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Lockhart became the Director (CEO) and Chairman of the Oversight Board of the Federal Housing Finance Agency (FHFA) upon the agency’s creation on July 30, 2008. The FHFA became the sole regulator of Fannie Mae, Freddie Mac and the 12 Federal Home Loan Banks; it also became the conservator of Fannie Mae and Freddie Mac. Prior to his position at the FHFA, Lockhart was, from June 2006, the Director of the Office of Federal Housing Enterprise Oversight (OFHEO), also a regulator of Fannie and Freddie, which was subsumed into the FHFA. This “Lessons Learned” is based on an interview with Mr. Lockhart.

Focus on first things first. The government’s hands were tied until Treasury could provide a financial backstop for the companies, which the newly-passed Housing and Economic Recovery Act (HERA) allowed.

“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 [for my position at OFHEO]. 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.”

“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.”

“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.”

“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.”
A crisis is always a Catch-22 situation. Do or say too little or too much, and you run the risk of spooking, rather than calming, the markets. However, in a crisis, it is important to prepare for a worst-case scenario without giving markets a reason to believe that such a scenario is inevitable.

“As I said in my FCIC testimony: ‘From the fall of 2007 to the conservatorships, it was a tightrope without a safety net.’”

“At this point [summer 2008], 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 [Treasury’s funding authority] – which didn’t arrive until the July 30th legislation – we had no way to bail them out. There just was no way to do it.”

“The August letter you mentioned [to the GSEs indicating that they were in compliance with statutory capital levels] was based on their financials as of June 30th. 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 30th, 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.”

**Although sometimes overlooked in the heat of battle, human capital concerns are critical. Nothing gets done without people.**

“[W]e were setting up a brand-new agency; 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.”

“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.”

“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...’

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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.”

**Several solutions were considered but conservatorship was the best solution given the fragility of the markets and the level of control needed by the federal government.**

“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.”

“I think [Paulson] 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.”

**While it may be tempting to address long-term policy issues, in a crisis, a narrow focus is most efficient.**

“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.”

“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 Fannie. 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.”

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