



**Statement of**

**Edward J. DeMarco**

**Acting Director**

**Federal Housing Finance Agency**

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

**“Compensation in the Financial Industry – Government Perspectives”**

**February 25, 2009**

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

**Initial Conservatorship Decisions**

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

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

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

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

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

### **New Compensation Structures**

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

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

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

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

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

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

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

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

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

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

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

- In 2010, no executive officers will receive perquisites exceeding \$25,000 without FHFA approval, in consultation with the Treasury.
- No retirement plans for executive officers will be continued that use more generous formulas for such officers than plans for lower ranking employees.
- No expense reimbursements to executives will provide so-called "tax gross-ups" that reimburse executives not only for the expenses they paid, but also for the taxes they must pay on the reimbursements themselves.
- Deferred salary and incentive pay for all executive officers will be subject to clawbacks by the Enterprises in the event of gross misconduct, gross negligence, conviction of a felony, or erroneous performance metrics.

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

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

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

### **Lessons Learned from the Enterprises' Conservatorship Operations**

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

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

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

## **Summary**

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

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

Attachments



FEDERAL HOUSING FINANCE AGENCY  
Office of the Director

March 20, 2009

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

Dear Mr. Chairman:

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

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

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

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

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



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

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

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

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

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

Sincerely

A handwritten signature in black ink that reads "James B. Lockhart III". The signature is written in a cursive style with a prominent "J" and "L".

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



FEDERAL HOUSING FINANCE AGENCY  
Office of the Director

February 2, 2010

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

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

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

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

Dear Chairmen and Ranking Members:

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

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

## **Background**

### ***Establishment and Purposes of the Conservatorships***

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

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

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

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

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

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

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

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

### ***Conservatorship Operations***

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

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

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

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

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

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

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

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

## **Accomplishing Conservatorship Goals Going Forward**

### ***Loan Modifications and Mitigating Credit Losses***

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

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

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

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

### ***Retained Portfolios***

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

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

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

### ***New Products***

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

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

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

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

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

### ***Affordable Housing Mission***

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

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

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

### **Concluding Thoughts**

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



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

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

Yours truly,



Edward J. DeMarco  
Acting Director