Statement of

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Acting Director
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Before the U.S. Senate
Committee on Banking, Housing, and Urban Affairs

"Oversight of the Federal Housing Finance Agency"

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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 two 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 three 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 six 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 recognition 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 non-agency securities. This was partially offset by a two 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 two 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 homeownership. 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 Treasury 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 non-performing 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 seven percent, and private-label mortgage-backed securities (PLMBS) were four 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 five 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 three 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, replaced 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 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 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 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 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 two 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 one-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 five-year average of 8 ½ percent. Fannie Mae's has risen to about an 11 percent annual rate so far this year after averaging a bit above six percent over the preceding three 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.