For Immediate Release
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Statement of The Honorable **James B. Lockhart III**,
Director Federal Housing Finance Agency
Before the Senate Committee on
Banking, Housing, and Urban Affairs
on the Appointment of FHFA as Conservator for
Fannie Mae and Freddie Mac

Chairman Dodd, Ranking Minority Member Shelby, and members of the Committee, thank you for the opportunity to testify on recent regulatory actions taken by the Federal Housing Finance Agency (FHFA) at Fannie Mae and Freddie Mac.

Fannie Mae and Freddie Mac share the critical mission of providing stability, liquidity, and affordability to the housing market. Between them, these Enterprises have $5.3 trillion of guaranteed mortgage-backed securities (MBS) and debt outstanding, which is equal to the publicly held debt of the United States. Their market share of all new mortgages was 76 percent during the first half of this year. During the turmoil that started last year, they have played a very important role in providing liquidity to the conforming mortgage market. That has required a careful and delicate balance of mission with safety and soundness. A key component of this balance has been their ability to raise and maintain capital. Because of recent market conditions, that balance was upset. Unfortunately, as house prices, earnings and capital have continued to deteriorate, their ability to fulfill their mission has deteriorated. In particular, the capacity to raise capital to absorb further losses without Treasury Department support vanished. That left both Enterprises unable to provide counter-cyclical support. Worse, it threatened to require substantial shedding of current positions with attendant further damage to mortgage and housing markets.

In retrospect and despite OFHEO's surplus capital requirements, portfolio caps, and repeated warnings about credit risk, the credit profile at both Enterprises followed the market down in 2006 and 2007 – without commensurate pricing for risk. They bought or guaranteed many more low documentation, low verification and non-standard ARM mortgages than they had in the past. For example, for the first half of 2007, roughly one-third of the Enterprises' new business was composed of Alt-A (less than standard documentation), interest-only, or Option ARM products, and mortgages with layered (multiple) risk characteristics vs. 14 percent in 2005. For Fannie Mae, roughly 40 percent of new business in the first half of 2007 was in Alt-A and interest-only products versus 26 percent in 2005. The quality of their holdings of private-label mortgage securities (PLS) issued by others also deteriorated. The portfolio caps restrained the size of their PLS books, but maturing subprime and Alt-A PLS were replaced by PLS from the much riskier 2006 and 2007 origination years. As house prices turned down, delinquencies, foreclosures, real-estate owned, losses and reserves against future losses soared.

Over the last several years OFHEO, now FHFA, worked hard to encourage the Enterprises to rectify their accounting, internal controls systems and risk management issues. Both Enterprises and their dedicated managers and employees made good progress in many areas, but market conditions overwhelmed that progress. Their antiquated capital structures even with the OFHEO additional requirement were not adequate for this market.

The result was that the Enterprises were unable to provide needed stability to the market. They also found themselves unable to meet their affordable housing mission. Rather than letting these conditions fester and worsen and put the mortgage and overall financial markets in further jeopardy, FHFA, after painstaking review, decided to take action. The goal of these dual conservatorship actions is to help restore confidence in Fannie Mae and Freddie Mac, enhance their capacity to fulfill their mission, and reduce the systemic risk that would have exacerbated the instability in the current market.

The Determination to Appoint a Conservator

FHFA based its determination that grounds existed to appoint a conservator for the Enterprises, and that it was necessary to do so, on five key areas, each of which worsened significantly over the past two months:

1. Accelerating safety and soundness weaknesses, especially with regard to credit risk, earnings outlook, and capitalization;

2. Continued and substantial deterioration in equity, debt, and MBS market conditions;

3. The current and projected financial performance and condition of each company as reflected in its second quarter financial reports and our ongoing examinations;

4. The inability of the companies to raise capital or to issue debt according to normal practices and prices; and

5. The critical importance of each company in supporting the country's residential mortgage market.

Over the last month I shared our growing concerns with the Chairman of the Federal Reserve Board, Ben Bernanke, who was made our consultant by the recent legislation, and with Secretary Paulson. After I presented my assessment of these developments to each of the companies with Chairman Bernanke and Secretary Paulson, their CEOs and boards consented to the appointment of a conservator. I would like to trace for you these developments and how, taken together, they led FHFA to this conclusion.

In August of last year, it became apparent that the boom in subprime and nontraditional lending was coming to an abrupt end. In particular, subprime loans originated in 2006 and 2007 have been found to be far less creditworthy than market participants had expected. The downturn in house prices in many markets across the nation accelerated the growing recognition of the poor credit quality of these loans.

Through the fall and then winter, the market continued to struggle as house price declines continued and delinquencies rose. Liquidity in PLS backed by subprime and Alt-A loans evaporated, and prices fell due to growing liquidity and credit concerns. In the fourth quarter, with our strong urging, Fannie Mae and Freddie Mac raised $13.9 billion in preferred stock. As house prices continued to fall, concern spread from subprime to Alt-A mortgages, and then finally to prime mortgages. These concerns have been driven by the continued deterioration in house prices coupled with the alarming increase in mortgage delinquencies and defaults, even among prime mortgages.

In March, we announced with the Enterprises an initiative to increase mortgage market liquidity and market confidence. We reduced the OFHEO-directed capital requirements in return for their commitments to raise significant capital and to maintain overall capital levels well in excess of requirements. Fannie Mae raised $7.4 billion in May, but Freddie Mac never fulfilled its commitment to raise capital.

As described in our April 2008 Annual Report to Congress, OFHEO continued to classify each company as a significant supervisory concern. In that report, we described the significant remediation progress that took place during 2007 but pointed specifically to concerns with the deteriorating credit environment and the risks it posed to the companies. Over the summer, we intensified our focus on a full range of credit-related issues, including loan loss reserving, securities valuation, and the management of real-estate owned (REO) due to foreclosures.

It became apparent during this intense supervisory review that market conditions were deteriorating more quickly than the companies had anticipated and more quickly than they could respond to by adjusting their models and forecasts. After the late-July enactment of the Housing and Economic Recovery Act of 2008, and as provided by that act, we supplemented our own examination activity with consultations with senior mortgage credit examiners from the Federal Reserve and the Office of the Comptroller of the Currency. These examiners assisted and corroborated our own analysis of the deteriorating credit environment and its implications for the companies. It was clear that capital would be threatened by increasing loss reserves, impairments, counterparty risks and other accounting issues.

During the last part of July and in August, FHFA was completing its confidential semi-annual examination ratings. FHFA's rating system is called GSE Enterprise Risk or G-Seer. It stands for Governance, Solvency, Earnings and Enterprise Risk which includes credit, market and operational risk. There were significant and critical weaknesses across the board, which continued to worsen after the end of the second quarter.

The Enterprises themselves disclosed how the rapidly changing credit environment was affecting their outlook. Notably, in its second quarter 10Q filing, Fannie Mae took the unusual step of providing a statement on post-closing developments, describing the effect that market events in July had on the company's outlook:

"In mid-July, following the close of the second quarter, liquidity and trading levels in the capital markets became extremely volatile, and the functioning of the markets was disrupted. The market value of our common stock dropped rapidly, to its lowest level since October 1990, and we experienced reduced demand for our unsecured debt and MBS products. This market disruption caused a significant increase in our cost of funding and a substantial increase in mark-to-market losses on our trading securities arising from a significant widening of credit spreads. In addition, during July, credit performance continued to deteriorate, and we recorded charge-offs and foreclosed property expenses that were higher than we had experienced in any month during the second quarter and higher than we expected, driven by higher defaults and higher loan loss severities in markets most affected by the steep home price declines. Greater credit losses in July not only reduce our July net income through our actual realized losses, but also affect us as we expect that we will need to make further increases to our combined loss reserves in the second half of 2008 to incorporate our experience in July." (FNMA Form 10-Q, August 8, 2008, pages 5-6)

Freddie Mac also announced adverse recent developments under "Recent Events" on page 1 of its 10-Q, including its expectation of a substantial dividend cut in the third quarter to conserve capital, a highly dilutive capital raise, and limitations on its ability to serve its mission as a result of efforts to conserve capital:

"Since mid-June 2008, there has been a substantial decline in the market price of our common stock. The market conditions that have contributed to this price decline are likely to affect our approach to raising new core capital including the timing, amount, type and mix of securities we may issue. We have committed to the Office of Federal Housing Enterprise Oversight, or OFHEO, to raise $5.5 billion of new capital. We remain committed to raising this capital given appropriate market conditions and will evaluate raising capital beyond this amount depending on our needs and as market conditions mandate.

"Our financial performance for the second quarter, while reflecting the challenges that face the industry, leaves us capitalized at a level greater than the 20% mandatory target capital surplus established by OFHEO and with a greater surplus above the statutory minimum capital requirement. Given the challenges facing the industry, we expect to take actions to maintain our capital position above the mandatory target capital surplus. Accordingly, subject to approval by our board of directors, we currently expect to reduce the dividend on our common stock in the third quarter of 2008 from $0.25 to $0.05 or less per share and to pay the full dividends at contractual rates on our preferred stock. In addition, we continue to review and consider other alternatives for managing our capital including issuing equity in amounts that could be substantial and materially dilutive to our existing shareholders, reducing or rebalancing risk, slowing purchases into our credit guarantee portfolio and limiting the growth or reducing the size of our retained portfolio by allowing the portfolio to run off and/or by selling securities classified as trading or carried at fair value …" (FHLMC Form 10-Q, August 6, 2008, page 1)

As noted earlier, Freddie Mac never fulfilled its March 2008 commitment to raise capital. Its own projections as disclosed to analysts on August 6 showed that, in the absence of such a capital raise, it would be unable to meet its commitment to maintain capital in excess of regulatory requirements.

The internal supervisory reviews and market evidence just presented led us to conclude that the companies each presented critical safety and soundness concerns pertaining to credit risk and to continued deterioration in the market environment. Importantly, key developments in July and August demonstrated market recognition of these heightened credit concerns and the effect of the deteriorating market environment on the Enterprises. New equity capital in any meaningful size became unavailable, and yields on Enterprise debt and mortgage-backed securities rose relative to other benchmarks. These developments convinced us that the time to act was now, before the conditions of each Enterprise worsened, and before the markets for their securities became too unstable to permit normal business activity and potentially threatened the financial health of many other institutions. The following developments in July and August provide context to this conclusion:

July 7 – A Lehman Brothers report speculating on the need for the Enterprises to raise substantial capital should a proposed accounting rule to put MBS currently off-balance sheet on balance sheet be adopted sends Enterprise common share prices into a tailspin.

July 13 – Secretary Paulson announces a proposed package of assistance for the Enterprises in response to fears of a debt market run on Enterprise securities.

July 15 – Moody's cuts the bank financial strength rating from B to B- for Fannie Mae, from B+ to B- for Freddie Mac, and the preferred stock rating from Aa3 to A1 for both Enterprises.

July 30 – President signs the Housing and Economic Recovery Act of 2008. Since I took the job as Director of OFHEO, I have been requesting regulatory reform legislation that would give the regulator much stronger, bank-like authorities, including expanded authority to set capital requirements and establish prudential safety and soundness standards. I am very grateful that Congress granted those authorities to FHFA, but regrettably they arrived too late to establish a strong capital regime in advance of this credit cycle. Going forward, we will be working towards creating a sounder capital structure for the Enterprises.

August 6 – Freddie Mac files its 10-Q, reporting losses of $0.8 billion and describing the deteriorating capital situation as noted above. The loss was Freddie Mac's seventh quarterly loss over the past eight quarters.

August 8 – Fannie Mae files its 10-Q, reporting losses of $2.3 billion and describing its July results and credit deterioration as noted above. This marked the fourth consecutive quarter of losses for Fannie Mae.

August 11, Standard and Poors cuts subordinated debt and preferred stock ratings for each GSE from AA- to A-; the risk-to-the-government rating from A+ to A for Fannie Mae and AA- to A for Freddie Mac.

August 22, Moody's cuts the bank financial strength rating from B- to D+ for each Enterprise and the preferred stock ratings from A1 to Baa3 for each.

August 26, Standard and Poors cuts its subordinated debt rating from A- to BBB+, preferred stock from A- to BBB-, and risk to the government ratings from A to A- for each Enterprise.

September 5 – The Mortgage Bankers Association reports new record highs for seasonally-adjusted total delinquencies, rate of foreclosure starts, and percentage of loans in foreclosures, consistent with the trends identified by our examination process.

Throughout July and August other pressures were mounting that made it more and more difficult for Fannie Mae and Freddie Mac to fulfill their missions:

Increased headline risk led to increased scrutiny of GSE debt, including by foreign investors and their regulators.

Central banks ceased buying and began selling Enterprise securities; relatively small sales triggered large price moves.

Despite financing 30-year mortgages, the Enterprises had to rely on short-term discount notes, with only a few fixed-rate debt securities issued, none with maturity greater than three years. Yet they have $89 billion in long-term debt maturing in the second half of 2008.

The spread between senior and subordinated Enterprise debt rose from less than 100 basis points in late June to as much as 500 basis points by late August.

The spread between preferred stock and Treasuries jumped in early July, settled back a bit after the July 13th Treasury Department announcement, and then spiked in August to roughly double the mid-July spread and four times the late June spread.

Stock analysts substantially lowered their prices targets for Enterprise stock, in one case from $45 to $8 for Freddie Mac and in another from $48 to $10 for Fannie Mae.

Press speculation of a government bailout became more frequent.

After substantial effort and communication with market participants, each company reported to FHFA and to Treasury that it was unable to access capital markets to bolster its capital position without Treasury financing. FHFA's and Treasury's own discussions with investment bankers and investors corroborated this conclusion.

In the absence of access to new capital, the only alternative left to the firms was to cease new business and shed assets in a weak market. That would have been disastrous for the mortgage markets as mortgage rates would have continued to move higher and, in turn, disastrous for the Enterprises as the prices of their securities would have fallen and credit losses would have increased.

Therefore, in order to restore the balance between safety and soundness and mission, FHFA placed Fannie Mae and Freddie Mac into conservatorship. That is a statutory process designed to stabilize a troubled institution with the objective of maintaining normal business operations and restoring its safety and soundness.

FHFA did not undertake this action lightly. We consulted with the Chairman of the Board of Governors of the Federal Reserve System, Ben Bernanke, who was made a consultant to FHFA under the new legislation. We also consulted with the Secretary of the Treasury, not only as an FHFA Oversight Board member, but also in line with his ability under the law to provide financing to the GSEs. They both concurred with me that conservatorship needed to be undertaken.

FHFA will act as the conservator to operate the Enterprises until they are stabilized. The Treasury's financial commitments, authorized by the new law, were critical to creating a workable conservatorship structure.

Operating the Enterprises in Conservatorship

Let me now turn to the conservatorships. Although it is very early, the first signs are that the conservatorships have had a very positive impact on mortgage markets. A lack of confidence had resulted in continued widening of the spread between yields of their MBS and yields of Treasury securities, which meant that virtually none of the large drop in Treasury interest rates over the past year had been passed on to the mortgage markets. On top of that, Freddie Mac and Fannie Mae, in order to try to build capital, may have raised prices and tightened credit standards beyond what was necessary for sound underwriting. I am pleased to say early indications are that the Enterprises' funding costs have declined, as have spreads on mortgage securities, as denoted in the attached chart. This lower cost has been passed on to homebuyers, with 30-year fixed-rate mortgage rates below 6 percent for the first time since January.

There are several key components of this conservatorship:

On the first day of the conservatorship businesses opened as normal, only with stronger backing for the holders of MBS, senior debt and subordinated debt. Consistent with the terms of the Treasury's financial assistance, over the next 15 months we will allow each company to increase its portfolio, up to $850 billion, before requiring gradual declines in the portfolios of 10 percent per year. That is less than their runoff rate. The Enterprises are allowed to grow their guarantee MBS books without volume limits.

As the conservator, FHFA assumed the power of the board and management. However, new Chief Executive Officers and Boards of Directors will have significant powers. I have selected Herb Allison to be the new CEO of Fannie Mae and David Moffett the CEO of Freddie Mac. Herb has been the Vice Chairman of Merrill Lynch and for the last eight years chairman of TIAA-CREF. David was the Vice Chairman and CFO of US Bancorp. I appreciate the willingness of these two men to take on these tough jobs during these challenging times. Their compensation will be significantly lower than the outgoing CEOs.

Although it is not necessary in a conservatorship, new boards are being formed as a matter of good governance. New non-executive Chairmen were announced yesterday. Philip Laskawy, former Chairman and CEO of Ernst and Young, and a Director for Loews Corporation, General Motors, Henry Schein, Inc., and Discover Financial

Services, has agreed to be the Chairman of Fannie Mae. John Koskinen, former President and CEO of Palmieri Company, a corporate turnaround management company, former Deputy Director for Management at OMB, and Director for American Capital Ltd., has agreed to be the Chairman of Freddie Mac.

The present CEOs will be leaving, but have agreed to stay on for a time to help with the transition. Consistent with the authorities granted in HERA, I have determined not to pay any golden parachute payments to either departing CEO.

FHFA worked with the new CEOs to establish employee retention programs. They agreed with me that it is 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.

All political activities -- including all lobbying -- were halted immediately. We will review the charitable activities to ensure that it reflects their mission and their conservatorship status.

In order to conserve over $2 billion in capital every year, the common stock and preferred stock dividends were eliminated, but the common and all preferred stocks will continue to remain outstanding. I recognize that the loss of dividend income may have an adverse affect on some investors, including depository institutions. Before taking our action, we consulted with the bank regulators and I understand that they are working with individual institutions under their jurisdiction that may have capital invested in Enterprise preferred stock. As you know, any preferred stock is part of the issuing firm's equity account and is issued to absorb losses ahead of debt holders. Subordinated debt interest and principal payments will continue to be made, even if the capital test is breached.

Finally and very importantly, there are the liquidity, MBS investment, and senior preferred stock facilities with the U.S. Treasury, which Secretary Paulson discussed. We believe that these facilities will provide critically needed support to Freddie Mac and Fannie Mae to fulfill their mission, most importantly of which is the liquidity of the mortgage market. In light of Treasury's senior preferred stock facility, we will continue to closely monitor capital levels, but the existing regulatory capital requirements will not be binding during the conservatorship. The Senior Preferred facility supports all past and future debt and MBS issuances, until the terms of the facility are completely satisfied. As SEC registrants the Enterprises will continue to report their financial results quarterly.

The secured liquidity facility is not only for Fannie Mae and Freddie Mac, but also for the 12 Federal Home Loan Banks that FHFA also regulates. The Federal Home Loan Banks have performed remarkably well over the last year as they have a different business model than Fannie Mae and Freddie Mac and a different capital structure that grows as their lending activity grows. They are jointly and severally liable for the Bank System's debt obligations and all but one of the 12 are profitable. Therefore, it is very unlikely that they will use the facility.

Let me now bring you up-to-date on our actions since September 7. The new CEOs were introduced to Enterprise senior management at separate meetings at FHFA offices on Sunday, September 7. To reassure financial counterparties, later that day FHFA posted a statement on its website emphasizing that all existing contracts with the Enterprises remain in effect, that the Enterprises have the authority to enter into new contracts, and that the enforceability of such new contracts is not affected by the appointment of the conservator. I also sent a statement to employees at both Enterprises explaining the conservatorships, and that the purposes of the action are to help restore confidence in the Enterprises, enhance their ability to fulfill their mission, and mitigate systemic risk.

Since the Enterprises opened for business on September 8, FHFA examiners have been continuously on site, both at the Enterprises' headquarters and locations of other key operations, to ensure a smooth transition. FHFA examiners are there to reassure Enterprise employees about the business-as-usual objective of the conservatorship, to allay fears and dispel rumors, to provide information to employees, to support the needs of the new CEOs as they become familiar with their new organizations, and to communicate any questions and issues that need resolution back to me as FHFA Director.

During the conservatorship period, FHFA will continue to work expeditiously on the many regulations needed to implement the new law. Some of the key regulations will be minimum capital standards, prudential safety and soundness standards and portfolio limits. It is critical to complete these regulations so that any new investor will understand the investment proposition.

Affordable Housing and Mission

The new legislation, for the first time, adds affordable housing and mission enforcement to the responsibilities of the safety and soundness regulator. While FHFA has had these responsibilities for only a matter of weeks, they rank among our most immediate concerns in making the determination to place the Enterprises into conservatorship. In short, a key reason for moving quickly rather than waiting any longer was that the companies' abilities to serve their mission had been impaired. As I noted earlier, ceasing new business activity and shedding assets was not acceptable, especially given the Enterprises' public purpose.

As the companies operate in conservatorship, I have already instructed each new CEO to examine the underwriting standards and pricing. They have begun to do so, and I expect any changes to reflect both safe and sound business strategy and attentiveness to the Enterprise's mission.

Fannie Mae and Freddie Mac are important to the secondary market for multifamily loans, and multifamily lending is critical to the affordable housing mission of the Enterprises. I am determined to ensure that, in conservatorship, both Enterprises remain dedicated to, and actively involved in, multifamily lending. I released a statement to this effect last Friday so that market participants may have assurance that the Enterprises will continue to be a source of underwriting and financing for multifamily loans.

The new legislation established a Housing Trust Fund to increase and preserve the supply of rental housing for extremely low and very low income families, including homeless families, and to increase homeownership for extremely low and very low income families. I recognize the importance of the Housing Trust Fund to many members of Congress. In the near-term, these funds will be used to fund a key component of the new law, the FHA HOPE for Homeowners Program, which will be funded by Treasury if the Enterprises do not.

Congress required that the FHFA Director consider annually circumstances in which such allocations would be suspended. Accordingly, I intend to make that determination only after a careful and thorough review of existing conditions.

Enforcement of the affordable housing goals established for the Enterprises by the Congress, once HUD's responsibility, is now up to FHFA. While ensuring liquidity in the mortgage marketplace has necessarily been a primary focus in recent weeks and months, ensuring that low and moderate income persons and underserved areas have ready access to affordable mortgage loans remains a critical responsibility of the Enterprises. In the near-term, the Enterprises are charged with meeting the very ambitious goals set by HUD back in 2004, a year in which the mortgage marketplace looked far, far different than it does today. In 2007, they missed two subgoals. Based on our discussions with the Enterprises, the miss will be larger in 2008. With the Enterprises now in conservatorship, even if some or all of these goals are found to be unattainable, I will expect each Enterprise to develop and implement ambitious plans to support the borrowers and markets targeted by the goals.

If we are to address the problem of mortgage delinquencies, a systematic approach to loan modification is essential. Well before last week's actions, we had already asked the Enterprises to facilitate the loan modification program the FDIC has undertaken with IndyMac Federal. I expect the ongoing work on loan modifications being done there, and with other seller servicers, to continue to be a high priority for the conservatorships, both as a matter of good business and as a matter of supporting the Enterprises' mission.

Finally, I am pleased to report that FHFA expects to have a regulation in place by October 1 to implement Section 1218 of HERA, which provides temporary authority for the Federal Home Loan Banks to use a portion of the subsidy money in Affordable Housing Program to refinance mortgages for families at or below 80 percent of area median income. In broad terms, we intend to issue a regulation implementing this program so that it supports the refinance program in HERA's Hope for Homeowners program by permitting AHP funding of additional principal write-downs or payment of closing costs. We've discussed this initiative with the FHA, which is very supportive of the prospect of added support on this initiative.

Conclusion

The decision to appoint a conservator for each Enterprise was a tough one for the FHFA team members who as they have worked so hard to help the Enterprises remain strong suppliers of support to the secondary mortgage markets. Unfortunately, all the good and hard work put in by the FHFA teams and the Enterprises' managers and employees was not sufficient to offset the consequences of the antiquated capital requirements and the turmoil in housing markets. Conservatorship will give the Enterprises the time to build on progress already made, to address more recently developing concerns, and ultimately, to restore the balances between safety and soundness and affordable housing market stability and liquidity. I want to thank the FHFA employees for their work during this intense regulatory process. They represent the best in public service.

I also recognize that many employees at each company have been working extremely hard through years of remediation and through the past year of market volatility. Employees have lost personal savings as a result of the plummet in their company's stock price and they have been working, and continue to work, long hours in the face of uncertainty. To them, I say thank you and pledge that, as conservator, we share the common goal of stabilizing your company while ensuring it continues to serve its public purpose of providing stability, liquidity, and affordability to the mortgage market.

Working together we can finish the job of restoring confidence in the Enterprises and with the new legislation build a stronger and safer future for the mortgage markets, homeowners and renters in America.

Thank you. I would be pleased to answer any questions you may have.