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## YPFS Lessons Learned Oral History Project: An Interview with James B. Lockhart III

James B. Lockhart

Rosalind Z. Wiggins

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## Lessons Learned Oral History Project Interview

<b>Interviewee Name and Crisis Position</b>	James B. Lockhart III <sup>1</sup> , Former Director, Federal Housing Finance Agency
<b>Interviewer Name</b>	Rosalind Wiggins, Director & Sr. Editor, Yale Program on Financial Stability Ben Henken, Research Associate, Yale Program on Financial Stability Dan Thompson, Research Associate, Yale Program on Financial Stability
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### **Introduction:**

The Yale Program on Financial Stability (YPFS) reached out to James B. Lockhart III via email to request an interview regarding Lockhart's time working as the Director of the Federal Housing Finance Agency (FHFA) during the Financial Crisis, and, more specifically, his role during the implementation of the Fannie Mae and Freddie Mac conservatorships<sup>2</sup>. While having previously served as the Principal Deputy Commissioner and Chief Operating Officer of the Social Security Administration (SSA), Lockhart was appointed director of the FHFA in May 2006. He led the agency until August 31, 2009 and oversaw a troubling period for Fannie Mae and Freddie Mac. He was also a member of the Financial Stability Oversight Board from its inception in October 2008 until August 2009. In the George H.W. Bush Administration, he led the Pension Benefit Guaranty Corporation, dealing with many bankrupt companies. At the time of this interview, Lockhart was Vice Chairman of WL Ross & Co. LLC, a major investor in banks and mortgage companies.

On September 6, 2008, pursuant to the recently enacted Housing and Economic Recovery Act (HERA), the government took control of Fannie Mae and Freddie Mac, placing them into conservatorships and ultimately investing \$191 billion to keep them solvent. It also purchased some of their debt and mortgage-backed securities (MBS). Despite the stabilization of the companies, the mortgage market continued to experience severe contraction aggravated by high interest rates. In December 2008, to lower rates and loosen credit, the Federal Reserve implemented the Large-Scale Asset Purchase (LSAP) Program pursuant to which it purchased over \$1 trillion in GSE debt and MBS between 2009 and 2010. By 2012, the companies had returned to profitability, although they remain in conservatorship to date.

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<sup>1</sup> The opinions expressed during this interview are those of Mr. Lockhart, and not those any of the institutions for which the interview subject is affiliated.

<sup>2</sup> A stylized summary of the key observations and insights gleaned from this interview with Mr. Lockhart is available [here](#) in the Yale Program on Financial Stability's *Journal of Financial Crises*.

*[This transcript of a telephone interview has been edited for accuracy and clarity.]*

**Transcript:**

**INTRODUCTION**

**YPFS:**           **A good place to start would be when you first came to the Office of Federal Housing Enterprise Oversight (OFHEO) in 2006. What were your views on the condition of the GSEs at this point? There had already been a lot of speculation about them.**

Lockhart:        Yes – I joined the OFHEO as acting director in May 2006. I was parachuted into the agency, which had an acting director – a career person. It was a very busy time, so the administration wanted a political appointee at the agency who understood finance. I had spent the previous four years as second-in-command at the Social Security Administration, where I worked on Social Security reform. When that wasn't implemented, I thought about leaving public service, but ultimately was persuaded to take the position at OFHEO.

My first order of business at OFHEO was the report on Fannie Mae's accounting scandals. The report was in pretty bad shape when I first arrived, so we ended up rewriting it and then negotiated an agreement with [Fannie Mae CEO] Dan Mudd. The agreement had many components, but **the overarching idea was to make sure Fannie's books would soon be in order.**

**YPFS:**           **That's the consent agreement?**

Lockhart:        Yes. The consent agreement. And it took Fannie Mae a couple of years to really get its books together. It was remarkable how bad the books of both Fannie and Freddie [Mac] were. At one point, Fannie even had more consultants than employees. Together, Fannie and Freddie owned or guaranteed more than \$5 trillion in mortgage assets, so they were two of the biggest financial institution in the country at the time. Both entities were very arrogant yet did not have proper accounting and many of the other basics in place. We ended up imposing a big fine on Fannie and Freddie and took a lot of other remedial actions as well.

A lot of people at this point were starting to worry about Fannie and Freddie. As a result, before I took the job at OFHEO (I actually was asked to take it the summer before but had declined), I spent a lot of time learning about the agency and getting a sense of what some of the major issues were. And even before my confirmation hearing in June I talked about the need for legislation to reform the GSEs.

One of the things we did early on was put a cap on Fannie's portfolios. The settlement with Freddie, which was done before I arrived, actually did not cap the firm's portfolios. What it did impose, however, was a 30% capital surcharge. As you know, though, their capital requirements were already so low that a 30% increase didn't really make much of a difference.

We followed this blueprint in our settlement with Fannie and also capped its portfolios. I also began to meet with the CEOs of both enterprises once per month. Sometimes they

were receptive and other times less so. As I've said, the GSEs were very arrogant organizations and had tremendous clout on the Hill, especially Fannie.

## **FANNIE MAE, FREDDIE MAC, AND THE COLLAPSE OF THE U.S. HOUSING BUBBLE**

**YPFS: You mentioned that people were starting to get worried about Fannie and Freddie in early 2006. Were these concerns unrelated to what was happening in the subprime mortgage market?**

Lockhart: Right – it was mostly in relation to their accounting issues and also the growth of their portfolios. I should note, though, that Fannie and Freddie were a reasonably big worry even before I arrived at OFHEO. About two years earlier, OFHEO's policy group put out a paper saying they were the two biggest systemic risks. And yet the point was mostly dismissed.

I'm not sure if it was before or after my confirmation, but I did meet with Freddie's Board to try to convince it to voluntarily accept a cap on the firm's portfolios; I didn't think it made sense to have a cap Fannie's portfolios but not on Freddie's. The meeting was contentious. I explained why Freddie also needed a cap, but the Board countered by saying that Freddie didn't have any credit risk, which is a pretty bold claim to make. The Board was heavily comprised of investment bankers and really thought it had the situation under control. And, you know, Fannie and Freddie historically had not had significant credit problems. Ultimately, though, we succeeded in getting the Board to agree to a cap on Freddie's portfolios as well.

The portfolios were being put to use to buy, in many cases, private label mortgage-backed securities (PLMBS) comprised of "affordable" mortgages, and so Fannie and Freddie were getting credit for pursuing their affordable housing missions. This was one of the issues we kept on raising when asking for legislation. OFHEO at the time was the safety and soundness regulator, but the mission regulator was HUD, so it was responsible for setting affordable housing goals with the White House. Over time these goals were repeatedly ratcheted up.

There was no doubt that President Bush did not like Fannie and Freddie. Before I arrived at OFHEO, he decided to stop appointing directors to their boards because he didn't want to be involved with the entities in that capacity. So it was clear that the administration already thought there were some big issues at both firms. People were worried about the size of their portfolios as well as their overall size and aggressiveness. In addition, they had been losing market share pretty dramatically to the PLMBS world.

**YPFS: Was this in large part due to the shift toward subprime?**

Lockhart: It was somewhat related to the shift toward subprime, but also the aggressiveness of mortgage originators. And the rating agencies, frankly, were pretty loose when it came to rating these instruments.

Fannie and Freddie were only buying the AAA tranches. They would look into these instruments to see if they fulfilled affordable housing goals, but largely ignored the issue

of credit risk because of the AAA rating. We ended up spending a lot of time thereafter on PLMBS, but it probably wasn't until the summer of 2007 that things really started to fall apart. But you could see as early as, say, the beginning of 2007 that the market was beginning to sell off mortgage-backed securities, especially the lower tranches.

Issues weren't confined to subprime, though. There were also "NINA" (no income, no assets) mortgages, which had no documentation and which also have been referred to as "liar loans." Bank regulators also started to worry about 2/28 and 3/27 mortgages – "teaser" mortgages, if you will. The idea behind these was to offer a really low rate for the first two or three years and to subsequently **ramp it up. The logic was that these borrowers then could refinance.**

**YPFS:** **As long as housing prices were going up.**

Lockhart: Exactly. The process began to break down once housing prices really started to fall, which I believe was late in 2006.

**YPFS:** **Right – late 2006.**

Lockhart: Bank regulators had adopted a rule on 2/28 and 3/27 mortgages but hadn't fully implemented it yet. I made Fannie and Freddie, who were buying tons of these mortgages, implement the rule sooner. Fannie and Freddie began to take a closer look at the risk associated with these mortgages. I remember Dick Syron, the CEO of Freddie Mac, telling me that his people were getting worried about the company's exposure to them.

By the summer of 2007, the situation was beginning to get very worrisome. Bear Stearns was starting to run into trouble; the BNP Paribas announcement spooked markets; and in September, Northern Rock in the UK needed emergency support. We also were starting to see some of the subprime lenders go belly-up. Both Fannie and Freddie were telling me that I should loosen their capital requirements and lift their portfolio caps so that they could step in and basically save the markets. They claimed that they had done so before when Long-Term Capital Management failed in 1998. I think they were able to help then, but the situation we now were facing was so much bigger. We negotiated somewhat with them and loosened some minor requirements – but didn't make too many concessions. And we made them raise more capital, which they did in December 2007– over \$17 billion. As I said in my FCIC testimony: "From the fall of 2007 to the conservatorships, it was a tightrope without a safety net."

**YPFS:** **That's an interesting point, because this is when you negotiated the loosening of the caps for an increase in capital.**

Lockhart: This was one of two sets of negotiations. In August or September 2007, we basically decided to allow Fannie and Freddie to acquire more mortgages, but they did not exceed the caps. The theory was – and this was according to Dan Mudd – that one-third of all subprime mortgages were going to go under no matter what – they were just that bad. Another one-third might survive the market downturn intact. And the final one-third were likely okay credits which shouldn't have been subprime in the first place. I think these percentages were somewhat off but that the general breakdown made sense. It's true there were people getting subprime mortgages who could've gotten good mortgages.

As I noted in a December 2007 interview, the portfolio caps imposed on Fannie and Freddie under the consent agreements were supposed to expire after the firms began filing with the SEC, which they did in February 2008.

The second set of negotiations took place while Hank [Paulson] was working on the Bear Stearns deal in March 2008. Bob Steel, his undersecretary, and I simultaneously worked with the CEOs of Fannie and Freddie on potential solutions for the frozen mortgage market. We recognized that Fannie and Freddie were the “only game in town,” and we wanted to figure out a way to keep the mortgage market going.

A deal was supposed to be announced at the same time as the rescue of Bear Stearns, but ended up being announced soon thereafter. Both companies agreed to raise more capital; they had raised capital in December but now were being told to do so again. In return, and because they had met their consent agreement requirements, we somewhat loosened their portfolio caps and agreed to potentially loosen the 30% excess capital requirement. Another thing – which was really important to me – was that they agreed to stop fighting legislation. I don't think we ultimately would have been able to get legislation if we hadn't convinced them to back off on this. Together, the two of them probably had as many as 100 lobbyists on Capitol Hill.

**YPFS: Where did the profit motive factor into all of this?**

Lockhart: Fannie and Freddie were very profit- and market share-oriented and were aggressive in pursuit of these aims. They were much more concerned about interest rate risk than credit risk, partially because 30-year, fixed-rate, fully pre-payable mortgages are very hard to hedge. So, they were spending a lot more time on interest rate risk than credit risk at the time. They were also spending a lot of time trying to get their books in order. Freddie Mac's 2<sup>nd</sup> quarter 2008 accounts were the company's first ever approved by the SEC. It was a busy time overall.

**YPFS: Were you in consultation with HUD on setting affordable housing goals?**

Lockhart: No – at least I wasn't while I was there. They were setting new goals in the summer of 2008 without even consulting me – and we had a crisis on our hands. They just kept on ramping the goals up.

We had people trying to push Fannie and Freddie to shore up its defenses, but there was a tug-of-war with respect to their missions to promote affordability and to keep the mortgage market afloat. On the one hand, you had the obligation to fulfill the affordable housing missions, but on the other, you had safety and soundness considerations.

Amid all of this, one of our key priorities was to get new legislation. We knew Fannie and Freddie needed more capital and a risk-based capital system, which wasn't really in place at this point. And we wanted more control over setting affordable housing goals. We needed these powers and a few others in order to really be a full regulator.

**THE HOUSING AND ECONOMIC RECOVERY ACT (HERA) OF JULY 2008**

**YPFS: How soon after arriving at OFHEO did you start to focus on getting new legislation?**

Lockhart: I mentioned the need for new legislation at the press conference on Fannie and Freddie's consent agreements – so, actually, even before I had been confirmed. People had told me to wait to confront this issue until my confirmation – but even at my confirmation hearing I touched upon the need for new legislation.

I spoke a lot about the need for reform, especially new legislation to give the regulator more power over their capital levels. At the time, we did not have this power; these rules were set by Congress. My PowerPoints became infamous. It was a constant theme; I wanted new legislation and so did the Bush Administration. For instance, unlike for banks, the GSEs' deferred tax assets were legally fully counted as capital, and they disappeared when the GSEs started posting losses. By the summer of 2007, Barney Frank and the House actually did produce some legislation. It wasn't as strong as we would have liked, but it was very much a step in the right direction.

**YPFS: At what point did you start talking to Secretary Paulson? He has said that getting new legislation was an early interest of his, too, upon becoming Treasury Secretary.**

Lockhart: I talked to him right away, though I think I joined OFHEO a little bit before he became Treasury Secretary. We ended up having several meetings with the President in the Oval Office about Fannie and Freddie.

**YPFS: What did it ultimately take to get new legislation?**

Lockhart: Overall, I think the Democrats were more sympathetic to Fannie and Freddie than Republicans were. One likely reason for this was the work Fannie and Freddie were doing on affordable housing. It was tough to get a majority to agree on new legislation. Some Republicans despised Fannie and Freddie and didn't want to help them at all, while some Democrats wanted us to loosen additional restrictions on them so that they could continue carrying out their mission. It really ended up being a balancing act. In the back of my mind, I always knew that if we were too tough on Fannie and Freddie, we might not have been able to get any legislation at all.

The legislation had been drafted such that I would be heading the new oversight agency, which would be responsible not only for supervising Fannie and Freddie but also the 12 Federal Home Loan Banks. This aspect created some tension since I was one of the key proponents of new legislation. Getting them to back down on protesting new legislation certainly made it easier to push the bill through Congress. Hank [Paulson] and Bob Steel were very helpful in getting the legislation through. It was a full-court press on the Hill. I think people were beginning to feel that things could fall apart, having seen Bear Stearns and what was going on in the private label MBS market. There was virtually no private label issuance at all by this point. So the market pretty much only consisted of Fannie and Freddie, the FHA [Federal Housing Administration], and the banks, who had started to pull back as well. Accordingly, from 2006 to 4<sup>th</sup> quarter 2007, Fannie and Freddie's market share had doubled from 37% to 75%.

## **SUMMER 2008: THE LEAD-UP TO THE CONSERVATORSHIPS**

**YPFS:** **At this point – during the summer of 2008 – were Fannie and Freddie still meeting their capital requirements?**

Lockhart: Yes, according to the flawed law.

**YPFS:** **Internally, did the OFHEO or FHFA make other calculations to evaluate their financial soundness?**

Lockhart: We used their financial statements to write the report on their capital position – that was the requirement. They were adequately capitalized at the time, at least according to the legislation in force, which I disagreed with. But according to the law, they were adequately capitalized. In fact, even their financial statements on June 30<sup>th</sup> showed they were still in compliance with existing requirements. This was also the first time ever that Freddie submitted its financials to the SEC for approval. We forced them to do this – there was no legislative requirement for it. We also did quarterly risk rating for Fannie and Freddie. In August, we downgraded them one notch to the lowest possible rating: “critical” concern.

We also spent a lot of time working with Fannie and Freddie on the issue of private label mortgage-backed securities and repeatedly told them they were “under-reserved”. At one point, one of the directors at Freddie told me I was being unpatriotic by putting so much pressure on the company [laughs].

We spent a lot of time addressing their capital adequacy, but frankly, it wasn’t enough. We should have spent more time with bank regulators – and should have done so earlier – to get a better understanding of how banks were setting aside reserves versus what Fannie and Freddie were doing. At this point, in the marketplace for private label mortgage-backed securities, you could see that prices were going down pretty dramatically. But Fannie and Freddie were still not setting aside enough reserves on their own mortgage-backed securities and portfolios. There was no doubt that they were “under-reserved” as we looked deeper into the issue. In addition, there was a rule dictating that if a mortgage was more than 90 days in arrears, Fannie and Freddie were supposed to pull it out of their mortgage-backed securities. So, these mortgages were ballooning in number on their books, too.

To be fair to Fannie and Freddie, their delinquencies and losses, in retrospect, were less than those suffered by virtually everyone else. The real problem was that they held such little capital. I mean, if you're writing mortgages on 1% capital, only a very small blip in the market can hit you really hard. It’s true that Fannie and Freddie held a lot of subprime mortgages and had delinquency problems, but even then, they were in somewhat better shape than mostly anybody else. Unlike banks, though, they didn't hold much capital. And of course, for many banks, even these capital cushions wouldn't be enough.

**YPFS:** **In their June 30th review – which was released in early August 2008 – Fannie and Freddie were deemed to be adequately capitalized. But markets had changed quite a bit in the time that had elapsed. By this point, HERA [Housing and Economic Recovery Act] had passed, giving you a new set of tools and the possibility of a conservatorship that could really work.**



Lockhart: HERA passed on July 30<sup>th</sup>. As we were leaving the Oval Office signing ceremony, I had a private conversation with the President, whom I had been friends with since Andover and Yale. He said the decision on what to do with Fannie and Freddie was now up to me. It was too late in the game to put out new capital rules. At the same time, we were setting up a brand new agency, the Federal Housing Finance Agency (FHFA). It was clearly a tense time. The FHFA also was inheriting the Federal Home Loan Banks – which felt as though they were being taken over – so we were trying to keep morale high there. But it was clear that Fannie and Freddie were having extreme difficulty fulfilling their missions of providing liquidity and affordability to the mortgage market.

At this point, several people were starting to blow the whistle on Fannie and Freddie. Of all people, Lehman Brothers put out a report warning about huge capital holes at the companies. Fannie and Freddie's stock prices were falling, too. Fannie actually did raise new capital in May – \$7.56 billion in preferred stock, as it had promised – with the help of JPMorgan, which ended up keeping a billion in stock on its books and took a hit when we put the GSEs into conservatorship. All of August, we intensely watched what was going on in the markets. We always had teams that were monitoring Fannie and Freddie, but a year before, we had created cross-Fannie-and-Freddie teams based on risks (credit, interest, and operational).

**YPFS: Were they embedded with Fannie and Freddie?**

Lockhart: Yes. Some members of the team regulating Fannie were probably a little too friendly – or captured – which was somewhat of a problem. This was likely somewhat the result of Fannie's aggressiveness as an organization. In general, though, the cross-functional teams tended to be more aggressive about identifying problems at the two firms.

At this point, the situation was such that if we decided to blow the whistle, all hell likely would have broken loose. If, for example, we had said that the GSEs were totally inadequately capitalized before receiving Hank's bazooka – which didn't arrive until the July 30<sup>th</sup> legislation – we had no way to bail them out. There just was no way to do it.

**YPFS: Was this because the conservatorship structure under the old legislation, in your opinion, was not effective?**

Lockhart: What was missing was a financial backstop. Otherwise, there would've been a “run on the bank” with no FDIC to stop it. People would've stopped buying GSE mortgage-backed securities and wouldn't roll over their debt. The \$10 trillion mortgage market would've dried up.

As you know, and as Hank and Ben Bernanke have said in their books, there was pressure from foreign countries to step in and save the GSEs, particularly from China. A lot was going on at this point. We responded by starting to build a case to put the GSEs into conservatorship. Even under the new legislation, as a practical matter, we needed the consent of both boards to put the GSEs into conservatorship. Even if they didn't consent, we could have proceeded with the conservatorships, but it could have prompted a lawsuit, which would have been devastating amid everything going on. That is all to say, we had to build a good case.

By this point in August, we were having regular meetings with Treasury and the Fed in particular. At one of these meetings, we had a discussion with Hank, who was originally leaning toward receivership. I let my general counsel speak in favor of almost the opposite position – a memo of understanding – instead of conservatorship. But I was in the conservatorship school. However, in order to eventually win the support of my staff – which was important – I thought it necessary to allow them to have their day in court to say: “Maybe it’s not as bad as you think it is. We can get through this with a memo of understanding,” which is what was done for a lot of banks during the crisis.

### **WEIGHING THE OPTIONS FOR INTERVENTION**

**YPFS:** **In your opinion, would a memo of understanding have given you sufficient control?**

Lockhart: No. We still would have needed to secure a loan from Treasury.

**YPFS:** **Was Secretary Paulson willing to do that?**

**Lockhart:** Oh, not even close. He was still in the receivership school. I think he ultimately opted for conservatorship because receivership would have spooked the markets too much. Even with a loan, I think there would have been a “run on the bank” – or at least a freezing of new mortgages – if we had chosen receivership. I think conservatorship was the middle ground.

**YPFS:** **HERA passed on July 30<sup>th</sup>, after which time no single event appears to have precipitated the shift toward conservatorship. What factors ultimately contributed to this new understanding?**

Lockhart: There were a lot of moving pieces. Certainly, the markets were giving many signals. Fannie and Freddie continued to report large losses and their stock prices were falling. A lot of comments were made publicly as well, including by individuals like Larry Summers, who served as Treasury Secretary in the Clinton Administration. Ben and Hank also were getting pressure from various parties, many of which were based outside of the U.S. Hank did not have the bazooka, even though he had only asked for it about two weeks before the legislation would pass. It really passed right at the last second.

I think the possibility of Fannie and Freddie receiving a loan from the government had been discussed before, but most people involved were too scared to ask for it out of fear of spooking the markets. We also thought doing so might make it impossible to pass new legislation, as some Republicans were adamantly opposed to this part of any solution.

**YPFS:** **Would it have been at all possible to save Fannie and Freddie without a loan from the government?**

Lockhart: No. Without the bazooka, it would have been much worse – in my mind – than Lehman. Fannie and Freddie owned or guaranteed more than \$5 trillion in mortgage-related assets and many trillions of dollars of derivatives. They were so intertwined with the markets that using the bazooka was the only possible solution.

One agency – it might have been the Congressional Budget Office – produced a report on whether we ultimately were going to need to fund the GSEs. It basically concluded that even if the bazooka were needed, the total cost for the government would only amount to \$25 billion. It turned out to be somewhat bigger [laughs]. Around this time, I actually heard from Chairman Bernanke more than anyone. From the outside looking in, his staff believed that Fannie and Freddie had approximately a \$50 billion hole.

**YPFS: That's based on the review they did over the summer?**

Lockhart: Earlier you asked what really stirred the pot and led us in the direction of conservatorship. This was one of those things. The summer financial review, which was conducted with help from market participants, basically applied the same rules that banks used for setting aside reserves. Fannie and Freddie had been somewhat looser in this respect.

We then did a really deep dive. We spent a lot of time with Treasury, and we wrote the report that ultimately illuminated many of the issues at Fannie and Freddie. In Hank's book – and maybe even Ben's and a few others' – it was suggested that we were resistant to the idea of conservatorship. I think there was some resistance within our agency. Some of my colleagues really understood how necessary it was to intervene, but others were still somewhat concerned about our reputation. Still others had spent much of their professional lives regulating these institutions and were traumatized to see them now on the brink of collapse.

Nonetheless, we spent the last two weeks of August diligently preparing our case for conservatorship. We were doing everything we could to make our case as strong as possible so that we could win the support of both boards.

**YPFS: Was the president's approval required before you could make the case to both boards?**

Lockhart: No – it was my responsibility as head of the FHFA to work with Hank, who had been delegated by the President to take the lead on Fannie and Freddie. I actually didn't end up speaking much with the President, partially due to our personal relationship. Hank was doing the heavy-lifting on this issue for the administration.

**YPFS: An FHFA letter on August 22<sup>nd</sup> asserted that Fannie and Freddie were adequately capitalized – at least based on their June 30<sup>th</sup> financials. Only a few weeks later, however, it was announced that they were being placed into conservatorship. It's interesting because in the past, Secretary Paulson has underscored the difficulty of putting all of the pieces in place to implement the conservatorships. But it really wasn't that long of a timeframe when you consider that these were trillion-dollar entities for which we were preparing this course of action.**

Lockhart: Right. The two entities had very strong, well-compensated boards. Overall, Fannie was more resistant to conservatorship than was Freddie. I think Dick Syron, CEO of Freddie Mac, was ready to step down once we actually did pull the trigger. Fannie Mae CEO Dan Mudd and his legal counsel Beth Wilkinson pushed back strongly during the Friday meeting at which we separately told the two CEOs our plan for their companies. Fannie suggested that the only reason we wanted to put it into conservatorship was that we were

reluctant to take only one of the GSEs [Freddie] under government control. As it turned out, because Fannie was bigger, it ended up having a bigger capital hole.

The August letter you mentioned was based on their financials as of June 30<sup>th</sup>. However, in the letter we told them that we were seriously concerned about the deterioration of the housing market and had discretionary authority to lower their classification. Over time, we repeatedly ramped up our warnings. Again, as of June 30<sup>th</sup>, the two entities were adequately capitalized according to the law. The capital requirement was so low, however, that even a little hiccup in the market had the potential to cause a big problem. And what we saw was a big hiccup.

It was a difficult situation. As I've said, we didn't want to cause a "run on the bank" until we were ready and able to do something about it. We weren't ready to do something about it at that point. As early as around the rescue of Bear Stearns, someone in the White House kept suggesting that Fannie and Freddie were a total mess. He was probably right. But it would have been a real problem if we had simply conveyed that sense of panic to the markets. We often felt as if we were walking a tightrope: we repeatedly put maximum pressure on Fannie and Freddie – and on Congress to get us the law we needed – but wanted to make sure we weren't also unnecessarily spooking the markets.

As you may remember, Freddie never was able to raise new capital during this period. Their excuse was that they wouldn't be able to do so until they filed with the SEC in early August [2008]. Around this time, I actually met with Freddie's management, its investment bankers, and a private equity investor. It became pretty obvious that Freddie would not be able to raise the money it needed. This was just one of many indications that these two GSEs were not going to raise any more capital on their own. It kept becoming more and more clear we would have no choice but to intervene.

**YPFS: If you were able to rehash the deals with Fannie and Freddie, would you have chosen not to loosen their portfolio caps until they raised new capital? Or was this not even an option given market constraints at the time?**

Lockhart: We went back and forth with Treasury on this issue, but as I said earlier, their consent agreements stated that the caps would be removed when they met the requisite requirements. The deal probably cost Fannie and Freddie – in the long-term – a few billion in additional losses, but it did at least calm the markets for a while. Again, without Hank's bazooka – which we did not then have – we certainly didn't want to cause a "run on the bank" – the FDIC would not have been able to step in to support the GSEs. Bear Stearns obviously scared the markets. As a result, we wanted to send a positive signal to the markets – in other words, to remind them that at least Fannie and Freddie were still around. And they ultimately were for another six months. Actually, despite the "loosening," both Fannie and Freddie were above the original 30% excess capital requirement in their June 30<sup>th</sup> accounts.

**YPFS: Do you think that Fannie and Freddie primarily ran into trouble because of their portfolios?**

Lockhart: This was an initial understanding and one of the reasons we sought to cap their portfolios. As it turned out, the MBS they issued with the underlying mortgages they guaranteed were just as responsible, since many subprime and Alt-A mortgages were packaged into

MBS and sold to the public with an implicit guarantee. Freddie had a bigger private label MBS portfolio than did Fannie, which helps to explain why Fannie often suggested Freddie was the real problem of the two. All mortgages, however, ended up being hit once the housing market really went south, with prices dropping 30%. Obviously, subprime mortgages – and those which were more leveraged – were hit hardest, but all mortgages were hit nonetheless.

**YPFS:** **Some people have mentioned that underwriting standards were lowered before this crisis, roughly during 2006 and 2007. Was this on the portfolio side? Did that ever apply to the amount that Fannie and Freddie could guarantee?**

**Lockhart:** Fannie and Freddie grew more creative at building programs for low-income individuals. This was especially true in 2007, when affordable housing goals were ramped up just as the housing market was starting to dry up. More broadly, part of Fannie and Freddie's mission was to support the mortgage market.

**YPFS:** **And this mission was best achieved with their portfolios?**

**Lockhart:** It often involved the mortgage-backed securities they issued. On the portfolio side, they purchased private label MBS, whole mortgages, their own securities and sometimes even each other's securities.

**YPFS:** **That really compounds the risk.**

**Lockhart:** At the time, Fannie and Freddie would have argued that mortgages were very safe. The bottom line is that they were monoline lenders: they had only one major credit risk – housing – aside from interest rate risk. As it turned out, they also had a big operational risk, mainly with respect to their accounting.

**YPFS:** **In August, after the passage of HERA, did you ever discuss the possibility of issuing a memorandum of understanding and lining up Treasury capital contributions, all without putting the two entities into conservatorship?**

**Lockhart:** Sure. After HERA passed, both CEOs called Hank directly asking for loans – or even preferred stock agreements – now that Treasury wielded the authority to make such investments in them. I think Fannie in particular really pushed hard on this. They were reporting that they could no longer issue long-term debt to support their portfolios.

Hank, however, pushed back. There just weren't enough protections built into this course of action. At the same time, we were interviewing candidates for chairman and CEO of the two institutions. Treasury, obviously, was very helpful throughout this process. We ended up putting new people in place the same day we announced the conservatorship. There were a lot of moving pieces.

**YPFS:** **So, both boards ultimately consented?**

**Lockhart:** Yes. Both boards consented on Saturday, September 6<sup>th</sup>. Both had good advisors who pretty much told them there was no other choice, even though they weren't happy to hear this. Again, I think Freddie was more understanding of the situation. Dick Syron appeared to be a bit overwhelmed by his current position. He had already lost his chief

operating officer (COO), and the board never ended up appointing an independent chairman. So, in effect, by the end, he was chairman, CEO, and COO.

The arrogance of Fannie and Freddie had been on display before the crisis, when it was evident that a lot of mortgages – especially Countrywide ones – were beginning to go bad. We kept telling Fannie to push these mortgages back onto Countrywide, but it said it couldn't do this out of fear of aggravating Countrywide, its biggest mortgage originator. By the time we got them to do this, it was too late to make much of a difference. We also spent some time with the Office of Thrift Supervision (OTS) – then the regulator of Countrywide and Washington Mutual (WaMu) – which helped arrange calls for us with the CEOs of those two institutions.

**YPFS: Was this before the announcement of the conservatorship?**

Lockhart: Yes – well before, perhaps six months before. Both CEOs told us there were no major problems, needless to say. The OTS also said it saw no major issues, which is one of the reasons it didn't ultimately survive.

### **THE CONSERVATORSHIPS OF FANNIE MAE AND FREDDIE MAC**

**YPFS: So, you put Fannie and Freddie into conservatorship during the first week of September 2008.**

Lockhart: Yes, and we immediately named new CEOs. At the FHFA, we put someone in charge of the conservatorships who reported to me, but we kept separate the teams regulating Fannie and Freddie. So, the structure was such that we had regulators looking into Fannie and Freddie but also conservators sitting atop the two entities.

Under conservatorship, we effectively were the CEOs of the two firms. We kept the two boards in place – although we replaced most of their members – thinking that this would be good for governance. Frankly, as Hank has said, we thought the conservatorships were going to serve as a “time out” for Fannie and Freddie. Perhaps they would last a couple of years in order to build a culture of good governance. The boards have been helpful in this respect.

We started to make changes right away. We put in place a Streamlined Loan Modification Program in order to help people quickly receive modifications on their mortgages without running into the bureaucratic hold-ups that sometimes plague this process.

It's important to note that Fannie and Freddie were not in the business of originating mortgages, and they didn't service them either. Independent servicers in general were not capable of handling the volume of mortgage modifications that needed to be made. This challenge became clear early on. That's why we put the streamlined process in place. I think it ended up helping. That program was put in place during the Bush Administration – probably sometime in October or November. The Home Affordable Modification Program (HAMP) and Home Affordable Refinance Program (HARP) were both introduced later on by the Obama Administration. Both programs were successful at

reducing foreclosures. HARP was purely for Fannie and Freddie, but in a role reversal they provided “government” oversight of HAMP.

I was at the FHFA until August of 2009, although I could have stayed on longer because of how the legislation was written. I was slated to head the agency until I was outright replaced, and there had been no nomination of a replacement for me when I ultimately stepped down. By August 2009, there was a glimmer of light at the end of the tunnel. I felt it was the right time for me to leave – it had been almost a year since we had implemented the conservatorships – and I had a very capable deputy, Ed DeMarco, who would become the acting director.

**YPFS: Aside from legal requirements, what were your guiding principles as you took on the responsibility of actually running these organizations, not just regulating them? Was there a lot of pressure given that Fannie and Freddie were still pretty much propping up the mortgage market?**

Lockhart: I think the key thing was to keep the mortgage market going. When I arrived at OFHEO in 2006, Fannie and Freddie’s market share probably was in the range of 30%. It shot up to 70% very quickly during the conservatorships. The FHA and VA [Department of Veterans Affairs] also started to build market share; they started with about 3% but then came to encompass roughly 30% of the market. The primary goal was to keep the mortgage market up-and-running. It was a \$10 trillion market.

We did some other things which sometimes were overlooked, such as the multi-family program, which worked relatively well despite some of the issues it encountered. The LIHTC, the low-income housing tax credits, also supported the market. And we worked with various state housing agencies, since a lot of them relied on Fannie and Freddie. There were a lot of moving pieces, as always.

**YPFS: How did you go about setting priorities? Did they come directly from Fannie and Freddie?**

Lockhart: Some came from Fannie and Freddie and Treasury, others came from the media, and still others came from people with a wide range of interests, not to mention Congress. It’s important to remember that Lehman filed for bankruptcy the next weekend. By taking Fannie and Freddie into conservatorship, we thought we had stabilized the financial system for the time-being. Unfortunately, that turned out not to be the case. Freddie actually had a lot of Lehman paper on its books, but that story is for another time.

**YPFS: This was a massive intervention. I’ve seen comments from others suggesting that it was supposed to buy the government some time. I assume you didn’t think conservatorship would solve all problems in the financial system, but did you think it would reassure the markets in a big way?**

Lockhart: Yes. We thought it would stabilize the markets – and I think it probably would have if not for Lehman. People understood the implicit guarantee was real and started to buy Fannie and Freddie paper again. I took a trip to Europe to help reassure investors over there. Fannie and Freddie were all over international markets selling the “new effective guarantee,” as I think I called it.

If we hadn't propped up Fannie and Freddie and protected the mortgage-backed securities they were issuing, the banking crisis would have escalated much more quickly. Fannie and Freddie were very intertwined with the financial markets. Throughout all of August, we all worked tirelessly on their issue. The administration received a lot of criticism for bailing them out, especially from Republicans who pointed to Paulson's suggestion that simply having the bazooka would significantly decrease the likelihood of having to use it. But he ultimately had to use it right away.

**YPFS:** **There's a theory suggesting that despite securing the future of Fannie and Freddie – as well as the mortgage market – perhaps the rescue actually had the reverse effect on some parts of market, causing them to begin to bleed, and potentially applying more pressure on Lehman and AIG. What are your thoughts on this?**

**Lockhart:** I think some of this was already happening. There was too much leverage in the system, not enough liquidity, and assets were mispriced. A general worry could have been: "Well, Fannie and Freddie were able to get help, but will other troubled institutions be able to?" Bear Stearns was one example being considered, although support for Bear was in the form of helping to find a buyer.

**YPFS:** **What's your overall takeaway on the implementation of the conservatorships?**

**Lockhart:** In my view, the conservatorships worked. They were very messy but ultimately did work. The problem, though, is that it's still working 10 years later.

#### **THE SENIOR PREFERRED STOCK PURCHASE AGREEMENTS (SPSPAs)**

**YPFS:** **At the same time that it announced the conservatorships, Treasury also announced that it had entered into senior preferred stock purchase agreements (SPSPAs) with Fannie and Freddie. Were you involved in structuring and negotiating these agreements?**

**Lockhart:** Yes – I ended up signing the deal as the conservator. Hank volunteered a few of his really talented people as counselors, including Dan Jester. Treasury also had Morgan Stanley as an advisor.

**YPFS:** **Could you speak a bit as to the structure of the deal?**

**Lockhart:** Sure. The preferred stock agreements were structured such that government preferred would be senior to all other paper, giving us maximum flexibility since we were unsure about the exact size of Fannie and Freddie's capital holes. We initially thought \$100 billion in funding per GSE would be sufficient, but that turned out not to be the case. The main goal was to give ourselves the flexibility to fund Fannie and Freddie as needed on an ongoing basis.

We also asked for warrants for 79.9% of common shares in order to effectively wipe out common shareholders. It was important for this amount to be less than 80% of all shares. If we were to acquire 80% or more, Fannie and Freddie's assets and liabilities would



have been consolidated onto the balance sheet of the U.S. government. We didn't want that to happen.

I'm sometimes asked why we didn't go after Fannie and Freddie's subordinated debtholders. A lot of critics pointed out that subordinated debt existed to be wiped out under these circumstances – and that we had occasionally made Fannie and Freddie raise subordinated debt with this express purpose in mind. The lawyers looked into the possibility of this, but it appeared that by wiping out subordinated debt, we would risk triggering a cross-default on senior debt and mortgage-backed securities. Treasury also spent a lot of time looking into this issue, but we ultimately could not come to a compromise. Even though we had always emphasized that subordinated debt existed to provide protection to senior debt, wiping it out almost certainly would have cross-defaulted the senior debt and had the potential to affect mortgage-backed securities as well. This was a major concern to us.

Morgan Stanley expected Fannie and Freddie's preferred shares to sell off but thought they would retain some value. Preferred shares, however, came pretty close to trading at zero. We were concerned that a lot of banks and insurance companies might be holding these shares, so we asked regulators to look into this risk and were told that no more than ten or so banks would be seriously affected. But many more banks than regulators had anticipated ended up being hit hard. Banks had been subject to virtually no capital requirements on Fannie and Freddie paper and held a lot of these securities.

**YPFS:** **At a later point, Fannie and Freddie were allowed to keep a little bit of capital, correct?**

Lockhart: Originally, preferred stock was issued quarterly to fund their losses, and the 10% dividend was intended to keep their capital at zero. A third amendment after I left did away with the fixed dividend, imposing what amounted to a sweep of all profits minus a small retained capital level. As of date, Fannie and Freddie have collectively drawn more than \$190 billion in capital from Treasury.

**YPFS:** **Can we return to HERA and the powers it granted the FHFA as a new regulator? Did you find these to be on par with what you were looking for?**

Lockhart: I thought it was a pretty complete package. The only problem was that rule-making – creating regulations to implement all of the new standards – would have taken a year or two. I don't think HERA was too little, but it was definitely too late. It's interesting that in all the speeches I gave I never once dared to ask for Hank's bazooka. But, as it turned out, this was the most critical part of HERA.

**YPFS:** **That's the funding?**

Lockhart: Yes. It all started with Hank's famous statement in mid-July 2008: "If you've got a bazooka, and people know you've got it, you may not have to take it out..." But it didn't turn out that way.

**YPFS:** **In July, when Fannie and Freddie were granted access to the discount window, other courses of action were discussed as well. The SEC ended up putting a hold on short-selling of GSE stock and that of other financial institutions. And Secretary**

**Paulson mentioned increasing the GSEs' existing lines of credit with Treasury. Were these the standing lines of credit? And what was the result of these discussions? As far as I can tell, credit lines weren't increased until HERA provided proper funding authority.**

Lockhart: Right – at that time, the lines of credit were tiny. There was a push to do something more but no real desire to do it without legislation.

**YPFS: And HERA stipulated that funding could be of an unlimited amount over a limited timeframe? Was this a compromise – a recognition of the ultimate importance of having unlimited funding, as it wasn't yet clear how much money would be needed?**

Lockhart: It was most important to be able to provide the necessary funding – whatever it ended up being. Could you remind me when the funding authority granted by HERA was set to expire?

**YPFS: Funding could extend through December 31, 2009.**

Lockhart: Yes. But it ultimately extended beyond that.

**YPFS: Right – that's because the SPSPAs allowed for additional draws as time went on.**

Lockhart: Right – the SPSPAs were really good agreements. But again, we didn't anticipate them to last forever. The original SPSPAs allowed for draws of up to \$100 billion, though we had to increase the limit with a first amendment during the spring of 2009 because, in particular, Freddie's CEO was getting worried.

**YPFS: Several months later, a second amendment would allow for unspecified draws for a limited time, after which time draws would be limited to a fixed amount. In your opinion, how important was the availability of Treasury funding during this process?**

Lockhart: From the viewpoint of crisis prevention, I think having the ability to backstop the GSEs is important. Unfortunately, there's also a moral hazard to creating this kind of backstop, which is why a lot of Republicans didn't want one – because once it's there, people will use it. There's an entire philosophical debate surrounding it, but having a backstop was critical.

**YPFS: There's an academic paper which posits that although Fannie and Freddie first were put into conservatorship, without government funding they essentially were insolvent – meaning receivership would have been a viable option as well. Was the possibility of converting the conservatorships into receiverships ever discussed?**

Lockhart: Sure – it was discussed, as I said earlier. Later on, this point was raised from time to time as a way to wipe out preferred and common shares on which hedge funds were later speculating. I actually met with the New York Stock Exchange when Fannie and Freddie's shares fell below \$1 and asked for them to be de-listed. I didn't want people buying these shares. Receivership is even discussed today as a way to wipe out their congressional charters.

**YPFS:** **Were these shares bought up pretty quickly?**

Lockhart: Well, some people thought that troubled or bankrupt companies might recover and generate huge gains for shareholders. So, yes, there were even “mom-and-pop” investors doing this. It didn't make much sense to me, but apparently it didn't have much of an impact once hedge funds swooped in to buy the shares. The New York Stock Exchange eventually did de-list the shares.

**YPFS:** **Ultimately, though, it was hedge fund shareholders who sued because of the third amendment to the SPSPA, which established that all profits netted by the GSEs would be swept up by Treasury? Were you there when this amendment was adopted?**

Lockhart: Ed DeMarco was acting director when that happened. I was director for the first amendment, but Ed was there for this one.

**YPFS:** **Do you wish to comment on the profits sweep? It was a major change.**

Lockhart: It was a major change. I think it had its pros and cons. Above all else, Fannie and Freddie would not be around today if not for Treasury's intervention. So, in my mind, any price tag can be attached to that kind of support. I thought the 10% dividend on the preferred shares was adequate. But Fannie and Freddie are still benefiting from the Treasury guarantee, which is worth a lot.

On a related note, Fannie and Freddie not only had very thin pre-crisis capital cushions, but roughly half of their capital was in the form of deferred tax assets. Existing law permitted the GSEs to count deferred tax assets as capital, even though bank regulators typically didn't do this. When Fannie and Freddie started to lose money, they also lost their deferred tax assets. These would be returned however, whenever they restored profitability, and ended up as part of the profits sweep.

### **INTERAGENCY COOPERATION**

**YPFS:** ***Were there ongoing meetings with Treasury during the conservatorships? Treasury obviously had a lot at stake as the funder of Fannie and Freddie. How were these meetings conducted?***

Lockhart: We had meetings with Treasury, oftentimes the Fed, and sometimes other bank regulators, too. It obviously was a very tense time. There was a lot of discussion on the various courses of action available to us to stabilize the markets. As it turned out, the mortgage market probably was more stabilized than some of the other markets at this point, because of what we did with Fannie and Freddie and also because of the efforts of the FHA. Back to the point – we had regular meetings, either at Treasury or at the White House, several of which involved the President. HERA established an Advisory Board for the FHFA that included the Secretaries of Treasury and HUD, the SEC Chair, and the FHFA Director as chair.

**YPFS: Were there times when Treasury pushed Fannie and Freddie to do something, which, in your view, didn't fall explicitly under the purview of the conservatorship?**

Lockhart: No – I don't think so. My main concern was stabilizing the mortgage market and, by connection, the capital markets. We did some pretty creative things – and perhaps we could have stretched some boundaries a little further. But, in general, I think we did things that hadn't been done before. Treasury, for example, began to purchase mortgage-backed securities. The Fed also ended up buying securities issued by Fannie and Freddie.

**YPFS: How did those programs come to be? The Treasury's MBS purchase program was part of the original announcement in September 2008. And it ended in December of 2009?**

Lockhart: Yes. Treasury decided it no longer had the firepower – they were doing a lot by that point. After Lehman went down, the Fed was very creative, too. At one point, I think it even held about one-third of all Fannie and Freddie paper. The full slate of TARP programs obviously helped these markets as well.

Other creative measures were put in place, too. GMAC (General Motors Acceptance Corporation), for example, a car lender which also was one of the big mortgage originators and servicers, ended up receiving TARP funds just as it was about to go under. The Fed and Treasury also created the TALF program to support the asset-backed securitization markets.

Additionally, Fannie and Freddie had the right to withdraw from servicers whom they believed were not doing a good job. Servicing rights for Fannie and Freddie often were some of the biggest assets these servicers had, and without Fannie and Freddie's business, these servicers were at risk of going under. Many servicers were really stretched financially – especially those that were nonbanks and didn't hold much capital – because of their duty to make advances for missed payments on mortgages they were servicing. So, we worked with Fannie and Freddie a bit on this issue.

Mortgage insurers suffered many of the same problems. They were essentially creatures of Fannie and Freddie – their books were mostly comprised of GSE mortgages. When they started running into trouble, mortgage insurers actually inquired about receiving TARP funds. Although I spoke with both Treasury secretaries about this, they ultimately said no. As a result, Fannie and Freddie were required to do some forbearance – as they didn't want to cause any more mortgage insurers to go under.

### **ASSISTANCE FOR STRUGGLING HOMEOWNERS**

**YPFS: The FHFA was also involved – either directly or indirectly – in a number of efforts to assist struggling homeowners.**

Lockhart: That's correct. Of all the things we did, I think HAMP and HARP were two of the most important. HAMP applied not only to Fannie and Freddie but to all institutions. Since Fannie and Freddie had the relevant expertise, they helped to implement it. I think they did a good job there.

Another concern was the growing number of underwater mortgages, which I think peaked at around 25% of all mortgages. Many of these mortgages had much higher interest rates than were prevailing post-conservatorships.

It wasn't easy to come up with a way to effectively address this issue. First of all, Fannie and Freddie could only buy or guarantee mortgages that were up to 80% loan-to-value, unless there was mortgage insurance. As a solution, we suggested the creation of HARP, which would allow them to refinance mortgages even if they were underwater or exceeded 80% loan-to-value. We had to be creative legally but ultimately it worked out, and I think the program was helpful. We initially set the expectation of completing three to four million refinances. HARP ended up facilitating well over three million. HAMP might have done a little less. However, there were also several other successful mortgage modification programs. And, for the most part, HAMP and HARP were actually pretty lucrative for mortgage servicers and originators.

**YPFS:** **There's been some criticism, however, suggesting these programs didn't do enough for homeowners who, as taxpayers, effectively were funding the cost of the government rescue effort. Do you think the government's housing programs could have been more effective?**

Lockhart: Ed Demarco – my successor, who actually worked for me at Social Security – was great. He adamantly opposed the idea of principal forgiveness, which was one of the issues up for debate as it related to further relief for homeowners. Secretary Geithner wanted principal forgiveness, but Ed pretty much refused, leading to a stalemate of sorts.

Some banks were forgiving loan principal, but Fannie and Freddie did very little of this. This was probably one of the key issues on which Fannie and Freddie fought back. Again, the issue is moral hazard. Would forgiving loan principal open Pandora's Box, causing people who otherwise were able to pay to stop making mortgage payments in order to get their principal reduced?

Alternatively, as Fannie and Freddie were two of the biggest LITHC (Low Income Housing Tax Credit) buyers, but no longer taxpayers, we tried to get Treasury to provide an alternative, although our attempt was unsuccessful.

**YPFS:** **Would it have been possible to forgive loan principal under the constraints of the conservatorship?**

Lockhart: Sure, it could have been done. The conservatorships gave us very broad powers. So, yes, it could have been done.

### **THE FUTURE OF FANNIE AND FREDDIE**

**YPFS:** **The so-called "time-out" has now been ten years. Of course, the FHFA cannot decide what to do with the GSEs without the approval of Congress. But a number of proposals have been floated, including ones suggesting that the GSEs should be completely privatized or that the affordable housing mission should be separated. Do you have a preferred solution?**

Lockhart: I think it's necessary to have some form of government support for the housing market in this country, although it should be much less than the extent we see today. In my career outside of government, I've directed investments in banks all over the world – so I've seen how housing markets work in different countries.

Other countries don't have entities like Fannie and Freddie. A major reason for this is that their housing markets don't offer a 30-year, fixed-rate, fully pre-payable mortgage. The biggest banks notwithstanding, this instrument is difficult to put on balance sheets.

**YPFS: Because it's so long?**

Lockhart: Yes. When interest rates rise, it becomes a long-term asset at a low rate. And when interest rates fall, it's often fully pre-paid, making it impossible to know the expected maturity, especially because there's no penalty for prepayment. This is one reason why Fannie and Freddie hedged so much.

In the U.S., we have this instrument – and it is seen as sacrosanct. As a result, there's a need for some kind of government support in the housing market. Government support is likely also needed to fulfill affordable housing missions, although we already have the FHA and VA. My solution would be for there to exist something like Fannie and Freddie, albeit much smaller, and whose mortgages would have a guarantee – perhaps a Ginnie Mae guarantee, or one that's separate. Whichever entity succeeds Fannie and Freddie, however, would have to pay for this guarantee and – equally important – would have to be more than adequately capitalized.

I'm not sure if you saw it, but the FHFA recently released new capital rules for Fannie and Freddie. I think they're very low – and they're suspended because Fannie and Freddie currently don't have much capital. However, I think it was right to put some numbers out there. At least it acknowledges that a lot of capital would have to be raised if they were actually released, as the hedge funds want them to be.

**YPFS: Should Fannie and Freddie be private entities?**

Lockhart: They could be made private, or they could even be newly created private entities. I think there's a case to be made for privatizing them because they have so much infrastructure.

It would be important to guarantee only their mortgage-backed securities – not the entities, themselves. And they'd pay a fee for this guarantee. It could even be structured as a backstop during a crisis instead of a full guarantee – there are various ways to do it.

Another thing I've pushed for – which doesn't seem to find its way into many discussions on potential legislation – is finding a way to make the mortgage market more countercyclical. As it is, we have pretty large peaks and valleys in housing prices. The government guarantee I mentioned could be used as a mechanism for this. You could pull back the guarantee – or raise the cost of it – if housing prices were to get out of line. But if problems arise, you could then expand the guarantee a bit, as we did with Fannie and Freddie. Either way, I think the presence of some sort of countercyclical mechanism is really important.

In general, there are a variety of proposals on what to do with Fannie and Freddie. Some members of the House of Representatives simply want to eliminate them. In the end, I think there will be some government involvement in the housing market, but it should be less than what we've seen and mostly in relation to affordable housing.

Additionally, Fannie and Freddie's lending limits – which were raised during the crisis – should be pulled back. They're starting to rise again, but I think they should be frozen.

YPFS: When you say “lending limits,” do you mean the loan amounts they could **guarantee**?

Lockhart: Right – the conforming loan limits. At the start of the crisis, the limit was around \$410,000. Then, as part of new legislation, Congress authorized higher lending limits around the country depending on the level of house prices in respective regions. The same thing was done for the FHA. The bottom line is that if you're going to have government involvement, make it for those who need it – the lower income individuals – but not for the wealthy. Although the higher limits have been lowered, the conforming loan limit has been raised twice recently.

YPFS: **One final question on this subject: In some of your testimonies, you discussed the difficulty of the GSEs balancing safety and soundness considerations with affordable housing missions. Should we continue to have GSEs, or is it an inherently flawed structure?**

Lockhart: Well, the GSEs are not only limited to Fannie and Freddie. The Federal Home Loan Banks (FHLBs), for example, also are GSEs, and I think they do a reasonable job of supporting their local banks. They make loans and have never suffered large losses on these advances. One of the FHLBs was merged out of existence after running into some issues with private label MBS – with which it should never have been involved. Aside from this, the FHLBs are a structure that seems to work.

Government programs seem to work, too, such as the FHA and VA.

But I think Fannie and Freddie's model is inherently flawed. Entities like these must either be in the public or private sector. Fannie and Freddie were somewhere in between. Under such a model, it's imperative to draw a very sharp line between public and private responsibilities, which we did not have.

In short, the hybrid model didn't work. I think a replacement for Fannie and Freddie could be entirely private firms with access to a guarantee in the event of catastrophe – one that is properly priced and whose characteristics are understood by the market. We should also focus on figuring out a way to draw more private capital into the mortgage market, so that the government doesn't have to back as many mortgages as it currently does.

In order to truly get something done on this issue, I thought both chambers of Congress and the presidency need to be controlled by the same party. This has been the case for the past eighteen months now. With respect to the GSEs, however, nothing has been accomplished. This is disappointing to me.

The Corker-Warner bill on housing finance reform was okay in m, and certainly a step in the right direction. I don't know when we'll ever have a solution, though. Peter Wallison of the American Enterprise Institute and others have expounded upon the need for a new FHFA director who is committed to reining in Fannie and Freddie – for example, by lowering conforming loan limits and refusing to finance purchases of second homes – until the two entities are a fraction of the size that they once were. In their opinion, this is a good solution if Congress never acts.

As the present director's term is up in early January [2019], that may be the first step. Today, the U.S. has one of the most – if not the most – socialized housing markets in the world, especially compared to Europe. Again, this boils down to the fact that housing markets in other countries offer 30-year mortgages for which only two or three years are at a fixed rate, while remaining interest payments are at a floating rate. It's much easier to put this kind of instrument on a bank balance sheet. The biggest banks in the U.S. are actually starting to invest again in 30-year fixed rate mortgages. This isn't feasible, however, for the smaller banks, who as a result go to Fannie, Freddie, or the FHA.

### **THE TROUBLED ASSET RELIEF PROGRAM AND OTHER RELATED MEASURES**

**YPFS:** I'd like to shift gears a bit to your time on the Financial Stability Oversight Board, where you oversaw implementation of the Troubled Asset Relief Program (TARP), and more generally, to your thoughts on the evolution of the financial system after the financial crisis. Would you care to discuss?

**Lockhart:** Sure. I'll begin with the Senate Banking Committee hearing at which TARP was introduced. The original purpose of the hearing was to discuss Fannie and Freddie, which is why I was present for it. As it turned out, I wasn't asked any questions until the very end – as the hearing mostly focused on the TARP proposal.

It was a difficult hearing for Hank and Ben. They were grilled by committee members for perhaps six hours with no breaks in between. Their suggestion, as you know, was to create a program to purchase troubled assets – notably the private label MBS we discussed earlier – which were eroding the capital of U.S. financial institutions. Their proposal was voted down on its first try through Congress, causing the stock market to crash.

Not long after, though, Hank and Ben were able to get the proposal passed by Congress. A few advisory boards subsequently were established to oversee the program: one [the Congressional Oversight Panel] responsible for advising Congress, which was led by Elizabeth Warren, and another [the Financial Stability Oversight Board], which was led by the Fed chairman. Aside from the chairman, the board consisted of the Treasury Secretary, HUD [Dept. of Housing and Urban Development] Secretary, SEC (U.S. Securities and Exchange Commission) Chairman, and FHFA director. A special inspector general was also appointed to oversee TARP. The overall idea was to have significant oversight of the disbursement of TARP funds.

Once TARP passed, Treasury officials scrambled to figure out how to build an asset purchase program while the banking system – not only in the U.S. but in Europe, too –



was in a freefall. After the UK announced it would inject a substantial amount of capital into its banking system, I think Hank decided to undertake a similar strategy, and so he announced what amounted to a 180-degree shift from buying troubled assets to putting preferred stock into banks.

**YPFS: Was this shift in strategy contested by the advisory boards?**

Lockhart: No. Troubled assets were so prevalent throughout the financial system that \$700 billion – the funding amount made available by TARP – likely wouldn't have been enough to fully root out the problem. It was thought that injecting TARP funds as capital would give us much more bang for our buck. Troubled assets were a concern all along. However, if banks had the requisite capital, they could afford to hold troubled assets on their books, preventing fire sales, with the hope that they eventually would recover – which some did.

TARP funds were available thereafter and were stretched in a number of ways – some of them very useful. An obvious example is the rescue of the auto companies. Another is HAMP. TARP funding also was used to establish public-private investment partnerships (through the Public-Private Investment Program, or PPIP) with private equity firms. Under this structure, a combination of Treasury and private funding was deployed to purchase troubled formerly AAA private label MBS from the financial system, principally those that were the subject of the original TARP proposal.

A program like the PPIP had been discussed while I was still on the oversight board, even though it ultimately was implemented after I left. Such a program was thought to be a good way to leverage the funding made available by TARP. I thought it ended up working really well. Nine private equity firms raised a lot of money and ultimately earned roughly a 20% return on investment, a lot of which was enjoyed by Treasury.

**YPFS: Was the Financial Stability Oversight Board engaged in decision-making with respect to TARP programs?**

Lockhart: We engaged in some decision-making, but most of our involvement lay in overseeing decisions made by those who directly administered TARP. As you remember, Paulson told the big nine banks on Columbus Day Weekend that they needed to take the money. I think Hank informed the Oversight Board of the decision to use TARP funding to purchase bank capital only the night before. (We approved the decision.) Bank regulators then decided which other banks would be eligible to receive TARP preferred. So, we weren't really involved.

I was, however, often in communication with GMAC because of their mortgage origination and servicing arms. I think their issues with mortgages may have even outweighed their problems with auto loans at that point.

**YPFS: Did you support the decision to use TARP funding to support the auto companies, even though this fell outside of the original purview of TARP?**

Lockhart: Yes. A “whatever it takes” mentality had taken hold by this point. For example, funds were being used to purchase bank preferred stock, not troubled assets, as was originally planned; AIG, an insurance company, received funding from both TARP and the Fed;

and Morgan Stanley and Goldman Sachs had become bank holding companies in order to have access to Fed liquidity and other funding.

By this point, a lot of creativity was on display, and I think it was incredibly necessary. We were not as prepared as we should have been for the financial crisis. A lot of people predicted a market downturn in some form, but I don't think anyone knew quite how big it was going to be. We experienced a global financial crisis extending far beyond the initial collapse of the subprime mortgage market. A lot of other countries actually experienced much bigger housing bubbles but didn't have entities such as Fannie and Freddie, and they ended up facing much larger problems. The U.S. actually faced up to its problems rather quickly compared to much of continental Europe.

### **AFTER THE FINANCIAL CRISIS**

**YPFS: In your opinion, what additional preparation could the financial regulatory system have taken before the financial crisis?**

Lockhart: A few things would have been particularly helpful. First, we should have had the ability to impose much higher capital requirements for Fannie and Freddie. (Since the crisis, bank capital requirements have risen pretty dramatically.) I also think that liquidity requirements should have been higher. In addition, it would have been very helpful if HERA had been passed two years earlier and affordable housing goals had not been pushed so hard right as the crisis was escalating.

In addition, I don't know what more we could've done about it, but it would have been helpful to once and for all demonstrate the government's liability for Fannie and Freddie. Prior to the crisis, the GSEs kept on selling their guarantee as an explicit government guarantee, while we in the Bush administration kept pushing back and saying it was not. It all leads back to the fact that they should have held more capital. About a year before the conservatorships, I even asked one of the rating agencies why Fannie and Freddie were still receiving AAA ratings with such low capital buffers. The answer was that they were just so big, implying they were seen to be too big to be allowed to fail.

Other tools would have been helpful, too, such as a credit line enabling policymakers to bail out some of the most important institutions, only after wiping out shareholders and some bondholders. Fannie and Freddie, as well as a handful of other banks and financial institutions, really were too big to fail.

**YPFS: What else do you think is important for future regulators and financial crisis firefighters to know whenever the next crisis strikes?**

Lockhart: Again, I think there's a need for much more rigorous capital standards, both risk-based and leverage. I also think our regulators should have been more embedded in the two institutions. None of us had seen something like this before. People simply were not modeling what ended up happening. Fannie and Freddie, for example, were modeling the California housing market or Texas oil market as their two "worst-case scenarios." In the future, I think we need to be more imaginative about the kinds of downside scenarios that are within the realm of possibility.

As I said earlier, we need to incorporate counter-cyclical tools into the markets. European banks are now issuing contingent capital notes. Peaks and valleys in housing and other markets could be dampened with fluctuating capital requirements, insurance availability and insurance cost.

Obviously, we now have a pretty good idea of what can happen. It's important we don't forget this – and it appears some already have. However, I also think it's important to make sure regulation doesn't swing in the opposite direction too much.

**YPFS: With respect to Dodd-Frank?**

Lockhart: Yes – but mostly with respect to regulators in general. Regulators have been all over banks, and in some cases it's been a good thing. Regulators now want to be more careful.

But for some of these banks, the cost of compliance has been pretty devastating. Since the crisis, roughly 3,000 banks – or 30% of all banks in the U.S. – have disappeared. Of this 3,000, over 500 were closed by the FDIC, while the rest were the result of mergers, the need for which has largely been precipitated by greater regulatory burdens for banks. I think we went too far in implementing new safeguards but are beginning to ease up a bit – although I hope not by too much. I would be very worried if regulations were to become too loose again.

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