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THE FINANCIAL CRISIS INQUIRY COMMISSION

Official Transcript

Commission Hearing

Friday, April 9, 2010

Rayburn House Office Building, Room 2123

Washington, D.C.

9:00 A.M.

COMMISSIONERS

PHIL ANGELIDES, CHAIRMAN

BILL THOMAS, VICE CHAIRMAN

BROOKSLEY BORN

BYRON GEORGIU

KEITH HENNESSEY

DOUGLAS HOLTZ-EAKIN

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C O N T E N T S

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SESSION 1:

FANNIE MAE

EXAMINATION OF ROBERT J. LEVIN and
DANIEL H. MUDD

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P R O C E E D I N G S

1
2 CHAIRMAN ANGELIDES: Good morning. The
3 meeting of the financial crisis inquiry division will
4 come to order. For those of you who have watched over
5 the past two days we have been examining the issues of
6 subprime lending and securitization and how they might
7 have affected the financial crisis and contributed to
8 the financial crisis that has gripped our country.

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

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

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

23 Do you solemnly swear or affirm, under
24 penalty of perjury, that the testimony you're about to
25 provide the Commission will be the truth, the whole

1 truth, and nothing but the truth to the best of your
2 knowledge?

3 MR. MUDD: Yes, I do.

4 MR. LEVIN: I do.

5 CHAIRMAN ANGELIDES: Thank you very, very
6 much.

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

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

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

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

24 MR. MUDD: Yes, sir.

25 MR. LEVIN: Yes.

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

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

5 MR. LEVIN: Thank you.

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

11 MR. LEVIN: Thank you.

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

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

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

24 VICE CHAIRMAN THOMAS: Mr. Levin, if you
25 would move the mic a little closer, they're very

1 sensitive and directional, is the light on --

2 CHAIRMAN ANGELIDES: Is the light on?

3 VICE CHAIRMAN THOMAS: Is the light on, on

4 the mic?

5 MR. LEVIN: There's a green light.

6 VICE CHAIRMAN THOMAS: Yeah, it just needs

7 to be a little closer.

8 CHAIRMAN ANGELIDES: Good.

9 MR. LEVIN: Okay, thank you.

10 CHAIRMAN ANGELIDES: We'll start your time

11 over. Good, sir.

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

13 CHAIRMAN ANGELIDES: Good, now, yes.

14 VICE CHAIRMAN THOMAS: It sounds better.

15 CHAIRMAN ANGELIDES: It sounded like a very

16 weak mic. All right.

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

18 CHAIRMAN ANGELIDES: We'll start over.

19 Good morning, Mr. Levin.

20 MR. LEVIN: Yes, thank you.

21 CHAIRMAN ANGELIDES: Let's go ahead and --

22 and start over and let's go.

23 MR. LEVIN: Okay. Start over, from

24 scratch, sir?

25 VICE CHAIRMAN THOMAS: Sure.

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

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

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

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

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

25 My pride at the contributions of Fannie Mae

1 has understandably been overshadowed by the events
2 that give rise to this hearing.

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

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

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

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

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

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

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

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

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

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

24 In general, certain goals required that a
25 specified percentage of our business be for families

1 at lower income levels, and other goals required that
2 a specified percentage of our business be in -- be
3 located in certain places in the country that were
4 considered underserved.

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

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

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

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

25 Fannie Mae and the other GSEs were unique.

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

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

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

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

18 In 2003, which was also a year of heavy
19 refinance activity, the size of the PLS market was
20 about half of the size of Fannie Mae's security
21 issuances. In 2004, that changed dramatically. The
22 PLS market increased and Fannie Mae decreased. Dollar
23 volumes of PLS exceeded that of Fannie Mae MBS and
24 almost reached the levels of Fannie Mae and Freddie
25 Mac combined. In 2005 and early in 2006, that trend

1 continued with the dollar volume of PLS issued
2 exceeding the MBS issue by Fannie Mae, Freddie Mac,
3 and Ginnie Mae combined.

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

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

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

22 Now issuer -- issuers of PLS are holding
23 the aces that were once held by the
24 government-sponsored enterprises, Fannie Mae and
25 Freddie Mac. Once a junior, the powerful player in

1 the market, PLS are now the leading force driving
2 product innovation and net overall volume of mortgage
3 origination. Further, it appears that the new,
4 dominant role for private securities may be here to
5 stay, unquote.

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

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

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

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

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

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

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

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

1 market had dried up.

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

4 MR. LEVIN: Yes, sir.

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

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

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

17

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

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

1 thank you for the opportunity to appear today.

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

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

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

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

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

23 Over the past couple of days I've heard
24 Mr. Greenspan assign himself a 70/30 rating, and I
25 believe the Chairman gave himself a 51/49 rating. I

1 am envious. My experience was that during the crisis
2 of 2007 and 2008, at the GSEs it was virtually
3 impossible to get on the positive side of that ratio
4 because so many decisions were a choice between
5 unsavory alternatives.

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

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

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

20 The GSE structure required the companies to
21 maintain a fine balance between financial goals and
22 what we call the mission goals. On one hand, without
23 revenue and profits and growth, the company could not
24 attract global capital to the U.S. housing market, and
25 on the other hand, without meeting the mission goals

1 for affordable housing and liquidity, the GSEs could
2 not meet the requirements of their congressional
3 charter.

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

11 The government-sponsored enterprises were
12 able to balance business and mission when home prices
13 were rising. They could perform when home prices were
14 flat. They could survive a 30-year flood, but not
15 2008.

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

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

23 Unlike other financial institutions, this
24 left the GSEs unable to diversify and, therefore, to
25 avoid losses stemming from any U.S. housing finance

1 crisis, and 2007 to 2010 was not merely a housing
2 crisis, we witnessed a market collapse, a collapse of
3 the only market that the GSEs were in.

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

10 Through the spring and summer of 2008, my
11 colleagues and I worked with government officials,
12 regulators, our customers in the banking system,
13 housing advocates and others to maintain the
14 excruciating balance between providing the liquidity
15 to keep the market functioning and protecting Fannie
16 Mae's regulatory capital.

17 Until the time the government imposed a
18 conservatorship, OFHEO stated that Fannie Mae had
19 maintained capital in accord with the relevant
20 regulatory standards, and we were still, along with
21 Freddie Mac, the principal source of lending to the
22 mortgage market.

23 Based on ongoing examinations and frequent,
24 if not daily, meetings into late August 2008, our
25 regulator continued to declare us in full compliance

1 with our capital requirements.

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

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

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

21 I sought to balance the fine points of
22 mission and business, insofar as I could understand
23 them, with the support of regulators and policy
24 makers. That was no longer possible by September 6th,
25 2008, and I am sorry for that.

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

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

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

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

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

1 housing finance system.

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

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

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

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

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

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

1 move into this.

2 EXAMINATION BY CHAIRMAN ANGELIDES

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

13 If you look at the losses, very
14 significantly, they come from loans with higher risk
15 product features, Alt-A, subprime, interest-only,
16 loan-to-value of 90 percent-plus, loans with FICO scores
17 of less than 620, that were originated in 2006 and
18 2007.

19 At the heart of it, looking back on that
20 business decision, would you kind of go to the
21 thinking behind the -- your thinking behind, as
22 leaders of this organization, that really the dramatic
23 expansion in these higher risk products in that 2006,
24 `7 period, what was at the core of the decision to
25 move more dramatically into that arena?

1 And just for the edification of you and
2 others I guess, as you look at losses, for example, in
3 losses in `07, all loans, the selected higher risk
4 product features constitute, I believe, 29 percent of
5 the loans with 58 percent of the losses; in `08, 28
6 percent of the loans, 75 percent of the losses; 19 --
7 2009, 24 percent of the loans and 69 percent of the
8 losses.

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

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

19 The thinking -- the thinking goes back over
20 a period of time. And just as a bit of context, the
21 company had come out of a period where, through the
22 `90s, Fannie Mae was really the dominant force in the
23 marketplace.

24 And during the period of the restatement,
25 that had slipped on one hand, and on the other hand,

1 the market had developed a number of ways to go
2 around, and any mortgage was a Fannie Mae mortgage,
3 and an Alt-A mortgage stood for nothing more than an
4 alternative to a -- an alternative to a Fannie Mae
5 mortgage.

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

12 CHAIRMAN ANGELIDES: Pull the mic into you.

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

14 CHAIRMAN ANGELIDES: Yeah.

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

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

23 So there was a sort of a strategic question
24 of relevance that went to that, led us to use the data
25 that we had to study the market, and develop a plan to

1 understand it, go in prudently, buy some securities,
2 get the data, look at the data, develop some experts
3 that understood how the market operated, look at the
4 originators, do business with those we knew, and we
5 built it out from there.

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

10 CHAIRMAN ANGELIDES: Let me ask, very
11 specifically, your market share in 2002 was of the
12 mortgage market about 29.4 percent; 2003, 36 percent;
13 2004, 24.8 percent; 2005, 19.6 percent. Was this --
14 and I don't want to tilt it, I want to ask, of the
15 things you laid out, in terms of your considerations,
16 was it market share, competitive position that drove
17 you or mission-related items that drove you?

18 MR. MUDD: Well, it was --

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

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

25 So market share, to me, is kind of a

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

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

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

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

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

24 MR. MUDD: I always try to weigh them about
25 equally over the course of time. Obviously, on any

1 given decision, you could move one thing up or one
2 thing down.

3 CHAIRMAN ANGELIDES: All right. Mr. Levin?

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

5 CHAIRMAN ANGELIDES: Can you pull that
6 microphone in close?

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

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

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

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

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

22 CHAIRMAN ANGELIDES: Right.

23 MR. LEVIN: -- dramatically.

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

1 the competition.

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

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

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

17 CHAIRMAN ANGELIDES: And that person would
18 be?

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

21 CHAIRMAN ANGELIDES: Oh, okay.

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

24 CHAIRMAN ANGELIDES: All right.

25 MR. LEVIN: -- same influence -- same

1 influence. I just happened to recall that
2 conversation.

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

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

13 CHAIRMAN ANGELIDES: Right.

14 MR. LEVIN: We --

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

1 anywhere from 62 to 1 to up to 73 to 1.

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

7 But, you know, on reflection, your capital
8 held was extraordinarily low, 2 and a half percent of
9 capital against on balance assets, just .45 percent or
10 45 basis points on your off sheet, on your
11 off-balance-sheet.

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

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

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

1 fundamental question, Mr. Chairman.

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

10 Other financial institutions during the --
11 the -- the period of my memory, probably in the 15,
12 18, 20 percent range of return on equity, our return
13 probably one notch below, below that, in the 15 to 17
14 percent range of return on equity.

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

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

21 MR. MUDD: Yes.

22 CHAIRMAN ANGELIDES: You could have been
23 above that?

24 MR. MUDD: And we were. And we were. We
25 were. We were above the minimum capital. There was a

1 regulatory override. We were above the regulatory
2 override and, in fact, had raised capital all the way
3 through 2007 and 2008 so that actually at the end of
4 my time at the company, we had more capital than we'd
5 had at any point in the company's recent history.

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

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

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

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

22 There was one other report, though, June
23 2005, at a company retreat, a Mr. Lund made a
24 presentation called Single-Family Guarantee Facing

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

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

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

22 CHAIRMAN ANGELIDES: Would not have been
23 enough?

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

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

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

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

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

1 that -- that -- that we faced.

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

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

7 CHAIRMAN ANGELIDES: No, as I say --

8 MR. MUDD: As opposed to what?

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

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

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

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

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

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

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

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

15 CHAIRMAN ANGELIDES: Okay. Thank you.

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

23 The first thing I did when the new director
24 came in was gave him the security badge that had all
25 of the same door openers that mine had; there were

1 examiners on-site; we were having conversations every
2 single day.

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

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

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

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

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

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

13 EXAMINATION BY COMMISSIONER MURREN

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

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

20 And I also refer back to some of the
21 documents that we've had an opportunity to review.
22 One of them is a strategic presentation from 2007
23 where goals are articulated in a list. It's on page
24 11, for -- for the record.

25 Also other documents, including annual

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

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

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

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

23 So for some period of time, the goals, if
24 you look back at the period of '05 and parts of '06,
25 were -- were not related to financial outputs,

1 although there were -- there were capital goals, per
2 se.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

24 So it -- it -- for those analysts, the
25 analysts that were on that plane, they were -- I think

1 they saw it as a balance but they didn't necessarily
2 model the mission in the same way that a financial
3 analyst would model a financial goal.

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

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

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

13 MR. MUDD: I think so.

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

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

25 The general process was that salaries were

1 set to be competitive at a marketplace level, bon- --
2 annual bonuses were determined based upon the
3 achievement of those goals that we talked about, so
4 back to the example, for a sales person, largely sales
5 and revenue-oriented, for a mission person, largely
6 oriented around projects that they were working on or
7 housing goals that they might have brought in the
8 door, and for somebody at our level, kind of an
9 aggregation of -- of -- of all those into our
10 individual -- my individual goals were not very
11 distinguishable from the corporate goals, being the
12 top guy.

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

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

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

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

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

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

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

1 comparables?

2 MR. MUDD: That would be -- two points.

3 That would be the reason that instead of total
4 compensation being pegged to 100 percent of market, it
5 was pegged to be 70 percent of the market.

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

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

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

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

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

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

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

24 And -- but we did -- we did bow to the
25 point you raised, I think, by saying no, actually, we

1 don't pay at a hundred percent of what -- what those
2 comparators pay for; we pay at 70 percent of that.
3 And that was about the balance that enabled us to
4 attract and retain the talent that we thought we
5 needed to run the organization.

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

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

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

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

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

25 COMMISSIONER MURREN: If it were, say, for

1 one of them, in the range of \$700,000 for one -- for
2 one assignment, does that ring a bell?

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

6 COMMISSIONER MURREN: Thank you.

7 MR. MUDD: Thank you.

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

10 COMMISSIONER MURREN: I yield my time.

11 CHAIRMAN ANGELIDES: All right.

12 Mr. Wallison?

13 EXAMINATION BY COMMISSIONER WALLISON

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

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

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

25 But the chairman, Chairman Angelides, did

1 focus on what I think is one of the most important
2 questions that I think we'll have to resolve, and that
3 is the reason that Fannie acquired so many subprime
4 and Alt-A loans.

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

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

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

1 these loans. You were competing with Wall Street,
2 wanting to increase your market share.

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

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

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

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

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

24 In -- in -- they started at 30 percent,
25 when they first came into effect in the -- in the

1 early `90s. But in -- but in 2000 they became 50
2 percent. And what that meant is that all of the loans
3 that you had that you bought, of the loans that you
4 bought from originators, 50 percent of those, and you
5 know this, of course, but for the audience they might
6 not, 50 percent of those had to be to people who were
7 at or below the median income in the areas where they
8 were living.

9 So at 50 percent, starting in the year
10 2000; it then increased to 52 percent in 2005, 53
11 percent in 2006, and 55 percent in 2007, in other
12 words -- and -- and some of this was in your -- in
13 your prepared remarks, and I got some of the same
14 sense listening to Mr. Levin and -- and to you that
15 you were really under pressure from HUD here.

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

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

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

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

20 So basically he says, realistically, we are
21 not in a position to meet the market today -- this is
22 in the middle of 2005 -- therefore, we recommend
23 something you've already mentioned, and that as
24 Mr. Levin has, is the "stay the course" idea. And it
25 appears that you did follow this advice, although it

1 wasn't quite as you suggested, just not going into
2 subprime. It was to kind of, as he put it in his
3 memo, underground efforts: Develop a subprime
4 infrastructure, develop modeling capabilities for
5 alternative markets, and develop a conduit capacity.

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

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

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

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

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

1 company ought to be.

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

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

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

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

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

20 COMMISSIONER WALLISON: Okay. And it
21 really focuses, of course, on it's title, 2007 to
22 2012, it focuses on what Fannie will do in the future.

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

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

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

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

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

1 growing part of the mortgage market.

2 Is that -- would that seem right to you?

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

6 COMMISSIONER WALLISON: That was '05.

7 MR. MUDD: '05.

8 COMMISSIONER WALLISON: Middle of '05,
9 about June of '05.

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

15 And, as -- as a result of -- of kind of
16 setting those bookends and having the debate, the
17 outcome -- the outcome was what you described the
18 single-family had a business recommending, which was
19 that we stay the course, we continue our investment,
20 we continue the process, we continue to emphasize the
21 30-year fixed rate mortgage, but that at the same
22 time, we developed the capabilities to understand the
23 business.

24 COMMISSIONER WALLISON: Right.

25 MR. MUDD: By way of reference the -- the

1 book of Fannie Mae's investment or participation or
2 guarantee of Alt-A goes all the way back to 1999.

3 COMMISSIONER WALLISON: Right.

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

8 COMMISSIONER WALLISON: Right.

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

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

23 COMMISSIONER WALLISON: Right.

24 MR. MUDD: -- you can't do the mission, you
25 can't earn a return, you can't raise capital and all

1 of that. So the question was, do you do it prudently.
2 And I think that the ultimate measure of prudence is
3 that a big problem -- and not perfect to be sure, but
4 Fannie Mae's participation in those segments to this
5 day, to my knowledge, is better by a factor of about
6 two than the same loans and the same securities that
7 were done by the banks in the private -- the private
8 market.

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

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

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

1 Indeed, Fannie and Freddie, but Fannie particularly,
2 was required from in the early 1990s, as I suggested,
3 to start making these kinds of investments. This was
4 not just something that occurred between 2005 and
5 2007. In fact, in -- in -- in 1999, there was a major
6 HUD press conference where the then-secretary,
7 Secretary Cuomo, announced that you would be required,
8 you and Freddie, would be required, with these -- with
9 new affordable housing requirements, to make two
10 and -- 2.4 trillion dollars in affordable housing
11 loans starting right then, and in fact, there was a
12 statement by President Clinton saying, this is
13 wonderful because housing homeownership in the United
14 States was increasing substantially.

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

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

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

6 COMMISSIONER WALLISON: Thank you.

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

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

22 So when you're required to have 57 percent
23 of your business be below 50 percent, that gap of
24 7 percent began to -- you have to create not just a
25 normal home for those mortgages, you have to create

1 attraction for those loans to come in the -- in the --
2 in the door.

3 COMMISSIONER WALLISON: Right.

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

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

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

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

24 However, in this 2007 report that we've
25 been talking about, you say this: The HUD affordable

1 housing goals are a public manifestation of our
2 mission. Our strategy of expanding and our credit
3 risk appetite is critical in meeting these goals. For
4 2004 to 2008, the goals require -- and this is exactly
5 what you're saying -- the goals require Fannie Mae's
6 acquisitions to finance a greater percentage of low-
7 and moderate-income family mortgages than the
8 proportion the market will produce. That's a
9 point.

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

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

24 MR. MUDD: Your impression is correct, and,
25 well, Mister -- Mr. Levin was right in the middle of

1 that analysis and he may be -- he may be in a better
2 position to answer it.

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

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

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

17 COMMISSIONER WALLISON: Okay.

18 COMMISSIONER MURREN: Thank you.

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

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

25 MR. LEVIN: Mr. Wallison, just rephrase

1 what you would like me to address.

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

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

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

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

1 money on -- on your affordable housing activities that
2 you were making on your standard kinds of activities.

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

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

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

15 CHAIRMAN ANGELIDES: Thank you,
16 Mr. Wallison.

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

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

21 COMMISSIONER GEORGIU: Thank you,
22 Mr. Chairman.

23 EXAMINATION BY COMMISSIONER GEORGIU

24 COMMISSIONER GEORGIU: Mr. Levin, I would
25 like to follow up on one thing I just got confused

1 about. I understood that Alt-A mortgages actually did
2 not count towards the affordable housing goals of
3 the -- of the mission; is that correct?

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

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

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

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

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

1 COMMISSIONER GEORGIU: Okay. And you did,
2 nonetheless, increase your financing of Alt-A loans, I
3 guess about a percent a year for every year, it looks
4 like, from `04, at 8 percent; `05, 9 percent; `06,
5 11 percent; and `07, 12 percent; is that right?

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

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

12 COMMISSIONER GEORGIU: Okay, very good.
13 Let's see.

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

22 And so subprime PLS was also one of the
23 initiatives, if you will, that filled the housing goal
24 gap. There was no tradeoff between making money and
25 hitting goals, it was a very broad brush effort that

1 could be characterized as win, win, win, money, goals,
2 and market share.

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

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

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

18 MR. LEVIN: Yes, sir.

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

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

23 COMMISSIONER GEORGIOU: Okay.

24 MR. MUDD: All of those were factors.

25 COMMISSIONER GEORGIOU: Very well, thank

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

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

10 I mean, it was 33.6 million in 2000; 26
11 almost 27 million in 2001; 26 million in 2002; up to
12 51 and a half million in 2003. It strikes me that
13 that's -- it sort of dwarfs the ability of the
14 regulator to really play a significant role.

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

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

23 COMMISSIONER GEORGIU: Well, I'm sure they
24 will, but I was wondering if you -- if your experience
25 as the regulated entity might give you some insight in

1 hire lobbyists to lobby against it?

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

4 COMMISSIONER GEORGIU: Well --

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

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

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

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

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

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

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

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

23 COMMISSIONER GEORGIU: At -- at one point
24 there was a suggestion by Mr. Falcon, who we'll hear
25 from after you, this afternoon, that Fannie Mae

1 executives acted on a plan to have Senator Kit Bond
2 initiate an investigation of OFHEO by the HUD
3 inspector general in an effort to -- to head off an
4 investigation that they were doing into Fannie's
5 accounting practices. Do you have any familiarity
6 with that particular effort?

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

12 COMMISSIONER GEORGIU: In what respect?
13 He was focused on that they were excessive?

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

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

24 MR. MUDD: I don't -- I don't remember
25 that. I think most of the -- of -- plurality of the

1 people that I talked to were generally interested
2 in -- in better oversight, including both Director
3 Falcon and Director Lockhart, and I -- and I shared
4 that, but that's --

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

7 MR. LEVIN: I don't.

8 COMMISSIONER GEORGIU: Okay. Let me try
9 and go back to capital, briefly.

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

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

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

24 And, you know, we, you know, my
25 recollection is when I left the company, we were in

1 compliance with both numbers, the leverage ratio, but
2 also the risk-based capital ratio, which attempted to
3 establish the correct capital levels based on the
4 exact product that we had and then stressing the
5 markets.

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

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

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

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

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

22 COMMISSIONER GEORGIU: So if you didn't
23 charge the fee that you modeled, then -- then your
24 charging the lower fees meant that effectively -- than
25 the model fee -- then effectively you weren't pricing

1 the MBS guarantees commensurate with the risks that
2 you had established yourselves; is that not correct?

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

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

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

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

1 three minutes.

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

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

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

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

25 What I always thought the models helped do

1 was to enable us to decide consciously, do we want
2 to -- do we want to give up a little potential return
3 here, because there's more volume or because there's
4 more goals-rich or because of some other exogenous
5 factor. The models in the model fee is one component
6 of the relationship.

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

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

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

21 MR. LEVIN: I don't recall.

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

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

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

11 CHAIRMAN ANGELIDES: Time.

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

15 CHAIRMAN ANGELIDES: Mr. Holtz-Eakin?

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

19 EXAMINATION BY COMMISSIONER HOLTZ-EAKIN

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

25 And so I guess my first question is, what

1 did your internal risk metrics tell you, you could
2 survive; what kind of price declines were survivable
3 given your business model?

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

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

16 But we -- we and outside advisors, as well,
17 looking at our capital, thought that that was
18 sufficient to withstand what I called earlier the
19 30-year flood.

20 But, just by way of reference, what that
21 30-year flood was, since the estimates had to be based
22 on a sample of real data, you couldn't make up the
23 data, we went back to -- to California in the 1990s,
24 the Texas oil patch in the 1980s, some of the severe
25 interest rate dislocations over a period of time, and

1 we took those scenarios and multiplied them by 50
2 states, and then extended them over a period of time
3 to do a stress assessment of whether we -- of whether
4 we would have sufficient capital.

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

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

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

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

21 MR. MUDD: Yes.

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

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

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

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

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

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

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

19 Talking over each other

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

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

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

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

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

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

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

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

14 My interest is in the internal risk
15 management procedures at Fannie Mae, which ultimately
16 failed and left the taxpayers with the single largest
17 bill we will face in this episode, and I'm curious as
18 to the nature of those procedures, their quantitative
19 assessment of the risk, not likely the outcomes but
20 worst case, and downside risk, and the degree
21 to which they were updated in light of clear misses,
22 and how they interacted with other mitigates against
23 risk, holding additional capital, which you have
24 already expressed an assertion that you held adequate
25 capital from all internal risk metrics, despite the

1 evidence to the contrary, and stronger regulation,
2 which would have put you in a better prudential
3 position.

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

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

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

24 And those were -- those were updated. They
25 were a topic of conversation at weekly management

1 meetings. And I think, in the year of either `07 or
2 `08, the board met something like 100 times, and this
3 would have been an item of discussion at that level.

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

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

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

22 MR. MUDD: I react to it that Fannie Mae
23 wasn't a national bank and under -- under its
24 regulatory regime, it was operating within the capital
25 standards that it had, A, and that, B, we were -- we

1 were aggressively raising capital throughout `07 and
2 into -- into `08.

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

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

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

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

25 But I -- the last output was the one that I

1 described to you in the end of `08. I don't know what
2 the outputs turned out to be subsequently once you had
3 the real data in terms of what -- in terms of what
4 actually happened.

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

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

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

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

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

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

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

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

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

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

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

24 COMMISSIONER HOLTZ-EAKIN: So number one,
25 it was a Triple-A security because it was guaranteed,

1 right? It was guaranteed. So they had
2 security.

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

6 MR. MUDD: No. No.

7 COMMISSIONER HOLTZ-EAKIN: How does that
8 help?

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

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

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

1 experience.

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

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

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

24 What did you do in the presence of this
25 very large, risky portfolio and what others have

1 testified to be sort of inadequate internal risk
2 management to ensure that you don't -- didn't end up
3 in the position that you ultimately ended up in?

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

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

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

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

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

1 So I guess maybe --

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

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

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

10 COMMISSIONER HOLTZ-EAKIN: Thank you.

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

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

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

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

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

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

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

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

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

24 COMMISSIONER THOMPSON: Thank you,
25 Mr. Chairman.

1 EXAMINATION BY COMMISSIONER THOMPSON

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

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

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

24 MR. MUDD: I think there is that, there is
25 that responsibility, we had those conversations

1 throughout the rule-making process as HUD established
2 the housing goals.

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

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

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

25 COMMISSIONER THOMPSON: So but it is true

1 that part of that increase in homeownership was
2 attributable to loans that were originated that had
3 very, very low standards of origination and,
4 therefore, could have contributed to an eventual
5 collapse. So the blind pursuit of metrics put our
6 country at risk.

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

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

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

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

24 COMMISSIONER THOMPSON: Mr. Levin, you were
25 with Fannie for a very, very long time. Would you

1 comment on that. Was part of the responsibility you
2 have to act on market knowledge?

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

7 COMMISSIONER THOMPSON: How about with
8 Congress or with HUD?

9 MR. LEVIN: With HUD.

10 COMMISSIONER THOMPSON: Okay.

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

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

1 was structured?

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

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

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

16 I do think that a -- a consensus around
17 what the models should be is important. If it were
18 for me to do, I would have the GSEs focused on
19 principally first-time home buyers getting -- getting
20 -- getting -- getting folks onto the ladder in the
21 first place, under terms, generally predictable
22 payment, fixed rate, 30-year loans with 20 percent
23 down, the old-fashioned way. There -- there would be
24 a portfolio. The portfolio would not be as large as
25 -- as it had been. And there would have to be some,

1 in my view, explication of exactly what the
2 relationship is between these entities and the
3 government.

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

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

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

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

22 COMMISSIONER THOMPSON: The goals should
23 have been more?

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

1 was --

2 COMMISSIONER THOMPSON: But they --

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

6 COMMISSIONER THOMPSON: Mr. Levin?

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

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

24 COMMISSIONER THOMPSON: Was there an
25 opportunity, perhaps, to reprioritize your charter and

1 focus on those things that were most relevant in the
2 marketplace that would have made the institution more
3 sound?

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

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

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

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

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

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

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

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

7 COMMISSIONER THOMPSON: Thank you very
8 much.

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

11 VICE CHAIRMAN THOMAS: Mr. Chairman?

12 CHAIRMAN ANGELIDES: Yes.

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

15 EXAMINATION BY VICE CHAIRMAN THOMAS

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

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

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

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

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

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

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

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

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

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

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

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

21 CHAIRMAN ANGELIDES: Mr. Hennessey?

22 COMMISSIONER HENNESSEY: Thank you,
23 Mr. Chairman.

24 EXAMINATION BY COMMISSIONER HENNESSEY

25 COMMISSIONER HENNESSEY: Mr. Mudd, in your

1 testimony you said, let me quote here, I believe that
2 in retrospect there was overinvestment in housing;
3 origination standards slipped; there was too little
4 skin in the game; homeownership rates probably rose
5 too high.

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

10 My personal views is I believe the policy
11 makers on both sides of the aisle contributed to each
12 of these four problems, and I would like to ask about
13 the contribution of your decision to guarantee roughly
14 350 billion dollars of Alt-A mortgages.

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

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

24 MR. MUDD: I think Fannie Mae's
25 investments, at large, given that it was in the

1 chartered purpose of increasing homeownership and
2 increasing affordable housing, did both of those
3 things: It increased homeownership and it increased
4 affordable housing. And therefore made the pie bigger
5 and therefore when the collapse came, more people were
6 exposed to the collapse.

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

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

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

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

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

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

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

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

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

25 MR. MUDD: Yes.

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

7 MR. MUDD: Contributed? I would say so.

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

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

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

25 COMMISSIONER HENNESSEY: Okay. So it's

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

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

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

21 And, Mr. Chairman, I would just suggest
22 that it's an important area for us to understand,
23 because we've heard several times that Fannie Mae was
24 in compliance with the regulatory capital standards,
25 but if Fannie or its proxies were at the same time

1 trying to keep those capital standards from being
2 raised to something more like what a national bank or
3 another large financial institution would have used,
4 then there's a problem.

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

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

22 COMMISSIONER HENNESSEY: Thank you.

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

25 COMMISSIONER BORN: Thank you very much.

1 EXAMINATION BY COMMISSIONER BORN

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

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

11 And I understand from our staff that Fannie
12 held about 1.2 trillion dollars in notional amount of
13 derivatives in the summer of 2008 prior to the
14 conservatorship, and that Freddie had an additional
15 1.6 trillion dollars in notional amount of
16 derivatives.

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

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

25 COMMISSIONER BORN: So they were basically

1 being used for hedging purposes?

2 MR. MUDD: Yes.

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

6 MR. MUDD: Yes, ma'am, the -- the feature
7 of the 30-year fixed rate mortgage is that the
8 individual consumer can pay it off anytime they want
9 to, and ideally you would match 30-year funding to a
10 30-year asset.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

20 MR. MUDD: I -- I --

21 COMMISSIONER BORN: -- on the derivatives
22 portfolio positions.

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

25 COMMISSIONER BORN: The Wall Street

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

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

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

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

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

24 My observation of reading the article was
25 that, as I note in my testimony, the companies were

1 being used in some ways to effectuate changes in
2 public policies and public markets, and so there may
3 be other reasons to do that that I'm not aware of
4 anymore.

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

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

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

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

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

24 MR. MUDD: No, it does not.

25 COMMISSIONER BORN: Why not?

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

5 COMMISSIONER BORN: When was that?

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

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

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

25 But with the regulatory bill, which

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

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

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

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

23 CHAIRMAN ANGELIDES: All right. Two
24 minutes?

25 COMMISSIONER BORN: That would be fine.

1 CHAIRMAN ANGELIDES: Whether -- yes.

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

6 MR. MUDD: Yes.

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

9 MR. MUDD: Fannie PAC or something like
10 that.

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

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

16 COMMISSIONER BORN: I'm sure it is.

17 MR. MUDD: But I don't know.

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

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

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

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

5 COMMISSIONER HENNESSEY: I certainly won't.

6 EXAMINATION BY COMMISSIONER HENNESSEY

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

17 My question, you talked a lot about the
18 balance between your fiduciary responsibilities to
19 your shareholders and the need to fulfill your public
20 purpose. And in your testimony, you said, without
21 earnings the GSEs would not have been able to attract
22 capital, to post reserves, to finance affordable
23 housing projects or to perform the function of
24 channeling global capital flows into U.S.
25 homeownership.

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

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

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

9 COMMISSIONER HENNESSEY: And what was the
10 direct benefit?

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

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

22 Now, that would -- that -- you might or
23 might not agree that that would be a laudable purpose,
24 but in either case, that would be an Alt-A loan. So
25 that's just an illustration of my thinking in terms of

1 how Alt-A could serve the mission as well as the
2 financial side of the business.

3 COMMISSIONER HENNESSEY: Thank you.

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

7 EXAMINATION BY COMMISSIONER GEORGIOU

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

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

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

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

25 Did Fannie make unsecured loans to

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

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

11 COMMISSIONER GEORGIU: Thanks.

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

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

16 EXAMINATION BY COMMISSIONER WALLISON

17 COMMISSIONER WALLISON: Just for those who
18 are watching.

19 CHAIRMAN ANGELIDES: Two minutes,
20 Mr. Wallison.

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

25 And on page 8 of that report, there is a

1 chart which shows Fannie and Freddie's compliance with
2 the affordable housing guidelines and how that rises
3 just above the requirements that HUD was imposing as
4 it went on.

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

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

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

1 housing goals.

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

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

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

20 COMMISSIONER WALLISON: I will. The odd
21 part is, in buying these pools, you were in fact
22 advancing your competition's position, because they
23 would assemble these pools of conforming loans and
24 sell them to you, and they helped you with your
25 affordable housing guidelines. And they were also

1 profitable. But it also helped Wall Street do more of
2 the securitization that they were doing.

3 CHAIRMAN ANGELIDES: All right.

4 VICE CHAIRMAN THOMAS: Thank you.

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

8 Mr. Thomas?

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

11 EXAMINATION BY VICE CHAIRMAN THOMAS

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

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

1 profit, at some point, they cease to exist.

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

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

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

19 Again, this is `02. It says down in the
20 corner, Fannie Mae papers is an occasional series on
21 policy issues of interest to the housing community.
22 And the conclusion of the paper, and not unsurprising
23 or probably wouldn't have seen the light of day, this
24 analysis shows that, quote, based on historical data
25 the probability of a shock as severe is embodied in

1 the risk-based capital standard is substantially less
2 than one in 500,000 and may be smaller than 1 in
3 3 million.

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

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

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

21 I want to talk about small town/company
22 town. Franklin Raines was Fannie Mae's Vice Chairman
23 from 1991 to 1996. In 1996 he moved directly from
24 Fannie Mae to be the director of the Office of
25 Management and the Budget, from `96 to `98. When he

1 left the director of the Office of Management and the
2 Budget, he became CEO at Fannie Mae, 1999 to `04.

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

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

18 And I think there's just overwhelming
19 evidence. When you look at those people that were
20 employed for lobbying, once again, I probably read
21 this book differently than others, I'm shocked at the
22 virtual 100 percent content of the profile of the
23 lobbying firms. They're either former members of
24 Congress, members of Congress-to-be, or spouses of
25 members of Congress or, depending on who's in control,

1 a significant staffer who had been with the majority,
2 when Democrats were in the majority, or with the
3 Republicans, if they were in the majority, or back
4 again.

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

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

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

20 And over my 30 years, I got to know -- I
21 never wanted to be on the appropriations committee,
22 but I got to know those who were, and I think it would
23 be fair to say that given the size of the
24 appropriations committee, it breaks up into
25 subcommittees that look at specific areas of the

1 federal government that need the appropriations from
2 those specific areas, both in the House and the
3 Senate.

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

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

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

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

24 VICE CHAIRMAN THOMAS: I -- I've got very
25 little time. Really, a yes or no would be sufficient,

1 because you can follow it up with comments to
2 elaborate.

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

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

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

8 VICE CHAIRMAN THOMAS: Mr. Chairman?

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

12 VICE CHAIRMAN THOMAS: I just lost a minute
13 of time.

14 CHAIRMAN ANGELIDES: Well, you'll get --

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

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

20 MR. LEVIN: Yes.

21 CHAIRMAN ANGELIDES: About whether you were
22 in a meeting or not in which the subject of
23 approaching a member of Congress was raised with
24 respect to advancing the interests of Fannie Mae. I
25 think that's a fair characterization. I think a yes

1 or no would be appropriate.

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

4 VICE CHAIRMAN THOMAS: You've gone --

5 MR. LEVIN: As a goodwill in the community.

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

8 CHAIRMAN ANGELIDES: Please answer the
9 question.

10 MR. LEVIN: Yes.

11 CHAIRMAN ANGELIDES: Thank you.

12 VICE CHAIRMAN THOMAS: Mr. Mudd?

13 COMMISSIONER HENNESSEY: Yes.

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

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

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

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

24 MR. MUDD: Yes.

25 VICE CHAIRMAN THOMAS: You did. So that's

1 what I mean by not having to worry about who's on the
2 field if you have access to the locker room.

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

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

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

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

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

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

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

1 Mr. Mudd, in conclusion.

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

8 MR. MUDD: Yes.

9 MR. LEVIN: Yes.

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

16 MR. MUDD: Yes.

17 MR. LEVIN: Yes.

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

25 MR. MUDD: Not to my knowledge.

1 CHAIRMAN ANGELIDES: Okay. Mr. Thomas?

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

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

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

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

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

23 I mean, did anyone ever come to you and
24 say, look, Wall Street's -- in 2007 -- things are
25 beginning to -- they're pulling out of the market, a

1 lot of the firms on Wall Street have very significant
2 private label securities, we want you to help offload
3 some of that, was that ever -- did that ever occur?

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

5 MR. LEVIN: Same.

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

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

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

22 So our -- our -- our ask was to give some
23 flexibility around that line on the capital
24 requirements but to ameliorate the logical concerns
25 that would come out of that by expressing our

1 interests to maintain those levels of capital if not
2 raise capital.

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

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

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

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

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

21 CHAIRMAN ANGELIDES: So why were the
22 portfolio caps lifted?

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

1 CHAIRMAN ANGELIDES: You didn't ask for it?

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

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

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

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

23 CHAIRMAN ANGELIDES: Well, we can have
24 revisit this. I don't want to take anymore time. The

1 regulator will be here, and obviously the regulator
2 was very involved in that, in that transaction, so we
3 can explore that more.

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

8 MR. MUDD: Yes, sir.

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

12 VICE CHAIRMAN THOMAS: Thank you very much.

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

15 (Recess.)

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

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

25 Do you solemnly swear or affirm, under

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

5 MR. LOCKHART: I do.

6 MR. FALCON: I do.

7 CHAIRMAN ANGELIDES: Thank you very much.

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

16 So, Mr. Falcon, proceed.

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

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

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

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

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

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

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

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

5 The lack of flexibility on setting capital
6 requirements was especially troubling. By statute the
7 enterprise's minimum capital requirement was set at
8 2.5 percent, which permitted them to operate at a
9 highly leveraged level with very little margin for
10 error.

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

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

23 The result was that the agency was starved
24 for resources for many years. To illustrate this
25 point, I recall that when I first took office, I

1 received briefings from the exam staff on their work
2 schedule and latest examination findings.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

24 He asked for a copy, which I provided, and
25 he respected my decision not to delay its release. A

1 few days later, on February 4th of 2003, I was in New
2 York to give a speech on the findings of the report,
3 which was being released that day.

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

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

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

24 In 2004, as OFHEO began its special
25 accounting examination of Fannie Mae, the political

1 attacks and efforts at obstruction intensified.

2 Fannie was uncooperative with document requests and
3 they engaged their supporters in Congress for
4 assistance.

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

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

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

25 Also in that same month, OFHEO released its

1 risk report on the accounting misconduct at Fannie Mae
2 and we took supervisory actions to correct the
3 problems.

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

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

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

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

22 Fannie Mae began the last decade with an
23 ambitious goal. Double earnings in five years to
24 \$6.46. A large part of the executives' compensation was tied to
25 meeting that goal.

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

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

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

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

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

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

8 CHAIRMAN ANGELIDES: That's okay.

9 MR. FALCON: Okay.

10 One very telling example of how greed drove
11 the accounting violations was a 200-million-dollar
12 maneuver in the fourth quarter of 2004, by shifting
13 200 million dollars into future years, they were able
14 to obtain 100 percent of the bonus compensation that
15 year as opposed to zero if they had properly accounted
16 for that 400-million properly.

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

21 The firm's not engaged in any activity,
22 goal-fulfilling, or otherwise, unless there was a
23 profit to be made. In the end, despite management
24 turnover at both companies, cultural problems
25 persisted. The companies could not accept their

1 diminished role in the mortgage market and reduction
2 of profitability.

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

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

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

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

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

25 I served as director of OFHEO and then FHFA

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

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

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

25 I endorsed, strongly, in three

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

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

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

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

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

25 President Bush had been pushing for GSE

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

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

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

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

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

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

11 If you look at Fannie's acquisitions from
12 2001 to 2007, the percent of subprime mortgages
13 actually remained relatively stable at 16 to 18
14 percent even though the subprime market was tripling
15 or more than that and represented about a third of the
16 market at the end.

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

24 As OFHEO's budget was subject to
25 congressional political process, OFHEO's growth was

1 constrained and subject to annual freezes. The other
2 issue, major issue was receivership. We did not have
3 that in the original legislation, we got it in the new
4 legislation.

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

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

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

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

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

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

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

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

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

23 The enterprise's management and the credit
24 models they relied on failed to identify how badly the
25 mortgage market was deteriorating. Many others failed

1 to understand how bad the toxicness was: Booming and
2 then falling house prices, abysmally low underwriting
3 standards, plentiful and then disappearing financing,
4 and Wall Street's destructive creativity.

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

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

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

21 We encouraged the enterprises to cut their
22 dividends, and they raised 17 and a half billion
23 dollars in preferred stock in 2007. They represented
24 about 75 percent of the market at that point, but
25 sitting on over 5 trillion dollars -- in market -- on

1 mortgages, and razor-thin capital, it was critical for
2 their country's financial future that the mortgage
3 market stabilize. Their withdrawal would have created
4 a self-fulfilling credit crisis.

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

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

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

24 Before concluding, I would just like to
25 thank the team at OFHEO, FHA, for their extraordinary

1 work during that period.

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

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

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

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

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

25 CHAIRMAN ANGELIDES: Thank you,

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

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

6 EXAMINATION BY VICE CHAIRMAN THOMAS

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

9 MR. FALCON: It was in 19 -- it was in
10 1999.

11 VICE CHAIRMAN THOMAS: Fess up, fess up.

12 MR. FALCON: 1989, I believe.

13 VICE CHAIRMAN THOMAS: 1989. Mr. Lockhart?

14 MR. LOCKHART: 1989, as well.

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

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

23 I just have to say, I was there for the
24 movie as well, and I think your version tends to have
25 a greater degree of credibility about relationships

1 than the one that I heard earlier.

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

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

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

22 VICE CHAIRMAN THOMAS: Right.

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

1 VICE CHAIRMAN THOMAS: And then we passed
2 through the end of December of `07, into February of
3 `08, and then some of it's interesting, but for the
4 sake of time, move on into early March, where things
5 start to happen fairly quickly. On March 7, we're
6 aware -- we're aware of an e-mail exchange between
7 Mr. Mudd, the CEO, and Mr. Steel, who is the
8 undersecretary of the Treasury.

9 And my understanding is that Mudd writes to
10 Steel that OFHEO, having unrestricted capital
11 authority will as ever be the sticking point. Mudd
12 writes to Levin, quote, it's a time game, whether they
13 need us more, sooner, to show administrative action or
14 if we hit the capital wall first, be cool. Did you
15 know about this communication?

16 MR. LOCKHART: I didn't see the e-mail but
17 I knew that Secretary Steel and Dan Mudd and Dick
18 Syron were talking, as they were talking
19 with me, at the time.

20 VICE CHAIRMAN THOMAS: Well then, the next
21 day I have, and this is easier for you to refer to, an
22 e-mail from you to Undersecretary Steel in which you
23 write that the Freddie board is against raising equity
24 but it may be possible if timed with some capital
25 relief.

1 Why didn't Freddie want to raise equity?

2 Is that a question that --

3 MR. LOCKHART: They did not want to dilute
4 their shareholders. I mean, they were still
5 shareholder-centric, at that point, and they really,
6 in discussions I've had with that board over the
7 years, they were very, very reluctant to raise equity.

8 VICE CHAIRMAN THOMAS: Is that an
9 indication of a partial lose of focus as to who they
10 were and what their fundamental underlying goal is,
11 notwithstanding making a profit is always nice?

12 MR. LOCKHART: Well, as I said in my
13 written testimony, the boards were much more focused
14 on profitability. They felt that that was their
15 fiduciary responsibility to the shareholders. And the
16 mission was a distant, not even second, and it -- that
17 was my view and certainly had many conversations with
18 the boards on that topic.

19 VICE CHAIRMAN THOMAS: My assumption is
20 there was virtually no discussion about taxpayers
21 rather than shareholders. You don't have to answer
22 that.

23 Obviously background ended that first week
24 in March, March 11th the Barrons article comes out
25 suggesting that Fannie Mae is insolvent and predicting

1 that the government will bail the company out.

2 March 16th, Undersecretary Steel e-mails to
3 others at Treasury, Lockhart needs to eliminate --
4 that's you, Lockhart needs to eliminate the negative
5 rhetoric. I have e-mailed and called Syron and
6 waiting to hear back. I was leaned on very hard by
7 Bill Dudley, official at Treasury.

8 MR. LOCKHART: At New York Fed.

9 VICE CHAIRMAN THOMAS: Pardon?

10 MR. LOCKHART: He's at the New York Fed.

11 VICE CHAIRMAN THOMAS: He's at the New York
12 Fed. To harden substantially. I do not like that and
13 it has not been part of my conversation with anyone
14 else. I viewed it as a very significant move, way
15 above, we've heard this before, my pay grade to double
16 the size of the U.S. debt in one fell swoop.

17 Since it was directed toward you, what --
18 what do you think was meant by eliminating the
19 negative rhetoric?

20 MR. LOCKHART: Well, I think it's well
21 known that I was pretty strong against some of the
22 things the two companies were doing. And I was very
23 strong in supporting legislation.

24 And what, you know, as I said in my
25 testimony, we had a fine line here. We had to force

1 the companies to get more capital or they weren't
2 going to make it. The legislation was flawed, so I
3 was using the press, occasionally, but more often just
4 talking to the two CEOs about the need to raise
5 capital.

6 VICE CHAIRMAN THOMAS: And the same day,
7 March 16th, 2008, Bear Stearns collapses?

8 MR. LOCKHART: Right. I mean, that weekend
9 there was a lot obviously going on in the
10 administration. And certainly I did talk to the
11 Treasury and the Fed that weekend. And, you know, our
12 concern was that Fannie and Freddie could be next.

13 And so we thought it was critical to raise
14 capital. And to do so we basically, as you know, did
15 an agreement with them. And in return for raising a very
16 significant amount of capital and committing to keep
17 the capital well above the minimum standards that we
18 start to lower their capital.

19 VICE CHAIRMAN THOMAS: Well, but on March
20 17th that was the subject of an e-mail from -- talking
21 about OFHEO releasing capital surplus in the
22 consent order and GSEs commit to invest 300 billion in
23 market to raise capital.

24 What -- what was your opinion of that
25 particular deal?

1 MR. LOCKHART: I did the deal so I --

2 VICE CHAIRMAN THOMAS: I understand you did
3 the deal. But what was your opinion of the deal at
4 the time?

5 MR. LOCKHART: I thought it was necessary
6 because we needed to stabilize --

7 VICE CHAIRMAN THOMAS: A number of us take
8 out garbage but that doesn't mean that that's our
9 ideal.

10 MR. LOCKHART: We -- we had to play the
11 cards that we were dealt with, and we had a capital
12 structure that didn't work. We had a GSE structure
13 that didn't work, and we had a 11-trillion-dollar
14 mortgage market that would have cratered if we hadn't
15 done something.

16 VICE CHAIRMAN THOMAS: Okay. Then
17 obviously, after that, what you did, which you felt
18 was absolutely essential, not perhaps ideal, March
19 19th timeline, Graham-Fisher, GSE analyst Joshua
20 Rosner states, that quote, any reduction in capital is
21 a comment not on the current safety and soundness of
22 the GSEs but on the burgeoning panic in Washington,
23 end of quote.

24 We believe that OFHEO Director Lockhart
25 took this action results in the destabilizing of the

1 GSEs. OFHEO will go from being the only regulator who
2 had prevented their charges from getting into trouble
3 to a textbook example of why regulators should be
4 shielded from outside political pressure.

5 Do you feel that the decision that you
6 arrived at was substantially based upon the outside
7 political pressure that you received or, in your
8 professional judgment, absent any pressure, that it
9 was okay?

10 MR. LOCKHART: In my professional judgment
11 it was the necessary step. I had run the pension
12 benefit guarantee corporation, Bush 41, made a lot of
13 life-and-death decision for corporations, at that
14 point, so I had a lot of experience. TWA was an
15 example, Pan Am, there are a whole series of them, LTD
16 Steel, so I had a lot of experience on working with
17 financial markets. And in my professional judgment,
18 it was necessary.

19 Now, I would have loved to have more
20 capital. I would have loved to have countercyclical
21 capital in the structure so that they would have had
22 the capital at that point to do what was necessary.
23 They didn't so they had to raise it.

24 VICE CHAIRMAN THOMAS: Mr. Chairman, full
25 disclosure, I worked with Mr. Lockhart on the PBGC, in

1 a number of ways, and we wound up finally, I think,
2 rewriting the structure which allows corporations to
3 not short commitments that they make.

4 But it would have been useful to have
5 capital at an earlier time. I believe your testimony
6 and others clearly indicate there was great resistance
7 because you'd have to go through Congress to achieve
8 that, and we've heard from Mr. Falcon's testimony,
9 Mr. Falcon's testimony that there was constant
10 pressure from Congress.

11 And I just want to reaffirm the argument
12 that that sounds a whole lot more like the Washington
13 that I was in for three decades, especially when they
14 have the ability to communicate to you through the
15 appropriations process.

16 Thank you, Mr. Chairman.

17 CHAIRMAN ANGELIDES: All right. I'm --
18 let's do this; I'm going to defer for a moment.
19 Ms. Murren?

20 COMMISSIONER MURREN: Thank you.

21 EXAMINATION BY COMMISSIONER MURREN

22 COMMISSIONER MURREN: And thanks to you
23 both for being here today and for your testimony.

24 I have, in an interest of looking more
25 broadly at the regulatory processes, and the framework

1 that really are the -- the basis for which
2 shareholders and taxpayers rely on the ability for the
3 financial systems to be transparent.

4 I'm interested in the -- in some instances
5 in the mechanics and the practical realities of that,
6 so I would like to ask a couple questions to begin
7 with on your daily interactions with the people or
8 that of your staff at Fannie Mae.

9 And the way you described the relationship,
10 obviously, is it seems very tense, certainly at the
11 senior levels.

12 Could you talk a little bit about whether
13 that type of tension was also evident when you carried
14 out or when your staff carried out their daily duties
15 in interacting with the line staff there? Maybe if
16 you could each comment on it?

17 MR. FALCON: On the -- sorry -- on the
18 daily the level, there's much interaction between the
19 examination staffs, research staffs, legal staffs,
20 basically there's a lot of interaction down at the
21 staff level of both entities.

22 Part of my responsibility as leading the
23 agency is to try to make sure the people in the agency
24 had what they needed to do their jobs properly. And
25 so I was often in the position of seeing deficiencies

1 with our structure and funding.

2 So taking the responsibility, as the head
3 of the agency, to try to seek broader policy changes
4 to help the agency.

5 And -- and those were certainly in the
6 realm of what I tried to accomplish, among other
7 things at the agency, and there were tensions. And
8 there were tensions between the senior executives and
9 myself and my senior staff on those issues, I wouldn't
10 say that that filtered down below us to the people
11 doing their day -- their job day-in and day-out at the
12 agency.

13 COMMISSIONER MURREN: Would you say that
14 the people that worked for you found that when they
15 reached out to their counterparts at the company that
16 they were -- they found that there was a cooperative
17 mindset on the other side? In other words, did this
18 sort of resistance that you described filter down to
19 the lower ranks over at Fannie Mae?

20 MR. FALCON: I think, yes, many times we
21 did have difficulties in the lower ranks, as well. I
22 recall one of the early meetings with my staff, and it
23 was an issue of we needed some data, and I was told
24 that it would be difficult to get the data because we
25 would get resistance from the companies.

1 We had another pending request, and they
2 didn't like to have two requests at the same time, and
3 then so they said we don't know if we can deal with
4 this now.

5 So there was these all sorts of, at the
6 staff level, these cultural problems. And so I had to
7 try to change all of that and I insisted to my staff
8 that go make this request; we're going to get this
9 data; if they had to assign more people to the
10 agencies reporting these, they need to do so.

11 But at the very beginning there was always
12 a very deep relationship issue about the agency not
13 having problems getting full cooperation out of the
14 companies on something as minimal as a data request,
15 and that had to change.

16 MR. LOCKHART: From my standpoint we
17 actually put a lot of that into the consent agreement.
18 And so we actually wrote it in that they had to
19 cooperate. They had to change their tone at the top.

20 And we really worked hard with the board
21 and the management team do that, and they did actually
22 make progress on a lot of that over that period. In
23 fact, they really, by the end of the period, actually
24 had complied with the consent agreement.

25 There always has to be some tension between

1 a regulator and a regulatee. And in this situation,
2 where you had the two firms that couldn't produce
3 financial statements on a timely basis, that didn't
4 have good internal controls, you had have a regulator
5 that was in there all the time, working with them,
6 trying to fix the problems.

7 On the staff level, the cooperation was
8 good. I would have meetings with, you know, quite a
9 few of their people, down three or four levels,
10 occasionally, on a topic. And I always found it
11 cooperative, you know. Occasionally there was an
12 issue that we just disagreed on and we couldn't come
13 to an agreement on, but the key thing, to me, was that
14 we had to have a professional approach and my team
15 really did.

16 COMMISSIONER MURREN: So would it be fair
17 to say, then, that sometimes if the response that you
18 get from one of these entities that you supervise or
19 that you're requesting data or information from that
20 says, gosh, the nature of your request is too vague or
21 it's just too much for us to do in a particular
22 timeframe, that really that reflects a resistance at
23 the top to the work that they're doing in producing
24 this information?

25 MR. FALCON: I think there was that

1 resistance, as I pointed out. Now, the agencies that
2 I was dealing with were much different than the
3 agencies that Director Lockhart had to deal with by
4 the time he came into the office.

5 So perhaps he didn't encounter the same
6 kind of issues that I had at the time that I was
7 director of the agency but we did have those problems.

8 MR. LOCKHART: I think that's right. I
9 think it changed somewhat because of the consent
10 agreement, because of all their problems. You know,
11 there's still arrogance at that company and, you know,
12 certainly their fighting of legislation over that
13 period was probably the worst set of arrogance and the
14 biggest mistake that they made.

15 COMMISSIONER MURREN: Generally speaking,
16 how did you convey any concerns that you might have to
17 the management of Fannie Mae? Was everything
18 documented or did you attempt to have an oral
19 discussion beforehand, before you would send an e-mail
20 or a formal document?

21 MR. LOCKHART: From my standpoint, I was
22 meeting with the CEOs monthly. And in those
23 conversations, we tended to have very frank
24 conversations about what the key issues was, were. I
25 would give them some heads up on some examination

1 reports that were about ready to put out and really
2 try to work with them to, you know, help move the
3 organizations ahead.

4 You know, at the time we were there, Fannie
5 Mae probably had 5,000 employees and maybe two or
6 three thousand consultants trying to fix their
7 problems. It was a major, major problem with those
8 companies. And so we were all working to try to fix
9 those operational and financial and accounting
10 problems.

11 COMMISSIONER MURREN: And you both
12 mentioned the fact that you felt that your own
13 resources and your ability to manage this was -- it
14 was less than ideal. You didn't have, necessarily,
15 the greatest amount of resources to be able to address
16 the problems that you just described.

17 How, then, did you allocate your resources?
18 How did you think about the way that you would take
19 what was fairly precious and make sure that it was
20 allocated properly to be able to perform the duties
21 with which you had been entrusted?

22 MR. FALCON: I think you prioritize. And
23 that's a painful process. When you have a list of
24 many priorities, and all very important to fulfilling
25 your mission, and you realize that you can only fund a

1 handful of them, it's not an easy thing to do, but you
2 have to prioritize and hope that you can at least give
3 some amount of coverage to the other issues. While
4 not in the same depth as others, you try to stretch
5 your resources as thin as you can.

6 MR. LOCKHART: We were -- had less problem
7 with resources because Director Falcon had made such a
8 big issue of it that Congress had backed down and we
9 were getting our requests through.

10 The real problem with us was every
11 September there was a freeze. And so you go through
12 three or four months. So you can never build up to
13 the staff level you wanted.

14 And -- but we set priorities. We put the
15 resources on the examination side as much as we could.
16 But we also had a capital team. We had the risk-based
17 capital model team. There was a lot of things that
18 need to be improved in the company at that point, the
19 companies.

20 COMMISSIONER MURREN: This is the final
21 question, and in reading your testimony and listening
22 to what you have to say, it sounds as though this
23 doesn't sound like an especially enjoyable position to
24 be in. It sounds like there was an enormous amount of
25 pressure.

1 Can you talk about, why did you continue to
2 do what you were doing? A lot of people, I don't
3 know, would have made that same decision.

4 MR. FALCON: Well, in my case, I had worked
5 for the House Banking Committee under Chairman Henry
6 Gonzalez for eight years. And I was at the committee
7 when the law creating OFHEO was enacted and understood
8 the motivation behind it following the savings and
9 loan crisis.

10 So I did understand and believe in the
11 agency's mission and why it was created. So the
12 agency was struggling at the time that I -- I was
13 approached about running this agency.

14 And given my background with the banking
15 committee, I thought here's an opportunity to take
16 on a challenge and try to help build this agency and
17 help it fulfill its mission, because it was struggling
18 very much. And so it was a challenge and it was
19 something that I believed in because of why it was
20 created.

21 COMMISSIONER MURREN: And you?

22 MR. LOCKHART: Well, I would -- I would
23 echo that. This is sort of my third major job in the
24 government, and -- but I'm really from the private
25 sector.

1 And each time it was a challenge, PBGC,
2 Social Security, and OFHEO. And certainly, you know,
3 the housing market is so important to the U.S.
4 economy, and Fannie and Freddie were so important to
5 the U.S. economy, and they were struggling at that
6 point, that I seized the challenge.

7 Sometimes it was fun, sometimes it was very
8 difficult but, you know, we made progress until the
9 housing market just fell apart.

10 COMMISSIONER MURREN: Thank you. I am -- I
11 cede my time.

12 CHAIRMAN ANGELIDES: Thank you, Ms. Murren.

13 EXAMINATION BY CHAIRMAN ANGELIDES

14 CHAIRMAN ANGELIDES: I'm actually going to
15 take the opportunity, now, to ask a set of questions,
16 because I want to -- I want to build on a line of
17 questioning that Mr. Thomas engaged in with you.

18 And I really want to, I think, set a
19 context here. It's March of 2008, obviously the
20 housing markets are in substantial trouble, Bear
21 Stearns has collapsed, and I think it's fair to say
22 that liquidities drying up in the housing market
23 dramatically.

24 So there is a big challenge posed here of
25 the safety and soundness and solvency of these

1 corporations, and then, obviously, liquidity, a larger
2 mission, in the sense that there's probably no time
3 when this dual mission clashes or it comes together so
4 dramatically.

5 MR. LOCKHART: Well, it clashed and it
6 didn't clash. Because they were sitting on 5 trillion
7 dollars in mortgages. And if we couldn't stabilize
8 that mortgage market, the safety and soundness was not
9 going to work. I mean, basically, they were going to
10 fall if we couldn't stabilize the mortgage market. So
11 it was a tightrope we were walking.

12 CHAIRMAN ANGELIDES: All right. So I do
13 want to ask you a couple more questions about this.

14 You know, Mr. Thomas laid out a timeline,
15 and he referenced, on March 17th, a press release that
16 was proposed. And then there was one other item. You
17 actually did respond to that first draft press
18 release, and I just want to get your thinking, because
19 you're there on the ground, and I will have a
20 follow-up. When you responded, I think on March 17th,
21 to Mr. Mudd, who sent you a draft press release, and I
22 believe there was a quote where you -- they have
23 proposed a quote for you, that said, let me be clear,
24 both companies are well capitalized and have adequate
25 reserves.

1 They also have quote for Secretary Paulson,
2 which is -- these are draft quotes, it is important
3 that the housing GSE step-up to provide liquidity in
4 the critical mortgage markets. They must be a key
5 part of the solution.

6 You wrote back, say it at first read appears that
7 OFHEO is being asked to be first, last, and only with
8 no firm commitment by the GSEs, and that's in
9 brackets, to raise capital. And the idea, quotes,
10 strikes me as perverse as it assumes it would seem
11 perverse to the markets that a regulator would agree
12 to allow a regulatee to increase its very high
13 mortgage credit risk leverage, not to mention
14 increasing interest rate risk, without any new
15 capital.

16 We seem to have gone from 2 to 1 right
17 through to 1 to 1 and zero to 1. Obviously you are
18 not comfortable with this. Now a press release is
19 issued two days later, your quote has changed to --
20 let me be clear, both companies have prudent questions
21 above the OFHEO directed capital requirements and
22 they'll increase their reserves.

23 I'm just trying to probe to see, as a
24 regulator, what kind of pressures you were under and
25 how you're balancing out this need for national

1 liquidity with obviously some pretty grave concerns
2 you have about the conditions of these GS -- of these
3 two entities, Fannie and Freddie, and then I have a
4 larger follow-up question.

5 MR. LOCKHART: Well, it was definitely a
6 balancing act, but that press release you quote was a
7 draft one and did not reflect the deal that we had
8 cut, and that's why I responded the way I did.

9 I mean, they had to commit to raise
10 capital. That's the only way we would have ever
11 lowered that capital requirement, failing them,
12 meaning the consent agreement requirements, which was
13 actually the test for the whole 30 percent to come
14 off.

15 So, from our standpoint --

16 CHAIRMAN ANGELIDES: Can I ask you a
17 question on that, Mr. Lockhart?

18 The ultimate deal or transaction or
19 agreement was that you would lower the capital
20 standard for Fannie in exchange for their willingness
21 to raise or their commitment to raise new capital,
22 right, and Freddie? Was there any capital relief
23 without a money raise?

24 MR. LOCKHART: There was a -- went from 30
25 percent to 20 percent, without the money raise, but

1 with a promise from the board of directors that they
2 would do it.

3 CHAIRMAN ANGELIDES: So for both of them,
4 it was a commitment and Fannie Mae fulfilled its
5 commitment, Freddie Mac did not; correct?

6 MR. LOCKHART: Exactly.

7 CHAIRMAN ANGELIDES: Okay. But go ahead, I
8 interrupted you.

9 MR. LOCKHART: So I mean, from my
10 standpoint, what we were trying to do, as I said
11 before, is to stabilize the mortgage market, stabilize
12 the two firms, and the only way we felt we could do
13 that was to get them to raise significant capital and
14 also agree to keep capital well above the minimum
15 levels.

16 And they did do that, and so -- they did
17 agree to it -- and so that's the reason we lowered
18 from 30 to 20 percent.

19 CHAIRMAN ANGELIDES: So in the large
20 picture, here's what I'm trying to understand. So
21 it's March of 2008, was the view -- because obviously
22 you're a participant, was the view of the depth of the
23 crisis in subprime lending at this point was that it
24 would stabilize?

25 Because if you viewed it would stabilize --

1 I guess I understand this transaction the hope was it
2 would, at which point you've lowered capital, I mean,
3 in normal circumstances, as Mr. Thomas said, a normal
4 business may have acted differently. They probably
5 wouldn't be lowering capital, moving into the breach
6 like this. In fact, everyone else was retreating.

7 MR. LOCKHART: Well, they didn't lower
8 capital. I mean, we lowered the standard but, in
9 fact, at the end of the period Fannie actually still
10 had 30 percent, more than 30 percent extra capital.

11 We lowered their requirement but the
12 capital really did not come down because they actually
13 raised more capital.

14 CHAIRMAN ANGELIDES: In terms of real
15 capital?

16 MR. LOCKHART: Yes.

17 CHAIRMAN ANGELIDES: Freddie?

18 MR. LOCKHART: Freddie's capital came down.
19 They were still above the 20 percent limit at the
20 period, probably about 25 percent.

21 CHAIRMAN ANGELIDES: Okay. But was the
22 view at that time that we think this market will
23 stabilize, this makes sense, or was it also the view
24 that perhaps what would happen, at this time, is there
25 was an acknowledgment that at some point, at some

1 point these institutions might have to be seized?

2 MR. LOCKHART: Well, we were hoping to
3 stabilize the mortgage market, there's no doubt about
4 it. We did not, you know, have, assuredly, that we
5 were going to do it, and -- but we felt the
6 combination of the Bear Stearns trend, purchase by
7 J.P. Morgan, and this would help stabilize the markets
8 and we might be able to get through it. It didn't
9 work, as we all know.

10 CHAIRMAN ANGELIDES: All right. Couple of
11 other quick questions, just about -- about your
12 reviews.

13 You did mention you noticed credit risk in
14 2006. Did you note credit -- and -- but, at the time,
15 I think you had said there's credit risk but I think
16 you felt reasonable. Is this a fair interpretation
17 about the quality of the assets?

18 I think, at that time, high-risk loans were
19 about 20 percent of the book, but they were still
20 pretty darn substantial in terms of percentage of
21 capital, you know. For Alt-A loans, they were 750
22 percent of capital.

23 You know, they were -- the amount of
24 high-risk loans were anywhere from, you know, 500 to a
25 thousand percent of capital depending on the category.

1 They were very substantial.

2 In 2007 and early 2008, at least my
3 recollection is, you didn't focus much on credit risk.
4 I guess my larger question is, you said you didn't do
5 it enough. Looking back on it do you feel like OFHEO
6 missed the depth of the credit risk?

7 MR. LOCKHART: We started a task force in
8 2007, a unified task force of Freddie and Fannie
9 examiners, the credit teams to look at credit, and we
10 were continually working with the companies, looking
11 at their credit risk models, and -- and -- and
12 continuing to look at -- take a look at the credit
13 risk and those private label mortgage-backed
14 securities that, you know, Freddie was the biggest
15 buyer of those securities by far; Fannie was the
16 second biggest buyer.

17 So we spent a lot of time on the credit
18 risks in those books. We forced them to take, other
19 than temporary impairments, we proposed a new approach
20 to that, so we were focused on credit risk.

21 You know, I think the failure was a failure
22 that no one understood how bad it was going to be.
23 You know, the models, whether they were the rating
24 agency models, the Wall Street models, Fannie and
25 Freddie's models or our models never really got that

1 really downside in the models. And we really did not
2 forecast what happened.

3 CHAIRMAN ANGELIDES: All right. Did you
4 ever -- did you ever ask them to cut back on their
5 level of high-risk lending? Did you ever weigh in and
6 say, enough is enough here?

7 MR. LOCKHART: We -- we did ask them,
8 obviously, to freeze their portfolios and --

9 CHAIRMAN ANGELIDES: A total cap, right?

10 MR. LOCKHART: Right. And that really
11 stopped a lot of the private labels securities. We
12 certainly looked at their, Fannie's, expended authority.
13 And my examiners were always talking to them and
14 asking them and probing them to try to slow it down.

15 CHAIRMAN ANGELIDES: In writing or --

16 MR. LOCKHART: Probably mainly verbally.
17 There were some reports though.

18 CHAIRMAN ANGELIDES: Because one thing that
19 strikes me is the language of the conservatorship
20 memo.

21 MR. LOCKHART: Right.

22 CHAIRMAN ANGELIDES: I think the memo from
23 Mr. Dickerson to you; is that correct?

24 MR. LOCKHART: That's correct.

25 CHAIRMAN ANGELIDES: Is -- it's pretty

1 dramatic. I mean, it's very stark and it doesn't
2 quite comport with the other examinations I see along
3 the way.

4 MR. LOCKHART: Well, as you heard Mr. Mudd
5 say, there wasn't anything new in that report. He
6 knew it all. I think that's what he said this
7 morning.

8 What we did was we compiled it all, because
9 what we were trying to do is make a case to the board
10 of directors that they had to voluntarily agree to a
11 consent agreement. We wanted that to happen rather
12 than have the regulator have to do it and all the
13 nasty lawsuits that might happen.

14 So we made a -- you know, we pulled it all
15 together to make a very strong case so that the board
16 of directors did not have a choice.

17 CHAIRMAN ANGELIDES: All right.
18 Mr. Falcon, last question before I moved to
19 Mr. Georgiou.

20 What did you see in terms of the ramp-up
21 of -- why did each of you, just very quickly, why did
22 you see Fannie, in particular, moving into the
23 subprime breach? Competitive pressure?

24 I mean, if you were to weigh these on a
25 scale, competitive pressures, affordable housing

1 goals, what were the driving forces, profit,
2 compet- -- you said profit?

3 MR. FALCON: In my opinion, I think the --
4 it was driven by a desire to once again regain their
5 dominance in the market and to try to increase
6 profitability to what it had been in its heyday. And
7 given this is where the market's going this is where
8 they thought they had to go to try to achieve that.

9 CHAIRMAN ANGELIDES: All right.

10 MR. LOCKHART: From my standpoint it was
11 really a combination, partially because those goals
12 had increased so rapidly over the period since
13 Director Falcon had left.

14 And the 55 percent goal almost is
15 mathematically impossible. So that drove them a lot
16 to hit that mission goal. And partially it was HUD
17 could put them on a consent agreement. But I think
18 also importantly, it would have incurred the wrath of
19 Congress if they had missed their goals.

20 Profit was very important to them and
21 market share was very important to them, so it was
22 really all three.

23 CHAIRMAN ANGELIDES: It was the trifecta,
24 in your view?

25 MR. LOCKHART: Yes.

1 CHAIRMAN ANGELIDES: Did you ever call
2 these loans -- in your conservatorship memo, you
3 referred to the high-risk loans as imprudent, unsafe,
4 and unsound.

5 Prior to September, did you ever flatly
6 just say, this stuff is beyond the level of risks we
7 should be taking?

8 MR. LOCKHART: Certainly we talked about
9 some of those loans over time. Whether we put it in
10 writing or not, I have been away too long and I
11 haven't been able to see the papers.

12 CHAIRMAN ANGELIDES: All right. We may
13 follow up and ask you further questions on it.
14 Mr. Georgiou?

15 COMMISSIONER GEORGIU: Thank you,
16 Mr. Chairman.

17 EXAMINATION BY COMMISSIONER GEORGIU

18 COMMISSIONER GEORGIU: And thank you
19 gentlemen for joining us this afternoon.

20 I want to ask you a provocative question,
21 right out -- out of the box here. And I'm giving you
22 a little warning.

23 As of 12/31/09, these two
24 government-sponsored enterprises cost the taxpayers
25 111 billion dollars. And in the first quarter of '10

1 another 15.1 from Fannie. And I'm not sure what the
2 number is for Freddie, so it's at least 126 billion
3 dollars.

4 Given your perspectives on the
5 circumstances, can you give us any estimate on how
6 much money ultimately the taxpayers will have to pay
7 to -- to back up the losses that were suffered by
8 these -- that will be suffered by these two agencies?

9 MR. LOCKHART: The losses will be
10 significantly more than that -- what -- what we'll
11 see, actually, is because the way Fannie and Freddie
12 had their investment portfolios and their -- actually
13 how they got to their affordable housing goals were
14 quite different.

15 And also because Fannie is about a third
16 larger than Freddie, that we'll see continually higher
17 losses at Fannie and Freddie for a while.

18 So I would think over the next year we'll
19 see significantly higher losses, and then hopefully it
20 will trail off.

21 COMMISSIONER GEORGIU: Can you give me any
22 estimate?

23 MR. LOCKHART: I've been away too long.
24 You know, I can give you a two-year-old estimate but I
25 don't think that would be very relevant today.

1 A lot of it really depends on what happens
2 to the mortgage market. If we can stabilize the
3 mortgage market, if we can prevent foreclosures, that
4 will have a pretty dramatic impact on how big the
5 losses will be to the taxpayers.

6 COMMISSIONER GEORGIOU: It doesn't appear
7 that we are really preventing foreclosures now, does
8 it?

9 MR. LOCKHART: The administration has the
10 HAMP program and, you know, it's starting to take some
11 traction, but it was slower than anybody wanted. It's
12 going to take time. I mean, it's -- it's -- it's --
13 there is going to be many million more foreclosures.

14 COMMISSIONER GEORGIOU: Okay. Do you want
15 to hazard a guess, Mr. Falcon?

16 MR. FALCON: I don't. I can't give you an
17 estimate of what I think the number would be, but
18 obviously one dollar is too much. I think it's
19 unconscionable.

20 COMMISSIONER GEORGIOU: And 126 billion is
21 126 billion more too much than a dollar, but do you
22 have any thoughts?

23 MR. FALCON: I think it will go up. I
24 think the trend in the prime book certainly indicates
25 that given that it's a much bigger pool of assets than

1 the subprime and the Alt-A pool, the trends in the
2 sub -- and the prime assets they have are showing
3 deterioration.

4 So it may be one indication for people on
5 the inside was when Treasury decided to lift the
6 200-billion-dollar cap on capital assistance to both
7 companies. Perhaps that was their statement of
8 concern or that it could go over that amount.

9 COMMISSIONER GEORGIU: Right. Okay. Let
10 me -- and then I want to try to go back to what you
11 each tried to do, respectively, to beef up the capital
12 of these institutions during your respective tenure as
13 the head of the regulator.

14 Mr. Falcon, could you outline what you
15 tried to do and what you were basically prevented from
16 doing in that regard?

17 MR. FALCON: Well, we -- the capital
18 standards are hardwired in the legislation. It's 2
19 and a half percent on balance sheet, 45 basis points
20 off-balance-sheet. And that minimum capital
21 requirement didn't give us discretion to increase it
22 in any way.

23 So we, from the very beginning, we sought
24 the flexibility in statute, just the same kind of
25 authority that every other safety and soundness

1 regulator had to have full discretion to raise that
2 amount if we thought it was necessary.

3 We could never get that authority. And as
4 I said in my testimony, finally we -- after the
5 accounting scandals, we were able to get the companies
6 to agree to holding a 30 percent capital cushion in
7 reaction to that. That wasn't based on any clear
8 statutory authority, but they agreed to it and so we
9 did it.

10 COMMISSIONER GEORGIU: Okay.

11 Mr. Lockhart?

12 MR. LOCKHART: Well, certainly what we
13 tried to do is we had a very large campaign going
14 really basically to make it clear to everybody that
15 their capital was too low. And we worked to get
16 legislation. And so that was probably the key thing
17 because it was hardwired into the legislation.

18 We did work somewhat on the risk cap, base
19 capital models, to try to strengthen that, but
20 unfortunately the legislation that built that was too
21 weak as well. So we really didn't have a good tool
22 and which we kept telling Congress repeatedly. And,
23 unfortunately, you know, by the time the law passed in
24 July 30th, 2008, it was much too late.

25 COMMISSIONER GEORGIU: Right. And, of

1 course, at that point it would be almost impossible to
2 raise the capital under these circumstances.

3 MR. LOCKHART: Yeah, it would have been
4 impossible even to put a new regulation in place. You
5 know, it would probably would have taken six months to
6 a year.

7 COMMISSIONER GEORGIU: Right.

8 MR. LOCKHART: To even do it, so, I mean,
9 you know, it was much too late.

10 COMMISSIONER GEORGIU: And you took them
11 over, too, a couple months later, after that?

12 MR. LOCKHART: Yeah.

13 COMMISSIONER GEORGIU: Did -- did you ever
14 have any issues of capital arbitrage in com- -- when
15 things were moved off-balance-sheet to have the
16 reduced capital associated with off-balance-sheet as
17 opposed to on balance sheet treatment, Mr. Falcon?

18 MR. FALCON: I think, at one point the
19 enterprises would come to us with some novel ideas
20 about treating some new kind of product as capitalist,
21 Tier 1 capital, and they wanted us to -- I guess they
22 were sold some innovation about how to better receive
23 more return on their capital. And they wanted us to
24 be able to count that as core capital.

25 I think that would have diluted the quality

1 of core capital. If we had agreement to do that, so
2 we always told them no. But they were coming to us
3 with ideas on some innovative kind of products that
4 should be counted as capital. And we never agreed to
5 it.

6 MR. LOCKHART: They really didn't, despite
7 what you may have heard, they really never thought
8 that they didn't have enough capital.

9 And in my experience, they could have very
10 easily raised capital by -- they had 700, 800 billion
11 of their own mortgage-backed securities on their
12 portfolios.

13 COMMISSIONER GEORGIU: Right.

14 MR. LOCKHART: Two and a half percent, they
15 could have reduced their capital requirement by 80
16 percent by selling them.

17 COMMISSIONER GEORGIU: Exactly.

18 MR. LOCKHART: So they had the ability they
19 just didn't do it.

20 COMMISSIONER GEORGIU: Right. And -- but
21 if you keep them on and they're earning -- and they're
22 earning a nice spread --

23 MR. LOCKHART: Right.

24 COMMISSIONER GEORGIU: -- if you're
25 getting credit at a government -- this effectively

1 government-guaranteed rate, you're making a nice
2 spread, then you're making more profit, more earnings
3 on the capital that you have, which then leads to
4 bigger bonuses, does it not?

5 MR. LOCKHART: That's certainly one way to
6 look at it, yes.

7 COMMISSIONER GEORGIU: Okay.

8 CHAIRMAN ANGELIDES: Mr. Vice Chair? Would
9 you mind if you yield?

10 COMMISSIONER GEORGIU: I would love to, I
11 invite the Vice Chair to enter.

12 VICE CHAIRMAN THOMAS: I was just trying to
13 figure out what the other one -- other one would be,
14 is all. It ran through my mind. I couldn't come up
15 with one.

16 CHAIRMAN ANGELIDES: Back on your time,
17 Mr. Georgiou.

18 COMMISSIONER GEORGIU: I think that would
19 be the main one, Mr. Vice Chair.

20 Let me go back, I want to ask you about a
21 few accounting issues, because both of these
22 institutions were, at one point in the past, cooking
23 their books, basically, or so they were found to have
24 done.

25 And I -- I -- I understand from your

1 testimony that part of the reason why you didn't have
2 the opportunity to evaluate credit risk as well as you
3 might otherwise have done is that you were spending a
4 lot of time cleaning up the appropriateness of the
5 accounting. Is that -- wasn't that your testimony,
6 Mr. Falcon?

7 MR. LOCKHART: I think that was my
8 testimony.

9 COMMISSIONER GEORGIU: I'm sorry,
10 Mr. Lockhart. I apologize.

11 MR. LOCKHART: What I was saying is that in
12 2006, that first six months I was there, we were so
13 focused on market risks and operational risks that we
14 were only starting to focus inasmuch as we should have
15 on credit risks. And we did set up a task force in
16 2007 to intentionally look at the credit risk.

17 COMMISSIONER GEORGIU: Right. Well, let
18 me just ask you about a few things that have been
19 brought to our staff's attention.

20 Fannie wasn't recording losses on
21 delinquent loans until they were 24 months delinquent;
22 is that correct?

23 MR. LOCKHART: Not entirely correct.

24 COMMISSIONER GEORGIU: Well, maybe you
25 could edify.

1 MR. LOCKHART: Let me try to explain what
2 happened.

3 Fannie, in their mortgage-backed
4 securities, when a loan became delinquent, they had
5 the option to take them out after 120 days and rework
6 them and modify them. But if they did that, then they
7 would have to write it down.

8 COMMISSIONER GEORGIU: Correct.

9 MR. LOCKHART: So they changed their
10 approach to leave them in the securities until they
11 had the modification ready. And that meant anywhere
12 from 120 days to 20 -- you know, two years. They --
13 they did not take that fair value cap. They still had
14 to look at them from a credit standpoint though.

15 COMMISSIONER GEORGIU: Right. But they
16 didn't have to mark down their books to recognize the
17 loss on that particular delinquent loan; is that
18 right?

19 MR. LOCKHART: That's how the accounting
20 worked. Actually, the accounting was changed this
21 year, so now they would have to do that.

22 COMMISSIONER GEORGIU: Right. And weren't
23 they also actually lending -- providing
24 uncollateralized loans to some of the people who were
25 delinquent to extend it and then treat it as -- treat

1 it as a performing loan to extend the deadline for its
2 recognition as a loss?

3 MR. LOCKHART: They had the HomeSaver, I
4 think it was called, HomeSaver Advantage Loan or
5 something like that.

6 COMMISSIONER GEORGIOU: Right.

7 MR. LOCKHART: Which was the idea that
8 oftentimes when you cure a loan, you just sort of wrap
9 up the principal and interest that hasn't been paid
10 back into the principal balance.

11 COMMISSIONER GEORGIOU: Right.

12 MR. LOCKHART: Instead of doing that, they
13 actually just took that amount and gave an unsecured
14 loan for it. They actually wrote those loans down to
15 probably 10 percent, because they knew they were not
16 going to get value for them.

17 COMMISSIONER GEORGIOU: They just wrote
18 down the advanced loan?

19 MR. LOCKHART: Right.

20 COMMISSIONER GEORGIOU: But they didn't
21 write down the underlying loan?

22 MR. LOCKHART: Until it looked like it
23 wasn't going to cure.

24 COMMISSIONER GEORGIOU: Right.

25 MR. LOCKHART: I mean, the idea was they

1 only did that if people were starting to make their
2 payments again.

3 COMMISSIONER GEORGIU: But those were
4 relatively modest loans that they treated as 10
5 percent.

6 MR. LOCKHART: Right, it was a process that
7 was delaying the inevitable. And we put a lot of
8 pressure on them to start modifying those loans more
9 realistically.

10 COMMISSIONER GEORGIU: Right.

11 MR. LOCKHART: And when they did start
12 modifying the loans more realistically, there was less
13 default.

14 COMMISSIONER GEORGIU: Right. Did you --
15 did you ever talk to the OCC or the Fed about this
16 practice, anybody, either of you? That would be you.

17 MR. LOCKHART: No, I did not. By the time
18 that the OCC and Fed came in in August of `08, I think
19 the practice may have been lessened. I can't remember
20 exactly. But certainly from our standpoint they wrote
21 down that unsecured loan to a value that we were
22 comfortable with.

23 COMMISSIONER GEORGIU: Okay. And the
24 practices, as you understand it, has been modified by
25 the legislation effective 1/1 of 2010?

1 MR. LOCKHART: The way that you account for
2 securities now, they're all on their balance sheet and
3 they have to account for them as if they were a loan.

4 COMMISSIONER GEORGIU: Right. Okay. Let
5 me ask you, let me turn, if I can, briefly, to this
6 lobbying business which everybody seems to think.

7 I take it this was an equal opportunity
8 bipartisan lobbying push over the years that Fannie
9 and Freddie were engaging in this practice?

10 I mean, that is, they were well-connected
11 people, who were either former legislators or former
12 staffers, and others, from both parties, who were
13 retained by these institutions to lobby. Would
14 you characterize it in that way, Mr. Falcon?

15 MR. FALCON: Yes, I would.

16 COMMISSIONER GEORGIU: Okay.

17 Mr. Lockhart, have you seen that?

18 MR. LOCKHART: Yes. They had big groups of
19 lobbyists on both sides of the aisle, yes.

20 COMMISSIONER GEORGIU: And were you -- did
21 you -- I mean, obviously, the experience that you had,
22 Mr. Falcon, in connection with your -- which the
23 announcement of your successor before there was any
24 vacancy certainly was an extreme example of -- of the
25 influence that was exercised, was it not?

1 MR. FALCON: Yes, it was one of the extreme
2 examples, absolutely.

3 COMMISSIONER GEORGIU: Can you tell us
4 about any other efforts that -- that were significant
5 by these two agencies?

6 MR. FALCON: At one point they -- they
7 worked hard to try to kill our risk-based capital
8 rule. And we designed a very detailed cash flow model
9 to come up with a risk-based capital requirement.

10 And while it was at OMB for review, they
11 worked very hard to try to kill it, and had OMB send
12 it back to us and promulgate a new rule that relied on
13 their own internal models for -- for setting
14 risk-based capital.

15 Ultimately that OMB rejected their
16 position, and we were able to get that rule out. But
17 they, at the peak of their political power, they
18 weren't shy about flexing their muscles on not just
19 big issues but small ones. They gave no quarter on
20 any issue.

21 COMMISSIONER GEORGIU: But, I mean, isn't
22 this a particularly egregious lobbying abuse in that
23 at least when the private sector is lobbying,
24 theoretically, if they are putting at risk their own
25 shareholder returns by spending lobbying -- advancing

1 lobbying expenditures which may or may not advance
2 their private interests.

3 But here you had effectively a taxpayer
4 buttressed two institutions, who were spending
5 taxpayer money to lobby the administrations and the
6 Congress, who were responsible for their oversight,
7 which ultimately rebounded back to the detriment of
8 the taxpayers themselves. I mean, it strikes me as
9 absolutely astonishing.

10 MR. FALCON: I think it is astonishing,
11 especially -- and, of course, we all respect an
12 individual's right to voice their opinion, but their
13 tactics frequently involved misinformation, character
14 attacks, questioning people's motives, just brutal
15 strong-arm tactics that none of us would think is
16 acceptable. I think that's what made it very
17 unseemly.

18 MR. LOCKHART: From our standpoint, as you
19 know, one of the first -- when we announced the
20 conservatorship, we closed the lobbying shops down.
21 We also had in our consent agreement --

22 CHAIRMAN ANGELIDES: Just hold it, I'm
23 going to add two -- how much time do you need?

24 COMMISSIONER GEORGIU: Thank you, that's
25 fine, that will be fine, two minutes will be fine.

1 MR. LOCKHART: In our consent agreement in
2 `06, we had them do a study of best practices for
3 lobbying and institute it. I think they instituted
4 most of it.

5 So where we saw the lobbying from our
6 standpoint was they drug their heels on the
7 legislation. They -- they -- and, you know, that was
8 a fatal flaw, as I said before. Also, in the summer
9 of `07 when they felt they could save the market,
10 they were lobbying very hard against us from a
11 standpoint that they wanted us to remove the portfolio
12 caps and also to lower the capital requirement and,
13 you know, we resisted it.

14 COMMISSIONER GEORGIU: But that's the
15 point that others had made as well, and I want to
16 reiterate.

17 Why would you go into a market that's
18 collapsing, that's presenting greater credit risk,
19 except for the purpose in the -- I'm talking in the
20 late stages, now, except for the purpose of
21 essentially making more and more money on the spreads
22 between your cost of capital, which is effectively
23 taxpayer subsidized, and the returns you can get in
24 the market?

25 MR. LOCKHART: To be fair, they actually

1 thought that they had the power to do it, I mean, they
2 used to quote to me long-term capital situation where
3 they came into the marketplace and stabilized it.
4 They thought that just their ability to come in there,
5 their big balance sheets, unfortunately they didn't
6 have the capital to go with those big balance sheets,
7 could stabilize the market.

8 And in summer of '07 it was really starting
9 to happen, so it wasn't at the end that they were
10 talking about this.

11 COMMISSIONER GEORGIU: And they were able
12 to postpone this legislation for almost two years,
13 were they not?

14 MR. LOCKHART: Oh, I think you could
15 probably go five years.

16 COMMISSIONER GEORGIU: Five years? Five
17 years?

18 VICE CHAIRMAN THOMAS: Four.

19 COMMISSIONER GEORGIU: Four years, well,
20 that's -- that's -- that's an awful long time. Okay,
21 thank you very much gentlemen. I appreciate it.

22 CHAIRMAN ANGELIDES: Thank you very much,
23 Mr. Georgiou. Mister -- yes, Mr. Holtz-Eakin. At the
24 end of three days, I was confusing myself.

25 COMMISSIONER HOLTZ-EAKIN: Thank you,

1 Mr. Chairman.

2 EXAMINATION BY COMMISSIONER HOLTZ-EAKIN

3 COMMISSIONER HOLTZ-EAKIN: And thank you,
4 both Mr. Falcon and Mr. Lockhart, for both your
5 service and coming here talk with us today.

6 I think this is of interest not just
7 because of the particular business model that these
8 institutions followed, which I have an openly failing
9 malignant opinion on, and I'll come back to that, but
10 also their role in the larger crisis, where their
11 failure occurred during that window, September 6th,
12 September 15th, when we saw the transmission of this
13 crisis from what was originally a housing and housing
14 mortgage-related event into a financial crisis that
15 spanned the breadth of all financial markets and
16 ultimately the economy, as a whole.

17 I wanted to ask you a couple of questions
18 about both. You know, I think today has been pretty
19 illustrative in painting a pictures of two
20 institutions who had that narrow housing
21 market-related product line that suffered from poor
22 internal controls, that had risk management systems
23 that were below the industry standard, that were
24 poorly capitalized.

25 And I guess my question is, if you have

1 institutions like that, how do they get so big,
2 Mr. Falcon?

3 MR. FALCON: Well, I think growth really
4 began in the late `80s, perhaps, as they began to build
5 their mortgage portfolios.

6 COMMISSIONER HOLTZ-EAKIN: How could they
7 do that given the flaws that both that OFHEO and
8 others have chronicled under your guidance?

9 MR. FALCON: Well, the growth in the
10 mortgage portfolios, as long as we -- we did not have
11 discretion to stop them from doing those mortgage
12 portfolios as long as they were hedging that risk of
13 those portfolios.

14 And so we paid very close attention to the
15 issues like their duration gap, as you understand.
16 And so -- but it was that growth of that portfolio
17 under ability just to earn the spread. So the more
18 they grew those portfolios the more spread -- profit
19 they made off of the spread.

20 COMMISSIONER HOLTZ-EAKIN: And they were
21 able to continue access credit markets despite these
22 poor characteristics and risky portfolios?

23 MR. FALCON: Well, until the bubble burst,
24 everyone was willing to buy their debt, whether it was
25 straight bullet debt or their mortgage-backed

1 securities.

2 MR. LOCKHART: They were -- had a Triple-A,
3 I talked to the rating agencies, asked them the exact
4 same questions actually, and their answer was that
5 they had such a large market, almost turning your
6 question on the head, they had such a large market
7 share that the Triple-A was very strong. And,
8 besides, the U.S. government had the implicit back
9 support because they couldn't let something that big
10 fail.

11 COMMISSIONER HOLTZ-EAKIN: Mr. Falcon, would
12 you agree that the -- the -- the implicit guarantee was
13 an important part of the business model?

14 MR. FALCON: Absolutely.

15 COMMISSIONER HOLTZ-EAKIN: The panel before you
16 disputed this, and I wanted to get you both on the
17 record in that regard.

18 MR. FALCON: Yes, sir.

19 COMMISSIONER HOLTZ-EAKIN: Was the large
20 portfolio part of their public service mission to
21 provide liquidity, and just that, as the panel argued
22 before?

23 MR. FALCON: I think they certainly tried
24 to argue that the portfolio was essential in order to
25 promote liquidity in their products.

1 COMMISSIONER HOLTZ-EAKIN: Is that the only
2 purpose it served?

3 MR. FALCON: There was -- it did serve
4 somewhat -- a very small portfolio, I think, was
5 essential basically to warehouse mortgage loans until
6 they were able to turn around and securitize them.

7 But for that kind of a function, they did
8 not have to grow anywhere near the size that they did.
9 I mean, the overwhelming amount of mortgages they held
10 in those portfolios were simply to earn that spread.

11 COMMISSIONER HOLTZ-EAKIN: Mr. Lockhart?

12 MR. LOCKHART: I would have to agree that
13 the portfolios didn't need to be anywhere near as
14 large. In retrospect they didn't need to buy those
15 private labeled securities, at all. And the reason
16 they did primarily was this spread and the affordable
17 housing goals, both.

18 The -- so my view is that the portfolios in
19 any going-forward structures should be minimal, if at
20 all.

21 COMMISSIONER HOLTZ-EAKIN: So we have these
22 fundamentally flawed institutions that are allowed to
23 become so large as to be systemically dangerous. Why
24 as the regulator did you not stop this?

25 MR. FALCON: We had bifurcation of mission

1 and safety and soundness regulation. HUD was not of
2 an opinion that the portfolios were improper. As
3 long as they were managing the risk of the duration
4 between their assets' liabilities in those
5 portfolios, we were not in a position to be able to
6 tell them no in that bifurcated oversight structure.

7 COMMISSIONER HOLTZ-EAKIN: And your own
8 records having said in many ways you tried to post
9 that?

10 VICE CHAIRMAN THOMAS: Yes.

11 COMMISSIONER HOLTZ-EAKIN: I stopped you.
12 Mr. Lockhart, do you agree?

13 MR. LOCKHART: We certainly leaned about --
14 against their growth in any way we could, dividends,
15 raising more capital. But the key thing, again, was
16 that the legislation wasn't there and we couldn't get
17 it through Congress to give us the power and
18 particularly the capital.

19 You know, we keep talking about the
20 portfolios, but in retrospect, the MBSs with only 45
21 basis points of capital was also a very tricky
22 situation, and certainly they've gone through that.

23 COMMISSIONER HOLTZ-EAKIN: So let me now
24 turn to the moment when the legislation actually
25 finally does pass. And in the course of the debate

1 over the hero legislation, Secretary Paulson says
2 something to the effect of, I, you know, want to have
3 a bazooka although I will never have to use it. And
4 then not long before conservatorship became the path,
5 I believe you, Mr. Lockhart, OFHEO, FHFA, at that
6 point, issued a letter saying they were well
7 capitalized; is that right?

8 MR. LOCKHART: I said that they were
9 legally adequately capitalized and they were.

10 COMMISSIONER HOLTZ-EAKIN: And why did you
11 send out that letter?

12 MR. LOCKHART: I'm not sure if it was a
13 letter or a public statement. Was it a letter? I
14 mean, I did say it.

15 COMMISSIONER HOLTZ-EAKIN: We can check.

16 MR. LOCKHART: But, either way -- oh, I
17 know what you're talking about.

18 COMMISSIONER HOLTZ-EAKIN: Yeah.

19 MR. LOCKHART: What you're talking about is
20 when we capitalized them, when we grade them every
21 quarter, we send off a preliminary letter that says
22 what we're going to capitalize, what we're going to
23 grade them at.

24 COMMISSIONER HOLTZ-EAKIN: I see.

25 MR. LOCKHART: And the numbers were that

1 they were adequately capitalized. I also said in that
2 letter, and this is a preliminary letter, that we had
3 the right to downgrade them so that we put them on
4 notice on that letter that we might downgrade them.

5 COMMISSIONER HOLTZ-EAKIN: And this was
6 August 22nd?

7 MR. LOCKHART: Right.

8 COMMISSIONER HOLTZ-EAKIN: That's a fair
9 characterization letter.

10 MR. LOCKHART: Right.

11 COMMISSIONER HOLTZ-EAKIN: My -- thank
12 you -- my question then, is, now, shortly thereafter
13 on September 6th, it is apparent that they are failing
14 and that they are a danger, when was this recognized?
15 Were you the first to recognize this?

16 MR. LOCKHART: We were working all through
17 August through that period. And we were particularly
18 looking at their reserves. But we were also looking
19 at the issue of the deferred tax asset, which was
20 allowed to count for capital, the other than temporary
21 impairments on the private label securities. We were
22 going through a whole exercise, with the help of the
23 Fed, the OCC and Treasury to look through it.

24 By August 22nd we -- we -- our view was
25 that it was going to be very difficult for them to

1 make it. But factually, they were adequately
2 capitalized based on the numbers that they put out in
3 early August.

4 COMMISSIONER HOLTZ-EAKIN: And I understand
5 that. I'm just trying to -- from the 22nd to the 6th,
6 somewhere in there the realization arise that this
7 can't go on, that realization that --

8 MR. LOCKHART: No, the realization happened
9 actually potentially before the 22nd.

10 COMMISSIONER HOLTZ-EAKIN: What I would
11 like to ask next is, you know, the decision's made,
12 they go into conservatorship, as lifetime participants
13 in financial markets and those quite expert in this
14 area, what is your estimate of the impact more broadly
15 of having these two institutions, which the Secretary
16 of Treasury has said he's got a bazooka but he's not
17 going to need to use it, and which have been
18 implicitly backed by the taxpayer, as part of their
19 business model, what is the market impact of seeing
20 them fail in this way?

21 MR. LOCKHART: My view is, at least for
22 that first week, before Lehman hit, it actually helped.
23 And you can see the spreads come in pretty
24 dramatically.

25 Certainly the foreign investors and their

1 securities, which were putting a lot of pressure --

2 COMMISSIONER HOLTZ-EAKIN: Helped the
3 securities of Fannie and Freddie?

4 MR. LOCKHART: Yes.

5 COMMISSIONER HOLTZ-EAKIN: And the markets,
6 more generally?

7 MR. LOCKHART: I can't make a judgment on
8 the markets more generally at that, but, you know,
9 there was some stabilization starting to occur and
10 then, you know, the Lehman weekend.

11 COMMISSIONER HOLTZ-EAKIN: And that would
12 be because the guarantees been hardened as hard as
13 even Bill Dudley could want?

14 MR. LOCKHART: Yeah, right.

15 COMMISSIONER HOLTZ-EAKIN: Mr. Falcon?

16 MR. FALCON: I would just concur with what
17 Director Lockhart said.

18 COMMISSIONER HOLTZ-EAKIN: Thank you,
19 Mr. Chair.

20 CHAIRMAN ANGELIDES: Can I just, I would
21 like to take a moment on my time to really just follow
22 up on this line of questioning, because I am struck,
23 and I don't know if -- I'm trying to get to the
24 essence of what happened here, is it a little --
25 remember when we were kids, they had these little toy

1 guns that would shoot out the darts that had the
2 little rubber tip; and whether you were in the
3 position of trying to bring down an elephant with one
4 of those or whether you were wrestling with a
5 mattress.

6 But, you know, in `05, `06, `07, there are
7 exams done. You mention in `07 there's a task force.
8 You do issue letters and I understand they are legally
9 capitalized, but it's not as though the alarm bells
10 are going off in very visible ways that danger is
11 coming.

12 And, you know, there is a little element
13 when the conservatorship occurs, and whether it's a
14 Claude Rains moment, I'm shocked, I'm shocked, there's
15 gambling going on here. I guess what I'm trying to
16 get to is that you didn't -- it just couldn't --
17 didn't frankly have the political heft to move this
18 ball or was -- what was happening at Fannie Mae and at
19 OFHEO much of what was happening, also on Wall Street,
20 which is that no one really calibrated the magnitude
21 of risks that had been taken.

22 It's just something that has been gnawing
23 at me. And when Mr. Holtz-Eakin asked those
24 questions, that's what I'm trying to drive at, which
25 is, of course, we're in that moment. What's the

1 essence of this story, from your perspective, each of
2 you?

3 MR. LOCKHART: My belief is we -- no one
4 had really calibrated the risk. And that risk and the
5 economy in the market just continued to deteriorate
6 from that March period we were talking about through
7 September, and just people lost faith in Fannie and
8 Freddie. There was a lot of speculation at that point
9 that they were insolvent.

10 There was a lot of articles written. There
11 was a new accounting principles announced that was
12 going to put all their mortgages-backed securities on
13 their balance sheet and people were afraid that their
14 capital requirement was going to be five times as
15 high.

16 There was just a lot of things happening
17 that really caused spreads to widen dramatically. In
18 August they couldn't borrow long anymore; they had to
19 borrow short. Everything started to pile up. Yes,
20 there was problems in `06 and `07 starting to build.
21 But by the summer of `08, it was obvious that they
22 couldn't make it in August.

23 CHAIRMAN ANGELIDES: I know you weren't around--

24 VICE CHAIRMAN THOMAS: Mr. Chairman, on this point--

25 CHAIRMAN ANGELIDES: Yes, absolutely, Mr.

1 Vice Chair.

2 VICE CHAIRMAN THOMAS: But the one thing that's really hard for
3 people to appreciate, for example, your reference to
4 Casablanca. He could say that with impunity in the
5 middle of the cafe because he was the authority.

6 When you've had the ability to control
7 Congress in producing legislation and -- and think
8 you've got a fallback, while others around you are
9 looking at the world as it falls apart, you're slow to
10 come to the realization that it's you too, because at
11 some point they're still thinking they've got this
12 reserve available to them which has always pulled them
13 out.

14 So even they, notwithstanding all the
15 market symbols, were looking at the world like they
16 normally looked at the world. They've got that in
17 their back pocket.

18 CHAIRMAN ANGELIDES: Well, I'll just ask, and I do
19 want to move on to the other members, but do you think
20 it was also this situation here? I mean, you pretty
21 much said you're on the scene. I'll probably just ask
22 you this, because you're an observer.

23 But -- so you really say, okay, very much
24 like much of the world didn't see the magnitude of
25 what had come, hadn't prepared in the right ways, but

1 perhaps this is exacerbated, as Mr. Thomas suggests,
2 by the company itself thinking at the end of the day
3 there is no downside because they -- do you think that
4 -- do you think that that exacerbated the situation,
5 the implicit, slash, explicit?

6 MR. LOCKHART: Well, I think they thought
7 there was a downside here. They, like everybody else,
8 didn't realize how big the downside was.

9 You know, another important thing is, when
10 you look back at it and you can only sort of do this
11 in retrospect, that I don't think we could have put
12 them in conservatorship before that legislation passed
13 on July 30th.

14 CHAIRMAN ANGELIDES: Legally.

15 MR. LOCKHART: We could have legally but
16 there would have been chaos. There was no FDIC to back
17 Fannie and Freddie. There was no money to back Fannie
18 and Freddie.

19 CHAIRMAN ANGELIDES: Well, I guess in May
20 they raised 7 billion. So I guess that's some market
21 indication that some people did believe that this
22 entity would survive? I assumed that --

23 MR. LOCKHART: Yes, absolutely.

24 CHAIRMAN ANGELIDES: Unless -- unless, and
25 this is not an accusation, unless the representations

1 made by the entity in doing the raise were not
2 accurate, to which I cannot speak nor would I allege.

3 MR. LOCKHART: They had sophisticated
4 investors. They were buying it. And they actually
5 exercised the Greenshoe. So they got the extra 15
6 percent too. So they had people that did believe, at
7 that point.

8 CHAIRMAN ANGELIDES: All right. Let's now
9 go now to Ms. Born.

10 COMMISSIONER BORN: Thank you. Thank you
11 very much.

12 EXAMINATION BY COMMISSIONER BORN

13 COMMISSIONER BORN: And thank you both for
14 appearing before us. And I personally would like to
15 thank both of you for the public service that you gave
16 the American people during your years as the director
17 of OFHEO in trying to do your best against very
18 powerful interests that were aligned against you.

19 I noticed that Mr. Falcon, you say in your
20 testimony, the Fannie and Freddie political machine
21 resisted any meaningful regulation using highly
22 improper tactics.

23 And I'd like to discuss how Fannie and
24 Freddie used their political power to resist
25 meaningful regulation.

1 You testified as to a number of steps that
2 they've taken, resisting reform legislation, for
3 example, which wasn't really put in place in a timely
4 fashion in order to save the organizations.

5 These institutions had an implicit
6 government guarantee. So they were benefitting
7 financially in their dealings in the marketplace from
8 that guarantee. They were getting very low-cost money
9 because of the guarantee. And they were then turning
10 around and putting an enormous amount of their
11 resources into making sure that there was really no
12 effective government oversight to protect the American
13 public.

14 I know that you were both doing the best
15 you could with the powers you had, but it raises a
16 question, in my mind, of this undue political power
17 that a financial institution can obtain and how it can
18 be used to resist the actions that government needs to
19 take to rein in excesses and to make sure the
20 institutions are safe.

21 I wonder how we can protect against this in
22 the future, and I would like each of your
23 observations. I'm sure because of your situations,
24 you have thought about this.

25 MR. FALCON: Thank you. Thank you very

1 much. I do feel strongly that we cannot go back to
2 any kind of model where you have a privately held and
3 publically traded stock company that has these kind of
4 government subsidies. I think that that kind of a
5 model is just prone to the abuses, as we saw with the
6 Fannie/Freddie.

7 And so if there's going to be any kind of
8 government subsidization or role in our housing
9 finance system going forward, I think it should be
10 with a clear separation of a government role by
11 entities fully -- being full government entities and
12 in the private sector and have any government subsidies
13 be through government entities and not through some
14 institution like Fannie Mae and Freddie Mac.

15 I think that's a very clear lesson.
16 Otherwise you do get the kind of abuses that we saw
17 with these two companies.

18 COMMISSIONER BORN: Mr. Lockhart?

19 MR. LOCKHART: Well, certainly the power
20 that they had, from the lobbying standpoint was abused
21 and abused a lot over the years.

22 The GSE models fought, it didn't work, and
23 it needs to be totally restructured. But I have to
24 tell you, I've also run some other government agencies
25 that the models were flawed over the years.

1 And that is a problem, you know, I mean,
2 you know, legislation can be a messy process and we
3 don't always get the best part of it, so I think we
4 need to take some of this and put it back into the
5 private sector.

6 At the moment, a hundred percent virtually
7 of our secondary mortgage market is in the government
8 sector. And we have to undo that and we have to get
9 the right incentives back into the marketplace.

10 There was no debt discipline for these two
11 companies. People didn't care that they couldn't put
12 out financial statements for five years. People
13 didn't care that, you know, they were starting to lose
14 money until the very end.

15 So we need to restructure the whole
16 mortgage market in this country. And that's where we
17 should start, what do we want the mortgage market to
18 look like, what do we want the new mortgage-backed
19 securities to look like. To me, that's critical, then
20 you decide the future of Fannie and Freddie.

21 COMMISSIONER BORN: I wonder if you have
22 any views as to whether this problem that you faced of
23 an institution that has government subsidies in
24 effect, government support, but ineffective government
25 regulation because of their political power has any

1 broader relevance to the financial services industry,
2 as a whole. You know, for example, banks get the
3 benefit of deposit insurance and other support by the
4 government.

5 Certainly they're getting a lot of support
6 now. And yet I think they, too, have been very ready
7 to spend resources on lobbying campaign contributions
8 through PACs and other activities that has given them,
9 over the last decade or so, a great deal of political
10 power in resisting regulation.

11 MR. FALCON: I think the difference with
12 the bank, the banking system and their regulation is
13 that if there were any flaws in the regulation of the
14 banking system, I would say it would -- whether there
15 are or not, I would say it is the result of policy
16 judgments made by regulators.

17 In the case of OFHEO, we didn't even have
18 the authority to make poor policy judgments. We were
19 forced to do the best we could with the authorities that
20 we had, I think that's a very key difference there.

21 COMMISSIONER BORN: Well, you certainly did
22 not have anything like the powers of a banking
23 regulator. And that you can't really be a safety and
24 soundness supervisor of an enormous financial
25 institution, like each of the GSEs were, without

1 significantly additional powers.

2 Mr. Lockhart, do you have any --

3 MR. LOCKHART: That's very true. You know
4 lobbying, per se, is not a bad profession to the
5 extent that they're informing members of Congress
6 about what's going on. What happened was that they
7 were using it to constrict what should have happened.
8 In the banking case, at least, the FDIC fund is
9 pre-funded, at least there's money there, and they've
10 already paid for some of the insurance.

11 In this case they're getting the implicit
12 guarantee for free, and the taxpayer was paying the
13 whole cost. But moving forward, again, the model's
14 flawed and we have to recreate something.

15 COMMISSIONER BORN: Mr. Lockhart, you
16 testified that the mortgage portfolios of Fannie Mae
17 and Freddie Mac were a concern because they posed
18 interest rate and prepayment risk and other risks.

19 And that those risks required an extensive
20 use of derivatives and that some officials, including
21 I think you said the Federal Reserve, Chairman
22 Greenspan, expressed concerns about the large
23 derivatives positions.

24 And I understand that Fannie and Freddie
25 held about 2.8 trillion dollars in notional amount of

1 derivatives during the summer of 2008, what were they
2 using these derivatives for?

3 MR. LOCKHART: They were hedging their
4 portfolios. And as interest rates started to
5 fluctuate pretty widely and especially the spreads
6 between their borrowing costs and treasuries, they really
7 beefed up the derivative activities. And they didn't
8 close them out, they just kept them in place. So the
9 would just do another derivative, replace the
10 derivative, and keep growing, growing.

11 Now historically they used to claim that
12 they used callable-debt, and they really didn't need a
13 lot of derivatives. As it turned out, they needed
14 them extensively.

15 They had very sophisticated risk managers
16 on the interest-rate side. And they tightly managed
17 that prepayment risk that Mr. Mudd talked about a lot.
18 And, you know, that -- that required very
19 sophisticated approach and lots of derivatives.

20 And we were concerned and we had market
21 risk teams that were all over them on what was going
22 there. But we were also concerned about the credit
23 risks as well as, you know, those derivative books
24 grew and grew.

25 COMMISSIONER BORN: Well, I was going to

1 ask you, were they adequately hedging their credit
2 risk?

3 CHAIRMAN ANGELIDES: Would you like a
4 couple more minutes, Ms. Born?

5 COMMISSIONER BORN: Please.

6 CHAIRMAN ANGELIDES: Two more minutes,
7 please.

8 MR. LOCKHART: They didn't hedge their
9 credit risks. And they didn't hedge their
10 counterparty risks. The only thing, as was mentioned,
11 they used mortgage insurance because, by law, they
12 couldn't make a loan, an 80 percent loan to value, so
13 they used mortgage insurance to cover up that gap.

14 COMMISSIONER BORN: So despite the fact
15 that they were hedging some of the risks in their
16 portfolios, the risk that really hit them the most,
17 credit risk, both on the underlying in the portfolio
18 and on the credit and on the derivatives part, were
19 not hedged, and that's where they suffered; correct?

20 MR. LOCKHART: Yes, that's where they
21 suffered. Whether they could -- they probably could
22 not have hedged a 5.5-trillion-dollar housing mortgage
23 credit risk. I mean, they -- you know, they
24 represented so much of the mortgage market, at that
25 point, it was probably not possible.

1 And as soon as they went into the market to
2 start hedging, they probably would have tanked the
3 whole market. So that they were in the position that
4 they, you know, they were too big to fail.

5 COMMISSIONER BORN: Well, there were 60
6 trillion dollars worth of credit default swaps out
7 there.

8 MR. LOCKHART: Right.

9 COMMISSIONER BORN: But even for that
10 enormous of market, this would have been a very
11 significant -- had a very significant impact.

12 MR. FALCON: Ma'am?

13 COMMISSIONER BORN: Thank you very much.
14 Yes, Mr. Falcon?

15 CHAIRMAN ANGELIDES: Do you have a comment,
16 Mr. Falcon?

17 MR. FALCON: I would just say that there's
18 one thing to hedge their credit risk, and that's to
19 hold more capital. They chose not to do that.

20 COMMISSIONER BORN: Good point. Thank you.

21 CHAIRMAN ANGELIDES: Mr. Hennessey?

22 COMMISSIONER HENNESSEY: Thank you,
23 Mr. Chairman.

24 EXAMINATION BY COMMISSIONER HENNESSEY

25 COMMISSIONER HENNESSEY: Mr. Lockhart, can

1 we talk a little bit about the failure of Fannie and
2 Freddie and, specifically, why you felt they had to be
3 put into conservatorship. In particular, could you
4 talk about what might have happened to mortgage
5 markets had you not done that and why you drew the
6 line with Secretary Paulson between equity and debt?

7 MR. LOCKHART: Okay, some good questions,
8 there.

9 We put them into conservatorship because we
10 felt and as we really laid out in those various
11 reports, which I think you all have seen copies of,
12 that their -- their capital was eroding extremely
13 quickly.

14 They -- we saw credit losses that were
15 significantly more than their capital. We saw that
16 the deferred tax asset was not going to be worth
17 anything. We saw that the low-income housing tax
18 credit would, therefore, not be worth anything,
19 because they're going to be losing money far into the
20 future, and that their private label securities were
21 really suffering badly.

22 COMMISSIONER HENNESSEY: So why not -- why
23 not just let them fail?

24 MR. LOCKHART: Why not let them fail?
25 Well, we felt that if we let them fail, that what

1 happened after Lehman would have been very small
2 compared to these 5.5-trillion-dollar institutions
3 failing.

4 So we felt that the best thing to do, and
5 we actually, you know, I've gotten some questions
6 about why conservatorship versus receivership, and we
7 made the decision, there were some legal reasons, but
8 I think also market reasons, we wanted to keep some
9 faith in those institutions.

10 And we had foreign sovereign governments in
11 their securities. We had a lot of the banks in this
12 country invested in their mortgage-backed securities
13 and their preferred stocks, which gets me to your
14 second question of where we drew the line on the
15 conservatorship.

16 One would have thought that we would have
17 let this subordinated debt go. And that's where I
18 thought we were going to do it.

19 The preferred stock and the common stock,
20 to my mind, if you're an equity owner and your
21 institution fails, you should lose it. And -- and
22 they're worthless at this point in my mind.

23 But the issue was the subordinated stock,
24 for many years people talked the subordinated stock as
25 being one of the --

1 COMMISSIONER HENNESSEY: Subordinated debt?

2 MR. LOCKHART: Debt, debt, yeah, sorry,
3 sorry. They had talked about subordinated debt as
4 sort of being a cushion and would actually give some
5 market discipline.

6 As we looked into the structure of that debt -- and
7 the intertwining with the law, if we had let that debt
8 go down, it would have defaulted all their debt, and
9 that would have pulled down the whole institution. So
10 we had to keep it in place.

11 COMMISSIONER HENNESSEY: Okay. Just a
12 follow-up on that, as I understand it, if I'm running
13 a bank, I cannot hold all of my assets in the debt of
14 IBM or General Motors or Caterpillar, right? There
15 are, as I understand it, there are banking rules, per
16 se?

17 MR. LOCKHART: 10 percent or whatever the
18 rule.

19 COMMISSIONER HENNESSEY: You can't put all
20 of your eggs into the -- into one basket where that
21 basket is the debt of a particular company, but the
22 same is not true for so-called agency debt; is that
23 correct?

24 MR. LOCKHART: Yes, agency debt, which I
25 never liked that term because they were not government

1 agencies, they were enterprises, that was treated very
2 much like Ginnie Mae debt, that had the full faith and
3 credit of the United States government on it, and they
4 had to hold very little capital against it, and
5 unfortunately, you know, some of the buyers of that
6 preferred stock were banks, and they took very -- they
7 took a hundred percent hit on it.

8 COMMISSIONER HENNESSEY: Okay. We talked a
9 lot about lobbying. Capital standards, minimum
10 capital standards, risk-based capital standards, and
11 then the ability to consider systemic risk in the size
12 of the portfolio.

13 Do you have knowledge of Fannie Mae and
14 Freddie Mac lobbying on any of those points, either
15 from a legislative standpoint or from a regulatory
16 standpoint?

17 MR. LOCKHART: I do not have direct
18 knowledge but I have indirect knowledge that they
19 certainly had people up on Capitol Hill talking
20 through the issues of legislation and the harm it
21 might do to the housing market.

22 COMMISSIONER HENNESSEY: Okay. Were you,
23 then, indirectly aware that they were lobbying against
24 you having the authority to raise capital standards
25 and against the authority for you to be able to

1 consider systemic risks?

2 MR. LOCKHART: In our monthly meetings with
3 the CEOs, we often talked about legislation, needless
4 to say. And certainly, to me, they resisted some of
5 those and especially the capital ones.

6 So as no doubt in my mind that if they were
7 resisting to me that they were probably resisting up
8 on Capitol Hill.

9 COMMISSIONER HENNESSEY: Okay. And
10 Mr. Falcon you were considered to be an aggressive
11 regulator when you were in this job but you were
12 limited in terms of the authorities that you had.

13 As you look at the legislation that was
14 enacted in 2008, which provided now FHFA with
15 significant authorities, can you give us a sense of
16 what you think you might have done with those
17 authorities had you had them in, say, 2004 and 2005?

18 Now, I know you have the benefit of
19 hindsight in knowing what happened, but based on the
20 kinds of things that you were pushing for, can you
21 give us a sense, had you had the ability to set
22 minimum capital, risk-based capital, even effect the
23 size of their portfolios? What do you believe would
24 have been consistent with your actions at the time?

25 MR. FALCON: Well, in the 2004-5 time

1 period, if we had those authorities, I think we would
2 have had more flexibility to deal with the capital
3 issues and try to deal with the leverage issue.

4 I think we would have moved towards having
5 them increase their capital, have a plan to increase
6 capital, even above the 30 percent that we had imposed on
7 them, we probably would have moved aggressively to
8 begin to shrink that portfolio, the portfolios that
9 both of them had, and we might have moved more
10 aggressively on even considering some form of a
11 conservatorship to deal with the cultural issues that
12 continued to exist at both companies.

13 COMMISSIONER HENNESSEY: Okay. If I could,
14 I would like to ask a couple of questions that I asked
15 Mr. Mudd this morning. The Alt-A mortgages that they
16 purchased in '05, '06, '07, do you believe that there
17 was a public purpose, a mission-related purchase for
18 those, or do you believe that they were primarily
19 driven by profit motives or market share? Jim?

20 MR. LOCKHART: Okay, sure, would be happy
21 to. The -- I would say it was both. They certainly
22 did not want to be left out of that segment of the
23 market. There was certainly a portion of them that
24 had mission affordable housing.

25 I'm not sure that on average that they met

1 the 55 percent. I would have guessed that there was
2 probably less than 55 percent of the Alt-A's that they
3 had that would have met the mission goals.

4 So the other piece was obviously the profit
5 component and the market share component. You know,
6 they were seeing some of their biggest suppliers go
7 elsewhere, to the private label marketplace or
8 whatever, and I think that they felt that they wanted
9 to be a player.

10 COMMISSIONER HENNESSEY: Okay. And
11 Mr. Mudd raised the issue, he seemed to be suggesting
12 that one of the reasons why Fannie failed was that
13 they were, in effect, a mono-line firm that lacked the
14 ability to diversify risk.

15 And I was asking, it seemed to me that a
16 more realistic explanation is that they didn't have
17 enough capital and they were poor at managing their
18 risks.

19 Can you each give us a sense of your
20 perspective on the mono-line argument that we heard
21 this morning?

22 MR. LOCKHART: Well, I'll start. First of
23 all, they were a mono-line insurance company. That's
24 really what they were, the mortgage-backed securities
25 they were insuring. They doubled up that risk, unlike

1 the other mono-line insurance companies, by having
2 giant portfolios. So they actually doubled up their
3 risk, and that was a problem.

4 But the key problem, they did not have
5 anywhere near as cap- -- capital -- enough capital as
6 they needed. And, in retrospect, I think we all
7 understand, and we talked about it today, that no one
8 understood how bad the mortgage market was going to
9 be.

10 When you really think about it, Congress,
11 when they set OFHEO up, only putting 45 basis points
12 of risk on mortgage credit risks, you just have to
13 scratch your head.

14 COMMISSIONER HENNESSEY: Mr. Falcon?

15 MR. FALCON: Yes, sir. I think that's a
16 convenient argument to make now. But throughout the
17 existence of these companies, they often touted about
18 how, in their opinion, they were the best risk
19 managers of any firm out there.

20 And to now say that they couldn't manage a
21 single risk, mono-line risk, I think is just contrary
22 to what they were saying.

23 The fact is that they had the ability to
24 control the risk that they took. They set their
25 underwriting standards. They didn't just buy whatever

1 their servicers sent to them. They set those
2 guidelines, themselves.

3 And if they had ability to better hedge
4 risk. They had ability to voluntarily hold more
5 capital if they thought that was essential to manage
6 their credit risks. They had the lowest cost of funds
7 of anyone in the private sector. I think this was
8 clearly a failure of management to properly run these
9 two companies.

10 COMMISSIONER HENNESSEY: Thank you,
11 Mr. Chairman.

12 CHAIRMAN ANGELIDES: Thank you,
13 Mr. Hennessey. By the way, the claim to be the best
14 risk manager in the world was a shared prize,
15 apparently, from what we've heard in our hearings
16 today. Yes, Mr. Thomas?

17 VICE CHAIRMAN THOMAS: Just quickly on the
18 follow-up to Mr. Falcon's last statement.

19 EXAMINATION BY VICE CHAIRMAN THOMAS

20 VICE CHAIRMAN THOMAS: You said that you
21 thought it was basically the management and their
22 failure to run the company properly. It depends on
23 the profile or the understanding or the assumed
24 purpose of the company. And if you're a private
25 company, in terms of profit and the argument about the

1 shareholders and the rest, I'm trying to see if you
2 could focus on the fact that they came to understand,
3 for them, the basic value and purpose of the company.

4 And in that score, notwithstanding their
5 failure, they really did a pretty good job of managing
6 it up until it became, as with everything else in that
7 market segment, unmanageable.

8 I mean, I see a pretty clear movement
9 towards the self-interest. That may have been one of
10 the reasons they were structuring the operation the
11 way they were. Weren't they pretty successful in that
12 regard for quite a while?

13 MR. FALCON: Well, except for the fact that
14 through their accounting misconduct, they were masking
15 many problems within the companies.

16 VICE CHAIRMAN THOMAS: Well, then, you ask
17 yourself, what would motivate someone to mask some of
18 the problems, because it would get in the way of their
19 focus of what they were doing, wouldn't it?

20 MR. FALCON: Well, they were trying to mask
21 volatility in their business. They were trying to
22 mask the risk in their balance sheets. And through
23 the political process trying to manage OFHEO's ability
24 to actually go in and dig deep and find these things.

25 VICE CHAIRMAN THOMAS: Yeah?

1 MR. FALCON: Yeah.

2 VICE CHAIRMAN THOMAS: It may not have been
3 that that mismanaged based upon their focus and goal.

4 MR. FALCON: I think they were --

5 MR. LOCKHART: Well, excuse me, we're
6 working within a legal framework that didn't work.
7 And they -- you know, before I arrived they were
8 definitely mismanaged from the accounting and all
9 those areas. They finally got that actually in pretty
10 good shape after all those consultants I mentioned.

11 But the fatal flaw, really, was the
12 legislation. The management teams and the board of
13 directors could have gotten that legislation through
14 very quickly if they wanted to, and they didn't.

15 MR. FALCON: I understand your point.

16 VICE CHAIRMAN THOMAS: Thank you.

17 MR. FALCON: And I agree with you.

18 VICE CHAIRMAN THOMAS: Yeah.

19 MR. FALCON: Mismanagement implies that
20 they incompetently -- that they didn't know what they
21 were doing. They knew what they were doing.

22 VICE CHAIRMAN THOMAS: Yeah, that's the
23 point I wanted to -- thanks.

24 CHAIRMAN ANGELIDES: Mr. Thompson?

25 COMMISSIONER HENNESSEY: Mr. Chairman,

1 just, if I could, just ten seconds.

2 COMMISSIONER THOMPSON: No, not now, you
3 can't. I'm sorry.

4 COMMISSIONER HENNESSEY: Mr. Georgiou had a
5 question earlier just about the costs, and I just want
6 to add a CBO wrote, in January of this year, quote, in
7 its August 2009 baseline, CBO projected that the
8 operations of Fannie Mae and Freddie Mac would have a
9 total budgetary cost of 389 billion dollars between
10 2009 and 2019.

11 CHAIRMAN ANGELIDES: Is that the budgetary
12 or the economic? I thought the budgetary cost was
13 191.

14 COMMISSIONER HENNESSEY: That is their
15 estimate of the budgetary cost, which is the subsidy
16 for budget experts. It's a credit subsidy model. I'm
17 sure Doug could tell us a lot more about it.

18 CHAIRMAN ANGELIDES: I'll await the tutorial.

19 COMMISSIONER HENNESSEY: 389 billion.

20 CHAIRMAN ANGELIDES: I would like to go to
21 Mr. Thompson.

22 COMMISSIONER GEORGIU: I wanted to
23 follow-up on that point. Maybe I can make it later
24 but I just wanted to add to what Commissioner
25 Hennessey said, which is that in addition to the
26 dollars that were lost, there also were and are

1 significant investments in both the preferred
2 securities, which Mr. Lockhart has told us that he
3 thinks may be may never be worth anything, that the
4 Treasury has purchased 75.2 billion of Fannie
5 preferred stock, and in addition, the Federal Reserve
6 has been purchasing mortgage-backed securities and has
7 purchased 1.026 trillion of Fannie and Freddie MBS,
8 and Treasury has purchased 254 billion of
9 mortgage-backed securities, of course hoping that they
10 won't reduce in value, but certainly there's a serious
11 question whether they will under the circumstances.

12 MR. LOCKHART: Well, they're backed by that
13 preferred stock, effectively those mortgaged-backed
14 securities. So if there's further losses, the U.S.
15 government is effectively backing those
16 mortgage-backed securities. But, you know, they have
17 put another one and a trillion dollars into it to help
18 solve this problem, and it's just amazing how bad it
19 got.

20 CHAIRMAN ANGELIDES: All right. Go to
21 Mr. Thompson.

22 COMMISSIONER THOMPSON: Oh, I don't want to
23 do it now.

24 CHAIRMAN ANGELIDES: You've been
25 extraordinarily patient.

1 VICE CHAIRMAN THOMAS: Yield the gentleman
2 an additional five minutes.

3 COMMISSIONER THOMPSON: I don't think I'll
4 take that long now.

5 EXAMINATION BY COMMISSIONER THOMPSON

6 COMMISSIONER THOMPSON: As you well know,
7 gentlemen, our mission here is to try to explain to
8 the American people what caused this crisis and what
9 almost brought our economy to its knees.

10 And, as such, we are asked to look at the
11 issues and the institutions. And you, Mr. Falcon,
12 said Fannie and Freddie are failed enterprises. You
13 also acknowledged that you were outmaneuvered
14 politically, your budget was inadequate, your staff
15 was too small, you were under skilled for the task
16 that was before you.

17 You are the fifth regulator we've had
18 before us in the series of hearings that we've
19 conducted. Why do you exist, as opposed to this
20 mission being within the SEC or OCC or one of those
21 other regulators, if you were in such bad shape?

22 MR. FALCON: Well, I think if we were originally-- OFHEO was
23 set up as an independent regulatory entity. I think the idea was try to
24 make it independent and not subject to the political influences of being
25 part of the Treasury Department or some other government entity.

26 I think that was sound except for the lack

1 of authorities and resources on par with every other
2 safety and soundness regulator.

3 COMMISSIONER THOMPSON: Couldn't another
4 safety and soundness regulator have done this work?
5 Given that you got outmaneuvered politically, that you
6 were underskilled and understaffed, I mean, I just
7 don't get why you exist.

8 MR. FALCON: Well, the agency was
9 Created, I think the law was in the 1992 Act that created the
10 agency.

11 COMMISSIONER THOMPSON: I understand that,
12 but couldn't someone else have done this work?

13 MR. LOCKHART: Someone else had done it
14 before, the Federal Home Loan Board, was
15 responsible for Freddie and the S&Ls. And, you know,
16 so out of that they decided that they needed an agency
17 that could focus on these two giants.

18 And, you know, Fannie and Freddie didn't
19 want it at the time and they had made sure that the
20 legislation, at the time, was very weak.

21 And that was, to me, again, the problem,
22 here. Actually, it makes a lot of sense. I think the
23 new legislation that gave us the responsibility not

1 only for Fannie and Freddie, but the federal home loan
2 banks now, actually does create a regulator that has
3 the power to really oversee the whole secondary
4 mortgage market in this country.

5 MR. FALCON: But I think the answer to your
6 question is, yes. The congress could have decided to
7 not create OFHEO and give this authority to the OCC or
8 the Federal Reserve or some other safety and soundness
9 regulator. That was always a possibility.

10 COMMISSIONER THOMPSON: Well, it seems as
11 if you were inadequate in skills and capabilities that
12 there was a heck of a lot more capability for similar
13 instruments to be evaluated and assessed sitting
14 inside the SEC or the OCC, but be that as it may.

15 MR. LOCKHART: Well, actually, most of our
16 examiners came from the OCC or OTS. So we actually
17 did raid that talent pool to build up the agency.

18 COMMISSIONER THOMPSON: But my point is
19 there are economies of scale to be derived from
20 consolidation of organizations as opposed to
21 fracturing and splintering the organizations
22 throughout an enterprise.

23 VICE CHAIRMAN THOMAS: Commissioner, if I
24 might, for just a minute?

25 COMMISSIONER THOMPSON: Sure.

1 CHAIRMAN ANGELIDES: Mr. Thomas, on his own
2 time.

3 VICE CHAIRMAN THOMAS: None of those other
4 regulatory agencies would have been subject to the
5 appropriations process.

6 COMMISSIONER THOMPSON: Maybe that would
7 have helped.

8 VICE CHAIRMAN THOMAS: Let me explain this.
9 I was new to the Ways and Means Committee, and I came
10 up with the proposal to make this adjustment that
11 President Reagan had asked for, all in one year, it
12 was a 30-billion-dollar proposal.

13 I was taken aside and explained, you don't
14 do things that way; we will make it in three
15 10-billion-dollar amounts because then they will have
16 to come to us three different times.

17 COMMISSIONER THOMPSON: And that's supposed
18 to be good?

19 VICE CHAIRMAN THOMAS: From the position of
20 the chairman of the Ways and Means Committee,
21 apparently it sure was.

22 COMMISSIONER THOMPSON: Well, Mr. Lockhart,
23 you described the future of this industry and you gave
24 a very rational view of what might happen. I then
25 asked the question, what happens to OFHEO when, if in

1 fact that were to evolve, is this a regulatory body
2 that in a repackaged industry we really need?

3 MR. LOCKHART: Depending on how the
4 repackaging goes, no. It could be, depending, if we
5 recreate new GSEs, yes. If we go to some other
6 structure, maybe not.

7 I think the key thing though, is whatever
8 we have, we have to have a group that really
9 understands the mortgage market and has oversight of
10 it.

11 Our -- the mortgage market was very
12 fractured from a regulatory standpoint. The
13 nontraditional mortgage guidance that the bank
14 regulators put out, we weren't even involved in, and
15 yet we were the biggest player in the mortgage market.

16 So the key thing in regulatory reform, to
17 me, is you've got to pull people together. How many
18 agencies you end up with is not as important as you
19 have to have those agencies work very closely
20 together.

21 COMMISSIONER THOMPSON: Well it -- it
22 certainly would cost the American taxpayers a lot less
23 money if we aggregated the infrastructure that
24 underpins these agencies that oversee the financial
25 soundness of our economy.

1 MR. LOCKHART: One could argue that. On
2 the other hand, I think actually our ability to work
3 on just a few agencies has actually helped in some
4 areas.

5 I mean, you know, a big bank regulator may
6 have a thousand different entities that it has to
7 regulate, and that could be cumbersome as well.

8 COMMISSIONER THOMPSON: It's all about
9 organization then. All right, I yield my time.

10 CHAIRMAN ANGELIDES: Thank you,
11 Mr. Thompson.

12 Just one observation, I was going to ask a
13 question, but I am going to ask the question related
14 to Mr. Thompson's questioning about the need for this
15 regulator.

16 And it really does go to 2008, just in all
17 candor, do the -- did the Federal Reserve and OCC, when
18 they came in, I believe in, what, July/August?

19 MR. LOCKHART: Yes.

20 CHAIRMAN ANGELIDES: Did they find things
21 that you had not found, or were they affirming what
22 you had already found?

23 MR. LOCKHART: Some of both, they found
24 some things that we hadn't found.

25 CHAIRMAN ANGELIDES: And you hadn't found

1 it just because of their capability, the breadth or
2 depth of their bench, or why is that?

3 MR. LOCKHART: Well, one thing, is they
4 actually, the bank regulators, had a somewhat
5 different approach to reserving than Fannie and
6 Freddie did, and when we ran -- run the portfolios
7 through their approach, the losses got bigger.

8 CHAIRMAN ANGELIDES: All right. So they
9 did have a different perspective that you did not
10 have.

11 MR. LOCKHART: Yes.

12 CHAIRMAN ANGELIDES: Okay. Mr. Mudd
13 earlier today noted the delinquency rate of GSE, of
14 Fannie and Freddie loans, versus the Wall Street or
15 private market was definitively less.

16 He noted that, you know, the risk of coming
17 with -- by being a big mono-line insurer, and I do
18 wonder, and I only say this because I'm picking up on
19 your comment, in the end, you know, so many mono-line
20 entities went down; mono-line insurers, large thrifts
21 went down, because when the market turns against you
22 and that's your only business it's very hard to
23 sustain it. He made the observation that even if they
24 had been extraordinarily well capitalized, because at
25 some point you have to have a return on equity for

1 investors, so there's a balance here. I mean, you
2 can't be so well-capitalized there's no return.

3 He essentially made the point we would have
4 had levels of -- needed levels of capital such that
5 they were not feasible in the marketplace to have
6 sustained this way; do you agree with that?

7 MR. FALCON: At some point too much
8 capital, right, doesn't serve the entities. But at
9 that level, 2.5 percent, I think it was very, very
10 highly leveraged then.

11 CHAIRMAN ANGELIDES: So they would have --
12 agreed, they were -- they were 61 -- well, they
13 weren't even at 2 and a half percent. They were
14 off-balance-sheet they were effectively at one and a
15 half, 60 to 1, 70 to 1 ratio. But the only reason I
16 mention it is it reinforces your observation, that
17 there is part of this market that can legitimately be
18 served by the private markets and some that cannot be
19 and therefore we shouldn't have the false promise that
20 it can be.

21 Because what turned out to be it was a
22 massive false promise to the American people that
23 somehow that these activities could be sustained
24 without subsidy in the end.

25 MR. LOCKHART: If you look at the number

1 Commissioner Hennessey just put out, that would have
2 been well less than 10 percent of their risk. And
3 we're now asking banks to put up capital around 10
4 percent.

5 And what really happened here is we
6 subsidized homeowners by that very low capital charge.

7 CHAIRMAN ANGELIDES: And also compen- --
8 well, we subsidized homeowners, shareholders, and
9 executives?

10 MR. LOCKHART: I agree.

11 CHAIRMAN ANGELIDES: Okay. Is that a fair
12 statement?

13 MR. LOCKHART: That's a fair statement.

14 CHAIRMAN ANGELIDES: Yeah, we did more --
15 there was a fair -- it turned out to be a relatively
16 inefficient way to subsidize homeowners.

17 MR. LOCKHART: Right. And now the
18 taxpayers' paying all that subsidy back.

19 CHAIRMAN ANGELIDES: Because there's some
20 barnacles, there were some barnacles on the whale.

21 COMMISSIONER HOLTZ-EAKIN: I will simply
22 note for the record that the CBO actually broke apart,
23 who got the subsidies that were implicit in
24 separation, and the homeowners got a de minimus part
25 of the subsidy. The vast majority went to

1 shareholders and management.

2 CHAIRMAN ANGELIDES: Mr. Holtz-Eakin, would
3 you be willing to provide that information to the
4 Commission, under oath, or under subpoena, or voluntarily?

5 COMMISSIONER HOLTZ-EAKIN: One can get it
6 from the CBO website.

7 CHAIRMAN ANGELIDES: Thank you. I want to
8 talk, just for minute, as we wrap up here about the
9 affordable housing goals, because I want to understand
10 a little bit about how the process worked.

11 HUD would propose them, how iterative a
12 process was this; in other words, was it a process in
13 which Fannie and Freddie would say here's where we
14 legitimately can meet, or do they really flow out of
15 HUD? And would you look at them for safety and
16 soundness?

17 MR. FALCON: I was not -- OFHEO -- the
18 OFHEO director is not directly involved in setting the
19 goals. But we do play a role and I am a little
20 familiar with how it works.

21 And my understanding, it was a sort of a
22 back-and-forth that the goals were frequently proposed
23 by HUD, there was push-back by Fannie and Freddie, and
24 eventually they came out with a number where HUD
25 thought it showed advancement, and higher goals and

1 Fannie and Freddie were of the opinion that they could
2 meet them.

3 And this typically is the way this
4 negotiation happened as I understand the process.

5 CHAIRMAN ANGELIDES: Because in our
6 interviews with Fannie staff, according to our staff,
7 no one of the Fannie folks, Fannie Mae folks we
8 interviewed recalled that they raised concerns that, I
9 guess, there was an iterative process.

10 But at the end of the day, no one said this
11 is going to jeopardize safety and soundness. My
12 question is, did you ever comment on them?

13 MR. FALCON: Yes, HUD would run the
14 goals by OFHEO, and we would examine them and opine
15 whether or not we thought they could --

16 CHAIRMAN ANGELIDES: All right.

17 So under your tenure, which ended in 2005;
18 correct?

19 MR. FALCON: Yes.

20 CHAIRMAN ANGELIDES: Did you ever voice an
21 objection to them on safety and soundness grounds.

22 MR. FALCON: No. But -

23 CHAIRMAN ANGELIDES: Go ahead. I don't want to cut you off.

24 MR. FALCON: But we also always told the
25 enterprises that if situations ever changed and we --
26 and they thought that they couldn't meet the goals

1 without taking on an excessive risk, then we made it
2 clear to them that they should not take on that excessive
3 risk.

4 CHAIRMAN ANGELIDES: And did they ever
5 circle back to you and say we've got a problem here?

6 MR. FALCON: No.

7 CHAIRMAN ANGELIDES: Okay, Mr. Lockhart,
8 same set of questions?

9 MR. LOCKHART: The goals were set I think
10 in 2004 for a four- or five-year period.

11 CHAIRMAN ANGELIDES: And they did escalate
12 in 2004; correct?

13 MR. LOCKHART: Yes, they did.

14 CHAIRMAN ANGELIDES: So this is the first
15 time I think they began to nudge above 50.

16 MR. LOCKHART: Yeah.

17 CHAIRMAN ANGELIDES: In which you were
18 talking about?

19 MR. LOCKHART: Yes. They kept pushing them
20 and pushing them, but that whole set of decisions was
21 made in 2004, I think. And so we never really got
22 involved in the goal-setting while I was there because
23 they were just about ready to be reset when everything
24 started.

25 CHAIRMAN ANGELIDES: So they weren't

1 annualized, there weren't annualized renewals of those?

2 MR. LOCKHART: It was cast in concrete, if
3 you will, and it was not market-related, which was
4 really the fatal flaw.

5 CHAIRMAN ANGELIDES: And so in 2004 they
6 set them on an escalator.

7 MR. LOCKHART: Exactly.

8 CHAIRMAN ANGELIDES: Did you have the
9 ability, statutorily, to, like in 2005 or '6, to
10 express safety and soundness objections?

11 MR. LOCKHART: I could have talked to the
12 HUD secretary but I didn't have any authority.

13 CHAIRMAN ANGELIDES: But did you? Or did
14 you -- or did you -- did you ever express concerns
15 about them? I'm just trying to get to what -- how
16 parties felt about them.

17 And, of course, I can see in an up market,
18 where everyone's feeling like we can get there. But
19 I'm just curious about whether or not you expressed
20 objections or concerns about them.

21 MR. LOCKHART: Internally, but I don't
22 think we talked to HUD about them.

23 CHAIRMAN ANGELIDES: Okay or to Fannie?

24 MR. LOCKHART: Fannie talked to us about
25 them a lot.

1 CHAIRMAN ANGELIDES: And we'll explore --
2 they talked to you about them in what regard?

3 MR. LOCKHART: Well, how tough they were.
4 As I said before, the CEOs were very afraid of missing
5 them, they missed part of them, I guess, in `07. They
6 missed them by a mile in `08.

7 And part of the legislation, you know, we
8 did get authority for that, and while I was there, we
9 changed that structure pretty dramatically.

10 CHAIRMAN ANGELIDES: So they were -- they
11 were expressing concern they weren't going to get
12 there?

13 MR. LOCKHART: Yes.

14 CHAIRMAN ANGELIDES: Okay. Because I
15 understand HUD did lower some standards at their
16 request, but we'll look at the record.

17 MR. LOCKHART: I think what they did is
18 when they missed them they allowed them to miss them.

19 CHAIRMAN ANGELIDES: They missed them and
20 then, in a sense, excused the miss.

21 MR. LOCKHART: Yes.

22 CHAIRMAN ANGELIDES: All right.

23 VICE CHAIRMAN THOMAS: Mr. Chairman?

24 CHAIRMAN ANGELIDES: Yes.

25 VICE CHAIRMAN THOMAS: The expressed

1 concerns, were they on safety and soundness? What
2 were the grounds on expressing concern?

3 MR. LOCKHART: The underlying was safety
4 and soundness. But the real concern was that they
5 were just not going to meet the goals, that it was
6 just not possible.

7 There were some years, you can look in the
8 historical record, that they did transactions right in
9 December to make those goals.

10 The goals not only were a single-family but
11 they were -- multi-family added a lot to the goals.
12 So you can see some years they did some very large
13 multi-family transactions just to hit the goals.

14 VICE CHAIRMAN THOMAS: So they knew what
15 the targets were and they sometimes shaped their
16 behavior --

17 MR. LOCKHART: Yes.

18 VICE CHAIRMAN THOMAS: -- to meet those
19 specific targets?

20 MR. LOCKHART: Yes.

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

23 CHAIRMAN ANGELIDES: All right. Thank you
24 all very much. So let me just conclude this meeting
25 by, first of all, thanking the witnesses. Thank you

1 for your time. Thank you for your public service.

2 Thank you for being here today.

3 I want to thank Vice Chairman Thomas for
4 his continued work with me and the other commissioners
5 as we, as a bipartisan Commission with a nonpartisan
6 mission, really try to do the best job of examining
7 what happened here in this event of tremendous
8 consequence or series events of consequence for this
9 country.

10 I want to thank all the members of the
11 Commission. I want to particularly thank the lead
12 commissioners on this research and investigation
13 project on subprime lending securitization, this
14 hearing, Mr. Wallison, Mr. Georgiou, and Ms. Murren.

15 I want to thank our staff, who has provided
16 an exceptional amount of information, literally
17 hundreds of interviews to date, hundreds of thousands
18 of documents, for their excellent staff work and their
19 very long hours.

20 And thank you, the public, who has joined
21 us. And I also want to remind everyone, as the Vice
22 Chairman reminded me to, that you folks should go to
23 our website at FCIC.gov. We have posted papers on
24 that website, background, staff reports, preliminary
25 staff reports that have not been adopted by this

1 Commission, and they are available for comment. And
2 we encourage comments or would like comments by May
3 15th. Mr. Thomas?

4 VICE CHAIRMAN THOMAS: Mr. Chairman, in
5 continuing the bipartisanship that we have displayed,
6 on behalf of the Commission I would like to thank the
7 Chairman of the Energy and Commerce Committee,
8 Mr. Waxman and his staff, for providing us
9 accommodations.

10 I would have liked a couple more degrees
11 down on the thermostat but it's -- understanding what
12 our options were, we do appreciate and thank them.
13 For those who have never tried to run these kinds of
14 hearings outside of a congressional hearing room, it's
15 really, really hard to do, and I want to thank them
16 for their courtesy.

17 CHAIRMAN ANGELIDES: Thank you all, I would
18 like to ask if the commissioners would gather
19 extraordinarily briefly in the anteroom right after
20 this meeting. Thank you all very much.

21 (FCIC Hearing adjourned at 2:45 P.M.)

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