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Introduction

Good morning Chairman Johnson, Ranking Member Crapo and members of the Committee. My name is John Bovenzi, and I am a Partner at Oliver Wyman, a business unit of Marsh & McLennan Companies (MMC). I would like to thank you for affording me an opportunity to share my perspective on housing finance reform.

Much of my perspective on housing finance reform draws on my 28 years of experience at the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC). I served as Deputy to the Chairman of the FDIC from 1989 through 1992, the period of time when the FDIC was responsible for establishing and managing the RTC. From 1992 to 1999, I was Director of the FDIC's Division of Resolutions and Receiverships and played a key role in merging the RTC into the FDIC. From 1999 to 2009, I served as Deputy to the Chairman and Chief Operating Officer at the FDIC.

I believe there is much of value in the FDIC's and the RTC's experience that can be helpful to the committee as it determines the best path forward for housing finance reform.

Overview of the FDIC and the RTC

First, let me briefly provide an overview of the two agencies' missions and responsibilities.

As you know, the FDIC is an independent agency created by Congress in the aftermath of the Great Depression. Its mission is to maintain stability and public confidence in our nation's financial system, and it has three primary roles through which it carries out this mission: (1) by insuring deposits, (2) by examining and supervising financial institutions for safety and soundness and consumer protection, and (3) by managing receiverships of failed institutions.

The RTC was a temporary federal agency established under the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) in August of 1989. Its mission was to manage the assets and liabilities of Savings & Loan Institutions (S&L's) that had been placed into conservatorship. The agency's goal was to dispose of these assets as quickly as practicable at maximum value in order to reduce taxpayer expense.

The RTC resolved 747 S&L's with assets totaling nearly $400B during its six-year existence. While heavily criticized at the time, today, the RTC is widely viewed as a success story. The total cost to taxpayers from the failed S&L's wound down by the RTC was about $80B, a far lower number than originally projected. After its work was done, the RTC demonstrated that a government agency can put itself out of business effectively and efficiently once its mission has been accomplished.

How the FDIC's and the RTC's experience can be applied to a new Federal Mortgage Insurance Corporation

Title 1 of the "Housing Finance Reform and Taxpayer Protection Act" would create a new Federal Mortgage Insurance Corporation (FMIC) to provide insurance protection for mortgage-backed securities. In the proposed legislation, the new FMIC is modeled to a large extent after the FDIC, so observations on the FDIC's structure and experience may be useful. Also, as a start-up federal agency, the RTC experience in establishing itself also should be of value.

Lessons from the RTC's experience

I'll start with the RTC's experience in creating a new federal agency, since I believe that is where we can learn the most. There are three important points I would like to make at the outset.

First, the creation and subsequent experience of the RTC show that a new federal agency can start up and be successful in a relatively short period of time. However, the RTC experience also shows that the complexity of the political and operational issues that must be addressed requires that stakeholders show some degree of patience. There will be bumps, missteps and delays along the way.

Second, the leadership of such an organization is critically important. The Director will need to possess both the skills to work effectively with a large number of stakeholder groups, as well as the managerial skills to effectively address the many operational issues that will be faced by a new agency.

Third, ultimately the employees of the two government sponsored enterprises and the Federal Housing Finance Agency (FHFA) will determine whether the start-up is a success or a failure. They are the people who have the ability to effectively transfer critical functions to a new agency. Their experience and expertise should not be undervalued or lost if Congress decides to move in the direction of the proposed legislation.

Let me elaborate on these three points.

Regarding the first point, that time and patience will be necessary, when the RTC was created, it needed a new governance structure, new information systems, new staff, and new policies and procedures. The FDIC was able to provide a great deal of support, but not nearly enough. Initially, seven hundred employees were transferred from the FDIC to the RTC. Still, the RTC needed to hire many more employees and contractors. Both the internal hiring and contractor procurement processes had to be fair and transparent, with all of the necessary controls, including background checks. This took time, when people outside the agency were more focused on seeing immediate results.

To get off to a faster start, the RTC initially adopted many of the FDIC's policies and procedures, but these proved to be insufficient. The RTC's mission and duties were not the same as the FDIC's so most of those policies and procedures needed to be revised or created from scratch, generally with sufficient time for public comment and revisions based on those comments. Information systems were an even greater challenge. The FDIC's systems were not suited for the RTC's needs. New systems had to be created, only to be populated with poor data from insolvent S&L's. Finally, as a political compromise, the RTC's governance structure started out with two Boards of Directors, one for policy and one for operations. The blurred line between these two sets of responsibilities led to finger pointing and a lack of accountability.

As a result, the RTC's start-up went slower than what most observers had hoped for and there was a great deal of frustration with the RTC. But some perspective is necessary. The RTC successfully managed its way through those problems and today is widely viewed as a success story. The agency saved taxpayers money and finished its work early.

Regarding the second point, that the new agency's leadership will need to possess both leadership and management skills, I'll simply say that while this may be obvious to most people, there is an occasional tendency for the leadership of a government agency to focus almost exclusively on high level policy issues and not give sufficient attention to operational details. A director need not personally focus on all of the operational details involved in the start-up of a government agency, in fact that would be counterproductive. However, that person must have a clear appreciation of the significance of internal operations and ensure there are clear delegations of authority and accountability.

As to the third point, that a new agency's success or failure will be determined by the employees of the GSE's and the FHFA, there are a few issues that Congress should consider based on the RTC's experience.

Title 3 of the proposed legislation abolishes the Federal Housing Finance Agency and transfers its staff, infrastructure, technology and other resources to the FMIC, but the bill is silent as to the fate of the employees of Fannie Mae and Freddie Mac. If those two enterprises are to be shut down some of their operations will have to be transferred to the FMIC or elsewhere, which means some jobs would become available in other organizations. But the uncertainty surrounding how many jobs will be available, on what terms, and who will get them will create significant complications in ensuring a smooth transition. The experience and the expertise of Fannie Mae's and Freddie Mac's employees will be needed to have an effective transition, so some thought needs to be given as to how that skill and talent can be preserved.

As a limited life agency, the RTC's employees knew that by doing their jobs correctly they might be putting themselves out of a job. The same applied to the FDIC's employees who were responsible for handling the spike in bank closings. Eventually the economy would recover and their workload would vanish.

Certain steps were taken to mitigate the harmful effects on the RTC's and the FDIC's employees. By law, RTC employees also were FDIC employees, thus they had the same rights as FDIC's employees. This meant that when the two agencies were merged together the career civil servants in each agency had equal rights to the remaining jobs. Other FDIC and RTC employees who had been hired on a temporary basis were in a more tenuous position. In most cases, they were not likely to have their contracts renewed once the workload diminished to the point where staff reductions were necessary.

To the credit of the employees at both agencies, they continued to do their jobs effectively even though they did not know if, or for how long, those jobs might last. Indeed after the two agencies were merged together, the FDIC had to undergo a large and painful downsizing given the substantial reduction in its workload in going from the crisis to the post-crisis period.

Throughout that difficult period constant and clear communication was critical. Employees needed as much information as possible so they could better plan for their future. The same would be true here. It will not be possible to provide jobs for everyone and some attrition will certainly occur, but should Congress go down this path, the employees at the GSE's should know that they will be treated fairly and respectfully.

Lessons from the FDIC's Experience

Regarding lessons that may be learned from the FDIC's experience, I would like to make some comments on three broad areas: (1) corporate governance; (2) financial strength, and (3) the supervision of financial-sector participants.

Corporate Governance

Independence and a system of checks and balances are two important features of the FDIC's governance structure that have served the agency well over time. These features also are part of the proposed structure for the Federal Mortgage Insurance Corporation.

Once certain parameters have been established around an agency's power and authority, an independent structure allows an agency to carry out its duties in a responsive manner. Because the market is constantly changing, an agency needs the ability to continually assess new information and adapt to those changes.

The FDIC has a five person Board of Directors, each appointed by the President and confirmed by the Senate. No more than three Board members may be from the same political party. In my view, this structure has served the FDIC well over time by providing appropriate checks and balances on important policy decisions.

The FDIC also has a strong Office of the Inspector General that provides independent reviews of the agency's operations to prevent waste, fraud and abuse. The Inspector General is appointed by the President and reports directly to Congress as well as to the FDIC Chairman. This too has served the FDIC well as part of an overall system of checks and balances. The creation of an Office of the Inspector General is an important safeguard that has been included in the proposed bill.

Based on my experience it appears that the proposed bill covers the most important aspects of creating a strong governance structure.

Financial Strength

Much has been learned over the past thirty years about what is required to maintain a deposit insurance fund strong enough to not have to rely on taxpayer support during a financial crisis. During the 1980's and early 1990's nearly 3,000 insured depository institutions became insolvent and were closed. As a result, the Bank Insurance Fund became insolvent. While the FDIC did not have to rely on taxpayer support, it did have to substantially raise bank deposit insurance premiums during the crisis period, when banks could least afford to pay more. This had several adverse effects, not the least of which was exacerbating the credit crunch that existed at that time.

Because of that experience, Congress relaxed some of the controls on the FDIC's ability to manage the size of its deposit insurance fund, but it was not enough. During the 2008 financial crisis the FDIC's deposit insurance fund again had insufficient funds. The agency did not have to rely on taxpayer support, but once more it did have to charge banks substantially higher premiums when banks could least afford to pay them. As a result Congress further relaxed the controls on the FDIC's ability to assess high enough premiums over the course of the business cycle. Now the agency has the authority it needs to build the deposit insurance fund to high enough levels that it can withstand a crisis period. This new authority allows the FDIC to charge higher premiums during the healthy part of the economic cycle, so it will not be forced to further dampen credit availability during an economic downturn.

The proposed bill includes targets for the size of the FMIC's Mortgage Insurance Fund. After the first five years of its existence the FMIC is expected to have charged participating institutions fees sufficient to create a fund that is 1.25% of all outstanding covered securities. After ten years the ratio is targeted to be 2.5% of all outstanding covered securities. It is difficult to know what size fund is needed to protect taxpayers against losses. For many years the FDIC's statutory target ratio of the deposit insurance fund to insured deposits was 1.25%. Prior to the 1980's the rationale was that while arbitrary, history had shown that the 1.25% target ratio worked. In the aftermath of two financial crises it was clear the 1.25% ratio did not work. Since then the FDIC analyzed what fund size would have been necessary to keep the deposit insurance fund from becoming insolvent. That review led the agency to raise its target ratio to 2%.

The important point is that the FMIC will need sufficient flexibility and authority to manage the size of the Mortgage Insurance Fund based on continuous analysis so it can protect taxpayers against losses during economic downturns.

Supervision of Financial-Sector Participants

The FDIC sets standards for bank behavior. The agency has the authority to set entry standards for groups that seek to obtain bank charters and the authority to remove deposit insurance protection for banks that aren't meeting those standards. In between, the FDIC has a wide range of formal and informal enforcement actions it can employ to force banks to meet its supervisory standards without removing a bank's deposit insurance coverage. These authorities include issuing formal cease-and-desist orders, civil money penalties, and agreeing to informal memoranda of understanding. The FDIC also has examination authority to ensure banks are in compliance with FDIC supervisory standards and to determine whether enforcement actions are necessary. Also, to help ensure that supervisory actions are taken in a timely manner, the FDIC is subject to Prompt Corrective Action requirements, which mandate that certain supervisory actions be taken as bank capital levels drop below prescribed levels. In their entirety these powers are an important part of safeguarding the financial system and protecting the deposit insurance fund.

The proposed bill would grant some, but not all, of these authorities to the FMIC. The new agency would have authority to determine entry standards for mortgage servicers, issuers, and guarantors. Those standards track the FDIC standards in many respects, since they include a review of the financial history of the applicant, its capital adequacy, the character of management and the risk posed to the insurance fund. The bill also empowers the FMIC to issue civil money penalties and revoke its approval if a participating institution does not continue to meet its standards. However, the bill does not grant the FMIC examination authority, nor does it allow for a full range of enforcement actions.

Based on my experience, it would be worth considering whether the FMIC should be granted broader supervisory and enforcement authorities beyond controlling entry and exit into and out of the program and the ability to issue civil money penalties. The FDIC has rarely used its power to revoke deposit insurance coverage, finding it to be a cumbersome process compared to its other enforcement alternatives such informal memoranda of understanding and formal cease-and-desist orders. The FMIC likely would have the same experience. Other more practical enforcement tools may be more effective in helping the FMIC accomplish its objectives. Also, consideration should be given to giving the FMIC examination authority. While off-site monitoring can be used to help monitor bank behavior, over time the FDIC has found there is no substitute for the direct interaction with bank management that occurs during the examination process.

How the RTC's experience can be applied to the proposed wind down of Fannie and Freddie

Title 5 of the "Housing Finance Reform and Taxpayer Protection Act" requires that Fannie Mae and Freddie Mac be wound down and phased out of business over a five-year period. The RTC had a similar requirement in its original charter. By statute the agency, which was created in 1989, had to be wound down and merged into the FDIC by year-end 1996. It accomplished that objective a year earlier than originally planned. Given those similarities there may be some valuable lessons based on the RTC's experience should Congress determine that it wants to wind down Fannie and Freddie's operations. We already covered issues related to the treatment of the GSE's employees so I won't repeat those concerns here, rather I'll talk briefly about governance issues and sales processes.

Corporate Governance

Many of the same governance principles that apply to the creation of a new agency also apply to the wind down of an existing agency or agencies. Strong oversight is critical because taxpayer dollars and important public policy objectives are at stake.

The RTC was governed by a Board of Directors with additional oversight provided by Congress, an Office of the Inspector General, and the General Accounting Office (GAO), among others. Such checks and balances, while introducing some degree of inefficiency, are well worth the costs in order to ensure there are strong oversight, effective internal controls, and fair processes.

Sales Processes

According to the proposed legislation, Fannie Mae and Freddie Mac should have no more than $552.5B in real estate related assets (mortgage loans and mortgage-backed securities) by year-end 2013. The bill requires that these assets be reduced by at least 15% a year over a five-year period. Any remaining assets are to be put into receivership after that point. This is not significantly different than what the RTC was charged with accomplishing. Most of the $400B in assets from the insolvent S&L's that the RTC was responsible for also were real estate related assets.

The RTC experimented with a large variety of sales processes for the different types of assets it managed. It learned much through trial and error, but a few key principles emerged to help guide the agency.

First, virtually all sales were subject to an inclusive, open and transparent competitive bidding process. The RTC did not engage in negotiated sales with individual buyers for pools of assets, despite the desire for such by many potential buyers. The agency recognized that open competition would maximize value and that it also reduced the possibilities for fraud or abuse. Given that a number of the insolvent S&L's that were costing taxpayer money had committed fraud and abuse, it was that much more important that the government cleanup be beyond reproach.

Second, the RTC partnered with the private sector in the disposition of many its assets. For pools of assets that required particular expertise, the RTC found it best to sell a portion of the pool to private-sector investors with the required expertise and retain partial ownership of the assets. Such partnerships allowed the RTC, and hence taxpayers, to benefit from the added value the right management could bring to those assets as well as from any appreciation in assets value over time due to an improving economy.

Such public/private-sector partnerships in managing and disposing of assets aren’t without their challenges. Often both sides have a healthy degree of mistrust for one another. The private sector often views the government as an unreliable and slow business partner, while the government often sees the private sector as overly focused on its financial returns and under appreciative of the types of processes and controls that must be put into place whenever taxpayer money is at stake.

These differences can be overcome by clarifying up front what the expectations are for each business partner. The government needs to understand that financial incentives for the private sector maximize value for taxpayers. Private sector asset managers need to understand that they have to comply with certain processes and oversight that they may view as inefficient and time consuming, but that are necessary to show the public that the overall process is being managed in a way that treats people fairly and shows them that their money is not being wasted.

During the most recent financial crisis the FDIC effectively used public/private equity partnerships (and the closely related loss-sharing agreements it entered into with the acquirers of insolvent banks) to manage many of the assets it was responsible for as receiver for failed banks. It found that these partnerships greatly enhanced asset values and returns to failed-bank creditors, including the FDIC’s deposit insurance fund.

Such agreements between the public and private sector, while valuable in certain situations, are not necessarily the preferable sales technique in all situations. Some assets can be sold outright and still maximize value, in part by eliminating ongoing commitments and administrative burdens on the part of the government. Each asset category and situation should be evaluated on its own merits to determine the best strategy.

As the Committee and the Congress deliberate further on this important issue, I and my colleagues at Oliver Wyman are ready to collaborate with you to offer our experience and expertise on this key public policy matter.