put on the books closer to the time that the -- the underlying home market collapsed were the worst performing and were the -- were the first to go.

So if you could go back retrospectively and look across the book of loans, I think anybody could -- anybody could say that in particular, the Alt-A book is, as you pointed out in your data, a source of the difficulty.

The thinking -- the thinking goes back over a period of time. And just as a bit of context, the company had come out of a period where, through the `90s, Fannie Mae was really the dominant force in the marketplace.

And during the period of the restatement, that had slipped on one hand, and on the other hand, the market had developed a number of ways to go around, and any mortgage was a Fannie Mae mortgage, and an Alt-A mortgage stood for nothing more than an alternative to a -- an alternative to a Fannie Mae mortgage.

So there were a number of -- a number of studies, questions, process to look at the market and to determine whether the features that went with Alt-A mortgages were things that we had been asking for, for ten or fifteen or twenty years that were no longer relevant to the market.

CHAIRMAN ANGELIDES: Pull the mic into you.

MR. MUDD: Oh, yes, sir, I'm sorry.

CHAIRMAN ANGELIDES: Yeah.

MR. MUDD: Or whether they -- whether they were -- whether they were key data that were still needed, what were the variances between the A market and Alt-A market and so forth.

And overriding that, a broad -- a broad concern that under the continuation of these trends, Fannie Mae and, by derivation, Freddie Mac's role in the market would be less relevant.

So there was a sort of a strategic question of relevance that went to that, led us to use the data that we had to study the market, and develop a plan to understand it, go in prudently, buy some securities, get the data, look at the data, develop some experts that understood how the market operated, look at the originators, do business with those we knew, and we built it out from there.

It was a reflection of the growth that Mr. Levin described in his statement of that whole segment of the market, but that portion of the book grew; it grew along with the market.

CHAIRMAN ANGELIDES: Let me ask, very specifically, your market share in 2002 was of the mortgage market about 29.4 percent; 2003, 36 percent; 2004, 24.8 percent; 2005, 19.6 percent. Was this -- and I don't want to tilt it, I want to ask, of the things you laid out, in terms of your considerations, was it market share, competitive position that drove you or mission-related items that drove you?

MR. MUDD: Well, it was --

CHAIRMAN ANGELIDES: And I -- I would actually like to ask you and you, also, Mr. Levin.

MR. MUDD: Sorry. I would say it was a combination of those things, but I would say that we did not consider market share itself to be a primary output, right.

So market share, to me, is kind of a

secondary indicator of our -- do you have a role in the market or are you -- are you remaining relevant to the market. I mean, it's really a very fine point.

CHAIRMAN ANGELIDES: So if that's secondary, what's primary?

MR. MUDD: Primary is the mission component in the business. So, are we -- are we -- are we performing our mission, are we in the markets that we're supposed to be in, is homeownership growing, on one hand, and on the other hand are we maintaining capital, are we earning a fair return for our investments, are we managing the financial side of this.

CHAIRMAN ANGELIDES: And I'm asking –you to weigh these, so you’re saying market share is not the driver unto itself, but then let me take the two mission-related, and to be clear, you're not necessarily talking about public-policy-related, but it could include that; you're talking about your corporate mission at large.

And you are saying, obviously, return on equity to shareholders, profitability growth, and then homeownership mission. How would you weigh those?

MR. MUDD: I always try to weigh them about equally over the course of time. Obviously, on any given decision, you could move one thing up or one thing down.

CHAIRMAN ANGELIDES: All right. Mr. Levin?

MR. LEVIN: I'm sorry, I would repeat.

CHAIRMAN ANGELIDES: Can you pull that microphone in close?

MR. LEVIN: Sorry, I'll get better as we go along.

The -- I would repeat, I think, the items that Mr. Mudd said. I think the major macro driver was this growth in the private label securities market, which ultimately became larger in issuances than Fannie Mae and Freddie Mac and Ginnie Mae combined.

And that was the main cause behind the numbers that you went over about our share of the market.

CHAIRMAN ANGELIDES: So competition from Wall Street, bluntly stated?

MR. LEVIN: That impacted -- that impacted our market position --

CHAIRMAN ANGELIDES: Right.

MR. LEVIN: -- dramatically.

Also dramatically impacted our ability to influence what was going on in the market because of the competition.

And it posed a number of threats to the company. And it posed a financial threat because there was just simply less -- less business that was coming into our market. The business was going into another market.

It posed a mission threat, because many of the products that were financed by PLS had affordability features and so it threatened our ability to meet our government -- government-mandated housing -- housing goals.

It also threatened our relevance with our customers. And I -- you know, I recall a customer saying, you know, to the degree I'm doing less business with you, why should I invest in my own company resources to continue to do more business.

CHAIRMAN ANGELIDES: And that person would be?

MR. LEVIN: That was a -- that was a conversation I had with the multi-family side.

CHAIRMAN ANGELIDES: Oh, okay.

MR. LEVIN: You know, which also affected by this same --

CHAIRMAN ANGELIDES: All right.

MR. LEVIN: -- same influence -- same

influence. I just happened to recall that conversation.

And -- and, you know, and then overall, there was such a strategic positioning in the marketplace.

And so those were the strategic issues that we were confronting and that we were trying to deal with, you know, along with associated issues of, you know, to what degree was this phenomenon permanent, you know, to what degree was it temporary. You know, could we really sit out, would we be permitted to sit out; that's what we were grappling with.

CHAIRMAN ANGELIDES: Right.

MR. LEVIN: We --

CHAIRMAN ANGELIDES: Let me see if I can quickly move to some other questions here. Not unlike some others, you pursued a highly, I would say, a highly leveraged growth strategy. Your assets went from about 1. -- your total assets plus off-balance-sheet guaranteed mortgage-backed securities went from about 1.4 trillion in 2000 to 3.2 trillion. Your capital ratio was about 1.5 percent. So that's about a leverage ratio, if my math training does me well, probably on the order of, well, I got it here, actually, your leverage ratio was generally anywhere from 62 to 1 to up to 73 to 1.

Now, you weren't alone. I mean, during this same period when, you know, you're doubling -- more than doubling your assets, Goldman Sachs is almost tripling them, J.P. Morgan is almost doubling them.

But, you know, on reflection, your capital held was extraordinarily low, 2 and a half percent of capital against on balance assets, just .45 percent or 45 basis points on your off sheet, on your off-balance-sheet.

And if you look at some of the numbers that -- when we look at our investigation of all, you know, your data, it shows that the level of loans with higher risk product features were many times the level of Fannie's reported capital; for example, Alt-A loans alone were 583 percent of capital in 2006; 644 percent of capital in 2007.

I just have to ask you, and this is not a question, I'll just say, but what were you guys thinking just in terms of that extraordinary level of leverage? Where you're 62 to 1, you're 72 to 1, so that any kind of market bump is going to shake your company to its very foundations, if not collapse it?

MR. MUDD: It's a -- it's a terrific and

fundamental question, Mr. Chairman.

The -- my interpretation is that by virtue of the -- the GSEs being put into business as private companies with a public mission, the private company component of it, in order for Fannie Mae and Freddie Mac to attract global capital and put it to work in the U.S. housing market, we had to be able to provide a competitive return on that capital, e.g., competitive with other financial institutions.

Other financial institutions during the -- the -- the period of my memory, probably in the 15, 18, 20 percent range of return on equity, our return probably one notch below, below that, in the 15 to 17 percent range of return on equity.

So -- so, in some sense, the capital, which was statutory on the government's side, became the capital to do business on the business side of the -- of the equation.

CHAIRMAN ANGELIDES: But that was the minimum capital, statutorily?

MR. MUDD: Yes.

CHAIRMAN ANGELIDES: You could have been above that?

MR. MUDD: And we were. And we were. We were. We were above the minimum capital. There was a regulatory override. We were above the regulatory override and, in fact, had raised capital all the way through 2007 and 2008 so that actually at the end of my time at the company, we had more capital than we'd had at any point in the company's recent history.

CHAIRMAN ANGELIDES: All right. Let me ask you a couple of other questions here in the way of framework.

There are a number of documents we looked at, July 19, 2005, board meeting where Citi and McKinsey, who I guess were financial advisors, you basically stated that staying the course was not an option; in other words, that you did have to move into the nontraditional market more dramatically.

There was a February 21st board meeting where I believe you presented a plan that said we need to reserve -- reverse market share by increasing market share of mortgage-backed securities from 23 percent to at least 25 percent.

There's a July 18th board meeting in which you talk about why you need to ramp up again because this issue of market share relevance.

There was one other report, though, June 2005, at a company retreat, a Mr. Lund made a presentation called Single-Family Guarantee Facing

Strategic Crossroads, in which, at least he indicated to us, that he recommended staying the course.

And I guess, had you taken that more conservative route, looking back on it, would it have been wiser to maintain your underwriting standards, stay on the existing market course, or would you still have been swept under by the size of the wave?

MR. MUDD: It's -- it's -- if I can give you a three-part answer. The -- on the last part, the analysis that -- that -- that I've done suggests, if you presume that Fannie Mae would need to remain a Triple-A company to do the business that it was in, and you presume that in order to maintain a Triple-A rating that agencies usually require no more than 30 percent preferred capital, and if you used every dollar of the maximum net income that the company ever -- ever earned, about 6 billion dollars and put it to servicing additional capital, the maximum theoretical capital that the company could have raised would have been about 90 billion dollars. And that wouldn't have been enough under any circumstances.

CHAIRMAN ANGELIDES: Would not have been enough?

MR. MUDD: To -- to my -- to my knowledge. That -- that's the first part.

The second part, Mr. Lund's presentation, we -- we actually did follow his advice. And his advice was to -- we didn't think of it as a black-and-white choice. Do you -- do you -- do you do the 30 or 40 amortizing fixed rate loans only, or do you do only the other stuff.

The question was how -- how far do you want to move to make sure that the market's not going to shift away from you permanently.

So his suggestion, as I recall it, was, let's -- let's stick to our knitting. Let's -- let's -- let's emphasize the product that, after all, is our bread and butter, that 30-year loan, but we also need to understand these other markets and have controlled, managed, high process intensive participation in the -- in the -- in the markets.

And then the third point is actually separated from that, not really part of that analysis, was the McKenzie Citi work, which was really to assess whether, in the context of thinking about the business model that I've -- we've talked about probably enough today, was another business model appropriate; in other words, should we -- should we turn in the charter and privatize the -- privatize the company and thereby restructure through some of these challenges that -- that -- that we faced.

CHAIRMAN ANGELIDES: And let me just -- the Citigroup was as a financial advisor to you in this capacity; correct?

MR. MUDD: Yes. But I don't want to miss answers there.

CHAIRMAN ANGELIDES: No, as I say --

MR. MUDD: As opposed to what?

CHAIRMAN ANGELIDES: It was -- yeah, they were advising; correct?

MR. MUDD: They were advising and they are -- they and McKenzie were more or less engaged under the same terms to do the same work but to do it independently so that we could -- there wouldn't be group think, if you will.

CHAIRMAN ANGELIDES: All right. Here's my last question for both of you and then I want to move onto other members.

The conservatorship, the memo recommending conservatorship, which was, I think, September 6th, correct, from FHFA, it's a pretty damning document in terms of its assessment of Fannie, and it, you know, refers to members of the executive management team made imprudent decisions. Many of the decisions were unsafe and unsound.

They go on to talk about, despite clear signs in the latter half of 2006 and `7 of growing problems in the economy, management continued activity in riskier programs and maintained its higher eligibility program for Alt-A loans.

I'm just going to ask you to comment on whether you agreed or not with the assessment of the conservator's report?

And both of you, just as briefly as you can, and I may ask you for more, on the record, in this, in terms of writing, so I don't consume all the time, here.

MR. LEVIN: I had announced my retirement. I never saw that document at that time.

CHAIRMAN ANGELIDES: Okay. Thank you.

MR. MUDD: I did not agree. And if I can just back up for a short period of time. Throughout the spring, summer, and fall of 2008, we were engaged in a -- a really broad array of wide-ranging good faith discussions with both OFHEO and -- my first visit, when I became the CEO, was to get in a car and go downtown and see the then-director.

The first thing I did when the new director came in was gave him the security badge that had all of the same door openers that mine had; there were examiners on-site; we were having conversations every single day.

And like with any examination routine, there are issues that are identified, could be self-identified, could be identified by the regulator. You put a project and a process and a budget and some people around them, and you work your way through them. And that's happening all the time, in this day and age no examiner's going to sit there and say, you know, we're not paying attention to anything.

So those conversations continued all the way through the date of that letter. And when I -- when I -- I received it I was -- I -- I had to believe that it had been stuck up in the mail somewhere and it was something from so far in the past, because the issues were known in the process, were remediating, many of them had already been remediated; they had all been identified to the regulator.

So I think it simply goes to the context that the purpose of the letter was really to force conservatorship.

CHAIRMAN ANGELIDES: All right. I may ask for more in terms of written. I'll stop my questioning now and go to the vice chairman. Mr. Vice Chairman? Thank you, by the way.

VICE CHAIRMAN THOMAS: Thank you, Mr. Chairman. I'm going to hold my questions to the end, because there are commissioners who have not only have a very great interest in this area, I do as well, but they have spent not just the time of this Commission, but years, examining these institutions and the circumstances surrounding them as you have been asking questions, Mr. Chairman. So I'll defer my questions until the end and let those folks carry the questioning for now.

CHAIRMAN ANGELIDES: All right. Thank you, Mr. Vice Chairman. Ms. Murren?

EXAMINATION BY COMMISSIONER MURREN

COMMISSIONER MURREN: Good morning and thank you for being here.

I'd like to follow the -- the discussion from earlier about corporate goals and individual professional goals and specifically looking at the way that you determined those -- those particular goals.

And I also refer back to some of the documents that we've had an opportunity to review. One of them is a strategic presentation from 2007 where goals are articulated in a list. It's on page 11, for -- for the record.

Also other documents, including annual

reports, proxy statements, internal types of presentations, PowerPoints, and what was remarkable to me or what was noteworthy, and perhaps you can help me understand a little bit better, is when -- when goals were articulated in their most elemental form, typically the growth goals were the first ones, earnings growth, revenue growth, market share growth.

And later on, you would also mention what you described as your public purpose or your mission-driven type of orientation.

And again, I would like to get back to whether you could give us a sense of which ones were the most important. Were -- was that in priority? Was there a rating that you could assign? You referenced that you looked at them all equally. Would you look at it the same way? Could you characterize for us in a more quantitative manner perhaps?

MR. MUDD: I can try. The goals changed over a period of time. So one of the -- one of the lingering issues post the restatement was that there -- there had been an overemphasis on earnings per share.

So for some period of time, the goals, if you look back at the period of `05 and parts of `06, were -- were not related to financial outputs, although there were -- there were capital goals, per se.

They were mostly related to the things that were most important to the company at that time, get the restatement, get in good -- get in a good -- a good faith, goodwill relationship with the regulator, manage risk, build out.

We were under a consent order at the time that I took the job. And there was an item -- a list of something like 80 items that needed to be completed for that, so that was an objective in that time.

What we tried to do in `07 and `08 was to kind of rebalance those goals out so that we didn't lose sight of the mission responsibility, regulatory side of it, but, you know, if you're not making money, you're not driving profits, you're not increasing revenues, you're also unable to grow your capital and, therefore, you're unable to participate in the -- in the -- in the marketplace.

So I would say that, for me, as the CEO of the organization, it was about an equal balance. For folks that worked for me, depending on the nature of their job, if it were really, you know, in its -- in its extreme example, an origination job or a sales job, that was much more financial-goal-oriented.

But we also had people who did work with Indian reservations in the west, and they would have mostly goals oriented around the mission. And as you tiered from those folks to me, the proportions would change.

But at the top of the organization, I think the concept was always that there was a -- there was a fine balance to be found there.

COMMISSIONER MURREN: So the notion that because of its order, that revenue and earnings growth were not necessarily the driving forces behind your motivations to achieve your corporate or individual goals?

MR. MUDD: They were -- they were -- they were a driving force and, you know, in my -- my -- my mind's balance, half of it.

COMMISSIONER MURREN: And when you think about compensation, which is -- for executives at any corporation are really oriented to the performance of the corporate goals, there is an emphasis on stock ownership which aligns your interest with shareholders.

Could you talk about what Wall Street's goals were for your company? I would guess that they were oriented towards earnings and revenue growth; is that correct?

MR. MUDD: I'm sorry, just to understand, so what was my impression of what Wall Street expected as, kind of, output measures for Fannie Mae?

COMMISSIONER MURREN: Yes. I would think that as a large stockholder, that you would be very sensitive to the orientation of Wall Street.

So Wall Street's impression or their expectations for your company and what drove the stock price related to financial performance?

MR. MUDD: They're, as I think you know from your background, their models are largely related to having financial outputs from the company that go into their models and their expectations for the company's financial performance.

I think, in addition to that, there was an understanding from the analysts that I talked to that -- that, you know, there was -- there was -- the company had to perform its mission as well and in -- and in parallel, or else it would be hard to achieve the financial goals, or the non-achievement of mission goals would translate themselves into headline risks. And headline risk in and of itself would have an effect on the stock price.

So it -- it -- for those analysts, the analysts that were on that plane, they were -- I think they saw it as a balance but they didn't necessarily model the mission in the same way that a financial analyst would model a financial goal.

COMMISSIONER MURREN: Okay. So there was still a balance there between financial and mission goals; correct?

MR. MUDD: I think they saw the company in that light, yes.

COMMISSIONER MURREN: So let's talk a little bit about the numbers. You were over the course of your tenure at Fannie Mae extremely well paid, both of you were; correct?

MR. MUDD: I think so.

COMMISSIONER MURREN: When you look at how the board determined compensation, could you talk about how they actually got to the numbers? What was the methodology that they used to determine your cash bonus and your stock compensation?

MR. MUDD: Directionally, although I -- I -- I was not in the room, it was executive session of independent directors, and I did not make any recommendations whatsoever on my own compensation or see it before it went into the room. But I can tell you what the general process was.

The general process was that salaries were set to be competitive at a marketplace level, bon- -- annual bonuses were determined based upon the achievement of those goals that we talked about, so back to the example, for a sales person, largely sales and revenue-oriented, for a mission person, largely oriented around projects that they were working on or housing goals that they might have brought in the door, and for somebody at our level, kind of an aggregation of -- of -- of all those into our individual -- my individual goals were not very distinguishable from the corporate goals, being the top guy.

And then the long term was -- was set to a level, to the best of my knowledge, about 70 percent of the total compensation for comparable positions in the marketplace.

COMMISSIONER MURREN: Okay. So the use of comparables was an important part of determining what the actual numbers were. It wasn't so much a measure of performance, per se, but what is the marketplace for someone with your skill set, with your responsibilities, that would serve in the same types of institutions as yours that would have similar types of goals; correct?

MR. MUDD: Yes, I think that's fair.

COMMISSIONER MURREN: Okay. So, when I go back to the proxy for 2006 on page 33, they also mentioned that this is, in fact, correct that comparability is a very important part of how you measure compensation.

And in fact, they give a very specific list of companies, there's 17 of them, against whom you are measured to be comparable. And we've now heard, for almost ten minutes, about how you served a number of different constituencies: Corporate America, your own company, Wall Street, and a mission driven in a public purpose.

But what was really striking to me is in this list of 17 companies, which I will not make you listen to, but I do note that they include AIG, Countrywide, Allstate, American Express, Wachovia, U.S. Bankcorp, Citigroup, and Wells Fargo, among others, there is not one single company there that is a mission-driven company.

And I would wonder if you could explain to me, please, why you did not compare your compensation to, say, someone like the director of the Homeless Coalition, because if you have a public purpose, then would your comparables not be at least balanced as much as your goals are when you think about your comparables?

MR. MUDD: That would be -- two points. That would be the reason that instead of total compensation being pegged to 100 percent of market, it was pegged to be 70 percent of the market.

Secondly, my experience in the company was that for the people that we hired or the people that we lost out of the company, most of them tended to go to companies like those that you mentioned. To the extent that people went to Homeless Coalition or many of the other organizations that we -- that we know relatively well, it was because they had retired and taken on a job there or they were -- they were going on to do voluntary service.

And so while -- while relevant, it wasn't a competitive factor in compensation.

COMMISSIONER MURREN: But what you're talking about is comparability and motivation. And to the extent that you have an opportunity to cloak yourself in the public service mission, whether it be in your goals or the carrying out of your activities, I've sat on a public company board, among others, and when you look at comparables, they are supposed to span the waterfront of all of what it is that you do and motivates you.

And you just told us that you were motivated by a public purpose. But I don't see that reflected anywhere in how you actually got paid, which, to me, suggests that maybe your motivation for doing what you did was not related necessarily in that great of a part to the public mission, but really rather to achieving financial goals.

MR. MUDD: Well, I -- I -- I have a different opinion. And my opinion is that we had to -- as during my time, we had to recruit people or try to retain people. And the places that they were going tended to be on the business side of the equation.

For example, to hire a senior systems person, a senior risk manager, a senior financial person, the pay for being in a -- a public service-oriented organization, unfortunately wouldn't be sufficient to attract them to come to the company.

So, yes, you had an alternative, there, and the alternative was probably to get somebody that had less experience in the things that we were looking for: Capital markets, risk management, systems technology.

And -- but we did -- we did bow to the point you raised, I think, by saying no, actually, we don't pay at a hundred percent of what -- what those comparators pay for; we pay at 70 percent of that. And that was about the balance that enabled us to attract and retain the talent that we thought we needed to run the organization.

COMMISSIONER MURREN: Well, I would say that 75 percent of a huge amount of money is still a huge amount of money.

Furthermore, could you tell me how many consultants you engaged to determine your compensation, both in terms of its amount and also the methodology behind how you determined it?

MR. MUDD: I think that there were two different firms that were engaged independently, one by the compensation committee of the board, the other by the -- by the human resources management, because in order to get that comparable data and so forth, and then there was a third override, which is throughout my period, senior executive compensation was submitted to the regulator before it was announced, awarded, or granted.

COMMISSIONER MURREN: Do you recall what you paid those firms?

MR. MUDD: I'm sorry, I don't.

COMMISSIONER MURREN: If it were, say, for one of them, in the range of $700,000 for one -- for one assignment, does that ring a bell?

MR. MUDD: Well, it doesn't. It just wasn't -- I can attempt to find out for you but I just don't know what the number was.

COMMISSIONER MURREN: Thank you.

MR. MUDD: Thank you.

CHAIRMAN ANGELIDES: All right. There's some time left on your clock.

COMMISSIONER MURREN: I yield my time.

CHAIRMAN ANGELIDES: All right. Mr. Wallison?

EXAMINATION BY COMMISSIONER WALLISON

COMMISSIONER WALLISON: Well, now, for some easy questions.

Mr. Mudd, I would agree with you that -- that right after you took over as the head of Fannie, you did reach out to people in the community, in Washington, to try to gather the critics' views as well as the views of others in order to -- in order to do a better job.

And you were hit by a terrible crisis that we heard about from, I assure you, many other witnesses who have been before us.

But the chairman, Chairman Angelides, did focus on what I think is one of the most important questions that I think we'll have to resolve, and that is the reason that Fannie acquired so many subprime and Alt-A loans.

Between Fannie and Freddie, there were about 12 million such loans out of a total, probably of about 27 million loans, subprime and Alt-A loans, all together in our economy. So it was about, between these two companies, about two-fifths of all the -- all the loans that were likely to fail when the bubble deflated. So I think it's quite important for us to try to find out why, exactly, this was done.

Now, it seems to me that there are three possible ways, possible reasons, for proceeding in this direction, acquiring what were acknowledged to be risky loans, subprime and Alt-A mortgages, in other words, between two -- 2005 and 2007, which everyone seems to agree were the ones that have caused most of the financial difficulties for you.

First of all, you've mentioned market share, expand market share. Maybe you bought them in order to expand your market share. You said that was a secondary consideration. But that's -- that's one that has been repeated frequently in the media as the reason for competing with Wall Street or acquiring these loans. You were competing with Wall Street, wanting to increase your market share.

I -- I think that the documentary evidence, and we'll go through that in a little bit, does confirm that this is a secondary matter, if even that.

The second idea is that you wanted to make profits. And we did hear this from an academic expert who the Commission had engaged a few weeks ago; that is that you acquired these loans in order -- the subprime and Alt-A loans -- in order to make money from them.

And the third is, of course, to comply with the HUD's -- HUD's affordable housing regulations. And that is what we've been referring to or you've been referring to as your mission.

And I'll try to unpack all of these things, because they are, of course, in your mind, and they should be in your mind, all mixed together, because they were all very important to the kind of thing you were trying to do with this company.

But let me just mention that these, the -- the HUD housing goals did increase substantially during the time that we're talking about here.

In -- in -- they started at 30 percent, when they first came into effect in the -- in the early `90s. But in -- but in 2000 they became 50 percent. And what that meant is that all of the loans that you had that you bought, of the loans that you bought from originators, 50 percent of those, and you know this, of course, but for the audience they might not, 50 percent of those had to be to people who were at or below the median income in the areas where they were living.

So at 50 percent, starting in the year 2000; it then increased to 52 percent in 2005, 53 percent in 2006, and 55 percent in 2007, in other words -- and -- and some of this was in your -- in your prepared remarks, and I got some of the same sense listening to Mr. Levin and -- and to you that you were really under pressure from HUD here.

They -- despite the fact that you had had difficulties, accounting difficulties, which required you to spend a lot of time on writing your accounting, getting things back on course in your accounting, HUD was not giving up on you. They were pressing you to continue to make more investments in these affordable housing loans. So it was going up during the exactly the time that we're talking about, between 2005 and 2007.

Now, let's -- let's consider the things

that I was referring to before. First, this question of the market share. Now, the Chairman made a reference to the presentation by Tom Lund in -- in June of 2005, and in there he -- he really said, we're facing a choice here; we either meet the market, which meant that we're going to have to change the way we do business; we're going to have to go after more of these subprime and Alt-A loans, because that's where things seem to be going, or we should stay the course.

And he considered whether you had the resources to do that, not the financial resources, but whether you had the resources of personnel and skill and so forth. And he said, no, actually, lack of capabilities, we lack the capability to go into this market, we lack the knowledge of credit risks, we lack -- we lack the willingness to compete on market price, we lack the value proposition for subprime, and we lack a conduit capacity, and there are also regulatory concerns.

So basically he says, realistically, we are not in a position to meet the market today -- this is in the middle of 2005 -- therefore, we recommend something you've already mentioned, and that as Mr. Levin has, is the "stay the course" idea. And it appears that you did follow this advice, although it wasn't quite as you suggested, just not going into subprime. It was to kind of, as he put it in his memo, underground efforts: Develop a subprime infrastructure, develop modeling capabilities for alternative markets, and develop a conduit capacity.

So does all that sound right to you, about the middle of 2005, you are agreeing with that?

MR. MUDD: Yes, I -- that -- that -- that's correct.

COMMISSIONER WALLISON: Now, there is no documentary support for a contrary decision on this market share or relevancy issue after that mid-June presentation and recommendation. There's -- there's nothing until 2007, and there's a very important document in 2007. I want to be sure I know that you wrote that, there's an 84-page comprehensive thing that says -- it's called the Fannie Mae Strategic Plan, 2007 to 2012; was that -- was that your work?

MR. MUDD: I -- I -- that sounds like something I would have done, yes.

COMMISSIONER WALLISON: I mean, it's a very fine piece of work, I must say, and very comprehensive. But I just wanted to be sure this was -- this was the product of management's work coming together to decide what the strategy of the company ought to be.

MR. MUDD: There was a -- we did a document every year, and one of those years it was more extensive, and without seeing it, it's hard to be affirmative but I -- that's -- that sounds like --

COMMISSIONER WALLISON: It's an 84-page document.

MR. MUDD: That sounds like the annual strategic planning document that the board would read before going to its annual strategic planning session.

COMMISSIONER WALLISON: Okay. Now, it was -- the date of -- oddly enough, it was not dated, but it did refer to the mortgage meltdown as something you had to deal with, and so I would place it, then, probably in June, July, or August of 2007. Would that be about right for when you had these regular planning meetings?

MR. MUDD: They were normally in the summer, yes.

COMMISSIONER WALLISON: Okay. And it really focuses, of course, on it's title, 2007 to 2012, it focuses on what Fannie will do in the future.

Seems pretty clear from that report, however, that there was no plan at this time to move strongly into the subprime and Alt-A market.

What we -- what we see is that that is what is being decided, what has been decided and put in the plan for the future. You say, after months of research, and this is from the plan, after months of research, analysis, discussion, preparation, our senior management team met for two days in June in a college classroom near the Fannie Mae headquarters, and we made several strategic decisions at that point.

Item one on that list was deepen and broaden business to maximize value, of course, right? Item two was to add more credit-sensitive assets. And you say, under our new strategy, we will take and manage more mortgage credit risk, moving deeper into the credit pool to serve a large and growing part of the mortgage market.

Helping reputable lenders serve emerging borrowers provides an enormous opportunity for Fannie Mae to grow, provide value to customers, the market and shareholders and -- and the "and" is emphasized in this -- expand our affordable housing mission.

So it seems to me, and I'd like you to address this, it seems to me that actually only in mid-2007, when this piece was written, was it really decided to expand market share by, quote, moving deeper into the credit pool to serve a large and growing part of the mortgage market.

Is that -- would that seem right to you?

MR. MUDD: I'll -- I'll -- I'll -- I'll add some perspective to it, Mr. Wallison. The -- going back to the 2000 -- and was Mr. Lund's `05 or `06?

COMMISSIONER WALLISON: That was `05.

MR. MUDD: '05.

COMMISSIONER WALLISON: Middle of `05, about June of `05.

MR. MUDD: A process that we would use, not uncommonly, to discuss the strategy was to kind of create a framework that sets up two alternatives that are starker than the alternatives that exist in real life.

And, as -- as a result of -- of kind of setting those bookends and having the debate, the outcome -- the outcome was what you described the single-family had a business recommending, which was that we stay the course, we continue our investment, we continue the process, we continue to emphasize the 30-year fixed rate mortgage, but that at the same time, we developed the capabilities to understand the business.

COMMISSIONER WALLISON: Right.

MR. MUDD: By way of reference the -- the book of Fannie Mae's investment or participation or guarantee of Alt-A goes all the way back to 1999.

COMMISSIONER WALLISON: Right.

MR. MUDD: So -- so the reason I point that out is that Mr. Lund's presentation was part of the continuum and participation of business was part of a continuum.

COMMISSIONER WALLISON: Right.

MR. MUDD: And if you go through it, you -- you -- you go through the years, the numbers that I have here, the Alt-A business goes from 2000, 10 billion, 30, 60, 90, down a little bit, down a little bit, then a hundred, and then it stays at -- then it stays at about a hundred, certainly a significant -- a significant part of the book.

But the -- the process was to develop those capabilities. The construct of your question was, you know, market share, profit, HUD goals. My answer is yes. I can't -- I can't -- I cannot make any apologies for trying to earn a profit when I was running Fannie Mae. If you can't make a profit when you're running the business --

COMMISSIONER WALLISON: Right.

MR. MUDD: -- you can't do the mission, you can't earn a return, you can't raise capital and all of that. So the question was, do you do it prudently. And I think that the ultimate measure of prudence is that a big problem -- and not perfect to be sure, but Fannie Mae's participation in those segments to this day, to my knowledge, is better by a factor of about two than the same loans and the same securities that were done by the banks in the private -- the private market.

So I think that the -- the process was solid; the approach built itself out; there were myriad activities going on between Mr. Lund's presentation and the strategic document you referenced, including, you know, building out, we hired people from the industry who had been in the subprime business, that had specialization in modeling around Alt-A and all of that. So as we did that, that gave us the ability to continue to participate in the market.

COMMISSIONER WALLISON: Yes, absolutely. You were following the Lund recommendations. But what I'm just trying to pin down is kind of the date when the decision was actually made to go more deeply into this subprime and Alt-A market.

Now, I want to -- I want to just mention something for the sake of everybody who's listening.

Indeed, Fannie and Freddie, but Fannie particularly, was required from in the early 1990s, as I suggested, to start making these kinds of investments. This was not just something that occurred between 2005 and 2007. In fact, in -- in -- in 1999, there was a major HUD press conference where the then-secretary, Secretary Cuomo, announced that you would be required, you and Freddie, would be required, with these -- with new affordable housing requirements, to make two and -- 2.4 trillion dollars in affordable housing loans starting right then, and in fact, there was a statement by President Clinton saying, this is wonderful because housing homeownership in the United States was increasing substantially.

And that shows, in fact, that you were under, really substantial, I think, political pressure to make sure that you did these things, because not only was it important for all of us to see that homeownership was increasing in the United States -- this is something that Americans have always wanted -- but it was of particular interest of the Clinton Administration and then subsequently, the Bush Administration. Both of them were focused on improving homeownership. And I -- I would assume you would agree with that?

MR. MUDD: I would agree with that, my short comment --

VICE CHAIRMAN THOMAS: Mr. Chairman, Mr. Chairman, I would yield the Commissioner an additional five minutes.

COMMISSIONER WALLISON: Thank you.

MR. MUDD: My short comment would be that because Fannie Mae and Freddie Mac don't originate, the business that comes in their door depends upon what originators or others are willing to originate and then willing to sell to them.

But the businesses being so big, usually an actuarial sample, if you will, in the market would come in. And until the point when the housing goals went north of 50 percent, just by virtue of being there and receiving loans, the companies generally were able to reach their housing goals with a reasonable degree of effort but not -- the mathematical conundrum that I have always had, Mr. Wallison, is -- and you touched upon this -- is, as far as I understand it, median is about 50 percent.

So when you're required to have 57 percent of your business be below 50 percent, that gap of 7 percent began to -- you have to create not just a normal home for those mortgages, you have to create attraction for those loans to come in the -- in the -- in the door.

COMMISSIONER WALLISON: Right.

MR. MUDD: And that took an enormous amount of our time and attention to continue to try to chase that wheel.

COMMISSIONER WALLISON: Right. And, indeed, you make that clear, because we're going to turn -- I want to turn now to this question of could this possibly have been for the purpose of making profits?

Responding to -- as you -- as you were speaking with the Chairman and Ms. Murren, you were talking about your responsibility to the capital markets to keep the company together as a profit-making operation, hopefully even a Triple-A operation, so that you would continue to be able to function in that part of your mission.

So the question is, could you have been buying these subprime and Alt-A loans in order to be profitable. And as I suggested, we have heard from an academic student of Fannie and Freddie that that was one of the motives.

However, in this 2007 report that we've been talking about, you say this: The HUD affordable housing goals are a public manifestation of our mission. Our strategy of expanding and our credit risk appetite is critical in meeting these goals. For 2004 to 2008, the goals require -- and this is exactly what you're saying -- the goals require Fannie Mae's acquisitions to finance a greater percentage of low- and moderate-income family mortgages than the proportion the market will produce. That's a point.

That is especially true as housing affordability, the combination of home prices, mortgage costs, and incomes, has fallen. We had to absorb significant costs to meet the HUD purchase money goals in 2006, and we are struggling to meet the goals and sub-goals in 2007. We will continue to pursue every reasonable opportunity to expand our purchases of goals-eligible mortgages.

So to me, at least, and I would like your sense of what that language meant, but to me it says, these things are costly to do. We are not making money on these things. They are expensive and we're struggling to do it. Is that your assessment too, or what do you think it meant?

MR. MUDD: Your impression is correct, and, well, Mister -- Mr. Levin was right in the middle of that analysis and he may be -- he may be in a better position to answer it.

COMMISSIONER WALLISON: I have a question for Mr. Levin, but that's a question of time, and I probably won't have any, so why don't you just go ahead, Mr. Levin, and respond to that?

COMMISSIONER MURREN: If I could, for one second, Commissioner, respectfully, I just wanted to make sure that I clarified the relationship between the compensation and profitability or Wall Street expectations.

It's not so much I meant, and perhaps I didn't express myself clearly, that Wall Street expects firms to be profitable; it's that they expect them to grow and they expect them to grow at a certain rate.

COMMISSIONER WALLISON: Okay.

COMMISSIONER MURREN: Thank you.

VICE CHAIRMAN THOMAS: Mr. Chairman, yield the gentleman an additional two minutes.

CHAIRMAN ANGELIDES: Two minutes, and then we'll add another 30 seconds to that for that to accommodate Ms. Murren's comments. So why don't you put it to 2:30.

MR. LEVIN: Mr. Wallison, just rephrase

what you would like me to address.

COMMISSIONER WALLISON: Well, the paragraph that I just read said, to me, at least, and I can read it, I'll just read portions of it again. This is at the very end of this paragraph, and Mr. Mudd, who I think was the author here, has written: We had to absorb significant costs to meet the HUD purchase money goals in 2006, and we are struggling to meet the goals and sub-goals in 2007.

What that says to me is, this was not a profitable activity; this was something you were doing because you had to do it.

MR. LEVIN: Much of the business that met our housing goals came through standard channels at standard returns. But because the goals were set at higher levels than what the market was producing, we had to make special efforts that involved outreach, pricing adjustments, underwriting adjustments, and there was a whole set of business that we did at returns that were less than our normal returns.

COMMISSIONER WALLISON: Okay. Thanks very much. Now, I'm not saying that you lost money. What I'm -- we don't know that actually. I don't know that even your accounting would be able to show us that, but it was clear that you were not making the kinds of money on -- on your affordable housing activities that you were making on your standard kinds of activities.

And so this was something that had to be done for mission purposes but not because it was a profitable activity in preference to -- as it was for example, for the Wall Street firms, it was probably very profitable for them.

But you have a completely different set of standards and -- and your business model is different from the Wall Street firms. And so for you, it probably wasn't profitable. And I think this paragraph suggests that that's true.

So if I could get some time, later, we'll -- I'd like to, but I don't know that I will.

CHAIRMAN ANGELIDES: Thank you, Mr. Wallison.

COMMISSIONER WALLISON: Thank you very much for answering those questions.

CHAIRMAN ANGELIDES: Thank you, Mr. Wallison. And Mr. Georgiou?

COMMISSIONER GEORGIOU: Thank you, Mr. Chairman.

EXAMINATION BY COMMISSIONER GEORGIOU

COMMISSIONER GEORGIOU: Mr. Levin, I would like to follow up on one thing I just got confused about. I understood that Alt-A mortgages actually did not count towards the affordable housing goals of the -- of the mission; is that correct?

MR. LEVIN: It depends. So the affordable housing goals related to the income level of the borrower and where the loan was located. And there were Alt-A loans that did count and there were Alt-A loans that did not count.

COMMISSIONER GEORGIOU: Right. But in your -- I understood in your interview with our staff that you suggested that for the most part, Alt-A loans generally did not count.

MR. LEVIN: My recollection that in the aggregate, that Alt-A was less rich than the goals, but that there would be portions of Alt-A that would have contributed to the goals.

COMMISSIONER GEORGIOU: Right. But to the extent that you actually financed Alt-A loans that didn't contribute to the mission, then they would actually reduce your ability to meet the mission because they would increase the denominator, the total number of loans that you had to compare your -- your loan -- your mission-related loans to; isn't that correct?

MR. LEVIN: That's right. That's right.

COMMISSIONER GEORGIOU: Okay. And you did, nonetheless, increase your financing of Alt-A loans, I guess about a percent a year for every year, it looks like, from `04, at 8 percent; `05, 9 percent; `06, 11 percent; and `07, 12 percent; is that right?

These are figures that I'm looking at from your purchases of nontraditional single-family mortgages, from our staff report, which you may not have seen.

MR. LEVIN: I'm not familiar with those, rest of the numbers, I'm sorry.

COMMISSIONER GEORGIOU: Okay, very good. Let's see.

Also in a summary that we have of the interview that was conducted with you by our staff, it says that in response to a question about Fannie Mae's increased acquisition of private label securities or PLS, that you said something to the effect that PLS was considered a money-making activity, it was all positive economics, and it was very conscious that subprime PLAs -- PLS was housing-goals rich.

And so subprime PLS was also one of the initiatives, if you will, that filled the housing goal gap. There was no tradeoff between making money and hitting goals, it was a very broad brush effort that could be characterized as win, win, win, money, goals, and market share.

Do you recall saying words to that effect to our staff?

MR. LEVIN: I do not recall those exact words but -- but, you know, I would say that the subprime PLS, we expected those to be profitable. And those did contribute -- contribute -- contribute significantly to the achievement of the housing goals.

COMMISSIONER GEORGIOU: Okay. All right. So really, there were double -- there were at least two mandates that you were following here in a lot of your acquisitions of subprime and Alt-A loans, which was to -- was to increase your profitability, increase your market share, and meet your housing goals, meet your affordable housing goals; would that be fair to say?

MR. LEVIN: Yes, sir.

COMMISSIONER GEORGIOU: Mr. Levin, Mr. Mudd, rather, you're nodding your head as well?

MR. MUDD: I'm nodding my head because I agree, yes.

COMMISSIONER GEORGIOU: Okay.

MR. MUDD: All of those were factors.

COMMISSIONER GEORGIOU: Very well, thank

you. I want to turn to compensation for just a second, because it's already been touched upon, but I think it's worthy of a little bit further elaboration.

During the years of 2000 to 2003, the OFHEO budget, that is, the entire budget of your regulator, ranged between 19 million and 30 million. And in -- in all those years, the total compensation of the top four executives at Fannie Mae and Freddie Mac exceeded the budget of the entire regulator.

I mean, it was 33.6 million in 2000; 26 almost 27 million in 2001; 26 million in 2002; up to 51 and a half million in 2003. It strikes me that that's -- it sort of dwarfs the ability of the regulator to really play a significant role.

Were you -- you -- would you concur that the regulator really didn't have adequate resources to do the kind of regulation that would be customary in a financial institution? Maybe Mr. Levin, since you had longer experience, really, at the agency, could you speak to that?

MR. LEVIN: I -- I really couldn't. I mean, that would be a matter for them to answer.

COMMISSIONER GEORGIOU: Well, I'm sure they will, but I was wondering if you -- if your experience as the regulated entity might give you some insight in that regard. Mr. Mudd?

MR. MUDD: I -- I thought and said at the time and through my tenure that I -- I thought a strong, credible, well-funded regulator made sense. And that wasn't just apple pie and motherhood, because it was actually helpful to me going out and meeting with international debt investors and the S and S and others to say, you know, the short story of Fannie Mae, government-sponsored enterprise, public-private mission, SEC registered, oh, and by the way, we're regulated by a credible, effective, well-funded regulator.

Their level of funding was set by Congress every year, which -- which history can decide whether that made -- that made sense or not. So we didn't have anything to do with that, per se.

The --

COMMISSIONER GEORGIOU: Well, it might be a little bit too much to say that you didn't have anything to do with it, because, if I recall, you lobbied against the increase in budgets that OFHEO requested, fairly considerably. Is that not true?

MR. MUDD: I did not lobby. I did not myself lobby against the OFHEO budgets.

COMMISSIONER GEORGIOU: But didn't Fannie hire lobbyists to lobby against it?

MR. MUDD: I -- I -- I don't know. Not in my tenure as CEO.

COMMISSIONER GEORGIOU: Well --

MR. MUDD: The thing that I would say, Commissioner, that might be helpful to the discussion is that OFHEO's heritage as a financial regulator of a complicated institution coming out of HUD and staffing itself with teams that had -- were available and therefore perhaps not at -- not at the top levels of other regulators and examiners and the statutory limitations that were -- that existed around the bifurcation of -- of -- of OFHEO being a safety and soundness regulator and HUD being a mission regulator, made it, in my experience running or working in regulated institutions over the years, not -- not very effective.

COMMISSIONER GEORGIOU: Okay, thank you. Just for the record, I think it's -- I think that Fannie's lobbying expenditures, according to our staff investigation from 1998 to 2008 were roughly 80 million dollars, 8-0, which I suppose one could argue, in light of the enormous lobbying that goes on by financial services companies generally is modest, but it -- but in a -- in a -- in an overall simply --

simply viewed, 80 million dollars is a considerable amount of money to be lobbying.

I mean, it was, in many instances, in some years, almost comparable to the entire budget of the regulator.

MR. MUDD: Just to comment there, Commissioner, that, you know, within the housing finance industry, you know, it is -- it is an industry which is -- I cut down lobbying during my time there and brought external lobbying inside, had people who actually knew about the company do any lobbying.

And we were requested to come up here quite often and talk about our programs, our efforts, our capital, or what have you. So it was important to have that interface.

But with a company so intimately involved, government, government in fact in the name of its business, as a government-sponsored enterprise, it -- it -- some of that came with the territory.

I agree that there are limits, and there are appropriate ways to do it, and we tried to follow those during my time.

COMMISSIONER GEORGIOU: At -- at one point there was a suggestion by Mr. Falcon, who we'll hear from after you, this afternoon, that Fannie Mae executives acted on a plan to have Senator Kit Bond initiate an investigation of OFHEO by the HUD inspector general in an effort to -- to head off an investigation that they were doing into Fannie's accounting practices. Do you have any familiarity with that particular effort?

MR. MUDD: No, other than I -- I recall that Senator Bond, as a general matter, was -- was -- had regulatory budgets and OFHEO's budgets and operations as an -- as an issue that he was focused on.

COMMISSIONER GEORGIOU: In what respect? He was focused on that they were excessive?

MR. MUDD: I think I just thought of -- I -- I -- I -- I remember thinking of him as sort of the watchdog person in Congress around the issues of -- of -- of -- of OFHEO budgets and operations and the regulatory -- lots of people had interest in the regulatory structure of Fannie and Freddie.

COMMISSIONER GEORGIOU: Right. But he -- but he wasn't in favor of additional regulation. He was -- I mean additional oversight, but lesser oversight of Fannie and Freddie at the time.

MR. MUDD: I don't -- I don't remember that. I think most of the -- of -- plurality of the people that I talked to were generally interested in -- in better oversight, including both Director Falcon and Director Lockhart, and I -- and I shared that, but that's --

COMMISSIONER GEORGIOU: Okay. Mr. Levin, do you have any recollection of that intervention?

MR. LEVIN: I don't.

COMMISSIONER GEORGIOU: Okay. Let me try and go back to capital, briefly.

Secretary Paulson described GSEs -- the GSE's capital as flimsy capital. Would you agree with that characterization, Mr. Levin?

MR. LEVIN: Well, we had -- we had regulatory capital requirements, and then we also did our own internal analysis on appropriate levels of capital.

On the regulatory side, there were what we call the minimum capital levels, which were leverage ratios, and there was also a risk-based regulatory standard that was set by stressing our business from a credit perspective and an interest rate perspective and, from that, developing an amount of capital to absorb any -- any -- any losses.

And, you know, we, you know, my recollection is when I left the company, we were in compliance with both numbers, the leverage ratio, but also the risk-based capital ratio, which attempted to establish the correct capital levels based on the exact product that we had and then stressing the markets.

COMMISSIONER GEORGIOU: Yeah, but it wasn't stressed adequately, in retrospect; would that be fair to say?

MR. LEVIN: I think one of the -- I think one of the lessons from the experience is -- is that scenarios that people thought were really adverse scenarios, that one of the lesson is, you can have even more adverse scenarios.

COMMISSIONER GEORGIOU: Indeed. And that's really what we ended up facing, which put us into this crisis.

But during `06 and `07, your modeled loan guarantee fees were higher than the fees you actually charged, were they not?

MR. LEVIN: I don't have specific recollection, but that would happen from time to time.

COMMISSIONER GEORGIOU: So if you didn't charge the fee that you modeled, then -- then your charging the lower fees meant that effectively -- than the model fee -- then effectively you weren't pricing the MBS guarantees commensurate with the risks that you had established yourselves; is that not correct?

MR. LEVIN: I think the perspective that I would put on that is that the model, the models would set a target fee for the business. And sometimes we were able to -- to get that target fee; sometimes we were able to get more than that target fee; sometimes we were -- the market only permitted us to get less than that target fee.

So for example, and I'm just making these numbers up to give the conceptual example, you know, the model might -- the model might say -- the model might say that the fee ought to be at a level that produces a 16 percent rate of return, but what was available in the marketplace was a 15 percent rate of return, not what the model was as a target, but something less that we still might consider acceptable.

And if we consider those numbers acceptable that we would do business at less than the model fees. Although, we always had plans and we always pushed the businesses to develop plans on how to get back up to the model fees.

CHAIRMAN ANGELIDES: All right. I will yield three minutes, we want to keep on schedule, three minutes.

COMMISSIONER GEORGIOU: Thank you. I guess, you know, I guess I'm trying to get to what you could have done to enhance your capital structure, your capital base, to have avoided some of the problems.

I mean, obviously I understand the market didn't want to pay them, but if your model suggested that the risk of the associated asset that you were buying required that kind of fee to provide you a sufficient return, it seems to me it was a deficiency to -- to not attempt to collect it, to not -- or to -- or to choose not to purchase those assets unless you could actually obtain the guarantee fee that your model suggested.

Mr. Mudd, you were looking to try to respond to that?

MR. MUDD: Just to say that that -- that one -- one option here would be to -- to -- to trade at market and then therefore be in the position of unconsciously knowing, and we're talking about matters of single-digit basis points here whether you're being accreted or decreted in terms of individual transactions.

What I always thought the models helped do was to enable us to decide consciously, do we want to -- do we want to give up a little potential return here, because there's more volume or because there's more goals-rich or because of some other exogenous factor. The models in the model fee is one component of the relationship.

At the other end, you can't run a business that's active in the capital markets every minute, as you know, just by saying I can't answer questions, the model has to answer the questions for you, because the model themselves, the models themselves have to be dynamic and reflective of what's going on in the marketplace.

COMMISSIONER GEORGIOU: Understood. Let me turn really quickly, I've only got a minute left, to a couple of possible accounting issues that I think were of some significance.

Did you actually not record losses on delinquent loans until they were 24 months delinquent; was that the policy at Fannie, Mr. Levin?

MR. LEVIN: I don't recall.

COMMISSIONER GEORGIOU: And -- and were you required to repurchase loans from MBS Trust once they became delinquent and then report them at fair value on the balance sheet? Mr. Mudd, do you recall?

MR. MUDD: To my recollection, the way that the accounting handled a purchase of a loan out of a security, that -- that -- that loan had to come out and be -- be marked at fair value and then, should it recover, the -- the -- the -- the income off of that loan would amortize back into the --

COMMISSIONER GEORGIOU: But that didn't happen until 24 months after the loan became delinquent; isn't that right? Which is a little bit late in the accounting world.

CHAIRMAN ANGELIDES: Time.

COMMISSIONER GEORGIOU: I'll leave it at that. My time is done. Thank you very much, gentlemen.

CHAIRMAN ANGELIDES: Mr. Holtz-Eakin?

COMMISSIONER HOLTZ-EAKIN: Thank you, Mr. Chairman, and thank you gentlemen for taking your time to be with us today.

EXAMINATION BY COMMISSIONER HOLTZ-EAKIN

COMMISSIONER HOLTZ-EAKIN: One of the very clear messages that both of you shared with us is that the business model that was Fannie Mae simply could not survive the precipitous price declines we saw in residential real estate in United States.

And so I guess my first question is, what did your internal risk metrics tell you, you could survive; what kind of price declines were survivable given your business model?

MR. MUDD: We -- our model, the models ran thousands of paths, as you can imagine, and at any time through the summer and fall of 2008, we were disclosing what our best estimation was of -- of what the likely losses were going to be.

We found ourselves, through that period, basically not being able to imagine how bad reality would be. So looking backwards, those estimates of what the losses were ultimately going to be were -- were trailing what the markets were actually delivering as home prices fell, delinquencies went up, and the macro economy had its effect.

But we -- we and outside advisors, as well, looking at our capital, thought that that was sufficient to withstand what I called earlier the 30-year flood.

But, just by way of reference, what that 30-year flood was, since the estimates had to be based on a sample of real data, you couldn't make up the data, we went back to -- to California in the 1990s, the Texas oil patch in the 1980s, some of the severe interest rate dislocations over a period of time, and we took those scenarios and multiplied them by 50 states, and then extended them over a period of time to do a stress assessment of whether we -- of whether we would have sufficient capital.

And as we all know now, the reality of it was that 2008 and 2009 and until home prices eventually bottomed were worse than 50 times Texas oil patch or 50 times California.

COMMISSIONER HOLTZ-EAKIN: So that was the out-of-bound; I was just curious to know how badly you contemplated in your stress testing of your portfolio?

MR. MUDD: Well, I think that the answer is that our best estimate of the most likely outcome was what we were disclosing, you know.

COMMISSIONER HOLTZ-EAKIN: It's not in the disclosure. I mean, the question is, what constituted stress in your scenarios, what I just described, 50 times oil patch in California or something like that. That was a standard internal risk assessment being done on a quantitative basis ongoing?

MR. MUDD: Yes.

COMMISSIONER HOLTZ-EAKIN: Okay. Did, as things developed and you realized that you were missing, did you alter those stress tests in any way?

MR. MUDD: This -- the stress tests were --

were updated on a regular basis, I don't remember what the regularity was but less -- you know, within some number of months, to reflect the reality. As I was describing the earlier part answer to your question, I wrote it down here somewhere, as of -- as of mid-2007, our internal estimate of conventional conforming home prices was a 1 percent decline for `07, a 1 percent increase for `08, and a 3 percent increase for `09, and a 4 percent increase for `010.

So that close to the collapse of housing prices we were -- we were still estimating that the -- the odds were things were going to remain within their historical parameters.

COMMISSIONER HOLTZ-EAKIN: And, just to be clear, that constituted stress?

MR. MUDD: No, no, no, that constituted --

COMMISSIONER HOLTZ-EAKIN: I'm interested in that vision --

Talking over each other

MR. MUDD: There's a stress case, on the downside there's a nice case, on the upside --

COMMISSIONER HOLTZ-EAKIN: That's what I'm interested in, stress on the downside.

MR. MUDD: The stress test on the downside would have --

VICE CHAIRMAN THOMAS: Mr. Chairman, it's very difficult to follow the questions and answers when the witness overrides the question of the Commissioner.

CHAIRMAN ANGELIDES: Let -- let Mr. Holtz-Eakin ask the question and then respond.

VICE CHAIRMAN THOMAS: And then respond, it's beginning to look like some of the shows on television.

CHAIRMAN ANGELIDES: Let's add a minute back onto Mr. Holtz-Eakin.

COMMISSIONER HOLTZ-EAKIN: Thank you, Mr. Chairman.

My interest is in the internal risk management procedures at Fannie Mae, which ultimately failed and left the taxpayers with the single largest bill we will face in this episode, and I'm curious as to the nature of those procedures, their quantitative assessment of the risk, not likely the outcomes but worst case, and downside risk, and the degree to which they were updated in light of clear misses, and how they interacted with other mitigates against risk, holding additional capital, which you have already expressed an assertion that you held adequate capital from all internal risk metrics, despite the evidence to the contrary, and stronger regulation, which would have put you in a better prudential position.

So, that's where I'm going, it's not a mystery, and I would just like to know how it was done?

MR. MUDD: I apologize, I didn't mean to be disrespectful.

The -- I'll try to be brief but we had a -- an independent risk management committee of the board; we had an independent view from OFHEO, who effectively ran a parallel model with their own set of stress scenarios. We had an independent chief risk officer with -- who reported dotted line to me and straight line to the board. Under his organization, we had individuals who focused on single-family credit, multi-family credit, et cetera. We had models which were independently verified. And -- and we used an increasing amount of independent verification to basically develop richer data as it became clear that we were going through the phenomenon that I described to you of the models not being able to catch up with the reality.

And those were -- those were updated. They were a topic of conversation at weekly management meetings. And I think, in the year of either `07 or `08, the board met something like 100 times, and this would have been an item of discussion at that level.

So I was -- and the process, our chief risk officer had come out of the money-centered bank that we had judged had the best process, and we asked basically to install something that looked like a blueprint of that, of that process, and that's -- that -- that -- that, in summary, is how the system was set up and operated.

And then those scenarios that we described in the earlier question were -- were inputted and run through.

COMMISSIONER HOLTZ-EAKIN: Are you aware that yesterday we received testimony from the Comptroller of the Currency, Mr. Dugan, who said that when invited by the Fed to review risk management procedures and the capital held at Fannie Mae was shocked that they did not meet the standards that, for example, a national bank would have, and that the capital was so inadequate. How do you react to that?

MR. MUDD: I react to it that Fannie Mae wasn't a national bank and under -- under its regulatory regime, it was operating within the capital standards that it had, A, and that, B, we were -- we were aggressively raising capital throughout `07 and into -- into `08.

So I don't want to dispute the notion that -- that more capital was a better thing and yet more capital would have been even a better thing.

There are natural financial limits, if you will, on the amount of capital that you can actually raise in the real world. There was a point in `08, maybe -- maybe even earlier than that, where it became, you know, it became clear that -- that the bar shouldn't be minimum statutory capital, that it should be higher than that, and we tried to operate accordingly.

COMMISSIONER HOLTZ-EAKIN: If I can just get, before we leave this, and I appreciate your forthcoming on this, what precisely was the number for the downside scenario? Was this a 5 percent decline, was it a 10 percent decline?

MR. MUDD: I will try, I will be forthcoming, but I can't tell you anything that I don't specifically remember, because based upon what the inputs and the methodology were, you could come up with a variety of different -- a variety of different numbers.

But I -- the last output was the one that I described to you in the end of `08. I don't know what the outputs turned out to be subsequently once you had the real data in terms of what -- in terms of what actually happened.

But the downside was consistent with the structure and the calculations that we went through to develop regulatory, consistent.

COMMISSIONER HOLTZ-EAKIN: I want to make sure I understand the business model, because it's always been of interest to me.

There were really two things that you did: One was to purchase mortgages, provide a guarantee and generate MBSs for sale, and the second business was to borrow and hold those risky MBSs in a large portfolio; fair characterization of the basic, overall operation?

VICE CHAIRMAN THOMAS: Mr. Chairman, yield the Commissioner five additional minutes.

COMMISSIONER HOLTZ-EAKIN: Thank you. And in this spectrum of purposes that you had to pursue, the public purposes, the product purposes, what purpose did the portfolio hold?

MR. MUDD: When a -- when an originator originates mortgages and builds up a book of loans that they then put into a -- into a Fannie Mae or Freddie Mac security, they -- they are still --

they're the originator of those loans obviously, but they still hold those loans but they're now in the form of a mortgaged-backed security on their books.

The reason that the mortgage-backed security is more valuable, per se, on their books is because it's -- it's a straightaway Fannie Mae MBS Triple-A security.

And therefore, it has a liquidity value in that the CFO, the treasurer, or whatever of the bank can get those sold into the marketplace very expeditiously should they have any, which they couldn't do with the individual loans.

One of the things and to my view one of the most important things that the portfolio did was it provided the liquidity to ensure that even at the worst times in the marketplace, 9/11 or parts of 2008, there was always going to be a bid out there for those mortgages.

And so we sort of were able to achieve a liquidity premium on the price of the MBS through the existence of the portfolio because there was certainly no guarantee that anybody else would be out there in tight markets.

COMMISSIONER HOLTZ-EAKIN: So number one, it was a Triple-A security because it was guaranteed, right? It was guaranteed. So they had security.

Number two, you're saying that by already holding 3.2 trillion dollars worth of assets, this gave them assurance that you would buy more?

MR. MUDD: No. No.

COMMISSIONER HOLTZ-EAKIN: How does that help?

MR. MUDD: That was what I said, it was the question of what was the purpose of being in that business, and that was one of the purposes of being in the business.

COMMISSIONER HOLTZ-EAKIN: Another purpose to be in that business was be to simply borrow what was an implicit government guarantee very cheaply, and invest in a very risky set of assets that, by your own admission, got riskier as time went on, and take advantage of the implicit backing of the taxpayer to make money. How do you feel about that?

MR. MUDD: Not in agreement. The -- the overwhelming bulk of the assets that were in the portfolio were actually typical, conventional, conforming mortgages. So the notion that -- the notion that the portfolio was a locus of riskier loans than the broad book was not accurate, in my experience.

COMMISSIONER HOLTZ-EAKIN: So that you held a different set of assets in your portfolio than you actually were funneling into MBSs, because, as you said, you made a conscious, continual shifting to Alt-A's, greater magnitude 2003, 2004, 2005. Didn't your portfolio also become riskier as a result?

MR. MUDD: Over time the portfolio grew and over time as the portfolio participated in investments and private label securities and other investments consistent with the market, but I guess the point I was trying to make was that -- that directionally and qualitatively, though, the businesses are different, but the classes of assets in which the two businesses are investing are largely the same.

COMMISSIONER HOLTZ-EAKIN: But over time, by process of elimination, there was not a decision to hold greater capital backing, stay at the regulatory minimums; there wasn't a decision in any way to stress test more aggressively until very late. Indeed, the only thing that seems to have happened is you have relied more and more on the ability of the taxpayer to pick up the pieces when it falls apart.

What did you do in the presence of this very large, risky portfolio and what others have testified to be sort of inadequate internal risk management to ensure that you don't -- didn't end up in the position that you ultimately ended up in?

MR. MUDD: I will start and Mr. Levin might have some additional comments, if that's okay.

COMMISSIONER HOLTZ-EAKIN: I'm happy to hear it, and I want to point out, this is not something that is a revelation in circa 2010; this is a concern circa 2003, when I testified at the congressional budget office; this is something that many people predicted. And knowing that, I'm curious that it was allowed to happen.

MR. MUDD: By and large -- by and large the locus of the credit crisis has been around credit risk and not interest rate risk, the rate risk fundamentally taken in the portfolio is interest rate risk.

And the procedures around managing interest rate, we've talked mostly today about credit risk, had the same degree of controls and limits and models and the other things that you would expect.

We -- we raised capital; we reduced limits, we charged higher fees; we focused -- we focused all of the organization on the risk management within the -- within the portfolio.

So I guess maybe --

COMMISSIONER HOLTZ-EAKIN: Mr. Levin, briefly, and then I'll yield back, Mr. Chairman.

MR. LEVIN: Yes. I wanted to go back to one of your initial questions, which was why the portfolio; what purpose did it serve?

VICE CHAIRMAN THOMAS: Yield the gentleman an additional two minutes for purposes of the witness answering the question.

COMMISSIONER HOLTZ-EAKIN: Thank you.

MR. LEVIN: And our portfolio served a very important liquidity function in the marketplace. And -- and -- and I would ascribe three levels of liquidity, you know. One would just be general contribution to liquidity, which helped reduced mortgage rates, which helped people get into homes.

A second dimension of it would be in periods of stress in the marketplace when other sources didn't exist, the portfolio was a critical -- critical function.

And Mr. Mudd mentioned 9/11, and I think the 2007 and 2008 period would be additional examples.

And then a third function of liquidity for the portfolio would be for the class of mortgages for which an active securitization market did not exist.

And I think a prime example of this would have been the multi-family market, which over this time period, there really wasn't much of a securitization market. Virtually all of that business was done in whole loan form in the portfolio.

And then just the final comment I would make on purposes of the portfolio that there were also products that would contribute to our affordable housing goals that were better done through the portfolio as opposed to being better done through the other line of business.

And so I would put the -- what we did in the subprime in that example.

COMMISSIONER HOLTZ-EAKIN: I thank you both for this. I do want to reserve the right to come back to and pursue some of this, and just close with the observation that even a very weak regulator took the very first opportunity it had to limit the size of your portfolios would suggest they were not entirely in the interest of your public-for-risk mission. Thank you.

CHAIRMAN ANGELIDES: Thank you, Mr. Holtz-Eakin. Mr. Thompson.

COMMISSIONER THOMPSON: Thank you, Mr. Chairman.

EXAMINATION BY COMMISSIONER THOMPSON

COMMISSIONER THOMPSON: Good morning, gentlemen. Many in our country have believed that the housing bubble may very well have been a significant contributor to the financial collapse. And arguably, Fannie and Freddie probably had the best view of the U.S. housing market, particularly the segment of the market targeted at low- to mid-income buyers.

And while the private label security guys were the Johnny-come-latelies you guys have been in the market for -- since 1938, no question about that, I think if you look at the period where house ownership or homeownership in our country grew substantially, there was about a four- to five-year period where there was a 10 percent increase in homeownership, quite substantially from historical norms.

And so I guess my question is, at what point does someone who has such great market knowledge and has a public mission have a responsibility to also say, something is going wrong here, and therefore use your knowledge of the market to tell HUD and to tell Congress, slow down, something's not right. Mr. Mudd?

MR. MUDD: I think there is that, there is that responsibility, we had those conversations throughout the rule-making process as HUD established the housing goals.

The other side of the coin, a little bit to me, was that when I first started to look at this, the data of homeownership, there was a 10 or 15, maybe more, percent gap in -- in homeownership rates between minorities and the majority. And there was clearly ground to be made up there on a -- on a fairness basis.

And President Bush had a minority homeownership initiative that we participated in. There were similar programs in earlier administrations. And a lot of the -- a lot of the increase in homeownership was -- was -- was driven by folks able to access the homeownership market for the first time.

In -- in -- in -- in retrospect, I think that -- I think that it got too high. At the time, it reflected that there had been no progress for a period of time, and then -- and then suddenly, in my interpretation, as a confluence of all the different programs and focuses and initiatives and so forth that were underway, there was progress. And I thought that that was good progress.

COMMISSIONER THOMPSON: So but it is true that part of that increase in homeownership was attributable to loans that were originated that had very, very low standards of origination and, therefore, could have contributed to an eventual collapse. So the blind pursuit of metrics put our country at risk.

MR. MUDD: Well, as I tried to indicate before, the business that Fannie Mae did was -- was in order of do better than market, leaving at large, to this day, about 70 percent of the loans in the market are Fannie or Freddie loans, in total, and about 30 percent of the total market delinquency is Fannie/Freddie.

Thirty percent of the loans in the market are held by private institutions wherein reside 70 percent of the delinquency.

So I think we did act with prudence, we did act as a breaking force. In retrospect, you're absolutely right. Folks that get in near the end of the home price rise with lower -- with lower equity in the house are going to be the first to get hurt.

And, unfortunately, those were a lot of the emerging homeowners I was just describing.

COMMISSIONER THOMPSON: Mr. Levin, you were with Fannie for a very, very long time. Would you comment on that. Was part of the responsibility you have to act on market knowledge?

MR. LEVIN: You know, we had -- we had continual conversations with our regulators about what we were seeing in the marketplace and so, you know, on the --

COMMISSIONER THOMPSON: How about with Congress or with HUD?

MR. LEVIN: With HUD.

COMMISSIONER THOMPSON: Okay.

MR. LEVIN: And there were conversations with, you know, with -- with all parts of -- all parts of the government, but with HUD, we had regular quarterly meetings where we would discuss issues like this, and they were usually centered around our housing goals and what we were seeing in connection with our housing goals. And, you know, we would express what we thought to them as part of these meetings.

COMMISSIONER THOMPSON: So you could certainly describe your mission as somewhat schizophrenic, the cross between trying to serve the public's interests and the interests of shareholders. As you look with the benefit of hindsight now at what has happened with the GSEs, is this a mission that really should have been undertaken, particularly as it was structured?

MR. MUDD: It's -- in my mind, Commissioner, it's the most important question in the whole discussion. And it goes to a broad determination of whether you want an American government in some way to tweak the system to the advantage of homeownership.

COMMISSIONER THOMPSON: But I'm asking for your opinion.

MR. MUDD: My opinion, my opinion is that with where we are at 90-something percent of the loans in the market today being -- being run through the government in one form or another, the notion that you would go back to a fully private structure cannot be logistically accomplished in our lifetimes.

I do think that a -- a consensus around what the models should be is important. If it were for me to do, I would have the GSEs focused on principally first-time home buyers getting -- getting -- getting -- getting folks onto the ladder in the first place, under terms, generally predictable payment, fixed rate, 30-year loans with 20 percent down, the old-fashioned way. There -- there would be a portfolio. The portfolio would not be as large as -- as it had been. And there would have to be some, in my view, explication of exactly what the relationship is between these entities and the government.

COMMISSIONER THOMPSON: So what would that change do to your housing goals? If that's the more plausible approach to the market, what should the housing goals therefore be?

MR. MUDD: Well, it always seemed to me, sir, that if you were going to have -- if you were going to have requirements like the housing goals, they should also -- they should also be balanced by the capabilities of the organization.

So I think the notion of, if you had entities like this, they would be supervised and regulated to attain mission goals has to make sense.

To my judgment, the flaw in the -- in the -- I guess it's now an old goals regime, because it doesn't apply anymore, the flaw in the goals regime was that it was set without respect to the market, which effectively put the companies in a position of having to outstrip the market.

COMMISSIONER THOMPSON: The goals should have been more?

MR. MUDD: The goals -- the goals should have been floating with respect to where the market was --

COMMISSIONER THOMPSON: But they --

MR. MUDD: -- on a periodic basis, as opposed to straight-lined under the numbers that Mr. Wallison described.

COMMISSIONER THOMPSON: Mr. Levin?

MR. LEVIN: My view on the housing goals is that numbers just for numbers aren't useful. Then what would have been more useful would have been to identify what really were the problems in the housing and mortgage markets and then to direct the companies to address what were really considered real -- real problems.

And so, for example, if policy makers would determine that there was a problem with new rental housing for seniors, just making up an example, which would direct -- to direct the enterprises to help fix that problem would make sense to me because it was, you know, if that was a problem, then it was a problem worth fixing. And if the next year there was another problem, then to have us address that other problem, but not numbers for numbers' sake where there might not be a problem.

COMMISSIONER THOMPSON: Was there an opportunity, perhaps, to reprioritize your charter and focus on those things that were most relevant in the marketplace that would have made the institution more sound?

MR. LEVIN: That wasn't done at my pay grade.

COMMISSIONER THOMPSON: Well, Mr. Mudd, I guess you've got the only pay grade that it might have been done on?

MR. MUDD: It comes with the territory, which seem -- I'm sorry, could you --

COMMISSIONER THOMPSON: Could you have reclassified or changed your charter to go focus on the things that would have made this institution more sound?

MR. MUDD: I think that the thing that would have made the institution more sound or have produced a different outcome would have been for it to have become over time a more normal financial institution able to diversify, able to allocate capital, able to be long or short in the market, able to operate internationally.

And if the trade for that would have been, you know, a cut in the so-called implicit ties with the government, I think that would have -- that would have been a better solution.

That -- that -- the items that were discussed earlier, the work that Citibank and McKenzie did was, in part, to evaluate -- evaluate that course.

In my experience there was never any genuine interest, on the part of government, in -- in pursuing that or allowing that to happen.

COMMISSIONER THOMPSON: Thank you very much.

CHAIRMAN ANGELIDES: Thank you, Mr. Thompson. Mr. Hennessey?

VICE CHAIRMAN THOMAS: Mr. Chairman?

CHAIRMAN ANGELIDES: Yes.

VICE CHAIRMAN THOMAS: Thirty seconds prior to moving to the Commissioner?

EXAMINATION BY VICE CHAIRMAN THOMAS

VICE CHAIRMAN THOMAS: My understanding is that, Mr. Levin, was in your response to the question asked by Commissioner Holtz-Eakin -- oh, it was Thompson that asked the question -- it was above your pay grade?

MR. LEVIN: No, that was sloppy language. Let me -- let me --

VICE CHAIRMAN THOMAS: No, it wasn't sloppy. It was quite clear. My understanding is between 2000 and 2008, you made 45 million dollars?

So only people above 45,000 -- 45, excuse me -- million dollars, between 2- and 2008 could answer that question?

MR. LEVIN: What I meant by the -- what I meant -- what -- what I was addressing was the question of could we have affected the Charter Act.

VICE CHAIRMAN THOMAS: Right. And it was above your pay grade?

MR. LEVIN: Yes. And -- and my language was sloppy.

VICE CHAIRMAN THOMAS: No, it wasn't sloppy.

MR. LEVIN: And what I meant by that --

VICE CHAIRMAN THOMAS: It was flippant, if you want that as a choice.

MR. LEVIN: What I meant by that, sir, was that was in the purview of the Congress, not the company.

VICE CHAIRMAN THOMAS: Oh, Mr. Chairman, I'll get to those questions in a minute.

CHAIRMAN ANGELIDES: Mr. Hennessey?

COMMISSIONER HENNESSEY: Thank you, Mr. Chairman.

EXAMINATION BY COMMISSIONER HENNESSEY

COMMISSIONER HENNESSEY: Mr. Mudd, in your testimony you said, let me quote here, 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.

I -- I agree with that assessment and I want to better understand your view about whether Fannie's actions contributed to each of these four outcomes.

My personal views is I believe the policy makers on both sides of the aisle contributed to each of these four problems, and I would like to ask about the contribution of your decision to guarantee roughly 350 billion dollars of Alt-A mortgages.

So let me go through each of the four, quickly, in turn. You said there was an overinvestment in housing, but Fannie is not just a market follower. When Fannie takes an action, they become a market leader just because of their size.

Do you think that your decision to increase participation in the Alt-A market caused this market to expand further? Did Fannie's guarantees contribute to overinvestment in Alt-A mortgages?

MR. MUDD: I think Fannie Mae's investments, at large, given that it was in the chartered purpose of increasing homeownership and increasing affordable housing, did both of those things: It increased homeownership and it increased affordable housing. And therefore made the pie bigger and therefore when the collapse came, more people were exposed to the collapse.

COMMISSIONER HENNESSEY: Okay. And then you said that origination standards slipped. Now, I understand your point that you had lower default rates than your competitors, but did Fannie's origination standards slip on Alt-A mortgages?

MR. MUDD: We tried to be very prudent and procedural in the process and -- and -- and -- and you've already mentioned the point about the comparison to the -- to the market at large.

I think that in -- in retrospect, there was a -- there was -- there were kind of three factors around the Alt-A mortgages that probably deserved greater examination, although it's data that I don't have access to anymore, where the state concentrations in Alt-A tended to be the states with the least affordable housing. The states with the least affordable housing also happened to be among the biggest states, California and Florida, among them, one.

And then, two, a proportion of that business, a high proportion of Alt-A business, came through broker channels. And I think that the broker channels, the broker channel, by and large, allowed a lot of leakage into the system of loans that were not underwritten to a higher quality. So that was what I -- what I had in mind, there.

We charged higher fees, we charged adverse market overrides on the Alt-A, on the Alt-A book, but because of its vintage being as close as it was to the collapse in home prices those also tended to be the first ones to get --

COMMISSIONER HENNESSEY: I think what I'm hearing from you there is, yes, the standards slipped but you did your best to manage it; is that fair?

MR. MUDD: Well, under the --

COMMISSIONER HENNESSEY: Or maybe -- or maybe it slipped, but it wasn't intentional and you did your best to manage it?

MR. MUDD: I think that that's -- that is a -- I think that that's a fair statement, that it -- that it was not our intention to slip it but it -- and, in fact, it was our intention to tighten the standards around Alt-A.

And, in fact, they were tighter, as you

pointed out, than the private market at large. But if -- if you go back and look at it in retrospect, they weren't tight enough.

COMMISSIONER HENNESSEY: Okay. You said that there was too little skin in the game. Did Fannie lower its down payment requirements for subprime and Alt-A mortgages?

MR. MUDD: Not in the -- not directly in the way that you're describing. The participation in those markets -- if -- there was something -- there were -- there were credit grids that had a multiplicity of factors on them that sort of sum-totaled down to a number about whether a loan would be approved or not approved in the -- in the Fannie Mae system.

So to the extent that a LTV ratio was higher, somewhere else in the underwriting there would have to be a compensating factor that would -- that would move those up.

COMMISSIONER HENNESSEY: I got it, let me try, then, let me rephrase a little bit.

Did Fannie Mae understand that they were guaranteeing mortgages that had higher LTV ratios and lower down payments?

MR. MUDD: Yes.

COMMISSIONER HENNESSEY: Okay. And then you said that homeownership rates probably rose too high. Do you think that Fannie Mae's increased participation in subprime and Alt-A markets contributed to these homeownership rates rising too high?

MR. MUDD: Contributed? I would say so.

COMMISSIONER HENNESSEY: Okay. Next, in your testimony, different topic here, you said, a mono-line GSE structure, asked to perform multiple tasks, cannot withstand a multi-year 30 percent home price decline on a national scale, even without the accompanying global financial turmoil.

And you mentioned several times that because you were a mono-line firm, because you couldn't diversify, that was a significant contribution to the firm's failure, it seems to me that the key phrase there is, asked to perform multiple tasks. Because a mono-line firm can survive a severe shock if it does an excellent job at risk management and if -- if it is sufficiently well capitalized. Yes?

MR. MUDD: Yes. I thought about those words carefully and you've interpreted them correctly.

COMMISSIONER HENNESSEY: Okay. So it's

not -- I am concerned. You seem to be ranking lack of diversity high in the reason for failure. And maybe I'm just reading something that's implicit, but it seems to me that having these extremely high leverage ratios and the inability to manage the risks was probably more important to the firm failing than a lack of diversification, would you agree?

MR. MUDD: Well, the lack of diversification left the GSEs exclusively exposed to the one market that cratered the worst. So, respectfully, I don't know how I can distinguish those, the -- the -- the two factors from each other. I would be happy to try.

COMMISSIONER HENNESSEY: Okay. And then, if I could, I just want to follow up on Mr. Georgiou's line of questioning, because what you said about not being aware of the firm trying to lobby Congress on the appropriation for the regulator just completely contradicts my experience over the past probably ten years.

And, Mr. Chairman, I would just suggest that it's an important area for us to understand, because we've heard several times that Fannie Mae was in compliance with the regulatory capital standards, but if Fannie or its proxies were at the same time trying to keep those capital standards from being raised to something more like what a national bank or another large financial institution would have used, then there's a problem.

I remember back to political science class, we learned about iron triangles right between a regulated firm, the Congress, and the regulator. And I just think we need to understand, now that the taxpayers in effect own these firms, to what extent were these firms trying to influence both legislative and executive branch policy makers to not just keep the funding for the regulator low, but to prevent stricter capital standards and to prevent the regulator from having stronger authority over the size of the portfolios.

CHAIRMAN ANGELIDES: All right. We'll note that for the record and also instruction to staff, and I know they've already provided some information on lobbying expenses, which I think were cited by Mr. Georgiou as accumulating to 80 million dollars over the timeframe referenced.

COMMISSIONER HENNESSEY: Thank you.

CHAIRMAN ANGELIDES: Thank you, Mr. Hennessey. Ms. Born.

COMMISSIONER BORN: Thank you very much.

EXAMINATION BY COMMISSIONER BORN

COMMISSIONER BORN: And thank you both for being willing to appear before us and help us with our work.

In the written testimony of James Lockhart, who was the director of OFHEO from 2006 and 2008 and who is going to appear before us this afternoon, he said that Fannie and Freddie had very large derivatives positions in connection with their portfolios of mortgage interest.

And I understand from our staff that Fannie held about 1.2 trillion dollars in notional amount of derivatives in the summer of 2008 prior to the conservatorship, and that Freddie had an additional 1.6 trillion dollars in notional amount of derivatives.

If you can -- if you have knowledge of this, could you tell us what kinds of derivatives were being held by Fannie Mae?

MR. MUDD: They were -- they were principally in the form of options swaps and swaps, there on plain vanilla, used for the purpose of extending the match on the debt to the underlying mortgage assets.

COMMISSIONER BORN: So they were basically being used for hedging purposes?

MR. MUDD: Yes.

COMMISSIONER BORN: And they were trying to hedge the interest rates risk that you had; is that right?

MR. MUDD: Yes, ma'am, the -- the feature of the 30-year fixed rate mortgage is that the individual consumer can pay it off anytime they want to, and ideally you would match 30-year funding to a 30-year asset.

But because of that option, you have to understand what the -- what the likely actuarial statistical life of the book of the mortgages was going to be.

And therefore it was -- it was generally most efficient to -- to fund components of the portfolio with short-term paper or bullet debt or other forms of straight debt and then use the derivatives market in order to create the optionality to match the term of the mortgage and then to adjust that book depending on if interest rates were going up and the book was extending or interest rates were coming down and the book was paying off.

COMMISSIONER BORN: So was both interest rate risk and prepayment risk?

MR. MUDD: Yes, ma'am, which are derived of the same root cause.

COMMISSIONER BORN: Right. Did you also hedge against default risk in the portfolios.

MR. LEVIN: Not in the form of derivatives. We would, you know, purchase credit enhancement in the form of mortgage insurance, was the -- was the way we would do it.

COMMISSIONER BORN: Did you engage in any kind of speculation with derivatives trading?

MR. MUDD: No. It was, to my knowledge, it was all in the book, not for speculative purposes.

COMMISSIONER BORN: Mr. Lockhart suggested that there were concerns during the time he was the director of OFHEO, about the derivatives position with respect to Fannie Mae's and Freddie Mac's exposure to counterparty risk and also, he said, interest rate risks. Can you explain what those concerns were?

MR. MUDD: I can explain how -- how I thought about them from the standpoint of counterparty risk. I'm not sure -- I was not able to read Mr. Lockhart's testimony but, as a general matter, as -- as I suspect you know, the risks on the derivatives book is the failure of one of the counter-parties to perform.

So within the risk management function, we -- we built out a team that was focused on counterparty risk and aggregate exposure with limits to each of those counter-parties.

And we actually, in the cases of Fannie Mae, had to look at it across the book because we -- it -- it would have been possible for us to have an exposure on the derivative side, on the debt side, on -- and as well as the institution could have been a customer of ours on the credit side of the business.

So that function was created to enable us to look across an entire counterparty and understand what the exposure was there. And that actually, I think, enabled us to reduce the exposure in both the Bear Stearns and the Lehman's situations in advance, so it proved fortuitous.

COMMISSIONER BORN: Did you experience any default to -- defaults in connection with Bear or Lehman or otherwise during, say, 2007 or 2008 --

MR. MUDD: I -- I --

COMMISSIONER BORN: -- on the derivatives portfolio positions.

MR. MUDD: I don't know. I don't have access to the place.

COMMISSIONER BORN: The Wall Street

Journal, on Tuesday, April 6th, reported that Fannie Mae and Freddie Mac currently have more than 2 trillion dollars in notional amount of interest rate swaps on their books. And they are thereby among the largest participants in that market.

And evidently the Federal Housing Finance Agency is considering requiring that all those instruments be centrally cleared through a clearinghouse in order to diminish counterparty risk and also to obtain improved pricing information.

Would you have considered that a good move while you were at Fannie Mae?

MR. MUDD: I -- I -- I find it hard to -- hard to reposition myself in the past, but I think my concern would have been that -- that putting limitations on the markets where Fannie and Freddie could hedge that didn't -- as very large users of derivatives, would put them in a different position with respect to the rest of the market.

And that could either advantage others at the expense of Fannie and Freddie, or it could disadvantage Fannie and Freddie at the expense of not having as wide a palette of tools to use.

My observation of reading the article was that, as I note in my testimony, the companies were being used in some ways to effectuate changes in public policies and public markets, and so there may be other reasons to do that that I'm not aware of anymore.

COMMISSIONER BORN: Mr. Levin, do you have a reaction?

MR. LEVIN: I -- I -- I would be interested in the proposal. I've not seen the proposal. But it's difficult, without seeing it, to respond.

COMMISSIONER BORN: Let me just follow up a little bit on some questioning that you had from Commissioner Georgiou and Hennessey about the political power and influence that Fannie Mae exercised prior to the conservatorship.

Fannie Mae certainly had a reputation of exercising very significant political power in Washington through both extensive lobbying and government relations expenditures, and also hiring or retaining high former government officials to conduct its government relations and lobbying.

Does it seem unusual to you that millions of dollars were being spent each year during the time you were CEO for lobbying expenses?

MR. MUDD: No, it does not.

COMMISSIONER BORN: Why not?

MR. MUDD: There -- there -- in premise, I would agree that there was a time when there was -- there was -- there were too many of the behaviors or activities that you described. So this was --

COMMISSIONER BORN: When was that?

MR. MUDD: Prior to -- prior to my time as CEO, certainly. And one of the things that was on my list upon -- upon accession to the job was to -- to get that right.

And my thought was that -- but at the same time, there were a number of complicated issues that went fundamentally to the existence of the companies before Congress, and secondly, there were inbound calls from Congress and other branches of the government, that had to be responded to, and they had to be responded by somebody that understood what the lobbying rules and the interaction rules of government are, and those people happen to be called lobbyists.

My determination was that the thing to do was to bring them inside the company so they were under -- under my direct supervision. But they also understood what the company was doing, and instead of, you know, schmoozing, they were actually working on the issues of the day.

But with the regulatory bill, which

changed, I hoped, the fundamental nature under which the company was going to operate, I thought and I still think to this moment that it was very important to get that exactly right and for us not to be on the field having our voice heard in terms of this provision will have this specific impact on what the company can and can't do, how we do and don't run the company, what our effect on the capital markets will and won't be; didn't seem like the appropriate way to do it.

Last sentence on that is that, as you may know, the lobbying numbers are derived as a head count percentage multiplied by the overall expenses of the firm. And during the period, we were going through an expensive restatement, which made that denominator higher than it would have been in the ordinary course. The numbers, excuse me, have to be used with some degree of caution.

CHAIRMAN ANGELIDES: Ms. Born, do you need any more time on this matter?

COMMISSIONER BORN: I would like to ask one more question.

CHAIRMAN ANGELIDES: All right. Two minutes?

COMMISSIONER BORN: That would be fine.

CHAIRMAN ANGELIDES: Whether -- yes.

COMMISSIONER BORN: I would just like to ask whether Fannie Mae had a PAC that its officials would contribute to and that would be used to make contributions to public officials?

MR. MUDD: Yes.

COMMISSIONER BORN: And what was the name of the PAC.

MR. MUDD: Fannie PAC or something like that.

COMMISSIONER BORN: Do you have any recollection of how large that PAC was and how large the contributions to it were?

MR. MUDD: I don't, I know it's a matter of public record. I can find that, I think.

COMMISSIONER BORN: I'm sure it is.

MR. MUDD: But I don't know.

COMMISSIONER BORN: I'll just have to go find it. Thank you.

CHAIRMAN ANGELIDES: All right. Mr. Hennessey I'm going to move back to you because you did have one minute and fifty seconds. But we're going to give you two minutes because of, you know, our generosity with time. But you had another question?

COMMISSIONER HENNESSEY: You are too kind, Mr. Chairman.

CHAIRMAN ANGELIDES: I know, but don't forget it though.

COMMISSIONER HENNESSEY: I certainly won't.

EXAMINATION BY COMMISSIONER HENNESSEY

COMMISSIONER HENNESSEY: Frankly, I'm just stunned by these comments, because as a White House official over the past decade, I was directly lobbied by outside consultants who were -- who told me they were hired by Fannie and who told me that in fact Fannie had gone through the White House staff who they thought were working on the issue and targeted a specific lobbyist at each one of those staff. So my experience is just different than what you're describing.

My question, you talked a lot about the balance between your fiduciary responsibilities to your shareholders and the need to fulfill your public purpose. And in your testimony, you said, 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.

So earnings are key to both those private goals and those public goals. And I'm confused about the public purpose of buying, guaranteeing about 350 billion dollars of Alt-A mortgages.

Was there a direct benefit to the housing market from these, these guarantees, or was it indirect through higher profits for the firm?

MR. MUDD: Well, I think -- I think both.

COMMISSIONER HENNESSEY: And what was the direct benefit?

MR. MUDD: The direct benefit is that there -- there were, as Mr. Levin mentioned earlier, there were -- there were loans in the Alt-A category that were -- that were obviously conventional conforming loans, but for want of some traditional part of the non-Alt-A loan underwriting.

Just to pick an example, at one point we looked at providing loans to teachers. A loan to teachers wouldn't have 12 monthly amortizing payments. Could they have nine months of payments and then three months of nonpayment when the teacher's not working?

Now, that would -- that -- you might or might not agree that that would be a laudable purpose, but in either case, that would be an Alt-A loan. So that's just an illustration of my thinking in terms of how Alt-A could serve the mission as well as the financial side of the business.

COMMISSIONER HENNESSEY: Thank you.

CHAIRMAN ANGELIDES: Mr. Georgiou, you have the same amount of place on the record before we go to the Vice Chair. Microphone, please.

EXAMINATION BY COMMISSIONER GEORGIOU

COMMISSIONER GEORGIOU: I'm sorry, I just want to finish briefly on the list of what I would regard as potential accounting improprieties.

The FHFA and OCC noted that Fannie did not recognize losses until a loan had been delinquent 24 months and that Fannie made unsecured loans to delinquent borrowers. OCC noted, in their report, that allowance methodologies must be revised to recognize inherent losses in their portfolios regardless of the timing of the loss event.

And it was critical, given the extremely liberal attitude with respect to loss recognition and compounded by significant business initiatives undertaken by the GSEs to defer losses.

There are three areas, and I guess I just state it for the record, and maybe you could respond in writing, thereafter.

Did Fannie make unsecured loans to

delinquent borrowers under the HomeSaver Advance Program or any other program where the underlying loans thereafter no longer reported as delinquent loans? And did Fannie make those unsecured loans so as -- so it would not have to repurchase the underlying loans and record mark-to-market charges? Thank you very much.

CHAIRMAN ANGELIDES: And you would like -- and we're going to ask you for written responses to those questions, all right, gentlemen?

COMMISSIONER GEORGIOU: Thanks.

CHAIRMAN ANGELIDES: All right, thank you. Mr. Wallison?

COMMISSIONER WALLISON: Thank you, Mr. Chairman. Just a few minor matters, I think.

EXAMINATION BY COMMISSIONER WALLISON

COMMISSIONER WALLISON: Just for those who are watching.

CHAIRMAN ANGELIDES: Two minutes, Mr. Wallison.

COMMISSIONER WALLISON: Those who are watching on television, it would be important for you, if you want to take a look at our website, where there is a staff report on Fannie and Freddie.

And on page 8 of that report, there is a chart which shows Fannie and Freddie's compliance with the affordable housing guidelines and how that rises just above the requirements that HUD was imposing as it went on.

So it would be useful to see how influential those guidelines were in Fannie's purchase of subprime and Alt-A loans. A question came up about whether Alt-A loans are, in fact, goals-rich. And there is some information on that. In 2000 HUD adopted a rule which said new -- and what they -- as they describe their rule -- new provisions clarify certain other provisions of HUD's rules for counting different types of mortgage purchases towards goals, including provisions regarding the use of bonus points for mortgages that are secured by certain -- by certain single-family rental properties.

That's why an Alt-A loan would be a goals-rich loan, because it allowed a non- -- non-owned investment to be rented. And a rental property did provide housing for the groups that were supposed to be included within the affordable housing loans. So that explains it.

And we do have some information that was turned over by Freddie, Freddie Mac, that on balance, they say, Alt-A loans were net positive for the housing goals.

And, finally, I want to talk about this question of private label securities which, in fact, Fannie and Freddie did purchase in -- in substantial numbers. This was a significant element of their purchases. And they were profitable because these were high-interest loans, unlike many of the loans that Fannie had made, and they were not as good quality. They were -- they were -- there was not as good quality as the loans that Fannie was making.

So when you made the point, Mr. Mudd, that it was -- it -- your loans were performing better than other loans, this is exactly right. Those subprime loans that underlay the -- the private label securities were much worse in terms of their quality and have a much higher delinquency rate. And the odd part is that --

CHAIRMAN ANGELIDES: Mr. Wallison, if you would just wrap up. We're over time.

COMMISSIONER WALLISON: I will. The odd part is, in buying these pools, you were in fact advancing your competition's position, because they would assemble these pools of conforming loans and sell them to you, and they helped you with your affordable housing guidelines. And they were also profitable. But it also helped Wall Street do more of the securitization that they were doing.

CHAIRMAN ANGELIDES: All right.

VICE CHAIRMAN THOMAS: Thank you.

CHAIRMAN ANGELIDES: We'll leave that, and if you would like to respond, we'll ask you do that in writing.

Mr. Thomas?

VICE CHAIRMAN THOMAS: Thank you, Mr. Chairman.

EXAMINATION BY VICE CHAIRMAN THOMAS

VICE CHAIRMAN THOMAS: Much of the questioning that we've heard today is based on the fact that you obviously were dealing in, quote, unquote, investments, which look a lot like some of the other folk who were in front of us in dealing in investments, unfortunately with much the same outcome, but in fact, you folks really aren't a business at all.

I mean, when you -- when Ms. Murren asked you about compensation and the companies that you compared yourself with, those really are companies. They -- they have articles of incorporation, a lot of them in Delaware because of their rules. They basically have to make a profit. If they don't make a profit, at some point, they cease to exist.

But you didn't have to have articles of incorporation. And you didn't have to make a profit. So in any of those discussions, I'm going to spend a little time to bring it back into what I would probably say more so than any other Commissioner, my world. For more than three decades, I've been in Washington.

People look at Washington, D.C., as a national capital, international capital. But Tom Brokaw, in his book, talked about Washington, D.C., as being a small town. And in the time that I've been here, I can tell you that, in spades, it's also a company town.

I'm looking at a 2002 paper, put out by Fannie Mae, under the heading, Fannie Mae papers, headline, title, implications of the new Fannie Mae and Freddie Mac risk-based capital standard.

Again, this is `02. It says down in the corner, Fannie Mae papers is an occasional series on policy issues of interest to the housing community. And the conclusion of the paper, and not unsurprising or probably wouldn't have seen the light of day, this analysis shows that, quote, based on historical data the probability of a shock as severe is embodied in the risk-based capital standard is substantially less than one in 500,000 and may be smaller than 1 in 3 million.

Given the low probability of the stress test shock occurring and assuming that Fannie Mae and Freddie Mac hold sufficient capital to withstand that shock, the exposure of the government to the risk of the GSEs will become insolvent appears quite low.

Commissioner Hennessey talked to you about the fact that as there was an attempt to get Fannie Mae to increase its capital levels, there was resistance from Fannie Mae. Yet this document, based upon that assumption, was put out, I assume, to try to attract business under your concept of your business model.

But probably as important as the content of this is who wrote it. There are three names on here. The one that I was drawn to was a fellow by the name of Peter R. Orszag, who's currently the director of the Office of Management and the Budget.

I want to talk about small town/company town. Franklin Raines was Fannie Mae's Vice Chairman from 1991 to 1996. In 1996 he moved directly from Fannie Mae to be the director of the Office of Management and the Budget, from `96 to `98. When he left the director of the Office of Management and the Budget, he became CEO at Fannie Mae, 1999 to `04.

In my more than 30 years, I don't recall, because in yesterday's panel former comptroller of the currency, Mr. Hawke, talked about the advantage of going in and out of government and the cross-fertilization and the benefit. And I agree with that, with certain limitations, but I have never seen the in-and-out-of-government revolving door quite so focused on a position of significant importance in an administration from your, quote, unquote, business back to your, quote, unquote, business.

I look at lobbying slightly differently than I think most people here. You said that you wanted to make sure that you had people on the field. I think you and I both know it's a whole lot better if you have people in the locker room.

And I think there's just overwhelming evidence. When you look at those people that were employed for lobbying, once again, I probably read this book differently than others, I'm shocked at the virtual 100 percent content of the profile of the lobbying firms. They're either former members of Congress, members of Congress-to-be, or spouses of members of Congress or, depending on who's in control, a significant staffer who had been with the majority, when Democrats were in the majority, or with the Republicans, if they were in the majority, or back again.

I mean, it is a clear indication that notwithstanding their knowledge, there may have been a secondary reason, and maybe the knowledge might have been secondary, as to why these people were employed, in my opinion.

Commissioner Born asked you about the involvement in the political process, political action committees.

I'm a little more interested in a slightly different way, because you really have, as a kind of a board of directors, based upon your origin, that is, by statute, that's why you didn't have to incorporate, and that the money that is your life blood in terms of structured movement is actually appropriated by Congress.

And over my 30 years, I got to know -- I never wanted to be on the appropriations committee, but I got to know those who were, and I think it would be fair to say that given the size of the appropriations committee, it breaks up into subcommittees that look at specific areas of the federal government that need the appropriations from those specific areas, both in the House and the Senate.

And they take a very proprietary attitude towards those areas. They're theirs. You mentioned -- Senator Kit Bond was mentioned, Senator from Missouri, as, at that time, chairman of the VA apropos subcommittee, ranking member Senator Mikulski from Maryland.

It's true in the House as well and we'll hear some testimony with the panel following yours to reflect more on those particular activities.

I just want to ask a simple question of you about what went on behind closed doors. Mr. Levin, you were there longer than Mr. Mudd. Did you ever -- were you ever present at a meeting in which there was a discussion about how a particular member of Congress might be approached in attempting to advance the quote, unquote, business model of Fannie Mae?

MR. LEVIN: My recollection is -- stems from the days that I ran the Housing and Community Development Organization in Fannie Mae, which was the organization that made --

VICE CHAIRMAN THOMAS: I -- I've got very little time. Really, a yes or no would be sufficient, because you can follow it up with comments to elaborate.

MR. LEVIN: I'll be short. We made a big effort to try to do important things in communities --

VICE CHAIRMAN THOMAS: I'll try it again. Yes or no?

MR. LEVIN: -- and we made a --

VICE CHAIRMAN THOMAS: Mr. Chairman?

CHAIRMAN ANGELIDES: I was going to say, Mr. Levin, can you answer the question? It was a pretty straightforward question.

VICE CHAIRMAN THOMAS: I just lot a minute of time.

CHAIRMAN ANGELIDES: Well, you'll get --

VICE CHAIRMAN THOMAS: I don't have a lot of time because I conceded it to others.

CHAIRMAN ANGELIDES: Yeah, I'll give it back. I think it's a pretty straightforward question, Mr. Levin.

MR. LEVIN: Yes.

CHAIRMAN ANGELIDES: About whether you were in a meeting or not in which the subject of approaching a member of Congress was raised with respect to advancing the interests of Fannie Mae. I think that's a fair characterization. I think a yes or no would be appropriate.

MR. LEVIN: Five words. We wanted a -- we wanted members of Congress to be awarded --

VICE CHAIRMAN THOMAS: You've gone --

MR. LEVIN: As a goodwill in the community.

VICE CHAIRMAN THOMAS: -- five words. No, come on, yes or no. The answer's yes, right?

CHAIRMAN ANGELIDES: Please answer the question.

MR. LEVIN: Yes.

CHAIRMAN ANGELIDES: Thank you.

VICE CHAIRMAN THOMAS: Mr. Mudd?

COMMISSIONER HENNESSEY: Yes.

VICE CHAIRMAN THOMAS: Yes? Not that hard. See, once you get in the rhythm, it's easier.

Did you ever attend an event which was classified as a political event for a then-sitting member of Congress in either the House or the Senate?

MR. LEVIN: I don't recall if I ever did.

VICE CHAIRMAN THOMAS: You don't recall if you ever did? They're pretty boring so you wouldn't have remembered going to an event for a particular member of Congress. Mr. Mudd?

MR. MUDD: Yes.

VICE CHAIRMAN THOMAS: You did. So that's what I mean by not having to worry about who's on the field if you have access to the locker room.

I don't know why people focus on paying for lobbyists. So I guess what I'm trying to point out to you is, in reference to Commissioner Born's statement, there were a lot of people, including myself, who were well aware of the intimate access by Fannie Mae, both through your political action Commission and direct involvement, that was designed, to a very great extent, to promote your, quote, unquote, business model.

In testimony that we're going to hear very briefly, in reference to Commissioner Murren's question, there's a quote, and it's attributed to Fannie Mae's internal auditor, focused on the last decade, in the effort to double earnings in five years to 6.46, and I assume that's billion.

The quote is, by now you must have 646 branded in your brains. You must be able to say it in your sleep. You must be able to recite it forwards and backwards. You must have a raging fire in the belly that burns away all doubts. You must live, breathe, and dream 646. You must be obsessed on 646. After all, thanks to Frank, we all have a lot of money riding on it.

There was a book and a movie, and it occurred when I was relatively young and had a big impression on me, it was called Bridge Over the River Quai. In terms of someone so enthusiastically involved in their work that at the uh-huh moment, it was what have I done, in terms of building a really good bridge to help the Japanese move their supplies in Southeast Asia during World War II.

The idea that you would ask someone here, how much would you give to make sure that government had its program tweaked toward homeownership? Come on, how much would you give back to help the taxpayers with their burden left by the way in which you and cohorts ran this particular, quote, unquote, company? Because I think you lost your way to a certain extent.

It was, more than it ever should have been, focused on the amount of money that you folks could earn. And I’m just amazed, Mr. Levin, if the kind of decisions that ran the company in the ground were above the 45-million-dollar markup, which was your pay grade. Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: Thank you, Mr. Vice Chair. I have some just very quick concluding questions, and they're really clarifications, so very brief answers. And then I have one question for you, Mr. Mudd, in conclusion.

When you talk about mission, I just want to be clear that obviously there's the -- the business, the profit mission, and I mentioned the affordable housing goals, did you -- would liquidity be included in mission, liquidity for the housing market, okay, just for the record?

MR. MUDD: Yes.

MR. LEVIN: Yes.

CHAIRMAN ANGELIDES: Again, for the record, as I understood the interchange with you Mr. Wallison, and I think I'm characterizing it, that all lines of business were pursued with an eye towards making money but there may have been differential profit goals for those various lines of business; correct?

MR. MUDD: Yes.

MR. LEVIN: Yes.

CHAIRMAN ANGELIDES: Okay. So, all right, I just want to be clear. But there were no businesses in which you deliberately engaged with the idea, even though obviously it turned out such, but in which you engaged or underwrote them in which would you do cross-subsidization to the extent of loss in a particular business unit?

MR. MUDD: Not to my knowledge.

CHAIRMAN ANGELIDES: Okay. Mr. Thomas?

VICE CHAIRMAN THOMAS: Mr. Chairman, I want to clarify. In the quote that talked about what was burning in their belly, that 646, it was a goal of earnings per share, which really brings it home.

CHAIRMAN ANGELIDES: Thank you. It's too long a question. All right, here are my final two comments or questions.

In 2007 you bought -- as the market's beginning to crash, really, you bought 21 billion dollars of private label securities in that year when most of the markets were trenching pretty traumatically.

I'm just going to ask you -- were you -- was there any pressure brought on you to do that by folks, for example, in political positions and without regard to party administration or Congress to support Wall Street?

So you guys got to move in and continue to buy PLS, or in 2007, were you buying private label securities because you still thought they were a reasonable bet?

I mean, did anyone ever come to you and say, look, Wall Street's -- in 2007 -- things are beginning to -- they're pulling out of the market, a lot of the firms on Wall Street have very significant private label securities, we want you to help offload some of that, was that ever -- did that ever occur?

MR. MUDD: No one ever said that to me.

MR. LEVIN: Same.

CHAIRMAN ANGELIDES: Okay, good. Final question, and that is, that March 19th, there's a press release, Fannie Mae, Freddie Mac, OFHEO, in which you had your portfolio limits lifted, you had your capital surplus reduced, and you commit to raise some more capital.

Why on God's earth in 2008 would you be position yourselves to do more in the market as a straight business enterprise?

MR. MUDD: The -- the capital override that the regulator had in place at that time was set up as a hard line. And with the volatility in the markets, we had a concern that on account of nothing that we did, but external market volatility, we could go under the capital line and therefore be in technical violation.

So our -- our -- our ask was to give some flexibility around that line on the capital requirements but to ameliorate the logical concerns that would come out of that by expressing our interests to maintain those levels of capital if not raise capital.

We thought, at that point in the market, with ARMs resetting, subprime loans not being financeable, that there was some good that we could do by helping to finance borrowers coming out of those loans who otherwise would have qualified for a conventional conforming-type loan.

CHAIRMAN ANGELIDES: All right. My question was March of 2008, though. Is that what you're referring to in the response?

MR. MUDD: The -- the -- the discussion went on before that and after that, but that's the --

CHAIRMAN ANGELIDES: But you had sought also to lift your portfolio caps so you could do more, correct? Or was that something that was suggested to you?

MR. MUDD: We had -- we had taken the portfolio down below where it was actually required to be because --

CHAIRMAN ANGELIDES: So why were the portfolio caps lifted?

MR. MUDD: That would be a topic you would have to talk about with the regulator but I think the general concern --

CHAIRMAN ANGELIDES: You didn't ask for it?

MR. MUDD: I think that we were in favor of doing it because it gave us more flexibility.

CHAIRMAN ANGELIDES: All right. Because it seems odd to me that as the markets most business enterprises are looking at a market in which value are decreasing, risk is -- risk is increasing, and what Fannie Mae is doing and announcing with OFHEO is -- and Freddie -- you know, concerted action is these two business enterprises are increasing their portfolio caps, i.e., the ability to do more business and lowering capital. So I'm just trying to understand why it happened.

MR. MUDD: I think at least a component of it is that it was seen as an indication that -- that there would be some -- there's liquidity crisis, right? So there would be some expectation that there would be liquidity available in the marketplace.

But it did not imply that we were going to do anything that was outside prudent standards with that liquidity. When everybody else left the spreads widened up and made that more attractive.

CHAIRMAN ANGELIDES: Well, we can have revisit this. I don't want to take anymore time. The regulator will be here, and obviously the regulator was very involved in that, in that transaction, so we can explore that more.

We may have some written questions for you to fully understand exactly what happened, why, and what were -- who were the parties engaged in those discussions.

MR. MUDD: Yes, sir.

CHAIRMAN ANGELIDES: Okay, Commissioners, thank you very much, Mr. Levin. Thank you very much, Mr. Mudd.

VICE CHAIRMAN THOMAS: Thank you very much.

CHAIRMAN ANGELIDES: We will break, Commissioners, until 12:25.Thank you.

(Recess.)

CHAIRMAN ANGELIDES: The meeting of the Financial Crisis Inquiry Commission will come to order. Thank you, Mr. Falcon, Mr. Lockhart, for being with us today.

As we have done throughout the course of our hearings, for all the folks that came before you and will come after you, we swear all our witness. So I'm going to start off by asking each of you to stand and be sworn.

Do you solemnly swear or affirm, under

penalty of perjury, that the testimony you're about to provide the Commission will be the truth, the whole truth and nothing but truth, to the best of your knowledge?

MR. LOCKHART: I do.

MR. FALCON: I do.

CHAIRMAN ANGELIDES: Thank you very much.

Now, gentlemen, we do have your written testimony, but as you know, we would also invite you to make comments today -- comments to us today. And in that regard we would ask that you make an opening statement of no more than ten minutes. And I think what I'll do in kind of chronology of service to this country, I will start with you, Mr. Falcon, and ask you to go first and then, Mr. Lockhart, turn to you.

So, Mr. Falcon, proceed.

MR. FALCON: Thank you, Mr. Chairman, Mr. Vice Chairman, and members of the Commission, thank you for having me here today.

The failure of Fannie Mae and Freddie Mac will be a case study in business schools for decades. How do you operate a business with the most generous government subsidies, which confer very powerful market advantages, and run the business into the ground?

Ultimately, the companies were not unwitting victims of an economic down cycle or a flawed products and services of theirs. Their failure was deeply rooted in a culture of arrogance and greed.

I should be clear that this was a failure of leadership. There were and are many good people in the ranks of both companies. I would address the issues raised in the invitation letter by explaining the activities of OFHEO and overseeing Fannie Mae and Freddie Mac and the challenges we face.

I remain proud of what a small and dedicated group of people at OFHEO accomplished. We stood up to the full political onslaught of Fannie Mae, Freddie Mac, and their allies all over town, and we did our jobs as public servants.

We accomplished much despite the fact that OFHEO was structurally weak and almost designed to fail. OFHEO lacked the statutory powers of every other safety and soundness regulator. And the key areas, such as enforcement powers, capital requirements, funding mechanism and receivership authority.

At one point we attempted to stop bonus payments to departed executives responsible for the accounting misconduct only to be rebuked by a Federal

Judge for exceeding our authority. From beginning to end of my tenure as director, I took every opportunity to press for legislation to fill these important gaps in OFHEO's authority.

The lack of flexibility on setting capital requirements was especially troubling. By statute the enterprise's minimum capital requirement was set at 2.5 percent, which permitted them to operate at a highly leveraged level with very little margin for error.

We never received the regulatory discretion to raise this standard. Our only opportunity to increase capital and reduce leverage was in connection with the supervisory agreements to remediate the accounting violations.

Only then was I able to impose a 30 percent capital surcharge on both enterprises. In addition, OFHEO was the only safety and soundness regulator that was required to obtain its funding through the appropriations process. This was despite the fact that our funding was provided by assessments on Fannie and Freddie and not derived from taxpayer funds.

The result was that the agency was starved for resources for many years. To illustrate this point, I recall that when I first took office, I received briefings from the exam staff on their work schedule and latest examination findings.

When I inquired about some key areas that they had omitted they responded that due to staff limitations, a review of that particular risk area was put off until the following year's exam cycle.

In response, I asked exam staff to conduct a study and tell me how many examiners would be assigned to examine Fannie and Freddie, if they were regulated by another federal safety and soundness regulator.

Their conclusion was that the other regulators, with their funding outside the appropriations process, would maintain a team of at least 30 or so examiners per enterprise.

By contrast, at the time OFHEO had a total exam staff of less than 20, perhaps less than 15, to cover both companies.

Despite that kind of data to support a funding request, we had a very difficult time getting meaningful budget increases.

Before OFHEO's budget request even went to the Congress for consideration, the agency’s request first went to the office of management and budget for review and approval.

We received very large budget cuts at OMB, until about 2003, when our requests began to receive more favorable consideration.

A few years later, when OFHEO needed additional resources to conduct a special examination of Fannie Mae's accounting practices, we encountered more difficulty and delay.

Fannie's lobbyists were on the Hill spreading misinformation about my motives and asserting that the special exam was unnecessary.

We eventually received the funding and finally we had the resources to dig deeply into Fannie Mae's accounting. It wasn't long before we realized that Fannie Mae's problems were even worse than Freddie Mac's.

The enterprise's arrogance manifests itself into many efforts to obstruct the regulatory process. Let me describe just a few. The first involves the circumstances around my forced resignation, on February 4th, 2003, a year and a half before the expiration of my term.

At that time the agency was preparing to release a new research report that analyzed the systemic risks created by the enterprise's growing portfolios, debt, and role in the mortgage market.

We needed to be sure the agency and others in government fully understood the nature of their systemic risks, how to minimize it, and how to deal with it if the companies ever experienced financial problems.

The enterprises did not want the agency conducting such a study and certainly did not want it released to the public. At that time they were doing everything possible to convince the public and policy makers that their operations did not pose any systemic risk to our financial system.

A few days before the agency was scheduled to release the systemic risk report, the Chairman of Fannie Mae, Franklin Raines, called me to protest about the release of the report and its conclusions. He urged me to not to release it, and when I reaffirmed my plans, he threatened to bring down me and the agency.

Our call was over and I soon received another call from a Treasury official who stated that Fannie Mae's lobbyists were calling other agencies to urge then to press OFHEO not to release the systemic risk report.

He asked for a copy, which I provided, and he respected my decision not to delay its release. A few days later, on February 4th of 2003, I was in New York to give a speech on the findings of the report, which was being released that day.

In the morning, as I was waiting to give my speech, I received a call from the White House personnel office, who informed me that the White House was issuing an announcement on the nomination of someone to replace me as director of OFHEO. By the way, it was not Director Lockhart, it was someone in between.

I informed the personnel official that their announcement would seem odd since there was not a vacancy in the position. I asked the official to withhold the announcement for a day while I considered my options. They declined and I issued a resignation letter later that day.

The next day's news emphasized coverage of the personnel change and gave very scant coverage to the findings of the systemic risk report. This was, of course, exactly the result intended by those who engineered the timing of the announcement of my replacement. The White House eventually withdrew its nominee and I remained in office for two more years.

In 2004, as OFHEO began its special accounting examination of Fannie Mae, the political attacks and efforts at obstruction intensified. Fannie was uncooperative with document requests and they engaged their supporters in Congress for assistance.

And as described in OFHEO -- in the OFHEO -- OFHEO special exam report, in April of 2004, Fannie Mae executives acted on a plan to have a key senior -- key senator initiate an investigation of OFHEO by the HUD Inspector General. The goal was to try to discredit the agency in advance of its report on Fannie's accounting practices.

The intrusive nature of the IG review was clearly designed to intimidate OFHEO personnel and distract them from their work. The IAG eventually concluded that the agency had done nothing improper but wrote a very biased report designed to curry favor.

Later, in September of 2004, the Senate Appropriations VA HUD subcommittee passed the bill that provided funding for OFHEO's budget in 2005. The bill included specific language stating that 10 million of the agency's 2005 budget could not be spent until I was removed from office. The language was later removed from the final appropriations bill.

Also in that same month, OFHEO released its risk report on the accounting misconduct at Fannie Mae and we took supervisory actions to correct the problems.

I was summoned before the House Financial Services Committee to testify on the findings of the report. It was a vast understatement to say that I was met with a well-orchestrated effort to discredit the report and my character.

One member of the committee even accused me of conducting a, quote, political lynching. It was a shameful day in the committee's history, which I worked at that committee for eight years and another example of the dangerous political power Fannie Mae had amassed.

While all of this political power satisfied the egos of Fannie and Freddie executives, it ultimately served one primary purpose: The expedient accumulation of personal wealth by any means.

Of course, we all support the American dream of wealth accumulation as long as it is done within the rules.

Fannie Mae began the last decade with an ambitious goal. Double earnings in five years to $6.46. A large part of the executives’ compensation was tied to meeting that goal.

The internal auditor of Fannie Mae made a famous quote, which was detailed in the OFHEO special report of examination, which Vice Chairman Thomas mentioned earlier, so I will not repeat it, but it just went to the heart of how much 646 and these earnings per share targets were so important to the personnel within the companies and the compensation that they would receive as a result of meeting those goals.

And they did receive a great deal of compensation. In the case of CEO Franklin Raines, he collected over 90 million dollars in total compensation from 1998 to 2003. Of that amount, 52 million was directly tied to achieving earnings-per-share goals.

However, the earnings goal turned out to be unachievable without breaking the rules and hiding risks. Fannie and Freddie executives worked hard to persuade investors that mortgage-related assets were a riskless investment, while at the same time covering up the volatility and risk of their own mortgage portfolios and balance sheets.

The OFHEO special exam reports go into great detail on how this was done over the years. One, very telling --

CHAIRMAN ANGELIDES: Mr. Falcon, can you wrap up? I know this is your written statement but if you can quickly just, very quickly, make the points of the balance of your statement so we can stick to our schedule. Is that okay? Thank you.

MR. FALCON: I will, Mr. Chairman. Sorry, I thought I could get this done in 10 minutes.

CHAIRMAN ANGELIDES: That's okay.

MR. FALCON: Okay.

One very telling example of how greed drove the accounting violations was a 200-million-dollar maneuver in the fourth quarter of 2004, by shifting 200 million dollars into future years, they were able to obtain 100 percent of the bonus compensation that year as opposed to zero if they had properly accounted for that 400-million properly.

Your letter also asked me to talk about the impact of the affordable housing goals on their financial problems. In my opinion, the goals were not the cause of the enterprise's demise.

The firm's not engaged in any activity, goal-fulfilling, or otherwise, unless there was a profit to be made. In the end, despite management turnover at both companies, cultural problems persisted. The companies could not accept their diminished role in the mortgage market and reduction of profitability.

So they made a fateful decision to make big investments in subprime and Alt-A assets. This certainly accelerated their demise when the housing bubble burst.

In summary, the Fannie and Freddie model of publically traded and privately chartered companies is inherently flawed. The market and political power that it confers breeds arrogance, greed, excessive risk-taking and abuse.

If Fannie and Freddie are allowed to continue in any variation of the current form another Commission, at some future date, will again be asking the question of what went wrong. That is why the work of this Commission is so important, and I appreciate the opportunity to be here to testify today.

CHAIRMAN ANGELIDES: Thank you very much, Mr. Falcon. Mr. Lockhart?

MR. LOCKHART: Thank you, Mr. Chairman, for inviting me to testify about Fannie Mae's and Freddie Mac's role in the housing market, the flaws in the regulatory structure, and the actions we took prior to conservatorship.

I served as director of OFHEO and then FHFA from May 2006 to August 2009. The enterprise's mission is to provide stability, liquidity, and affordability to the housing market. Despite having over 4.3 billion of debt at that point and being some of the largest financial institutions, Fannie Mae and Freddie Mac were both very troubled as they were unable to produce timely financial statements and had serious deficiencies in systems, risk managements and internal controls.

OFHEO was finalizing its special examination report of Fannie Mae and also a consent agreement as I arrived. We fined them 400 million dollars and imposed about 80 remedial action items. Very importantly, we froze the growth of Fannie Mae's mortgage portfolio and continued the 30 percent minimum capital requirement.

The report quoted an e-mail from then-Fannie Mae's CEO, COO, Dan Mudd, at that point, and the quote is, the old political reality was that we always won. We took no prisoners. We used to be able to write or have written rules that worked for us, that was really the key flaw as the weak legislation that created OFHEO in 1992 was a product of that old political reality.

I endorsed, strongly, in three

congressional hearings, three recommendations from the report that removes the caps to Freddie as well as Fannie. We would support legislation to affix the -- in the agency and we needed to strengthen our regulatory infrastructure. In June I met with Freddie's board and asked them to voluntarily freeze their portfolios.

The portfolios, as you know, have been a major target of advocates of GSE reform because of their interest rate risk. And that required extensive uses of derivatives.

Their portfolios were a major source of income even though half the portfolios were in their own mortgaged-backed securities. The other half were in Triple-A private labeled securities and whole loans. And that compounded the credit risk, as we've heard.

At the Freddie board meeting, I went through a long list of issues, and we mentioned credit risk. And on credit risk, the push-back was extremely intense, but they did agree to the freeze.

In retrospect, capping the growth in portfolios prevented tens of billions of dollars in more losses.

President Bush had been pushing for GSE

reform for many years, the need for the legislation was obvious, and so OFHEO is regulating two of the largest, systemically important U.S. financial institutions, which -- which would require extraordinary powers for the regulator.

And we had just the opposite. The key components we asked for finally got into law only 38 days before we had to put them into conservatorship. First issue was capital. Both minimum capital and risk-based capital requirements were weak and outmoded.

The minimum capital standard actually allowed them to get leveraged to over 100 to 1. The definition of capital itself was inflexible, but it excluded large losses. Just one month before the conservatorship, both Fannie and Freddie published financial statements that showed that they were in excess of the legal adequately capitalized standard, even though in the case of Freddie, they had a negative fair value of equity.

The portfolios, as mentioned, compounded the mortgage credit risk and then introduced large interest rate and derivative counterparty risk. There were no mission-related reason why the portfolios had to be 1.5 trillion dollars.

HUD was the enterprise's mission regulator. In retrospect, HUD pushed the housing goals too high and erred by giving credit for the underlying mortgages in private label mortgage-backed securities.

Both CEOs told me that one of their worst fears was missing their affordable housing goals. The high affordable housing goals plus their drive for market share and profits were major reasons why they lowered their underwriting standards. But I must add that they were still much higher than the marketplace.

If you look at Fannie's acquisitions from 2001 to 2007, the percent of subprime mortgages actually remained relatively stable at 16 to 18 percent even though the subprime market was tripling or more than that and represented about a third of the market at the end.

However, as mentioned this morning, their purchases of Alt-A's went up dramatically. They also indirectly encouraged lower standards by purchasing those private label securities and also by not aggressively forcing originators to repurchase noncomplying mortgages for fear of offending major customers, such as Countrywide.

As OFHEO's budget was subject to congressional political process, OFHEO's growth was constrained and subject to annual freezes. The other issue, major issue was receivership. We did not have that in the original legislation, we got it in the new legislation.

However, at the end, we did decide to put them in conservatorship rather than receivership because we felt it was critically important to keep the enterprises running to prevent a total collapse in the mortgage market and potentially the U.S. financial systems.

Without Treasury authority to fund the enterprises, which was inserted into the legislation in really the last few weeks, is my belief the conservatorship would have failed.

The company's opposition to legislation for so long was a major mistake. The boards focused on maximizing shareholder profitability. In the end, they failed both the shareholders and the taxpayers.

Our third goal was to strengthen our regulatory oversight. We had large teams at Fannie and Freddie, and we continued to add skilled examiners. I met monthly with the CEOs.

We sent an annual report to Congress on the enterprises which detailed the many problems in the remediation efforts.

In the 2006 report, we rated -- we rated -- we rated them significantly supervisory concerns. We met with the boards annually to discuss the reports and at other times. And midyear 2008, we lowered the rating to our lowest category.

Although the enterprises never violated even in OFHEO's directed extra capital requirements, as the markets began to deteriorate, they hit triggers in our prompt corrective actions regulations. OFHEO made escalating requests in [inaudible] capital, including detailed capital plans, dividend constraints, and increased capital requests.

OFHEO created the first government regulation on mortgage fraud. In 2008 we adopted a new ratings scheme called GSEER, which stands for government solvency earnings and enterprise risk, market credit and operational, and we reorganized our operation or examination teams around those areas.

On the compensation side, our authority was relatively weak but we did successfully pressure the boards for some moderation and created broader performance metrics.

The enterprise's management and the credit models they relied on failed to identify how badly the mortgage market was deteriorating. Many others failed to understand how bad the toxicness was: Booming and then falling house prices, abysmally low underwriting standards, plentiful and then disappearing financing, and Wall Street's destructive creativity.

The enterprises believed that they could save the troubled market that began to erupt in 2007. We constrained Fannie Mae from construction lending and from buying less than Triple-A private label securities.

By mid-2007 they were putting extreme pressure on OFHEO, backed by members of Congress, for us to remove the portfolio caps and the 30 percent extra capital constraints. OFHEO turned down their request as it would impair their critical need to support the conforming mortgage market.

From the fall of 2007, to the conservatorships, it was a tightrope with no safety net. House prices were continuing to fall, delinquencies in foreclosures were rising, and mortgage credit was drying up.

We encouraged the enterprises to cut their dividends, and they raised 17 and a half billion dollars in preferred stock in 2007. They represented about 75 percent of the market at that point, but sitting on over 5 trillion dollars -- in market -- on mortgages, and razor-thin capital, it was critical for their country's financial future that the mortgage market stabilize. Their withdrawal would have created a self-fulfilling credit crisis.

As the enterprises struggle with mounting losses, our communications with them, Treasury and the Fed grew, in February we published -- they published timely financial statements and, as agreed, we removed the portfolio caps.

We also mentioned at that point that we looked at lowering the capital's requirements, and we did in March, slightly, and also did that only because they agreed to raise significantly more capital and to keep capital well in excess of requirements and support GSE reform.

Fannie Mae actually did raise capital but Freddie was unable to, and by August it was obvious that they could not. By August the confidence to the enterprises plunged. Working with the Treasury and the Federal Reserve, we made a recommendation, my staff made a recommendation to put them in conservatorship, which we did in September, and they voluntarily consented.

Before concluding, I would just like to thank the team at OFHEO, FHA, for their extraordinary work during that period.

Although OFHEO warned repeatedly of the systemic risk that Fannie Mae and Freddie Mac presented to the financial markets and took many steps to help lessen the damage, everybody, including OFHEO, could have done more.

There was a strong emphasize -- such a strong emphasize on remediating -- remeding -- remediating their operation -- operational risk and monitor their interest rate risk, the credit risk was not emphasized as much as it should have been in 2006.

We did require them to adopt the bank regulator's nontraditional mortgage guidance and subprime guidance and even extended it to those private label securities.

But the foremost failing was the legislative framework, especially the capital rules. The GSE structure allowed them to be so politically strong that they resisted the very legislation that might have saved them.

The only silver lining was that legislation was finally passed and allowed the conservatorships to function fairly smoothly. The enterprises are continuing to fill their mission. Thank you.

CHAIRMAN ANGELIDES: Thank you,

Mr. Lockhart. So, I'm going to actually defer, right now, to the vice chair to start this session, so Mr. Vice Chairman.

VICE CHAIRMAN THOMAS: Thank you, Mr. Chairman.

EXAMINATION BY VICE CHAIRMAN THOMAS

VICE CHAIRMAN THOMAS: Mr. Falcon, when did you come to Washington?

MR. FALCON: It was in 19 -- it was in 1999.

VICE CHAIRMAN THOMAS: Fess up, fess up.

MR. FALCON: 1989, I believe.

VICE CHAIRMAN THOMAS: 1989. Mr. Lockhart?

MR. LOCKHART: 1989, as well.

VICE CHAIRMAN THOMAS: 1989. I'm reminded of the movie, (inaudible) actually, which basically has a story but then it's seen from various participants as to what they saw.

So your testimony is one view of what happened. And if you were privy to the panel in front of us, decidedly it was somewhat of a different view in terms of attitudes and relationships.

I just have to say, I was there for the movie as well, and I think your version tends to have a greater degree of credibility about relationships than the one that I heard earlier.

To bolster this, we're trying -- I say we, staff and Commissioners are trying to work out a timeline with specific events, some of which are public, others are much more private, including e-mails between individuals and statements from individuals. And we're going to continue to work on the voracity of it but I -- eventually, Mr. Chairman, plan to place it in the record to let people in a relatively brief almost visual way take a look at those events.

And the first date we have down is September 19th, 2007, with a press release on portfolio caps and liquidity, where I think you -- would you agree that the significance was basically the recognition that safety and soundness is probably more important than the liquidity mission based upon the circumstances that we were in?

MR. LOCKHART: What I was trying to say in that is safety and soundness was critical and liquidity was critical, as well.

VICE CHAIRMAN THOMAS: Right.

MR. LOCKHART: And they couldn't provide liquidity to all the housing market. They did not have the capital to do that.

VICE CHAIRMAN THOMAS: And then we passed through the end of December of `07, into February of `08, and then some of it's interesting, but for the sake of time, move on into early March, where things start to happen fairly quickly. On March 7, we're aware -- we're aware of an e-mail exchange between Mr. Mudd, the CEO, and Mr. Steel, who is the undersecretary of the Treasury.

And my understanding is that Mudd writes to Steel that OFHEO, having unrestricted capital authority will as ever be the sticking point. Mudd writes to Levin, quote, it's a time game, whether they need us more, sooner, to show administrative action or if we hit the capital wall first, be cool. Did you know about this communication?

MR. LOCKHART: I didn't see the e-mail but I knew that Secretary Steel and Dan Mudd and Dick Syron were talking, as they were talking with me, at the time.

VICE CHAIRMAN THOMAS: Well then, the next day I have, and this is easier for you to refer to, an e-mail from you to Undersecretary Steel in which you write that the Freddie board is against raising equity but it may be possible if timed with some capital relief.

Why didn't Freddie want to raise equity? Is that a question that --

MR. LOCKHART: They did not want to dilute their shareholders. I mean, they were still shareholder-centric, at that point, and they really, in discussions I've had with that board over the years, they were very, very reluctant to raise equity.

VICE CHAIRMAN THOMAS: Is that an indication of a partial lose of focus as to who they were and what their fundamental underlying goal is, notwithstanding making a profit is always nice?

MR. LOCKHART: Well, as I said in my written testimony, the boards were much more focused on profitability. They felt that that was their fiduciary responsibility to the shareholders. And the mission was a distant, not even second, and it -- that was my view and certainly had many conversations with the boards on that topic.

VICE CHAIRMAN THOMAS: My assumption is there was virtually no discussion about taxpayers rather than shareholders. You don't have to answer that.

Obviously background ended that first week in March, March 11th the Barrons article comes out suggesting that Fannie Mae is insolvent and predicting that the government will bail the company out.

March 16th, Undersecretary Steel e-mails to others at Treasury, Lockhart needs to eliminate -- that's you, Lockhart needs to eliminate the negative rhetoric. I have e-mailed and called Syron and waiting to hear back. I was leaned on very hard by Bill Dudley, official at Treasury.

MR. LOCKHART: At New York Fed.

VICE CHAIRMAN THOMAS: Pardon?

MR. LOCKHART: He's at the New York Fed.

VICE CHAIRMAN THOMAS: He's at the New York Fed. To harden substantially. I do not like that and it has not been part of my conversation with anyone else. I viewed it as a very significant move, way above, we've heard this before, my pay grade to double the size of the U.S. debt in one fell swoop.

Since it was directed toward you, what -- what do you think was meant by eliminating the negative rhetoric?

MR. LOCKHART: Well, I think it's well known that I was pretty strong against some of the things the two companies were doing. And I was very strong in supporting legislation.

And what, you know, as I said in my testimony, we had a fine line here. We had to force the companies to get more capital or they weren't going to make it. The legislation was flawed, so I was using the press, occasionally, but more often just talking to the two CEOs about the need to raise capital.

VICE CHAIRMAN THOMAS: And the same day, March 16th, 2008, Bear Stearns collapses?

MR. LOCKHART: Right. I mean, that weekend there was a lot obviously going on in the administration. And certainly I did talk to the Treasury and the Fed that weekend. And, you know, our concern was that Fannie and Freddie could be next.

And so we thought it was critical to raise capital. And to do so we basically, as you know, did an agreement with them. And in return for raising a very significant amount of capital and committing to keep the capital well above the minimum standards that we start to lower their capital.

VICE CHAIRMAN THOMAS: Well, but on March 17th that was the subject of an e-mail from -- talking about OFHEO releasing capital surplus in the consent order and GSEs commit to invest 300 billion in market to raise capital.

What -- what was your opinion of that particular deal?

MR. LOCKHART: I did the deal so I --

VICE CHAIRMAN THOMAS: I understand you did the deal. But what was your opinion of the deal at the time?

MR. LOCKHART: I thought it was necessary because we needed to stabilize --

VICE CHAIRMAN THOMAS: A number of us take out garbage but that doesn't mean that that's our ideal.

MR. LOCKHART: We -- we had to play the cards that we were dealt with, and we had a capital structure that didn't work. We had a GSE structure that didn't work, and we had a 11-trillion-dollar mortgage market that would have cratered if we hadn't done something.

VICE CHAIRMAN THOMAS: Okay. Then obviously, after that, what you did, which you felt was absolutely essential, not perhaps ideal, March 19th timeline, Graham-Fisher, GSE analyst Joshua Rosner states, that quote, any reduction in capital is a comment not on the current safety and soundness of the GSEs but on the burgeoning panic in Washington, end of quote.

We believe that OFHEO Director Lockhart took this action results in the destabilizing of the

GSEs. OFHEO will go from being the only regulator who had prevented their charges from getting into trouble to a textbook example of why regulators should be shielded from outside political pressure.

Do you feel that the decision that you arrived at was substantially based upon the outside political pressure that you received or, in your professional judgment, absent any pressure, that it was okay?

MR. LOCKHART: In my professional judgment it was the necessary step. I had run the pension benefit guarantee corporation, Bush 41, made a lot of life-and-death decision for corporations, at that point, so I had a lot of experience. TWA was an example, Pan Am, there are a whole series of them, LTD Steel, so I had a lot of experience on working with financial markets. And in my professional judgment, it was necessary.

Now, I would have loved to have more capital. I would have loved to have countercyclical capital in the structure so that they would have had the capital at that point to do what was necessary. They didn't so they had to raise it.

VICE CHAIRMAN THOMAS: Mr. Chairman, full disclosure, I worked with Mr. Lockhart on the PBGC, in a number of ways, and we wound up finally, I think, rewriting the structure which allows corporations to not short commitments that they make.

But it would have been useful to have capital at an earlier time. I believe your testimony and others clearly indicate there was great resistance because you'd have to go through Congress to achieve that, and we've heard from Mr. Falcon's testimony, Mr. Falcon's testimony that there was constant pressure from Congress.

And I just want to reaffirm the argument that that sounds a whole lot more like the Washington that I was in for three decades, especially when they have the ability to communicate to you through the appropriations process.

Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: All right. I'm -- let's do this; I'm going to defer for a moment. Ms. Murren?

COMMISSIONER MURREN: Thank you.

EXAMINATION BY COMMISSIONER MURREN

COMMISSIONER MURREN: And thanks to you both for being here today and for your testimony.

I have, in an interest of looking more broadly at the regulatory processes, and the framework that really are the -- the basis for which shareholders and taxpayers rely on the ability for the financial systems to be transparent.

I'm interested in the -- in some instances in the mechanics and the practical realities of that, so I would like to ask a couple questions to begin with on your daily interactions with the people or that of your staff at Fannie Mae.

And the way you described the relationship, obviously, is it seems very tense, certainly at the senior levels.

Could you talk a little bit about whether that type of tension was also evident when you carried out or when your staff carried out their daily duties in interacting with the line staff there? Maybe if you could each comment on it?

MR. FALCON: On the -- sorry -- on the daily the level, there's much interaction between the examination staffs, research staffs, legal staffs, basically there's a lot of interaction down at the staff level of both entities.

Part of my responsibility as leading the agency is to try to make sure the people in the agency had what they needed to do their jobs properly. And so I was often in the position of seeing deficiencies with our structure and funding.

So taking the responsibility, as the head of the agency, to try to seek broader policy changes to help the agency.

And -- and those were certainly in the realm of what I tried to accomplish, among other things at the agency, and there were tensions. And there were tensions between the senior executives and myself and my senior staff on those issues, I wouldn't say that that filtered down below us to the people doing their day -- their job day-in and day-out at the agency.

COMMISSIONER MURREN: Would you say that the people that worked for you found that when they reached out to their counterparts at the company that they were -- they found that there was a cooperative mindset on the other side? In other words, did this sort of resistance that you described filter down to the lower ranks over at Fannie Mae?

MR. FALCON: I think, yes, many times we did have difficulties in the lower ranks, as well. I recall one of the early meetings with my staff, and it was an issue of we needed some data, and I was told that it would be difficult to get the data because we would get resistance from the companies.

We had another pending request, and they didn’t like to have two requests at the same time, and then so they said we don't know if we can deal with this now.

So there was these all sorts of, at the staff level, these cultural problems. And so I had to try to change all of that and I insisted to my staff that go make this request; we're going to get this data; if they had to assign more people to the agencies reporting these, they need to do so.

But at the very beginning there was always a very deep relationship issue about the agency not having problems getting full cooperation out of the companies on something as minimal as a data request, and that had to change.

MR. LOCKHART: From my standpoint we actually put a lot of that into the consent agreement. And so we actually wrote it in that they had to cooperate. They had to change their tone at the top.

And we really worked hard with the board and the management team do that, and they did actually make progress on a lot of that over that period. In fact, they really, by the end of the period, actually had complied with the consent agreement.

There always has to be some tension between a regulator and a regulatee. And in this situation, where you had the two firms that couldn't produce financial statements on a timely basis, that didn't have good internal controls, you had have a regulator that was in there all the time, working with them, trying to fix the problems.

On the staff level, the cooperation was good. I would have meetings with, you know, quite a few of their people, down three or four levels, occasionally, on a topic. And I always found it cooperative, you know. Occasionally there was an issue that we just disagreed on and we couldn't come to an agreement on, but the key thing, to me, was that we had to have a professional approach and my team really did.

COMMISSIONER MURREN: So would it be fair to say, then, that sometimes if the response that you get from one of these entities that you supervise or that you're requesting data or information from that says, gosh, the nature of your request is too vague or it's just too much for us to do in a particular timeframe, that really that reflects a resistance at the top to the work that they're doing in producing this information?

MR. FALCON: I think there was that

resistance, as I pointed out. Now, the agencies that I was dealing with were much different than the agencies that Director Lockhart had to deal with by the time he came into the office.

So perhaps he didn't encounter the same kind of issues that I had at the time that I was director of the agency but we did have those problems.

MR. LOCKHART: I think that's right. I think it changed somewhat because of the consent agreement, because of all their problems. You know, there's still arrogance at that company and, you know, certainly their fighting of legislation over that period was probably the worst set of arrogance and the biggest mistake that they made.

COMMISSIONER MURREN: Generally speaking, how did you convey any concerns that you might have to the management of Fannie Mae? Was everything documented or did you attempt to have an oral discussion beforehand, before you would send an e-mail or a formal document?

MR. LOCKHART: From my standpoint, I was meeting with the CEOs monthly. And in those conversations, we tended to have very frank conversations about what the key issues was, were. I would give them some heads up on some examination reports that were about ready to put out and really try to work with them to, you know, help move the organizations ahead.

You know, at the time we were there, Fannie Mae probably had 5,000 employees and maybe two or three thousand consultants trying to fix their problems. It was a major, major problem with those companies. And so we were all working to try to fix those operational and financial and accounting problems.

COMMISSIONER MURREN: And you both mentioned the fact that you felt that your own resources and your ability to manage this was -- it was less than ideal. You didn't have, necessarily, the greatest amount of resources to be able to address the problems that you just described.

How, then, did you allocate your resources? How did you think about the way that you would take what was fairly precious and make sure that it was allocated properly to be able to perform the duties with which you had been entrusted?

MR. FALCON: I think you prioritize. And that's a painful process. When you have a list of many priorities, and all very important to fulfilling your mission, and you realize that you can only fund a handful of them, it's not an easy thing to do, but you have to prioritize and hope that you can at least give some amount of coverage to the other issues. While not in the same depth as others, you try to stretch your resources as thin as you can.

MR. LOCKHART: We were -- had less problem with resources because Director Falcon had made such a big issue of it that Congress had backed down and we were getting our requests through.

The real problem with us was every September there was a freeze. And so you go through three or four months. So you can never build up to the staff level you wanted.

And -- but we set priorities. We put the resources on the examination side as much as we could. But we also had a capital team. We had the risk-based capital model team. There was a lot of things that need to be improved in the company at that point, the companies.

COMMISSIONER MURREN: This is the final question, and in reading your testimony and listening to what you have to say, it sounds as though this doesn't sound like an especially enjoyable position to be in. It sounds like there was an enormous amount of pressure.

Can you talk about, why did you continue to do what you were doing? A lot of people, I don't know, would have made that same decision.

MR. FALCON: Well, in my case, I had worked for the House Banking Committee under Chairman Henry Gonzalez for eight years. And I was at the committee when the law creating OFHEO was enacted and understood the motivation behind it following the savings and loan crisis.

So I did understand and believe in the agency's mission and why it was created. So the agency was struggling at the time that I -- I was approached about running this agency.

And given my background with the banking committee, I thought here’s an opportunity to take on a challenge and try to help build this agency and help it fulfill its mission, because it was struggling very much. And so it was a challenge and it was something that I believed in because of why it was created.

COMMISSIONER MURREN: And you?

MR. LOCKHART: Well, I would -- I would echo that. This is sort of my third major job in the government, and -- but I'm really from the private sector.

And each time it was a challenge, PBGC, Social Security, and OFHEO. And certainly, you know, the housing market is so important to the U.S. economy, and Fannie and Freddie were so important to the U.S. economy, and they were struggling at that point, that I seized the challenge.

Sometimes it was fun, sometimes it was very difficult but, you know, we made progress until the housing market just fell apart.

COMMISSIONER MURREN: Thank you. I am -- I cede my time.

CHAIRMAN ANGELIDES: Thank you, Ms. Murren.

EXAMINATION BY CHAIRMAN ANGELIDES

CHAIRMAN ANGELIDES: I'm actually going to take the opportunity, now, to ask a set of questions, because I want to -- I want to build on a line of questioning that Mr. Thomas engaged in with you.

And I really want to, I think, set a context here. It's March of 2008, obviously the housing markets are in substantial trouble, Bear Stearns has collapsed, and I think it's fair to say that liquidities drying up in the housing market dramatically.

So there is a big challenge posed here of the safety and soundness and solvency of these corporations, and then, obviously, liquidity, a larger mission, in the sense that there's probably no time when this dual mission clashes or it comes together so dramatically.

MR. LOCKHART: Well, it clashed and it didn't clash. Because they were sitting on 5 trillion dollars in mortgages. And if we couldn't stabilize that mortgage market, the safety and soundness was not going to work. I mean, basically, they were going to fall if we couldn't stabilize the mortgage market. So it was a tightrope we were walking.

CHAIRMAN ANGELIDES: All right. So I do want to ask you a couple more questions about this.

You know, Mr. Thomas laid out a timeline, and he referenced, on March 17th, a press release that was proposed. And then there was one other item. You actually did respond to that first draft press release, and I just want to get your thinking, because you're there on the ground, and I will have a follow-up. When you responded, I think on March 17th, to Mr. Mudd, who sent you a draft press release, and I believe there was a quote where you -- they have proposed a quote for you, that said, let me be clear, both companies are well capitalized and have adequate reserves.

They also have quote for Secretary Paulson, which is -- these are draft quotes, it is important that the housing GSE step-up to provide liquidity in the critical mortgage markets. They must be a key part of the solution.

You wrote back, say it at first read appears that OFHEO is being asked to be first, last, and only with no firm commitment by the GSEs, and that's in brackets, to raise capital. And the idea, quotes, strikes me as perverse as it assumes it would seem perverse to the markets that a regulator would agree to allow a regulatee to increase its very high mortgage credit risk leverage, not to mention increasing interest rate risk, without any new capital.

We seem to have gone from 2 to 1 right through to 1 to 1 and zero to 1. Obviously you are not comfortable with this. Now a press release is issued two days later, your quote has changed to -- let me be clear, both companies have prudent questions above the OFHEO directed capital requirements and they'll increase their reserves.

I'm just trying to probe to see, as a regulator, what kind of pressures you were under and how you're balancing out this need for national liquidity with obviously some pretty grave concerns you have about the conditions of these GS -- of these two entities, Fannie and Freddie, and then I have a larger follow-up question.

MR. LOCKHART: Well, it was definitely a balancing act, but that press release you quote was a draft one and did not reflect the deal that we had cut, and that's why I responded the way I did.

I mean, they had to commit to raise capital. That's the only way we would have ever lowered that capital requirement, failing them, meaning the consent agreement requirements, which was actually the test for the whole 30 percent to come off.

So, from our standpoint --

CHAIRMAN ANGELIDES: Can I ask you a question on that, Mr. Lockhart?

The ultimate deal or transaction or agreement was that you would lower the capital standard for Fannie in exchange for their willingness to raise or their commitment to raise new capital, right, and Freddie? Was there any capital relief without a money raise?

MR. LOCKHART: There was a -- went from 30 percent to 20 percent, without the money raise, but with a promise from the board of directors that they would do it.

CHAIRMAN ANGELIDES: So for both of them, it was a commitment and Fannie Mae fulfilled its commitment, Freddie Mac did not; correct?

MR. LOCKHART: Exactly.

CHAIRMAN ANGELIDES: Okay. But go ahead, I interrupted you.

MR. LOCKHART: So I mean, from my standpoint, what we were trying to do, as I said before, is to stabilize the mortgage market, stabilize the two firms, and the only way we felt we could do that was to get them to raise significant capital and also agree to keep capital well above the minimum levels.

And they did do that, and so -- they did agree to it -- and so that's the reason we lowered from 30 to 20 percent.

CHAIRMAN ANGELIDES: So in the large picture, here's what I'm trying to understand. So it's March of 2008, was the view -- because obviously you're a participant, was the view of the depth of the crisis in subprime lending at this point was that it would stabilize?

Because if you viewed it would stabilize --

I guess I understand this transaction the hope was it would, at which point you've lowered capital, I mean, in normal circumstances, as Mr. Thomas said, a normal business may have acted differently. They probably wouldn't be lowering capital, moving into the breech like this. In fact, everyone else was retreating.

MR. LOCKHART: Well, they didn't lower capital. I mean, we lowered the standard but, in fact, at the end of the period Fannie actually still had 30 percent, more than 30 percent extra capital.

We lowered their requirement but the capital really did not come down because they actually raised more capital.

CHAIRMAN ANGELIDES: In terms of real capital?

MR. LOCKHART: Yes.

CHAIRMAN ANGELIDES: Freddie?

MR. LOCKHART: Freddie's capital came down. They were still above the 20 percent limit at the period, probably about 25 percent.

CHAIRMAN ANGELIDES: Okay. But was the view at that time that we think this market will stabilize, this makes sense, or was it also the view that perhaps what would happen, at this time, is there was an acknowledgment that at some point, at some point these institutions might have to be seized?

MR. LOCKHART: Well, we were hoping to stabilize the mortgage market, there's no doubt about it. We did not, you know, have, assuredly, that we were going to do it, and -- but we felt the combination of the Bear Stearns trend, purchase by J.P. Morgan, and this would help stabilize the markets and we might be able to get through it. It didn't work, as we all know.

CHAIRMAN ANGELIDES: All right. Couple of other quick questions, just about -- about your reviews.

You did mention you noticed credit risk in 2006. Did you note credit -- and -- but, at the time, I think you had said there's credit risk but I think you felt reasonable. Is this a fair interpretation about the quality of the assets?

I think, at that time, high-risk loans were about 20 percent of the book, but they were still pretty darn substantial in terms of percentage of capital, you know. For Alt-A loans, they were 750 percent of capital.

You know, they were -- the amount of high-risk loans were anywhere from, you know, 500 to a thousand percent of capital depending on the category.

They were very substantial.

In 2007 and early 2008, at least my recollection is, you didn't focus much on credit risk. I guess my larger question is, you said you didn't do it enough. Looking back on it do you feel like OFHEO missed the depth of the credit risk?

MR. LOCKHART: We started a task force in 2007, a unified task force of Freddie and Fannie examiners, the credit teams to look at credit, and we were continually working with the companies, looking at their credit risk models, and -- and -- and continuing to look at -- take a look at the credit risk and those private label mortgage-backed securities that, you know, Freddie was the biggest buyer of those securities by far; Fannie was the second biggest buyer.

So we spent a lot of time on the credit risks in those books. We forced them to take, other than temporary impairments, we proposed a new approach to that, so we were focused on credit risk.

You know, I think the failure was a failure that no one understood how bad it was going to be. You know, the models, whether they were the rating agency models, the Wall Street models, Fannie and Freddie's models or our models never really got that really downside in the models. And we really did not forecast what happened.

CHAIRMAN ANGELIDES: All right. Did you ever -- did you ever ask them to cut back on their level of high-risk lending? Did you ever weigh in and say, enough is enough here?

MR. LOCKHART: We -- we did ask them, obviously, to freeze their portfolios and --

CHAIRMAN ANGELIDES: A total cap, right?

MR. LOCKHART: Right. And that really stopped a lot of the private labels securities. We certainly looked at their, Fannie's, expended authority. And my examiners were always talking to them and asking them and probing them to try to slow it down.

CHAIRMAN ANGELIDES: In writing or --

MR. LOCKHART: Probably mainly verbally. There were some reports though.

CHAIRMAN ANGELIDES: Because one thing that strikes me is the language of the conservatorship memo.

MR. LOCKHART: Right.

CHAIRMAN ANGELIDES: I think the memo from Mr. Dickerson to you; is that correct?

MR. LOCKHART: That's correct.

CHAIRMAN ANGELIDES: Is -- it's pretty

dramatic. I mean, it's very stark and it doesn't quite comport with the other examinations I see along the way.

MR. LOCKHART: Well, as you heard Mr. Mudd say, there wasn't anything new in that report. He knew it all. I think that's what he said this morning.

What we did was we compiled it all, because what we were trying to do is make a case to the board of directors that they had to voluntarily agree to a consent agreement. We wanted that to happen rather than have the regulator have to do it and all the nasty lawsuits that might happen.

So we made a -- you know, we pulled it all together to make a very strong case so that the board of directors did not have a choice.

CHAIRMAN ANGELIDES: All right. Mr. Falcon, last question before I moved to Mr. Georgiou.

What did you see in terms of the ramp-up of -- why did each of you, just very quickly, why did you see Fannie, in particular, moving into the subprime breech? Competitive pressure?

I mean, if you were to weigh these on a scale, competitive pressures, affordable housing goals, what were the driving forces, profit, compet- -- you said profit?

MR. FALCON: In my opinion, I think the -- it was driven by a desire to once again regain their dominance in the market and to try to increase profitability to what it had been in its heyday. And given this is where the market's going this is where they thought they had to go to try to achieve that.

CHAIRMAN ANGELIDES: All right.

MR. LOCKHART: From my standpoint it was really a combination, partially because those goals had increased so rapidly over the period since Director Falcon had left.

And the 55 percent goal almost is mathematically impossible. So that drove them a lot to hit that mission goal. And partially it was HUD could put them on a consent agreement. But I think also importantly, it would have incurred the wrath of Congress if they had missed their goals.

Profit was very important to them and market share was very important to them, so it was really all three.

CHAIRMAN ANGELIDES: It was the trifecta, in your view?

MR. LOCKHART: Yes.

CHAIRMAN ANGELIDES: Did you ever call these loans -- in your conservatorship memo, you referred to the high-risk loans as imprudent, unsafe, and unsound.

Prior to September, did you ever flatly just say, this stuff is beyond the level of risks we should be taking?

MR. LOCKHART: Certainly we talked about some of those loans over time. Whether we put it in writing or not, I have been away too long and I haven't been able to see the papers.

CHAIRMAN ANGELIDES: All right. We may follow up and ask you further questions on it. Mr. Georgiou?

COMMISSIONER GEORGIOU: Thank you, Mr. Chairman.

EXAMINATION BY COMMISSIONER GEORGIOU

COMMISSIONER GEORGIOU: And thank you gentlemen for joining us this afternoon.

I want to ask you a provocative question, right out -- out of the box here. And I'm giving you a little warning.

As of 12/31/09, these two government-sponsored enterprises cost the taxpayers 111 billion dollars. And in the first quarter of '10 another 15.1 from Fannie. And I'm not sure what the number is for Freddie, so it's at least 126 billion dollars.

Given your perspectives on the circumstances, can you give us any estimate on how much money ultimately the taxpayers will have to pay to -- to back up the losses that were suffered by these -- that will be suffered by these two agencies?

MR. LOCKHART: The losses will be significantly more than that -- what -- what we'll see, actually, is because the way Fannie and Freddie had their investment portfolios and their -- actually how they got to their affordable housing goals were quite different.

And also because Fannie is about a third larger than Freddie, that we'll see continually higher losses at Fannie and Freddie for a while.

So I would think over the next year we'll see significantly higher losses, and then hopefully it will trail off.

COMMISSIONER GEORGIOU: Can you give me any estimate?

MR. LOCKHART: I've been away too long. You know, I can give you a two-year-old estimate but I don't think that would be very relevant today.

A lot of it really depends on what happens to the mortgage market. If we can stabilize the mortgage market, if we can prevent foreclosures, that will have a pretty dramatic impact on how big the losses will be to the taxpayers.

COMMISSIONER GEORGIOU: It doesn't appear that we are really preventing foreclosures now, does it?

MR. LOCKHART: The administration has the HAMP rogram and, you know, it's starting to take some traction, but it was slower than anybody wanted. It's going to take time. I mean, it's -- it's -- it's -- there is going to be many million more foreclosures.

COMMISSIONER GEORGIOU: Okay. Do you want to hazard a guess, Mr. Falcon?

MR. FALCON: I don't. I can't give you an estimate of what I think the number would be, but obviously one dollar is too much. I think it's unconscionable.

COMMISSIONER GEORGIOU: And 126 billion is 126 billion more too much than a dollar, but do you have any thoughts?

MR. FALCON: I think it will go up. I think the trend in the prime book certainly indicates that given that it's a much bigger pool of assets than the subprime and the Alt-A pool, the trends in the sub -- and the prime assets they have are showing deterioration.

So it may be one indication for people on the inside was when Treasury decided to lift the 200-billion-dollar cap on capital assistance to both companies. Perhaps that was their statement of concern or that it could go over that amount.

COMMISSIONER GEORGIOU: Right. Okay. Let me -- and then I want to try to go back to what you each tried to do, respectively, to beef up the capital of these institutions during your respective tenure as the head of the regulator.

Mr. Falcon, could you outline what you tried to do and what you were basically prevented from doing in that regard?

MR. FALCON: Well, we -- the capital standards are hardwired in the legislation. It's 2 and a half percent on balance sheet, 45 basis points off-balance-sheet. And that minimum capital requirement didn't give us discretion to increase it in any way.

So we, from the very beginning, we sought the flexibility in statute, just the same kind of authority that every other safety and soundness regulator had to have full discretion to raise that amount if we thought it was necessary.

We could never get that authority. And as I said in my testimony, finally we -- after the accounting scandals, we were able to get the companies to agree to holding a 30 percent capital cushion in reaction to that. That wasn't based on any clear statutory authority, but they agreed to it and so we did it.

COMMISSIONER GEORGIOU: Okay. Mr. Lockhart?

MR. LOCKHART: Well, certainly what we tried to do is we had a very large campaign going really basically to make it clear to everybody that their capital was too low. And we worked to get legislation. And so that was probably the key thing because it was hardwired into the legislation.

We did work somewhat on the risk cap, base capital models, to try to strengthen that, but unfortunately the legislation that built that was too weak as well. So we really didn't have a good tool and which we kept telling Congress repeatedly. And, unfortunately, you know, by the time the law passed in July 30th, 2008, it was much too late.

COMMISSIONER GEORGIOU: Right. And, of

course, at that point it would be almost impossible to raise the capital under these circumstances.

MR. LOCKHART: Yeah, it would have been impossible even to put a new regulation in place. You know, it would probably would have taken six months to a year.

COMMISSIONER GEORGIOU: Right.

MR. LOCKHART: To even do it, so, I mean, you know, it was much too late.

COMMISSIONER GEORGIOU: And you took them over, too, a couple months later, after that?

MR. LOCKHART: Yeah.

COMMISSIONER GEORGIOU: Did -- did you ever have any issues of capital arbitrage in com- -- when things were moved off-balance-sheet to have the reduced capital associated with off-balance-sheet as opposed to on balance sheet treatment, Mr. Falcon?

MR. FALCON: I think, at one point the enterprises would come to us with some novel ideas about treating some new kind of product as capitalist, Tier 1 capital, and they wanted us to -- I guess they were sold some innovation about how to better receive more return on their capital. And they wanted us to be able to count that as core capital.

I think that would have diluted the quality of core capital. If we had agreement to do that, so we always told them no. But they were coming to us with ideas on some innovative kind of products that should be counted as capital. And we never agreed to it.

MR. LOCKHART: They really didn't, despite what you may have heard, they really never thought that they didn't have enough capital.

And in my experience, they could have very easily raised capital by -- they had 700, 800 billion of their own mortgage-backed securities on their portfolios.

COMMISSIONER GEORGIOU: Right.

MR. LOCKHART: Two and a half percent, they could have reduced their capital requirement by 80 percent by selling them.

COMMISSIONER GEORGIOU: Exactly.

MR. LOCKHART: So they had the ability they just didn't do it.

COMMISSIONER GEORGIOU: Right. And -- but if you keep them on and they're earning -- and they're earning a nice spread --

MR. LOCKHART: Right.

COMMISSIONER GEORGIOU: -- if you're getting credit at a government -- this effectively government-guaranteed rate, you're making a nice spread, then you're making more profit, more earnings on the capital that you have, which then leads to bigger bonuses, does it not?

MR. LOCKHART: That's certainly one way to look at it, yes.

COMMISSIONER GEORGIOU: Okay.

CHAIRMAN ANGELIDES: Mr. Vice Chair? Would you mind if you yield?

COMMISSIONER GEORGIOU: I would love to, I invite the Vice Chair to enter.

VICE CHAIRMAN THOMAS: I was just trying to figure out what the other one -- other one would be, is all. It ran through my mind. I couldn't come up with one.

CHAIRMAN ANGELIDES: Back on your time, Mr. Georgiou.

COMMISSIONER GEORGIOU: I think that would be the main one, Mr. Vice Chair.

Let me go back, I want to ask you about a few accounting issues, because both of these institutions were, at one point in the past, cooking their books, basically, or so they were found to have done.

And I -- I -- I understand from your

testimony that part of the reason why you didn't have the opportunity to evaluate credit risk as well as you might otherwise have done is that you were spending a lot of time cleaning up the appropriateness of the accounting. Is that -- wasn't that your testimony, Mr. Falcon?

MR. LOCKHART: I think that was my testimony.

COMMISSIONER GEORGIOU: I'm sorry, Mr. Lockhart. I apologize.

MR. LOCKHART: What I was saying is that in 2006, that first six months I was there, we were so focused on market risks and operational risks that we were only starting to focus inasmuch as we should have on credit risks. And we did set up a task force in 2007 to intentionally look at the credit risk.

COMMISSIONER GEORGIOU: Right. Well, let me just ask you about a few things that have been brought to our staff's attention.

Fannie wasn't recording losses on delinquent loans until they were 24 months delinquent; is that correct?

MR. LOCKHART: Not entirely correct.

COMMISSIONER GEORGIOU: Well, maybe you could edify.

MR. LOCKHART: Let me try to explain what happened.

Fannie, in their mortgage-backed securities, when a loan became delinquent, they had the option to take them out after 120 days and rework them and modify them. But if they did that, then they would have to write it down.

COMMISSIONER GEORGIOU: Correct.

MR. LOCKHART: So they changed their approach to leave them in the securities until they had the modification ready. And that meant anywhere from 120 days to 20 -- you know, two years. They -- they did not take that fair value cap. They still had to look at them from a credit standpoint though.

COMMISSIONER GEORGIOU: Right. But they didn't have to mark down their books to recognize the loss on that particular delinquent loan; is that right?

MR. LOCKHART: That's how the accounting worked. Actually, the accounting was changed this year, so now they would have to do that.

COMMISSIONER GEORGIOU: Right. And weren't they also actually lending -- providing uncollateralized loans to some of the people who were delinquent to extend it and then treat it as -- treat it as a performing loan to extend the deadline for its recognition as a loss?

MR. LOCKHART: They had the HomeSaver, I think it was called, HomeSaver Advantage Loan or something like that.

COMMISSIONER GEORGIOU: Right.

MR. LOCKHART: Which was the idea that oftentimes when you cure a loan, you just sort of wrap up the principal and interest that hasn't been paid back into the principal balance.

COMMISSIONER GEORGIOU: Right.

MR. LOCKHART: Instead of doing that, they actually just took that amount and gave an unsecured loan for it. They actually wrote those loans down to probably 10 percent, because they knew they were not going to get value for them.

COMMISSIONER GEORGIOU: They just wrote down the advanced loan?

MR. LOCKHART: Right.

COMMISSIONER GEORGIOU: But they didn't write down the underlying loan?

MR. LOCKHART: Until it looked like it wasn't going to cure.

COMMISSIONER GEORGIOU: Right.

MR. LOCKHART: I mean, the idea was they

only did that if people were starting to make their payments again.

COMMISSIONER GEORGIOU: But those were relatively modest loans that they treated as 10 percent.

MR. LOCKHART: Right, it was a process that was delaying the inevitable. And we put a lot of pressure on them to start modifying those loans more realistically.

COMMISSIONER GEORGIOU: Right.

MR. LOCKHART: And when they did start modifying the loans more realistically, there was less default.

COMMISSIONER GEORGIOU: Right. Did you -- did you ever talk to the OCC or the Fed about this practice, anybody, either of you? That would be you.

MR. LOCKHART: No, I did not. By the time that the OCC and Fed came in in August of `08, I think the practice may have been lessened. I can't remember exactly. But certainly from our standpoint they wrote down that unsecured loan to a value that we were comfortable with.

COMMISSIONER GEORGIOU: Okay. And the practices, as you understand it, has been modified by the legislation effective 1/1 of 2010?

MR. LOCKHART: The way that you account for securities now, they're all on their balance sheet and they have to account for them as if they were a loan.

COMMISSIONER GEORGIOU: Right. Okay. Let me ask you, let me turn, if I can, briefly, to this lobbying business which everybody seems to think.

I take it this was an equal opportunity bipartisan lobbying push over the years that Fannie and Freddie were engaging in this practice?

I mean, that is, they were well-connected people, who were either former legislators or former staffers, and others, from both parties, who were retained by these institutions to lobby. Would you characterize it in that way, Mr. Falcon?

MR. FALCON: Yes, I would.

COMMISSIONER GEORGIOU: Okay. Mr. Lockhart, have you seen that?

MR. LOCKHART: Yes. They had big groups of lobbyists on both sides of the aisle, yes.

COMMISSIONER GEORGIOU: And were you -- did you -- I mean, obviously, the experience that you had, Mr. Falcon, in connection with your -- which the announcement of your successor before there was any vacancy certainly was an extreme example of -- of the influence that was exercised, was it not?

MR. FALCON: Yes, it was one of the extreme examples, absolutely.

COMMISSIONER GEORGIOU: Can you tell us about any other efforts that -- that were significant by these two agencies?

MR. FALCON: At one point they -- they worked hard to try to kill our risk-based capital rule. And we designed a very detailed cash flow model to come up with a risk-based capital requirement.

And while it was at OMB for review, they worked very hard to try to kill it, and had OMB send it back to us and promulgate a new rule that relied on their own internal models for -- for setting risk-based capital.

Ultimately that OMB rejected their position, and we were able to get that rule out. But they, at the peak of their political power, they weren't shy about flexing their muscles on not just big issues but small ones. They gave no quarter on any issue.

COMMISSIONER GEORGIOU: But, I mean, isn't this a particularly egregious lobbying abuse in that at least when the private sector is lobbying, theoretically, if they are putting at risk their own shareholder returns by spending lobbying -- advancing lobbying expenditures which may or may not advance their private interests.

But here you had effectively a taxpayer buttressed two institutions, who were spending taxpayer money to lobby the administrations and the Congress, who were responsible for their oversight, which ultimately rebounded back to the detriment of the taxpayers themselves. I mean, it strikes me as absolutely astonishing.

MR. FALCON: I think it is astonishing, especially -- and, of course, we all respect an individual's right to voice their opinion, but their tactics frequently involved misinformation, character attacks, questioning people's motives, just brutal strong-arm tactics that none of us would think is acceptable. I think that's what made it very unseemly.

MR. LOCKHART: From our standpoint, as you know, one of the first -- when we announced the conservatorship, we closed the lobbying shops down. We also had in our consent agreement --

CHAIRMAN ANGELIDES: Just hold it, I'm going to add two -- how much time do you need?

COMMISSIONER GEORGIOU: Thank you, that's fine, that will be fine, two minutes will be fine.

MR. LOCKHART: In our consent agreement in `06, we had them do a study of best practices for lobbying and institute it. I think they instituted most of it.

So where we saw the lobbying from our standpoint was they drug their heels on the legislation. They -- they -- and, you know, that was a fatal flaw, as I said before. Also, in the summer of `07 when they felt they could save the market, they were lobbying very hard against us from a standpoint that they wanted us to remove the portfolio caps and also to lower the capital requirement and, you know, we resisted it.

COMMISSIONER GEORGIOU: But that's the point that others had made as well, and I want to reiterate.

Why would you go into a market that's collapsing, that's presenting greater credit risk, except for the purpose in the -- I'm talking in the late stages, now, except for the purpose of essentially making more and more money on the spreads between your cost of capital, which is effectively taxpayer subsidized, and the returns you can get in the market?

MR. LOCKHART: To be fair, they actually

thought that they had the power to do it, I mean, they used to quote to me long-term capital situation where they came into the marketplace and stabilized it. They thought that just their ability to come in there, their big balance sheets, unfortunately they didn't have the capital to go with those big balance sheets, could stabilize the market.

And in summer of `07 it was really starting to happen, so it wasn't at the end that they were talking about this.

COMMISSIONER GEORGIOU: And they were able to postpone this legislation for almost two years, were they not?

MR. LOCKHART: Oh, I think you could probably go five years.

COMMISSIONER GEORGIOU: Five years? Five years?

VICE CHAIRMAN THOMAS: Four.

COMMISSIONER GEORGIOU: Four years, well, that's -- that's -- that's an awful long time. Okay, thank you very much gentlemen. I appreciate it.

CHAIRMAN ANGELIDES: Thank you very much, Mr. Georgiou. Mister -- yes, Mr. Holtz-Eakin. At the end of three days, I was confusing myself.

COMMISSIONER HOLTZ-EAKIN: Thank you,

Mr. Chairman.

EXAMINATION BY COMMISSIONER HOLTZ-EAKIN

COMMISSIONER HOLTZ-EAKIN: And thank you, both Mr. Falcon and Mr. Lockhart, for both your service and coming here talk with us today.

I think this is of interest not just because of the particular business model that these institutions followed, which I have an openly failing malignant opinion on, and I'll come back to that, but also their role in the larger crisis, where their failure occurred during that window, September 6th, September 15th, when we saw the transmission of this crisis from what was originally a housing and housing mortgage-related event into a financial crisis that spanned the breadth of all financial markets and ultimately the economy, as a whole.

I wanted to ask you a couple of questions about both. You know, I think today has been pretty illustrative in painting a pictures of two institutions who had that narrow housing market-related product line that suffered from poor internal controls, that had risk management systems that were below the industry standard, that were poorly capitalized.

And I guess my question is, if you have

institutions like that, how do they get so big, Mr. Falcon?

MR. FALCON: Well, I think growth really began in the late `80s, perhaps, as they began to build their mortgage portfolios.

COMMISSIONER HOLTZ-EAKIN: How could they do that given the flaws that both that OFHEO and others have chronicled under your guidance?

MR. FALCON: Well, the growth in the mortgage portfolios, as long as we -- we did not have discretion to stop them from doing those mortgage portfolios as long as they were hedging that risk of those portfolios.

And so we paid very close attention to the issues like their duration gap, as you understand. And so -- but it was that growth of that portfolio under ability just to earn the spread. So the more they grew those portfolios the more spread -- profit they made off of the spread.

COMMISSIONER HOLTZ-EAKIN: And they were able to continue access credit markets despite these poor characteristics and risky portfolios?

MR. FALCON: Well, until the bubble burst, everyone was willing to buy their debt, whether it was straight bullet debt or their mortgage-backed securities.

MR. LOCKHART: They were -- had a Triple-A, I talked to the rating agencies, asked them the exact same questions actually, and their answer was that they had such a large market, almost turning your question on the head, they had such a large market share that the Triple-A was very strong. And, besides, the U.S. government had the implicit back support because they couldn't let something that big fail.

COMMISSIONER HOLTZ-EAKIN: Mr. Falcon, would you agree that the -- the -- the implicit guarantee was an important part of the business model?

MR. FALCON: Absolutely.

COMMISSIONER HOLTZ-EAKIN: The panel before you disputed this, and I wanted to get you both on the record in that regard.

MR. FALCON: Yes, sir.

COMMISSIONER HOLTZ-EAKIN: Was the large portfolio part of their public service mission to provide liquidity, and just that, as the panel argued before?

MR. FALCON: I think they certainly tried to argue that the portfolio was essential in order to promote liquidity in their products.

COMMISSIONER HOLTZ-EAKIN: Is that the only purpose it served?

MR. FALCON: There was -- it did serve somewhat -- a very small portfolio, I think, was essential basically to warehouse mortgage loans until they were able to turn around and securitize them.

But for that kind of a function, they did not have to grow anywhere near the size that they did. I mean, the overwhelming amount of mortgages they held in those portfolios were simply to earn that spread.

COMMISSIONER HOLTZ-EAKIN: Mr. Lockhart?

MR. LOCKHART: I would have to agree that the portfolios didn't need to be anywhere near as large. In retrospect they didn't need to buy those private labeled securities, at all. And the reason they did primarily was this spread and the affordable housing goals, both.

The -- so my view is that the portfolios in any going-forward structures should be minimal, if at all.

COMMISSIONER HOLTZ-EAKIN: So we have these fundamentally flawed institutions that are allowed to become so large as to be systemically dangerous. Why as the regulator did you not stop this?

MR. FALCON: We had bifurcation of mission and safety and soundness regulation. HUD was not of an opinion that the portfolios were improper. As long as they were managing the risk of the duration between their assets’ liabilities in those portfolios, we were not in a position to be able to tell them no in that bifurcated oversight structure.

COMMISSIONER HOLTZ-EAKIN: And your own records having said in many ways you tried to post that?

VICE CHAIRMAN THOMAS: Yes.

COMMISSIONER HOLTZ-EAKIN: I stopped you. Mr. Lockhart, do you agree?

MR. LOCKHART: We certainly leaned about -- against their growth in any way we could, dividends, raising more capital. But the key thing, again, was that the legislation wasn't there and we couldn't get it through Congress to give us the power and particularly the capital.

You know, we keep talking about the portfolios, but in retrospect, the MBSs with only 45 basis points of capital was also a very tricky situation, and certainly they've gone through that.

COMMISSIONER HOLTZ-EAKIN: So let me now turn to the moment when the legislation actually finally does pass. And in the course of the debate over the hero legislation, Secretary Paulson says something to the effect of, I, you know, want to have a bazooka although I will never have to use it. And then not long before conservatorship became the path, I believe you, Mr. Lockhart, OFHEO, FHFA, at that point, issued a letter saying they were well capitalized; is that right?

MR. LOCKHART: I said that they were legally adequately capitalized and they were.

COMMISSIONER HOLTZ-EAKIN: And why did you send out that letter?

MR. LOCKHART: I'm not sure if it was a letter or a public statement. Was it a letter? I mean, I did say it.

COMMISSIONER HOLTZ-EAKIN: We can check.

MR. LOCKHART: But, either way -- oh, I know what you're talking about.

COMMISSIONER HOLTZ-EAKIN: Yeah.

MR. LOCKHART: What you're talking about is when we capitalized them, when we grade them every quarter, we send off a preliminary letter that says what we're going to capitalize, what we're going to grade them at.

COMMISSIONER HOLTZ-EAKIN: I see.

MR. LOCKHART: And the numbers were that

they were adequately capitalized. I also said in that letter, and this is a preliminary letter, that we had the right to downgrade them so that we put them on notice on that letter that we might downgrade them.

COMMISSIONER HOLTZ-EAKIN: And this was August 22nd?

MR. LOCKHART: Right.

COMMISSIONER HOLTZ-EAKIN: That's a fair characterization letter.

MR. LOCKHART: Right.

COMMISSIONER HOLTZ-EAKIN: My -- thank you -- my question then, is, now, shortly thereafter on September 6th, it is apparent that they are failing and that they are a danger, when was this recognized? Were you the first to recognize this?

MR. LOCKHART: We were working all through August through that period. And we were particularly looking at their reserves. But we were also looking at the issue of the deferred tax asset, which was allowed to count for capital, the other than temporary impairments on the private label securities. We were going through a whole exercise, with the help of the Fed, the OCC and Treasury to look through it.

By August 22nd we -- we -- our view was that it was going to be very difficult for them to make it. But factually, they were adequately capitalized based on the numbers that they put out in early August.

COMMISSIONER HOLTZ-EAKIN: And I understand that. I'm just trying to -- from the 22nd to the 6th, somewhere in there the realization arise that this can’t go on, that realization that --

MR. LOCKHART: No, the realization happened actually potentially before the 22nd.

COMMISSIONER HOLTZ-EAKIN: What I would like to ask next is, you know, the decision's made, they go into conservatorship, as lifetime participants in financial markets and those quite expert in this area, what is your estimate of the impact more broadly of having these two institutions, which the Secretary of Treasury has said he's got a bazooka but he's not going to need to use it, and which have been implicitly backed by the taxpayer, as part of their business model, what is the market impact of seeing them fail in this way?

MR. LOCKHART: My view is, at least for that first week, before Lehman hit, it actually helped. And you can see the spreads come in pretty dramatically.

Certainly the foreign investors and their securities, which were putting a lot of pressure --

COMMISSIONER HOLTZ-EAKIN: Helped the securities of Fannie and Freddie?

MR. LOCKHART: Yes.

COMMISSIONER HOLTZ-EAKIN: And the markets, more generally?

MR. LOCKHART: I can't make a judgment on the markets more generally at that, but, you know, there was some stabilization starting to occur and then, you know, the Lehman weekend.

COMMISSIONER HOLTZ-EAKIN: And that would be because the guarantees been hardened as hard as even Bill Dudley could want?

MR. LOCKHART: Yeah, right.

COMMISSIONER HOLTZ-EAKIN: Mr. Falcon?

MR. FALCON: I would just concur with what Director Lockhart said.

COMMISSIONER HOLTZ-EAKIN: Thank you, Mr. Chair.

CHAIRMAN ANGELIDES: Can I just, I would like to take a moment on my time to really just follow up on this line of questioning, because I am struck, and I don't know if -- I'm trying to get to the essence of what happened here, is it a little -- remember when we were kids, they had these little toy guns that would shoot out the darts that had the little rubber tip; and whether you were in the position of trying to bring down an elephant with one of those or whether you were wrestling with a mattress.

But, you know, in `05, `06, `07, there are exams done. You mention in `07 there's a task force. You do issue letters and I understand they are legally capitalized, but it's not as though the alarm bells are going off in very visible ways that danger is coming.

And, you know, there is a little element when the conservatorship occurs, and whether it's a Claude Rains moment, I'm shocked, I'm shocked, there's gambling going on here. I guess what I'm trying to get to is that you didn't -- it just couldn't -- didn't frankly have the political heft to move this ball or was -- what was happening at Fannie Mae and at OFHEO much of what was happening, also on Wall Street, which is that no one really calibrated the magnitude of risks that had been taken.

It's just something that has been gnawing at me. And when Mr. Holtz-Eakin asked those questions, that's what I'm trying to drive at, which is, of course, we're in that moment. What's the essence of this story, from your perspective, each of you?

MR. LOCKHART: My belief is we -- no one had really calibrated the risk. And that risk and the economy in the market just continued to deteriorate from that March period we were talking about through September, and just people lost faith in Fannie and Freddie. There was a lot of speculation at that point that they were insolvent.

There was a lot of articles written. There was a new accounting principles announced that was going to put all their mortgages-backed securities on their balance sheet and people were afraid that their capital requirement was going to be five times as high.

There was just a lot of things happening that really caused spreads to widen dramatically. In August they couldn't borrow long anymore; they had to borrow short. Everything started to pile up. Yes, there was problems in `06 and `07 starting to build. But by the summer of `08, it was obvious that they couldn't make it in August.

CHAIRMAN ANGELIDES: I know you weren’t around--

VICE CHAIRMAN THOMAS: Mr. Chairman, on this point--

CHAIRMAN ANGELIDES: Yes, absolutely, Mr.

Vice Chair.

VICE CHAIRMAN THOMAS: But the one thing that's really hard for people to appreciate, for example, your reference to Casablanca. He could say that with impunity in the middle of the cafe because he was the authority.

When you've had the ability to control Congress in producing legislation and -- and think you've got a fallback, while others around you are looking at the world as it falls apart, you're slow to come to the realization that it's you too, because at some point they're still thinking they've got this reserve available to them which has always pulled them out.

So even they, notwithstanding all the market symbols, were looking at the world like they normally looked at the world. They've got that in their back pocket.

CHAIRMAN ANGELIDES: Well, I’ll just ask, and I do want to move on to the other members, but do you think it was also this situation here? I mean, you pretty much said you're on the scene. I'll probably just ask you this, because you're an observer.

But -- so you really say, okay, very much like much of the world didn't see the magnitude of what had come, hadn't prepared in the right ways, but perhaps this is exacerbated, as Mr. Thomas suggests, by the company itself thinking at the end of the day there is no downside because they -- do you think that -- do you think that that exacerbated the situation, the implicit, slash, explicit?

MR. LOCKHART: Well, I think they thought there was a downside here. They, like everybody else, didn't realize how big the downside was.

You know, another important thing is, when you look back at it and you can only sort of do this in retrospect, that I don't think we could have put them in conservatorship before that legislation passed on July 30th.

CHAIRMAN ANGELIDES: Legally.

MR. LOCKHART: We could have legally but there would have been chaos. There was no FDIC to back Fannie and Freddie. There was no money to back Fannie and Freddie.

CHAIRMAN ANGELIDES: Well, I guess in May they raised 7 billion. So I guess that's some market indication that some people did believe that this entity would survive? I assumed that --

MR. LOCKHART: Yes, absolutely.

CHAIRMAN ANGELIDES: Unless -- unless, and this is not an accusation, unless the representations made by the entity in doing the raise were not accurate, to which I cannot speak nor would I allege.

MR. LOCKHART: They had sophisticated investors. They were buying it. And they actually exercised the Greenshoe. So they got the extra 15 percent too. So they had people that did believe, at that point.

CHAIRMAN ANGELIDES: All right. Let's now go now to Ms. Born.

COMMISSIONER BORN: Thank you. Thank you very much.

EXAMINATION BY COMMISSIONER BORN

COMMISSIONER BORN: And thank you both for appearing before us. And I personally would like to thank both of you for the public service that you gave the American people during your years as the director of OFHEO in trying to do your best against very powerful interests that were aligned against you.

I noticed that Mr. Falcon, you say in your testimony, the Fannie and Freddie political machine resisted any meaningful regulation using highly improper tactics.

And I'd like to discuss how Fannie and Freddie used their political power to resist meaningful regulation.

You testified as to a number of steps that they've taken, resisting reform legislation, for example, which wasn't really put in place in a timely fashion in order to save the organizations.

These institutions had an implicit government guarantee. So they were benefitting financially in their dealings in the marketplace from that guarantee. They were getting very low-cost money because of the guarantee. And they were then turning around and putting an enormous amount of their resources into making sure that there was really no effective government oversight to protect the American public.

I know that you were both doing the best you could with the powers you had, but it raises a question, in my mind, of this undue political power that a financial institution can obtain and how it can be used to resist the actions that government needs to take to rein in excesses and to make sure the institutions are safe.

I wonder how we can protect against this in the future, and I would like each of your observations. I'm sure because of your situations, you have thought about this.

MR. FALCON: Thank you. Thank you very

much. I do feel strongly that we cannot go back to any kind of model where you have a privately held and publically traded stock company that has these kind of government subsidies. I think that that kind of a model is just prone to the abuses, as we saw with the Fannie/Freddie.

And so if there's going to be any kind of government subsidization or role in our housing finance system going forward, I think it should be with a clear separation of a government role by entities fully -- being full government entities and in the private sector and have any government subsidies be through government entities and not through some institution like Fannie Mae and Freddie Mac.

I think that's a very clear lesson. Otherwise you do get the kind of abuses that we saw with these two companies.

COMMISSIONER BORN: Mr. Lockhart?

MR. LOCKHART: Well, certainly the power that they had, from the lobbying standpoint was abused and abused a lot over the years.

The GSE models fought, it didn't work, and it needs to be totally restructured. But I have to tell you, I've also run some other government agencies that the models were flawed over the years.

And that is a problem, you know, I mean, you know, legislation can be a messy process and we don't always get the best part of it, so I think we need to take some of this and put it back into the private sector.

At the moment, a hundred percent virtually of our secondary mortgage market is in the government sector. And we have to undo that and we have to get the right incentives back into the marketplace.

There was no debt discipline for these two companies. People didn't care that they couldn't put out financial statements for five years. People didn't care that, you know, they were starting to lose money until the very end.

So we need to restructure the whole mortgage market in this country. And that's where we should start, what do we want the mortgage market to look like, what do we want the new mortgage-backed securities to look like. To me, that's critical, then you decide the future of Fannie and Freddie.

COMMISSIONER BORN: I wonder if you have any views as to whether this problem that you faced of an institution that has government subsidies in effect, government support, but ineffective government regulation because of their political power has any broader relevance to the financial services industry, as a whole. You know, for example, banks get the benefit of deposit insurance and other support by the government.

Certainly they're getting a lot of support now. And yet I think they, too, have been very ready to spend resources on lobbying campaign contributions through PACs and other activities that has given them, over the last decade or so, a great deal of political power in resisting regulation.

MR. FALCON: I think the difference with the bank, the banking system and their regulation is that if there were any flaws in the regulation of the banking system, I would say it would -- whether there are or not, I would say it is the result of policy judgments made by regulators.

In the case of OFHEO, we didn't even have the authority to make poor policy judgments. We were forced to do the best we could with the authorities that we had, I think that's a very key difference there.

COMMISSIONER BORN: Well, you certainly did not have anything like the powers of a banking regulator. And that you can't really be a safety and soundness supervisor of an enormous financial institution, like each of the GSEs were, without significantly additional powers.

Mr. Lockhart, do you have any --

MR. LOCKHART: That's very true. You know lobbying, per se, is not a bad profession to the extent that they're informing members of Congress about what's going on. What happened was that they were using it to constrict what should have happened. In the banking case, at least, the FDIC fund is pre-funded, at least there's money there, and they've already paid for some of the insurance.

In this case they're getting the implicit guarantee for free, and the taxpayer was paying the whole cost. But moving forward, again, the model's flawed and we have to recreate something.

COMMISSIONER BORN: Mr. Lockhart, you testified that the mortgage portfolios of Fannie Mae and Freddie Mac were a concern because they posed interest rate and prepayment risk and other risks.

And that those risks required an extensive use of derivatives and that some officials, including I think you said the Federal Reserve, Chairman Greenspan, expressed concerns about the large derivatives positions.

And I understand that Fannie and Freddie held about 2.8 trillion dollars in notional amount of derivatives during the summer of 2008, what were they using these derivatives for?

MR. LOCKHART: They were hedging their portfolios. And as interest rates started to fluctuate pretty widely and especially the spreads between their borrowing costs and treasuries, they really beefed up the derivative activities. And they didn't close them out, they just kept them in place. So the would just do another derivative, replace the derivative, and keep growing, growing.

Now historically they used to claim that they used callable-debt, and they really didn't need a lot of derivatives. As it turned out, they needed them extensively.

They had very sophisticated risk managers on the interest-rate side. And they tightly managed that prepayment risk that Mr. Mudd talked about a lot. And, you know, that -- that required very sophisticated approach and lots of derivatives.

And we were concerned and we had market risk teams that were all over them on what was going there. But we were also concerned about the credit risks as well as, you know, those derivative books grew and grew.

COMMISSIONER BORN: Well, I was going to

ask you, were they adequately hedging their credit risk?

CHAIRMAN ANGELIDES: Would you like a couple more minutes, Ms. Born?

COMMISSIONER BORN: Please.

CHAIRMAN ANGELIDES: Two more minutes, please.

MR. LOCKHART: They didn't hedge their credit risks. And they didn't hedge their counterparty risks. The only thing, as was mentioned, they used mortgage insurance because, by law, they couldn't make a loan, an 80 percent loan to value, so they used mortgage insurance to cover up that gap.

COMMISSIONER BORN: So despite the fact that they were hedging some of the risks in their portfolios, the risk that really hit them the most, credit risk, both on the underlying in the portfolio and on the credit and on the derivatives part, were not hedged, and that's where they suffered; correct?

MR. LOCKHART: Yes, that's where they suffered. Whether they could -- they probably could not have hedged a 5.5-trillion-dollar housing mortgage credit risk. I mean, they -- you know, they represented so much of the mortgage market, at that point, it was probably not possible.

And as soon as they went into the market to start hedging, they probably would have tanked the whole market. So that they were in the position that they, you know, they were too big to fail.

COMMISSIONER BORN: Well, there were 60 trillion dollars worth of credit default swaps out there.

MR. LOCKHART: Right.

COMMISSIONER BORN: But even for that enormous of market, this would have been a very significant -- had a very significant impact.

MR. FALCON: Ma'am?

COMMISSIONER BORN: Thank you very much. Yes, Mr. Falcon?

CHAIRMAN ANGELIDES: Do you have a comment, Mr. Falcon?

MR. FALCON: I would just say that there's one thing to hedge their credit risk, and that's to hold more capital. They chose not to do that.

COMMISSIONER BORN: Good point. Thank you.

CHAIRMAN ANGELIDES: Mr. Hennessey?

COMMISSIONER HENNESSEY: Thank you, Mr. Chairman.

EXAMINATION BY COMMISSIONER HENNESSEY

COMMISSIONER HENNESSEY: Mr. Lockhart, can we talk a little bit about the failure of Fannie and Freddie and, specifically, why you felt they had to be put into conservatorship. In particular, could you talk about what might have happened to mortgage markets had you not done that and why you drew the line with Secretary Paulson between equity and debt?

MR. LOCKHART: Okay, some good questions, there.

We put them into conservatorship because we felt and as we really laid out in those various reports, which I think you all have seen copies of, that their -- their capital was eroding extremely quickly.

They -- we saw credit losses that were significantly more than their capital. We saw that the deferred tax asset was not going to be worth anything. We saw that the low-income housing tax credit would, therefore, not be worth anything, because they're going to be losing money far into the future, and that their private label securities were really suffering badly.

COMMISSIONER HENNESSEY: So why not -- why not just let them fail?

MR. LOCKHART: Why not let them fail? Well, we felt that if we let them fail, that what happened after Lehman would have been very small compared to these 5.5-trillion-dollar institutions failing.

So we felt that the best thing to do, and we actually, you know, I've gotten some questions about why conservatorship versus receivership, and we made the decision, there were some legal reasons, but I think also market reasons, we wanted to keep some faith in those institutions.

And we had foreign sovereign governments in their securities. We had a lot of the banks in this country invested in their mortgage-backed securities and their preferred stocks, which gets me to your second question of where we drew the line on the conservatorship.

One would have thought that we would have let this subordinated debt go. And that's where I thought we were going to do it.

The preferred stock and the common stock, to my mind, if you're an equity owner and your institution fails, you should lose it. And -- and they're worthless at this point in my mind.

But the issue was the subordinated stock, for many years people talked the subordinated stock as being one of the --

COMMISSIONER HENNESSEY: Subordinated debt?

MR. LOCKHART: Debt, debt, yeah, sorry, sorry. They had talked about subordinated debt as sort of being a cushion and would actually give some market discipline.

As we looked into the structure of that debt -- and the intertwining with the law, if we had let that debt go down, it would have defaulted all their debt, and that would have pulled down the whole institution. So we had to keep it in place.

COMMISSIONER HENNESSEY: Okay. Just a follow-up on that, as I understand it, if I'm running a bank, I cannot hold all of my assets in the debt of IBM or General Motors or Caterpillar, right? There are, as I understand it, there are banking rules, per se?

MR. LOCKHART: 10 percent or whatever the rule.

COMMISSIONER HENNESSEY: You can't put all of your eggs into the -- into one basket where that basket is the debt of a particular company, but the same is not true for so-called agency debt; is that correct?

MR. LOCKHART: Yes, agency debt, which I never liked that term because they were not government agencies, they were enterprises, that was treated very much like Ginnie Mae debt, that had the full faith and credit of the United States government on it, and they had to hold very little capital against it, and unfortunately, you know, some of the buyers of that preferred stock were banks, and they took very -- they took a hundred percent hit on it.

COMMISSIONER HENNESSEY: Okay. We talked a lot about lobbying. Capital standards, minimum capital standards, risk-based capital standards, and then the ability to consider systemic risk in the size of the portfolio.

Do you have knowledge of Fannie Mae and Freddie Mac lobbying on any of those points, either from a legislative standpoint or from a regulatory standpoint?

MR. LOCKHART: I do not have direct knowledge but I have indirect knowledge that they certainly had people up on Capitol Hill talking through the issues of legislation and the harm it might do to the housing market.

COMMISSIONER HENNESSEY: Okay. Were you, then, indirectly aware that they were lobbying against you having the authority to raise capital standards and against the authority for you to be able to consider systemic risks?

MR. LOCKHART: In our monthly meetings with the CEOs, we often talked about legislation, needless to say. And certainly, to me, they resisted some of those and especially the capital ones.

So as no doubt in my mind that if they were resisting to me that they were probably resisting up on Capitol Hill.

COMMISSIONER HENNESSEY: Okay. And Mr. Falcon you were considered to be an aggressive regulator when you were in this job but you were limited in terms of the authorities that you had.

As you look at the legislation that was enacted in 2008, which provided now FHFA with significant authorities, can you give us a sense of what you think you might have done with those authorities had you had them in, say, 2004 and 2005?

Now, I know you have the benefit of hindsight in knowing what happened, but based on the kinds of things that you were pushing for, can you give us a sense, had you had the ability to set minimum capital, risk-based capital, even effect the size of their portfolios? What do you believe would have been consistent with your actions at the time?

MR. FALCON: Well, in the 2004-5 time

period, if we had those authorities, I think we would have had more flexibility to deal with the capital issues and try to deal with the leverage issue.

I think we would have moved towards having them increase their capital, have a plan to increase capital, even above the 30 percent that we had imposed on them, we probably would have moved aggressively to begin to shrink that portfolio, the portfolios that both of them had, and we might have moved more aggressively on even considering some form of a conservatorship to deal with the cultural issues that continued to exist at both companies.

COMMISSIONER HENNESSEY: Okay. If I could, I would like to ask a couple of questions that I asked Mr. Mudd this morning. The Alt-A mortgages that they purchased in `05, `06, `07, do you believe that there was a public purpose, a mission-related purchase for those, or do you believe that they were primarily driven by profit motives or market share? Jim?

MR. LOCKHART: Okay, sure, would be happy to. The -- I would say it was both. They certainly did not want to be left out of that segment of the market. There was certainly a portion of them that had mission affordable housing.

I'm not sure that on average that they met the 55 percent. I would have guessed that there was probably less than 55 percent of the Alt-A's that they had that would have met the mission goals.

So the other piece was obviously the profit component and the market share component. You know, they were seeing some of their biggest suppliers go elsewhere, to the private label marketplace or whatever, and I think that they felt that they wanted to be a player.

COMMISSIONER HENNESSEY: Okay. And Mr. Mudd raised the issue, he seemed to be suggesting that one of the reasons why Fannie failed was that they were, in effect, a mono-line firm that lacked the ability to diversify risk.

And I was asking, it seemed to me that a more realistic explanation is that they didn't have enough capital and they were poor at managing their risks.

Can you each give us a sense of your perspective on the mono-line argument that we heard this morning?

MR. LOCKHART: Well, I'll start. First of all, they were a mono-line insurance company. That's really what they were, the mortgage-backed securities they were insuring. They doubled up that risk, unlike the other mono-line insurance companies, by having giant portfolios. So they actually doubled up their risk, and that was a problem.

But the key problem, they did not have anywhere near as cap- -- capital -- enough capital as they needed. And, in retrospect, I think we all understand, and we talked about it today, that no one understood how bad the mortgage market was going to be.

When you really think about it, Congress, when they set OFHEO up, only putting 45 basis points of risk on mortgage credit risks, you just have to scratch your head.

COMMISSIONER HENNESSEY: Mr. Falcon?

MR. FALCON: Yes, sir. I think that's a convenient argument to make now. But throughout the existence of these companies, they often touted about how, in their opinion, they were the best risk managers of any firm out there.

And to now say that they couldn't manage a single risk, mono-line risk, I think is just contrary to what they were saying.

The fact is that they had the ability to control the risk that they took. They set their underwriting standards. They didn't just buy whatever their servicers sent to them. They set those guidelines, themselves.

And if they had ability to better hedge risk. They had ability to voluntarily hold more capital if they thought that was essential to manage their credit risks. They had the lowest cost of funds of anyone in the private sector. I think this was clearly a failure of management to properly run these two companies.

COMMISSIONER HENNESSEY: Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: Thank you, Mr. Hennessey. By the way, the claim to be the best risk manager in the world was a shared prize, apparently, from what we've heard in our hearings today. Yes, Mr. Thomas?

VICE CHAIRMAN THOMAS: Just quickly on the follow-up to Mr. Falcon's last statement.

EXAMINATION BY VICE CHAIRMAN THOMAS

VICE CHAIRMAN THOMAS: You said that you thought it was basically the management and their failure to run the company properly. It depends on the profile or the understanding or the assumed purpose of the company. And if you're a private company, in terms of profit and the argument about the shareholders and the rest, I'm trying to see if you could focus on the fact that they came to understand, for them, the basic value and purpose of the company.

And in that score, notwithstanding their failure, they really did a pretty good job of managing it up until it became, as with everything else in that market segment, unmanageable.

I mean, I see a pretty clear movement towards the self-interest. That may have been one of the reasons they were structuring the operation the way they were. Weren't they pretty successful in that regard for quite a while?

MR. FALCON: Well, except for the fact that through their accounting misconduct, they were masking many problems within the companies.

VICE CHAIRMAN THOMAS: Well, then, you ask yourself, what would motivate someone to mask some of the problems, because it would get in the way of their focus of what they were doing, wouldn't it?

MR. FALCON: Well, they were trying to mask volatility in their business. They were trying to mask the risk in their balance sheets. And through the political process trying to manage OFHEO's ability to actually go in and dig deep and find these things.

VICE CHAIRMAN THOMAS: Yeah?

MR. FALCON: Yeah.
VICE CHAIRMAN THOMAS: It may not have been that that mismanaged based upon their focus and goal.
MR. FALCON: I think they were --
MR. LOCKHART: Well, excuse me, we're working within a legal framework that didn't work. And they -- you know, before I arrived they were definitely mismanaged from the accounting and all those areas. They finally got that actually in pretty good shape after all those consultants I mentioned.
But the fatal flaw, really, was the legislation. The management teams and the board of directors could have gotten that legislation through very quickly if they wanted to, and they didn't.
MR. FALCON: I understand your point.
VICE CHAIRMAN THOMAS: Thank you.
MR. FALCON: And I agree with you.
VICE CHAIRMAN THOMAS: Yeah.
MR. FALCON: Mismanagement implies that they incompetently -- that they didn't know what they were doing. They knew what they were doing.
VICE CHAIRMAN THOMAS: Yeah, that's the point I wanted to -- thanks.
CHAIRMAN ANGELIDES: Mr. Thompson?
COMMISSIONER HENNESSEY: Mr. Chairman,

just, if I could, just ten seconds.

COMMISSIONER THOMPSON: No, not now, you can't. I'm sorry.

COMMISSIONER HENNESSEY: Mr. Georgiou had a question earlier just about the costs, and I just want to add a CBO wrote, in January of this year, quote, in its August 2009 baseline, CBO projected that the operations of Fannie Mae and Freddie Mac would have a total budgetary cost of 389 billion dollars between 2009 and 2019.

CHAIRMAN ANGELIDES: Is that the budgetary or the economic? I thought the budgetary cost was 191.

COMMISSIONER HENNESSEY: That is their estimate of the budgetary cost, which is the subsidy for budget experts. It's a credit subsidy model. I'm sure Doug could tell us a lot more about it.

CHAIRMAN ANGELIDES: I'll await the tutorial.

COMMISSIONER HENNESSEY: 389 billion.

CHAIRMAN ANGELIDES: I would like to go to Mr. Thompson.

COMMISSIONER GEORGIOU: I wanted to follow-up on that point. Maybe I can make it later but I just wanted to add to what Commissioner Hennessey said, which is that in addition to the dollars that were lost, there also were and are significant investments in both the preferred securities, which Mr. Lockhart has told us that he thinks may be may never be worth anything, that the Treasury has purchased 75.2 billion of Fannie preferred stock, and in addition, the Federal Reserve has been purchasing mortgage-backed securities and has purchased 1.026 trillion of Fannie and Freddie MBS, and Treasury has purchased 254 billion of mortgage-backed securities, of course hoping that they won't reduce in value, but certainly there's a serious question whether they will under the circumstances.

MR. LOCKHART: Well, they're backed by that preferred stock, effectively those mortgaged-backed securities. So if there's further losses, the U.S. government is effectively backing those mortgage-backed securities. But, you know, they have put another one and a trillion dollars into it to help solve this problem, and it's just amazing how bad it got.

CHAIRMAN ANGELIDES: All right. Go to Mr. Thompson.

COMMISSIONER THOMPSON: Oh, I don't want to do it now.

CHAIRMAN ANGELIDES: You've been extraordinarily patient.

VICE CHAIRMAN THOMAS: Yield the gentleman an additional five minutes.

COMMISSIONER THOMPSON: I don't think I'll take that long now.

EXAMINATION BY COMMISSIONER THOMPSON

COMMISSIONER THOMPSON: As you well know, gentlemen, our mission here is to try to explain to the American people what caused this crisis and what almost brought our economy to its knees.

And, as such, we are asked to look at the issues and the institutions. And you, Mr. Falcon, said Fannie and Freddie are failed enterprises. You also acknowledged that you were outmaneuvered politically, your budget was inadequate, your staff was too small, you were under skilled for the task that was before you.

You are the fifth regulator we've had before us in the series of hearings that we've conducted. Why do you exist, as opposed to this mission being within the SEC or OCC or one of those other regulators, if you were in such bad shape?

MR. FALCON: Well, I think if we were originally-- OFHEO was set up as an independent regulatory entity. I think the idea was try to make it independent and not subject to the political influences of being part of the Treasury Department or some other government entity.

I think that was sound except for the lack of authorities and resources on par with every other safety and soundness regulator.

COMMISSIONER THOMPSON: Couldn't another safety and soundness regulator have done this work? Given that you got outmaneuvered politically, that you were underskilled and understaffed, I mean, I just don't get why you exist.

MR. FALCON: Well, the agency was Created, I think the law was in the 1992 Act that created the agency.

COMMISSIONER THOMPSON: I understand that, but couldn't someone else have done this work?

MR. LOCKHART: Someone else had done it before, the Federal Home Loan Board, was responsible for Freddie and the S&Ls. And, you know, so out of that they decided that they needed an agency that could focus on these two giants.

And, you know, Fannie and Freddie didn't want it at the time and they had made sure that the legislation, at the time, was very weak.

And that was, to me, again, the problem, here. Actually, it makes a lot of sense. I think the new legislation that gave us the responsibility not only for Fannie and Freddie, but the federal home loan banks now, actually does create a regulator that has the power to really oversee the whole secondary mortgage market in this country.

MR. FALCON: But I think the answer to your question is, yes. The congress could have decided to not create OFHEO and give this authority to the OCC or the Federal Reserve or some other safety and soundness regulator. That was always a possibility.

COMMISSIONER THOMPSON: Well, it seems as if you were inadequate in skills and capabilities that there was a heck of a lot more capability for similar instruments to be evaluated and assessed sitting inside the SEC or the OCC, but be that as it may.

MR. LOCKHART: Well, actually, most of our examiners came from the OCC or OTS. So we actually did raid that talent pool to build up the agency.

COMMISSIONER THOMPSON: But my point is there are economies of scale to be derived from consolidation of organizations as opposed to fracturing and splintering the organizations throughout an enterprise.

VICE CHAIRMAN THOMAS: Commissioner, if I might, for just a minute?

COMMISSIONER THOMPSON: Sure.

CHAIRMAN ANGELIDES: Mr. Thomas, on his own time.

VICE CHAIRMAN THOMAS: None of those other regulatory agencies would have been subject to the appropriations process.

COMMISSIONER THOMPSON: Maybe that would have helped.

VICE CHAIRMAN THOMAS: Let me explain this. I was new to the Ways and Means Committee, and I came up with the proposal to make this adjustment that President Reagan had asked for, all in one year, it was a 30-billion-dollar proposal.

I was taken aside and explained, you don't do things that way; we will make it in three 10-billion-dollar amounts because then they will have to come to us three different times.

COMMISSIONER THOMPSON: And that's supposed to be good?

VICE CHAIRMAN THOMAS: From the position of the chairman of the Ways and Means Committee, apparently it sure was.

COMMISSIONER THOMPSON: Well, Mr. Lockhart, you described the future of this industry and you gave a very rational view of what might happen. I then asked the question, what happens to OFHEO when, if in fact that were to evolve, is this a regulatory body that in a repackaged industry we really need?

MR. LOCKHART: Depending on how the repackaging goes, no. It could be, depending, if we recreate new GSEs, yes. If we go to some other structure, maybe not.

I think the key thing though, is whatever we have, we have to have a group that really understands the mortgage market and has oversight of it.

Our -- the mortgage market was very fractured from a regulatory standpoint. The nontraditional mortgage guidance that the bank regulators put out, we weren't even involved in, and yet we were the biggest player in the mortgage market.

So the key thing in regulatory reform, to me, is you've got to pull people together. How many agencies you end up with is not as important as you have to have those agencies work very closely together.

COMMISSIONER THOMPSON: Well it -- it certainly would cost the American taxpayers a lot less money if we aggregated the infrastructure that underpins these agencies that oversee the financial soundness of our economy.

MR. LOCKHART: One could argue that. On the other hand, I think actually our ability to work on just a few agencies has actually helped in some areas.

I mean, you know, a big bank regulator may have a thousand different entities that it has to regulate, and that could be cumbersome as well.

COMMISSIONER THOMPSON: It's all about organization then. All right, I yield my time.

CHAIRMAN ANGELIDES: Thank you, Mr. Thompson.

Just one observation, I was going to ask a question, but I am going to ask the question related to Mr. Thompson's questioning about the need for this regulator.

And it really does go to 2008, just in all candor, do the -- did the Federal Reserve and OCC, when they came in, I believe in, what, July/August?

MR. LOCKHART: Yes.

CHAIRMAN ANGELIDES: Did they find things that you had not found, or were they affirming what you had already found?

MR. LOCKHART: Some of both, they found some things that we hadn't found.

CHAIRMAN ANGELIDES: And you hadn't found it just because of their capability, the breadth or depth of their bench, or why is that?

MR. LOCKHART: Well, one thing, is they actually, the bank regulators, had a somewhat different approach to reserving than Fannie and Freddie did, and when we ran -- run the portfolios through their approach, the losses got bigger.

CHAIRMAN ANGELIDES: All right. So they did have a different perspective that you did not have.

MR. LOCKHART: Yes.

CHAIRMAN ANGELIDES: Okay. Mr. Mudd earlier today noted the delinquency rate of GSE, of Fannie and Freddie loans, versus the Wall Street or private market was definitively less.

He noted that, you know, the risk of coming with -- by being a big mono-line insurer, and I do wonder, and I only say this because I'm picking up on your comment, in the end, you know, so many mono-line entities went down; mono-line insurers, large thrifts went down, because when the market turns against you and that's your only business it's very hard to sustain it. He made the observation that even if they had been extraordinarily well capitalized, because at some point you have to have a return on equity for investors, so there's a balance here. I mean, you can't be so well-capitalized there's no return.

He essentially made the point we would have had levels of -- needed levels of capital such that they were not feasible in the marketplace to have sustained this way; do you agree with that?

MR. FALCON: At some point too much capital, right, doesn't serve the entities. But at that level, 2.5 percent, I think it was very, very highly leveraged then.

CHAIRMAN ANGELIDES: So they would have -- agreed, they were -- they were 61 -- well, they weren't even at 2 and a half percent. They were off-balance-sheet they were effectively at one and a half, 60 to 1, 70 to 1 ratio. But the only reason I mention it is it reinforces your observation, that there is part of this market that can legitimately be served by the private markets and some that cannot be and therefore we shouldn't have the false promise that it can be.

Because what turned out to be it was a massive false promise to the American people that somehow that these activities could be sustained without subsidy in the end.

MR. LOCKHART: If you look at the number

Commissioner Hennessey just put out, that would have been well less than 10 percent of their risk. And we're now asking banks to put up capital around 10 percent.

And what really happened here is we subsidized homeowners by that very low capital charge.

CHAIRMAN ANGELIDES: And also compen- -- well, we subsidized homeowners, shareholders, and executives?

MR. LOCKHART: I agree.

CHAIRMAN ANGELIDES: Okay. Is that a fair statement?

MR. LOCKHART: That's a fair statement.

CHAIRMAN ANGELIDES: Yeah, we did more -- there was a fair -- it turned out to be a relatively inefficient way to subsidize homeowners.

MR. LOCKHART: Right. And now the taxpayers' paying all that subsidy back.

CHAIRMAN ANGELIDES: Because there's some barnacles, there were some barnacles on the whale.

COMMISSIONER HOLTZ-EAKIN: I will simply note for the record that the CBO actually broke apart, who got the subsidies that were implicit in separation, and the homeowners got a de minimus part of the subsidy. The vast majority went to shareholders and management.

CHAIRMAN ANGELIDES: Mr. Holtz-Eakin, would you be willing to provide that information to the Commission, under oath, or under subpoena, or voluntarily?

COMMISSIONER HOLTZ-EAKIN: One can get it from the CBO website.

CHAIRMAN ANGELIDES: Thank you. I want to talk, just for minute, as we wrap up here about the affordable housing goals, because I want to understand a little bit about how the process worked.

HUD would propose them, how iterative a process was this; in other words, was it a process in which Fannie and Freddie would say here's where we legitimately can meet, or do they really flow out of HUD? And would you look at them for safety and soundness?

MR. FALCON: I was not -- OFHEO -- the OFHEO director is not directly involved in setting the goals. But we do play a role and I am a little familiar with how it works.

And my understanding, it was a sort of a back-and-forth that the goals were frequently proposed by HUD, there was push-back by Fannie and Freddie, and eventually they came out with a number where HUD thought it showed advancement, and higher goals and

Fannie and Freddie were of the opinion that they could meet them.

And this typically is the way this negotiation happened as I understand the process.

CHAIRMAN ANGELIDES: Because in our interviews with Fannie staff, according to our staff, no one of the Fannie folks, Fannie Mae folks we interviewed recalled that they raised concerns that, I guess, there was an iterative process.

But at the end of the day, no one said this is going to jeopardize safety and soundness. My question is, did you ever comment on them?

MR. FALCON: Yes, HUD would run the goals by OFHEO, and we would examine them and opine whether or not we thought they could --

CHAIRMAN ANGELIDES: All right.

So under your tenure, which ended in 2005; correct?

MR. FALCON: Yes.

CHAIRMAN ANGELIDES: Did you ever voice an objection to them on safety and soundness grounds.

MR. FALCON: No. But –

CHAIRMAN ANGELIDES: Go ahead. I don’t want to cut you off.

MR. FALCON: But we also always told the enterprises that if situations ever changed and we -- and they thought that they couldn't meet the goals without taking on an excessive risk, then we made it clear to them that they should not take on that excessive risk.

CHAIRMAN ANGELIDES: And did they ever circle back to you and say we've got a problem here?

MR. FALCON: No.

CHAIRMAN ANGELIDES: Okay, Mr. Lockhart, same set of questions?

MR. LOCKHART: The goals were set I think in 2004 for a four- or five-year period.

CHAIRMAN ANGELIDES: And they did escalate in 2004; correct?

MR. LOCKHART: Yes, they did.

CHAIRMAN ANGELIDES: So this is the first time I think they began to nudge above 50.

MR. LOCKHART: Yeah.

CHAIRMAN ANGELIDES: In which you were talking about?

MR. LOCKHART: Yes. They kept pushing them and pushing them, but that whole set of decisions was made in 2004, I think. And so we never really got involved in the goal-setting while I was there because they were just about ready to be reset when everything started.

CHAIRMAN ANGELIDES: So they weren't

annualized, there weren't annualized renewals of those?

MR. LOCKHART: It was cast in concrete, if you will, and it was not market-related, which was really the fatal flaw.

CHAIRMAN ANGELIDES: And so in 2004 they set them on an escalator.

MR. LOCKHART: Exactly.

CHAIRMAN ANGELIDES: Did you have the ability, statutorily, to, like in 2005 or `6, to express safety and soundness objections?

MR. LOCKHART: I could have talked to the HUD secretary but I didn't have any authority.

CHAIRMAN ANGELIDES: But did you? Or did you -- or did you -- did you ever express concerns about them? I'm just trying to get to what -- how parties felt about them.

And, of course, I can see in an up market, where everyone's feeling like we can get there. But I'm just curious about whether or not you expressed objections or concerns about them.

MR. LOCKHART: Internally, but I don't think we talked to HUD about them.

CHAIRMAN ANGELIDES: Okay or to Fannie?

MR. LOCKHART: Fannie talked to us about them a lot.

CHAIRMAN ANGELIDES: And we'll explore -- they talked to you about them in what regard?

MR. LOCKHART: Well, how tough they were. As I said before, the CEOs were very afraid of missing them, they missed part of them, I guess, in `07. They missed them by a mile in `08.

And part of the legislation, you know, we did get authority for that, and while I was there, we changed that structure pretty dramatically.

CHAIRMAN ANGELIDES: So they were -- they were expressing concern they weren't going to get there?

MR. LOCKHART: Yes.

CHAIRMAN ANGELIDES: Okay. Because I understand HUD did lower some standards at their request, but we'll look at the record.

MR. LOCKHART: I think what they did is when they missed them they allowed them to miss them.

CHAIRMAN ANGELIDES: They missed them and then, in a sense, excused the miss.

MR. LOCKHART: Yes.

CHAIRMAN ANGELIDES: All right.

VICE CHAIRMAN THOMAS: Mr. Chairman?

CHAIRMAN ANGELIDES: Yes.

VICE CHAIRMAN THOMAS: The expressed

concerns, were they on safety and soundness? What were the grounds on expressing concern?

MR. LOCKHART: The underlying was safety and soundness. But the real concern was that they were just not going to meet the goals, that it was just not possible.

There were some years, you can look in the historical record, that they did transactions right in December to make those goals.

The goals not only were a single-family but they were -- multi-family added a lot to the goals. So you can see some years they did some very large multi-family transactions just to hit the goals.

VICE CHAIRMAN THOMAS: So they knew what the targets were and they sometimes shaped their behavior --

MR. LOCKHART: Yes.

VICE CHAIRMAN THOMAS: -- to meet those specific targets?

MR. LOCKHART: Yes.

VICE CHAIRMAN THOMAS: Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: All right. Thank you all very much. So let me just conclude this meeting by, first of all, thanking the witnesses. Thank you for your time. Thank you for your public service. Thank you for being here today.

I want to thank Vice Chairman Thomas for his continued work with me and the other commissioners as we, as a bipartisan Commission with a nonpartisan mission, really try to do the best job of examining what happened here in this event of tremendous consequence or series events of consequence for this country.

I want to thank all the members of the Commission. I want to particularly thank the lead commissioners on this research and investigation project on subprime lending securitization, this hearing, Mr. Wallison, Mr. Georgiou, and Ms. Murren.

I want to thank our staff, who has provided an exceptional amount of information, literally hundreds of interviews to date, hundreds of thousands of documents, for their excellent staff work and their very long hours.

And thank you, the public, who has joined us. And I also want to remind everyone, as the Vice Chairman reminded me to, that you folks should go to our website at FCIC.gov. We have posted papers on that website, background, staff reports, preliminary staff reports that have not been adopted by this

Commission, and they are available for comment. And we encourage comments or would like comments by May 15th. Mr. Thomas?

VICE CHAIRMAN THOMAS: Mr. Chairman, in continuing the bipartisanship that we have displayed, on behalf of the Commission I would like to thank the Chairman of the Energy and Commerce Committee, Mr. Waxman and his staff, for providing us accommodations.

I would have liked a couple more degrees down on the thermostat but it's -- understanding what our options were, we do appreciate and thank them. For those who have never tried to run these kinds of hearings outside of a congressional hearing room, it's really, really hard to do, and I want to thank them for their courtesy.

CHAIRMAN ANGELIDES: Thank you all, I would like to ask if the commissioners would gather extraordinarily briefly in the anteroom right after this meeting. Thank you all very much.

(FCIC Hearing adjourned at 2:45 P.M.)