

**OVERSIGHT OF THE FEDERAL HOUSING FINANCE  
AGENCY**

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**HEARING**  
BEFORE THE  
**COMMITTEE ON  
BANKING, HOUSING, AND URBAN AFFAIRS**  
**UNITED STATES SENATE**  
**ONE HUNDRED TWELFTH CONGRESS**

FIRST SESSION

ON

EXAMINING THE OVERSIGHT OF THE FEDERAL HOUSING FINANCE  
AGENCY

NOVEMBER 15 AND DECEMBER 13, 2011

Printed for the use of the Committee on Banking, Housing, and Urban Affairs



Available at: <http://www.fdsys.gov/>

U.S. GOVERNMENT PRINTING OFFICE

74-411 PDF

WASHINGTON : 2013

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# OVERSIGHT OF THE FEDERAL HOUSING FINANCE AGENCY—PART I

TUESDAY, NOVEMBER 15, 2011

U.S. SENATE,  
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,  
*Washington, DC.*

The Committee met at 10:02 a.m., in room SD-538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

## OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I call this hearing to order.

I would like to thank Mr. DeMarco for being here today.

As I mentioned at our hearing on November 3, we have been planning to hold an FHFA oversight hearing and am pleased it was able to come together so quickly.

As Ranking Member Shelby and others have so accurately noted during the consideration of the Housing and Economic Recovery Act in 2008, one of the most important aspects of the bill was the establishment of the Federal Housing Finance Agency as an independent regulator. This ensures that it can operate without undue political interference and that the appropriations process cannot be used to hold the regulator hostage. With this independence, the Banking Committee must exercise Congressional oversight to ensure that the agency is balancing its attention among the entities it regulates and the role as conservator of Fannie Mae and Freddie Mac.

To give the Committee and the public greater confidence in the new regulator, HERA also established the FHFA Office of the Inspector General to investigate potential concerns and ensure transparency of the regulator's operations. I plan to invite Inspector General Linick before the Committee at a date to be determined. It is only appropriate that we should hear from him, as well. The Inspector General's role is even more important while FHFA is acting as both conservator and regulator.

It is important for this Committee to understand how FHFA evaluates new opportunities and programs at Fannie Mae and Freddie Mac during the conservatorship, including the decision to allow them to participate in certain Making Home Affordable programs and the decision not to participate in or initiate other programs.

The internal operations at FHFA are also important, as staffing of the regulator will affect its oversight of the GSEs. Oversight of executive compensation structures and evaluations of executive

performance goals both require the regulator's attention. FHFA must have proper management of operational risks as well as secure and updated information systems and privacy policies. I am concerned about recent reports that show problems in each of these areas and that FHFA does not have adequate certified staff to perform examinations of the entities under its supervision.

FHFA is tasked with regulating two of the largest entities in the mortgage market, Fannie Mae and Freddie Mac, which together backstop about \$5 trillion in mortgages and help support nearly \$11 trillion in the U.S. mortgage market. Unfortunately, that market is now supported by \$170 billion in assistance from the taxpayers. As we have heard from other witnesses before this Committee, the mortgage market would be even worse off than it is today if they had not been placed under conservatorship during the Bush administration. But as we have said over and over again, we need to find ways to end the need for future support without destabilizing the housing market further.

Finding a path out of conservatorship is a task for both the FHFA and the Committee. I would like to thank Senator Shelby and his staff for working so closely with me and my staff in laying out the hearings the Committee has held so far this year. I hope we can continue to work together to do our homework and create a sustainable system for the housing market going forward that can protect taxpayers and spur economic growth.

An adequately staffed and engaged regulator is a key component to a stable housing market. Mr. DeMarco, I look forward to hearing about the steps you have taken as Acting Director of FHFA since the last time you were before the Committee.

With that, I turn to Senator Shelby for his opening statement.

#### **STATEMENT OF SENATOR RICHARD C. SHELBY**

Senator SHELBY. Thank you, Mr. Chairman. Thank you for calling this hearing.

Today, the Committee will hear from the Federal Housing Finance Acting Director Ed DeMarco, as the Chairman has indicated. The FHFA is the regulator of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. Since 2008, the FHFA has served as the conservator for Fannie and Freddie. It has been more than 2 years since this Committee has heard from Director DeMarco on the conservatorships of Fannie and Freddie and the future of the GSEs. Since then, the taxpayer has lost an additional \$84.1 billion, bringing the total cost of these conservatorships to \$169 billion. Worse yet, Fannie and Freddie have already stated that they will need another \$14 billion for last quarter's losses.

These conservatorships were never intended to last for 3 years, yet because Congress has failed to address the future of GSEs, the conservatorships go on with no end in sight. This has cast a cloud of regulatory uncertainty over our mortgage market while taxpayers have had to continue to inject money into Fannie and Freddie to keep them afloat.

If at any point during the last 3 years the administration and the majority party had done more than talk about the need for reform, we might be looking at a very different picture in the housing market. If Congress had acted, Fannie and Freddie could have been

prevented from crowding out the private sector by backing 71 percent of mortgage originations. If Congress had acted, a comprehensive solution could have been devised to deal with foreclosures and struggling homeowners. If Congress had acted, taxpayers would not be subsidizing the pay of Fannie and Freddie executives. Instead, there has been no action, despite the fact that the GSEs were a significant player in the financial crisis.

In calling for this hearing, the Chairman has focused on the over \$12 million in bonuses paid to senior officers at Fannie and Freddie. I hope today that Director DeMarco will tell us exactly how these compensation packages were designed and which officials were involved and why. The American taxpayers should not have to subsidize million dollar compensation packages for Fannie and Freddie executives. This is just another example of the flawed structure of the GSEs. Their public-private structure has always meant that taxpayers were effectively subsidizing the pay of their CEOs. This is one of the many reasons I have long advocated reforming the GSEs.

Mr. Chairman, last week here, I asked that a representative of the Department of the Treasury be present at today's hearing. I am disappointed that Secretary Geithner or his representatives were not asked to participate. The U.S. Treasury Department played an important role in creating the bonus structure in question. The Treasury and the FHFA are both parties to the preferred stock purchase agreement, which is the contract that governs how the U.S. taxpayer will support Fannie Mae and Freddie Mac.

Section 510 of that contract requires that the Federal Housing Finance Agency consult—this is important—consult with the Treasury Secretary before allowing Fannie and Freddie to enter into any new compensation arrangements. I understand that Treasury was actively consulted by the Federal Housing Finance Agency on these compensation arrangements and never disapproved them.

Furthermore, while the Treasury Secretary has no authority to direct the Federal Housing Finance Agency in matters involving conservatorship, the purchase agreement prevents the FHFA from taking a variety of actions without, quote, “the prior written consent of the Treasury Department.” These matters include permitting Fannie and Freddie to issue stock, transfer assets, and incur certain indebtedness. Given the ability to veto and these other actions, the Treasury Secretary, I believe, has a lot of authority in matters dealing with the conservatorship.

Finally, the administration has been actively involved with the Federal Housing Finance Agency in making changes to the Home Affordable Refinance Program. The President stated that he, quote, “directed his economic team to work with the Federal Housing Finance Agency” in the lead-up to the recently announced changes and has referred to executive actions he took in this matter. These changes to HARP could have a significant impact on the financial health of GSEs and could impact housing finance reform.

Accordingly, if the Treasury Secretary were here today, we could have had a discussion on the future of Fannie and Freddie that included the two officials with the most knowledge and responsibility

for the GSEs. Apparently, that discussion, Mr. Chairman, will have to wait for another day.

Thank you.

Chairman JOHNSON. Thank you, Senator Shelby.

Are there any other Members who wish to make a brief opening statement?

#### **STATEMENT OF SENATOR ROBERT MENENDEZ**

Senator MENENDEZ. Thank you, Mr. Chairman. I, just briefly, I want to thank you first for holding this hearing. I think it is overdue and an important one. There are a lot of issues to explore in getting our housing market moving again, so many that it is difficult to know where to begin.

Let me just say, first, that I applaud the FHFA's recent initiative to remove barriers to help underwater homeowners refinance, and I think that is a step in the right direction. The problem is that it is a bright spot in what I believe has otherwise been a dismal lack of initiative at the FHFA in taking aggressive steps that could get the housing market moving again.

Congressional intent for the conservatorship is to save taxpayers money, but it is clear that taxpayers will do much better with a housing market that is functioning again and the resulting economic boom that will be derived from that, and I believe that that can be done without sacrificing taxpayers' interests because Fannie and Freddie's financial health is directly tied to how quickly the housing market recovers.

So I look forward to discussing the many ways in which we can do that, including principal reduction, converting vacant and foreclosed properties to rental in certain areas, and better outreach to borrowers, among others, as a way in which we both get this housing market moving and improve the status of taxpayers that right now are the focus of the conservatorship's efforts, but in my mind, we are just not doing what is necessary to enhance their position at the end of the day.

Thank you, Mr. Chairman.

Chairman JOHNSON. I thank the Ranking Member for his comments, but would note that this hearing is an oversight hearing of the Federal Housing Finance Agency. As the Ranking Member has stressed during the consideration of the Housing and Economic Recovery Act which created the FHFA, it is an independent regulator. Recognizing that independent role, I invited the Acting Director, Mr. Ed DeMarco, to testify before the Committee regarding the responsibilities of FHFA.

As my staff discussed with your staff 2 weeks ago, the minority is permitted to invite a witness. As has been the traditional practice of the Committee, your staff invites that witness and my staff sends a confirmation letter with procedural details. Nothing has prevented you from doing that. Alternatively, a representative from the Treasury Department will be before the Committee next month and Members can ask questions regarding the consultative role at that point.

Are there any other questions?



Thank you all. I want to remind my colleagues that the record will be open for the next 7 days for opening statements and for any other materials you would like to submit.

Now, I would like to briefly introduce our witness here today. Mr. Ed DeMarco is the Acting Director of the Federal Housing Finance Agency and is no stranger to this Committee. Mr. DeMarco has served as Acting Director since 2009, having previously served as Deputy Director and Chief Operating Officer at OFHEO, the former regulator of both Fannie Mae and Freddie Mac.

We welcome you here today, Mr. DeMarco, and thank you for your time. Mr. DeMarco, you may proceed with your testimony.

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

Mr. DEMARCO. Thank you, Chairman Johnson. Good morning, everyone. Chairman Johnson, Ranking Member Shelby, Members of the Committee, I am pleased to be here today.

My written statement provides updates on a range of topics regarding FHFA's oversight of Fannie Mae and Freddie Mac, or the Enterprises, as I will refer to them, and the Federal Home Loan Banks. I would be pleased to discuss any of those issues with you.

In the few minutes I have, I would like to focus on two matters. First, Fannie Mae and Freddie Mac have been in conservatorship for more than 3 years. The draws from the Treasury now exceed \$180 billion, reflecting losses from mortgages originated during the years leading up to conservatorship. Minimizing those losses as much as possible while maximizing assistance to homeowners is a key focus of FHFA and the Enterprises. Since conservatorship, the Enterprises have completed more than 1.9 million foreclosure prevention actions, including nearly one million permanent loan modifications.

While in conservatorship, we are also seeking to ensure the country continues to have a reliable supply of mortgage finance. The Enterprises have guaranteed roughly three out of four conforming mortgages since conservatorship.

While we await Congressional action in the future of housing finance, FHFA has initiated several projects to prepare for that future system. These are detailed in my statement and include standards for mortgage servicing, reconsideration of mortgage servicing compensation, and establishing loan level disclosures for mortgage-backed securities.

Second, I recognize that there is a great deal of concern today with executive compensation at the Enterprises. My written statement details the background and history surrounding the compensation program and my views about it. I would like to make just three observations here.

First, the executives most responsible for the poor business decisions that led the Enterprises into conservatorship and that led to these taxpayer losses are long gone from the companies.

Second, the best way to address concerns with executive compensation is action by Congress to restructure the nation's housing finance system and dissolve the conservatorships. Conservatorship is not designed to be a multiyear holding state.

Third, as conservator, I need to ensure that the Enterprises have people with the skills needed to manage \$5 trillion worth of mortgage assets and \$1 trillion of annual new business that the American taxpayer is supporting. Others may believe that this sort of talent is easily and quickly hired at compensation far below that of competing private firms, but I do not. Bottom line: This is a question of judgment, judgment exercised by balancing the need to limit compensation as much as possible while ensuring stable, continuous operations at the Enterprises in support of the country's housing finance system.

It has been FHFA's judgment that taxpayers who are providing financial support to the Enterprises and their guarantees on \$5 trillion of mortgages would not be better off if we provoke a rapid turnover of senior management by further slashing compensation. Indeed, such pay cuts would increase the risk of higher losses in the future. Executive compensation was already reduced by 40 percent on average when the compensation program was put into place.

I would also note that continued employment at an Enterprise risks substantial career uncertainty. By working at Fannie Mae or Freddie Mac, your work comes under a much higher degree of scrutiny and criticism than exists at other private firms. Executives who have spent a career developing their reputations risk tarnish to their reputations under the highly charged environment in which these companies operate today. This is regardless of how well they perform their duties or how great a financial sacrifice they may have made by forsaking other private sector opportunities in order to assist the country's housing finance system.

There has been intense criticism launched at corporate executives not even employed by the companies when the bad loans leading to the majority of today's losses were booked, people who arrived after conservatorship to try and make things better. I am trying to encourage these people to stay and continue to mitigate losses and keep the current infrastructure of the country's housing finance system operating.

To repeat myself on one point, the only way to finally resolve this question is for Congress to act to end the conservatorships and chart a new course for the country's housing finance system, and Mr. Chairman, I certainly heard you in your opening remarks and FHFA stands ready to work with you and all the Members of this Committee on that very important effort.

So with that, Mr. Chairman, thank you again for this opportunity to be here today. I do look forward to responding to the Committee's questions.

Chairman JOHNSON. Thank you for your testimony.

As we begin questions, I will ask the Clerk to put 5 minutes on the clock for each Member.

Mr. DeMarco, in August of 2009, you probably never imagined you would still be the Acting Director 2 years later.

Mr. DEMARCO. That is correct.

Chairman JOHNSON. Has the lack of a confirmed Director created additional challenges for FHFA? Are there oversight responsibilities that cannot be executed without a confirmed Director?

Mr. DEMARCO. That is a fair question, Mr. Chairman, and you are right in your opening remarks. I did not anticipate being Acting Director for more than 2 years. But I did not know when I took it over how long I would be Acting Director, so from the first day on, I have tried to lead the agency and conduct the agency's activities without paying much mind to what the ultimate tenure of me in this position would be.

So I do not think that it has altered or affected things that we have done. I do think that it certainly has created another hole in the agency, which meant I stepped up into an acting role. I had to ask others to likewise step up. So it created a domino effect where we did have fewer people at the top leading the agency. I was a little slow to start filling that under the belief that I would not be acting for very long, but I have since changed direction on that and have created some additional senior positions in order to fill out these responsibilities more completely and permanently with other senior executives at the agency.

Chairman JOHNSON. With several executive level vacancies to fill at the Enterprises, how involved will FHFA be in the hiring process? Will its involvement include negotiating compensation?

Mr. DEMARCO. So certainly for any of the senior officers, any of the named executive officers at Fannie and Freddie that need to be hired, we do delegate, at least below the CEO level, to the management to initiate the recruitment process. But in terms of the interview process, the selection, and then ultimately the compensation for a selected individual, that is all subject to the review and approval of FHFA. So both the selection and then ultimately the compensation, and with the compensation, as has been noted, we do then, after we are comfortable with a compensation package, we consult with the Treasury Department on it before it is finalized.

Chairman JOHNSON. The Preferred Stock Purchase Agreement provides a consultative role for the Treasury Department regarding executive compensation. Does the PSPA limit FHFA's authority to approve or deny a compensation package? In other words, are you forced to accept the suggestions from the TARP Special Master?

Mr. DEMARCO. We are not forced to, Mr. Chairman. It is a consultative role and that is how it has been carried out. I would say that, particularly back in 2009 when the compensation structure was being developed, I believe FHFA benefited from the consultations with Mr. Feinberg, who at the time was the Special Pay Master, and it enhanced what we were doing in fine-tuning that. But the ultimate decisions here remain the responsibility of FHFA.

Chairman JOHNSON. You have stated that competitive executive compensation is necessary to attract qualified executives. Do you have evidence that higher compensation yields better results in recruiting and retaining qualified executives?

Mr. DEMARCO. Well, I certainly think we have an entire competitive marketplace in the financial industry that suggests that compensation is an important factor in attracting and retaining high-quality talent. I would also say that in our time as conservator, we have had quite a number of senior executives depart both companies and it has not always been easy to fill these positions with people from the outside, and compensation and the uncertain future of the companies are both often cited as key reasons why po-

tential—why candidates for these positions end up backing out or not wanting to continue the process further or ultimately turn us down when an offer is made.

Chairman JOHNSON. On the issue of conservatorship, FHFA did not permit the Enterprises to participate in the FHFA Short Refinance Program. Can you describe how you came to that conclusion and how the evaluation of the program differed from the recent decision to expand the HARP program?

Mr. DEMARCO. Certainly, Mr. Chairman. It was the judgment of the FHFA that the Short Refi Program, and, frankly, the principal reduction alternative in the HAMP program, did not meet our mandate as conservator to minimize losses on these mortgages.

With regard to the HARP program, we reached a different conclusion and believe that the HARP program, which, in fact, has been in place since early 2009, which we have made several adjustments to since that time, including some larger adjustments last month, we believe that that program is consistent with our conservatorship responsibility and our other statutory responsibilities to support the housing market and maximize assistance to homeowners.

But with regard to the program you mentioned, that would impose certain losses on the Enterprises without an opportunity to recoup that.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you.

Mr. DeMarco, the Housing and Economic Recovery Act of 2008 requires you to, and I will quote, “preserve and conserve the assets and property of Fannie and Freddie,” is that right?

Mr. DEMARCO. That is correct, Senator.

Senator SHELBY. Explain how you determined that the bonus structures of Fannie and Freddie fulfilled this requirement. You have already alluded to this.

Mr. DEMARCO. Right. It essentially boiled down to this, that we were overseeing two companies with \$5 trillion worth of mortgages—

Senator SHELBY. Five trillion dollars.

Mr. DEMARCO. Five trillion dollars—that these are large companies, 10,000, 12,000 employees or more, with complex operations, operating in global financial markets with challenging hedging operations and credit and interest rate risk management responsibilities.

These are specialized skills, and with the American taxpayer backing this \$5 trillion worth of mortgage guarantees, it was our judgment that we needed to ensure we had highly competent people coming in to operate the companies to ensure that these losses were mitigated, that the companies run well. Otherwise, we risked far greater losses to the American taxpayers.

Senator SHELBY. And how do you get these people? I mean, they are in the marketplace, are they not?

Mr. DEMARCO. They are, Senator, and so we are recruiting people away from other major financial institutions to fill these positions.

Senator SHELBY. In your bonus structure, did you have incentives for these executives to do things, or how do you structure them?

Mr. DEMARCO. We—

Senator SHELBY. I know it is probably very complex.

Mr. DEMARCO. Well, it is a little complex, Senator. We modeled it after the compensation structure that was developed for the exceptionally assisted TARP firms, although I will say it largely reflects what we put in place in the first days after conservatorship. It has three basic components to it. It has a base salary that is paid over the course of the year, a deferred base salary that is paid out over the following year. Half of that has incentive components to it.

Senator SHELBY. Is that how you keep people—

Mr. DEMARCO. It is, very much—

Senator SHELBY. —otherwise they would—

Mr. DEMARCO. The deferred salary, Senator Shelby, is a very key component in the retention aspects of this compensation structure. So executives that leave during the course of the year are leaving a considerable amount of their compensation for that year on the table.

And then, finally, the last one-third of target compensation for executives is what we call a target incentive opportunity and it is based on the corporate performance.

Senator SHELBY. The Preferred Stock Purchase Agreement—I alluded to that earlier—established the rules by which the taxpayer funds the bailout of Fannie and Freddie. That contract requires you to consult with the Secretary of the Treasury on any new executive compensation arrangement, does it not?

Mr. DEMARCO. It does.

Senator SHELBY. Did you consult with the Treasury Department while you were establishing the current compensation arrangement?

Mr. DEMARCO. Yes, Senator.

Senator SHELBY. Did that consultation result in Treasury being aware of the compensation arrangement prior to their ultimate adoption?

Mr. DEMARCO. It did.

Senator SHELBY. Did Secretary Geithner or any of his representatives at Treasury express disapproval of the final structure of the executive compensation arrangement that you had proposed?

Mr. DEMARCO. No, Senator.

Senator SHELBY. How does the compensation arrangement of Fannie and Freddie compare with that of AIG and other TARP recipients? Did you base it on that, or what?

Mr. DEMARCO. Yes, Senator. The structures are comparable. The key difference is AIG and the other exceptional assistance TARP firms remained private firms with trading stock and they were not in a conservatorship or receivership. So the deferred base salary component of our compensation in the TARP world, that was done in the form of stock, but it made no sense to use equity grants to Fannie Mae and Freddie Mac employees and so we replaced that with cash, deferred cash.

Senator SHELBY. I am going to get into another area while I have got a minute. Recently, Director DeMarco, the Senate approved language to raise the conforming loan limits for FHA, Fannie Mae, and Freddie Mac. What message did that send to the Enterprises by voting to raise these loan limits?

Mr. DEMARCO. Well, the Enterprises certainly know from me that we are working to gradually step back their imprint on the mortgage market and to try to, over time, reduce the taxpayers' exposure to the mortgage market. And the fact that the reduction in the conforming loan limit was something that everybody saw coming, was prepared for both by Fannie and Freddie and by the marketplace, it sends a different signal to now be stepping back in after we had started to step away.

Senator SHELBY. It is my understanding, although it has not yet passed Congress, that the Conference Report for the appropriations bill is probably going to contain or will contain a compromise on conforming loan limits that would raise the loan limit made for FHA but not for Fannie and Freddie. That is kind of a strange deal there. If that happened, what would be the result of that?

Mr. DEMARCO. Well, it certainly could lead in certain markets to some confusion about what loan limits we are applying to what loans a borrower might make. So I think that it certainly could contribute to some confusion and another sense of in which direction are we moving with regard to the Government's role in the mortgage market.

Senator SHELBY. Thank you. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Tester.

Senator TESTER. Well, thank you, Mr. Chairman, for holding this hearing, and thank you, Mr. DeMarco, for being here today. And I appreciate your offer to meet last week. Unfortunately, I was on a jet plane flying back to Montana and then I did not get back until late last night, but I appreciate the contact.

This hearing is important as we deal with executive compensation for Fannie Mae and Freddie Mac consistent with protecting taxpayers, yet keeping these institutions running. As you have said yourself, Mr. DeMarco, the Enterprises operate today only with the support of taxpayers. It is obvious. And yet the compensation packages and the description of performance-based that these executives—I think has failed to recognize that point.

Now, you have suggested that the salaries for executives should be benchmarked against private firms in the banking and mortgage sector. Freddie Mac's corporate filings list companies like Wells Fargo and U.S. Bank for comparison. There is a big difference, and the big difference is that these companies are profitable and they are solvent and they do not rely on taxpayer funds to keep their lights on.

We are talking about the CEOs of Fannie and Freddie receiving \$12.2 and \$7.5 million in compensation in 2009 and 2010, respectively, to run a large but insolvent housing GSE. The taxpayers is what we need to keep in mind. Even the executives of many of the TARP banks and CEOs of Detroit automakers in hearings held by this Committee that got bailed out, decided to forgo their salaries. Quite frankly, they had to be shamed into it in some cases, but they did it.

Did it ever cross your mind when dealing with these compensation packages to say, hey, this is a tough year. The housing market is in a bad place. The taxpayers are on the hook for the Government Enterprises. Let us revisit this and use of common sense on the executives' pay for this year.

Mr. DEMARCO. In fact, that judgment was applied in 2008 in the year in which the Government placed these two companies into conservatorship. All bonuses, awards, incentives, and so forth were dispensed with in 2008. At the same time, there was a great deal of turnover in the executive leadership at both Fannie and Freddie, including bringing in new executives from outside the firms that were not involved in making the loans here but were being asked to come in and manage highly complex financial institutions.

Where to set this dial on CEO compensation, what I can say about that is that from my predecessor, this was a challenging determination, and the CEO compensation, as large as it is—and I will readily admit, Senator, it is large, it is—the last time Fannie and Freddie's CEOs saw that level of compensation prior to conservatorship was 1999, which is an indication of two things, an indication that the executives that have been leading Fannie and Freddie during the years running up to conservatorship were being paid an extraordinary amount of money. It also is indicative that our major financial institutions, in competing for talent to run these companies, they all pay a considerable amount of money.

Senator TESTER. I understand that. I understand what you are saying. The problem is, at this point in time, where we are at, heck, there are even "Occupy Wall Street" demonstrations as you were developing these—would it not have been more prudent on your part—and I am not in your shoes but I am in mine and I deal with folks when I go home every week that want to know about executive compensation with taxpayer dollars—would it not have been more prudent just to say, let us take a step back. This is a special time, we are dealing with the worst economic problems since the Great Depression, we are not out of it yet, to say, let us dial them back.

Now, let me give you an example. You guys oversee the Home Loan Bank of New York, for example, that you folks oversee. The executive compensation is \$4.9 billion—\$4.9 million, I will make that clear—\$4.9 million—it is a much smaller entity, but it is profitable. Would it not have been—I mean, there is plenty of room there for reasonableness, unless you think you were just going to lose your executive staff if that happened.

Mr. DEMARCO. Basically, that last point, Senator, is the biggest concern that has driven where these compensation levels have settled out. I do not believe that the Federal Home Loan Banks generally are the appropriate market comparables for Fannie and Freddie. They are much simpler and much smaller institutions. They employ far fewer people. But I certainly take the point, Senator, and I agree with it.

The one thing I can say, I do not know if it will help you or not, but we set these—there were judgments made in 2009 to set both the compensation structure and the level. Since that time, I have, with each opening of an executive position, and we have had plenty of those, worked to step down the compensation. So just like we are

trying to gradually withdraw Fannie and Freddie's footprint in the market, just like we are trying to gradually shrink their retained portfolio, we are trying now to go from where we set it in 2009 to gradually pull compensation back further.

Senator TESTER. OK. Just as a sidebar, and I have run out of time, but just as a sidebar, I will just say this. Twelve-point-two million dollars is pile of money. I mean, it is a pile of money. And when we are dealing with folks in the State of Montana or in the State of Tennessee or in the State of Colorado that are having a hard time paying their electric bills or paying for their prescription drugs or making their books balance at the end of the month and they see these kind of compensations come down utilizing taxpayer dollars, there is a reason people are protesting on the streets.

Mr. DEMARCO. Yes. I understand that, Senator. I think the point that you are making, the concern that Americans have about this, is something that I well understand and I appreciate them. We will continue to focus on this issue and see what we can do to further address the concerns you are raising, Senator.

Senator TESTER. Thank you for being here. I only say this because there are folks in this body that want to see Fannie Mae and Freddie Mac done away with so that there is no backstop on the housing. This does not help. This does not help.

Thank you very much, Mr. Chairman.

Chairman JOHNSON. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman.

Mr. DeMarco, thank you for being here and for the work you are doing. I find these hearings a lot of times semi-humorous in that we have really given you no clarity whatsoever as to the future of these organizations, or if we have, could you share that with me.

Mr. DEMARCO. Not a whole lot of clarity, Senator.

Senator CORKER. Let me ask you, are there concerns about—is there a danger with having a permanent conservatorship as we now have?

Mr. DEMARCO. I do, and I think that Senator Tester's questioning starts to get at some of those various concerns. I mean, before conservatorship, Fannie Mae and Freddie Mac were these odd institutions. They were not Government agencies, but they were not fully public, right? I am sorry, they were not really private firms, and they often sort of operated in this sort of gray area in between. Being in conservatorship is actually continuing that weird place between being a Government agency and being a truly private firm. We have got the taxpayers even more explicitly on the hook here.

But as conservator, when you are overseeing a company, you are trying to make long-term decisions about the direction of a company, both the investment in human capital, the investment in business processes and platforms, and it is very difficult to try to decide how to make those judgments while we are in this holding state of conservatorship.

Senator CORKER. So, in essence, we have a conservatorship that has been set up and Congress has not done its job as it relates to telling you what you would like these organizations to be. I would expect that the CEOs and others who run these companies have no



idea whether Fannie and Freddie will exist as they are forever or whether they are going to be out of business. Is that the case?

Mr. DEMARCO. That is the case. It is difficult for the CEOs and the boards.

Senator CORKER. To that end, I have offered a piece of legislation to deal with these two organizations and I have offered it in a way to actually try to solve the problem and hope to bring some bipartisan support toward that end and to really backfill. In other words, as Fannie and Freddie decline in the amount of percentage that they have of mortgage originations in the country and guarantees, that we backfill that with the private sector.

Let me ask you, what have you seen as we have these declining amounts, from 729 to 625, what actually took place in the private sector to backfill those?

Mr. DEMARCO. Well, it is a little early to tell, Senator, since the loan limit just went down a couple of months ago, but I have not been presented with any information or evidence suggesting that there has been a sudden disruption in the local markets where that happened. I am sure that there has been a change in pricing for mortgages that are in that affected band. But, frankly, Fannie and Freddie didn't purchase a whole lot of mortgages above the 625 limit when they had the capacity to. It is still a fairly small market.

Senator CORKER. What would be a reasonable amount of time to wind down the efforts of Fannie and Freddie? And I think there has actually been consensus that that needs to occur, and people have talked about replacement mechanisms and all that. But what would be a reasonable timeframe to wind down the actual operations? I know the mortgages will run on for some time, but what would you view to be a reasonable time?

Mr. DEMARCO. It would—I would have to qualify this in one way. It sort of depends on how much legal certainty is in place or what private capital engagement in the mortgage market would look like as Fannie and Freddie are stepping back. But I would think that over the course of a few years, we should be able to start making meaningful progress to seeing the Enterprises' imprint on the marketplace be able to recede without causing major disruption in the marketplace.

Senator CORKER. And so do you think if we had a wind-down of, say, a 10-year period, would that be something reasonable to look at?

Mr. DEMARCO. That would certainly seem plenty gradual to me, Senator.

Senator CORKER. So, again, I thank you for what you are doing, and we, in order to try to fill the vacuum, have offered a piece of legislation that, again, we are getting input from both sides of the aisle right now, trying to make it better. We will probably reintroduce it again. But in order to place a marker and to move us ahead, we have looked at limiting the amount that the Federal Government guarantees on the mortgages, not by the loan limit but by saying 90 percent of the mortgage itself will be guaranteed, 80 percent. That way, you have some market signals. You can tell the difference in pricing between what the Government is guaranteeing and what it is not. We can get a good indication of how the private

sector is responding. Does that seem like a reasonable approach to look at how we might unwind Fannie and Freddie?

Mr. DEMARCO. It certainly is a reasonable approach, Senator. In fact, it is one that is not dissimilar from one I mentioned in a speech a couple of months ago, where I said that I was looking to gradually increase the Enterprises' risk sharing with the private sector so that some of the mortgage credit risk that Fannie and Freddie are taking on board today with the taxpayers backing, if we cannot find some way of gradually putting some of that on private capital. So I believe your approach is well consistent with that thought process.

Senator CORKER. Well, we certainly welcome your input and I thank the Chairman for having this hearing. I encourage Members on both sides to look at how we might do that.

I will say that unless Congress comes forward and gives you concrete direction, we are going to end up in a permanent conservatorship, and Mr. Chairman, it seems to me that Mr. DeMarco ought to be interviewing us instead of us interviewing him because the fact is, we have taken no action. There has been a lot of chest beating about Fannie and Freddie, a lot of people saying what ought to happen, but candidly, we have done nothing. Hopefully, that will change very quickly. And again, I thank you for your service.

Mr. DEMARCO. Thank you, Senator.

Chairman JOHNSON. Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair, and thank you, Mr. DeMarco, for your testimony.

You note in your testimony on page 3, and I think you mentioned in your opening comments that you have three goals: minimizing taxpayer losses, first; second, providing stability and liquidity to the market; and third, maximizing assistance to homeowners to avoid foreclosure. In your testimony, you do address the revisions of the HARP program on page 7. Those have been pretty widely discussed. Largely, the impression I have received from just about everyone in the housing world is that rather than a sense of urgency and leadership, FHFA has been more in the role on those HARP revisions of fighting them and finally acceding to them.

In terms of actually helping homeowners, there is a reference in your testimony that says FHFA is proceeding prudently but with a sense of urgency to lay the groundwork for development of good initial pilot transactions. I must say, we are years into this now and here is FHFA testifying—you are testifying that you are kind of thinking about some possible initial pilots. That does not convey any sense of urgency. And indeed, it has been enormously frustrating to FHFA to have Fannie and Freddie very resistant to their Short Refinance Program. It has been very frustrating to folks throughout the rest of the housing world, the administration, that have been pushing for the HARP revisions.

And in terms of the pilots, the hardest hit funds, a good share of—a good chunk of the hardest hit funds went to Oregon for a pilot in which they have worked with your agency—Oregon has worked with your agency to try to acquire mortgages that are in severe risk of default, highly underwater, income vastly reduced. And after a great deal of effort, 100 tentative mortgages were sent out to Oregon and they identified, I think, 37 of those.

But it has been—even those 37, well, now there is an accounting problem and it took a long time to get the accounting problem sorted out. And then there was an issue over selling the mortgages versus short-sale strategy and that took forever. Then FHFA was insisting on individual appraisals while Oregon was pushing for a block approach, and now FHFA says it wishes it had done a block approach rather than doing individual appraisals.

In other words, at every point, no sense of urgency, no sense of leadership. We are years into this crisis. We are not at the beginning of this in 2007. This is 2011 and we are still talking about initial pilots and there is still no sense of top-level drive saying we have got to find ways to keep families in their home.

The reason this is so troubling is because we have millions of foreclosures yet to come. You are at the head of the agency that has the biggest potential influence to be powerful, creative, in driving a vision of how we can seize this opportunity. We have so many working families, that if they could buy homes now at these low prices and low interest rates would be empowered for the rest of their lives and help absorb this overflow of empty homes that has been driving down the price of houses.

So I say all of this to basically encourage you to shift gears, to shift out of neutral and into drive, to really help lead this conversation about restoring the housing market rather than being this highly resistant force that has not taken the third piece of the mission seriously.

Mr. DEMARCO. I appreciate your concern, Senator. I will just briefly respond with a couple points. First, with regard to HARP, you are correct that it has been characterized that FHFA was dragged into these HARP changes. I do not agree with that characterization. I think FHFA showed a lot of leadership in actually pulling together the mortgage industry and the mortgage insurance companies to figure out how we could make this program that had already been around for 2½ years work more effectively.

For the benefit of the rest of the Senators, the pilot that you are referring to in my written statement has to do with our look at how we can otherwise dispose of real estate owned, that is foreclosed properties that Fannie Mae and Freddie Mac have. We did solicit public comment on this in August and we received 4,000 comment letters with regard to that. This is not something new. We—in fact, Fannie and Freddie have each tried some bulk approaches to REO disposition in the marketplace and the results were clearly not satisfactory from a conservator standpoint, and we decided to take this approach of inviting market input into how to do this better so that maybe we could have a more robust framework for REO disposition, one that was more transparent and competitive. I am sorry this does take a little time, but I am—I want you to know, Senator, I am committed to this REO program moving forward.

And with regard to everything else in the housing market, I have in past forums addressed some of these concerns about what FHFA is or is not doing in its role as conservator. I do think hard about the statutory framework in which we operate as conservator, the mandate that we have and the funds that were provided to FHFA—to Fannie and Freddie through the Treasury Department and the purpose for that, and I have contended in the past that if

there were things that the lawmakers felt were in the best interest of the country and the country's housing finance system to legislate the use of taxpayer money for these things, FHFA would be ready to participate in that. But with the authorities that we have today, we made decisions about certain programs we just felt that the authority was not there for us given our conservatorship responsibilities. It is a respectful disagreement that I have with certain people regarding that.

But we are trying to be consistent in our application of the law and we certainly recognize the trouble and hardship that is out there in the housing market around the country, and so I appreciate your concern. We will continue to press ahead, Senator, to provide the assistance and support to the market that we are charged with doing, and I appreciate your comments.

Senator MERKLEY. I will say, even in your response, I do not sense that you have come to embrace that third mission seriously, and I just—there was a hope, and certainly the Treasury Department, the Treasury Secretary had this hope that the general market would recover in a way that would make serious direct action to support homeowners unnecessary. I think we all know that did not happen. I think it is time to reframe our conversation again, 4 years into this, and realize that, for example, the Short Refi Program that FHA put forward would be enormously improved if it had the full encouragement, partnership, desire to sit down and say, how can we make this happen, as opposed to what feels like that is not our concern and not our interest.

Mr. DEMARCO. I will say, Senator, because this FHA Short Refi Program is focused on underwater borrowers, I do not think it is appreciated enough in sort of public discussions, that while Fannie and Freddie certainly are guaranteeing mortgages that are underwater. The majority of these American homeowners that are underwater, continuing to perform in their mortgage, they are honoring their financial obligation, and I think that is the best thing to minimize taxpayer losses, is that folks that have committed to paying a mortgage, they have seen their house price decline. They are continuing to make good on that payment, and that is why I think things like the HARP program changes we made are actually the more appropriate way for us to reach out and provide added support to these folks to be able to continue to perform in their mortgage and provide stability to the marketplace.

The one other thing that might be useful with regard to your comments, I think that one of the really important things FHFA did earlier this year was through our Servicing Alignment Initiative with Fannie and Freddie. We established a new set of standards for mortgage servicers dealing with a mortgage from the moment it first goes delinquent, and what we did here is we tried to learn from the mistakes of the last couple of years. We tried to simplify the process and to provide very uniform, for Fannie and Freddie, uniform guidance to mortgage servicers what to do the next day after that mortgage payment has been missed, because the experience has been that the best way to help a homeowner in a troubled situation is to get hold of that homeowner right away when they first start missing their payments and work with them in those early days. That maximizes the opportunity for success,

and we have invested a lot of resources this year in terms of Fannie and Freddie working with servicers to reorient mortgage servicing to take that approach.

Chairman JOHNSON. Senator Kirk.

Senator MERKLEY. Thank you.

Senator KIRK. Thank you, Mr. Chairman.

Mr. Chairman, I just would like to ask that, again, that we do a Committee hearing on the European debt crisis and especially the exposure of U.S. institutions to that. I would just note this morning, the market is rendering a fairly surprising judgment on U.S. debt. German 30-year bonds are selling at 2.48 percent, while U.S. bonds are selling at 3.9 percent. That means that the U.S. is borrowing at 24 percent more cost than the Germans, and I think it shows a fairly devastating expectation for the supercommittee and where we are going.

And also with regard to the FHA, I just ask, I know you have probably read Morganstern and Rosner's book, right, *Reckless Endangerment*?

Mr. DEMARCO. I have, Senator.

Senator KIRK. Yes. Robert Reich—I have not read it, but I read Robert Reich's summary of it in the *New York Times* and he talks about Fannie and Freddie losing another \$13.8 billion of taxpayer money, worsening the perception that we are quite bad with being able to repay our loans. These institutions—one of the colossal failures in U.S. history, \$182 billion now that taxpayers have squandered on these institutions.

James A. Johnson pocketed, according to the book, \$100 million for himself, and the GAO said that of the subsidies Congress provided starting in the 1990s, that Fannie and Freddie pocketed one-third for themselves. That Franklin Raines followed this policy, that Lawrence Summers buried a report recommending privatization of the institution, that Ken Starr intimidated Members of Congress for asking about compensation.

Now, we have dealt with that issue a lot. I want to touch on two things. First, the *Wall Street Journal* reported that since last year, the White House has been pushing DeMarco's agency to embrace the biggie of housing bailouts principal write-downs in which lenders would be required to outright forgive a portion of homeowners' outstanding mortgage debt. The White House sees it as a free stimulus, no Congressional approval or official spending estimate needed. Fannie and Freddie would then swallow additional losses, quietly adding to the \$141 billion already sunk into the loss of the insurance.

But DeMarco, a 51-year-old regulator who is a career professional, will not play ball. Thank you. He pushed back on these housing schemes because he takes his mission as conservator seriously while still posting an impressive record, it says, of engaging in 1.9 million transactions to actually help homeowners out. You pushed back because you have said, and you told this Committee earlier that there is no upside to the taxpayers in what the White House is trying to push on you.

And then I note this morning the *Wall Street Journal* reports the Federal Housing Administration's cash reserves have fallen so low there is close to a 50 percent chance the agency will run out of

money and require a taxpayer bailout next year, according to an annual independent audit of FHA's finances. The audit, to be released Tuesday by FHA, estimated the value of the agency's reserves stood at \$2.6 billion as of September 30, down 45 percent from the \$4.7 billion last year.

So I wonder if you could comment on that, and I commend you for being a career professional who took conservatorship correctly. We are already now running on close to \$200 billion in losses from these corrupt institutions, and with the credit rating of the United States under attack and markets now saying that it is probably safer to lend Germany money in the middle of the European—than the United States, I think your conservator message is well taken.

Mr. DEMARCO. Thank you, Senator. I appreciate that.

Senator KIRK. Can you just comment on the fact that this independent auditing agency now says there is a 50 percent chance that the agency will run out of money, requiring a taxpayer bailout next year?

Mr. DEMARCO. Senator, I have seen the same headlines you have referenced, but I am afraid I am not familiar with the report and I have kind of got my hands full with Fannie and Freddie's finances, so I am probably not the best one to speak to FHA's current financial condition.

Senator KIRK. Well, I would just say that I would underscore the conservator side of your mission because we have already lost enough and it is imperative for the Congress and for you to differentiate our exposure from practices that we see in Europe. I just noted yesterday, I heard that the average Italian retirement age was 58, and so they were basically banking 15 years' work for 30 years' pension, and we need to differentiate ourselves from policies like that so that we once again appear to be a good creditor, and I commend you for your leadership on this conservator issue.

Mr. Chairman, thank you.

Mr. DEMARCO. Thank you, Senator.

Chairman JOHNSON. Senator Reed, are you—

Senator REED. No.

Chairman JOHNSON. Senator Bennet.

Senator BENNET. Thank you, Mr. Chairman. Thank you for holding this hearing.

Mr. DeMarco, I wanted to shift gears a little bit while we have you here today to ask you a couple of questions about the Property Assessed Clean Energy, the PACE Program, which, as you know, Colorado actually was a leader in implementing that program before the FHFA halted it in 2010, I think, because of concerns about second lien status. Are you familiar with what I am talking about?

Mr. DEMARCO. I am, Senator.

Senator BENNET. The puzzle that I have is that there are, I think, 37,000 Special Assessment Districts in the United States, including many that are similar to PACE Districts. They have different purposes, but there are, for example, Septic Tank Remediation Districts, Geologic Hazard Abatement Districts, and others that are similar in many ways to PACE, although what we liked about PACE in Colorado was that we were actually seeing substantial retrofits and job creation as a result. And just as in these other programs, property owners can voluntarily opt into them or out of

them. The assessments are a similar size and duration to PACE Districts.

So I wonder—I would like to get to a place, and as you know, I have some draft legislation to do it, to a place where a program that seemed to make all the sense in the world could actually go forward, but that you are reassured that your position is what you need it to be, and I wonder in that spirit whether you would talk a little bit about where the FHFA is and where we might be able to go together to try to get this program moving again.

Mr. DEMARCO. Certainly. Thank you, Senator. You know, the general goal of PACE programs in Colorado and around the country are certainly laudable. They are designed to enhance—to provide financing for energy retrofits for an aging housing stock so that we become more energy efficient as a country and can reduce costs to homeowners of energy expense over time.

The challenge that FHFA saw with regard to the PACE program as it was emerging was that it made a material change in the credit risk exposure of the first mortgage after that first mortgage had been made. Because the way the PACE was structured is that this was a sizable advance, but essentially a loan to a homeowner to make a home improvement to the house, and normally that is done in a second lien position. By using the tax status of the local jurisdiction, it was taking this home improvement loan and making it something that came in advance of the first mortgage.

And so the first mortgage holder would price the credit risk on this transaction at the time the loan was made and was suddenly being put in a subordinate position, and this really is not like normal tax assessment jurisdictions here because it is really designed for the benefit of a particular dwelling. It is—oftentimes, these things as normally done are not voluntary and they are not nearly the same dollar amount or duration as these PACE loans are. We also, when this first emerged, raised concerns with a number of the jurisdictions doing it regarding consumer protections and disclosures regarding the cost of these programs.

I really do look forward to working with you, because I think that the principle of energy retrofits and these sorts of home improvements have a lot of positive elements to it, but I think that the financing structure for that is better done in a traditional way of being subordinate to the first mortgage that has already been in place.

Senator BENNET. Well, I would like to take you up on your offer to work on it, because I think there is, both with respect to PACE and some other work that Johnny Isakson and I, Senator Isakson and I are doing in something called the SAVE Act, a huge opportunity here if we can think about how to do the financing, because the up-front costs that people have, which we then know can be paid back if we do the math properly and prudently, among other things, will make us more energy efficient but also give the 25 percent of people in the trades who are unemployed something to do before this housing market actually comes back.

So I hope that we could look at this with some urgency and try to figure out how to get it done.

Mr. DEMARCO. OK. Thank you.

Senator BENNET. Thank you. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman.

Mr. DeMarco, the focal point of this hearing is the bonuses that have been received by executives at Fannie and Freddie. Just to try to, in my own mind, at least, clarify, these contracts were approved by FHFA, not by the Department of Treasury, is that correct?

Mr. DEMARCO. Both the structure and the amounts were the responsibility and approved by FHFA. FHFA has a contractual responsibility to consult with the Treasury Department on it to get and consider their feedback, but we are ultimately responsible for the decision.

Senator REED. So that there is no legal ability for the Department of Treasury to veto your decision. You simply give them—they give you their advice as to what you should do, is that—

Mr. DEMARCO. That is—consultation, yes, Senator.

Senator REED. Typically, and I do not have to tell you, you are quite aware of it and the country is aware, there are so many people desperately looking for a job. The idea of these huge bonuses just is inconceivable to so many people. But typically in a bonus arrangement, there are some performance criteria. Can you outline the performance criteria that would entitle these individuals to bonuses?

Mr. DEMARCO. Certainly, and these are actually detailed in the public disclosures that Fannie Mae and Freddie Mac make in their SEC filings, but I can give you a sample of them. It has included loss mitigation activity, such as getting folks for taking foreclosure prevention activities, getting folks into loan modifications. It has included remediating the operational and risk management deficiencies that FHFA in its supervisory practice has identified for the companies so that they become more efficient and less risky, more safe and sound as they go forward. And it has gone to ensuring that they remain active participants on the mortgage market so that we have stability in the marketplace.

Senator REED. There are many who would look at the performance of Fannie and Freddie and say that, frankly, they have not done a very good job in those areas that you have pointed out—loss mitigation, getting people into modifications. In fact, I think some troubling numbers, 2010 modifications were significantly far ahead of what we have seen this year, and yet they are still collecting bonuses. And that is one point, which is how do you sort of rationalize what we are seeing and the award. And the second more specific question, who makes the judgment that they have achieved these objectives? Is it the Board of Directors or is it you or is it a combination of the Directors and you?

Mr. DEMARCO. So it is a combination. We do work with the Boards of Directors, so the scorecards are there in advance. The assessment of it is done by management. Those assessments are reviewed by internal audit of the companies. Those assessments are then reviewed both by the Boards of Directors and by my own staff before the ultimate sort of determination is left with me.

With regard to the question about bonuses and these losses, I think it is a very fair observation, Senator, and it is one that I think many citizens have, and I would like to maybe expand on it for just a moment, if I may. Here is the real challenge of overseeing



Fannie Mae and Freddie Mac in conservatorship. These losses that the American taxpayer has been incurring are a result of business decisions that were made at Fannie and Freddie, principally in the period from 2005 until the first half of 2008. So those were business decisions that were made at a time past by a leadership team that is no longer with the company.

We are now in conservatorship with a new leadership team faced with the prospect of a lot of poorly underwritten mortgages that were badly priced, but we cannot undo that. The best we can do is to see, given these lousy mortgages, what can we do to minimize the losses on them and what can we do to strengthen the business going forward.

So we know that we are going to see over a period of several years, from 2008 really certainly at least through next year, we are going to see these losses start to wash through the financial statements, but these are losses that are on mortgages that were originated a while ago. But I need to have a management team come in and be willing to do the hard work of trying to clean this up and build something better for the new mortgage book that we are having, and so getting that sort of separation in mind is one of the things I feel I have to do and it is a challenge in sort of recruiting people into these positions.

Senator REED. No, I think we understand that. But I think my office has been in touch with you on several different initiatives—

Mr. DEMARCO. Mm-hmm.

Senator REED. —and let me suggest that your individual activity is absolutely critical, but there are many other factors here—what the State Attorney Generals do with respect to their activities. But Fannie and Freddie have such a dominant position, particularly with, literally, the collapse of all the private label folks who were eating their lunch in 2005 and now they are no longer there, leaving Fannie striving to keep the housing markets moving forward.

But I think we all have to be much more creative, and I think you have to be much more demanding in terms of those types of performance ends you expect and also the innovative ways in which your management, or the management of these two companies, carry out their responsibilities, because ultimately, the only way we can justify these types of compensation arrangements is discernible progress that is recognized not just here, but across the country. And you have a difficult job and I think you are obviously putting a great deal of effort in, but we all have to do much better.

Mr. DEMARCO. Well, I accept that, Senator, and as I tried to say in my written statement, I am committed to looking at these scorecards and how we go about doing that and taking some further steps in the coming year in the direction that you have outlined.

Senator REED. And if I may, one final point. The overall health of the housing market, its sort of stabilizing and then beginning to slowly appreciate, is ultimately what will make the balance sheets of Fannie and Freddie look much, much, much, much better. Do you agree?

Mr. DEMARCO. Yes. No, I think that is right, Senator.

Senator REED. Thank you.

Chairman JOHNSON. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

Mr. DeMarco, I want to pick up where Senator Reed just left off. Earlier this past month, former Treasury Secretary Larry Summers published an op-ed piece in the *Washington Post* that pretty much, I think conveys the sentiments that I have, which is that the FHFA has taken a narrow view of the public interest and that it has neglected its conservatorship mandate to ensure that the GSEs help stabilize the nation's housing market. It has taken no account for the reality that the GSEs' health depends on a national housing recovery. And instead, you know, it seems to me that you all have been focused on reversing previous policies, heedless of the changes in the environment, and treating mortgage finance as a morality play.

The question for me, I have never seen the Nation move into an economic recovery without housing being one of the drivers, and in terms of ensuring the best results for the taxpayers, having a housing market that is on the move and thriving again is going to be critical to that. So it seems to me that you have a narrow and cramped view of the public interest that is hurting the housing market's recovery. What is your response to that?

Mr. DEMARCO. Well, Senator, I have had the honor of working with Mr. Summers. I have a great deal of respect for him. But on this, I do disagree, and I would not say that I have a cramped view. I think I have a view that is following the law as I understand it has been written by Congress. I do not believe that the Congress of the United States has authorized me to expend taxpayer funds for the general support and uplift of the housing market.

I believe that the funds that the Congress gave to the Treasury Department to purchase securities of Fannie Mae and Freddie Mac were designed to support the operations of this conservatorship, and as conservator, Congress has given me a statutory obligation to conserve and preserve the property and assets of these companies, and that does not extend to providing general support. If general support is what lawmakers believe is what is going to help the country's economy and housing sector recover, I believe that that needs to be appropriated for that purpose by Congress.

Senator MENENDEZ. How do you define conserve and preserve? Give me your definition of that.

Mr. DEMARCO. I believe that it means that we are not supposed to dissipate assets. We are supposed to work to mitigate the losses that are there so that there is—we are maximizing what is left for the owners of the company. In this case, with the Treasury Department essentially having these warrants in the company that give it an 80 percent ownership interest, that goes to minimizing losses for the taxpayer. But that is the view and interpretation that the agency has taken as it has studied the statute.

Senator MENENDEZ. So if you want to minimize the loss of the taxpayer, one of the things you want to do is make sure that, for example, my understanding is that GSEs lose about \$65,000 per property per foreclosure. Is that a fair estimate?

Mr. DEMARCO. It could be. I am sorry, Senator. I do not know—

Senator MENENDEZ. So it seems to me that if we were looking at how do we deal with mitigation if we were looking at a more aggressive borrower outreach and response, which we have written letters to you about and which Freddie Mac has not been responsive to, that maybe we would be avoiding on behalf of the taxpayers a loss of \$65,000 per foreclosed property. Is Freddie Mac going to be in the midst of implementing a similar borrower outreach program that Fannie has begun?

Mr. DEMARCO. Honestly, Senator, I am not sure which particular outreach effort that Freddie Mac is not doing that you are talking about. But, look, both companies have been working on outreach efforts and working with mortgage servicers to contact troubled borrowers rapidly.

There is no disagreement with you, Senator. You are absolutely correct that the best thing we can do to minimize losses on these troubled mortgages is to contact borrowers early and to try to find foreclosure alternatives for them, ideally where the homeowner stays in their home. And I believe we put a great deal of effort into that. We have had 1.6 million successful foreclosure alternative transactions done that have resulted in the borrower staying in their home. But we do need to continue to do more and I do believe that we have taken some important steps, Fannie and Freddie together with us this year, to improve the instruction to servicers to contact borrowers and work with them in an aggressive way from the moment they first become delinquent on their mortgage.

Senator MENENDEZ. Well—

Mr. DEMARCO. Because you are quite right, Senator. This is very costly, especially when the mortgage goes to foreclosure.

Senator MENENDEZ. Well, Fannie is headed in the right direction. Freddie Mac has a dismal record. I would commend it to your attention and like to see your response to it.

Second, under the Emergency Economic Stabilization Act of 2008, you have a statutory responsibility to, quote, “implement a plan that seeks to maximize assistance for homeowners”—maximize assistance for homeowners—“and use its authority to encourage the servicers of the underlying mortgages in considering net present values to the taxpayer to take advantage of available programs to minimize foreclosures.” Is that not an equal responsibility that you have?

Mr. DEMARCO. It is, Senator, and I believe it is one that we have been working very hard on since Congress enacted it, and we send a monthly report to the Senate Banking Committee outlining—updating the Committee on the actions that have taken place in the last month and running a—we have a running tally of what are all the different things that have been done and how many homeowners have been assisted by that, and that is provided monthly, and that is where that 1.6 million figure that I mentioned a moment ago is reported at.

Senator MENENDEZ. But if that answer you gave Senator Reed, that a robust housing market is ultimately going to place the taxpayers in a better position, why is it that you view so narrowly the ability to think a little bit outside of the box and help to achieve a housing market that is more robust?

Mr. DEMARCO. Well, that is fair, Senator, but the statutory provision that you read includes in that a consideration of the net present value to the taxpayer, which I believe is consistent with the HERA mandate that we have as conservator to preserve and conserve the assets of the Enterprise. And so we look at all these various programs, HAMP, HARP, and other proprietary loan modification programs that Fannie and Freddie do, but we do it with a consideration of will this foreclosure alternative transaction reduce the cost to the taxpayer relative to foreclosure? If the answer to that question is yes, by all means, Senator, we want that transaction to be executed, whether it is a loan modification, a forbearance plan, a short sale, depending on the facts and circumstances.

If that transaction is going to lower costs relative to foreclosure, we are very committed to wanting to see that done because we believe it is consistent with the EESA mandate, and that is how we are interpreting the EESA mandate, to maximize assistance, and we think it is in harmony with our HERA mandate to conserve and preserve the assets of the—

Senator MENENDEZ. Well, finally, Mr. Chairman, as someone who supported and voted for the legislation, it seems to me that I have a different vision, and I think many of us share that vision, of what your mandate is. At the end of the day, the biggest holders of these mortgages is all of us as U.S. taxpayers through the GSEs. We want to maximize the opportunity for people to be able to mitigate our losses, and in part, that means a robust housing market.

Let me ask you one last question with the indulgence of the Chair. Do you not agree—this issue of loan limits was raised, something that I and Senator Isakson have been pursuing and that 60 members of the Senate supported—CBO says keeping the loan limits at the higher rate that had expired will not cost taxpayers one dime. Do you agree with that statement?

Mr. DEMARCO. I have not seen the CBO statement, but the loan limits themselves, I am not sure how I would say that it would add or subtract from the taxpayer. The mortgages would certainly have to be underwritten properly and priced properly and that is what we have been doing.

Senator MENENDEZ. Well, the CBO says keeping the limits would not cost taxpayers one dime because the cost of the defaults are paid by the premium loan fee of 15 basis points per year from the loans that benefit from this. And in a housing market that certainly we might think that this is not appropriate 2 years from now, but in a housing market right now, certainly along the coasts it would be pretty devastating, not only because of the higher limits, but 125 median ratio, and that would dramatically affect housing across the country.

So I just hope that we are adopting policies that give us long-term growth in the housing market, which is going to be part of our solution, versus just whittle ourselves down to a set of circumstances in which we may be viewing that we are saving the taxpayers from a greater liability instead of growing and mitigating more effectively. I hope that you will consider that as part of your deliberations moving forward.

Mr. DEMARCO. Well, thank you, Senator. We will. Obviously, the conforming loan limit is a matter that has been for Congress to set and adjust.

The one thing about the bill of yours that you mentioned, of course, is that this added fee does not go to Fannie and Freddie to offset their credit risk directly. It is going to the Treasury Department and then would need to be appropriated back. I do not entirely follow the connections there in how that would—so that might affect the answer in terms of how this loss would affect the taxpayer versus how it would show up on Fannie and Freddie if the fee was going away from them.

Senator MENENDEZ. Clearly, the fee is meant to ensure that the borrower is the one who bears the burden, not the entities, and so I am sure that issue can be easily resolved.

Thank you, Mr. Chairman, for your indulgence.

Chairman JOHNSON. Mr. DeMarco, thank you for your testimony and being here with us today.

Oversight of FHFA is and will continue to be an extremely high priority of the Committee. With the housing market still in flux, a robust and proactive FHFA is essential.

This hearing is adjourned.

[Whereupon, at 11:27 a.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

**PREPARED STATEMENT OF CHAIRMAN TIM JOHNSON**

I would like to thank Mr. DeMarco for being here today. As I mentioned at our hearing on November 3, we have been planning to hold an FHFA oversight hearing, and I am pleased it was able to come together so quickly.

As Ranking Member Shelby, and others, so accurately noted during consideration of the Housing and Economic Recovery Act in 2008, one of the most important aspects of the bill was the establishment of the Federal Housing Finance Agency as an independent regulator. This ensures that it can operate without undue political interference and that the appropriations process cannot be used to hold the regulator hostage.

With this independence, the Banking Committee must exercise Congressional oversight to ensure that the agency is balancing its attention among the entities it regulates and the role as conservator of Fannie Mae and Freddie Mac.

To give the Committee and the public greater confidence in the new regulator, HERA also established the FHFA Office of the Inspector General to investigate potential concerns and ensure transparency of the regulator's operations. I plan to invite Inspector General Linick before the Committee at a date to be determined. It is only appropriate that we should hear from him as well. The Inspector General's role is even more important while FHFA is acting as both conservator and regulator.

It is important for this Committee to understand how FHFA evaluates new opportunities and programs at Fannie Mae and Freddie Mac during conservatorship, including the decision to allow them to participate in certain Making Home Affordable programs and the decision not to participate in or initiate other programs.

The internal operations at FHFA are also important, as staffing of the regulator will affect its oversight of the GSEs. Oversight of executive compensation structures and evaluations of executive performance goals both require the regulator's attention. FHFA must have proper management of operational risks, as well as secure and updated information systems and privacy policies. I am concerned about recent reports that show problems in each of these areas, and that FHFA does not have adequate certified staff to perform examinations of the entities under its supervision.

FHFA is tasked with regulating two of the largest entities in the mortgage market, Fannie Mae and Freddie Mac, which together backstop approximately \$5 trillion in mortgages and help support the nearly \$11 trillion U.S. mortgage market. Unfortunately, that market is now supported by \$170 billion in assistance from the taxpayers. As we've heard from other witnesses before this Committee, the mortgage market would be even worse-off than it is today if they had not been placed into conservatorship during the Bush Administration.

But as we have said over and over again, we need to find ways to end the need for future support without destabilizing the housing market further.

Finding a path out of conservatorship is a task for both the FHFA and this Committee. I would like to thank Senator Shelby and his staff for working so closely with me and my staff in laying out the hearings the Committee has held so far this year. I hope we can continue to work together to do our homework and create a sustainable system for the housing market going forward that can protect taxpayers and spur economic growth.

An adequately staffed and engaged regulator is a key component to a stable housing market. Mr. DeMarco, I look forward to hearing about the steps you have taken as Acting Director of FHFA since the last time you were before the Committee.

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**PREPARED STATEMENT OF EDWARD J. DEMARCO**

ACTING DIRECTOR, FEDERAL HOUSING FINANCE AGENCY

NOVEMBER 15, 2011

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, I am pleased to be invited here today to discuss the Federal Housing Finance Agency's (FHFA) oversight of our regulated entities (Fannie Mae and Freddie Mac, together the Enterprises) and the Federal Home Loan Banks (FHLBanks).

The main focus of my testimony will be on key topics related to FHFA's role as the Enterprises' conservator and regulator. I will update you on the financial condition of the Enterprises in conservatorship. Then I will review FHFA's approach to preparing for increased private market participation in housing finance and describe significant activities that FHFA has undertaken during the past year to further our conservatorship goals. I will then briefly report on several Federal Home Loan Bank

(FHLBank) issues and, as requested, on recent reports issued by the FHFA Office of Inspector General.

I will conclude with a review of FHFA's oversight of the executive compensation structure for Fannie Mae and Freddie Mac. I will explain how the Enterprises' executive compensation program supports the statutory mandates of the Enterprises in conservatorship, how it was developed, and how it is structured.

### **Introduction**

As it has been more than 2 years since I appeared before this Committee at a general oversight hearing, it may be useful for me to begin with a brief overview of what it means for Fannie Mae and Freddie Mac to be in conservatorship and what legal responsibilities FHFA operates under as conservator.

The determination to place Fannie Mae and Freddie Mac, or the Enterprises as I will refer to them, in conservatorship, was made as the financial crisis of the autumn of 2008 was taking shape. At that time, the private mortgage securitization market had already vanished, house prices were declining rapidly, and the Enterprises' eroding financial condition and inability to access capital markets threatened a collapse of the country's housing finance system. FHFA, with financial support from and substantial consultation with the Treasury Department, placed the Enterprises into conservatorship on September 6, 2008.

Conservatorship, along with financial support from Treasury, permitted the Government to take greater management control of the Enterprises and give investors in the Enterprises' debt and mortgage-backed securities confidence that the Enterprises would have the financial capacity to honor their financial obligations. The alternative, receivership, was rejected at the time, in part because such action would have placed greater limits on the timing and approach for the Congress and the incoming Administration to analyze and respond to the problems confronted by the Enterprises and the country's housing finance system. At the time, Treasury Secretary Paulson referred to conservatorship as a "time-out" to allow markets to continue to function while policymakers considered and acted on a permanent resolution. More than 3 years later, we are still waiting for that resolution.

As conservator, FHFA stands in the place of each company's shareholders, boards, and management, with the responsibility to "preserve and conserve the assets and property" of the companies. The statute also charges the conservator with the responsibility to place the companies in "a sound and solvent condition." At the time the conservatorships were established, FHFA was less than 6 weeks old as an agency, and had fewer than 400 employees. To accomplish these responsibilities, FHFA made the practical judgment that the most effective means to carry out these functions was to replace the boards and senior management, and then delegate to new boards and management day-to-day responsibility. Since then, reconstituted boards of directors have worked with FHFA to define the operational goals in conservatorship and to support FHFA in its work to guide and oversee management in fulfilling these goals. Likewise, the new CEOs and executive officers have worked with FHFA to these same ends.

As conservator and regulator, FHFA has three principal mandates set forth in law that direct and motivate FHFA's activities and decisions involving the Enterprises.

First, as I have noted, FHFA has a statutory responsibility as conservator of the Enterprises to "take such action as may be: necessary to put the regulated entity in a sound and solvent condition; and appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity." As FHFA has stated on numerous occasions, with taxpayers providing the capital supporting the Enterprises' operations, this "preserve and conserve" mandate directs us to minimize losses on behalf of taxpayers.

Second, even though the Enterprises are in conservatorship, without further statutory changes they have the same mission and obligations as they did prior to being placed into conservatorship. FHFA has a statutory responsibility to ensure the Enterprises "operate in a safe and sound manner" and that "the operations and activities of each regulated entity foster liquid, efficient, competitive, and resilient national housing finance markets." We typically refer to this requirement as "supporting a stable and liquid mortgage market."

Third, under the Emergency Economic Stabilization Act of 2008, FHFA has a statutory responsibility 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 . . . available programs to minimize foreclosures."

These three mandates form the basis for how FHFA views its responsibilities as conservator of the Enterprises. In view of the critical and substantial resource requirements of conserving assets and restoring financial health, combined with a rec-

ognition that the Enterprises operate today only with the support of taxpayers, FHFA has focused the Enterprises on their existing core business, including minimizing credit losses. This means that FHFA is not permitting the Enterprises to offer new products or enter new lines of business. Their operations are focused on their core business activities and loss mitigation. 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.

As a final introductory comment, the Enterprises' equity holders retain an economic claim on the companies but that claim is subordinate to taxpayer claims. As a practical matter, taxpayers are not likely to be repaid in full, so Enterprise stock lower in priority is not likely to have any value. Prior to conservatorship, much executive compensation, and indeed some staff compensation, was in the form of company stock, so the value of such compensation has essentially vanished. Finally, the company leaders most responsible for the business decisions that led to the Enterprises ending up in conservatorship had either left the company before conservatorship, at the time of the conservatorship, or shortly thereafter. The boards of directors were also replaced.

Thus, the leadership working at the Enterprises today is not the same as those chiefly responsible for the business decisions that led to conservatorship and that continue to drive the financial results. Moreover, they are there to further the goals of conservatorship and ensure the country has a functioning secondary mortgage market while lawmakers deliberate the future structure for housing finance. The boards, executives, and staff have been and are working with FHFA in its efforts to minimize taxpayer losses, provide stability and liquidity to the market, and maximize assistance to homeowners to avoid foreclosure. They do so knowing that the long-term outlook is that neither Enterprise will continue to exist, at least in its current form, in the future.

### **Third Quarter 2011 Financial Performance and Condition of the Enterprises**

#### *Providing Liquidity to the Market*

Since conservatorship, Fannie Mae and Freddie Mac have been the largest issuers of mortgage-related securities in the secondary market, guaranteeing roughly three-quarters of single-family mortgage-backed securities (MBS) issued.

#### *Capital*

Combined Treasury support as a result of financial performance in the third quarter of 2011 was \$13.8 billion. The Single-Family Credit Guarantee segment continued to drive losses as credit-related expenses remained high. Additionally, the Investments segment results turned negative in the third quarter of 2011, due primarily to a significant decrease in interest rates and a widening of credit spreads on nonagency securities. This was partially offset by a 2 percent increase in net interest income. Four point one billion dollars of the \$13.8 billion draw is to pay interest to the Treasury on previous draws.

#### *Credit Quality of New Single-Family Book of Business*

The quality of new business remained high in the third quarter of 2011. The percentage of new business volume with FICO scores below 620 remained below 2 percent and the average loan-to-value ratio (LTV) for new business was roughly 70 percent for both Enterprises, reflecting in part the high degree of refinance activity.

#### *Loss Mitigation Activity*

Loan modifications are on pace to be below 2010 levels. Total home retention actions as of August, 2011, were approximately 375,000 compared with 832,000 for all of 2010. Significantly, loans modified since late 2009 continue to perform substantially better than loans modified before then.

Since conservatorship, the Enterprises have completed 1.9 million foreclosure prevention transactions, of which nearly 1 million have been permanent loan modifications and another 650,000 have been other forms of assistance that have allowed homeowners to retain home ownership. Separately, another 260,000 transactions have resulted in households leaving their homes but without going through foreclosure. Most of these actions have been short sales.

#### *Projections of Financial Performance*

To provide additional information on future Enterprise financial performance, beginning in October, 2010, FHFA published financial projections of the Enterprises' financial performance across different house price scenarios. Those initial projections were updated a few weeks ago, and the projected combined cumulative Treas-



ury draws (which includes 10 percent dividend payments to Treasury) through the end of 2014 range between \$220 and \$311 billion. In general, these financial projections show that under less stressful house price scenarios, the cumulative draws from Treasury would stabilize in the next year or so, with the Enterprises earning enough income to cover dividend payments to Treasury.

#### **FHFA Initiatives**

Recent Congressional efforts to begin serious discussion of a gradual transition to greater private capital participation in housing finance and greater distribution of risk to participants other than the Government are important. FHFA has already begun taking actions in support of these objectives. Since conservatorship, underwriting standards have been strengthened and several price increases have been initiated to better align pricing with risk. Additionally, we have had several guarantee fee price increases and we will continue to gradually increase guarantee fee pricing to better reflect that which would be anticipated in a private, competitive market. Also, we will soon be exploring more private sector risk-sharing opportunities. Such steps are consistent with actions already taken in conservatorship and we are examining further options along these lines in support of a stable transition over time.

While debate over the future of the housing finance system progresses, FHFA has and will continue to focus on meeting the goals of the conservatorships through a series of initiatives aimed at retaining value in the business operations of Fannie Mae and Freddie Mac, maintaining their support for the housing market, and mitigating losses to taxpayers.

#### *Recovering Certain Losses*

Consistent with FHFA's mission to preserve and conserve the Enterprises' assets on behalf of taxpayers, this year we filed lawsuits against 18 financial institutions to recover certain losses suffered by Freddie Mac and Fannie Mae that we believe are the legal responsibility of others. We believe that the loans in these private-label mortgage-backed securities had different and more risky characteristics than the descriptions contained in the marketing and sales materials provided to the Enterprises for those securities.

#### *Real Estate-Owned Request for Information*

In August, FHFA in conjunction with the Department of Housing and Urban Development (HUD) and the Treasury Department, issued a Request for Information (RFI) seeking input on new options for selling single-family real estate owned (REO) held by Freddie Mac, Fannie Mae, and FHA. We are looking for approaches to reduce the REO portfolios of the Enterprises in a cost-effective manner, as well as to reduce the losses on individual distressed properties. We are seeking alternatives that will maximize value to taxpayers and increase private investments in the housing market, including approaches that support rental and affordable housing needs. We are not trying to develop a single, national program for REO disposition. We are most interested in proposals tailored to the needs and economic conditions of local communities. Based on the input of RFI responders we understand the magnitude of the task at hand. FHFA is proceeding prudently, but with a sense of urgency, to lay the groundwork for the development of good initial pilot transactions.

#### *Uniform Mortgage Data Program*

In May, 2010, FHFA directed the Enterprises to develop uniform standards for data reporting on mortgage loans and appraisals. This Uniform Mortgage Data Program is designed to improve the consistency, quality, and uniformity of data that are collected at the front end of the mortgage process. By identifying potential defects at the front end of the mortgage process, the Enterprises will improve the quality of mortgage purchases, which should reduce repurchase risk for originators. This initiative will be phased in over the rest of this year and next.

#### *Loan Level Disclosures*

Earlier this year I announced that FHFA is considering ways to enhance loan-level disclosures on Enterprise MBS, both at the time of origination and throughout a security's life. I believe that improving Enterprise MBS disclosures over time will help establish consistency and quality of such data. Moreover, it will contribute to an environment in which private capital has the information needed to efficiently measure and price mortgage credit risk, thereby facilitating the shifting of this risk away from the Government and back into the private sector.

#### *Servicing Alignment Initiative*

Our Servicing Alignment Initiative (SAI), which we announced last April, responded to concerns about how delinquent mortgages were being serviced. SAI

meets the conservatorship objectives of minimizing losses and assisting homeowners with alternatives to foreclosure. FHFA instructed Freddie Mac and Fannie Mae to establish a single, consistent set of procedures for servicing Enterprise mortgages, from the time they first become delinquent. The updated framework, which went into effect on October 1, prioritizes early borrower outreach, streamlines documentation requirements, simplifies mortgage modification terms and requirements, and establishes a schedule of performance-based incentive payments and penalties aimed at ensuring that servicers review foreclosure alternatives in a timely manner. We are also working to align and improve Fannie Mae and Freddie Mac policies regarding unemployment forbearance to reflect the realities of the current job market.

#### *Foreclosure Attorney Networks*

Last month, as an adjunct to SAI, FHFA directed Freddie Mac and Fannie Mae to change the way foreclosure attorneys are selected in an effort to produce uniform foreclosure processing standards to assist servicers, homeowners, and lenders. Under current practice, in certain States each Enterprise designates law firms eligible under the Enterprise's criteria to undertake foreclosure work and mortgage servicers then select and work with these firms. FHFA instructed Fannie Mae and Freddie Mac to transition away from current foreclosure attorney network programs and move to a system where mortgage servicers select qualified law firms that meet certain minimum, uniform criteria. These efforts will lead to greater transparency and benefit delinquent borrowers who become subject to the foreclosure process. FHFA is now working with other regulators and industry stakeholders to create uniform qualifications and oversight of foreclosure attorneys.

I am hopeful that these new directives, which create uniform procedures for servicing delinquent loans and processing foreclosures, will gain acceptance beyond the Enterprises and become "best practices" throughout the industry.

#### *Home Affordable Refinance Program*

On October 24, we announced a series of changes to the Home Affordable Refinance Program (HARP). These changes should make HARP refinances accessible to more households with mortgages owned or guaranteed by the Enterprises. Changes to the program include: eliminating or reducing certain risk-based fees; removing the current 125 percent LTV ceiling; waiving certain representations and warranties; eliminating the need for certain property appraisals; improving the process for carrying over mortgage insurance coverage; and extending the end date for HARP to December 31, 2013.

Importantly, such refinances should also reduce the Enterprises' credit risk, and thus losses to taxpayers. HARP, even with the new enhancements, is not a mass refinancing program; it was designed to help a defined set of borrowers with Fannie Mae and Freddie Mac mortgages that are underwater or nearly underwater.

It is impossible to project accurately how many homeowners will benefit from the enhancements to HARP because of unknowable factors, such as future interest rate fluctuations and the desire of borrowers to enter into a refinance transaction. Since HARP was introduced in 2009, more than 900,000 homeowners have refinanced through the HARP program. We believe the announced changes may double the number of homeowners helped through HARP. The Enterprises plan to issue guidance with operational details about the HARP changes to mortgage lenders and servicers today. Since industry participation in HARP is not mandatory, implementation schedules will vary as individual lenders, mortgage insurers and other market participants modify their processes.

Separately, the Enterprises have refinanced approximately 9 million mortgages since 2009.

#### *Servicing Compensation Initiative*

The last initiative I will discuss today, the Joint Servicing Compensation Initiative, made up of FHFA, Fannie Mae, Freddie Mac, and HUD, is one of the initiatives we have directed the Enterprises to undertake that are designed to broadly consider changes that will lead to improvements in the operations of the Enterprises and the overall mortgage market. The goals of the Joint Initiative are to improve service for borrowers, reduce financial risk to servicers, and provide flexibility for guarantors to better manage nonperforming loans, while promoting continued liquidity in the To Be Announced mortgage securities market. In addition to those specific goals, the Joint Initiative seeks broader options for mortgage servicing compensation that lead to enhanced competition in mortgage servicing and origination, and that can be replicated across multiple future states of housing finance.

At the end of September, the Joint Initiative released a discussion document seeking comments on two alternative servicing compensation structures for servicing single-family mortgages. One proposal would establish a reserve account within the

current servicing compensation structure. The other proposal would create a new fee-for-service compensation structure that would replace today's fixed fee approach. We requested that comments be submitted by late December, after which they will be considered and evaluated by the Joint Initiative.

### **Federal Home Loan Bank Supervision**

#### *Third Quarter 2011 Performance and Condition of the FHLBanks*

Total assets of the FHLBanks declined by \$31 billion in the third quarter of 2011 and by \$100 billion during the first three quarters of the year. From a peak in 2008 of \$1.4 trillion, combined assets have nearly halved to \$778 billion at September 30, 2011. Advances (collateralized loans to members) are driving the decline, as balances have fallen from a 2008 high of \$1.0 trillion to just \$415 billion, or about the level of advances last seen in the first quarter of 2000. More recently, advances declined \$13 billion in the third quarter of 2011, and \$63 billion year-to-date through September. The decline, in part, reflects high levels of liquidity at member banks with a consequent decline in the demand for advances. At September 30, 2011, advances comprised 53 percent of assets, non-MBS investments were 19 percent, agency and Federal MBS were 15 percent, mortgage loans were 7 percent, and private-label mortgage-backed securities (PLMBS) were 4 percent. Though PLMBS assets are relatively small, their distribution among FHLBanks is uneven, leading to pockets of concentration at some FHLBanks.

The FHLBanks principally fund themselves by issuing consolidated obligations in the capital markets. Market access remains excellent, and spreads to comparable Treasury securities are narrow. Total regulatory capital at September 30, 2011, was \$55.4 billion or 6.5 percent of assets.

Net income is declining at the FHLBanks as fewer earning assets generate less net interest income, and as lower interest rates reduce the return on the FHLBanks' invested capital. Offsetting these factors is a decline in credit-related other-than-temporary impairment (OTTI) on PLMBS, though this remains a potentially volatile item, with the possibility to increase should collateral performance or the broader housing market deteriorate further. On a year-to-date basis through September 30, 2011, all FHLBanks were profitable, though some did have quarterly net losses. Combined net income was \$475 million for the third quarter of 2011 and \$1.1 billion year-to-date. This is down from comparable periods in 2010, when net income was \$680 million in the third quarter and \$1.3 billion year-to-date through September 2011. A significant factor in the lower quarterly net income was mark-to-market losses on derivatives. These derivatives are part of a prudent risk-management strategy, and the losses should reverse as the derivatives approach maturity. Credit OTTI charges were lower in 2011 relative to 2010—credit OTTI totaled \$775 million in the first three quarters of 2011, down from \$905 million for the same period in 2011. To-date, the FHLBanks have reported a total of \$4.4 billion in credit-OTTI charges on PLMBS, which amounts to about 5 percent of the peak balance of this asset category. PLMBS remain a supervisory concern.

#### *Resolution Funding Corporation*

In 2011, the FHLBanks satisfied their collective obligation to make payments related to the Resolution Funding Corporation (REFCORP), a funding mechanism used during the savings and loan crisis. Related to this accomplishment, the FHLBanks collectively entered into a Joint Capital Enhancement Agreement, which requires each FHLBank to allocate 20 percent of its net income to a restricted retained earnings account, from which it cannot pay dividends and which serves to enhance the joint-and-several liability features inherent in FHLBank consolidated obligations.

#### *FHLBank of Chicago*

On September 31, 2011, FHFA approved the capital plan of the FHLBank of Chicago, a requirement of the 2007 Consent Order with that FHLBank. Implementation is expected on January 1, 2012. Until then, the FHLBank of Chicago remains the only FHLBank still operating under a pre- Gramm-Leach-Bliley Act capital structure.

#### *FHLBank of Seattle*

The FHLBank of Seattle faces a declining advance franchise, a problematic PLMBS portfolio, and insufficient retained earnings. Although the FHLBank has capital equal to 6.8 percent of assets, FHFA has exercised its discretion to classify the FHLBank as "undercapitalized." The FHLBank of Seattle has operated under a Consent Order to resolve outstanding capital and supervisory matters since October 2010.

### **Office of Inspector General Reports**

Mr. Chairman, you asked me to comment on the recent reports issued by FHFA's Office of Inspector General (OIG). In response, I offer four observations.

First, my staff has heard from me repeatedly that I believe Inspectors General are in place to help make Federal agencies better, to see what we sometimes cannot see for ourselves, or see things in a different way from those who are up close to an issue. Since FHFA is committed to continually improving itself, I look forward to input from the Office of Inspector General to assist us in that objective.

Second, FHFA has agreed to carry out all of the formal recommendations made by the Office of Inspector General in each of these reports. I believe it reflects a good-faith partnering with the OIG to be complete and timely in responding to the various recommendations and we are doing so.

Third, while we are implementing all the recommendations in these recent reports, I do not agree with some of the statements, inferences, and conclusions drawn in some of these reports. Where we do have disagreements, I believe they reflect a new office and staff getting to learn the FHFA's statutory responsibilities, safety and soundness regulation, and the business of the regulated entities. By the same token, FHFA is learning how to work with an OIG. I expect such disagreements to decline with time.

Finally, it appears from these reports that the OIG's view is that FHFA should be a larger organization than it is today. A recurring conclusion in the OIG reports to-date is that FHFA is understaffed and that it should be more directly engaged day-to-day in the Enterprises' business activities, independently repeating and validating numerous business decisions and calculations. This could involve a costly build-up of staff at FHFA with an uncertain long-term future for this work if Congress legislates away the conservatorships. It would also result in greater taxpayer draws to fund this build-up through assessments on Fannie Mae and Freddie Mac. It also raises questions as to the purpose of Enterprise management and boards if FHFA reviews and repeats so much of their work. As I noted earlier in my statement, conservatorship has been predicated on a delegated authority for the Enterprises to run their day-to-day business. This approach is aimed at achieving operational savings and reducing operational risks. I believe changes to this approach would need to demonstrate benefits that outweigh the costs.

In any event, FHFA is already undergoing considerable growth, albeit not at the pace and ultimate size that may be contemplated by the OIG. From the fewer than 400 people composing FHFA at the outset 3 years ago, we now have more than 520 staff and have budgeted for growth to a level slightly above 600. Furthermore, the OIG itself is growing rapidly to a scale unprecedented for an agency OIG. The OIG's budget request for FY2012, which Congress has not yet acted on, would provide the OIG with a budget of \$48 million and a staffing level of 150. This would give the OIG one staff member for every four at FHFA, to my knowledge an unprecedented ratio. The ratio of our respective budgets would be of similar magnitude. Since both FHFA and OIG are funded by assessments on FHFA's regulated entities, the growth at FHFA and OIG is adding costs to the conservatorships and to the FHLBanks.

### **Executive Compensation**

You have asked me to address executive compensation for Fannie Mae and Freddie Mac executives. At the outset let me state that the best way to address concerns with executive compensation is action by Congress to restructure the nation's housing finance system and dissolve the conservatorships. In the absence of that resolution, FHFA will continue to evaluate the appropriateness of executive compensation at the Enterprises given their ongoing activities.

Before getting into the details, I would like to begin by sharing my own frustration with compensation issues in conservatorship. Nothing like this has been done before—placing two of the largest private financial institutions in the world into Government conservatorship and then overseeing their operations in that State for multiple years. Determining appropriate compensation in this situation is vexing. As a career-long Federal employee, I, too, perceive the compensation agreements as large. I also share the frustration of many that past leaders of these companies received enormous compensation pre-conservatorship. Yet, while frustration with the past business decisions of Fannie Mae and Freddie Mac leadership, past policy failures, and the resulting enormous taxpayer costs is understandable—and I share it—it cannot distract us from the task at hand.

As conservator, I need to ensure that the companies have people with the skills needed to manage the credit and interest rate risks of \$5 trillion worth of mortgage assets and \$1 trillion of annual new business that the American taxpayer is supporting. I have concluded that it would be irresponsible of me to risk this enormous contingent taxpayer liability with a rapid turnover of management and staff, re-

placed with people lacking the institutional, technical, operational, and risk management knowledge requisite to the running of corporations with thousands of employees and more than \$2 trillion in financial obligations each. That conclusion is further buttressed by the realization that, from an Enterprise executive's or staff's point of view, continued employment at an Enterprise risks substantial job and career uncertainty. The public scrutiny and criticism is often harsh, and almost everyone expects the Enterprises to cease to exist, at least in their current form, in the future. At the same time, the taxpayer is backing Enterprise financial commitments that have 30-year lives, and we will need expert management of those guarantees for years to come. Given the amount of money at risk here, small mistakes can easily be amplified to losses far greater than the compensation paid to Enterprise executives.

In short, as Congress considers executive compensation at the Enterprises, the basic fact is that despite the large amounts of Government support provided to the Enterprises they remain private companies with uncertain futures, not Government agencies. They employ thousands of people. We cannot maintain operational effectiveness while suddenly treating them as ongoing Government agencies—something they are not. Major changes to compensation, for executives or staff, cannot be done safely and soundly in a short period of time and attempting to do so would pose substantial risk to the mortgage market and a greater risk of loss to taxpayers.

In the next section, I will review the history of how FHFA established the executive compensation program operating today, and describe the details of that program and how it has been working. I will then conclude with a few thoughts on the program going forward and the role Congress might play to bring this difficult matter to an end.

#### *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 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 2 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 and remains essential that the Enterprises continue to bring liquidity, stability, and affordability to the mortgage market. Furthermore, the Enterprises' enormous size, including more than \$5 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. 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. Payments under the plans were virtually the only nonsalary 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 the Housing and Recovery Act of 2008 (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 the top four Freddie Mac executives left in one fashion or another during the first months of conservatorship, 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 Structure*

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 control 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 to the Enterprises the approach he was developing for TARP institutions.

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 was and remains 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 does not depend on results more than 2 years out. To encourage talent to stay put, FHFA made deferred payments generally dependent on an executive's continued employment at the Enterprise. We also made half of the deferred pay subject to adjustment based on corporate performance to partially simulate the effect of corporate performance on the corporate shares paid to executives at TARP firms for their deferred pay. That allows for reductions in deferred salary if the Enterprise's goals, as set by the Board with increasing input from FHFA, are not met. As I will explain further below, corporate performance in this context is tied to the goals of conservatorship.

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 was, as it must be, balanced by our efforts to keep the cost to taxpayers as low as we possibly could.

Based on review of past compensation, the market comparables identified by outside pay consultants, discussions with each board of directors, recent experience in recruiting CEOs, and consultation with the Treasury Department, 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. 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. As at the TARP-assisted firms, base salaries generally are capped at \$500,000 with a few exceptions. Before the conservatorships, the two Enterprises had 16 officers earning base salaries higher than that amount, now there are only four.

Both Enterprises' charter acts, which remain operational in conservatorship, require that "a significant portion" of executive compensation be tied to corporate performance. Consistent with that requirement, while also following the approach taken for 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 approved for each Enterprise funding of incentive payment pools at 90 percent of aggregate targets. For 2010, I again approved Fannie Mae funding of its pool at 90 percent, and I approved funding of Freddie Mac's pool at 95 percent. Individual executives could receive more or less, as long as the aggregate did not exceed the pool amount. 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. Next year's goals will emphasize not only loss mitigation and progress on REO disposition, but improvements that will benefit mortgage market functioning, whatever new structure Congress may ultimately decide on, such as improved servicing standards, improved securities disclosures, the Uniform Mortgage Data Program, and development of risk-sharing pilots.

The remaining portion of compensation is deferred salary, which is paid with a 1-year lag to executives still working for their Enterprise at that time. For the highest paid executives, deferred salary is the largest component of their compensation. As noted earlier, deferred salary motivates retention. An executive that voluntarily departs forfeits their deferred but not-yet-paid salary. Any exceptions require FHFA approval, in consultation with the Treasury. Starting with payments made in 2011, the amounts are adjusted up or down, based on each Enterprise's performance on its deferred salary scorecard. I approved a 10-percent deduction for Fannie Mae and a 12-percent deduction for Freddie Mac.

The revised compensation structure was designed to align pay with taxpayer interests. Deferred salary and incentive pay for all executive officers are subject to claw backs by the Enterprises in the event of gross misconduct, gross negligence, conviction of a felony, or erroneous performance metrics. The structure also adopts and in some respects expands on reforms advanced by the Special Master for firms receiving exceptional TARP assistance. This structure, established in 2009, and the annual targeted compensation amounts for executive officers remain in place today. Whenever Congress acts to direct how and when the conservatorships end and to decide the ultimate resolution of the companies, these executive positions, and the compensation program, are subject to change or elimination.

News reports have described \$12.8 million of 2010 pay as "bonuses." That number is the sum of \$7.5 million in deferred salary and \$5.3 million in target incentive opportunity payments.

#### *Turnover and Compensation Under the Program*

Both Enterprises have experienced some increase in turnover. Freddie Mac's voluntary turnover rate over the past two quarters has averaged more than 13 percent compared to its 5-year average of 8½ percent. Fannie Mae's has risen to about an 11 percent annual rate so far this year after averaging a bit above 6 percent over the preceding 3 years. Among officers at Fannie Mae, more than 11 percent have left so far this year. Five of Freddie Mac's 16 executive officers have left voluntarily since the beginning of the year. Both Enterprises have experienced some difficulty filling vacancies from outside, as candidates have expressed concern about the Enterprises' future and the lack of any remuneration in the form of equity.

#### *Compensation in the Near-Term*

At the present, my plan for executive compensation is to continue to seek opportunities for gradual reductions, particularly when executives leave. This approach is consistent with the Administration's notion of a gradual wind down. I also believe it important for FHFA to continue to assess the corporate scorecards used to improve the alignment between the scorecards and the goals of conservatorship.

Earlier in this prepared statement I described positive steps FHFA has undertaken to prepare the mortgage market for the future, with or without the Enterprises. I have recently spoken publicly of my goal to bring greater private capital participation into the Enterprises' mortgage purchases so that the taxpayer is not

the sole source of support. And I have spoken of my goal to continue a gradual program of guarantee fee increases by the Enterprises so that their pricing better reflects that one would expect from a purely private company operating with its own capital at risk. I believe the executive compensation program in place today would be enhanced by more tightly aligning corporate goals with the successful achievement of these recently established conservatorship goals. Likewise, I believe we should be striving to simplify and shrink the operations at each Enterprise, and should award successful steps toward those ends.

*Executive Compensation—Concluding Thoughts*

I recognize that this Committee, or the full Senate, may soon consider legislating changes to the executive compensation program I have just described. The House Financial Services Committee is scheduled to consider legislation today that would put Enterprise employees on the Federal Government's GS-pay scale. I have already testified before that body why I do not think that would be a good idea.

I am grateful for this opportunity to explain the program that is in place today, its rationale and its features. I hope that this explanation has cleared up some misunderstandings and placed the matter in a different light. I would like to close with a few final thoughts, respectfully submitted for your consideration.

I believe that commitments already made by the Government through the compensation already awarded by FHFA should be respected, whether lawmakers completely agree with the judgments FHFA made or not. Changing compensation going forward, thereby allowing Enterprise employees to make an informed choice about their continued employment, is fair. Changing what has already been promised and earned is not.

Some have suggested that we should have no trouble maintaining adequate staffing at far smaller pay levels, pointing to outstanding cabinet members who serve or have served with distinction on Government pay scales. I have serious doubts about taking this approach to the management of the Enterprises. People come to work for the Government for a variety of reasons. The opportunity to serve our country is important for many of us. Some especially desire the relative job security of the career service, others the policymaking roles and the stature that comes with temporarily filling high-ranking jobs. If you want to influence the determination of our nation's financial and economic policies, a job in the Government may well be what you want, despite better pay offers elsewhere. But if you are working at an Enterprise in conservatorship, you have less say in the direction or outcome of your company than in normal businesses. And one of our first rules of conservatorship is that company employees may not lobby or participate in the policymaking process to decide the future of housing finance. At the same time, by working at Fannie Mae or Freddie Mac your work comes under a much higher degree of scrutiny and criticism, and with a lot less job security than comes with working for any other private firm engaged in housing finance. Executives who have spent a career developing their reputations risk tarnish to those reputations under the highly charged environment in which these companies operate today, regardless of how well they perform their duties or how great a financial sacrifice they make forsaking other private sector opportunities to assist the country's housing finance system.

I do not question that, despite these drawbacks, some might be willing to sign up at Fannie Mae or Freddie Mac for relatively little pay, and I am committed to finding capable people willing to do so. But I have not seen, even in this marketplace, that people with the right skills to run these two companies, as they exist today with all the uncertainty involved and the negative atmosphere, are easy to find.

But even if it could be done, and I think it might be possible if the missions and operations of the Enterprises were sufficiently streamlined, it would require a careful transition over time. The people who are there now did not choose Government jobs. A sudden and sharp change in pay would certainly risk a substantial exodus of talent, the best leaving first in many instances. The Enterprises likely would suffer a rapidly growing vacancy list and replacements with lesser skills and no experience in their specific jobs. A significant increase in safety and soundness risks and in costly operational failures would, in my opinion, be highly likely. Thus, sharp and sudden pay cuts should not be expected to lower taxpayer costs, but rather to raise them. Because of the huge size of these institutions, the potential consequences of any increases in risk are magnified. Additional losses amounting to just one basis point on their \$5 trillion of assets and liabilities would translate to \$500 million, nearly 40 times the "bonuses" that have received so much attention.

Should the risks I fear materialize, FHFA might well be forced to limit the Enterprises' business activities. Such cut backs likely would drive much larger business volumes to FHA and Ginnie Mae, potentially straining their capacities. Some of the



business the Enterprises would be unable to undertake might simply not occur, with potential disruption in housing markets and the economy.

No one wants that. Whether you prefer that the secondary mortgage market be a purely governmental or a predominately private sector activity, we need to have an orderly transition, not a sudden shock. The best way to accomplish that is for lawmakers and the Administration to decide on the future structure of housing finance, especially as it regards the secondary mortgage market. Then we could have a final resolution of Fannie Mae and Freddie Mac in conservatorship, which would resolve the compensation issue once and for all.

Mr. Chairman, thank you again for this opportunity. I have tried to provide the Committee with a clear overview of key aspects of our current activities and oversight goals as we await direction on the future of the housing finance markets. I look forward to responding to the Committee's questions.



## OVERSIGHT OF THE FEDERAL HOUSING FINANCE AGENCY—PART II

TUESDAY, DECEMBER 13, 2011

U.S. SENATE,  
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,  
*Washington, DC.*

The Committee met at 10:03 a.m., in room SD-538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

### OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. Good morning. I would like to call this hearing to order. I would like to welcome the first Inspector General of the FHFA, Steve Linick, before the Committee today.

As we wrap up the hearings for this year, I am pleased that the Ranking Member and I were able to agree to a plan for the hearings that the Committee held on housing finance reform this year and hope that we will be able to continue that bipartisan approach next year.

The 12 housing finance-related hearings we held this year have highlighted some general principles I believe we hold in common that will guide us going forward. Small institutions that maintained sound underwriting standards during the boom should still have access to any secondary market that is created in the future. This is important for maintaining strong, responsible home ownership opportunities in rural and underserved areas. Fully documented underwriting should be the standard practice in any system going forward. Clear rules of the road are essential for providing stability to the market, but the transition must be a gradual one, given the current fragile state of the market.

The Committee's exploration of these specific topics has helped inform members and build a record on which the Committee can evaluate legislative efforts. Looking ahead to next year, there are some topics that still need to be explored, but I am hopeful that Senator Shelby and I can continue moving forward on housing finance reform in the same bipartisan way that we have conducted hearings and markups this year.

In nearly every hearing this year, the current state of the economy and strategies for improving the housing market were topics of discussion. The need to reform our housing finance system and the need to improve the housing market go hand in hand. The Federal Housing Finance Agency, as the conservator of Fannie Mae and Freddie Mac, could play a significant role in improving the housing market, but based on reports from the Inspector General's

office, there are deficiencies at the agency that are holding back those efforts.

I am concerned that the reports produced by the Inspector General's office show several negative trends in FHFA's oversight of operations at Fannie Mae and Freddie Mac. First, the regulator defers to the GSEs on major decisions without independently verifying the benefits to the conservatorship or the taxpayers. Second, the FHFA appears to allocate staffing resources in a manner that limits its ability to enforce directives and adequately oversee operations at the GSEs. These two trends appear to restrict the FHFA's ability to help stabilize the housing market and protect taxpayer dollars while also continuing the problematic relationship that Fannie Mae and Freddie Mac had with their previous regulator.

Despite its independent status, which was granted on a bipartisan basis in 2008 as a single director with congressional appropriations and expanded powers as conservator, FHFA could be doing more to prevent losses and enforce required changes at Fannie Mae and Freddie Mac. As the regulator of two of the largest entities in the housing market, it is essential that FHFA prioritize oversight as one of the strategies necessary to stabilize our housing market. This would benefit the taxpayers both by strengthening the current state of the GSEs and also providing guidance and consistency to a large sector of the housing market to further create stability for homeowners and potential homebuyers.

I look forward to hearing your recommendations for improvements and the possible reasons for the trends that you continue to see, Inspector General Linick.

With that, I turn to Senator Shelby.

#### **STATEMENT OF SENATOR RICHARD C. SHELBY**

Senator SHELBY. Thank you, Mr. Chairman.

Today, as the Chairman has mentioned, the Committee will hear the testimony of the Inspector General of the Federal Housing Finance Agency, Mr. Steve Linick. This will be his first appearance before us.

The Office of the Inspector General oversees the Federal Housing Finance Agency's regulation of Fannie Mae, Freddie Mac, and the Federal home loan banks. I look forward to hearing the testimony today from the Inspector General about the status of Fannie, Freddie, and the Federal Housing Finance Agency, as well as how he plans to carry out his duties. I am interested to hear how his office can help FHFA, the Federal Housing Finance Agency, oversee the conservatorship of Fannie and Freddie.

Unfortunately, before Mr. Linick was confirmed, the post of the Federal Housing Finance Inspector General was vacant for 2 years, a period when the need for oversight I believe was critical. During that time Fannie and Freddie were placed into conservatorship, and taxpayers began paying for their losses. So far, Fannie and Freddie have cost almost \$183 billion and counting.

Despite their financial problems, Fannie and Freddie's dominant role in the housing market persists as they currently back 71 percent—71 percent—of new mortgage-backed securities. The delay in

filling the IG post means that Mr. Linick has a lot of important work, I believe, to catch up on.

First and foremost, I believe we must provide oversight of the Federal Housing Finance Agency's conservatorship of Fannie and Freddie to ensure that the taxpayers' dollars are spent wisely. During its short existence, the Office of the Inspector General here has already identified several ways in which the Federal Housing Finance Agency can do a better job of protecting taxpayers. For example, in its semiannual report, the Inspector General noted that the FHFA did not effectively oversee Fannie and Freddie's negotiations with Treasury on the administration's Home Affordable Modification Program that we call "HAMP."

According to the report, this contributed to the GSEs' entering into a poorly drafted agreement. As a result, there have been significant disputes between the Federal Housing Finance Agency and the Treasury about how the GSEs should run HAMP.

The report also notes that HAMP has undermined the ability of the GSEs to perform their core functions. Indeed, FHFA Acting Director Ed DeMarco concluded in a letter, and I will quote. He said, "HAMP created operational risk with the enterprises and diverted staff and resources from other critical priorities." This report recommends that the Federal Housing Finance Agency better engage with Treasury and the GSEs to clarify certain aspects of the HAMP agreements, including establishing a dispute resolution mechanism.

Another issue that the IG mentions in his semiannual report is FHFA's lack of analysis or compensation for Fannie and Freddie executives here. According to the Office of the Inspector General, and I quote again, "FHFA had not considered factors that might have resulted in reduced executive compensation costs."

To improve FHFA's framework for making executive pay decisions, the Office of Inspector General recommended that FHFA use performance data and independent verification of compensation levels. Taxpayers I believe should never be put in the position of paying millions to executives of any company. Yet as long as we have had the GSEs, this has been the case. The OIG recommendations are intended to ensure that taxpayers spend only what is required, what is necessary.

The OIG's work also shines a light on the larger issue of the costs arising from the administration's failure to propose a detailed plan to end the conservatorship of Fannie and Freddie. It has been 3 years and 98 days since the conservatorship began. The conservatorship was never intended to last this long. Nor was FHFA designed to handle the "conservatorship to nowhere" that we face today.

It should not be surprising that the OIG has found significant shortfalls in the FHFA's examination program, including having too few examiners overall to ensure the efficiency and effectiveness of FHFA's oversight of the GSEs.

This is no small finding since examination is the primary means by which the FHFA supervises and regulates the GSEs. This serious problem here exists in large measure because the perceived short-term nature of the conservatorship makes it difficult for FHFA to hire enough qualified examiners. This is just one of many problems created by the GSEs' prolonged conservatorship, and the

longer we wait to reform our housing finance system, the larger these problems will grow, and the solutions will become more expensive for the taxpayer.

Nevertheless, the majority decided not to tackle housing finance reform in Dodd-Frank, as many people on this Committee recommended. At some point, however, the majority is going to find that it can no longer kick the can down the road. We need to work together on this.

Thank you.

Chairman JOHNSON. Thank you, Senator Shelby.

[Whereupon, at 10:15 a.m., the Committee proceeded to other business and reconvened at 10:22 a.m.]

Chairman JOHNSON. Returning from Executive Sessions, are there any other Members who wish to make a brief opening statement?

[No response.]

Chairman JOHNSON. Thank you all. I want to remind my colleagues that the record will be open for the next 7 days for opening statements and other materials you would like to submit.

Now, I would like to briefly introduce our witness here today. The Honorable Steve A. Linick is Inspector General of the Federal Housing Finance Agency. Mr. Linick has served in this capacity since October 2010, having previously served in various senior positions at the Department of Justice. We welcome you here today Mr. Linick and ask you for your time.

Mr. Linick, you may proceed with your testimony.

**STATEMENT OF STEVE A. LINICK, INSPECTOR GENERAL,  
FEDERAL HOUSING FINANCE AGENCY**

Mr. LINICK. Thank you, Chairman Johnson, Ranking Member Shelby, and Members of the Committee, for inviting me to testify today. I will provide an assessment of our emerging trends based on the work we have conducted to date and describe our operations.

I am the Agency's first Inspector General. My office began operations after I was sworn in in October of 2010. Over the past 14 months, we have hired a professional staff and have gotten the office up and running. To date, we have published 10 audits and evaluations. We have commenced multiple criminal and civil investigations. We have issued our second semi-annual report to Congress just 2 weeks ago.

I want to tell you about emerging trends we have seen in a number of our reports, to which Chairman Johnson has alluded. Let me begin with some of the positives for which FHFA deserves credit.

For example, FHFA has eliminated golden parachute compensation awards to terminated Fannie Mae and Freddie Mac executives. In addition, FHFA has accepted our recommendations to improve its effectiveness and efficiency and to reduce its vulnerability to fraud, waste, and abuse.

On the other hand, however, our reports have also identified deficiencies reflecting two significant and related emerging trends. First, FHFA often relied on determinations of the Enterprises without independently testing and validating them, thereby giving undue deference to Enterprise decision making. Second, FHFA's de-

cisions about how it allocated its resources may have affected its ability to oversee the GSEs.

Let me start with the first emerging trend. FHFA has not independently tested and validated Enterprise decision making. In brief, we believe FHFA has displayed undue deference to the Enterprises in a number of areas. The Agency's actions appear to reflect its approach as conservator to delegate most business decisions to the Enterprises. In four of our reports, we identified instances in which the Agency relied upon review and corporate governance processes already in place at the Enterprises. However, we believe there are some matters that are sufficiently important to warrant greater involvement and scrutiny by the Agency. Here are illustrations from two of the four reports.

First, I will discuss FHFA-OIG's report on the review and approval of the Freddie Mac settlement of repurchase claims with Bank of America. At the end of 2010, FHFA approved a \$1.35 billion settlement of mortgage repurchase claims between Freddie Mac and Bank of America. In approving the settlement, FHFA relied on Freddie Mac's analysis of the settlement benefits. But there was reason to question the settlement based on a significant flaw identified in the Freddie Mac loan review process. Before the settlement came up, an FHFA senior examiner questioned whether Freddie Mac's process accounted for housing boom loans. Freddie Mac's internal auditors raised similar questions at the end of 2010 and in the middle of 2011. Nonetheless, FHFA did not independently test the assumptions underlying Freddie Mac's settlement. According to the senior FHFA examiner, he believed the flaw he identified could be costing Freddie Mac a significant amount of money.

In the wake of our report, FHFA has suspended approvals of additional repurchase settlements, agreed to improvements in its internal management process, and has initiated further study of the issue.

Second, I will discuss another example involving FHFA's review and approval of executive compensation. In another report, we found that for 2009 and 2010, Fannie Mae and Freddie Mac paid their top six executives over \$35 million in salaries and benefits over those 2 years. FHFA reviewed and approved those payments based on recommendations made by Fannie Mae and Freddie Mac. But FHFA did not independently test or validate the recommendations. And given the amounts involved, we concluded that FHFA should have done more, for instance, by including a wider range of salaries for pay comparison purposes and a review of performance metrics used to judge the executives' compensation levels.

Let me now turn to the second emerging trend. FHFA's resource allocations may have affected its ability to oversee the GSEs and enforce its directives. Again, in brief, we identified in four reports situations in which FHFA was not proactive in its oversight and enforcement. Inadequate resource allocations may explain these failings. Here are two illustrations.

First, I will discuss a report involving FHFA's oversight of foreclosure process abuses. News reports about foreclosure abuses in the foreclosure process by law firms and their agents began to surface in a big way starting in the summer of 2010. But only after

the news surfaced did FHFA begin to schedule comprehensive examination coverage of foreclosure issues. Before that time, FHFA had not considered the risks associated with foreclosure processing to be significant. However, our report identified multiple indications of foreclosure abuse issues prior to mid-2010 that could have led FHFA to foresee the heightened risk in foreclosure processing abuses. FHFA had not acted on the issue before mid-2010 because neither the Agency nor its predecessor agency considered the matter to be a priority.

The second illustration involves a report addressing FHFA examination capacity. As noted in this report, FHFA believes it has too few examiners monitoring the operations of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. Moreover, about only a third of FHFA line examiners are accredited. Our report concluded that this examination shortage may have contributed to FHFA's lack of oversight in significant areas, such as real estate owned property.

I would now like to provide a brief overview of my office's operations. Broadly, our plans for audits and evaluations include reviews of the following Agency activities: Management of the Enterprise conservatorship, including servicing and real estate owned property; oversight of the Federal Home Loan Banks; and FHFA internal operations.

We also operate a separate Office of Investigations. It, too, has made significant contributions to a range of mortgage-related investigations. For example, we recently participated in the investigation, prosecutions, and convictions associated with the Taylor, Bean & Whitaker case. In that case, the defendants perpetrated a \$2.9 billion fraud that has been described as among the largest in history. Freddie Mac reported losses in that case alone of \$1.8 billion.

The Office of Investigations also operates the FHFA-OIG Hotline, which allows for confidential reporting of fraud, waste, or abuse, and that hotline can be reached at 1-800-793-7724.

In closing, we look forward to continuing to work with the Committee to provide independent, relevant, and objective assessments of FHFA's operations and programs. FHFA continues to face significant challenges based on the continuing fragility of the Nation's housing market and the continuing key roles still played by Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, and I hope the work by my office will be of assistance in meeting those challenges.

Thank you, and I am happy to answer your questions.

Chairman JOHNSON. Thank you very much for your testimony.

As we begin questions, I will ask the Clerk to put 5 minutes on the clock for each Member.

Mr. Linick, according to your semi-annual report, FHFA and its predecessor have failed to enforce requirements that Fannie Mae implement an operational risk program. Does this lack of follow-through pose an operational risk to the conservatorship and taxpayer dollars, in your opinion? What is providing the Agency, especially now as conservator, from taking further actions to force compliance?



Mr. LINICK. Senator, operational risk involves identifying losses caused by people, processes, and external events, such as foreclosure abuses. Operational risk is critical to corporate governance. Good operational risk programs would require the Enterprise to self-identify, report, and correct risks as they emerge.

What we found in our report on operational risk is that for 5 years, between 2006 and 2011, FHFA and its predecessor agency, OFHEO, had repeatedly cited Fannie for not implementing an effective operational risk program. In 2009, FHFA said it was a critical concern and issued numerous citations. Yet despite these findings, Fannie Mae has not implemented an operational risk program and FHFA has not required it to, and that is of concern to us.

It is of concern to us because FHFA's own examination shortages cause concerns, and if FHFA is weak as a regulator or as a conservator, it is important that Fannie's and Freddie's operational risk programs be strong because they go hand-in-hand. So that is why operational risk is a critical element to oversight and accountability.

In terms of what is preventing the Agency from enforcing this and requiring Fannie Mae to develop an operational risk program, I do not know why. It is rather shocking, since they have been telling Fannie Mae for 5 years that they need an operational risk program. FHFA has broad authorities as conservator. They can fire people. And as regulator, they certainly can issue cease and desist orders and the like.

They have promised that they will implement an effective operational risk program by 2012 and we are monitoring it.

Chairman JOHNSON. Can you give examples of areas where staff and resources are not being allocated to prioritize oversight and how this could impact FHFA's ability to limit taxpayer losses.

Mr. LINICK. We have issued a report on examination capacity at the Agency, and this report reflected what the Agency told us about staffing shortages resulting in limited transaction testing, scaled back examination, and delays in examination. We heard that from the Agency. In part, it involved the HAMP program. Transfer of risk examiners to the HAMP program early on caused stressors on the examination program.

The examination program is absolutely critical to assessing risk management at the Enterprises, and we have noticed that as a result of these shortages, there have not been targeted examinations of real estate owned property until very recently. There have not been examinations of critical business lines, such as multifamily housing. And there have been insufficient examinations at the Federal Home Loan Banks.

Clearly, if FHFA does not have the capacity to examine critical programs at the GSEs, there is a risk of loss to taxpayers and it is very important that the Agency takes steps to mitigate these shortfalls, which it is doing.

Chairman JOHNSON. Does the FHFA have the resources and staff to provide proper oversight and examinations of a \$5 trillion mortgage portfolio and entities responsible for supporting the majority of the \$11 trillion mortgage market?

Mr. LINICK. The staffing issue is a complicated issue because there is no doubt that the Agency, in our view, could do a better job prioritizing and allocating resources. But we have not done an across-the-board human capital assessment to determine whether, overall, the Agency needs to staff up to address the conservatorship.

We have looked at staffing in one area, examination capacity, and we concur with the Agency that they need more examiners. We are also concerned because their Office of Conservatorship Operations has six individuals in it, and we are looking at that issue now to determine whether or not that is sufficient.

But staffing also relies on other considerations. Bigger is not necessarily better for an organization. So, for example, it is possible that the Agency can beef up its conservatorship operations if their examination operations are not strong, or vice-versa.

The Agency can also ensure through operational risk programs, that Fannie and Freddie and the Federal Home Loan Banks have their house in order to compensate for examination shortfalls.

So, clearly, more can be done to improve. We have recommended that the Agency study this issue to determine how it can mitigate these examination shortfalls. Ultimately, Mr. DeMarco is going to have to find the optimal point of how to staff the Agency in a way in which resources are allocated appropriately and strategically.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Linick, in addition to managing a brand new Inspector General's office, you lead a very unique office here. The conservatorship of Fannie Mae and Freddie Mac have now lasted for over 3 years, as I mentioned in my opening statement, at a cost of \$183 billion, I understand, and growing. In your position, you provide oversight of the Federal Housing Finance Agency not only in its traditional role as a regulator, but also now as a conservator.

During your tenure, and I know you have not been there that long, what will be your priorities, number one, and what issues do you intend to focus on specifically? I know there will be some that will pop up to you, but on the overall substantive issues. And how will you implement your agenda going forward as an independent Inspector General at the Federal Housing Finance Agency?

Mr. LINICK. Senator, as you mentioned, our role is unique given we have a conservatorship and a regulator all wrapped in one.

In terms of our priorities, our number one priority is looking at conservatorship management and Enterprise oversight. We are looking at every stage of the mortgage loan process, from underwriting all the way to deficiency judgments. We are looking at various stages of servicing, from the beginning of servicing to the end of servicing. And we have already issued reports on default-related legal services, how attorneys relate to the servicing process and foreclosure processing abuses, and we have issued an operational risk report.

We are also looking at risk management. The operational risk report addresses that and we are looking at other types of risk management and Enterprise board governance. We are also looking at how the \$183 billion is being spent, just to name a few.

We are also looking at the Federal Home Loan Banks—

Senator SHELBY. Good.

Mr. LINICK. —and there are a number of issues associated with management of the Federal Home Loan Banks as well as FHFA capacity and internal operations.

Senator SHELBY. And also the Federal Home Loan Banks' risk to the taxpayer?

Mr. LINICK. Absolutely. Regarding the Federal Home Loan Banks, there are a number of issues we are looking at. In fact, we have a couple of reports which are in progress now, including one on the four troubled banks. We are also looking at advance and collateral management and we are looking at capital management, as well.

We also have a robust Investigations Division which we would like to hold people accountable and institutions accountable for defrauding the GSEs and defrauding individuals holding GSE loans. So our investigations section, combined with our audit and evaluation section, is how we plan to attack the issues facing the Agency.

Senator SHELBY. OK. In your testimony, you also mentioned that the Federal Housing Finance Agency views operational risk—you alluded to it earlier—as an important safety and soundness challenge to all of us facing, of course, Fannie and Freddie. Yet, during the past 5 years, Fannie has consistently failed to manage operational risk. Although the Federal Housing Finance Agency has the authority to discipline the GSEs for such failures, including removing personnel, FHFA so far has not chosen to exercise this authority. That does not mean you will not in the future. I understand that.

In your view, should the Federal Housing Finance Agency take stronger action to discipline the GSEs for their failure to manage operational risk, and why has FHFA not taken stronger remedial action, and does the perceived temporary nature of FHFA's role as a conservator create challenges to managing these significant and ongoing risks, \$5 trillion, I believe the Chairman mentioned.

Mr. LINICK. Senator, let me start with the question of enforcement. The operational risk report is just one report we have done on the issue of enforcement. But enforcement, in our view, is critical to ensuring that losses are mitigated and that there is proper oversight. Enforcement not only in ensuring the operational risk program is implemented, but also enforcement in servicing, in foreclosure processing abuses.

We are in the middle of a servicing report now, but standards alone are not sufficient. There is an initiative currently proposed by FHFA, a servicing alignment initiative, and we are monitoring that, and that is a good step forward. However, what we want to see is not just standards but compliance with those standards and enforcement by FHFA.

Senator SHELBY. What additional challenges have been created by the—for, not by, but for the Federal Housing Finance Agency—by the uncertain nature of the ongoing conservatorship of the GSEs? In other words, you do not know what the future is going to be.

Mr. LINICK. Senator, uncertainty is always a bad thing, and the uncertainty factor has created difficulties for the Agency in recruiting qualified personnel to the Agency. It has affected their ability

to plan, how to staff resources, such as, whether they should staff the conservatorship operations or the regulatory operations. And I think it has had an effect on oversight, as well, because one of the factors that Mr. DeMarco has cited as the reason for employing a delegated approach to conservatorship is the prospect of a wind-down.

Senator SHELBY. Sure. FHFA was created to be an agency independent of executive branch influence, whoever the party was in power. There have been multiple reports of executive branch officials attempting to pressure the Federal Housing Finance Agency and the GSEs into implementing programs with political benefits to the Administration.

Do you believe that it is important for the Federal Housing Finance Agency to continue to operate free from executive branch influence, as is mandated by the statute that created the Federal Housing Finance Agency? And two, how can your office most effectively ensure that your independence is not compromised by the executive branch? And third, do you believe that increased transparency requirements are needed for FHFA and the GSEs regarding their interactions with the executive branch?

Mr. LINICK. Senator—

Senator SHELBY. I know that is a lot, but I just had a little time.

Mr. LINICK. Let me answer the third question.

Senator SHELBY. OK.

Mr. LINICK. Transparency is always a good thing. Our role is to promote transparency—

Senator SHELBY. Right.

Mr. LINICK. —in Government operations, and we have recommended that the Agency be transparent in a number of different areas, from executive compensation to operational risk, whatever it is.

One of the reports we issued is the Treasury Making Home Affordable report, in which we looked at the independence of the Agency. We do believe that it is absolutely essential for the Agency to be independent and to act independently, and we found in that particular report that with respect to FHFA's role negotiating the financial agency agreements for HAMP that its independence was not undermined. The problem in that particular review was the lack of engagement by FHFA in participating in those negotiations and—

Senator SHELBY. And what brought that about?

Mr. LINICK. Well, FHFA decided to leave those negotiations up to the Enterprises and Treasury, and—

Senator SHELBY. But that is not always a good idea, is it?

Mr. LINICK. It is not a good idea. These involve 5-year commitments by the Enterprises to administer efforts to potentially modify millions of mortgages, and there were significant financial obligations. The Enterprises were in conservatorship at the time. We recommended that FHFA be more engaged. This was another example of a situation where the Agency deferred too much to the Enterprises—

Senator SHELBY. But would that not have been at a cost to FHFA, perhaps, to allow that modification, or those modifications?

Mr. LINICK. I am sorry, a cost to FHFA?

Senator SHELBY. I said, a lot of the modifications that we are talking about, somebody has to pay for that. Was FHFA going to have to absorb some of that?

Mr. LINICK. Well, one of the issues that we looked at is whether or not the Treasury was going to be paying for the administrative efforts—

Senator SHELBY. Mm-hmm.

Mr. LINICK. —of the Enterprises, and that was a point of contention that was never ironed out in the agreement.

Senator SHELBY. OK. Well, we wish you well in your job.

Mr. LINICK. Thank you, Senator.

Chairman JOHNSON. Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman, and thank you, Mr. Linick, and your staff for your efforts.

You are very clear in your September 23 evaluation that the FHFA has too few examiners, which goes to the very basic ability to conduct their operations. Just can you confirm that is, in fact, your conclusion? And second, what can they do to increase the examiners? Otherwise, they are under-resourced and noneffective.

Mr. LINICK. Well, the FHFA told us that they have too few examiners and we concur with that assertion. We have recommended a number of things that they undertake to remedy that.

Number one, we asked them to study the issue because, as I mentioned earlier, shortfalls in examination capacity may be mitigated by strengthening operational risk or strengthening conservatorship. So we asked them to study that.

The Agency has taken a number of actions to mitigate that and we have recommended that they train, examiners to increase the number of accredited examiners, potentially hire detailees and contractors from other agencies, and finally, to be transparent about these examination shortfalls because Congress and the American public need to understand their ability to regulate Fannie and Freddie.

Senator REED. Are they moving aggressively to fulfill your recommendations and to correct this, and do they have the resources to do it?

Mr. LINICK. Well, I believe that they are moving aggressively in this area. I know that they have reorganized the Agency and made examination a priority. But it has been very difficult, from what I understand, based on my conversations with Mr. DeMarco, to attract examiners. It is already difficult when you are not in a conservatorship—when you are not in a financial crisis. It is very difficult when you are. I do think that examiners are reluctant to come to the Agency because they do not know where their future lies.

This has been a very difficult area. I know the Agency has been putting out notices and advertisements. I am confident that they are trying as best as they can. From what I have heard, however, they are having trouble meeting their goals, and we are continuing to monitor and work on this and we will certainly brief you and the Committee—

Senator REED. I think you will have to, because you have identified this key fault line in the Agency.

Let me just shift gears slightly, but I think we have all been talking around this topic. The essence of the conservatorship is to maintain as best you can the value of the assets of the Enterprises. At least, that is my view point. And there is a constant debate whether that is done simply by sort of the status, maintaining the status quo, or it is done by engaging in modifications of some of the mortgages. All of that is at the heart of these discussions about HAMP and its successor programs.

Have you taken your office's perspective on how well they are doing managing or maintaining the value of the Enterprises, and have you evaluated whether alternative approaches, like mortgage modifications, *et cetera*, would yield more value over time?

Mr. LINICK. Senator, let me respond in two parts to your question. I think, first, this issue about monitoring the sale of assets and the modifications issue sort of underscores the tension that we have seen between the housing mission and safety and soundness mission. We are looking at how the Director is balancing those missions as he promulgates policies and so forth. So transparency is absolutely critical. We are trying to take a look at the rationale, the analysis that is being done, and trying to ensure that independent judgment is exercised and not undue deference on the Enterprises.

Let me see. The second question—can you just repeat the second question? I am sorry. I have lost my train of thought.

Senator REED. You assume my train is running better than your train.

[Laughter.]

Senator REED. What I—

Mr. LINICK. I had two parts.

Senator REED. You had two parts.

Mr. LINICK. I got the second part.

Senator REED. You had two parts. But I think, basically, the remaining question rests on this whole topic of how well they are doing maintaining the value as a conservator, and let me just—you have given me the opportunity to elaborate just a bit, and very quickly. One part of this is all about where the housing market is moving. If the housing market starts appreciating, then guess what. They will look like geniuses because they have held on to these assets, or they have had Fannie and Freddie hold on. If the market keeps deteriorating, then I think you could make the argument they should have disposed of the assets, modified the mortgages, done all sorts of things, and they have not done that. So there is uncertainty based on market movements.

But the other complicating factor, frankly, is because of the sheer size of Fannie and Freddie, what Fannie and Freddie each does, influences the market. So it is a very complicated, volatile situation, and again, from your perspective, are you trying to evaluate how well they are doing maximizing or maintaining—I guess maintaining would be better—the value of Fannie and Freddie, given that the market's future is uncertain and the fact that Fannie and Freddie influence the market? This is—it is almost like particle physics. It is pretty complicated, so—

Mr. LINICK. Got it.

Senator REED. Thank you, sir.

Mr. LINICK. Senator, we are looking at this issue from a number of different angles. Our Repurchase Claims Report is one way we have addressed this, looking at how well they are doing in recovering taxpayer monies through the repurchase process. There are a lot of different ways to slice this.

The other way we have started looking at this is the real estate-owned property. Holding that property or selling it quickly is a very important and tricky balance that needs to be made. If you hold that, obviously you have carrying costs and you have potential blight issues and so forth. If you sell it too quickly, it could affect the housing prices. We have an ongoing audit in that area, but we are looking at loss mitigation from a number of different angles.

Senator REED. Right. Well, I appreciate that, and I think that is absolutely critical, because you are—we do not want to compromise the independence of FHFA, but we do not want an agency that is paralyzed because of the complexity of the issues they face, and the uncertainty. And your office can help direct them, and I think you put your finger on the right terminology that I have been struggling with, which is minimize losses, either through a creative REO, renting it out, selling it quickly, modifications, *et cetera*. To take all those off the table and just sit pat I think is not the way to minimize losses going forward, unless you are very lucky and the market comes back on its own.

Thank you.

Chairman JOHNSON. Senator Tester.

Senator TESTER. Thank you, Mr. Chairman, and thank you for being here, Mr. Linick.

You addressed the \$35 million FHFA-approved compensation package in the March 30th report for the enterprises' top six officers. You referenced the fact that FHFA failed to identify or acknowledge the benefits of Federal assistance in enabling senior executives meet corporate and other performance goals. You also found that FHFA lacked the processes and controls necessary to monitor the GSEs' compensation decisions and that the FHFA failed to provide necessary transparency. You talked about it in your opening remarks.

You made a number of recommendations, and they agreed with some and they disagreed with others. Can you explain to me why FHFA disagreed with your recommendation to take a look at disparities between executive compensation at Fannie Mae and Freddie Mac and other Federal housing agencies, and a second recommendation that the FHFA test and independently verify the GSEs' individual salary recommendations? Can you give me any insight into their thought process on this?

Mr. LINICK. Senator, I think they actually have changed their tune on the comparability, and they are actually undertaking that analysis.

Senator TESTER. So to test and independently verify, or the first one you are talking about?

Mr. LINICK. I believe they have actually agreed to all of the recommendations.

Senator TESTER. Really?

Mr. LINICK. And they are actively engaged in looking at that.

Senator TESTER. OK. And so what are they doing looking at it? I mean, are they—OK. You can take a lot of heat off yourself and say, “Yes, well, I agree with the recommendation now, and we are going to look at it.” But what is the outcome of that?

Mr. LINICK. This is an area that concerns us because we are in compensation season right now when they are developing bonuses and so forth. And the way it works is essentially there is a base salary and then there is a performance base, and that performance piece is influenced by individual and corporate goals. Those corporate goals are developed and blessed, if you will, by the FHFA at the very beginning of the process, and those corporate goals influence what grade those executives get.

Senator TESTER. Right.

Mr. LINICK. We found in our report that there was not a lot of vetting being done of those goals. For example, one of the goals required the enterprises to increase market share. I think they were required to sell 37 percent of mortgage issue, 37 percent of—

Senator TESTER. So where you are going with this, what you are saying is next year it is going to be different.

Mr. LINICK. Well, what I am saying is I am concerned that we are going to be in the same exact spot next year as we are at this year.

Senator TESTER. Even though they agreed with the recommendation and said they are going to look at—

Mr. LINICK. Well, I believe that they are going to do it. The problem is whether they are going to do it in time for the next cycle. That is what concerns me, and I have alerted Mr. DeMarco to this particular concern, that they need to get procedures in place so they can evaluate these goals to make sure these goals are in sync with the conservatorship.

Senator TESTER. Did he seem to be open that it would make a difference next time around?

Mr. LINICK. He acknowledged the need to do that. I do not know what the status—I know that it is supposed to be done by the end of the year. The problem is all of this occurs right now and in November.

Senator TESTER. OK. Have you had an opportunity—taking our eyes off the six top folks, have you had an opportunity to look at the compensation of the other senior-level employees which we have heard bonuses are significant there?

Mr. LINICK. We have not issued a report on that topic.

Senator TESTER. Are you going to take a peek at it maybe?

Mr. LINICK. We have actually asked for documents reflecting what those salaries are.

Senator TESTER. Oh, good. So you have already started.

Mr. LINICK. We are looking at it, but we do not have a report, and I have no findings or conclusions in that regard.

Senator TESTER. OK. Well, we look forward to that, too, because that will also have an indication of how serious they are to deal with the problem that you pointed out that they disagreed with and then they agreed with, with the six top employees, in my opinion.

A previous questioner asked about reports, he had read reports of the administration’s pressure on FHFA. I have not read that re-



port, and sometimes you wonder about what you read about back here anyway. But your perspective is more important than any report I might read, anyway, except if it is your report. And that is, have you seen any examples of the administration applying pressure to the FHFA?

Mr. LINICK. No. Well, we have only looked at one sliver of the variety of relationships. The one relationship we looked at is the relationship between Treasury and negotiating the financial agency agreements, and we did not find that FHFA's independence was compromised in that arena.

Senator TESTER. All right. Well, thank you very much. That is probably about it. I could ask about solvency since the conservator took over, but I do not know that you can answer that question. Since FHFA has taken over, how has their portfolio looked from that time forward? Or have you had a chance to take a look at that?

Mr. LINICK. I do not have any independent findings on that, so I would rather defer to Mr. DeMarco and others.

Senator TESTER. Super. Thank you very much.

Thank you, Mr. Chairman.

Chairman JOHNSON. Mr. Linick, your work only strengthens my view that we need a permanent Director at FHFA. Unfortunately, the President's first nominee, Joe Smith, was blocked from confirmation despite a bipartisan vote of support in this Committee. Because of the importance of FHFA's mission, I urged the President to send to the Senate a new nominee as soon as possible.

Mr. Linick, I thank you for your testimony and for being here with us today. This Committee takes their oversight of FHFA very seriously, and your role as Inspector General serves as a valuable resource that we appreciate. FHFA continues to play a key role in the stabilization of the housing market, and a robust Inspector General will only assist them in this process.

This hearing is adjourned.

[Whereupon, at 11:02 a.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

**PREPARED STATEMENT OF CHAIRMAN TIM JOHNSON**

I would like to welcome the first Inspector General of the FHFA, Steve Linick, before the Committee today.

As we wrap up the hearings for this year, I am pleased that the Ranking Member and I were able to agree to a plan for the hearings the Committee held on housing finance reform this year, and hope that we will be able to continue that bipartisan approach next year.

The 12 housing finance related hearings we held this year have highlighted some general principles I believe we hold in common that will guide us going forward. Small institutions that maintained sound underwriting standards during the boom should still have access to any secondary market that is created in the future. This is important for maintaining strong, responsible home ownership opportunities in rural and underserved areas. Fully documented underwriting should be the standard practice in any system going forward. Clear rules of the road are essential for providing stability to the market, but the transition must be a gradual one given the current, fragile state of the market.

The Committee's exploration of these specific topics has helped inform Members and build a record on which the Committee can evaluate legislative efforts. Looking ahead to next year, there are some topics that still need to be explored, but I am hopeful that Senator Shelby and I can continue moving forward on housing finance reform in the same bipartisan way that we have conducted hearings and markups this year.

In nearly every hearing this year, the current state of the economy and strategies for improving the housing market were topics of discussion. The need to reform our housing finance system and the need to improve the housing market go hand in hand. The Federal Housing Finance Agency, as conservator of Fannie Mae and Freddie Mac, could play a significant role in improving the housing market, but based on reports from the Inspector General's office, there are deficiencies at the agency that are holding back those efforts.

I am concerned that the reports produced by the Inspector General's office show several negative trends in FHFA's oversight of operations at Fannie Mae and Freddie Mac. First, the regulator defers to the GSEs on major decisions without independently verifying the benefits to the conservatorship or the taxpayers. Second, the FHFA appears to allocate staffing resources in a manner that limits its ability to enforce directives and adequately oversee operations at the GSEs. These two trends appear to restrict the FHFA's ability to help stabilize the housing market and protect taxpayer dollars while also continuing the problematic relationship that Fannie Mae and Freddie Mac had with their previous regulator.

Despite its independent status, which was granted on a bipartisan basis in 2008 as a single director with Congressional appropriations, and expanded powers as conservator, FHFA could be doing more to prevent losses and enforce required changes at Fannie Mae and Freddie Mac. As the regulator of two of the largest entities in the housing market, it is essential that FHFA prioritize oversight as one of the strategies necessary to stabilize our housing market. This would benefit the taxpayers both by strengthening the current state of the GSEs and also providing guidance and consistency to a large sector of the housing market to further create stability for homeowners and potential homebuyers.

I look forward to hearing your recommendations for improvements and the possible reasons for the trends that you continue to see, Inspector General Linick.

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**PREPARED STATEMENT OF STEVE A. LINICK**  
INSPECTOR GENERAL, FEDERAL HOUSING FINANCE AGENCY

DECEMBER 13, 2011

Thank you, Chairman Johnson and Ranking Member Shelby, for inviting me to testify before the Senate Banking Committee. I appreciate the opportunity to summarize the work and findings of the Federal Housing Finance Agency Office of Inspector General (FHFA-OIG) to date.

I am the Agency's first Inspector General, and my office began operations following my swearing in on October 12, 2010, in the midst of a housing crisis of historic proportions. Over the past fourteen months, we have made great strides in hiring a professional staff and getting the organization up and running. We have published 10 audits and evaluations and have commenced numerous criminal and civil investigations. We also issued our second Semiannual Report to Congress 2 weeks

ago.<sup>1</sup> Today, I will provide an assessment of emerging trends based on the work we have conducted to date, describe our operations, and answer the Committee's questions.

FHFA–OIG oversees FHFA's operations and programs. This oversight includes the Agency's regulation of the housing Government-sponsored enterprises (GSEs)—Fannie Mae, Freddie Mac, and the 12 Federal Home Loan Banks; the GSEs' approximately 12,000 employees; as well as the conservatorships of Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac currently own or guarantee home mortgages worth over \$5 trillion and account for 70 percent of the Nation's secondary mortgage market. To date, they have received \$183 billion in taxpayer money in order to ensure their continuing solvency.

FHFA–OIG's mission is to promote the economy, efficiency, and effectiveness of FHFA's programs and operations. To carry out its mission, FHFA–OIG conducts, supervises, and coordinates audits of FHFA's programs and operations. FHFA–OIG also works to prevent and detect fraud, waste, and abuse in those programs and operations through investigations involving FHFA, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. Important features of FHFA–OIG's work are the promotion of transparency in FHFA programs and GSE oversight, as well as public understanding of matters affecting FHFA, the GSEs, and housing policy.

### **Emerging Trends**

Our reports have revealed a number of emerging trends. These reports credit FHFA's work in several areas, both as regulator of the GSEs and conservator of Fannie Mae and Freddie Mac (the Enterprises). For example, FHFA–OIG has found:

- FHFA has eliminated golden parachute compensation awards to terminated Fannie Mae and Freddie Mac executives;
- FHFA has taken steps to mitigate its shortage of qualified examiners;
- FHFA has increased underwriting standards and raised guarantee fees;
- FHFA has taken steps that may improve Enterprise repurchase claims recoveries, thereby reducing Enterprise losses; and
- FHFA has positively responded to FHFA–OIG's recommendations to improve FHFA's effectiveness and efficiency and to reduce its vulnerability to fraud, waste, and abuse.

On the other hand, FHFA–OIG reports also have identified deficiencies in FHFA operations, and these deficiencies appear to reflect two significant and related trends. First, FHFA often relied on determinations of the Enterprises without independently testing and validating them, thereby giving undue deference to Enterprise decision making. Second, FHFA was not proactive in oversight and enforcement, and accordingly, resource allocations may have affected its ability to oversee the GSEs and enforce its directives. Both trends have emerged in a number of our reports.

### **I. FHFA Has Not Independently Tested and Validated Enterprise Decision Making**

In four reports, FHFA–OIG identified significant instances in which FHFA has displayed undue deference to Enterprise decision-making. Without adequately testing or validating data, FHFA has deferred to the Enterprises regarding: (1) Freddie Mac's assessment of mortgage repurchase claim issues involving Bank of America; (2) the Enterprises' participation in the Making Home Affordable programs (MHA); (3) the Enterprises' decisions regarding executive compensation; and (4) numerous Enterprise transactions.

The Agency's actions in each case reflect its approach as conservator to delegate most business decisions to the Enterprises. In each case, it relied upon review and corporate governance processes already in place at the Enterprises. However, FHFA–OIG concluded that some matters are sufficiently important to warrant greater involvement and scrutiny by the Agency.

#### *a. FHFA Deferred to Freddie Mac's Analysis of Repurchase Claim Exposure*

At the end of 2010, FHFA approved a \$1.35 billion settlement of mortgage repurchase claims that Freddie Mac asserted against Bank of America. In approving the settlement, FHFA relied on Freddie Mac's analysis of the settlement without testing the assumptions underlying the Enterprise's existing loan review process. An FHFA–OIG report found that FHFA did not act timely or test concerns raised by an FHFA senior examiner months prior to the settlement about limitations in

<sup>1</sup> Available at <http://www.fhfaig.gov/Content/Files/second%20semiannual%20report.pdf>.

Freddie Mac's existing loan review process for mortgage repurchase claims. The senior examiner was concerned that the loan review process Freddie Mac used for repurchase claims failed to account adequately for changes in foreclosure patterns among loans originated during the housing boom. According to the senior examiner, this could potentially cost the Enterprise a considerable amount of money.<sup>2</sup> Freddie Mac's internal auditors independently identified concerns about the process and in June 2011, recommended that the issue be studied further. Following initiation of FHFA-OIG's report, FHFA suspended future Enterprise mortgage repurchase settlements premised on the Freddie Mac loan review process and set in motion activities to test the assumptions underlying the loan review process.

*b. FHFA Provided Limited Oversight of the Enterprises' Administration of the Home Affordable Modification Program*

In early 2009, the Department of the Treasury initiated the Making Home Affordable (MHA) programs. A key initiative of MHA is the Home Affordable Modification Program (HAMP), which involves servicers agreeing to modify mortgages for borrowers facing default or foreclosure. In early 2009, the Enterprises began participating in HAMP. They started modifying mortgages in their portfolios and entered into 5-year agreements with Treasury to manage the program and oversee participants' compliance with program requirements. An FHFA-OIG report found that FHFA largely removed itself from overseeing the negotiations of the 5-year agreements. FHFA believed its appropriate role was to ensure the Enterprises were legally authorized to administer HAMP, not to participate actively in negotiations between the Enterprises and Treasury. In other words, FHFA did not engage in any formal substantive review to evaluate the agreements' feasibility, risks, or the suitability of the Enterprises to serve as Treasury's financial agents. This lack of engagement may have contributed to the agreements' omission of significant details concerning payments to the Enterprises, the scope of their responsibilities, and processes to resolve differences. As a consequence of the omissions, significant problems developed in these areas almost from the beginning, requiring FHFA and the Enterprises to devote substantial time and resources to resolve ambiguities.<sup>3</sup>

*c. FHFA Did Not Fully Analyze Factors Related to Executive Compensation at Fannie Mae and Freddie Mac*

For 2009 and 2010, the Enterprises awarded their top six officers a cumulative total of over \$35 million in compensation. FHFA reviewed and approved these compensation awards based on the Enterprises' determinations and recommendations. However, an FHFA-OIG report found that FHFA did not independently test or validate the means by which the Enterprises calculated their recommended compensation levels and did not consider factors that might have resulted in reduced executive compensation costs. These factors included the lower compensation levels paid to senior officials at Federal agencies supporting the housing market and the extent to which Federal support for the Enterprises may facilitate the ability of Enterprise officers to meet individual and corporate performance targets.<sup>4</sup>

*d. FHFA Does Not Perform Sufficient Transaction Testing of Enterprise Activities*

Transaction testing is the method employed by financial institution examiners to make independent judgments about the financial and operational conditions of an institution, as well as its compliance with applicable laws and regulations. An example of transaction testing would be reviewing a regulated entity's loan files to test the veracity of statements concerning loan underwriting and performance. During an evaluation of FHFA's capacity to examine the GSEs, a senior FHFA manager acknowledged to FHFA-OIG that examiners too often accept assertions made by Enterprise managers rather than independently validate such assertions through appropriate transaction testing.<sup>5</sup>

**II. FHFA's Resource Allocations May Have Affected Its Ability To Oversee the GSEs and Enforce Its Directives**

In four reports, FHFA-OIG identified instances in which FHFA was not proactive in oversight and enforcement, and accordingly, resource allocations may have affected its ability to oversee the GSEs and enforce its directives. For example, FHFA did not assign sufficient priority and resources to handle consumer complaints. Additionally, FHFA-OIG found that FHFA (along with its predecessor agency, the Of-

<sup>2</sup> Available at <http://www.fhfaig.gov/Content/Files/EVL-2011-006.pdf>.

<sup>3</sup> Available at <http://www.fhfaig.gov/Content/Files/EVL-2011-003.pdf>.

<sup>4</sup> Available at <http://www.fhfaig.gov/Content/Files/Exec%20Comp%20DrRpt%2003302011%20final,%20signed.pdf>.

<sup>5</sup> Available at <http://www.fhfaig.gov/Content/Files/EVL-2011-005.pdf>.

office of Federal Housing Enterprise Oversight (OFHEO)) has permitted Fannie Mae to delay for 5 years the directives to implement an effective operational risk management program. Further, FHFA may not have allocated resources to or prioritized addressing new and emerging risks that may impact the GSEs. Finally, FHFA reported that it may have too few examiners to meet its oversight responsibilities. Some of FHFA's lack of oversight may have resulted from a lack of examination capacity, while other shortfalls may stem from a misallocation of resources.

*a. FHFA Did Not Allocate Sufficient Resources To Handle Consumer Complaints*

Due in part to deteriorating financial conditions in the housing market, FHFA and OFHEO experienced a substantial increase in consumer complaints about the Enterprises. A number of these complaints contained important information about alleged foreclosure processing abuses and fraud. However, an FHFA–OIG report found that FHFA did not adequately process consumer complaints. For example, the Agency did not: develop and maintain a consolidated system for receiving or processing complaints; consistently follow up on complaints referred to the Enterprises; prioritize complaints or assess the timeliness of responses to complaints; refer complaints to law enforcement for evaluation or possible investigation; or perform substantive analyses to identify overall trends in complaints. These deficiencies occurred because FHFA did not establish adequate internal controls and did not assign sufficient priority and resources to complaint processing. FHFA–OIG found that FHFA assigned only two employees—on a part-time basis—to handle consumer complaints.<sup>6</sup> FHFA's lack of oversight and prioritization in this area stemmed from its view that, among other things, addressing consumer complaints was not its role.

*b. FHFA Has Not Enforced Directives Regarding Fannie Mae's Operational Risk Program*

In 2006, OFHEO issued a Consent Order requiring Fannie Mae to establish an operational risk management program. FHFA views operational risk management as an important financial safety and soundness challenge facing the Enterprises. The Agency defines operational risk as the risk of loss resulting from failures in people, processes, systems, or from external events (such as foreclosure abuses). Between 2006 and 2011, FHFA and OFHEO repeatedly found that Fannie Mae had failed to establish an acceptable and effective program despite outstanding requirements to do so. As Fannie Mae's conservator and regulator, FHFA's authority over the Enterprise is broad and includes the ability to discipline or remove Enterprise personnel to ensure compliance with Agency mandates. However, an FHFA–OIG report found that FHFA has not exercised this or other authorities to compel Fannie Mae's compliance with the operational risk requirement.<sup>7</sup> Fannie Mae's lack of an acceptable and effective operational risk management program may have resulted in missed opportunities to strengthen oversight of law firms with which it contracts to process foreclosures.

*c. FHFA Did Not Identify and Address New and Emerging Risks Potentially Impacting the GSEs*

Only after news of foreclosure abuses surfaced in mid-2010 did FHFA begin to schedule comprehensive examination coverage of foreclosure issues, including allegations of abuse by its default-related legal services vendors. FHFA had not previously considered risks associated with foreclosure processing to be significant. However, an FHFA–OIG report found that there were multiple indications of foreclosure issues prior to mid-2010 that could have led FHFA to foresee the heightened risk in foreclosure processing abuses. These indications included significant increases in the volume of foreclosures (which accompanied the collapse of the housing market), rising consumer complaints alleging improper foreclosures, contemporaneous media reports about foreclosure abuses by the Enterprises' law firms, and public court filings highlighting such abuses.<sup>8</sup>

*d. FHFA May Not Have Enough Examiners To Meet Its Regulatory and Conservatorship Oversight Responsibilities*

FHFA has critical regulatory responsibilities with respect to the GSEs and conservator responsibilities regarding the Enterprises. To satisfy these responsibilities, Congress provided FHFA significant budget and hiring authority. Nonetheless, an FHFA–OIG report noted that FHFA had found shortfalls in the Agency's examination coverage. Internal Agency reviews also corroborated that FHFA believes it has too few examiners to ensure the efficiency and effectiveness of its examination pro-

<sup>6</sup> Available at <http://www.fhfa.gov/Content/Files/AUD-2011-001.pdf>.

<sup>7</sup> Available at <http://www.fhfa.gov/Content/Files/EVL-2011-004.pdf>.

<sup>8</sup> Available at <http://www.fhfa.gov/Content/Files/AUD-2011-004.pdf>.

gram. Additionally, only 34 percent of the Agency's line examiners are accredited Federal financial examiners. FHFA has taken steps to mitigate its shortage of qualified examiners, but it needs to move quickly and aggressively in this area. Last winter, for example, the Acting Director announced and implemented a substantial restructuring of FHFA's supervision units and reassigned numerous staff. These steps, which also include plans to add examination staff and implement an examiner accreditation program, are designed to enhance FHFA's supervision program. Further, although FHFA's near-term plans include hiring up to 44 additional staff in the supervision divisions, FHFA believes there is substantial uncertainty as to whether this number of additional examiners will enable FHFA to overcome its examination capacity shortfalls and ensure the success of the Agency's 2011 reorganization of its examination structure.<sup>9</sup> Insufficient examination capacity contributed to FHFA's lack of oversight by leaving key areas unchecked. For example, until recently there had been no targeted examinations involving the real estate owned (REO) area.

### **OIG Audits and Evaluations**

In addition to monitoring and reporting on FHFA's progress in implementing report recommendations, FHFA-OIG will continue to release new audits and evaluations covering key areas. FHFA-OIG maintains a detailed Audit, Evaluation, and Survey Plan that focuses strategically on the areas of FHFA's operations posing the greatest risks and providing the greatest potential benefits to FHFA, Congress, and the public. Originally developed with input from an independent, third-party risk assessment, the Audit, Evaluation, and Survey Plan reflects continuous feedback from FHFA-OIG's reviews of current events and comments from FHFA officials, members of Congress, and others. Broadly, FHFA-OIG's audit and evaluation strategies include reviews of the following FHFA activities:

- Regulatory efforts and its management of the Enterprise conservatorships. This is a particularly high-risk area because Treasury has to date invested \$183 billion of taxpayer funds in the Enterprises. As conservator, FHFA must regulate and oversee the Enterprises in an efficient, effective, and transparent manner so as to minimize taxpayer costs, conserve Enterprise resources, and meet all statutory mandates.
- Oversight of the Federal Home Loan Banks and their associated risks, including investment portfolio management and concentrations, credit underwriting, and administration.
- Internal operations, such as privacy and allegations of fraud, waste, or abuse.

The Audit, Evaluation, and Survey Plan identifies a number of other ongoing and planned reviews of specific FHFA programs.

Given the Committee's interest, I want to highlight two projects currently underway. First, we are assessing whether FHFA has an effective supervisory control structure and sufficient examination coverage to adequately and timely identify and mitigate mortgage servicing risks. We are also assessing FHFA's oversight of Enterprise controls over real estate owned (REO) operations, including management and sales activities and contractor performance. Given the breadth and importance of issues relating to servicing and REO, no doubt we will continue to examine them from various angles for some time to come. We look forward to working with you on these matters and reporting our findings and recommendations to the Committee.

### **Investigations**

As a further part of our mission to combat fraud, waste, and abuse, FHFA-OIG operates an active Office of Investigations that has made significant contributions to a range of mortgage-related investigations. While many remain confidential, FHFA-OIG and its law enforcement partners, which include Federal agencies, U.S. Attorneys' Offices, and State and local agencies nationwide, have released details about several high-profile mortgage fraud investigations involving Colonial Bank and Taylor, Bean & Whitaker Mortgage Corporation, Marshall Home and Margaret Broderick, and Home Owners Protection Economics, Inc.

FHFA-OIG's Office of Investigations currently has numerous open criminal and civil investigations involving a wide variety of allegations of wrongdoing. The Office of Investigations focuses on FHFA and the GSEs, both internally and externally, concentrating on those individuals and organizations that have victimized either FHFA or the GSEs or borrowers with GSE loans. While I cannot comment on spe-

<sup>9</sup> Available at <http://www.fhfaig.gov/Content/Files/EVL-2011-005.pdf>.

cific open cases, I can describe the trends we are seeing in fraud. The types of cases that we are actively investigating generally fall into the following six categories:

- Fraud involving mortgage-backed securities
- Mortgage origination related frauds
- Short sale and other mortgage modification frauds
- Fraud involving REO transactions
- Fraud involving mortgage servicing
- FHFA or GSE employee misconduct

*Fraud Involving Mortgage-Backed Securities* is a key area of focus. During the precrisis housing boom, the GSEs purchased and guaranteed hundreds of billions of dollars of residential mortgage-backed securities that have since declined precipitously in value due to the sharp deterioration in the value of those assets. The GSEs may have been victims of fraud in instances where the quality and value of the underlying assets they purchased or guaranteed was misrepresented to them.

*Mortgage Origination* related frauds include cases where the GSEs have been defrauded as the loan was being underwritten and sold to a GSE. These are the most commonly known frauds and could include schemes such as loan officers funding mortgages for otherwise ineligible borrowers. For example, one recent allegation reviewed by my office involved a borrower whose loan was funded despite the fact that the borrower was deceased. We have also seen schemes involving appraisers inflating the value of the property and straw buyers.

*Short Sale* frauds can include allegations of a non-arm's length transaction in which financial institutions are deceived into allowing a short sale through a straw buyer for a significantly lower price. Once the price decline is captured, the property is sold at the lower price to a relative or friend of the seller, with the owners ultimately staying in the property at a considerable loss to the GSE. In one of our cases, the average transaction loss to the GSE was approximately \$150,000.

*Mortgage Modification* frauds are a particularly insidious fraud. This type of fraud targets financially distressed homeowners who are underwater or have fallen behind on their mortgage payments. Some frauds involve advance fee schemes that require the homeowner to pay a fee for participating in supposedly "official" programs that are in fact completely fictitious or improperly imply participation in a U.S. Government housing relief program. Besides scamming vulnerable homeowners out of money they can ill afford to lose, these schemes are particularly harmful because by the time borrowers recognize the scam, they may have been foreclosed upon and have little recourse. Other scams are designed to force a distressed homeowner into default sooner than would otherwise be the case.

*REO Related* frauds may involve individuals connected to the foreclosure and subsequent resale of a property. This situation provides multiple opportunities for fraud. For example, the GSEs contract with so-called asset managers to maintain and prepare the property for sale. These asset managers may subcontract work to gardening companies to cut the grass, but the grass isn't cut; or they may contract with electricians for "required" maintenance that was neither required nor done, but still subsequently billed to a GSE. REO fraud can also involve realtors who collude with investors or other realtors and appraisers to drive down the price of properties they are selling on behalf of the GSEs. Over the past year, the Department of Justice's Anti-Trust Division has announced a number of convictions of real estate investors involved in such bid-rigging schemes designed to deflate property auction prices.

*Fraud Involving Mortgage Servicing* can include allegations that the mortgage servicer is not acting in the best interest of the GSE or the investor. For example, a mortgage servicer may make decisions regarding modifications or loan foreclosures with its own personal benefit in mind and contrary to GSE guidelines.

*FHFA or GSE Employee Misconduct* is another type of fraud. These are cases in which specific allegations are made involving administrative or criminal misconduct by FHFA or GSE employees or contractors.

Finally, I want to mention that the Office of Investigations operates the FHFA-OIG Hotline, which allows concerned parties to report information directly and in confidence regarding possible fraud, waste, or abuse related to FHFA or the GSEs. In the past year it has handled many allegations of wrongdoing or fraud. FHFA-OIG honors all applicable whistleblower protections. Should you or your constituents wish to report any allegations of fraud, waste, or abuse, the Hotline can be reached at 1-800-793-7724, by fax at 202-408-2972, or through our Web site at [www.fhfa.oig.gov](http://www.fhfa.oig.gov).

My staff and I look forward to continuing to work with the Banking Committee to provide independent, relevant, and objective assessments of FHFA's operations

and programs. The continuing fragility of our Nation's housing market remains a significant source of ongoing concern. Further, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks continue to be key market participants, and FHFA continues to face significant challenges. We are hopeful that our work will be of assistance in meeting those challenges.