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COMPENSATION IN THE FINANCIAL INDUSTRY—GOVERNMENT PERSPECTIVES

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

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COMPENSATION IN THE FINANCIAL INDUSTRY—GOVERNMENT PERSPECTIVES

Thursday, February 25, 2010

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 2:02 p.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Watt, Sherman, Moore of Kansas, Clay, McCarthy of New York, Green, Cleaver, Ellison, Perlmutter, Donnelly, Carson, Speier, Adler, Kosmas; Bachus, Royce, Biggert, Capito, Hensarling, Garrett, Gerlach, Neugebauer, Jenkins, Paulsen, and Lance.

The CHAIRMAN. The hearing will come to order. This is a hearing on the question of what restrictions are appropriate in compensation for people being paid with public funds. I have to announce that Ken Feinberg is, unfortunately, stuck on a train. He is on a train from New York that was behind a train that was involved in a fatal accident. He is trying to get here.

Given the time constraints we are facing as a result of having been snowed out, we can't really postpone things. So we hope he will get here at some point, but we're going to have to see.

And I recognize the gentleman from California, Mr. Sherman, for 2 minutes for an opening statement.

Mr. SHERMAN. Thank you, Mr. Chairman. Those who have repaid the TARP money are not truly independent of Federal involvement, for they enjoy the implicit Federal guarantee if they are too-big-to-fail.

We are told that old contracts must be honored, even if they were signed by entities which, by all rights, are bankrupt. And, therefore, enormous money must be paid to those who drag us and their companies down.

We are told the new lucrative contracts must be signed at AIG and elsewhere, so that we can have talented croupiers involved in continuing to gamble at taxpayer expense, when in fact, AIG should be liquidated. And you don't need talented croupiers to do that.

And we are told that we shouldn't focus on the enormous size of amounts being paid to those who are employed by government-subsidized entities, we should only focus on whether there are perverse incentives.

I think it's difficult to construct any contract that doesn't offer perverse incentives to somebody who is running a division of one

of these big banks, since by taking enormous risks, they could justify getting the grant of an enormous amount of restricted stock, which restricted stock will turn out to be valuable unless the heads of the other divisions have screwed up and the people taking enormous risks in their own division have no reason to think that everybody else is going to bring down the company.

So, these bonuses and compensation plans are outrageous, and the justifications of pre-existing contract—"We're done with TARP," or, "We need to preserve the assets for the benefit of the taxpayer"—don't hold water when you really examine them. I yield back.

The CHAIRMAN. I thank the gentleman. At the last hearing we had on executive compensation, the gentleman—our colleague from Vermont, Mr. Welch, had a statement he wanted to put in the record. I neglected to ask for permission to do that, so I now ask unanimous consent to include in the record the statement from Mr. Welch of Vermont on executive compensation. Hearing no objection, it will be included.

The gentleman from Alabama is now recognized for 4 minutes.

Mr. BACHUS. Thank you, Mr. Chairman, for holding this hearing. We are the largest and strongest economy in the world. America didn't get there by having the government run businesses.

The traditional view, which I share, is that we have the number one economy in the world because of the free enterprise system, in which it is inappropriate, ineffective, and dangerous for the government to impose controls on the executive compensation practices of privately-owned companies. It is inappropriate, because such companies' practices should be controlled by their shareholders, who are the owners of the money which is being paid to the executives. It is ineffective, because government bureaucrats have shown themselves to be particularly inept at making decisions governing executive compensation. Most critically, it is dangerous, because government bureaucrats and politicians inevitably allow political considerations to distort their decisions.

There is no need to elaborate on the first point. It is the stockholders' money. And unless the government is a shareholder, the government has no right to tell them how they may disburse it. The pretense that this is a safety and soundness issue is simply an excuse to disallow pay that many, myself included, often find excessive. But shareholders already have the power to stop their money from being paid to executives who do not deserve it.

To ensure stockholders have the information and access they need to exercise their control, Republicans have supported giving shareholders of publicly traded companies a triennial, non-binding shareholder vote on executive compensation. This approach is far preferable to entrusting more power to the same government whose regulatory failures have caused the financial meltdown.

The ineffectiveness of bureaucratic controls is clearly shown by the experience of Fannie Mae and Freddie Mac, which the government does own. I am particularly pleased that we will hear today from the acting Federal Housing Finance Agency Director, Mr. DeMarco, about the Christmas Eve decision to award multi-million dollar pay packages to the executives of Fannie and Freddie. The $6 million pay packages given to each of their CEOs—an amount

15 times more than the President makes, and 30 times more than a Cabinet Secretary—represents just one example of what happens when the Federal Government is given the responsibility for regulating compensation.

Employees of AIG, another company owned by the taxpayers, were awarded $100 million in bonuses this year.

Executives at General Motors, a firm that already has received $52.4 billion in bailout money, was recently given a waiver to receive compensation in excess of a $500,000 pay cap. In addition, GM's ousted former CEO is being brought back to serve as a consultant, and will receive compensation of $3,000 an hour.

These are two companies controlled by the government. The greatest danger is that dramatically increasing government micromanagement of compensation packages will provide politicians with a powerful tool to influence business decisions for political or policy purposes, but not economic purposes. Every society that has followed that path has come to grief. Governments should not be micromanaging private business.

We need to end the bailouts, and let businesses rise or fall on their own merits. Letting the government decide who prospers and who doesn't and bailing out those who fail is not how we became the most powerful economy in the world. Thank you.

The CHAIRMAN. I just want to, off the cuff, say I have this very nice, very sharply delineated clock here, that tells me when there is only 1 minute left. I did not realize that other Members didn't have it. So sometimes you get used to things and you don't realize. And it is theoretically there, but I can't see it. Maybe somebody else can. I cannot see it.

I have asked our very hard-working clerk, who puts up with a lot, to get us better graphics. Until we do that, it would be up to the Members. Would Members, because I have it here, like for me to say when it's 1 minute, or do a tap with the gavel when there is 1 minute?

Some people might find it disruptive. But I would just, when there is 1 minute, do that so that people would know that, because—

Mr. BACHUS. And when it's up, two taps.

The CHAIRMAN. Yes. Oh, no.

[laughter]

The CHAIRMAN. But yes, if that's not going to be disruptive—so—and I apologize, because I have said to Members, "Well, why did you wait so late," and then I realized that people did not know that. We are going to try and get a better set of graphics. And until then, that will mean that the Member has 1 minute left, to summarize.

And with that, the gentleman from Indiana is recognized for 2 minutes.

Mr. CARSON. Thank you, Mr. Chairman. I was outraged to hear earlier this month the latest move by AIG to, again, reward employees who nearly drove that company, and our Nation's economy, into the ground. Giving huge bonuses after such a colossal failure is horribly irresponsible, and simply unconscionable.

Millions of experienced Americans are struggling right now. They have played by the rules, and did everything asked of them. But

today they are out of work after falling victim to a steep recession that was fueled by foolish gambles taken by Wall Street. Despite all of this, AIG and its executives continue down the same path of greed and excess.

Americans aren't necessarily opposed to considerable pay packages. But injustice is quite another matter. And the Nation's ongoing financial crisis has provided numerous occasions for public fury. The recent discussion in controlling executive compensation has called for establishing a ratio between a CEO's salary and the average wage, for controlling the use of stock options, and for capping certain salaries.

I would argue that we should also look to remove impediments that prevent shareholders from playing the role that economic theory says they are supposed to play. I want executives to create shareholder value and be rewarded when they are successful. But I fail to see the need for excessive pay packages when they fail. Executives currently have abundant opportunities to enrich themselves at shareholders' expense, and to pursue business strategies that serve their own interest, rather than those of their companies' owners.

I look forward to today's testimony. I yield back my time. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Texas, Mr. Neugebauer.

Mr. BACHUS. And, Mr. Chairman, the next 6 speakers have 1 minute. So I guess we will depart from the tap rule.

The CHAIRMAN. I will do it in advance.

Mr. NEUGEBAUER. You all aren't using my time, are you?

The CHAIRMAN. The gentleman from Texas. I'm tapped out.

Mr. NEUGEBAUER. I see. Thank you, Mr. Chairman. On Christmas Eve, the taxpayers got a gift from the government that they want to return.

And, given the choice, they would exchange the Treasury's decision to give GSEs unlimited support for a limit, or removing the unlimited support on the tax dollars that can go into Fannie and Freddie from the treasury. They would exchange this multi-million dollar salary package approved for the GSEs for salaries along the same scale as senior Federal Government employees, since Fannie and Freddie are now essentially government agencies.

When it comes to GSEs, the government must be more honest and transparent. What the taxpayers are looking for is truth in government. Taxpayers need to know how much this bailout is really going to cost them, and when they're going to get their money back. While we can't shut down Freddie and Fannie right now without a replacement system of financing mortgages, Congress must start a plan for the transition now that puts plans in place to end this bailout.

We have to stop. And the reason we shouldn't have done these bailouts in the first place is because of the conversation we are having today.

The CHAIRMAN. The gentleman from California, Mr. Royce, for 1 minute.

Mr. ROYCE. Thank you, Mr. Chairman. Since the conservatorship back in the fall of 2008, there have been several missteps in the

handling of Fannie Mae and Freddie Mac, the two institutions at the epicenter of the financial collapse.

About a year ago we, heard from the FHFA that despite $60 billion in losses, Fannie and Freddie would be paying out $600,000 in bonuses to top executives at these failed companies.

In September of last year, despite even deeper losses, we learned that taxpayers had paid $6.3 million in legal defense bills for 3 top former executives. Then, last Christmas Eve, along with opening up these institutions to limitless losses, the Administration approved the payment of $42 million in additional compensation packages, bonuses to 12 top executives at these institutions.

It seems as though the bigger the bailout gets, the bigger the bonuses get. These institutions are essentially wards of the state, and they should be treated as such. I yield back.

The CHAIRMAN. The gentleman from Texas is now recognized for 1 minute.

Mr. GREEN. Thank you, Mr. Chairman. Mr. Chairman, I want to speak for those who agree with me. I don't always know who they are, and I don't always know who they aren't. But I say this: We don't want to regulate pay, per se.

We want to regulate pay that creates systemic risk—i.e., the yield spread premium, a kickback, lawful though it may have been, that was accorded persons who would get buyers to go into higher interest rates that they—when they qualified for lower rates, and get a bonus for it. We want to make sure that the shareholders are properly empowered. If they could have done this without some assistance from us, they probably would have, and we wouldn't be in the predicament we are in. I yield back.

The CHAIRMAN. The gentlewoman from West Virginia for 1 minute.

Mrs. CAPITO. Thank you, Mr. Chairman. Like many of my constituents, I was shocked when the Treasury Department and the Federal Housing Finance Agency approved compensation packages for the chief executive officers of Fannie and Freddie of $6 million each, including $2 million incentive payments. These compensation levels are 30 times more than a Cabinet Secretary, and were approved by entities that have borrowed $100 billion from our treasury.

This is an insult to the hard-working families across the country who are tightening their belt, trying to make ends meet in this economic downturn. But these compensation packages are but one of the many examples why this Congress should and needs to tackle the difficult task of GSE reform.

The chairman has indicated his desire to move forward on this. Unfortunately, the Administration has signaled that they do not want to put forth serious reform proposals until next year. I hope we move forward with GSE reform, and I would like to thank the chairman for holding this hearing. Thank you.

The CHAIRMAN. The gentlewoman from Illinois for 1 minute.

Mrs. BIGGERT. Thank you, Mr. Chairman, and thank you for holding today's hearing. And I would like to thank Ranking Member Bachus for inviting FHFA Acting Director DeMarco.

I look forward to hearing the Administration's proposals to reform the GSEs. It's important that we have a plan to end the con-

servatorship and the taxpayer subsidy, and take this Administration out of financing nearly three-fourths of the Nation's mortgages.

The public deserves clear, easily accessible information about the actions of FHFA, and about the actions of the Fed and Treasury that are supplying unlimited, unprecedented funds to keep Fannie Mae and Freddie Mac on taxpayer-funded life support.

Mr. DeMarco, your staff has reached out to my staff and indicated that you are familiar with and want to discuss my legislation to improve GSEs' transparency and accountability, and I look forward to our discussion today, as well as our meeting.

And I would hope that Congressman Moore would consider my request to add this language to another bill we introduced to establish an FHFA Inspector General.

The CHAIRMAN. I will yield myself the remaining 5 minutes on my side.

I shared the dismay at the announcement of the bonuses. I did try a couple of things to stop it. On March 19th—and I would ask unanimous consent to put in the record a letter I sent to James Lockhart. James Lockhart was Mr. DeMarco's predecessor. He was the appointee of the previous Administration. Continuity is one of the clear themes here. Mr. Lockhart was the appointee of the Bush Administration. He was continued for a while in the Obama Administration, and then replaced.

And I wrote and said, "I am writing to urge strongly that you rescind the retention bonus programs at Fannie Mae and Freddie Mac, prohibit any further payment of bonuses to executives under that program, and pursue repayment of any already-paid bonuses."

Mr. Lockhart wrote me back the next day, March 20th, and said, "No." And he said that Fannie Mae and Freddie Mac had important responsibilities, and he needed to keep them. The loss of key personnel would be devastating to the company's and to the government's efforts to stabilize the housing system.

So, I regretted that. I thought they were a mistake. I wrote to him to try and stop it. When that didn't work, we talked about legislation. In fact, the House did pass two bills on compensation last year. One was, I understand, somewhat controversial because it would have imposed—and it's still pending in the Senate, a phrase you hear a lot these days—restrictions involving purely private companies. And I believe that's appropriate as to the perverse incentive structure. But I understand Members' objections to it.

But we had an entirely separate bill that came out of this committee to restrict compensation to those entities getting public funds, the TARP, and specifically—and it says, "No financial institution has received or receives a direct capital investment under the TARP program, or with respect to the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, etc."

We specifically included Fannie Mae and Freddie Mac, and what we said was they couldn't get compensation if it provides for compensation that's unreasonable or excessive, defining standards established by the Secretary, in consultation with the chairman of the oversight panel, includes bonuses, supplemental payments, etc.

In other words, this was a piece of legislation that dealt only with TARP recipients in Fannie and Freddie. Of course, many of the TARP recipients have now paid back, so they would not be covered.

What we have here is a bill that would have covered Fannie and Freddie. And so, as I said, when they issued these bonuses, I wrote a letter to Mr. Lockhart, the hold-over appointee, and objected. He said he was going to use his authority to keep them in place.

We then did what we, as the Congress, can do when an executive refuses to accede to a request from us. We passed the bill. Unfortunately, the bill was somewhat partisan. I'm not sure why. Again, I understand why there was a debate about the bill to restrict purely private companies—although I agreed with what we did—but this was for TARP recipients, and those TARP recipients that were covered and—of course those who paid it back are not covered—and specifically Fannie and Freddie.

So, yes, they did put those through. We would have banned that with our legislation. The bonuses that came on Christmas would have been severely restricted had the legislation passed. It didn't pass, unfortunately, in the Senate. It passed in the House. And that's one of the reasons why we are in this situation.

I should add that I also believe the time has come to proceed to a total reorganization of housing finance, and I do want to mention again that I had—and this was on my initiative, although I knew there was an interest on both sides in doing this—scheduled a hearing for next Tuesday, and invited the Secretary of the Treasury and the Secretary of HUD to testify.

As we all know, we're not socialized. Some invitations are more happily received than others. These were not invitations which were met with a gushing, "Oh, thank you, I can't wait," but we are going to begin that process.

I then had to postpone it. I want to make it very clear. It was my constituency issues that intervened. They called a hearing on fishing in the City of Gloucester. It is very important for me. As I said, I had to decide, literally, to fish or cut bait, and the response will be a postponement of the hearing. That hearing will be rescheduled for March 23rd. Members will be aware we have a pretty packed hearing schedule, partly because we lost that week of snow.

But the Administration is on notice that they are going to be asked on March 23rd—and I will say this—had they appeared next Tuesday and told us they were still in a preliminary stage, I would have been more understanding. Now that they have another couple of weeks—3 weeks—to come, I expect them to be better prepared on March 23rd with an outline of what they think should be done than there would have been on March 2nd. So I hope, in terms of preparation, not much time is lost.

So, in summary, I did object to those bonuses when they were issued, and the holdover appointee kept them. And we did try to pass legislation to stop it.

The gentleman from Texas. Yes? The gentleman from Alabama?

Mr. BACHUS. I would like to commend the chairman. He set the hearing very promptly. So, had he set it for the date that it now postponed to, it would have been fine. And it was set, and I happened to visit that area of Massachusetts, just coincidentally, and

saw what a hot item that fishing issue is up there. And—but I did want to commend the chairman. And the postponement was done with my consent. Thank you.

The CHAIRMAN. I thank the gentleman. But again, I would say the Administration has 3 more weeks. But it won't be acceptable for them to be no better prepared on March 23rd than they would have been on—

Mr. BACHUS. And I actually think that it may be a more appropriate time, because I think there can be more preparation, and that they be prepared to go forward.

The CHAIRMAN. The gentleman from Texas for 1 minute.

Mr. HENSARLING. Thank you, Mr. Speaker. I heard one of my earlier colleagues mention executive compensation and systemic risk. It's interesting that most of the evidence we have seen has shown that many financial firms have the same compensation packages, and some went belly up and some didn't. So the connection is tenuous, at best, which suggests to me we ought to be guided by one overarching rule: What people do with their money is their business; what they do with the taxpayer money is our business.

And, certainly, I have seen—in the past, I know of no more outrageous use of the taxpayer money than on Christmas Eve, to announce these multi-million dollar bonuses for Fannie and Freddie, and simultaneously lift the cap on taxpayer exposure.

So, I am looking forward to having some explanation, because it wasn't a particularly merry Christmas for the taxpayers, who are looking at the mother of all bailouts with Fannie and Freddie, to know that they are looking at trillions of dollars of exposure, and then paying for the privilege at the same time. It is objectionable. I yield back.

The CHAIRMAN. The gentleman from New Jersey.

Mr. GARRETT. Thanks, Mr. Chairman. Yes, it was actually just about a couple of months ago that the ranking member and I did request from the chairman that we have a hearing, both on the issue of the bonuses and also, as Jeb says, with regard to the "Christmas Eve Massacre," as we call it, which is the lifting of the limits on the bailouts of Fannie and Freddie.

And this hearing today is important, with regard to the bonus issue. But really, as I say, the larger issue is the lifting of this cap, of going to $200 billion, to $400 billion, and now basically no limit whatsoever on the bailouts of the GSEs. This is certainly what we're hearing from our constituents back home.

To the chairman's point about having the Secretary come here next week, or in a couple of weeks, that's all well and good. But he was over at the Budget Committee just yesterday. And in Budget yesterday, the Secretary was asked, "When are you going to roll out a plan, as far as doing something about this," and he said, "Well, maybe we will have principal some time this year, but our plan is going to be next year."

Conversely, we had the Chairman of the Fed here yesterday and we asked him the question, "When should we do something about this," and I'm on the same page as the chairman as far as doing something quickly, and you heard the chairman yesterday say, "We should be doing something about this right away."

The CHAIRMAN. I thank the gentleman. You said—to clarify—obviously, the question—I would consider that, and have—and I should have been more explicit—fully within the subject of the hearing. That is, because again, that hearing is about housing finance, not simply about Fannie and Freddie.

So, the implications of what they did is very much on the table. And they will be on notice that they should be expected to addressed that. They would have been on Tuesday, and they will on the 23rd.

We will now begin with our witnesses. And again, I explained that Mr. Feinberg is being held up—by a train wreck, literally. Beyond that, I do want to—because the gentleman from Georgia, Mr. Price, asked a very good question as to why the FDIC is not here, since they are proposing a compensation scheme, and the answer is that's exactly why they're not here. I did invite them, and wanted them to come.

What they advised me is that, because—precisely because they have a proposal now pending to tie down compensation for some of those that they are working with, they are legally barred from saying anything because the comment period is gone now, and they have to keep that open, and they will be able to talk again at the end of the comment period.

So, once the comment period is over, we will invite them back. But that's why the FDIC is not here. And I apologize, obviously, for the fact that Mr. Feinberg—or I regret that he can't be here.

And we will begin with Mr. Edward DeMarco, who is the Acting Director of the Federal Housing Finance Agency. And aren't you glad you took the job?

Mr. DEMARCO. Thank you.

The CHAIRMAN. And any material that the witnesses want to submit will be put in the record.

And again, I would get unanimous consent to put the correspondence between myself and Mr. Lockhart in the record. Without objection, it is so ordered.

STATEMENT OF EDWARD J. DeMARCO, ACTING DIRECTOR, FEDERAL HOUSING FINANCE AGENCY

Mr. DEMARCO. Very good. Thank you, Mr. Chairman. Thank you for putting my prepared remarks in the record.

Chairman Frank, Ranking Member Bachus, and members of the committee, thank you for the opportunity to testify on this important subject. Compensating the executives at Fannie Mae and Freddie Mac—or the Enterprises, as I will refer to them—in conservatorship has raised numerous issues, many similar to those arising at other federally-assisted institutions, but some unique to the Enterprises.

Our principal aim in addressing these issues has been that Enterprise compensation be sufficient to attract and retain the executive leadership needed to ensure ongoing functioning of the Nation's secondary mortgage market, while minimizing taxpayer losses.

At the inception of the conservatorships, the incumbent CEOs were replaced. They received no severance payments. Because most of their compensation had been in the form of Enterprise stock,

roughly two-thirds of their previously reported pay during their tenures vanished with the collapse of the market price of their shares.

Ultimately, five of the six highest-paid Fannie Mae executives and the top four Freddie Mac executives left in one fashion or another, but none of them received severance or other golden parachute payments.

While today's hearing is on executive pay, I would like to add that many of the more than 11,000 Enterprise employees also had large portions of their life savings in Enterprise stock, and suffered accordingly.

In developing a new compensation structure for senior Enterprise executives, FHFA consulted with Mr. Feinberg on how we could adapt the approach he was developing for TARP institutions to the Enterprises. In making that adaptation, a major consideration was that compensating Enterprise executives with company stock would be ineffective, because of the questionable value of such stock.

Further, large grants of low-price stock could provide substantial incentives for executives to seek and take large risks. Accordingly, all components of executive compensation at the Enterprises are in cash.

Another consideration is the uncertain future of the Enterprises as continuing entities, which is in the hands of Congress and beyond the control of Enterprise executives.

It is generally best to focus management's incentives toward its institution's performance over the long run, rather than just the near term. In the case of the Enterprises—

The CHAIRMAN. Mr. DeMarco, let me interrupt you briefly.

Mr. DEMARCO. Certainly, sir.

The CHAIRMAN. Mr. Feinberg has arrived, and I just want to thank him—it hasn't been an easy day for him—and just reassure him that the next witness will be Mr. Alvarez, so he will have at least 7 or 8 minutes to collect himself. We understand that there was, literally, a train wreck, and we thank you for making every effort to come here.

I apologize, Mr. DeMarco. Please continue.

Mr. DEMARCO. In setting target compensation for the most senior positions, we considered data from consultants to both Enterprises, the data received earlier from our own consultant, and the reported plans of TARP-assisted firms. It was important to set pay at levels sufficient to compete for quality talent, because the Enterprises had many key vacancies to fill, potential departures to avoid, and pay had been a significant issue in some cases.

FHFA settled on a target of $6 million a year for each CEO, $3.5 million for the chief financial officers, and less than $3 million for executive vice presidents and below. I know $6 million is a considerable sum of money, but that amount rolls back Enterprise CEO pay to pre-2000 levels. It is less than half of target pay for Enterprise CEOs before the conservatorships. And for all executive officers, Fannie Mae and Freddie Mac have reduced target pay by an average of 40 percent.

The basic compensation structure for senior executives at both Enterprises, as at institutions receiving exceptional TARP assistance, comprises three elements: base salary; a performance-based

incentive opportunity; and deferred salary. My written statement details these components.

In my judgement, we have achieved the right balance between enough compensation to acquire and retain quality management, while preventing compensation from exceeding appropriate bounds.

In sum, the directors and senior executives tied to the financial collapse at each Enterprise are no longer with the companies. The group of senior executives who remain, as well as those who were recently hired, are essential to the Enterprises fulfilling their important and challenging responsibilities. And in attempting to do so, the Enterprises must operate with an uncertain future that will be the source of much public debate.

As conservator, I believe it is critical to protect the taxpayer interests in the Enterprises by ensuring that each company has experienced, qualified people managing the day-to-day business operations in the midst of this uncertainty. Any other approach puts at risk the management of more than $5 trillion in mortgage credit risk that is supported by the taxpayers.

Thank you and I am pleased to answer questions.

[The prepared statement of Mr. DeMarco can be found on page 53 of the appendix.]

The CHAIRMAN. Next, Mr. Scott Alvarez, General Counsel of the Federal Reserve.

STATEMENT OF SCOTT G. ALVAREZ, GENERAL COUNSEL, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. ALVAREZ. Chairman Frank, Ranking Member Bachus, and members of the committee, thank you for the opportunity to discuss incentive compensation practices in the financial services industry.

Compensation arrangements serve several important and worthy objectives. For example, they help firms attract and retain skilled staff, and promote better firm and employee performance. However, compensation arrangements can also provide employees with incentives to take excessive risks that are not consistent with the long-term health of the organization. This misalignment of incentives can occur at all levels of a firm, and is not limited to senior executives.

Having experienced the consequences of misaligned incentives, many financial firms are re-examining their compensation structures to better align the interests of managers and other employees with the long-term health of the firm.

For firms that have received assistance from TARP, that includes ensuring their compensation structures are consistent with the Special Master's rules designed to protect the financial interests of taxpayers.

The Federal Reserve has also acted as a prudential supervisor. In October, we proposed supervisory guidance on incentive compensation practices that would apply to all banking organizations that the Federal Reserve supervises. The guidance, which we expect to finalize shortly, is based on three key principles.

First, compensation arrangements should not provide employees incentives to take risks that the employer cannot effectively identify and manage. Financial firms should take a more balanced ap-

proach that adjusts incentive compensation, so that employees bear some of the risks, as well as the rewards associated with their activities over time.

Second, firms should integrate their approaches to incentive compensation arrangements with their risk management and internal control frameworks. Risk managers should be involved in the design of incentive compensation arrangements, and should regularly evaluate whether compensation is adjusted in fact to account for increased risk.

Third, boards of directors are expected to actively oversee compensation arrangements to ensure they strike the proper balance between risk and profit on an ongoing basis.

Recently, the Federal Reserve also began two supervisory initiatives to spur the prompt implementation of improved practices. The first is a special horizontal review of incentive compensation practices at large, complex banking organizations. Large firms warrant special supervisory attention, because the adverse effects of flawed approaches at these firms are more likely to have consequences for the broader financial system.

Although our review is ongoing, we have seen positive steps at many of these firms. However, substantial changes at many firms will be needed to fully conform incentive compensation practices with principles of safety and soundness. It will be some time before these changes are fully addressed. Nonetheless, we expect these firms to make significant progress in improving the risk sensitivity of their incentive compensation practices for the 2010 performance year.

The second initiative is tailored to regional and smaller banking organizations. Experience suggests that incentive compensation arrangements at smaller banks are not nearly as complex or prevalent as at larger institutions. Accordingly, review of incentive compensation practices at these firms will occur as part of the normal supervisory process, a process that we expect to be effective, yet to involve minimal burden for the vast majority of community banks.

Incentive compensation practices are likely to evolve significantly in the coming years. This committee's efforts in developing and passing H.R. 4173 will promote the uniform application of sound incentive compensation principles across large financial firms beyond those supervised by the Federal Reserve. In this way, H.R. 4173 would encourage financial firms, supervisors, shareholders, and others to develop incentive compensation practices that are more effectively balanced and reward and better align incentives.

We appreciate the committee's efforts in this area, and thank you for the opportunity to testify on this important topic. I would be happy to answer any questions.

[The prepared statement of Mr. Alvarez can be found on page 37 of the appendix.]

The CHAIRMAN. Thank you.

And next, Mr. Kenneth Feinberg, who is the Special Master for TARP Executive Compensation at the Department of the Treasury. And I reiterate, Mr. Feinberg's train was behind a train where there was an unfortunate accident. So it's an unusually stressful day, and we are deeply appreciative, Mr. Feinberg, seriously, of your appearing.

And please go ahead.

STATEMENT OF KENNETH R. FEINBERG, SPECIAL MASTER FOR TARP EXECUTIVE COMPENSATION, U.S. DEPARTMENT OF THE TREASURY

Mr. FEINBERG. Thank you, Mr. Chairman. It is a distinct honor for me to appear before your committee, before you, as chairman, and the ranking minority member, and I thank you for the invitation.

I will just summarize my written statement by pointing out highlights of what appears in the statement.

First, as this committee well knows, my jurisdiction is extremely limited, by statute. Right now, I am determining compensation for just the top 25 compensated officials at 5 companies that receive the most TARP assistance: GM; GMAC; Chrysler; Chrysler Financial; and AIG. If one of those exceptional assistance participants or recipients has repaid all of what they owe the taxpayer, they are automatically removed from my jurisdiction. And, as a result, Bank of America and Citigroup are no longer subject to my 2010 compensation determinations. It is, by statute, a very limited role.

I am also responsible, under the statute, for those 5 companies, for determining compensation structures for officials 26 to 100 in those 5 companies, only. Just those five. And again, we did that in 2009. We are moving forward, doing the same for the 5 companies, 1 to 25, 26 to 100, for 2010.

The second point I want to emphasize is under the statute, there are some principles laid out that I am obliged by law to follow in determining my compensation decisions. And when you read the statute, there they are. We shall make sure that compensation determinations maintain the competitiveness of these five companies, so that key employees will be retained, the companies will thrive, and they will repay the taxpayer.

But the compensation determination should be made in a way that avoids excessive risk-taking at these companies, that there will be an appropriate allocation between short-term compensation, in the form of cash, and long-term compensation, in the form of salaries and TARP stock that must be held for an extended period of time. The fortunes of the individual should rise or fall, depending on the performance and the fortunes of the company.

I should examine comparable structures and payments at other companies. I should consider empirical data on compensation levels at various companies that are similar in kind to the companies that fall under my jurisdiction. I have enjoyed the benefit of expert input from professors at Harvard Business School and the University of Southern California in advising me and my excellent staff—most of whom are here today, by the way, behind me—in reaching these compensation determinations.

As a result of the statute and the accompanying regulations promulgated by Treasury, there are a few basic conclusions that I have reached about executive compensation at these companies.

One, guaranteed income should not be permitted. Compensation of key officials at these companies that owe so much to the American taxpayer should depend on performance, not retention contracts, not guaranteed bonuses. What you earn, other than your

base cash salary, should depend on long-term performance, objective metrics promulgated by the company, in consultation with my office.

Second, base cash salaries should rarely exceed $500,000, and only then for good cause shown, and should be, in many cases, well under $500,000.

Third, the Special Master reserves the right to claw back excessive compensation, which is granted based on what proved to be material misstatements. And we will exercise that authority to claw back excess compensation in appropriate cases.

The final summary points I want to make concern an inquiry made by this committee, when the committee asked me to comment on a rather interesting question posed by the chairman and the members of the committee: What is unique about what I am doing? Are there unique features in this statute that really make the job I have undertaken particularly challenging? And I want to mention just a couple of those unique features that neither the Federal Reserve nor Fannie Mae have to deal with, the way I have to deal with it.

One I have already mentioned. My role is extremely limited.

The CHAIRMAN. If I may, we are over the time, so if you have already mentioned it—

Mr. FEINBERG. Second, I have no authority to restructure or demand a restructuring of old retention contracts that were entered into long before the TARP law was implemented.

And finally, I have the distinct challenge of actually calculating individual compensation for these top 25 officials in these 5 companies.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Feinberg can be found on page 60 of the appendix.]

The CHAIRMAN. Thank you. Let me begin. Mr. DeMarco, when did you take over?

Mr. DEMARCO. September 1st of last year, Mr. Chairman.

The CHAIRMAN. All right. And I gather there has been continuity on the compensation issues between yourself and—was it Mr. Lockhart, basically, who was your predecessor?

Mr. DEMARCO. I would say that is correct.

The CHAIRMAN. Let me ask all of you. One of the things we have to deal with is people threatening to walk away if the compensation isn't higher. How credible has that been?

At some levels, it seems to me not too credible, at least at some levels that these limits were applied across-the-board, unless someone is a heck of a shortstop, and there is probably not another place where they are going to make equal amounts of money.

But let me ask all of you. How credible? Do we have evidence of people walking away because they are inadequately compensated? Let me start with Mr. DeMarco.

Mr. DEMARCO. Yes, Mr. Chairman, we do. As conservator of these two companies—let me put it this way; it was a business—a senior executive business line manager at one of the Enterprises who had a critical role at that company, specifically to manage and reduce losses on foreclosed mortgages and the properties that are then taken in by the company afterwards. And this individual left

the Enterprise to join another very large, well-known financial institution at a considerable increase in pay.

The consequence of this individual's departure is that the head of this area of management at the Enterprise was vacant for a number of months. We lost several of the lieutenants in that particular part of the company as well, given the upset in there, and the opportunities that those individuals had because this is a significant area and there are a lot of financial—

The CHAIRMAN. All right, thank you. Let me ask Mr. Feinberg. I want to get to Mr. Alvarez last. Mr. Feinberg, what's your sense—

Mr. FEINBERG. I am dubious about that claim. Now, I will say this. First, the determinations we have made were only made last October, last December. We don't see any exit of individuals from these companies. Whatever individuals were exiting these companies, I suggest exited long before compensation determinations were made by this office. There were quite a few vacancies when I took over this assignment.

But I don't see exiting. We have to take that into account. It certainly impacts our decisions on compensation. But I am rather dubious about that claim.

The CHAIRMAN. Let me ask Mr. Alvarez. And I held you for last because, to the extent that we do these in a uniform way, and diminish competitive advantage in that, it's helpful. Now, I notice two things.

First of all, the Federal Reserve has promulgated, under its existing statutory authority, limitations. And again, am I correct? Not limited to TARP recipients. What the Federal Reserve Board of Governors—was there any dissent on the Board of Governors over that?

Mr. ALVAREZ. No.

The CHAIRMAN. Thank you. So what we have is—because it has been appointed by several Administrations.

So, the Board of Governors has imposed restrictions on all financial institutions that minimizes this as between—if the compensation restrictions are the same, you don't get that.

But also I gather—and I was gratified, frankly, that you expressed your support for those elements of H.R. 4173—I know the Federal Reserve is not for all elements of H.R. 4173, our financial regulatory bill—but that you do like the notion that we apply those across-the-board so that you would not have the theoretical competitive disadvantage, if there was one in retention, between the institutions that you regulate and other financial institutions. Is that accurate?

Mr. ALVAREZ. That's absolutely right. There is what the economists call a first-mover problem here. Many people recognize that incentive compensation structures need to be changed, that the incentives are not always aligned properly—sometimes very badly misaligned. But the first person who changes to fix those policies is concerned that they are going to lose personnel to others who don't change the incentives.

So, one of the things we can do—and you have helped us do—is to set a policy that broadly applies across the industry, has ev-

eryone subject to the same policies and principles, and that removes that difficulty.

The CHAIRMAN. And my time is close, so I won't start a new line. The gentleman from Alabama.

Mr. BACHUS. Thank you, Mr. Chairman. Mr. DeMarco, I know you were a career—had a career position. So I guess when the President asked you to take that position, you didn't have a lot of choice, did you?

Mr. DEMARCO. Well, Representative Bachus, I was honored that the President asked me. I still am a career official. I have spent my entire professional career as a civil servant at the Federal level at a variety of agencies. I am honored to serve as the Acting Director of FHFA, until such time as the President nominates and the Senate confirms a permanent director.

I believe we are at a very critical juncture, and I am very honored to lead an agency that is working incredibly hard right now to oversee these companies and to help bring stability back to the housing—

Mr. BACHUS. Thank you. That's a good answer. I appreciate that.

Mr. DeMarco, last year, the Administration's Regulatory Reform Blueprint indicated that the Administration would present a reform plan for Fannie and Freddie this month. Yesterday, Secretary Geithner testified before the House Budget Committee that the plan would not be ready until 2011 at the earliest. Congressman Garrett made reference to that.

Then, in testimony before this committee yesterday, Chairman Bernanke recommended we take steps to determine the future of the GSEs this year.

With the American taxpayers exposed to literally hundreds of billions of dollars in losses from Fannie and Freddie to continue operations, do you agree with Chairman Bernanke that we cannot afford to wait until next year to decide the GSEs' futures?

Mr. DEMARCO. Congressman, I believe the time is now to be figuring out what are the proper questions we need to be asking and answering, for example, what is the proper role of the government in the housing finance system and what is the future structure and objectives of the housing finance system that policymakers believe is in the best interest of the country.

I believe there are plenty of important questions and it is time to start asking and working towards answering those questions right now.

With that said, I appreciate the difficulty and the challenges in getting to specific answers and getting to a final structure. I understand that is going to take a while. I believe we ought to absolutely take the time to get it right.

I would be happy to work with this committee to start going through what some of those key questions are. I am ready for the discussion to get started.

Mr. BACHUS. Thank you. If you look at August of 2008, when we first had the bailout of Fannie and Freddie, I think we have had an adequate amount of time.

I appreciate you saying now is the time to start making those changes or at least advancing ideas.

Mr. Alvarez, in your testimony you said the misalignment of incentives is not confined to the top level executives. When the Federal Reserve or others start looking at these pay incentives, where do you stop? Do you include all employees of all financial institutions?

Mr. ALVAREZ. Congressman Bachus, what we are speaking of is employees who are given incentive compensation. A lot of organizations do not provide incentive compensation to the vast majority of their employees. It is selected groups that receive targeted incentives.

An example of the type of lower level non-executive employee that we would consider an organization should look at would be their mortgage brokers, where volume of mortgages produced—compensation is often tied to the volume of mortgages produced.

We have seen in this crisis that can encourage some employees to generate mortgages with weak underwriting so they can increase their own compensation.

Mr. BACHUS. When you get down to incentives for volume, would it not be better if they make bad loans, the bank would want to get rid of them?

Mr. ALVAREZ. You are exactly right. We would not try to set the compensation for those employees. What we ask is that the bank have a procedure in place to monitor the incentives it is creating and to take action when those incentives are misaligned.

Mr. BACHUS. I see. Mr. Feinberg, what did you think of the compensation packages awarded to the Fannie and Freddie executives that were announced Christmas Eve?

Mr. FEINBERG. Very high, but Fannie and Freddie, although they are not on my watch, pose some unique problems that I do not have to address with the five companies I am now dealing with.

First, the future of Fannie and Freddie is sufficiently uncertain, as you well know, so that attracting people to Fannie and Freddie with the talent necessary to administer that program is more problematic. Not impossible, of course, but more problematic.

Second, it is not easy to develop a pay package that has long-term performance-based delay, like I have with the five companies before me, when long-term performance-based delay is uncertain with a company like Fannie and Freddie.

You cannot simply say, we will pay you over 4 or 5 years out, when there is a question as to what Fannie and Freddie will look like 4 or 5 years out.

Finally, a major component of what I am doing and what the Office of the Special Master is doing is tied to stock. The fortunes of the individual will depend on the fortunes of the company. Your stock's value will depend on how well the company is doing. With Fannie and Freddie, there is no stock. It is cash.

The CHAIRMAN. The gentleman's time has expired.

Mr. BACHUS. Thank you.

The CHAIRMAN. The gentleman from Kansas.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman. Looking at executive compensation, Mr. Feinberg, I believe we share the view that for firms who repaid TARP, the government should not set specific pay levels for the private sector, but to better protect investors and taxpayers in the future, I believe we should look at pay

structure more broadly to ensure risk taking is properly aligned with rewards and does not impose a systemic risk.

For firms like AIG, GM, and Chrysler who continue to depend on taxpayer assistance, I believe more scrutiny of executive compensation is warranted.

I filed a bill, H.R. 857, the Limit Executive Compensation Abuse Act, that would limit compensation for employees of TARP firms to the same level of compensation the President receives.

Mr. Feinberg, in your work, have any of the TARP firms you have worked with conducted a cost/benefit analysis or other analysis of any employee making more than what the President receives, $400,000, or anyone making more than $1 million annually, so we have a better idea of what kind of taxpayer returns we should get from these employees in exchange for the compensation packages?

If not, would you provide a written response providing a cost/benefit analysis along those lines?

Mr. FEINBERG. I will be glad to provide you a written analysis. I would say, Congressman, that we have examined the prospective data as to what type of individual should receive what level of compensation.

It is a bit premature for us to draw any conclusions about the compensation determinations made just in the last few months because we will be monitoring that performance over time.

Mr. MOORE OF KANSAS. Very good. I appreciate that.

Same question to you, Mr. DeMarco, has FHFA performed any cost/benefit analysis of these compensation packages for Fannie and Freddie executives and would you be able to provide us details in writing along the lines I have discussed with Mr. Feinberg?

Mr. DEMARCO. We have not done what I would call a cost/benefit analysis, Congressman. We have analyzed what the market for financial executives with the requisite expertise is, and that certainly was a key input into the pay setting that was done.

We also have market experience in terms of the effort and what it has taken to recruit the senior executive positions that we had to fill at each company.

I would be glad to provide some more information along that line to you in writing.

Mr. MOORE OF KANSAS. I appreciate that very much, and I thank the witnesses for their testimony. Mr. Chairman, I yield back.

The CHAIRMAN. The gentleman from Texas.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

Mr. DeMarco, I probably want to change the direction of this a little bit in that I really want to talk about what activities are going on at Freddie and Fannie right now. Basically, you have two entities that are insolvent.

What is going on with their portfolios? How much portfolio growth are those two entities experiencing right now?

Mr. DEMARCO. Since the time the conservatorship was established, Congressman, the portfolios have risen modestly, from the low- to the mid-$700 billion range. They are on a path for the portfolios to gradually decline. They have a dollar cap at which the portfolios must be at the end of each year.

For this past year, 2009, the cap had been at $900 billion. For the end of this year, it is $810 billion, and will continue to decline by 10 percent per year.

I have made clear to the companies and I have communicated to the committee that it is certainly my objective as conservator to see that those reductions take place so the companies keep their portfolios within those caps. I believe the cap room they have today will be used principally for the purpose of pulling delinquent loans out of mortgage-backed security pools and to then seek loan modifications or other loss mitigation activity on that.

That is what the net additions to the portfolio will be, working on delinquent mortgages and trying to minimize the losses on those delinquencies.

Mr. NEUGEBAUER. Is portfolio reduction just primarily principal reduction in the portfolio or have you been able to sell any of the portfolio? What kind of activities are going on in that area?

Mr. DEMARCO. There is actually a fair amount of run-off every month in terms of the portfolios paying down. That leads to the decline. The additions are principally driven by loans coming out of mortgage-backed security pools so that they can be worked on.

If I followed the first part of your question, you were asking about the approach taken with respect to loss mitigation. The first approach taken by the Enterprises is consistent with and follows HAMP, the Homeowner Affordable Modification Program, and that is driven principally by reductions in interest rates and extending the term of the mortgage to try to get to an affordable mortgage set at 31 percent of the borrower's monthly income.

If that does not work as a loss mitigation strategy, the Enterprises are quite active and rigorous in seeking, whatever the circumstance for that particular borrower is, what is the way to resolve that delinquent mortgage at the lowest cost to the company, and hence, the lowest cost to the taxpayer. And that could include a short sale, it could include deed removal and foreclosure or a loan modification that does not follow HAMP.

But at the end of the day, if none of those are going to be able to produce a better outcome, then we will be moving expeditiously to foreclose on the mortgage and try to reduce the loss to the company and hence, to the taxpayer.

Mr. NEUGEBAUER. What about the securitization activity? What are your volumes seen there?

Mr. DEMARCO. Basically, they are securitizing almost all of the new business that they do, and they are responsible for about three out of every four mortgages that are being made in this country, with FHA representing most of the balance.

Mr. NEUGEBAUER. What are the credit quality and underwriting standards being used?

The CHAIRMAN. One minute remaining.

Mr. DEMARCO. The credit quality of the new book is substantially superior to that of the middle part of the past decade. The loan to value at origination is lower. The credit scores of the borrowers are higher. These are much sounder loans.

Mr. NEUGEBAUER. Thank you.

The CHAIRMAN. The gentleman from Missouri.

Mr. CLAY. Thank you, Mr. Chairman.

Mr. Feinberg, have you examined companies like Goldman Sachs who received pass-through TARP funds from AIG? The American public had to endure announcements recently from Goldman of record profits and record bonuses.

Can you determine if any of that pass-through money went toward paying those bonuses and if so, did you ever address it with them?

Mr. FEINBERG. Goldman is not one of the companies that falls under my mandatory jurisdiction. Unlike the others, the other seven, now five, I have no mandatory jurisdiction over Goldman.

There is a provision in the law that requires me to seek information about Goldman's pay practices, which we will do, and we will examine that data. We have no mandatory jurisdiction to set compensation at Goldman.

Mr. CLAY. Do you think any of the pass-through money went towards posting their profits and paying out record bonuses? We had to wait to see with bated breath, I guess, for most, what Mr. Blankfein's bonus was going to be, when the average American is trying to pay their mortgage.

Mr. FEINBERG. I share that concern. My role is somewhat limited, Congressman. I do have this one opportunity to inquire shortly, and we will do so.

Mr. CLAY. Thank you for that response. As a follow-up, what did you finally decide was fair compensation for AIG employees, and did you take any action toward their Financial Products Division, the sector of the company at AIG that devised and traded derivative swaps?

Mr. FEINBERG. We certainly did. There is a company that does fall within my jurisdiction. The retention contracts that were entered into are grandfathered, legally binding contracts that I could not invalidate.

I asked AIG Financial Products to roll those contracts forward, like other companies did. Instead of asking for the cash, put it into long-term stock, so that whether what it may be worth will depend in the long term on the future of the company.

Mr. CLAY. On the performance, did they follow your advice?

Mr. FEINBERG. They did not follow my advice. In 2009, last year, since they did not follow my advice, we slashed the base salaries, which I could do under the law, and reduced substantially the overall compensation of those officials, mainly in the 1–25 group, that refused to roll those retention contracts over. We are now in 2010, with Financial Products, in negotiations to do the very same thing.

Mr. CLAY. Thank you. I hope it goes well.

Citi comes under your jurisdiction also, right?

Mr. FEINBERG. Citigroup did come under my jurisdiction last year, Congressman. They have repaid the taxpayer all they owe and they are no longer within my jurisdiction in 2010.

Mr. CLAY. While they were under your jurisdiction, did they have compensation issues that you had to negotiate?

Mr. FEINBERG. Yes. We did negotiate with Citi. We did roll over their grandfathered retention contracts to long-term stock.

The CHAIRMAN. One minute left.

Mr. FEINBERG. We did negotiate and work out appropriate compensation at those levels, all under $500,000, base cash salary, which we were comfortable with.

Mr. CLAY. I am glad to hear that. Thank you so much for your responses. Mr. Chairman, I yield back.

The CHAIRMAN. The gentleman from California, Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman.

Mr. DeMarco, I mentioned the legal defense bills paid by the taxpayers to the ousted executives at Fannie Mae and Freddie Mac. Is the $6.3 million figure from September 6, 2008, to July 21st of last year accurate?

Mr. DEMARCO. Yes, sir.

Mr. ROYCE. That is the total amount that has been paid out to date?

Mr. DEMARCO. To my understanding.

Mr. ROYCE. How is paying out $6.3 million for the legal defense of former executives consistent with the conservatorship which requires you to preserve and conserve assets and property and to put the company in a sound and solvent condition?

Mr. DEMARCO. The payment here is covered under indemnification agreements that were in place and are in place, and that is the grounds for it. We also have considered looking at the ongoing litigation and the issues that are in play at the moment, i.e., what is the approach that best satisfies those goals of conservatorship. It is our judgement, Congressman, that proceeding as we have is the appropriate course of action.

Mr. ROYCE. Let me ask you this, if Fannie Mae and Freddie Mac move into receivership, should these institutions move into receivership, would you be able to do anything about those funds?

Mr. DEMARCO. I do not know the answer to that question at this moment, Congressman. I would have to look at that.

Mr. ROYCE. Again, I raise this issue not because this $6.3 million is going to make Fannie and Freddie solvent again, but because as we look at the housing boom and bust, which caused the financial collapse, one of the roads leads to Fannie Mae and Freddie Mac.

Some of us were raising alarms about these institutions long before their failure and well before their accounting scandals, and we understood the fundamentally flawed structure of socialized losses and privatized profits. We saw the overleveraging and the build-up in junk loans there.

Frankly, the Federal Reserve came and warned us about it. We had an obligation to the taxpayers to prevent their failure, but we failed, largely because of Chuck Hagel's bill the Fed had requested which passed out of committee on the Senate side and was blocked by the lobbying of Fannie and Freddie.

Fannie and Freddie executives leaned in and said no, in terms of those portfolios, in terms of the issue of the overleveraging and the arbitrage which the Fed was trying to get a handle on, we want to block that, and that legislation was blocked.

Now, because of that failure, the taxpayers own 80 percent of those companies. We now have an obligation, I think, to see that those most responsible for this failure are held accountable.

If the FHFA fails to take action to: first, get the money back from the legal defense fees; and second, curb these executive pay-

outs, then I hope Congress would intervene. These are wards of the state. In my view, at the end of the day, they should be treated as wards of the state.

I will yield back, Mr. Chairman.

Mr. DEMARCO. If I may, Congressman, just to respond, FHFA did, as a follow-up to its special examinations of both Fannie Mae and Freddie Mac, pursue former executives of those companies and reached settlements for certain payments.

To your larger point, Congressman, I would just like for you to be assured that it is personally my goal and it is absolutely the goal and the endeavor of the employees of FHFA to assure that the operation of the conservatorships of Fannie Mae and Freddie Mac are done in a way to meet the goals of conservatorship as Congress has set forth in the statutes. Those are to preserve and reserve the assets of the company, but most of all, we are focused on doing everything we can to minimize the losses that the taxpayer ends up incurring as a result of what has happened with these companies.

Everything we do is directed at that objective, of minimizing these losses. We have made that quite clear to the new Boards of Directors and the new senior managers.

I view what we are doing in the area of bringing in new executive leadership of these companies as part and parcel of that overriding objective, of minimizing losses.

Mr. ROYCE. Thank you, Mr. DeMarco. Thank you, Mr. Chairman.

The CHAIRMAN. The gentlewoman from New York.

Mrs. MCCARTHY OF NEW YORK. Thank you, Mr. Chairman. It is good to see you, Mr. Feinberg.

I was sitting here when you came in, and I am wondering, how do you get these jobs? Mr. Feinberg, very graciously, you took over the 9/11 Fund and did a tremendous job with those victims, and we have you here in front of the committee again working on these issues.

I think you explained what your mandatory jurisdiction is, and I think a lot of people need to understand that, especially with the exceptional assistance that you are doing with the TARP recipients.

My concern is the companies that are not in that status and may have resumed the excessive compensation structure, and if I understand this correctly, a company needs to be competitive in compensation for retention purposes.

However, if banks are free to start diverting increased revenues towards compensation, that leads them down the road to being less capitalized and ultimately unstable once again.

The question is, how are the financial institutions who are now not under your regulatory power handling compensation? Do you see them reverting back to their old ways or are they going along with your guidance?

Just to follow through, we all know you want top people at the top of the company, but when you have seen this whole financial mess starting going back, is there one person actually who deserved any of the compensation, being that they got this whole country and in my opinion, the world, into the mess we are in right now.

Mr. FEINBERG. First, I would like to think that much of the private sector that is not within my jurisdiction is adopting many of

the prescriptions that fall in my jurisdiction, low base cash salaries, stock rather than cash, no guaranteed bonuses.

Goldman, Morgan Stanley, Wachovia, Wells Fargo, I get the early signs that in terms of the criteria for compensation, they seem to be following voluntarily the prescriptions I have entered into.

In terms of long-term compensation, what I am doing is really as you know, Congresswoman, merely one small part of a much broader menu that the chairman and the committee know a great deal about, corporate governance reform, regulatory reform, the G-20 principles promoted by the Secretary, to make sure that foreign government corporations are doing what we are doing.

The Federal Reserve, Mr. Alvarez's efforts. The FDIC, the legislation of the chairman, there are a lot of other initiatives out there that can have an impact on those companies that are not part of my jurisdiction, including some advanced by the Administration concerning bank fees and other initiatives.

I take no position on all those other than to say that if you examine all of the items that are out there, that are being considered by this committee, it seems to me there is an appreciative opportunity to reign in some of that excessive pay that we see now that partly got us into this mess.

Mrs. MCCARTHY OF NEW YORK. I agree.

Mr. Alvarez, following up a little bit on that, especially when we start talking about the international community, we saw that France and the U.K. have put a fine onto their high bonuses, a 50 percent tax.

The CHAIRMAN. One minute remaining.

Mrs. MCCARTHY OF NEW YORK. Additional British action, they have put a one-time tax on the bonuses.

How do you think that might work with our companies that are international over there? Do they have to look at basically what we are saying to them to do? Do they have to bring that over to the foreign land?

Mr. ALVAREZ. A U.S. company that has an international presence, how it would have to deal with compensation rules abroad depends on its structure.

For example, if it were to own a bank, a U.S. bank owns a bank in France, the bank in France would likely have to abide by the compensation structures in France.

If it had a branch or some other extension of itself that was not a separate corporate entity, it would abide by the U.S. compensation standards on a worldwide basis.

That is one of the things that we tried to do in our guidance, to have the management focus on incentive compensation on a worldwide basis.

The CHAIRMAN. The gentlewoman from Illinois.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Mr. Feinberg, you are the pay czar?

Mr. FEINBERG. That is the characterization. I do not like that characterization, but that appears to be sticking in the public minds.

The CHAIRMAN. If the gentlewoman would yield, if his grandparents heard him referred to as a "czar," they would be very upset.

[laughter]

Mrs. BIGGERT. Who is the job czar? Is there a job czar?

Mr. FEINBERG. I have enough trouble keeping track of my "czarism."

Mrs. BIGGERT. I wish we would focus on the unemployed workers. I guess there is no job czar.

Mr. DeMarco, as your staff indicated, you reviewed the legislation; is that right?

Mr. DEMARCO. Yes, Congresswoman. I have taken a quick look. It has just come out. I am looking forward to looking at it in more depth and talking to you about it.

Mrs. BIGGERT. It is having the Inspector General reporting to Congress, the FHFA Inspector General reporting to Congress about a couple of things. For example, a description of the total Federal Government and taxpayers' liability of Fannie Mae and Freddie Mac.

Would you have a problem with that?

Mr. DEMARCO. Actually, as I have looked at some of the things you are interested in having reported, one of the things I am looking forward to going through with you is how much of that we are doing today. I can help indicate where this information is available now, and if it would be more useful to provide it in a different format or structure or to make it more readily known, some of this data is already being published either by FHFA or by the companies themselves. We would look forward to doing that and going over that with you.

Mrs. BIGGERT. This would be in statute. We have SIG TARP that reports to us. Is there any difference between SIG TARP and the Inspector General?

Mr. DEMARCO. TARP is not a supervision program. The Special Inspector General for TARP has a somewhat different function than the Inspector General for FHFA will have.

The thing to make clear about this is I am looking forward to the Administration nominating an Inspector General for us. The role of that Inspector General, though, will be to monitor and evaluate and report both to me and to the Congress on the efficiency and effectiveness of FHFA carrying out its responsibilities.

FHFA in turn is the Federal agency responsible for monitoring and overseeing and reporting on the activities of Fannie Mac, Freddie Mac, and the Federal Home Loan Banks.

Yes, I do think the structure Congress originally envisioned does include an IG, and I look forward to that piece of the structure being put in place.

Mrs. BIGGERT. Would not the GSEs with the conservatorship already be doing all these things? Reporting these things?

Mr. DEMARCO. Much of it they are reporting and a good bit of the information—

Mrs. BIGGERT. The problem is that Congress never really was able to question them about it.

Mr. DEMARCO. That is what I look forward to, figuring out what we can be doing, without waiting for additional legislation. I would be happy to see what we can be doing to get the information out.

Mrs. BIGGERT. Just like the bonuses and compensation paid to Fannie and Freddie, if this would come up on a quarterly basis with the Inspector General, it seems it would solve a lot of problems that we are having right now.

Mr. DEMARCO. Okay. In the meantime, as I said, I will be glad to respond to you or any other member who would like to have more information.

The CHAIRMAN. One minute.

Mrs. BIGGERT. Can you tell us what losses Fannie Mae and Freddie Mac have incurred to date?

Mr. DEMARCO. They have run through all of the shareholder equity they had pre-conservatorship, and combined between the two of them, through the third quarter of 2009, they have drawn $111 billion from the senior preferred stock purchase agreement with the Treasury.

They have run through all of their initial shareholder equity and an additional $111 billion.

Mrs. BIGGERT. Are there any other anticipated losses?

Mr. DEMARCO. I would expect there will be additional draws on the senior preferred agreement.

Mrs. BIGGERT. Do you think those losses could be more than TARP?

Mr. DEMARCO. TARP was initially authorized at $700 billion. If you are asking that, I would say it is not my expectation that combined we will be seeing $700 billion as to Fannie and Freddie.

The CHAIRMAN. The gentleman from Indiana.

Mr. DONNELLY. Thank you, Mr. Chairman.

Mr. Feinberg, when we look back, Goldman was very close to going over the cliff. Morgan Stanley was very close to going over the cliff. They were saved by money from everybody's paycheck in this country.

When you talk to them about these bonuses, what I was wondering is, did you ever ask them if they felt, as they were talking to you about these bonuses, any obligation to the people of this country to not conduct themselves this way?

Mr. FEINBERG. The answer is "yes." First, remember that Goldman is not on my watch.

Mr. DONNELLY. I understand that.

Mr. FEINBERG. Goldman and some others have asked my advice in following the prescriptions that I have laid out for the companies that are under my watch. I have at the request of Goldman and others not on my watch urged them to take into account the very reality that you are pointing out; yes.

Mr. DONNELLY. Obviously, they have the choice to do what they want, but they owe their very existence to the people who are riding the bus and heading to work every day.

Did they feel it was at all unseemly that when these small businesses, people who enable them to survive, cannot find credit because of the very actions that were taken, that it was inappropriate for these bonuses to be given?

Mr. FEINBERG. I do not know if that discussion took place. I do not think I am the right person to ask as to what they felt or what they thought.

Mr. DONNELLY. Did they ever express that to you?

Mr. FEINBERG. I do know that Goldman, for example, has tried somewhat to accommodate the principles I have annunciated with my office, with no cash bonuses, bonuses that will be paid in stock over many years, the CEO of Goldman refusing to take any cash at all. The CEO of Morgan Stanley refusing to take any cash bonus at all.

I think there is some effort. Whether or not that effort is satisfactory in light of the financial uncertainty you posit is a very fair question, but I think it has to be directed at them, not me.

Mr. DONNELLY. If you see them in your travels, as Mrs. McCarthy said, you are a widely traveled man, in your travels, the biggest problem we find is the ability to obtain credit, and we have company after company, not only in my home State of Indiana, but elsewhere, who cannot employ additional people because they cannot get the credit to go out and buy an additional piece of equipment or because their line of credit has been reduced, that if these funds were used for credit purposes instead of bonus purposes, it would be a great way to let the American people know we are all in in bringing this economy back.

If you have $20 billion plus in bonuses that are given out, if that was used for lending purposes, think of the job creation that could cause.

The only other question I have for you is this, I read an article where it said a gentleman that you talked to about compensation and the mention of $9 million, and he said to you, why don't you like me?

Is there any connection between the reality of what the rest of the people in this country go through and this kind of mindset?

Mr. FEINBERG. Not much connection. I am amazed in my work, Congressman, at the perception of Wall Street versus the perception of Main Street. It is one of the most difficult gaps that I am trying to bridge in doing what I am obligated to do under the statute.

Mr. DONNELLY. Thank you very much for your service, sir. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Texas.

Mr. HENSARLING. Thank you, Mr. Chairman.

Mr. DeMarco, I do have to ask this question, and that is the Christmas Eve question, when many Americans were singing, "over the river and through the woods, to grandmother's house we go," we end up with this release saying that the executives of Fannie and Freddie are going to end up with millions of dollars of bonuses, and then across town, we have the United States Treasury saying oh, by the way, U.S. taxpayer, we were only going to use $400 billion and now it is unlimited, the sky is the limit.

I would like to at least understand, since conventional wisdom would seem to indicate if you send out a press release on Christmas Eve when you do not want anybody to pay attention, what was the timing of this announcement?

Mr. DEMARCO. The timing of this announcement was rather regrettable, Congressman. That was not the original target date. The original target date that my staff and I had for making the compensation announcement was the previous Friday, December 18th.

We set that date several weeks in advance. We knew it was an aggressive date. We had a lot of work to do to try to get it out by then.

Congressman, it did not happen.

Mr. HENSARLING. I understand. Let me ask you another related question. I think the gentlelady from Illinois was trying to find out what your estimate was of ultimate taxpayer losses for the GSEs.

The Congressional Budget Office estimates $389 billion over 10 years. Originally, there was a $400 billion limit. Clearly, the Administration thinks it is going to be north of $400 billion. Otherwise, why did they go to unlimited taxpayer exposure.

I think I just heard you say you believed some number south of $700 billion. Do you have an estimate of the ultimate taxpayer loss for Fannie and Freddie?

Mr. DEMARCO. We are regularly running scenarios and examining the range of potential losses still to be incurred by these companies, still to be recognized, probably already incurred.

Mr. HENSARLING. If you do not have an estimate, I am just asking, is there no estimate at the moment that you have?

Mr. DEMARCO. There are a range of estimates, many of them rather conservative, that would suggest that for each company, the total losses will remain less than the $100 billion per company, Congressman.

Mr. HENSARLING. The less conservative estimates range up to?

Mr. DEMARCO. Most of the range stays below that 200 number, Congressman. I would say the Treasury Department needs—

Mr. HENSARLING. That is fine, Mr. DeMarco. My time is limited. If I could move on, recently there was a story in the Wall Street Journal on February 9th. I think there was an interview with Freddie Mac's chief executive, Charles Halderman.

In that Wall Street Journal article, Mr. Halderman is quoted as saying, "We are making decisions on loan modifications and other issues without being guided solely by profitability that no purely private bank ever could."

What does that tell us about taxpayer protection?

Mr. DEMARCO. I will have to check that quote and talk to Mr. Halderman. The approach that is being taken in modifying loans is to minimize the loss on that loan, and loan modification is typically going to be a—

Mr. HENSARLING. If this article is accurate, he clearly has a different opinion.

Mr. DEMARCO. That is fine. I do not believe he does. He and I talk regularly about the objectives we have, and it is to minimize losses and loan modifications. They are a key instrument in doing that.

Mr. HENSARLING. Perhaps the Wall Street Journal got it wrong. Perhaps it was taken out of context.

Mr. DEMARCO. One of the ways that happens is if these loan modifications result in a recognition of accounting losses.

The CHAIRMAN. One minute.

Mr. HENSARLING. Apparently, he was also quoted in the same article as saying, "They—which I assume is Freddie Mac—were fortunate to have such a clear mission," the governance foreclosure prevention drive, and we are doing what is best for the country."

As I look at the foreclosure mitigation programs, apparently we have HOPE for homeowners, the last information that I have seen, fewer than 100 families helped, authorized up to $300 billion; making homes affordable, 116,000 permanent modifications out of 3 to 4 million predicted; $75 billion, $50 billion from TARP, $25 billion from the GSEs.

I believe the last report I saw from SIG TARP, it was estimated the taxpayer would get zero, zero back from these programs.

Once again, it would seem to me to suggest that at least this GSE, Freddie Mac, does not have taxpayer protection anywhere in its business plan.

I yield back.

The CHAIRMAN. The gentleman from Minnesota.

Mr. ELLISON. Thank you, Mr. Chairman.

Forgive me if other members have asked these questions. We are running back and forth.

One of the complaints that I have heard from some folks who object to Congress weighing in on executive compensation is that it will chase away financial talent and send it overseas.

Could you offer your views? Have you heard this observation, and if you have, what do you think about it?

Mr. FEINBERG. I stated earlier, Congressman, in a question from the Chair, that I am dubious about that in my work. However, the statute does require that in my role in determining compensation, I must at least take that into account in determining appropriate compensation for the top 25 officials and compensation structures for some others.

It is a factor. It is a factor annunciated in the statute. I have not yet seen that as a result of compensation decisions, there is a mass exiting of people.

Mr. ELLISON. Would either of the other two gentlemen care to comment on the question?

Is greater scrutiny on executive compensation from the U.S. Congress going to cause us to bleed financial talent?

Mr. ALVAREZ. That is a slightly different question than the first one, I think.

Mr. ELLISON. Answer the one you like.

Mr. ALVAREZ. There certainly is a lot of fear about losing people built into the compensation decisions that organizations are doing. We are hearing this quite a lot.

There has not been much time to see if it really is true. We have only had bad times for now 2 years. Everyone is experiencing that bad time.

I understand and feel the same as Mr. Feinberg does, we hear this but we have not seen it. It is clearly built into the calculus. That is one of the things we are trying to strain out of the calculus, so that it is not such an important part of the decision.

Mr. ELLISON. I have heard it. I think everybody has heard it. I doubt it. It just seems like it is self-serving, do not scrutinize my pay because I might go to Borneo, but nobody is going to Borneo.

If you find information on that, I would be interested in looking at it.

Another question is, how would changing corporate governance help align the risks properly such that we did not undercompensate executives and we did not overcompensate them, they just got compensated based on the market signal?

It seems to me there might be some things we could do in corporate governance to have a better, more accurate reflection of what compensation should be.

Do you have any ideas about that?

Mr. ALVAREZ. That is at the heart of what we are trying to do with our guidance, to have a system that takes the risks that employees take into account and when those risks mature and companies lose money, that is reflected in the compensation that is given to the employees.

Mr. ELLISON. I understand that is what you are doing. I guess what I am curious to know, and perhaps I can send you a question on this, but what is the range of ideas, what is the menu? What are our options?

We have worked on pay. There are other things. I am curious to know what the full range of thinking is. Maybe we can get together on that.

Mr. ALVAREZ. I would be happy to. There are a lot of ideas. In fact, we have listed some in the guidance, but we would be happy to discuss more with you. Mr. Feinberg has pioneered a lot of those.

Mr. ELLISON. One more question I better get out because my time is running short. We are talking about executive pay at the top higher echelon.

The CHAIRMAN. One minute remaining.

Mr. ELLISON. One of the things that concerned me is I was speaking to some people who were working at the bank and these folks were just regular folks, like managers at the bank. They were saying they were getting low pay but high incentives to sell people accounts they may not need and push different kinds of financial products they do not need.

I know that is probably not within your purview, but have you thought about this and how does that impact the issue of risk, particularly for the individual, but maybe even economy-wide.

Mr. ALVAREZ. That is one of the things we do in our guidance. We go beyond just the executives to any employee or group of employees that take on extra risk for the organization. We would say compliance risk is part of the risk the organization should be checking on.

Mr. ELLISON. Have you seen this as a phenomenon? Is this something you have picked up, some of these lower echelon workers are being paid a little bit but being given this bonus structure so they can move product?

Mr. ALVAREZ. We have seen that, and in fact, we brought enforcement actions against organizations where they have encouraged violations of law, for example, because their compensation was so motivating towards volume.

Mr. ELLISON. Thank you.

The CHAIRMAN. The gentleman from New Jersey.

Mr. LANCE. Thank you, Mr. Chairman. Good afternoon to you all.

I have been following this in my office as I have also been following the health care debate. Thank you for your participation in this important panel.

I tend to be a free market Republican and do not like overregulation by the Federal Government in private matters. I certainly believe, however, regarding the GSEs, since the American people now own such a high percentage of them, it is somewhat different. I am sure this area has been well discussed in the hearing.

Specifically regarding deferred compensation, Mr. Feinberg, as I understand it, the compensation was roughly $900,000 in base salary with another $3.1 million in deferred compensation.

Could you explain, sir, in a little greater detail what is meant by "deferred compensation" and why that amount was chosen?

Mr. FEINBERG. In most cases, "deferred compensation" means stock, not cash.

Mr. LANCE. Yes, sir.

Mr. FEINBERG. That stock, if it involves one of the top 25 individuals in the company, like the CEO, by law that Congress enacted, that stock must vest immediately at the same time that individual gets a paycheck but we have established rules that defer the transferability of that stock.

Stock that is issued that is part of compensation cannot be sold or redeemed; one-third after 2 years from date of grant, one-third after 3 years from date of grant, and one-third after 4 years. We want to try and tie the long-term performance of the company to the individual compensation that goes to that official.

Mr. LANCE. I believe that this compensation is extremely generous, to put it mildly, whether or not it is immediate or deferred.

You are stating to us that there is a statutory framework under which these companies must operate, the deferral has to be as you have suggested, and that is by statute?

Mr. FEINBERG. That is not by statute. That is by our interim regulation. The statute talks about the vesting requirements that are required in the law.

Mr. LANCE. Would you recommend, sir, and perhaps you have covered this in previous testimony, amending either statutory law or the regulations as have been promulgated?

Mr. FEINBERG. It might be a good idea if we were starting over to allow a delay in how soon that compensation stock can vest, so that a corporate official has to stay on the job for a certain period of time before he or she even has a right to that stock, but the law prohibits that now. The law requires that salarized stock vest immediately.

Mr. LANCE. Thank you. An observation regarding companies that are largely owned by the government, GSEs, largely in my judgement, since the President of the United States makes what he makes, it is not clear to me that the compensation should be so generous.

I distinguish between those who are involved in any way in governmental service and I believe those at Fannie Mae and Freddie Mac certainly are, given the current ownership by the American people, and distinguish that from the private sector, where I repeat, I tend to be free market in my views.

Certainly, regarding these amounts of compensation, given the fact that the Federal Government is so heavily involved now—

The CHAIRMAN. One minute.

Mr. LANCE. This certainly is an area where I think we should review the situation.

Thank you, Mr. Chairman, and I yield back the balance of my time.

The CHAIRMAN. I will recognize the gentleman from Missouri and will take 10 seconds to note that in fact the House voted on a bill that came out of this committee giving power to control the salaries at Fannie Mae and Freddie Mac. It was unfortunately a partisan vote. For some reason, my Republican colleagues opposed it.

It dealt only with TARP recipients and Fannie Mae and Freddie Mac, and then died in the Senate. It is still alive in the Senate. Maybe my Republican colleagues who voted against it will tell the Senate they changed their minds. Maybe their example will inspire them.

The gentleman from Missouri.

Mr. CLEAVER. Thank you, Mr. Chairman. I was going to mention what you just mentioned.

I have been going to town hall meetings. I had two last week where obviously people are concerned about this subject. I do not have any answers beyond what we have from the experts and from the legislation that the House has already approved.

Is there a culture on Wall Street in the financial centers that is different from the American culture?

Conscience is that thing which hurts when everything else feels good. I know they feel good about the bonuses and the compensation. I just wonder whether they hurt knowing that we have almost 10 percent unemployment, 17 percent African-American unemployment, 13 percent Hispanic unemployment, and then if we start dealing with underemployment and people who are on the rolls, it just explodes.

I would like to understand the culture. The three of you ought to write a book on the culture. I want to understand why these people can do what they are doing in the face of what is taking place in our country.

Mr. FEINBERG. I will start my third of the book by simply stating, Congressman, that you have articulated a truism for me. In my work, I do see a real cultural divide between Wall Street thinking and Main Street thinking.

The reason for that divide or the genesis of that divide, I am not sure why. I do see that when we sit and meet with companies and talk about the requirements of the law, that we compare competitive salaries and competitive compensation, take that into account, there is a view constantly expressed by the companies under my jurisdiction that they are entitled to more and more and more.

That is the competitive market data they provide us. We have substantially reduced sometimes by up to 90 percent the cash that these individuals received, and up to 50 percent slashed their compensation overall, but there is this divide and this different perception on what is worth for a job. That is just the way it is.

Mr. CLEAVER. I understand that is the way it is. What I want to be able to say is that is the way it used to be. I guess the strug-

gle is how do we get to that point where we can put it in past tense.

Mr. FEINBERG. Well, we are trying in the Office of the Special Master to reduce this compensation, provide benchmarks and criteria and principles.

I think Mr. Alvarez and the Federal Reserve are trying to do the same.

I am sure Members of Congress will be watching to see if there is a trend towards more reasonable compensation.

Mr. ALVAREZ. That is absolutely right. I do think there is a divide, and there are other pockets of this, movie stars, athletes. There are different parts of our society who think differently about themselves than the rest of us.

One of the things that is at the heart of what we are doing is to try to make sure that the pain that companies feel as a result of the action of employees is actually reflected in the salary of the employees. It is not only heads, I win; tails, you lose. If there is a loss, that loss is then taken back to the employee.

That is a new mindset. It is going to take some time to change that mindset. We are definitely working in that direction.

Mr. DEMARCO. I would concur with that. One thing that has struck me is the fixation or concern about compensation by those who are the most highly compensated in a financial institution.

I do think as Mr. Alvarez just said, and Mr. Feinberg before, we are in a transition and coming to, I believe, perhaps a different understanding about the role of compensation and thinking about both its size and its structure.

I think the gentlemen on my left have done a terrific job in providing leadership and helping to provide those guideposts and helping that transition along. I would like to see it continue.

Mr. CLEAVER. I would agree. Thank you, Mr. Chairman.

The CHAIRMAN. I would just ask for 30 seconds to pose one question to all three of you. One of the arguments we get is well, if we overregulate, the United States will be at a competitive disadvantage.

I am pleased to say with general regulatory reform, that does not appear to be the case, with great consensus.

With regard to compensation, you three gentlemen may have some idea, my impression is we do not have to worry about that because we are so far ahead of other countries in compensation at this level of activity, that there is no danger that the kind of restrictions we are talking about are going to drive people to other countries.

Mr. Feinberg, you looked at this.

Mr. FEINBERG. First, I think that is absolutely right. Secondly, I note the work of Secretary Geithner in trying to coordinate executive compensation decisions and principles with the other members of the G-20.

I think in both respects, you are correct, and again, I am dubious that there is going to be an exit of talent to foreign companies.

The CHAIRMAN. Mr. Alvarez, is that something the Federal Reserve has to take into account?

Mr. ALVAREZ. Absolutely, it is. In fact, we have been working with the Financial Stability Board in Europe to try to get the same kind of principles and standards that we are implementing here.

It is something we have to watch. It is something we have to work on globally.

The CHAIRMAN. You have confidence that what you are proposing now, I assume, is not going to do us that kind of damage?

Mr. ALVAREZ. That is right.

The CHAIRMAN. Thank you. The hearing is adjourned.

[Whereupon, at 3:51 p.m., the hearing was adjourned.]

A P P E N D I X

February 25, 2010

Welch statement on Wall Street executive compensation

WASHINGTON, DC – Rep. Peter Welch (D-Vt.) released the following statement Wednesday ahead of the House Committee on Financial Services' hearing on compensation in the financial industry:

> "I want to commend Chairman Frank for holding this much-needed hearing on compensation within the financial industry.
>
> "The American people this week witnessed a parade of excess down Wall Street as the nation's biggest banks announced bonus figures far out of the realm of reasonable compensation. Just fifteen months after driving our economy to the brink of collapse, the biggest banks demonstrated fully and clearly that they are back to their old ways.
>
> "As many Americans struggle to find jobs and as many small businesses struggle to obtain credit, Wall Street bankers are focused on turning quick profits on commodities, currencies and complex derivatives. Rather than working to restore the real world economy, the 22 banks that relied the most on government assistance have cut small business lending by $12.5 billion since April.
>
> "Since Wall Street has shown an unwillingness to invest in our economy and practice restraint in awarding compensation, I believe Congress must take action. My Wall Street Bonus Tax Act (H.R. 4426) would address both of these failures by taxing excessive bonuses at TARP-supported institutions and channeling the revenues to a temporary direct-lending program at the Small Business Administration.
>
> "I look forward to working with Chairman Frank and members of the Financial Services Committee to pass meaningful legislation to crack down on egregious compensation on Wall Street."

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2/24/2010

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Testimony

by

Scott G. Alvarez

General Counsel

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

U.S. House of Representatives

February 25, 2010

Chairman Frank, Ranking Member Bachus, and other members of the committee, thank you for the opportunity to discuss incentive compensation practices in banking and financial services. Compensation practices were not the sole cause of the financial crisis, but they certainly were a contributing cause--a fact recognized by 98 percent of the respondents to survey of banking organizations engaged in wholesale banking activities conducted in 2009 by the Institute of International Finance.[1]

Importantly, problematic compensation practices were not limited to the most senior executives at financial firms. Compensation practices can incent even non-executive employees, either individually or as a group, to undertake imprudent risks that can significantly and adversely affect the risk profile of the firm. Moreover, the problems caused by improper compensation practices were not limited to U.S. financial firms, but were evident at major financial institutions worldwide, a fact recognized by international bodies such as the Financial Stability Board (FSB) and the Senior Supervisors Group.[2]

Having witnessed the painful consequences that can result from misaligned incentives, many financial firms are now reexamining their compensation structures with the goal of better aligning the interests of managers and other employees with the long-term health of the firms. And we, as supervisors, have been reminded that risk-management and internal control systems alone may not be sufficient to constrain excessive risk-taking if a firm's compensation structure provides managers and employees with strong financial incentives to take undue risks.

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[1] See Institute of International Finance, Inc. (2009), *Compensation in Financial Services: Industry Progress and the Agenda for Change* (Washington: IIF, March).

[2] See Financial Stability Forum (2009), *FSF Principles for Sound Compensation Practices* (Basel, Switzerland: FSF, April), available on the Financial Stability Board's website at www.financialstabilityboard.org/publications/r_0904b.pdf; and Senior Supervisors Group (2009), *Risk Management Lessons from the Global Banking Crisis of 2008* (Basel, Switzerland: SSG, October), available at Federal Reserve Bank of New York (2009), "Senior Supervisors Group Issues Report on Risk Management Practices," press release, October 21, www.newyorkfed.org/newsevents/news/banking/2009/ma091021.html. (The Financial Stability Forum was renamed the Financial Stability Board in April 2009.)

Building off of these lessons, in October of last year the Federal Reserve proposed supervisory guidance to help ensure that incentive compensation policies at banking organizations supervised by the Federal Reserve do not encourage excessive risk-taking and are consistent with the safety and soundness of the organization.[3] We have received helpful public comment on our guidance and expect to issue final guidance shortly. We also have commenced two supervisory initiatives designed to complement and reinforce the important goals of the guidance. One initiative is focused on large, complex banking organizations (LCBOs) and the other is tailored to smaller and regional organizations.

Our actions derive from our statutory mandate to protect the safety and soundness of the banking organizations we supervise. At the same time, that mission establishes the parameters for the Federal Reserve's action in this area. Because our guidance and initiatives are focused on safety and soundness, our actions are intended to help promote the financial strength of all banking organizations over the long term, not just those that have received financial assistance from the government.

The incentive compensation provisions of H.R. 4173, the Wall Street Reform and Consumer Protection Act of 2009, would reinforce these objectives and expand the authority of the federal banking agencies, as well as the Securities and Exchange Commission (SEC) and the Federal Housing Finance Agency (FHFA), to act in this key area. Importantly, H.R. 4173 would promote the uniform application of sound incentive compensation principles across large financial institutions supervised by the federal banking agencies, SEC, and FHFA. In this way, the bill would help ensure a level playing field, which is critical to the effectiveness of reforms.

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[3] Board of Governors of the Federal Reserve System (2009), "Federal Reserve Issues Proposed Guidance on Incentive Compensation," press release, October 22, www.federalreserve.gov/newsevents/press/bcreg/20091022a.htm.

In my testimony, I will review how compensation practices can undermine the safety and soundness of financial institutions and how prudential supervisors can help guard against such outcomes. In addition, I will review the main principles embodied in the Federal Reserve's proposed guidance on incentive compensation and provide an update on our related supervisory initiatives that are designed to help ensure that incentive compensation programs at banking organizations do not encourage excessive risk-taking.

Compensation and the Role of Prudential Supervisors

Compensation arrangements are critical tools in the successful management of financial institutions. These arrangements serve several important and worthy objectives, including attracting skilled staff, promoting better firm and employee performance, promoting employee retention, providing retirement security to employees, and allowing a firm's personnel costs to move along with revenues.

It is clear, however, that compensation arrangements can provide executives and employees with incentives to take excessive risks that are not consistent with the long-term health of the organization. For example, offering large payments to managers or employees to produce sizable increases in short-term revenue or profit--without regard for the potentially substantial short- or long-term risks associated with that revenue or profit--can encourage managers or employees to take risks that are beyond the capability of the financial institution to manage and control.

Prudential supervisors can play an important and constructive role in helping ensure that incentive compensation practices do not threaten the safety and soundness of financial institutions. First, supervisors can provide a common prudential foundation for incentive compensation arrangements across banking organizations. In this way, supervisors can help

address collective action, or "first mover," problems that may make it difficult for individual firms to act alone in addressing misaligned incentives. The owners or managers of a single firm may be unwilling to make unilateral changes to the firm's compensation arrangements--even if they believe changes are warranted--because doing so might mean losing valuable employees and business to other firms.

Second, supervisors can constructively add to the impetus for improvement in compensation practices that is already coming from shareholders. However, aligning the interests of shareholders and employees is not always sufficient to protect the safety and soundness of a banking organization. Due to the existence of the federal safety net, shareholders of a banking organization in some cases may be willing to tolerate a degree of risk that is inconsistent with the organization's safety and soundness. Thus, supervisory reviews of incentive compensation practices at banking organizations from a safety and soundness perspective are needed to protect the public's interest and the federal safety net.

Federal Reserve Guidance

The Federal Reserve has worked actively to incorporate the lessons learned from the financial crisis into our supervision activities and to promote needed improvements to incentive compensation practices within the banking industry. As mentioned earlier, in October 2009, the Federal Reserve issued, and requested public comment on, proposed supervisory guidance on incentive compensation practices at banking organizations. This guidance, which would apply to all banking organizations supervised by the Federal Reserve, is designed to help protect the safety and soundness of banking organizations and to promote the prompt improvement of

incentive compensation practices throughout the banking industry.[4] The guidance builds on, and is consistent with, the *Principles for Sound Compensation Practices* issued by the FSB in April 2009, as well as the implementation standards for those principles issued by the FSB in September 2009.[5] The Federal Reserve was instrumental in helping develop the principles and standards articulated by the FSB, and we continue to believe strongly that international consistency on this issue is important because competition among financial institutions--both for business and talent--is increasingly global in nature.

The Board's guidance is based on three key principles for incentive compensation arrangements at banking organizations: (1) The arrangements should not provide employees incentives to take risks that are beyond the organization's ability to effectively identify and manage; (2) those arrangements should be compatible with effective controls and risk management; and (3) they should be supported by strong corporate governance, including active and effective oversight by the organization's board of directors. Because compensation arrangements for executive and non-executive employees alike may pose safety and soundness risks if not properly structured, these principles and our guidance would apply both to senior executives and more broadly to other employees who, either individually or as part of a group, may expose the banking organization to material risks. Let me discuss each of the three principles in a bit more detail.

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[4] These organizations include all bank holding companies, financial holding companies, state member banks, and the U.S. operations of foreign banking organizations that have a branch, agency, or commercial lending company subsidiary in the United States.

[5] See Financial Stability Forum, *FSF Principles for Sound Compensation Practices*, in note 2; and Financial Stability Board (2009), *FSB Principles for Sound Compensation Practices: Implementation Standards* (Basel, Switzerland: FSB, September), www.financialstabilityboard.org/publications/r_090925c.pdf.

Balanced Risk-Taking Incentives

Firms must understand how their compensation structures create incentives and affect behavior; they also need to find ways to ensure that short-term profits are not encouraged at the expense of short- and longer-term risks to the firm. Compensation practices should not reward employees with substantial financial awards for meeting or exceeding volume, revenue, or other performance targets without due regard for the risks of the activities that allow those targets to be met. One key to achieving a more balanced approach between compensation and risk is for financial institutions to adjust compensation so that employees bear some of the risk associated with their activities and don't just share in increased profit or revenue. Employees are less likely to take an imprudent risk, for example, if their incentive payments are reduced or eliminated for activity that ends up imposing higher-than-expected losses on the firm.

To be fully effective, these adjustments should take account of the full range of risks that the employees' activities may pose for the firm, including credit, market, compliance, operational, reputational, and liquidity risks. Moreover, these adjustments must be implemented in practice so that actual payments vary based on risks or risk outcomes. Firms should not only provide rewards when performance standards are met or exceeded, they should also reduce compensation when standards are not met. If senior executives or other employees are paid substantially all of their potential incentive compensation when risk outcomes are materially worse than expected, employees may be encouraged to take large risks in the hope of substantially increasing their personal compensation, knowing that their downside risks are limited. Simply put, incentive compensation arrangements should not create a "heads I win, tails the firm loses" expectation.

The Board's guidance highlights several methods that banking organizations can use to adjust incentive compensation awards or payments to take account of risk. For example, one approach involves deferring some or all of an incentive compensation award and reducing the amount ultimately paid if the earnings from the transactions or business giving rise to the award turn out to be less than had been projected. Another way to improve the risk sensitivity of compensation is to take explicit account of the risk associated with a business line or employees' activities--such as loan origination or trading activities--in the performance measures or allocation methodologies that determine the amount of incentive compensation initially awarded.

As the guidance recognizes, each of these methods has advantages and disadvantages. Accordingly, a banking organization may need to use more than one method to ensure that an incentive compensation arrangement does not encourage excessive risk-taking. In addition, activities and risks may vary significantly across banking organizations and across employees within a particular banking organization. For this reason, the methods used to achieve appropriately risk-sensitive compensation arrangements likely will differ across and within firms, and use of a single, formulaic approach likely will provide at least some employees with incentives to take excessive risks.

For example, incentive compensation arrangements for senior executives at large, complex organizations are likely to be better balanced if they involve deferral of a substantial portion of the executives' incentive compensation over a multiyear period, with payment made in the form of stock or other equity-based instruments and with the number of instruments ultimately received dependent on the performance of the firm during the deferral period. Deferral, however, may not be effective in constraining the incentives of employees who may have the ability to expose the firm to long-term or "bad tail" risks, as these risks are unlikely to

be realized during a reasonable deferral period.[6] Similarly, the use of equity-based incentive compensation may not be effective in aligning the incentives of mid- and lower-level employees with the interests of the firm because these employees may view the outcomes of their decisions as unlikely to have much effect on the firm or its stock price.

These differences highlight the need for flexibility in approaches by financial institutions. As in many areas, one size certainly does not fit all. Indeed, there is no generally accepted view as to the optimal way to make incentive compensation arrangements appropriately risk sensitive at an individual firm or across the financial sector. The perfect, however, must not stand in the way of the good. There are many ways that large organizations can improve the risk sensitivity of their incentive compensation arrangements and move forward with improvements that are best suited to the individual firm's activities, strategy, and overall risk-management and internal control frameworks.

Compatibility with Effective Controls and Risk Management

One important lesson learned from recent experience is that institutions can no longer view incentive compensation as being unrelated to risk management. Rather, institutions must integrate their approaches to incentive compensation arrangements with their risk-management and internal control frameworks to better monitor and control the risks these arrangements may create for the organization. Accordingly, the guidance provides that banking organizations should ensure that risk-management personnel have an appropriate role in designing incentive compensation arrangements and assessing whether the arrangements may encourage excessive risk-taking. In addition, banking organizations should track incentive compensation awards and payments, risks taken, and actual risk outcomes to determine whether incentive compensation

[6] "Bad tail" risks are risks that have a low probability of being realized, but would have highly adverse effects on the organization if they were to be realized. These risks warrant special attention from a safety-and-soundness perspective given the threat they pose to a banking organization's solvency and the federal safety net.

payments to employees are reduced to reflect adverse risk outcomes. If the firm's incentive compensation system is not effectively balancing risks, the firm must act quickly to adjust its compensation practices.

Strong Corporate Governance

The board of directors of a banking organization is ultimately responsible for ensuring that the organization's incentive compensation arrangements do not jeopardize the safety and soundness of the organization. Accordingly, the board of directors must play an informed and active role in making sure that the firm's compensation arrangements strike the proper balance between risk and profit not only at the initiation of a compensation program, but on an ongoing basis.

Thus, the guidance provides that the board of directors of an organization should review and approve the key elements of the firm's compensation system, receive and review periodic evaluations of whether the firm's compensation systems are achieving their risk-mitigation objectives, and directly approve the incentive compensation arrangements for senior executives. For firms that have a separate compensation committee of the board, these functions should be the primary responsibility of the compensation committee. To make this engagement most effective, the guidance provides that relevant members of the board of directors should have, or have access to, the experience, knowledge, and resources to understand and address the interactions and incentives created by compensation programs firmwide.

Next Steps

The Federal Reserve has received more than 30 comments on the proposed guidance from a wide range of sources, including large and small banking organizations, labor organizations, organizations representing institutional shareholders, and individuals. Most

commenters supported the guidance, although many also recommended that the guidance be modified or clarified in various ways. For example, several commenters expressed concern that the guidance could impose undue burden on small banking organizations, which typically do not use incentive compensation arrangements as extensively as large, complex organizations.

We currently are working on finalizing the guidance, taking into account the comments received, and are coordinating these efforts with the other federal banking agencies. In doing so, we recognize the importance of avoiding unnecessary regulatory burden on small banking organizations. Indeed, this is why, as I will discuss in a moment, the Federal Reserve is developing a special, tailored supervisory initiative for small and regional banking organizations.

Supervisory Initiatives

As a complement to our guidance, the Federal Reserve also has commenced two supervisory initiatives to spur and monitor progress toward safe and sound incentive compensation arrangements, identify emerging best practices, and advance the state of practice more generally in the industry. The first of these initiatives involves a special "horizontal" review of incentive compensation practices at the large, complex banking organizations under the Federal Reserve's supervision.[7] Under the second supervisory initiative, the Federal Reserve will review the incentive compensation practices of small and regional banking organizations as part of the regular risk-focused examination process for these organizations. This two-tier approach is designed to take account of the real differences between the scope and complexity of the activities, as well as the incentive compensation practices, at LCBOs and smaller banking organizations. While firms of all sizes should manage the risks created by their incentive compensation policies, LCBOs also warrant special supervisory attention because the adverse

[7] Horizontal examinations, which the Federal Reserve has used for many years, involve a coordinated review of particular risks or activities across a group of banking organizations.

effects of flawed approaches at these institutions are more likely to have adverse effects on the broader financial system.

LCBO Horizontal Review

The horizontal review of practices at LCBOs is an important and major supervisory exercise. It is being led by a multidisciplinary coordinating group of Federal Reserve staff that includes supervisors, economists, and legal professionals. Overall, more than 150 staff members from the Federal Reserve System have participated in these reviews to date. In addition, early on we recognized the importance of including the other federal banking agencies in the process to promote full and consistent coverage of U.S. banking organizations. Representatives of each of the other federal banking agencies have been involved in the horizontal process, totaling more than 50 individuals so far.

Supervisory teams have collected substantial information--through questionnaires, documentary requests, and interviews with key executives and managers--from each LCBO concerning the firm's existing incentive compensation practices and related risk-management and corporate governance processes. In addition, each LCBO was required to submit an analysis of shortcomings or "gaps" in its existing practices relative to the principles contained in the proposed guidance, as well as plans--including timetables--for addressing any weaknesses in the firm's incentive compensation arrangements and related risk-management and corporate governance practices.

While our horizontal review is ongoing, and significant variations exist across and even within firms, some broad observations--both positive and negative--can be gleaned at this stage. On the positive side, many firms, spurred by supervisors, shareholders, and others, are reexamining their incentive compensation practices and analyzing, in ways they did not before,

the potential links between compensation and risk-taking behavior. As a result, some firms already have implemented changes to make their incentive compensation arrangements more risk sensitive, and all LCBOs plan improvements to their incentive compensation practices.

For example, most LCBOs have implemented measures that are designed to make the incentive compensation of senior executives more sensitive to risk, most commonly by increasing the share of executives' incentive compensation that is deferred and the share that is paid in equity or equity-linked instruments. A number of firms also have expanded or plan to expand the situations under which the incentive compensation of employees can be "clawed back" to include measures specifically related to risk. In addition, risk-management functions at many firms now have a greater role in the design of incentive compensation arrangements and in the evaluation of employee performance for compensation purposes, and at many firms the board of directors is becoming more actively engaged in overseeing compensation structures for non-executive employees.

With the strong encouragement of the Federal Reserve, an important shift in philosophy and approach also appears to be spreading across LCBOs. In the past, many firms, perhaps reasonably, believed that strong risk-management and control systems were all that was needed to protect an organization from undue risks, including the risks arising from unbalanced incentive compensation arrangements. However, the clear lesson from the financial crisis is that incentive compensation can no longer be viewed as being completely separate and apart from risk management. Through our work in the horizontal process, we are reemphasizing to firms that poorly balanced incentive compensation arrangements may themselves be a source of risk, and management at many firms now appears to understand that sound compensation practices complement and, indeed, are part of strong risk-management and internal control functions.

Nevertheless, it is clear that substantial changes at many firms likely will be necessary to fully conform their practices with principles of safety and soundness. For example, at many firms, the measures and systems needed to make the incentive compensation of non-executive employees appropriately risk sensitive are not well advanced. And, in some cases, the deferred compensation of senior executives is still not subject to downward adjustment based on the full range of potential risks facing the organization, such as liquidity or operational risk. In addition, few firms have processes in place that would allow them to compare incentive compensation payments to risk and risk outcomes. The lack of these processes can make it difficult for firms to effectively assess whether their efforts to better align risk incentives are successful, particularly where subjective and discretionary factors play an important role in determining incentive compensation awards.

Given firms' relatively unsophisticated approach to risk incentives before the crisis, the unavoidable complexity of compensation issues, and the large numbers of employees who receive incentive compensation at large banks, it should not be surprising that time will be required to implement all the improvements that are needed. Each LCBO is expected to ensure that the organization's plans are adequate to achieve incentive compensation arrangements that are consistent with safety and soundness. The Federal Reserve also expects that the organization's plans will be fully implemented in an expeditious manner. Though it will be some time before all necessary improvements are fully implemented and tested, the Federal Reserve expects organizations to make significant progress to improve the risk sensitivity of incentive compensation at LCBOs for the 2010 performance year.

Other Organizations

As mentioned earlier, the Federal Reserve is developing tailored supervisory initiatives for regional banking organizations that are not LCBOs and for small banking organizations. Experience to date suggests that incentive compensation arrangements at small banks are not nearly as complex or prevalent as those at larger institutions. In addition, smaller banking organizations tend to have fewer layers of management and less complex operations than at LCBOs, which can make it easier for the board of directors and senior management of a firm to monitor whether its incentive compensation practices may be encouraging excessive risk-taking and, where appropriate, make adjustments to those practices. As a result, reviews of incentive compensation practices at smaller firms are more easily integrated into the normal examination process.

For each set of organizations, examiners will gather a consistent set of information through regularly scheduled examinations and the normal supervisory process. Information collected from regional organizations will encompass information on their incentive compensation practices and related risk-management and corporate governance processes. The focus of the data collection effort at community banks will be to identify the types of incentive plans in place, the job types covered, and the characteristics, prevalence, and level of documentation available for those incentive plans.

After comparing and analyzing the information collected, supervisory efforts and expectations will be scaled appropriately to the size and complexity of the organization and its incentive compensation arrangements. For example, a large regional organization that uses incentive compensation arrangements extensively may require additional supervisory work to understand and assess the consistency of the organization's practices with principles of safety

and soundness. If practice is as expected at community banks, it is likely that very limited, if any, targeted examination work or supervisory follow-up will be required at a large portion of these organizations. In any event, the compensation-related policies and systems at community banks should be substantially less extensive, formalized, and detailed than those of larger, more complex organizations.

Conclusion

Thank you for the opportunity to testify on this important topic. The Federal Reserve is committed to moving the banking industry forward in developing and implementing incentive compensation practices that are consistent with prudent risk management and safety and soundness. We believe our proposed guidance and supervisory initiatives are important steps toward this goal, and we look forward to working with the Congress to achieve these objectives. I would be happy to answer any questions you may have.

Statement of

Edward J. DeMarco

Acting Director

Federal Housing Finance Agency

Before the U.S. House of Representatives Committee on Financial Services

"Compensation in the Financial Industry – Government Perspectives"

February 25, 2009

Embargoed until 2:00 P.M. EST, February 25, 2009

Statement of Edward J. DeMarco, Acting Director,
Federal Housing Finance Agency
Before the U.S. House of Representatives Committee on Financial Services
On "Compensation in the Financial Industry – Government Perspectives"
February 25, 2009

Thank you. Chairman Frank, Ranking Member Bachus, and members of the Committee, you have asked me to address recent actions taken by the Federal Housing Finance Agency (FHFA) in which we have had to make determinations concerning executive compensation at our regulated entities. This has been a particularly important topic for us for two reasons. First, the Housing and Economic Recovery Act of 2008 (HERA), which created FHFA, also expanded our compensation-related authorities beyond those of our predecessor agencies. Second, just 5 ½ weeks after HERA was enacted, FHFA placed Fannie Mae and Freddie Mac (the Enterprises) into conservatorship, with Treasury using new authorities in that law to provide a financial backstop. Compensating the executives in these conservatorships has raised numerous issues, many of them similar to those arising at other federally-assisted institutions, but some unique to the Enterprises. Our principle goal in these decisions was to provide sufficient compensation to achieve the goals of the conservatorships while avoiding excessive compensation and minimizing taxpayer costs.

Initial Conservatorship Decisions

During FHFA's intense preparations for placing the Enterprises into conservatorship, we received some valuable insights from discussions we had with the Federal Deposit Insurance Corporation (FDIC). The FDIC's experience in bank failure resolutions, including conservatorships, supported our view that achieving the goals of conservatorship depended on retaining capable and knowledgeable staff at the Enterprises. At the same time we sought to no longer employ those executives most responsible for the conditions leading to our action. As a part of our planning process, we hired Hay Group, a well respected executive compensation consultant, to help us design a plan to encourage the best employees to stay, while not rewarding poor performance.

In placing the Enterprises into conservatorship, our foremost concern was that their troubled condition was leading them to withdraw their services from housing finance markets at a time when they were greatly needed. Their combined market share in 2008 was more than double what it had been two years earlier, as most other participants went out of business or sought to avoid new risk exposure to the mortgage market. For the sake of our country's economy and especially its housing sector, it was essential that the Enterprises continue to bring liquidity, stability, and affordability to the secondary mortgage market. Furthermore, the Enterprises enormous size, including $5.4 trillion of mortgage credit risk, and taxpayer exposure to that risk in the face of rapidly deteriorating housing markets, made it imperative that the Enterprises strengthen their management in the areas of risk control and loss mitigation. In addition, it was and

remains imperative that the Enterprises attract and retain the particular and specialized skills needed to manage these activities.

To address these concerns, FHFA discussed our retention approach in some detail with both new Chief Executive Officers (CEOs) on the day before their new jobs officially began. As former FHFA Director Lockhart reported to this Committee later that month, both CEOs agreed with our view of the importance of such a plan, and over the next few weeks worked with us, Treasury, and Hay Group to customize plans for their respective institutions. Director Lockhart justified the resulting plans in a letter to Chairman Frank, which is attached. Payments under the plans were virtually the only non-salary compensation for Enterprise employees for the 2008 performance year, as no bonuses were paid for that year at either Enterprise.

At the inception of the conservatorships, we also announced that the incumbent CEOs would be leaving after a brief transition period. They received no severance payments. In prohibiting such payments, we relied in large part on the golden parachute provisions in HERA. In addition, because most of their remuneration had been in the form of Enterprise stock, roughly two-thirds of their previously reported pay during their tenures as CEOs vanished with the collapse in the market prices of their shares. The golden parachute provisions were also helpful in other cases, as ultimately, five of the six Fannie Mae executives that were highest paid before the conservatorships and all of the top four Freddie Mac executives left in one fashion or another, but none of them received severance or other golden parachute payments. They also saw a substantial reduction in the value of their past compensation due to the collapse in their company's stock price. While I know all the attention today is on executive pay, I'd like to add that many of the more than 11,000 rank and file employees at the Enterprises also had large portions of their life savings in Enterprise stock and suffered accordingly.

New Compensation Structures

FHFA's development of a new compensation structure for senior Enterprise executives for 2009 and beyond was delayed, first by our appointment of new boards of directors at the Enterprises, with new compensation committees, then by the departure of the CEOs hired at the start of the conservatorships. Additionally, FHFA had agreed, under the Senior Preferred Stock Purchase Agreements that provide financial support to the Enterprises, to consult with Treasury about new compensation arrangements with executive officers at the Enterprises. We wanted to consider fully the approach being developed at the Treasury for institutions receiving exceptional assistance from the Troubled Assets Relief Program (TARP). After Kenneth Feinberg was appointed Special Master for TARP Executive Compensation, Treasury asked us to consult with him, and we began to discuss how we could adapt the approach he was developing for TARP institutions to the Enterprises. I must say that I found those discussions productive and constructive, and I want to thank the Special Master for his thoughtfulness on these issues.

In making that adaptation, a major consideration was that compensating Enterprise executives with company stock would be ineffective because of the questionable value of such stock. Further, large grants of low-priced stock could provide substantial incentives for executives to seek and take large risks. Accordingly, all components of executive compensation at the Enterprises are in cash.

Another consideration is the uncertain future of the Enterprises as continuing entities, which is in the hands of Congress and beyond the control of Enterprise executives. It is generally best to focus management's incentives toward its institution's performance over the long-run rather than just the near-term. In the case of the Enterprises, that is nearly impossible. Therefore, compensation for current work will not depend on results beyond 2011. To encourage talent to stay put, FHFA made deferred payments generally dependent on an executive's continued employment at the Enterprise and corporate performance until the date of payment.

FHFA also looked to existing practice elsewhere to determine the appropriate levels of total target compensation for the most senior positions. We considered data from consultants to both Enterprises, data received earlier from our own consultant, and the reported plans of TARP-assisted firms. It was important to set pay at levels sufficient to compete for quality talent because the Enterprises had many key vacancies to fill, potential departures to avoid, and pay has been a significant issue in some cases. That need must be balanced by our efforts to keep the cost to taxpayers as low as we possibly can.

FHFA settled on a target of $6 million a year for each CEO, $3.5 million for the Chief Financial Officers (CFOs), and less than $3 million for Executive Vice Presidents and below. I know $6 million is a considerable sum of money. But that amount rolls back Enterprise CEO pay to pre-2000 levels. It is less than half of target pay for Enterprise CEOs before the conservatorships. For all executive officers, Fannie Mae and Freddie Mac have reduced target pay by an average of 40 percent.

The basic compensation structure for senior executives at both Enterprises, as at institutions receiving exceptional TARP assistance, comprises three elements: base salary, a performance-based incentive opportunity, and deferred salary. Salary scales have been sharply reduced from pre-conservatorship levels at both Enterprises. Going forward, as at the TARP-assisted firms, salaries will generally be capped at $500,000 with a few exceptions. Before the conservatorships, the two Enterprises had 16 officers earning salaries higher than that amount, now there are only five.

As at TARP-assisted firms, target incentive pay for the Enterprises is limited to a third of overall compensation. Payment is based on Enterprise performance, as measured by scorecards developed by each Enterprise subject to FHFA approval, and individual performance. In reviewing scorecards, we are particularly sensitive to ensuring that executives are not given incentives to take inappropriate risks. Our special examinations of accounting failures at each Enterprise in 2003-2006 revealed that badly-constructed

compensation incentives contributed significantly to excessive focus on near-term earnings reports to the serious detriment of the Enterprises.

Accordingly, FHFA has required a much broader focus that emphasizes remediation of operational and risk management weaknesses, loss mitigation, and mission achievement. For 2009, I have approved for each Enterprise funding of incentive payment pools at 90 percent of aggregate targets. Both Enterprises made substantial progress in loss mitigation and risk management, while meeting the challenges of implementing Treasury's Making Home Affordable Programs. However, the boards of both Enterprises, with my encouragement, recognized that those successes needed to be tempered by consideration of the sizable contributions of taxpayers needed to offset Enterprise losses, which occurred despite the generally strong efforts of the executives.

The remaining portion of compensation is deferred salary, which is paid with a one year lag to executives still working for their Enterprises at that time. Any exceptions will require FHFA approval, in consultation with the Treasury. Starting with payments made in 2011, the amounts will be adjusted up or down, based on each Enterprise's performance on its 2010 scorecard. Further details are available in the Enterprises 8-Ks, which were issued late last year in Fannie Mae's 10-K and in Freddie Mac's 10-K/A to be issued shortly.

These new structures are designed to align pay with taxpayer interests. They also adopt and in some respects expand on reforms advanced by the Special Master for firms receiving exceptional TARP assistance.

- In 2010, no executive officers will receive perquisites exceeding $25,000 without FHFA approval, in consultation with the Treasury.

- No retirement plans for executive officers will be continued that use more generous formulas for such officers than plans for lower ranking employees.

- No expense reimbursements to executives will provide so-called "tax gross-ups" that reimburse executives not only for the expenses they paid, but also for the taxes they must pay on the reimbursements themselves.

- Deferred salary and incentive pay for all executive officers will be subject to clawbacks by the Enterprises in the event of gross misconduct, gross negligence, conviction of a felony, or erroneous performance metrics.

Except for our use in certain instances of HERA's golden parachute authorities, these actions have relied principally on our conservatorship powers. We have also taken advantage of new authorities in a limited number of cases involving the hiring or departure of Federal Home Loan Bank (FHLBank) executives, and we have issued a new proposed rule broadly implementing our responsibility to prohibit excessive compensation at both the Enterprises and the FHLBanks. We expect to issue a final rule in the next few months. We have not had occasion to use new authority to withhold

compensation or to recapture previous payments under some circumstances, but we may find them valuable in the future. The broad authority provided in section 1117 of HERA to approve, disapprove, or modify the compensation of executive officers at regulated institutions has expired. It was not necessary to use this power with regard to the Enterprises because they are in conservatorship, and we did not determine a need to take such action with respect to any FHLBank.

In my judgment, we have achieved the right balance between enough compensation to acquire and retain quality management, while preventing compensation from exceeding appropriate bounds.

Lessons Learned from the Enterprises' Conservatorship Operations

Before closing, I would like to briefly review a few lessons we have learned about compensation for institutions operating in conservatorship. Some of these lessons may be relevant for Congressional consideration of future resolution authorities.

If the resolution of a failed institution requires maintaining ongoing business operations for a period of time, compensation and retention will be key concerns. For example, as I explained in my recent letter to the Committee's leadership (attached), at the inception of the conservatorships FHFA made clear that the Enterprises would continue to be responsible for normal business activities and day-to-day operations. To that end, we reconstituted the boards of directors of each Enterprise and appointed new CEOs. As with other private companies, the boards and CEOs must follow the laws and regulations governing financial disclosure, including requirements of the Securities and Exchange Commission. Like other corporate executives, the Enterprises' officers have a legal responsibility to use sound and prudent business judgment in their stewardship of the companies. These are large, complex businesses managing $5.4 trillion of risk exposure. The most efficient way to effectively protect taxpayers in this situation is to place management of normal business activities and day-to-day operations in the hands of qualified and experienced senior executives and boards of directors. I became acutely aware of the challenges of competing in the market for top executives, when Freddie Mac went a year or more without a Chief Operating Officer and a permanent CFO; it also operated for months with an interim CEO.

As Congress considers resolution regimes for potential future situations involving systemically important institutions, in some circumstances maintaining human capital will likely be important to an orderly resolution, and to accomplish that goal, whatever agencies are in charge of resolutions will have to pay sufficient compensations. This is especially important in a situation where the future of the firm in question is uncertain. It is particularly challenging to attract and retain executives that don't have the normal sort of control over outcomes. In the case of the Enterprises, the executive management teams may do a great job in meeting the goals of conservatorship but the future of the companies rests with Congress, not with them.

Summary

The directors and senior executives tied to the financial collapse at each Enterprise are no longer with the companies. The senior executives who remain as well as those that were recently hired are essential to the Enterprises fulfilling the important goals of the conservatorships. As FHFA has stated since the outset of the conservatorships, it is critical to retain existing staff, including many senior managers, and critical to attract new executive management to fill the vacancies. The challenge of meeting this goal with companies in conservatorship is immense. The Enterprises operate with an uncertain future that will be the source of much public debate. As conservator, I believe it is critical to protect the taxpayer interests in the Enterprises by ensuring that each company has experienced, qualified people managing the day-to-day business operations in the midst of this uncertainty. Any other approach puts at risk the management of more than $5 trillion in mortgage holdings and guarantees that are supported by taxpayers through the Treasury Senior Preferred Stock Purchase Agreements.

Thank you and I'll be happy to answer your questions.

Attachments

TESTIMONY OF
KENNETH R. FEINBERG
Special Master for TARP Executive Compensation

U.S. HOUSE OF REPRESENTATIVES, COMMITTEE ON FINANCIAL SERVICES
FEBRUARY 25, 2010

Mr. Chairman and Members of the Committee:

I thank you for the opportunity to testify today. The subject of executive compensation continues to concern the American people and the international business community, so I welcome your invitation and look forward to participating in this hearing.

As you know, in June of 2009 I was asked to serve as the Special Master for TARP Executive Compensation by Secretary Geithner. In that capacity, under the relevant statutory[1] and regulatory[2] authority, I have a number of responsibilities related to the oversight and review of financial industry compensation.

My primary responsibilities include making determinations regarding the compensation of certain employees of TARP recipients that have received exceptional financial assistance. There were originally seven recipients of exceptional financial assistance. Currently, five companies have outstanding "exceptional assistance" from the American taxpayer: AIG, Chrysler, Chrysler Financial, GM and GMAC. (Two companies that were previously under my jurisdiction—Bank of America and Citigroup—have repaid their "exceptional" taxpayer assistance, although Citigroup will continue to be subject to the rules applicable to all TARP recipients until it completes its repayment of all TARP obligations.) Under pertinent Treasury regulations, I am required to determine individual compensation for the "top 25" executives at these five companies, and to make determinations on compensation structures—but not individual payments—for executive officers and 75 additional employees who are not in the "top 25" group. This mandatory jurisdiction applies only to the "exceptional assistance" recipients and does not extend to employees of any other financial institutions or

[1] *See* Section 111 of the Emergency Economic Stabilization Act of 2008, as amended by the American Recovery and Reinvestment Act of 2009 (EESA).

[2] *See* TARP Standards for Compensation and Corporate Governance, 31 C.F.R. § 30.1 *et seq.*

corporations. Although I do have discretion to make recommendations and render nonbinding determinations concerning other TARP recipients, this jurisdiction is purely advisory and not mandatory, and I have no legal authority to make binding determinations pertaining to executive compensation for any companies other than the exceptional assistance recipients.

The Committee has asked me to focus on three separate inquiries.

First, you noted the necessity that I balance the competing obligations of reining in excessive compensation to protect the public good and allowing compensation sufficient to maximize the public's investment in the financial industry. The tension between reining in excessive compensation and allowing necessary compensation is, of course, a very real difficulty that I have faced and continue to face in making individual compensation determinations. Under Treasury regulations, my primary directive in overseeing compensation structures and payments within my jurisdiction is to determine whether the structures or payments in question were, are or may be "inconsistent with the purposes of section 111 of EESA or TARP, or are otherwise contrary to the public interest." In my determinations I have referred to this directive as the Public Interest Standard; to meet it, a compensation package must balance appropriately the competing obligations you described.

Because achieving this balance is a fundamental component of the Public Interest Standard, it has played a determinative role in each of the rulings issued by the Office of the Special Master. In particular, the October 22, 2009, Determination Memoranda, which addressed compensation structures and payments for the "top 25" executives of the exceptional assistance recipients, and the December 11, 2009, Determination Memoranda, which addressed compensation structures for executive officers not in the "top 25" and up to 75 additional most highly compensated employees, were designed to balance the need to protect the public good while allowing necessary compensation in appropriate cases. Likewise, whether compensation structures and payments meet the Public Interest Standard will be the basis of my forthcoming 2010 determinations for the five remaining exceptional assistance recipients.

Second, you asked for a description of the variables and considerations at issue when determining whether compensation levels or structures are appropriate. Treasury

regulations require that, when I determine whether a payment or compensation structure meets the Public Interest Standard, I consider the following six principles:[3]

(1) *Risk.* The compensation structure should avoid incentives that encourage employees to take unnecessary or excessive risks that could threaten the value of the company, including incentives that reward employees for short-term or temporary increases in value or performance; or similar measures that may undercut the long-term value of the company. Compensation packages should be aligned with sound risk management.

(2) *Taxpayer return.* The compensation structure and amount payable should reflect the need for the company to remain a competitive enterprise, to retain and recruit talented employees who will contribute to the recipient's future success, so that the company will ultimately be able to repay its TARP obligations.

(3) *Appropriate allocation.* The compensation structure should appropriately allocate the components of compensation such as salary and short-term and long-term performance incentives, as well as the extent to which compensation is provided in cash, equity, or other types of compensation such as executive pensions, or other benefits, or perquisites, based on the specific role of the employee and other relevant circumstances, including the nature and amount of current compensation, deferred compensation, or other compensation and benefits previously paid or awarded.

(4) *Performance-based compensation.* An appropriate portion of the compensation should be performance-based over a relevant performance period. Performance-based compensation should be determined through tailored metrics that encompass individual performance and/or the performance of the company or a relevant business unit taking into consideration specific business objectives. Performance metrics may relate to employee compliance with relevant corporate policies. In addition, the likelihood of meeting the performance metrics should not be so great that the arrangement fails to provide an adequate incentive for the employee to perform, and performance metrics should be measurable, enforceable, and actually enforced if not met.

(5) *Comparable structures and payments.* The compensation structure, and amounts payable where applicable, should be consistent with, and not excessive taking into account, compensation structures and amounts for persons in similar positions or roles at similar entities that are similarly situated, including, as applicable, entities competing in the same markets and similarly situated entities that are financially distressed or that are contemplating or undergoing reorganization.

(6) *Employee contribution to TARP recipient value.* The compensation structure and amount payable should reflect the current or prospective contributions of an employee to the value of the company, taking into account multiple factors such

[3] *See* 31 C.F.R. § 30.16(b)(i-vi).

> as revenue production, specific expertise, compliance with company policy and regulation (including risk management), and corporate leadership, as well as the role the employee may have had with respect to any change in the financial health or competitive position of the recipient.

Under the regulations, I have discretion to determine the appropriate weight or relevance of a particular principle depending on the facts and circumstances surrounding the compensation structure or payment for a particular executive, which I must often exercise when two or more principles are in conflict in a particular situation.

To actually apply these principles and make my compensation determinations, I have relied on numerous sources. Empirical compensation data has been provided to me by the exceptional assistance recipients, and additional data has been secured by my office through independent means.[4] My office includes a special detail of Treasury personnel, including executive compensation specialists with significant experience in reviewing, analyzing, designing and administering executive compensation plans, and attorneys with experience in matters related to executive compensation. I have also benefitted from the input and sound advice of outside academic experts—including world-renowned executive compensation experts Lucian A. Bebchuk of Harvard Law School and Kevin J. Murphy of the University of Southern California's Marshall School of Business—who were retained by my office to help guide me in making my individual and structural compensation decisions. My objective in employing each of these resources is a thorough application of the mandated principles to assure that my compensation determinations are consistent with the Public Interest Standard.

By application of the principles to the facts and circumstances underlying my determinations to date, I have developed a number of generally applicable, practical prescriptions under the Public Interest Standard, including the following:

(1) Guaranteed income (including guaranteed bonuses) is rejected, except for cash salaries at sufficient levels to attract and retain employees and provide them a reasonable level of liquidity. These generally should not exceed $500,000 per year, except in exceptional cases for good cause shown.

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[4] In particular, my office obtained access to independent compensation data from the *U.S. Mercer Benchmark Database-Executive* as well as Equilar's *ExecutiveInsight* database (which includes information drawn from public securities filings) and *Top 25 Survey Summary Report* (which includes information from a survey on pay of highly compensated employees).

(2) The value of any remaining compensation must be tied to performance. Accordingly, the majority of each employee's compensation should be paid in stock rather than cash. Under Treasury regulations, this stock will immediately vest, but will only be transferable in three equal, annual installments beginning on the second anniversary of grant—with each installment redeemable a year earlier if the company repays its obligations to the American taxpayer.

(3) Incentive compensation should be paid if—and only if—an executive achieves objective performance criteria approved by a compensation committee comprised solely of independent directors. Incentive compensation should be delivered in a mix of cash and stock, payable over time and subject to "clawback" if the performance resulting in the compensation is later discovered to be inaccurate.

(4) Each individual's total compensation must reflect the employee's value to the company and be appropriate when compared with the total compensation of similarly situated employees at similar companies. Total pay should generally not exceed the 50th percentile of total compensation for similarly situated employees.

(5) Employees should be prohibited from engaging in any hedging, derivative or other transactions that undermine the long-term performance incentives created by a company's compensation structures.

(6) Significant amounts should not be allocated to compensation components that are not performance-based and are difficult for shareholders to value, such as outsized perquisites and executive retirement plans.

Finally, Mr. Chairman, you asked that I identify the variables or considerations that are unique to my office. Aside from the principles previously articulated in my testimony above, and among the many distinctive aspects of our work, I wish to emphasize three unique characteristics of my limited mandate.

First, our office is charged with assuring both that the companies subject to our determinations thrive in the marketplace so that they can repay the American taxpayer and that those same companies avoid excessive risk taking that could threaten their long-term viability. To balance those objectives, we have emphasized that the bulk of compensation must be performance-based, and depend on the long-term performance of the company rather than short-term gains. We have also insisted that total compensation must be appropriately allocated and weighted heavily towards long-term structures that are tied to performance and easily understood by shareholders and the public.

Second, a distinctive and critical part of my work is the recognition that the authority of the Special Master is limited. In particular, under the pertinent statute and

regulations, I do not have the authority to unilaterally alter "grandfathered" contracts that companies entered into with employees prior to the enactment of the Recovery Act. I am, however, permitted to pursue voluntary restructuring of these contracts, and my office has had some success in doing so. For example, the October 22, 2009, Determination Memoranda covering Bank of America and Citigroup provided Special Master approval of restructured contracts in which employees agreed to forgo "grandfathered" guaranteed cash payments for a combination of reasonable cash salaries and long-term stock holdings in their companies. We have, however, been unable to restructure such agreements in other instances. In those cases, Treasury regulations permit me to take these payments into account when determining appropriate prospective compensation structures. For example, in my October 22, 2009, Determination Memorandum covering AIG, I took "grandfathered" retention contracts into account when setting prospective compensation. In particular, as a result of officials' refusals to restructure their cash retention payments, I refused to approve cash salary amounts proposed by the company, which, in light of the retention payments, would have resulted in an excessive level of cash compensation. Attempting to renegotiate these agreements—and, where necessary, taking payments under "grandfathered" contracts into account when setting prospective compensation—has been a unique challenge.

Third, a very unique aspect of my work is the fact that Treasury regulations give me the unprecedented responsibility of balancing the principles set forth in the regulations to actually make individual compensation determinations for 25 individual officials employed by the exceptional assistance firms, and setting the compensation structures that will apply to the 26 to 100 individual officials and executive officers. I believe that much of the attention focused on my work is directly attributable to this fact—not only has my office promulgated generally applicable compensation principles and prescriptions, but we have shown that these principles can work in practice by calculating individual compensation packages for officials in these companies. I believe this is the most "unique" aspect of my work and will hopefully have the most permanent impact.

Mr. Chairman, I thank you and the other members of the Committee. This statement constitutes my formal testimony.

BARNEY FRANK, MA, CHAIRMAN

U. S. House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

SPENCER BACHUS, AL, RANKING MEMBER

March 19, 2009

Mr. James B. Lockhart III
Director
Federal Housing Finance Agency
1700 G Street, NW, 4th Floor
Washington, DC 20552

Dear Director Lockhart:

I am writing to urge strongly that you rescind the retention bonus programs at Fannie Mae and Freddie Mac, prohibit any further payment of bonuses to executives under that program, and pursue repayment of any already-paid bonuses. The public, having provided significant support for the purpose of restoring trust and confidence in our country's financial system, rightfully insists that large bonuses such as these awarded by institutions receiving public funds at a time of a serious economic downturn cannot continue.

Fannie Mae and Freddie Mac have said that their retention program awards were structured in a way that would recognize the "unsatisfactory performance" of the companies, coupled with the "urgent need to retain people in the most critical positions." I remain very skeptical that retaining and rewarding people who made the mistakes that contributed to the unsatisfactory performance is a good idea. Further, in this troubled economy, and in this job market, it is difficult to imagine that the companies would not be able to find competent and talented replacements for anyone who chooses to leave.

Congress gave the Federal Housing Finance Agency (FHFA) broad general authority under the Housing and Economic Recovery Act to approve, disapprove or modify compensation paid by Fannie and Freddie. In its role as conservator, the FHFA has complete authority over compensation practices and already has exercised that authority to recover previously agreed-upon compensation from some executives. I urge you to use that authority now to reconsider the retention programs at Fannie Mae and Freddie Mac, cease any further payments, and recover previous payments under those programs.

Barney Frank

BARNEY FRANK
Chairman

FEDERAL HOUSING FINANCE AGENCY
Office of the Director

March 20, 2009

The Honorable Barney Frank
Chairman
House Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

Dear Mr. Chairman:

I am writing in response to your March 19th letter concerning employee retention programs at Fannie Mae and Freddie Mac. FHFA initiated these programs prior to conservatorship as we and our advisors agreed that they were critical to a successful conservatorship. I still believe that.

As you know, Fannie Mae and Freddie Mac were placed into conservatorship to ensure they fulfill their extremely important mission of providing liquidity, stability and affordability to the very troubled mortgage market. They continue to serve this vital mission. As the private mortgage market began to freeze in 2007, Fannie Mae and Freddie Mac's market share grew rapidly to where they had a 73 percent market share of all mortgages originated in 2008. Now they are the central players in the President's Making Home Affordable plan. Given the current predominant role the GSEs play in the nation's mortgage market, it is imperative that FHFA ensure their continued functioning and safe and sound operations.

In September, when the conservatorships were established, I made clear to Congress that we had developed, with the new CEOs and with an outside pay consultant, employee retention programs. As required by HERA, we consulted with the Treasury Department. I stated then my view that it was very important to work with the current management teams and employees to encourage them to stay and to continue to make important improvements to the Enterprises.

In response, most have stayed. Indeed, I can attest that many employees at all levels at each company have been working far more hours, with far less compensation than they did prior to conservatorship. The success of the Administration's recently announced Making Home Affordable program, aimed at preventing foreclosures and stabilizing housing markets, depends on the continued efforts of these employees, both executives and staff. But I can also say that we run a great risk of these same employees deciding this is the last straw and walking away.

The loss of key personnel would be devastating to the companies and to the government's efforts to stabilize the housing system.

1700 G Street, N.W., Washington, D.C. 20552-0003 • 202-414-3800 • 202-414-3823 (fax)

Retention payments are not a reward for the past. Unlike other financial institutions, I made the decision not to pay severance to the departing CEOs. All of the senior managers who made decisions that led to the current situation are gone. I might add that some of these senior managers for years stood in the way of the legislation that might have lessened the impact this housing market crash has had on their firms. Since last August, just before the appointment of the conservatorships, the four highest compensated executives at Freddie Mac and seven of the top eight at Fannie Mae have left and are not getting these retention payments.

If we don't provide the existing employees incentives to stay, we will have a serious problem. Remaining corporate executives are receiving much less in compensation than they received in recent years. They received no bonuses for their 2008 performance. The value of their stock holdings and options are worthless. We are taking actions to ensure that these retention payments are not excessive. The retention incentive payments that FHFA approved went to more than 5,000 employees at Fannie (average $21,000, spread over the first year-and-a-half of the conservatorship) and 4,000 at Freddie (average $19,000, also spread over the first year-and-a-half). They are going to employees at all levels, not just top executives. Of course, while it was necessary for certain top executives to leave, we very much wanted others to stay. Some are receiving significant retention payments, but their overall compensation still has declined considerably.

I have discussed your request with both the new Chief Executive Officers, who are not getting retention payments and I met with the new Board of Directors of one of the companies today. It is their strong belief that ending the retention program would be extremely detrimental to their ability to remediate these enterprises and fulfill their mission. We believe that FHFA would be violating its duties as conservator to end the retention plans and allow Fannie Mae and Freddie Mac to be hollowed out. There are no other financial institutions that can replace them in this critical time for the nation's economy.

We are preparing detailed information about these plans that we will forward to you next week. We are also working with the Boards of Directors on ongoing compensation issues. In this uncertain compensation environment, it is very difficult to hire people to fill vacancies of which there are a large number of senior ones at both companies, including the CEO, COO and CFO positions at Freddie Mac.

The retention programs at both companies are designed to pay for efforts that are underway to meet national goals. FHFA will continue to work with Congress as we ensure that Fannie Mae and Freddie Mac can fulfill their critical missions.

Sincerely

James B. Lockhart III

James B. Lockhart III
Director, Federal Housing Finance Agency
Chairman, FHF Oversight Board

FEDERAL HOUSING FINANCE AGENCY
Office of the Director

February 2, 2010

Honorable Christopher Dodd
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, DC 20510

Honorable Richard C. Shelby
Ranking Minority Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, DC 20510

The Honorable Barney Frank
Chairman
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

Honorable Spencer Bachus
Ranking Minority Member
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

Dear Chairmen and Ranking Members:

I am writing to update you on the conservatorships of Fannie Mae and Freddie Mac (the Enterprises). Recently there has been considerable speculation regarding how the future direction of the Enterprises' business activities interacts with their status in conservatorship. A key motivation for this letter is to provide greater clarity to policymakers and market participants on the Federal Housing Finance Agency's (FHFA) plans for the Enterprises' business activities while they operate in conservatorship.

The first part of the letter will review the establishment and purposes of the conservatorships, and how the conservatorships are operating. FHFA is focused on conserving the Enterprises' assets and meeting the goals of the conservatorship. The second part of the letter describes FHFA's views on the future direction of the Enterprises' business activities while they are in conservatorship, particularly: loan modifications and mitigating credit losses; retained portfolio; new products; and affordable housing mission.

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Background

Establishment and Purposes of the Conservatorships

After careful analysis and in consultation with the Secretary of the Treasury and the Chairman of the Board of Governors of the Federal Reserve System, FHFA placed each Enterprise into conservatorship on September 6, 2008. At that time and pursuant to the statute, FHFA set forth the purpose and goals of conservatorship as follows:

> The purpose of appointing the Conservator is to preserve and conserve the Company's assets and property and to put the Company in a sound and solvent condition. The goals of the conservatorship are to help restore confidence in the Company, enhance its capacity to fulfill its mission, and mitigate the systemic risk that has contributed directly to the instability in the current market.

Critical to the establishment of the conservatorships were the actions taken at the same time by Treasury, consistent with its authority granted in the Housing and Economic Recovery Act of 2008 (HERA), to establish three funding facilities. Two of these – the liquidity facility and the mortgage-backed securities purchase facility – expired as scheduled at the end of last year. The third facility – the Senior Preferred Stock Purchase Agreements (PSPAs) – was structured to provide ongoing financial support to the Enterprises to ensure they remain active participants in the marketplace. The PSPAs work by ensuring that the Enterprises maintain a positive net worth, and Treasury's initial financial commitment was up to $100 billion per company. As explained at the time of the conservatorships by Treasury Secretary Paulson:

> These agreements support market stability by providing additional security and clarity to GSE debt holders – senior and subordinated – and support mortgage availability by providing additional confidence to investors in GSE mortgage backed securities. This commitment will eliminate any mandatory triggering of receivership and will ensure that the conserved entities have the ability to fulfill their financial obligations. It is more efficient than a one-time equity injection, because it will be used only as needed and on terms that Treasury has set.

In the face of a potentially catastrophic failure of our nation's housing finance system, these actions, along with the Federal Reserve's decision a few months later to purchase Enterprise debt and mortgage-backed securities, succeeded in maintaining an important measure of stability in the housing finance market. As nearly all other non-governmental participants in housing finance abandoned the market, the Enterprises in conservatorship, operating with the benefit of the PSPAs, have ensured that credit continues to flow to housing. As evidence of this, the Enterprises' share in financing or guaranteeing new single-family mortgage production rose from 54 percent in 2006 to 73 percent in 2008 and 78 percent in 2009 through September. The Enterprises have also played a significant role in multifamily housing finance with their market share growing from 33 percent in 2006 to 79 percent in 2008 and 64 percent in 2009 through September.

In February 2009, the Obama Administration reiterated the importance of the PSPAs in maintaining market confidence in the Enterprises by announcing an increase in the financial commitment to each company from $100 billion to $200 billion. The importance of maintaining market confidence in the Enterprises was further reiterated with a final adjustment to the financial commitment under the PSPAs on December 24, 2009. That adjustment increased the Treasury's financial commitment to each company to the greater of $200 billion or $200 billion plus cumulative net worth deficits experienced during 2010, 2011, and 2012, less any net worth surplus remaining as of December 31, 2012.

Since the establishment of the conservatorships, Fannie Mae has realized losses of $111 billion, and Freddie Mac has realized losses of $63 billion. These losses have exhausted the value of each company's shareholder equity and resulted in considerable draws from Treasury under the PSPAs. To date, Fannie Mae has drawn $59.9 billion and Freddie Mac has drawn $50.7 billion. These calls on taxpayer funds are troubling to all of us.

The PSPAs continue to serve their original intent – providing assurance to capital market investors in Enterprise debt and mortgage-backed securities that continued investments in such securities are sound. In that way, the Enterprises remain a stable source of funds for new home purchases and refinancings of existing mortgages. However, given the existing taxpayer outlays and the extraordinary public backing now in place, I believe that FHFA owes your committees and taxpayers a clear view on how the conservatorships are operating to limit losses and maximize recoveries in the future. I will turn to those issues next.

Conservatorship Operations

As conservator, FHFA has the powers of the management, boards, and shareholders of the Enterprises. However, the Enterprises continue to operate as business corporations. For example, they have chief executive officers and boards of directors, and must follow the laws and regulations governing financial disclosure, including requirements of the Securities and Exchange Commission. Like other corporate executives, the Enterprises' executive officers are subject to the legal responsibility to use sound and prudent business judgment in their stewardship of their companies.

At the inception of the conservatorships, FHFA made clear that the Enterprises would continue to be responsible for normal business activities and day-to-day operations. FHFA continues to exercise oversight as safety and soundness regulator and has a more active role as conservator. While FHFA has very broad authority, the focus of the conservatorships is not to manage every aspect of the Enterprises' operations. Instead, FHFA reconstituted the boards of directors at each Enterprise and charged the boards with ensuring normal corporate governance practices and procedures are in place. The new boards are responsible for carrying out normal board functions, but they remain subject to review and approval on critical matters by FHFA as

conservator. The Enterprises are large, complex companies, and this division of responsibilities represents the most efficient structure for carrying out FHFA's responsibilities as conservator.

The reconstituted boards at each company oversee their respective management teams and are functioning as boards should. Like FHFA, the boards are focused on conserving assets, minimizing corporate losses, ensuring the Enterprises continue to serve their mission, overseeing remediation of identified weaknesses in corporate operations and risk management, and ensuring that sound corporate governance principles are followed.

In my view, maintaining and, where needed, strengthening these important private sector disciplines associated with each Enterprise's corporate infrastructure promotes the goals of the conservatorships and maximizes the government's options in a post-conservatorship world, including the opportunity to gain some return for taxpayers in a resolution of these companies. Any preservation of value in the Enterprises is directly related to maintaining the value of the intangible assets of these companies, including their human resources and business platforms.

There has been substantial executive management turnover at each Enterprise since the establishment of the conservatorships, starting with the replacement of each Enterprise's Chief Executive Officer (CEO) at the time the conservatorships were announced. At Fannie Mae, since conservatorship began, there have been two CEOs and new executives appointed to head almost every key business unit. Eight of the eleven highest paid employees pre-conservatorship are no longer with the company. At Freddie Mac, since conservatorship, there have been two CEOs and an Interim CEO. In just the past five months, after lengthy searches by the board, Freddie Mac has added a new Chief Operating Officer and a new Chief Financial Officer. The four highest paid employees at Freddie Mac pre-conservatorship are no longer with the company.

In short, the directors and senior executives tied to the financial collapse at each Enterprise are no longer with the companies. The senior executives who remain as well as those that were recently hired are essential to the Enterprises fulfilling the important goals of the conservatorships. As FHFA has stated since the outset of the conservatorships, it is critical to retain existing staff, including many senior managers, and critical to attract new executive management to fill the vacancies. The challenge of meeting this goal with companies in conservatorship is immense. The Enterprises operate with an uncertain future that will be the source of much public debate. As conservator, I believe it is critical to protect the taxpayer interests in the Enterprises by ensuring that each company has experienced, qualified people managing the day-to-day business operations in the midst of this uncertainty. Any other approach puts at risk the management of more than $5 trillion in mortgage holdings and guarantees that are supported by taxpayers through the PSPAs.

I will now turn to specific actions and issues pertinent to accomplishing the important goals of the conservatorships.

Accomplishing Conservatorship Goals Going Forward

Loan Modifications and Mitigating Credit Losses

Conserving the assets of the Enterprises requires, first and foremost, minimizing their credit losses from delinquent mortgages. This is and will remain the central goal of FHFA and the Enterprises.

Furthermore, FHFA operates under a statutory mandate in the Emergency Economic Stabilization Act of 2008 (EESA), Section 110, to "implement a plan that seeks to maximize assistance for homeowners and use its authority to encourage the servicers of the underlying mortgages, and considering net present value to the taxpayer, to take advantage of the HOPE for Homeowners Program ... or other available programs to minimize foreclosures." This provision specifies loan modifications and tenant protections as part of the mandate and establishes a monthly reporting requirement for FHFA. Our monthly reports pursuant to this requirement are sent to each of you and are on our website under Federal Property Managers Reports at http://www.fhfa.gov/Default.aspx?Page=172.

In pursuit of the goal of minimizing credit losses and fulfilling this statutory mandate, FHFA and the Enterprises worked with the Administration a year ago to help develop and implement the Making Home Affordable program (MHA). The Enterprises' participation in MHA is a critical step to minimizing their credit losses. Loan modifications are often a lower cost resolution to a delinquent mortgage than is foreclosure. Similarly, providing opportunities for borrowers to refinance into a more affordable mortgage helps mitigate future credit losses. Since the Enterprises own or guarantee about half the mortgages in the country, efforts like MHA that provide stability to borrowers also serve to restore stability to housing markets, which directly benefits the Enterprises by reducing credit exposure. The Enterprises also will continue to act as agents for Treasury in implementing the MHA loan modification program. FHFA views this activity as consistent with the goals of the conservatorship and the EESA mandate.

FHFA will continue to ensure the Enterprises look to foreclosure alternatives, starting with loan modifications, to minimize credit losses. I have communicated to each Enterprise the need for rigorous analytics in considering different forms of loss mitigation to ensure credit losses are being minimized. Such analysis will also guide the Enterprises' participation in any potential new Administration efforts regarding foreclosure prevention. The Enterprises' current and future efforts surrounding foreclosure prevention will focus on mitigating losses, which is fundamental to the FHFA's mandate to conserve assets. And where there is no available, lower-cost alternative to foreclosure for a particular defaulted mortgage, my expectation is that the Enterprises will move to foreclose expeditiously.

Retained Portfolios

The December amendments to the PSPAs included a change to the Enterprises' retained portfolio limits. Briefly, the change preserves the original PSPA requirement that the Enterprises begin shrinking their retained portfolios by ten percent per year, beginning this year. But, rather than starting the reduction from the Enterprises' year-end 2009 balances, the reduction now begins from their maximum allowed balances ($900 billion) as of year-end 2009. This means that each Enterprise may have a retained portfolio no greater than $810 billion by December 31, 2010. Currently, each Enterprise is below that amount.

FHFA remains committed to the principle of reducing the retained portfolios as set forth in the PSPAs. Consistent with the goals of conservatorship and in accord with the recent Treasury announcement, FHFA does not expect the Enterprises to be substantial buyers or sellers of mortgages, with an important exception. As I stated in December, the increased flexibility provided with the retained portfolio amendment may be important for maintaining the Enterprises' capacity to purchase delinquent mortgages out of guaranteed mortgage-backed security pools.

Given the size of the Enterprises' current outstanding retained portfolios, and the potential volume of delinquent mortgages to be purchased out of guaranteed mortgage-backed security pools, it is my expectation that any net additions to their retained mortgage portfolios would be related to this activity. I also expect that other private parties will begin to invest in new Enterprise mortgage-backed securities as the Federal Reserve gradually withdraws its purchase activity. To aid in complying with the requirements of the PSPA portfolio limitations in light of these factors, I am instructing each Enterprise to develop a detailed plan for how it will manage its portfolio to stay within those limitations.

New Products

HERA established a requirement that FHFA implement a public review process for new products that may be undertaken by the Enterprises. In July 2009, FHFA published an interim final rule implementing this provision. To date, no new product submission has gone through this process.

After considering the statutory requirement and the goals of conservatorship, I have concluded that permitting the Enterprises to engage in new products is inconsistent with the goals of conservatorship. Therefore, I am instructing the Enterprises not to submit such requests under the rule.

In view of the critical and substantial resource requirements of conserving assets and restoring financial health, combined with a recognition that the Enterprises operate today only with the support of taxpayers, I believe the Enterprises should concentrate on their existing core businesses, including minimizing credit losses. I reach this conclusion as various proposals seek

Enterprise involvement that, even if within charter limitations, could require large expenditures of funds, entry into new business lines with little prior experience, or dedication of personnel already operating in a stressed environment. New products could also require new risk measuring tools, compliance procedures, and additional oversight from FHFA.

In short, the Enterprises will be limited to continuing their existing core business activities and taking actions necessary to advance the goals of the conservatorship. This type of limitation on new business activities is consistent with the standard regulatory approach for addressing companies that are financially troubled. And it is even more pertinent for the Enterprises given their uncertain future and reliance on taxpayer funds.

Affordable Housing Mission

While the Enterprises are in conservatorship, FHFA expects them to continue to fulfill their core statutory purposes and that includes their support for affordable housing. One set of measures of the Enterprises' support for affordable housing comes through the housing goals, which Congress revised significantly in HERA.

Shortly, FHFA will publish for public comment a proposed rule setting the housing goals for 2010 and 2011. In that rule, FHFA will establish the framework for ensuring that the Enterprises' participation in the mortgage market includes support for the affordable housing segments of the market, consistent with their mission and with safety and soundness.

FHFA does not intend for the Enterprises to undertake uneconomic or high-risk activities in support of the goals nor does it intend for the state of conservatorship to be a justification for withdrawing support from these market segments. Under the conservatorships, the Enterprises have tightened their underwriting standards to avoid the poor quality mortgages that have contributed so much to their losses. Maintaining this type of sound underwriting discipline going forward is important for conserving assets and supporting the Enterprises' mission in a sustainable manner.

Concluding Thoughts

The Enterprises' operating in conservatorship cannot be a long-term solution. When the conservatorships and Treasury's financial commitment were established in 2008, Secretary Paulson described the arrangement as a "time-out" to allow policymakers to further consider the role of the Federal government and the Enterprises in the future system of housing finance. There are a variety of options available for post-conservatorship outcomes, but the only one that FHFA may implement today under existing law is to reconstitute the two companies under their current charters.

I recognize that the Administration and Congress have difficult and important decisions to make in the coming months on the future structure of the housing finance system. In my testimony before the Senate Banking Committee last October, I offered some of my own views on this subject. Going forward, FHFA looks forward to offering its technical assistance to both the Administration and Congress in considering policy alternatives.

The purpose of this letter has been to clarify the goals of the conservatorships and how FHFA is striving to achieve these goals. I also hope that this letter has helped to set the framework for how the Enterprises are operating in conservatorship as Congress considers the future structure of the housing finance system. I welcome the opportunity to meet with you personally to further discuss the matters covered here. As I believe the information contained here is also important to an improved public understanding of the conservatorships, I will be releasing this letter this afternoon.

Yours truly,

Edward J. DeMarco

Edward J. DeMarco
Acting Director