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FCIC memo of staff interview with James Lockhart, Federal Housing Finance Agency

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MEMORANDUM FOR THE RECORD

Event: Telephonic Interview with James B. Lockhart, III former Director of OFHEO

Type of Event: Telephonic Interview

Date of Event: March 19, 2010, 10:30-12:30 p.m.

Team Leader: Chris Seefer

Location: FCIC, large conference room

Participants - Non-Commission: James Lockhart

Participants - Commission: Chris Seefer, Tom Stanton, Al Crego, Mike Easterly, Clara Morain

Date of MFR: March 24, 2010

Note: This is a summary of the interview, not a complete transcript. Direct quotations appear inside quote marks.

Summary of the Interview or Submission:

Chris Seefer opened the meeting by summarizing the mandate of the Financial Crisis Inquiry Commission, noting specifically its statutory requirement to look into the role of GSEs and regulators in the financial crisis. He then asked Mr. Lockhart to give his narrative of the concerns he had over Fannie Mae and Freddie Mac from the time he joined OFHEO through the conservatorship. He also asked Mr. Lockhart to comment on mistakes or errors on the part of OFHEO.

Mr. Lockhart's Background

Mr. Lockhart said that after working for four years as Deputy Commissioner of the Social Security Administration, Mr. Lockhart was looking to leave government after Social Security reform failed. The Bush Administration approached him about leading OFHEO, and he was nominated to be Director and named Acting Director of OFHEO on the same day in May of 2006. He said his critical key goals were (1) to fix the GSEs' problems in accounting, corporate governance and risk management, and (2) to support legislative reform.

May 2006 Consent Agreement

Mr. Lockhart explained that when he was named Acting Director of OFHEO, the agency was about to release its exam report on Fannie Mae's accounting problems, Fannie Mae was about to pay a large fine to the Government, and the consent agreement was about to be signed.

He said that OFHEO froze the size of Fannie Mae's portfolio out of concern and that Fannie Mae had to implement significant changes in Risk Management.

He said that he went to the GSEs' Boards to get agreement about the terms of the consent agreement, and that the boards were then more interested in operational and interest rate risk than with credit risk. Mr. Lockhart said that his main leverage for getting agreement on the terms of the consent order was "moral suasion more than anything else. We didn't have a lot of hooks because the consent agreement was signed, but on other hand, they weren't regular filers, and the Boards just decided after tough conversation that it was not good to upset regulators." He said that, "for the next year or so a lot of what went on was them working through their issues, and hiring people to help them – Fannie Mae at one point had probably thousands of consultants helping them – and all during that period the portfolios were frozen. My predecessor had a 30% surplus for Fannie Mae, and in retrospect 30% was too low. The 30% was for operational risk as it turned out the credit risk was significantly higher than anyone anticipated at that point. And I probably testified about the Fannie Mae agreement and made the point for legislative reform and for a much stronger capital regime. The law that set up OFHEO allowed them to leverage themselves 30 to 1 even with the 30% [surplus] – an incredible amount of leverage on the MBS side. A key issue was that there was not a strong enough capital regime and the regulator couldn't increase capital the way a bank regulator would be able to." He said that when he became Acting Director, OFHEO was basically "locked into the 30% as a result of the consent agreement." He said that Fannie Mae's consent agreement was "much more robust than Freddie's agreement."

Chris asked if there was ever a legal opinion generated by OFHEO saying that it could not raise capital absent a legislative change. Mr. Lockhart said "I'm not sure if there was a legal opinion but that was the thinking – if [Fannie Mae] had fallen into trouble again, we could've required it again. We had prompt corrective action-type authority, but whether or not we could've done it legally, the companies had legal opinions saying we couldn't. And frankly, the other problem is that the Hill would've been all over us. So it was a combination of legal and political [pressure]. And then we also had a risk-based capital regime hard wired by legislation, which was very cumbersome, outmoded and just didn't work. So that also wasn't very helpful. The other piece is that the definition of capital was and is still hard-wired and that isn't very helpful. It's really GAAP capital and it ignored [Accumulated Other Comprehensive Income ("AOCI")] if that was negative and it ignored bank regulations and then there was the DTA. By the end, the capital wasn't very strong. [Fannie Mae] was adequately capitalized the day we put them into conservatorship. Another big issue was the companies and their Boards of Directors felt that their [first, second and third] job was to maximize returns for shareholder. I talked several times about their mission- they're GSEs, they have several privileges - and the discussions always went back and forth often on that."

Mr. Lockhart continued that "we wanted in legislative reform on capital, [we wanted] the ability to get outside the budget process. One reason OFHEO was so weak until really just before I

arrived was because we were part of the appropriations process and Congress kept funding very lean because of the GSEs' pressure on the Hill. Budgets freeze, and it's very hard to run an agency that way. We also wanted to be the mission and the safety and soundness regulator. HUD set goals and let [the GSEs get into new loan] products but the affordable housing goals in the Clinton and Bush administrations were too high."

GSEs' Increased Exposure to Non-Traditional Mortgage Products & Affordable Housing

Noting the increase in GSE holdings of non-traditional loan products, Chris asked (1) if OFHEO had the power to tell the GSEs that they could not guarantee or purchase certain kinds of loans or securities because of safety and soundness issues, and (2) if Mr. Lockhart had an understanding of whether or not the GSEs increased their holdings in non-traditional products in order to meet housing goals. Mr. Lockhart responded that "we had the moral suasion and examination process. We would comment on the risk on credit side. On the margin, we did affect that. On the triple-A MBS that they bought which we had basically frozen in their portfolios, that helped. But they were triple-A and it was difficult to make a case that they were not safe. We made a case that they shouldn't increase [their holdings of PLS], and HUD allowed them to get credit for underlying mortgages in those securities, so they were getting credit." He continued that "yes absolutely, we had the power to curtail activities we thought were unsafe and unsound. And in some places we did that – in construction and development. They wanted to do hedging instruments that we didn't allow them to do. We did have the power if [certain activities were] unsafe and unsound, and we also had moral suasion. On the other hand, both companies were very fearful of not meeting affordable housing goals because HUD had the ability to do consent agreements. And again, they were liked on Capitol Hill because of their work in affordable housing. We were really worried about affordable housing goals; we had a credit group go through their portfolio and let them know when we saw problems." Mr. Lockhart said that one thing OFHEO did to that end in 2007 was applying the Inter-Agency Guidance on Non-Traditional Mortgage Product Risk to the GSEs, and requiring that the underlying mortgages in the GSEs' MBS had to comply as well. He said that the guidance was "somewhat difficult to police, but to get affordable housing credit they had to go into the underlying mortgages and determine the income level and geographic area of the borrower, so there was more information in those PLS than people pretend at this point."

Tom Stanton asked for Mr. Lockhart to explain his reasoning for his earlier statement that the affordable housing goals were too high. Mr. Lockhart said "well, they kept ratcheting them up and by the end, they still couldn't make the goals. They missed them in 08 and certainly in 09. Even with their lowering credit quality. And regarding credit quality, the market lowered, the GSEs were not as low, and they were losing market share."

Chris asked if it was Mr. Lockhart's understanding that lowering credit quality was done before 2006 in response to harder affordable goals. Mr. Lockhart said that "I think if you go back and look at special programs, part of that, yes, was to try to hit affordable housing goals, and the

irony is that where a lot of affordable housing was going to was PLS. The marketplace lowered credit standards and [the GSEs] followed them down.”

Tom Stanton asked if Mr. Lockhart was consulted on the last round of HUD goals about their safety, and Mr. Lockhart said he was not there. “I can tell you they were in the process of doing another round [of housing goals] probably in 2008, and [OFHEO was] not involved at all. It was really HUD and OMB.”

Chris asked if Fannie Mae said that their increased exposure in riskier non-traditional mortgage products was exclusively done to meet affordable housing goals. Mr. Lockhart said “no, not exclusively. They wanted to regain market share. They wanted to make money. Goals were just one reason, certainly not the exclusive reason. But both CEOs were majorly concerned about not meeting their goals. It was a major issue for both companies.”

Tom Stanton asked if any studies were conducted about the extent of goals-product performance versus other products. Mr. Lockhart said “I think there’s been some work done at FHFA. I’m not sure if a formal paper was produced. The two companies actually went at this a little differently. Freddie bought more PLS, and especially subprime PLS, which were goals rich. They were getting goals that way, while Fannie Mae tended to do it on the loan side, not the PLS side. They did more of the expanded authority, stretch types of loans, so you will see now in their books that the Freddie book is better off because Fannie Mae was getting their affordable housing via loans, while Freddie Mac was doing it on average by securities.”

Chris asked Mr. Lockhart to continue describing the chronology of problems at the GSEs.

He continued: “I can’t remember when they started losing money but [they] were starting by 2007 to see the subprime market getting worse and we did a report to Congress every year and we certainly raised a lot of the issues about risk-taking, and not only the ongoing operational risk and interest rate risk but the credit risk as well. By the time we hit early 2007 and things were really starting to crack in subprime market, both GSEs had very little direct investments in subprime – it was more PLS than direct portfolio. It turned out that Fannie Mae had more than they let on. One problem was that there was no precise definition of subprime – some had low-FICO based definitions, some just said anything that was coming from a subprime pipeline was subprime.” Chris asked if OFHEO had a definition of subprime in mind, and Mr. Lockhart said no. He said the “working definition was 650 or whatever the bank regulator guidance was. We certainly looked at [that] when we did our guidance... But there was nothing to stop them from making those loans as long as they were safe and sound,” he said.

Chris asked how the determination was made of the safety and soundness of non-traditional products. Mr. Lockhart said that OFHEO “looked at credit aspects and the pricing of the loan. They’d charge more for low-FICO loan. It was a set of judgments. As we all know, the modeling people did not have the event that occurred. Based on historical modeling, it looked like these loans were ok.”

Chris asked if OFHEO looked at the concentrations of those products as a percentage of capital, and Mr. Lockhart said “yes, we had credit teams for both companies look at that as part of the analysis.”

Tom asked if it would surprise Mr. Lockhart if in mid-2007 Fannie Mae created a strategic planning document that essentially has message that “we’ve avoided credit risk but now is the time to go deeper into the pool of available mortgages.” Mr. Lockhart said “No, that wouldn’t have surprised me. I don’t remember that, surprisingly, but I had monthly meetings with Mudd and Syron and we went through in detail what was going on in the companies. In mid 2007 both GSEs said ‘we were created for a market like this; this is the reason for our existence. In Long Term Capital, we saved the mortgage market. And we want to do it again – we want to buy and securitize more mortgages.’ They wanted us to lower the 30% cap and we had intense discussions in July and August of 07 [about that].”

March 2008 Decision to Provide Liquidity to the Market

Chris asked if the GSEs were telling OFHEO that they wanted the caps removed to provide liquidity to the market because the street had effectively left, or if they were telling OFHEO that they saw it as an opportunity to make money because spreads increased. Mr. Lockhart said “they wanted both – portfolio caps removed and capital surplus, and they had both motivations, really. They really thought they could save the market and I truly believe they thought that. We didn’t think they could do it, and we didn’t think it was safe and sound. Our view of the market was this was just starting and they weren’t big enough to turn the market.”

Noting that by March 2008 the portfolio caps and 30% surplus were lifted, Chris asked how if the activity was unsafe in the fall of 2007 it was ok in 2008. Mr. Lockhart responded that “as they were through 2007, we were putting pressure on them to cut dividends, to raise capital - which they did in December 2007 - and what at that time appeared to be significant amount of capital turned out to be nowhere near enough. Then Bear Stearns happened and the market was freezing up. So we did a deal –for their agreement to raise capital, we agreed to lower the 30%. But we did it in a very controlled fashion. And we had them agree to keep [capital] significantly above the legal requirements so they agreed to raise more and keep [capital] above the legal minimums and to sign on for legislation - finally.”

Chris asked if OFHEO talked about those issues with representatives from the Treasury Department and the Federal Reserve. Mr. Lockhart said that “I would talk to Bernanke occasionally, I’d talk to Kevin Walsh more than occasionally, and some of the other governors. This really happened at the exact same time as Bear and the same weekend that they were working on that, we were trying to finalize [the deal to lift the cap limits and capital surplus]. The idea was to help stabilize the market by saying that the GSEs were out there raising capital.”

Mr. Lockhart said that “there was the theory that both companies had a statement that if you look at subprime, one third shouldn’t have been made, one third shouldn’t have been subprime, and one third were questionable. The [GSEs] said ‘we can help the third that should’ve never been subprime – we can help them refinance into a better loan.’ So [OFHEO] gave them a little leeway to do that.”

Chris asked if someone in Congress introduced a bill to reduce the portfolio caps, and Mr. Lockhart said “yes, plenty of people thought that the GSEs could solve the problem, and obviously we disagreed.”

Chris asked who from the government participated in those fall-2007 discussions, and Mr. Lockhart said that “HUD was not really involved. Nominally, we reported to them, but we really didn’t have much interaction. Our interaction was really with Treasury and the Fed. Everyone felt that there was too much systemic risk in Freddie and Fannie to allow them to increase their book.” He said that Treasury and the Fed shared OFHEO’s perspective.

Tom asked what his opinion was on the GSEs’ operational ability to expand. Mr. Lockhart said that “there was a whole series of concern. Their mortgage platforms were a concern [somewhat]. All of their operational risk was from financial side, not mortgage origination side. And we thought that even though Congress said they had enough capital, we thought capital was really thin and to leverage it more would be imprudent. There’s no doubt that they had lowered their mortgage standards during that period like everyone else. At least from our standpoint, we didn’t say stop, we just said don’t increase.”

Chris asked what the Fed’s and Treasury’s perspectives were on the March 2008 decision to remove the portfolio caps and reduce the capital surplus. Mr. Lockhart said that “by then, no one else making loans or buying loans, and there was no one in the secondary market besides the GSEs and FHA. The entire mortgage market was at risk. The key thing was that we demanded that they raise more capital and by doing that, we allowed them to do more business. The Boards of Directors were really against raising more capital, so there was a real showdown on that.”

Chris asked if there was ever discussion about not reducing the capital surplus until the capital was actually raised, and Mr. Lockhart said “there was, and you know as I remember, it ratcheted down as capital was raised, but at the end of the day Freddie couldn’t raise the capital.”

Recalling an interview in which Richard Syron said in late spring 2008 that he would not raise capital because it was bad for shareholders, Tom asked if Mr. Syron was “putting a good face on Freddie Mac’s inability to raise capital” or if he was reneging on the deal. Mr. Lockhart responded that “he was under a lot of pressure from his board to resist. He was getting advice from his attorneys about the high risk of raising capital before releasing the 10-Q, and [I think he was] putting a good face on their inability [to raise capital].” Mr. Lockhart also said that “our lawyers couldn’t disagree because we knew about their accounting issues. It wasn’t the same with Fannie Mae because Fannie was then an SEC registrant. There was certainly less risk of

committing securities fraud for Fannie than Freddie because they were already a registrant and I can't remember the time, but I think their 10-k for 2007 would've been timely. Freddie [still] had to go through the whole process."

Tom asked why given that legal argument Freddie Mac raised capital in 2007 but not 2008. Mr. Lockhart said that "some accounting issues have arisen since then. And at that point there could've been a need to restate previous financials, if they sold stock in May 2008 and put out financials in August – doing that so close together would've been more of a problem."

Chris asked if the plan to lower the surplus and then raise capital worked, and Mr. Lockhart said that Fannie Mae got theirs lowered and as of end of the second quarter of 2008 Fannie Mae was still near the 30% level.

Chris asked who Mr. Lockhart talked to about Freddie Mac's attorneys' concern about the advisability of raising capital. Mr. Lockhart responded that "certainly we were keeping the Fed and Treasury informed and I'm sure the Treasury was keeping NEC informed and occasionally I'd have conversations with Keith Hennessey about that. So we were keeping people informed of what was going on. There was a growing concern over the summer, and we were certainly starting to hear from investors concern over what was going on." He clarified that both Fannie's and Freddie's Boards committed to raise capital and OFHEO expected them both to follow through. He said that the accounting issues at Freddie Mac arose later.

Conservatorship

Tom Stanton asked Mr. Lockhart to comment on a talk Mr. Lockhart gave at AEI during which he said that conservatorship was not on the horizon for the GSEs. Mr. Lockhart said that "one factor was the legislation... without new legislation, conservatorship wouldn't have worked. They had the old provision, but there was no funding. We didn't have an FDIC, there was no one to cover the hole. There was nothing there. So that was one of the considerations."

Tom asked if under the 1992 Act before HERA was passed OFHEO in fact did not have the authority needed to take either company into conservatorship even if there was a substantial trigger. Mr. Lockhart said "we could have, but the chaos in marketplace would have been extreme. We had the power, but even at the end we wanted it to be consensual because they were adequately capitalized. It took all of August working very closely with Treasury and the Fed to make a case to bring to the Board." He mentioned that making a non-consensual decision could have led to lawsuits, and that he met with the companies' investment bankers in New York to hear from them whether or not the companies would be able to raise capital.

Al Crego said that the FDIC has precedent for putting companies into receivership that have 3-4% of capital over the regulatory minimum because they are unsafe and unsound, and asked if the fact that the GSEs met their regulatory minimum kept OFHEO from putting the companies into conservatorship without their consent. Mr. Lockhart responded that “that’s one of the reasons. We could have made a case that even though they were adequately capitalized, we could do it - and we did. But in June we didn’t have their second quarter numbers. And after the analysis of their credit books in August, we came to that conclusion. Without Treasury being able to put that senior preferred in, I don’t know what the consequences would’ve been.” In response to a follow-up question from Al about whether the size and risk of the guarantee book was considered in OFHEO’s assessment of safety and soundness, Mr. Lockhart said that “the view from everyone was that the portfolio was the biggest issue. In 2006 there was not that much concern about credit risk in the agency or the administration. It was really more about the market risk of the portfolios that was the concern.”

Chris asked if going forward there was discussion of putting a cap on the guarantee book, and Mr. Lockhart said no, not unless there was insufficient capital. “In retrospect, the guarantee book was levered 200 to one. It was ridiculous,” he said. “When we were talking about legislation, we talked about increasing capital for the MBS book and portfolio. It was always in our mind that capital might not be adequate for credit risk,” he said.

Chris asked if the fact that the GSEs were inadequately capitalized in a safety and soundness sense (regardless of the regulatory minimums) influenced OFHEO, Treasury or the Fed that capping the guarantee book was necessary as credit risk and systemic risk increased. Mr. Lockhart said “again, it’s a question of capping MBS outside of the consent agreement, and unless we felt that there was a significant safety and soundness issue we couldn’t justify that – we didn’t justify that until the end.” Chris asked if capping the guarantee book was ever considered in the 2006-2007 timeframe, and Mr. Lockhart said that he had been on the job for about one month when the consent agreement was finalized, and that “the idea of capping the portfolio wasn’t even on the list of things to consider until I got on the job.” Chris asked if the idea of capping the guarantee book was ever on the table prior to 2008, and Mr. Lockhart said that there may have been a discussion, but nothing that reached the point of serious consideration.

Chris asked if there was ever discussion or consideration of limiting some of the growth in types of assets. Mr. Lockhart said yes, but that it would have relied “more on moral suasion, but yes, we tried to get them moved away from some higher risk [product].” He continued that “we put out our annual report and in May our report made clear that we were extremely worried about credit risk. Then in the semiannual report we downgraded them to the equivalent to a CAMEL 5. [In the August review,] the whole market was continuing to deteriorate and certainly we were starting to see signs of distress in the prime book. The DTA was an issue at some point too. As soon as we saw how bad credit risk was going, we said that the DTA would have to be reversed. Things continued to evolve over 2008 that made it clear that there was no choice.” Mr. Lockhart

said that in OFHEO's 2006-2007 reports the GSEs were at the equivalent of CAMEL 3. In response to Chris Seefer's question about the report, Mr. Lockhart said that the report downgrading the GSEs to the equivalent to a CAMEL 5 was a non-public report done in July 2008 and released to the CEOs approximately one week before the conservatorship. He said that there was only verbal notification of the report in advance.

Chris then asked why the Fed participated in the August 2008 review. Mr. Lockhart said that HERA made the Fed effectively an advisor to OFHEO. He said that OFHEO asked for help from the Fed and the OCC to look at the mortgage books. He said that he worked closely with Morgan Stanley after it was hired by Treasury. He said that Morgan Stanley was evaluating the credit books and looking at other issues as well from a financial due diligence standpoint.

Response to Henry Paulson's Book

Tom Stanton asked Mr. Lockhart to respond to former Secretary Paulson's discussion of the period leading up to conservatorship in his recently published memoir. Mr. Lockhart said "He made it look like my agency was slow at responding. And the way I told it to him was that we were trying to be as careful as possible. These were the biggest financial institutions in world sitting on 5.5 trillion in mortgages. My troops may have been slower than his, but we wanted to make our case to their Boards as best we could. We weren't resistant, we were careful." He added that "In retrospect, it actually went pretty well. We had the new CEOs in place, new Boards. For better or worse, they were fulfilling their function."

Chris asked what mistakes were made at the companies or at OFHEO, and what he would do differently knowing what he knows now. Mr. Lockhart said that "I think obviously, we probably should've done more modeling around credit risk and had a better understanding of the potentials. People were using the Texas Problems as the big downside case, and we should have stretched that envelope significantly. We should have had more resources in the credit risk area. There are probably other things I'll think about. That's the major thing. We should have put pressure to raise capital quicker, but they were early with that, in December 2007. Somehow we should have gotten legislation quicker. [With respect to the GSEs], obviously, again, they should have put in more work on credit issues. They should not have fought legislation. Ultimately, they were pennywise and pound foolish."

Mr. Lockhart then had to leave the call because of a prior obligation on his schedule, and Chris thanked him for his time and concluded the interview.