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THE ROLE OF FANNIE MAE AND

FREDDIE MAC IN THE FINANCIAL CRISIS

Tuesday, December 9, 2008

House of Representatives,

Committee on Oversight and

Government Reform,

Washington, D.C.

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The committee met, pursuant to call, at 10:04 a.m., in Room 2154, Rayburn House Office Building, Hon. Henry A. Waxman [chairman of the committee] presiding.

Present: Representatives Waxman, Towns, Kanjorski, Maloney, Cummings, Kucinich, Davis of Illinois, Tierney, Clay, Lynch, Yarmuth, Braley, Norton, Cooper, Van Hollen, Murphy, Sarbanes, Speier, Burton, Shays, Mica, Souder, Platts, Turner, Issa, Westmoreland, McHenry, Foxx, Bilbray, Sali, and Jordan.

Staff Present: Phil Barnett, Staff Director; Kristin Amerling, Chief Counsel; Karen Lightfoot, Communications

Director and Senior Policy Advisor; David Rapallo, Chief Investigative Counsel; John Williams, Deputy Chief Investigative Counsel; Michael Gordon, Senior Investigative Counsel; David Leviss, Senior Investigative Counsel; Russell Anello, Counsel; Stacia Cardille, Counsel; Margaret Daum, Counsel; Alison Cassady, Professional Staff Member; Anna Laitin, Professional Staff Member; Earley Green, Chief Clerk; Jennifer Berenholz, Assistant Clerk; Alexandra Golden, Investigator; Caren Auchman, Communications Associate; Zhongrui "JR" Deng, Chief Information Office; Leneal Scott, Information Officer; Mitch Smiley, Staff Assistant; Matt Weiner, Staff Assistant; Lawrence Halloran, Minority Staff Director; Charles Phillips, Minority Senior Counsel; Brien Beattie, Minority Professional Staff Member; Molly Boyl, Minority Professional Staff Member; Larry Brady, Minority Senior Investigator and Policy Advisor; Christopher Bright, Minority Senior Professional Staff Member; Alex Cooper, Minority Professional Staff Member; John Cuaderes, Minority Senior Investigator and Policy Advisor; Adam Fromm, Minority Professional Staff Member; Todd Greenwood, Minority Professional Staff Member; Mark Lavin, Minority Army Fellow; Patrick Lyden, Minority Parliamentarian and Member Services Coordinator; Brian McNicoll, Minority Communications Director; and John Ohly, Minority Professional Staff Member.

Chairman WAXMAN. The committee will please come to order.

Today we are holding the committee's sixth hearing on the financial crisis. To date, we have examined the bankruptcy of the Lehman Brothers, the fall of AIG, and the role of credit-rating agencies. We held a hearing with Federal regulators and one with the Nation's most successful hedge fund managers. Today's hearing will focus on the collapse of two government-sponsored mortgage financing enterprises, Fannie Mae and Freddie Mac.

On September 7th, the Treasury Department took control over Fannie and Freddie. The companies have now been given access to $200 billion in capital from the Federal Government. Our job today is to examine why Freddie and Fannie failed.

As part of our investigation, the committee obtained nearly 4,000 documents from Fannie Mae and Freddie Mac. These documents show that the companies made irresponsible investments that are now costing Federal taxpayers billions of dollars.

One key document is a confidential presentation from the files of Fannie Mae's CEO, Daniel Mudd. According to this document, the company faced a strategic crossroads in June of 2005. The document states, "We face two stark choices: one, stay the course; or, two, meet the market where the market is." Staying the course meant focusing predominantly on more secure, prime and fixed-rate mortgages. The presentation explained that this option would, quote, "maintain our strong credit discipline and protect the quality of our book."

But according to the confidential presentation, the real revenue opportunity was in buying subprime and other alternative mortgages. To pursue this course, the company would have to, quote, "accept higher risk and higher volatility of earnings," end quote. This presentation recognized that homes were being utilized like an ATM. It acknowledged that investing in subprime and alternative mortgages would mean higher credit losses and increased exposure to unknown risks, but the lure of additional profits proved to be too great.

The documents make clear that Fannie Mae and Freddie Mac knew what they were doing. Their own risk managers raised warning after warning about the dangers of investing heavily in the subprime and alternative mortgage market, but these warnings were ignored.

In 2004, Freddie Mac's chief risk officer sent an e-mail to CEO Richard Syron urging Freddie Mac to stop purchasing loans with no income or asset requirements as soon as practicable. The risk officer warned that mortgage lenders were targeting borrowers who would have trouble qualifying for a mortgage if their financial position were adequately disclosed and that the, quote, "potential for the perception and the reality of predatory lending with this product is great." But Mr. Syron did not accept the chief risk officer's recommendation. Instead, the company fired him.

A year later, on November 10, 2005, a top Fannie Mae official warned, quote, "Our conclusion has consistently been that the lowering of risk in many of these private-label securities has not adequately been reflected in their pricing," end quote.

On October 28, 2006, Fannie's chief risk officer sent an e-mail to company CEO Daniel Mudd warning about a serious problem at the company. He wrote, quote, "There is a pattern emerging of inadequate regard for the control process," end quote. In another e-mail on July 16, 2007, the same risk officer wrote to Mr. Mudd again, this time complaining that the Board of Directors had been told falsely that, quote, "we have the will and the money to change our culture and support taking more credit risk," end quote. The risk officer wrote, "I have been saying that we are not even close to having proper control processes for credit market and operational risk. I got a 60 percent budget cut. Do I look stupid?"

But these warnings were routinely disregarded. In one 2007 presentation, the management of Fannie Mae told the Board, quote, "We want to go down the credit spectrum. Subprime spreads have widened dramatically to their widest level in years. We do not feel there is much risk going down to AA and A. We don't expect to take losses at AA and A level. Eventually we want to go to BBB. We want to move quickly while the opportunity is still here."

Taking these risks proved tremendously lucrative for Fannie and Freddie's CEOs. They made over $40 million between 2003 and 2007. But their irresponsible decisions are now costing the taxpayers billions of dollars.

At an earlier hearing, the minority, Republicans, released a report that called Fannie and Freddie, quote, "the central cancer of the mortgage market, which has now metastasized into the current financial crisis," end quote. The next day, John McCain made a similar statement during a presidential debate in Nashville, stating that, quote, "Fannie and Freddie were the catalyst, the match that started this forest fire," end quote.

The documents do not support these assertions. The CEOs of Fannie and Freddie made reckless bets that led to the downfall of their companies. Their actions could cost taxpayers hundreds of billions of dollars. But it is a myth to say they were the originators of the subprime crisis. Fundamentally, they were following the market, not leading it.

It is also a myth to blame the Nation's affordable housing goals. The bulk of Fannie and Freddie's credit losses, nearly $12 billion so far this year, are the result of their purchases of Alt-A loans and securities. Because many of these risky loans lack full documentation of income, they did not help the companies meet their affordable housing goals.

At today's hearing, we will have the opportunity to question four former CEOs of Fannie Mae and Freddie Mac, and I thank them for their cooperation. I also want to thank the companies themselves for cooperating with the committee's investigation.

But I especially want to thank and congratulate the members of this committee for their work in this Congress. This will be the last full committee hearing we will hold this year, and it will be the last Oversight Committee hearing that I will chair.

It has been a tremendous honor to chair this committee. We began our oversight efforts in February of 2007, with 4 days of back-to-back hearings on waste, fraud, and abuse in Federal spending. We investigated the missing $8 billion in cash handed out in Iraq, the actions of Blackwater's private security guards, the politicization of Federal science, high drug prices, and CEO pay. We took testimony from Valerie Plame and Condoleezza Rice, Kevin Tillman and Donald Rumsfeld, Roger Clemens and Brian McNamee, and dozens of corporate and government leaders. And our actions were the catalyst for legislative changes that will save the taxpayers billions of dollars.

It has been a busy schedule, but the one constant of all of this has been the dedication and commitment of the members of the committee. Oversight is not easy. To have an impact, you have to work hard and know your facts, and that is what the members have done in hearing after hearing. I will always be proud of the work of this committee and even prouder of the members with whom I have had the great fortune to serve.

I know that this committee will do great things next year under the leadership of your new chairman and your new ranking member. And I want you to know that I will miss being here, and it has been a tremendous privilege for me to serve with you.

And I want to recognize the ranking member of the committee, Mr. Issa, for his opening statement.

Mr. ISSA. Thank you, Mr. Chairman.

Before I begin, I would ask unanimous consent that my colleagues from Financial Services, the ranking member, Mr. Bachus, and Mr. Garrett of New Jersey, would be permitted to participate in this hearing today.

Chairman WAXMAN. Without objection, that will be the order.

Mr. ISSA. Mr. Chairman, I additionally ask unanimous consent that documents produced pursuant to the request by the committee, including certain e-mails, memorandum, and presentations of Fannie Mae and Freddie Mac, be inserted into the record of this hearing.

Chairman WAXMAN. If you gentlemen would withhold that unanimous consent request, we just want to be sure we are talking about the same documents.

Mr. ISSA. Of course, Mr. Chairman.

Chairman WAXMAN. Thank you.

Mr. ISSA. Mr. Chairman, also before I begin, on behalf of Ranking Member Tom Davis, who, as you know, has now left the Congress just slightly early, I have had the honor of serving with you and serving with Mr. Davis for these last 2 years. Although we have not always agreed--as a matter of fact, we have not often agreed--the elevation of this committee by your tireless effort has, in fact, put this committee where it should be: at the center of Congress's oversight of this large economy, both public and private.

And, for that, this committee will owe you--and hopefully the picture to be hung soon--a debt of gratitude, because to elevate a committee is one of the hardest things in the world to do. Many chairmen spend years at the helm of a committee and see it reduced or, at best, held the same. But you truly have left this committee much stronger than when you found it. And, for that, both sides of the aisle will always be grateful.

[Applause.]

Mr. MICA. Mr. Issa, would you yield to me?

Mr. ISSA. And I would yield to the gentleman.

Mr. MICA. You know, I think one of the reasons Mr. Waxman has probably sought the position on Energy and Commerce was to escape the claws of Mr. Issa and Mr. Mica. But we wish him well in his new endeavor.

Two things. One, there is no substance, as I told you before, to the fact that our steering committee is moving the two of us over to that committee. So that will be very good. And, also, could you please keep me posted on the exact date of the hanging of Henry Waxman? Because I want to be here for it.

Thank you.

Mr. ISSA. Thank you.

Thank you for your indulgence, Mr. Chairman.

Chairman WAXMAN. The gentleman's time has expired--no.

[Laughter.]

Mr. ISSA. Thank you, Mr. Chairman, for scheduling this important hearing. And thank you, again, for the second panel of expert witnesses. That shows a great deal of bipartisan cooperation, and, for that, again, I am grateful.

As we attempt to deal with the ongoing financial crisis, it is critical that we look at all the factors that caused the collapse of the financial system. The one thing we know for certain is that the overinflated housing market and defaulting subprime loans are at the center of the problem. And it is no secret that I believe that Fannie Mae and Freddie Mac had either the primary role or certainly a primary cause of this failure.

The analogy of the Chicago fire and Mrs. O'Leary's cow is particularly appropriate here. The cow was the immediate cause of the fire, but there were a number of factors that made the fire inevitable. The fire spread quickly because homes were densely packed and made of wood. It wasn't a question of whether the disaster would happen, but when. I believe that Freddie and Fannie had a great deal to do with packing that great deal of wood close together for a number of years.

These two government-sponsored enterprises were repeatedly urged by politicians to deliver affordable housing to the American people. There was an inevitability in this policy, just as the events that led to the Chicago fire. Traditional home loans were replaced with easy credit, no-document and no-downpayment loans. Instead of human judgment assessing risk, those responsibilities were shifted to rely on computer modeling. Outright fraud and greed wasn't isolated to just Wall Street, although I appreciate the chairman's work on uncovering the portion that was on

Wall Street. Fannie and Freddie shared in this disgrace as it drove much of the poor decision-making that have led us to where we are here today.

Mr. Chairman, the time for double talk, not in this committee but outside this committee, is over. Mr. Chairman, the election is behind us. So let us get to the bottom of this crisis and find out what really happened. We must work together to get to the root causes of this crisis, not just a root cause but all root causes. It is important that we find out what factors interacted with each other to bring about the degree of financial destruction.

Of all the work we have done to date, it is inconceivable that we have not had any discussion of the role that we played, the role that congressionally mandated policies played in this crisis. We must ask ourselves, did Congress advocate policies that fermented this crisis? Did individual congressmen and/or -women advocate because, in fact, it was a convenient relationship, both politically and perhaps personally?

Some will consider what I am about to say not politically correct. A few weeks ago, when the topic of Fannie Mae and Freddie Mac affordable housing loans were raised as a cause of this crisis, Chairman Barney Frank said it was racist to suggest as much. I will say here today, it is not racist to suggest anything and everything as a cause of this problem until it is properly eliminated by those who are not affected directly by it but, in fact, can dispassionately and objectively analyze what was or was not a cause of this problem.

In a recent Senate hearing on the automobile bailout, Chairman Christopher Dodd continued to point a finger at Wall Street as the culprit of the current crisis and many crises. Those two men are chairmen of the two most important committees, notwithstanding ours, dealing with the financial crisis, yet they appear to be wearing blinders in not wanting to discuss the full range of issues underlying this crisis.

Mr. Chairman, the goal of affordable housing is one of the most laudable goals we, as legislators, should seek to attain. But we should do it in a way that does not destroy the whole financial system, which is, in fact, what has happened.

Let me draw a contrast. For decades, under the GI Bill of Rights, we allowed and encouraged servicemen to get VA home loans with little or no money down. And that program, Mr. Chairman, works well. What I am saying is that affordable housing is a desirable goal, and it can be done the right way.

But in the case of the GSEs, how we encourage the program is something we have to come to grips with. We have to recognize that what we have done with the GSEs hasn't worked. Rather, it has allowed the most vulnerable in our society to be subject to predatory lenders. We gave hope to people with the promise of homeownership without telling them the American dream could turn into their personal nightmare. Mr. Chairman, we in the Congress have to look in the mirror, because part of the blame clearly lies at our footsteps.

I have introduced legislation to establish a 9/11-type independent, nonpartisan commission composed of experts, not politicians, to assess what went wrong and how the system should be remedied. Mr. Chairman, in your new role, I would hope that you would sign on in the next Congress as a cosponsor of this legislation.

I believe that this committee and others should continue to actively look into the causes. We should, in fact, do our oversight role. But the worst thing Congress can do now is to start legislating or advocating for regulation without a clear, nonpartisan analysis of what went wrong, including a look inward.

Business Week just ran an article indicating that many of the current reworked FHA loans will default in the near future and a second bailout will be necessary. Mr. Chairman, for all the committees in the Congress, this committee has a unique obligation and opportunity to work in a bipartisan way to follow the causes of this crisis, both independently and through a commission that can provide us with additional insight in all directions, including that which comes to our footsteps.

Mr. Chairman, I would hope that we will continue in the next Congress to make sure that the Financial Services Committee does not supplant this committee in making sure that government does what it should do, not only to encourage and allow homeownership to all, but, in fact, to protect the financial system that today is teetering on the edge of yet another precipitous fall.

If the Congress cannot do this in an objective and dispassionate way, then I assure you the minority will continue to pull at every possible lever to ensure that we can play a constructive role in ensuring that the wood will not be piled up again, that homes, whether in Chicago or throughout America, will not be built close together and of wood in order to have yet another Mrs. O'Leary's fire.

Mr. Chairman, thank you again for holding this important hearing. And I look forward to perhaps you being an original cosponsor of the legislation calling for a nonpartisan commission in the next Congress.

Chairman WAXMAN. Thank you, Mr. Issa.

I'm pleased to introduce our witnesses today.

We have Leland Brendsel, the former CEO of Freddie Mac. He worked at Freddie Mac for 21 years and left the company in June 2003.

Daniel Mudd, former CEO of Fannie Mae, served as the president and chief executive officer of Fannie Mae from June 2005 until September 2008. Mr. Mudd was also a member of the Fannie Mae Board of Directors from February 2000 until September 2008.

Franklin Raines is the former chief executive officer of Fannie Mae from 1999 until his retirement in December 2004. He previously served as Fannie Mae's vice president from 1991 until 1996.

And Richard Syron, as former CEO of Freddie Mac served as the chairman and CEO from December 2003 to September 2008.

I want to welcome each of you to our hearing today.

It is the custom of this committee that all members that testify do so under oath. So I would like to ask, if you would, please stand and raise your right hand.

[Witnesses sworn.]

Chairman WAXMAN. The record will indicate that each of the witnesses answered in the affirmative.

Your prepared statements will be in the record in its entirety. We will have a clock that will indicate a time for 5 minutes. At 4 minutes, it will be green. The last minute, it will turn orange. And then, when the 5 minutes is up, it will turn red. That will be an indication to you that we would like you then to conclude your comments. Even though it may not be the complete testimony, the whole testimony will already be in the record.

We will start with you, Mr. Syron. Why don't we start with you? There is a button on the base of the mike. Be sure to push it and have the mike close enough so that it can be picked up.

STATEMENTS OF RICHARD SYRON, FORMER CEO, FREDDIE MAC; DANIEL MUDD, FORMER CEO, FANNIE MAE; LELAND BRENDSEL, FORMER CEO, FREDDIE MAC; FRANKLIN RAINES, FORMER CEO, FANNIE MAE

STATEMENT OF RICHARD SYRON

Mr. SYRON. Thank you, Chairman Waxman and members of commit. Good morning. I appreciate the opportunity to testify today and address your issues of concern in light of the current financial crisis. As you know, I served as CEO of Freddie Mac essentially from 2004 to September of this year.

Let me start with a very basic proposition. Freddie Mac was, is and, by law, must be a nondiversified financial services company, limited to the business of residential mortgages. Given the recent severe nationwide downturn in housing market, the only nationwide housing decline in housing values since the Great Depression, any company limited exclusively to that line of business alone would be severely impacted. As Treasury Secretary Paulson recently noted, given that GSEs were solely involved in housing, and given the magnitude of the housing correction we have had, the losses by the GSEs should come as no surprise to anyone.

With respect to the housing market, the prolonged glut of credit certainly was one factor that contributed to the housing bubble and its subsequent collapse. Another important factor was the shift from a system in which mortgage originators held loans to maturity to a system in which mortgage originators immediately sold or securitized a loan and retained no risk. In more recent years, increasingly complex financial techniques were also applied to the process with the objective of minimizing, shifting or, some believed, virtually eliminating risk.

We all recognize that homeownership provides benefits and generates substantial social advantages beyond just shelter. We have learned the hard way, however, that the rapid expansion of homeownership is not without risk and ultimately not without cost if the choices made by individual homeowners are unaffordable.

What was the role of Fannie Mae and Freddie Mac in the credit crisis? These institutions were established by Congress to promote liquidity, affordability, and stability in housing finance. They do so primarily by guaranteeing the timely payment of principle and interest on mortgages originated by banks in order to facilitate the purchase of those mortgages by institutional investors, thereby enabling banks to make new loans. Congress has reaffirmed this role for Fannie and Freddie many times, including quite recently.

When the dramatic and widespread downturn in housing prices occurred, the pressures on Freddie Mac and Fannie Mae were enormous. The GSEs are a nondiversified business focused solely on residential housing in the United States. As the guarantor of almost half the home mortgages in the country, it is not surprising that these two firms would get hit hard by the biggest housing collapse in 75 years. This lack of diversification was extremely challenging for the GSEs, even though their credit standards were higher than other lenders.

There has been a lot of attention in the media and elsewhere to the problems associated with the nontraditional or subprime market. There is no question that Freddie Mac has incurred losses associated with nontraditional loans. But it is important to remember that Freddie and its sister institution, Fannie, did not create the subprime market, I think as the chairman said. Freddie was, in fact, a late entrant into the nontraditional, i.e. Non-30-year-fixed-rate conventional market, such as Alt-A.

The subprime market was developed largely by private-label participants, as were most nontraditional mortgage products. Freddie Mac entered the nontraditional slice of the market because, as the private lending sector shifted toward those type of loans, Freddie needed to participate in order to carry out its public mission of promoting affordability, stability, and liquidity in housing finance. In addition, if it had not done so, it could not have remained competitive or even relevant in the residential mortgage market we were designed to serve. Moreover, if you're going to take the mission of providing low-income lending seriously, then, by definition, you're going to take a somewhat greater level of risk.

Freddie's delinquency rates and default rates, both overall and for each type of loan, were much lower than those of the market overall and were especially lower than for mortgages underwritten my purely private institutions, many of which were severely impaired for some of the same reasons as Fannie and Freddie. Every institution with significant exposure to residential mortgages has been negatively impacted by the generally unforeseen magnitude and volatility and rapidity in the collapse of the housing price market.

Before I conclude, I just want to take a moment to recall the public mission of the GSEs. As everyone is aware, Freddie Mac is a shareholder-owned corporation, chartered for the purpose of supporting America's mortgage finance markets and operating under government mandates. We had obligations to Congress and to the public to promote our chartered purposes of increasing affordability, liquidity, and stability in housing finance, which included some very specific low-income housing goals. But we also had obligations to our regulator to pursue our goals in a manner that was prudent and reasonable. At the same time, we had the fiduciary obligation to our shareholders that were identical to any other publicly traded company.

Freddie Mac always worked hard to balance these multiple objectives, and for decades the company was effective. There is much to be said about the success of the GSE model, and those successes should not be totally overlooked because of the current crisis. As Congress looks to the future of residential housing finance, the GSEs can and should play an important role.

I would be pleased to answer your questions about my time at Freddie Mac and any lessons that might be learned. Thank you, sir.

[Prepared statement of Mr. Syron follows:]

******** INSERT 1-1 ********

Chairman WAXMAN. Thank you very much, Mr. Syron.

Mr. Mudd?

STATEMENT OF DANIEL MUDD

Mr. MUDD. Mr. Chairman, Representative Issa, members of the committee, thank you all for the opportunity to appear before you this morning. My name is Daniel Mudd. I joined Fannie Mae in 2000, following a decade at General Electric. I served consecutively as chief operating officer and interim chief executive officer of Fannie Mae.

In June of 2005, the Board of Directors, with the approval of our regulator, asked me to stay on as CEO, complete the accounting restatement, work cooperatively with our regulator, remediate a number of control weaknesses, and restore the company's position and standing in the capital markets. The company made significant progress in these areas, returning to timely and current filings with the SEC, settling matters with OFHEO and the SEC, meeting housing goals, and earning $13.3 billion of net income from 2005 through mid-2007. I also worked with members of this Congress to support legislation passed into law in July to create a strong world-class regulator for the GSEs.

As background, I believe the roots of this crisis go back to the enormous increase in consumer and commercial leverage in the 1990s. The trend built up through 2007, when the financial sector entered what most observers view as the worst conditions ever seen in the capital markets.

The GSEs were chartered by Congress to provide liquidity, affordability, and stability to the mortgage market at all times. In fact, in the midst of the present turmoil, when other companies decided not to invest, the GSEs were specifically charged to take up the slack. This had worked in several recessions, the Russian debt crisis of 1998, the aftermath of 9/11, but not--not--in 2008. The housing market went into a free-fall, with some predicting a decline now of as much as 30 percent from peak to trough. A business model requiring a company to continue to support the entire market could not work.

Through the spring and summer of this year, my colleagues and I worked with government officials, regulators, our customers in the banking system, housing advocates, and others to maintain what was really an excruciating balance between providing liquidity to keep the market functioning, protecting Fannie Mae regulatory capital, and advancing the interest of the company's owners. At the time the government declared conservatorship over the company, we were still maintaining regulatory capital in accord with all relevant standards, and we were still, along with Freddie Mac, the principal source of financing to the mortgage market.

While I deeply respect the myriad challenges facing the Treasury Department and the regulator, I did not believe that conservatorship was the best solution in the case of Fannie Mae. I believe that more modest government support, basically a program something like the banks are now eligible for, would have maintained a better model. Admittedly, it would not have been a magic bullet, but this market seems to defy magic bullets, whether they are fired by the private sector or by the government.

In any case, I think that is now water under the bridge, and the GSEs, like many other institutions, are stuck mid-crisis. I would, therefore, advocate moving the GSEs out of no man's land. Events have shown--events have certainly shown me--how difficult it is to balance financial, capital, market, housing, shareholder, bond holder, homeowner, public and private interests in a crisis of these proportions. We should examine whether the economy and the markets are better served by fully private or fully public GSEs. I hope we have a debate on the future structure of the housing finance market in the country before events themselves produce a fait accompli that answers this question.

It is possible, I think, in all of this, to forget the many positive achievements of the GSEs. We finance tens of millions of homes to Americans of low to moderate income. We made mortgages fairer, more transparent, and available to a broader spectrum of society. We developed colorblind underwriting. We assured the banking system that their loans would garner a predictable price, around the globe, 24 by 7. When asked by Congress and the administration, we stepped up and provided the only source of funding for loans in high-cost areas and elsewhere.

Let me end by suggesting that homeownership does remain a central dream for many Americans. I believe that, once the present crisis resolves itself, owning a home will again be a way for Americans to express confidence in their future.

Thank you.

[Prepared statement of Mr. Mudd follows:]

******** INSERT 1-2 ********

Chairman WAXMAN. Thank you very much, Mr. Mudd.

Mr. Brendsel?

STATEMENT OF LELAND BRENDSEL

Mr. BRENDSEL. Thank you, Mr. Chairman, Representative Issa, and other distinguished members of the committee. I am Leland Brendsel, and I was formally the chairman and chief executive officer of the Federal Home Loan Mortgage Corporation, more commonly referred to as Freddie Mac. And I want to thank you for the opportunity to address this committee as you consider the future of the government-sponsored enterprises and their importance to housing finance system in the United States of America.

I believe that we have had the best housing finance system in the world and that Freddie Mac and Fannie Mae have been vital to its success, and they are vital to its future. In particular, Freddie Mac and Fannie Mae have been instrumental in ensuring the continued availability of long-term fixed-rate mortgage loans. And I hope this hearing and future examinations will examine the critical importance of those mortgage loans and Freddie Mac's and Fannie Mae's essential role.

Before I do go further, I want to provide a little information on my background. I joined Freddie Mac in 1982 and devoted 21 years of my life to it. I left Freddie Mac in June of 2003 after more than 2 decades of service, and I have not had any role in the company now for over 5 1/2 years.

I do feel very fortunate to have been the leader of such a great company with such an important public mission. I was raised on a family farm in South Dakota, attended public schools in the Sioux Falls area. And after that, I graduated from the University of Colorado and ultimately earned a Ph.D. In financial economics from Northwestern University in Illinois in 1974. I spent 8 years teaching and working as an economist, first at the Farm Credit Administration here in Washington and later at the Federal Home Loan Bank in Iowa.

But, as I mentioned, I spent the bulk of my career at Freddie Mac. When I joined it in 1982, I served as Freddie Mac's chief financial officer, and then I assumed the role of chief executive officer in 1985. I was elected chairman of the Board beginning in 1989 at the time that Freddie Mac became publicly owned and listed on the New York Stock Exchange.

By the time I left Freddie Mac in 2003, the secondary mortgage market had become a major source of stability and reliability for financing housing and homeownership. Indeed, this is a tribute to the wisdom of Congress in chartering Freddie Mac with the mission of increasing the availability and affordability of mortgage credit by tapping the world's capital markets.

Today, many homeowners and the secondary markets certainly are in distress. Congress is rightly considering many proposals for restoring stability. And, in doing so, I hope that Congress will take steps, as it has in the past, to assure the continued availability and affordability of long-term fixed-rate mortgage loans. These mortgages have not contributed in any meaningful way to the present crisis, but their survival is in jeopardy because of it.

Freddie Mac was chartered in 1970 by Congress to provide stability and liquidity to the secondary market for residential mortgages. When I began at Freddie Mac in 1982, the secondary market was an embryonic market, and the company was still a small participant in it. At that time, in 1982, savings and loan associations and thrift institutions were still the primary mortgage lenders, they were portfolio lenders, but many of them had recently failed or were failing. The housing and mortgage markets were in turmoil, and the homeownership rates, in fact, were declining at that time.

A family trying to buy a home was faced with mortgage rates that swung between 13 and 17 percent alone for 30-year fixed-rate mortgage loans over the course of 1982. Because there was not widespread access to the national financial markets, the availability of mortgages depended on the amount of local bank deposits that could be loaned. In addition, the mortgage application and underwriting process was arbitrary, inconsistent. There were large regional disparities in the mortgage market, and too frequently the process disfavored minority and rural communities.

During the 1980s and 1990s, Freddie Mac played a major role in addressing the deficiencies in the mortgage markets. Freddie Mac broadened the potential sources of financing for residential loans. We helped preserve the 30-year fixed-rate mortgage, which had fallen out of favor with many portfolio lenders. We drove down origination costs, made it more efficient. We improved the speed, reliability, and fairness of the underwriting process. And we increased access to mortgages for minorities and underserved communities. As a result, one of which I am proud, by 2001, 2 years before I left, Freddie Mac had answered Congress's call by financing homes for 30 million Americans.

I still care deeply about Freddie Mac and its mission, and I share the committee's concern about how to best protect America's homeowners and communities. I thank the committee for the opportunity to be here today.

[Prepared statement of Mr. Brendsel follows:]

******** INSERT 1-3 ********

Chairman WAXMAN. Thank you very much, Mr. Brendsel.

Mr. Raines? Wait a second, until the bell stops. Okay, now.

STATEMENT OF FRANKLIN RAINES

Mr. RAINES. Thank you. Chairwoman Waxman, Mr. Issa, and distinguished members of the committee, my name is Franklin Raines. And I would like to thank the chairman for accepting my longer written testimony as part of the record.

I've worked in the financial services and investment industry for 27 years. I have had 12 years' experience in investment banking and 11 years of experience in the mortgage industry as vice chairman and chairman and CEO of Fannie Mae. I was appointed chairman and CEO by an independent board of directors, with 13 of its 18 members elected by public shareholders.

In my 6 years as chairman and CEO, Fannie Mae provided over $3.4 trillion of financing, serving more than 30 million low-, moderate- and middle-income families. The company's revenue, book of business, and economic value more than doubled during this period, and the stock outperformed the S&P 500.

On December 21, 2004, I announced my retirement from

Fannie Mae, and I've had no management role at the company since that time. My experience in financial services, along with my tenure as the Director of the Office of Management and Budget, will form the basis for much of my testimony today.

The current financial crisis has a variety of complex sources. However, in my view, it did not result from Fannie Mae's recent risk management decisions or from its accounting practices 4 years ago. There is no doubt that the crisis afflicting the national and international financial system is without precedence since the Great Depression. Yet the Federal Government's response, while large in dollars, has had limited success.

Financial market convulsions are not a new phenomena. The past quarter-century alone has witnessed the junk bond meltdown, the Internet stock implosion, and several others, including the present mortgage and credit derivatives crisis. These separate events have many features in common that I have outlined in my written statement.

Fannie Mae managed to avoid the major causes of the current crisis through 2004. The company had significant experience during the 1980s and early 1990s with the impact of falling housing prices on the value of mortgages. The company was also quite familiar with the different credit performance characteristics of mortgages with certain features, such as adjustable rates or negative amortization; with certain underwriting approaches, such as no documentation of assets or income; and with certain borrower types, such as marginal credit or housing speculators. The company undertook the quantitative research in the 1990s that showed all these features created greater credit risk.

As a result, Fannie Mae developed tools to evaluate and manage the new types of mortgages that had begun to come on the market in the early part of this decade. As subprime and Alt-A loans began to grow as a share of the overall mortgage market, the risk management restrictions Fannie Mae had in place limited the company's involvement with those products. And, as a result, in 2004 the company's share of the overall secondary market plummeted.

The company's public disclosures demonstrate that the credit risk profile of Fannie Mae changed after 2004. Fannie Mae, like a lot of smart investors, expanded its appetite for credit risk. However, it is important to note that, rather than lead the market toward looser credit standards, Fannie Mae generally resisted pressures to significantly lower its standards until about 2006.

There have been many assertions by commentators about the role of affordable housing lending regulation and financial services regulators as causes of the current financial crisis. There was no regulation that forced banks or GSEs to acquire loans that were so risky they imperiled the safety and soundness of the institution. The riskiest loans in the system tended to be originated by lenders not covered by the Community Reinvestment Act or the GSE affordable housing goals. On the other hand, the absence of consumer protection regulation allowed many bad loans to be made to the detriment of consumers.

The question remains, why did the regulators of banks and the GSEs not criticize or restrict the acquisition of risky loans by regulated institutions? It is remarkable that, during the period that Fannie Mae substantially increased its exposure to credit risk, its regulator made no visible effort to enforce any limits. This was true even though the regulator only oversaw two companies, had greatly increased its budget, and was then enforcing a form of quasi-conservatorship on the company.

Preventing future crises in the financial services industry and their attendant damage to consumers will require three things, in my judgment. First, executives will have to exercise greater discipline in managing risk. Second, there needs to be a better-informed regulation of large, leveraged financial entities. And third, there must be greater protection of consumers from financial products they cannot be reasonably expected to understand.

Finally, Mr. Chairman, the GSE model is not perfect.

However, if we maintain the public goal of marshalling private capital to achieve the public purpose of homeownership and affordable rental housing, it will be hard to find a model that has more benefits and fewer demerits than the model that worked reasonably well for almost 70 years at Fannie Mae.

It has been almost 4 years since my decisions have had any impact on Fannie Mae, the housing market, or the global market for mortgages and mortgage-backed securities. Even so, I continue to believe in the mission Congress gave to Fannie Mae and Freddie Mac. I also believe these companies can play an important role in helping to solve today's mortgage financing crisis.

Thank you, Mr. Chairman. I would be happy to answer any questions the committee might have.

[Prepared statement of Mr. Raines follows:]

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Chairman WAXMAN. Thank you very much, Mr. Raines. We appreciate your testimony.

Before we go to questions by the members of the committee, I would like to ask unanimous consent that all members may be permitted to enter an opening statement into the record. And, without objection, that will be the order.

By a previous agreement with the minority, I would ask unanimous consent that we start off the questioning with 12 minutes on the Democratic side and 12 minutes on the Republican side before we then go to the 5-minute rule. And, without objection, that will be the order.

The Chair, starting the questions for our side, would yield 10 minutes to the gentleman from Massachusetts, Mr. Tierney.

Mr. TIERNEY. Thank you, Mr. Chairman.

And before I start my questions, I just want to take one moment and appreciate your services here as chairman. I share with Mr. Issa the observation that you have lifted the stature of this committee substantially, and all the members and the staff are grateful for that.

When you were in the minority as the ranking member, you certainly made every attempt and were successful in refocusing the Congress and the committee on important matters. As chairman, you have focused on a number of important matters that were essential to the country and to the Congress. Now you bring your duties and your skills over to the Commerce Committee at our loss but, I think, the Nation and Congress's benefit.

And so we thank you very much, and I've been proud to serve with you.

Chairman WAXMAN. The gentleman will be given the full 10 minutes.

[Laughter.]

Mr. TIERNEY. I thank all of you gentlemen for being here this morning and working with us on this.

Mr. Mudd, if you might, I would like to ask you a couple of questions, in particular about a document that we found in your internal files at Fannie Mae. It says, "A single family guarantee business facing strategic crossroads," dated in June of 2005. And it is listed as confidential and highly restricted.

I'd like to get your responses to it. We have got some slides up there, if you find that helpful, sir.

The first slide in this says, "The risk in the environment has accelerated dramatically," and the bullets under that say that there has been a proliferation of higher-risk alternative mortgage products, there is a growing concern about housing bubbles, there is a growing concern about borrowers taking on increased risk and higher debt, and lenders have engaged in aggressive risk layering.

The next slide, if we switch over on that, says the growth in adjustable-rate mortgages continues at an aggressive pace. And here the presentation says that there has been an emphasis on the lowest possible payment and homes are being utilized more like an ATM.

It appears, Mr. Mudd, that you were aware of both the accelerating risk in this environment, as well as the concerns about housing bubbles as far back as 2005. Is that correct?

Mr. MUDD. Yes.

Mr. TIERNEY. The next slide says, "We are at a strategic crossroads, and we face two stark choices. One is stay the course, and the other is meet the market where the market is." The next slide shows the benefits of staying the course. It says, "Fannie could maintain our strong credit discipline, it would protect the quality of the book, it would intensify our public voice on concerns about the housing bubble and accelerating risk, and, most importantly, it would preserve capital."

The next slide shows the other alternative, meet the market where the market is. In other words, you would meet current consumer and customer demands for alternative mortgage products. This was viewed as a revenue opportunity and a growth area. But, under the alternative, you accept higher risk and higher volatility of earnings.

And the next slide puts these pro ands cons side by side. If you stay the course, you'll have lower revenues and slower growth, but you will have more security. On the other hand, if you invest in riskier mortgages, you have potential for high revenues and faster growth. But, as the slide says, you also have increased exposure to unknown risks.

Based on these slides, Mr. Mudd, you faced a fundamental decision in 2005: Do you keep your focus on the more secure fixed-rate mortgages but potentially lose out on some profits, or do you compete with private lenders by entering into riskier sectors of the market?

It doesn't seem that there was any real question that you were aware that you were increasing your risk significantly by entering the market. Is that correct?

Mr. MUDD. No, it is not exactly correct, Congressman.

Mr. TIERNEY. Now, the document indicates that you were aware that you were increasing your risk. You're saying that you weren't aware you were increasing your risk?

Mr. MUDD. Well, if I might give you a response in context, the process and what we were doing at that time was thinking through what our various alternatives were, in terms of the marketplace. The choice, as you do in corporations or other institutions, was presented relatively starkly in order to identify what the key issues were, but, in fact, the real choice that was made on the ground was not, do you do A, do you do B, do you do black, do you do red. The choice was, rather, what are the pros and cons of this decision, to make clear what the choices were.

Mr. TIERNEY. And that is reflected in that document.

Mr. MUDD. Yes, sir.

Mr. TIERNEY. And one of those is that you are increasing your risk significantly by entering that market, if you were to enter that market.

Mr. MUDD. If you were to make the full B decision--and that is not, in fact, what we did. So your choice was, how far do you adjust from where you are to meet the market, ultimately?

Mr. TIERNEY. It looks as if you made the choice to enter the alternative market. But let me put up two more slides, and we'll discuss it.

The first slide we are going to put up is the recommendation that was made in 2005 based on all the factors you just talked about. It starts by admitting that realistically we are not in a position to meet the markets, and that is because you had less experience with the riskier loans and you didn't have enough data to evaluate the credit risk. The slide says, "Therefore, we recommend that we pursue a stay-the-course strategy." However, the slide at the bottom recommends that you dedicate resources and funding to, quote, "underground efforts" to develop a subprime infrastructure and modeling for alternative markets.

The last slide says this: "If we do not seriously invest in these underground-type efforts, we risk becoming a niche player, becoming less of a market leader, and becoming less relevant to the secondary market."

So, Mr. Mudd, I reviewed your written statement, and I listened to what you had to say here today. You didn't seem to take any acknowledgement that you may have made some mistakes. And looking back in hindsight and directed by the slide that we just saw, you may not have led the market--and I really believe that is true; you didn't lead the market into the situation--but you faced a choice of whether to enter it, and it appears to me that you made the choice to enter that market and that was a wrong decision.

Do you agree that that was the wrong decision to make?

Mr. MUDD. No, sir. And what I would point to on this slide is the phrase that says we need to invest in these efforts if--and if the market changes prove to be secular. And the context I would point out to you on that was: We weren't sure. We weren't sure whether those changes in the marketplace were secular or whether they were cyclical, was it temporary or was it a permanent change in the market.

And we thought it was important that we couldn't afford to make the bet that the changes were not going to be permanent. We couldn't afford to make the bet that somebody who has a subprime mortgage, who, at the end of the day, is simply an American with a credit blemish, would never be able to get a loan in the country if the Fannie Mae approach, Fannie Mae standards, Fannie Mae qualities couldn't be applied there.

So when we looked at the market, we made a tradeoff between the choices, and we said, no, we are going to focus back on our bread and butter, but we're going to do this work to make sure we understand these new emerging markets and we can develop a better view of them.

Mr. TIERNEY. But in actuality, starting in 2005, you actually purchased hundreds of billions of dollars of those loan, correct?

Mr. MUDD. No, sir. I think it is important in that to break out the various categories of loans, because, in your question, you were asking about ARM loans, which were adjustable-rate mortgages, which many of us have; Alt-A loans, which are an alternative to an A loan, different documentation than an A loan; and subprime loans, which are a different matter entirely.

Going back through those, 85 percent of the book at Fannie Mae was standard A loans, the basic loans that had been done throughout time. A percentage around 10 percent or so was in the Alt-A category. And a much smaller percentage that never amounted to more than a percent or 2 of this total book was actually in subprime.

Mr. TIERNEY. I think, Mr. Mudd, that it's important that we make a distinction between the Alt-A and the subprime on that. And I think because some of the rhetoric that we have heard back and forth here, the subprime, as you said, was a very small part of the portfolio?

Mr. MUDD. Yes.

Mr. TIERNEY. All right. Explain for us the Alt-A. You didn't really get any credit, did you, on meeting your goals for affordable housing by buying the Alt-As because, in my understanding, they are not really clarified as to just what the basis of those loans are?

Mr. MUDD. I'm sorry. I missed the end of your question.

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DCMN HOFSTAD

[11:00 a.m.]

Mr. MUDD. It would depend on whether the actual character of the loan met the socio-economic categories that would count toward a goal per se. On their face, they might or might not count. The Alt-A loans were essentially a subset of overall A loans. As I indicated, Alt-A means an alternative to an A loan. So they bear many of the same characteristics. Otherwise, they qualified or counted--they might or might not count toward those affordable housing goals.

The market produced those loans, and Fannie Mae's participation in those loans, in fact, goes all the way back to 2000. We were doing, starting in the year 2000, $10 billion, up to 2003 about $100 billion, of Alt-A loans, down to $79 billion in 2005. I could go on. But those loans varied in terms of what the market was producing, as did the balance between fixed-rate loans.

Mr. TIERNEY. In June of 2005 was when you decided to go into Alt-A's a little more heavily, right?

Mr. MUDD. We decided to examine the market more carefully. In 2004, we were doing a rate of about $63 billion. In 2006, we were up to $106 billion, and in 2007, $198 billion.

Mr. TIERNEY. Up in 2005. And in this year, substantially the largest part of your losses come from your Alt-A loans, right?

Mr. MUDD. I am not completely up to date on the figures, Congressman. But I think that, of a single segment of the book--the largest losses come from Alt-A. But the predominance of the book, the old A rate, 85 percent of the book is also producing about half of the loans, as the housing market has gone down by 35 percent.

Mr. TIERNEY. Let me sum up. I don't think that Fannie Mae or Freddie Mac caused, but I do think--not just the slide, but the facts also indicate that you bear some responsibility for aggravating it, some responsibility for accepting those risks, knowing that those risks were not insignificant--in fact, they were substantial--and plunging into that market, sort of following the Wall Street gang into that. I think we are all going to pay the price for that, and we are going to have to deal with that now.

Chairman WAXMAN. Thank you, Mr. Tierney.

Mr. Issa?

Mr. ISSA. Thank you, Mr. Chairman.

I look at all four of you, and the one thing that I seem to find is that all four of you still seem to be in complete denial that Freddie and Fannie are in any way responsible for this. Your testimony says you are not accepting any blame for this at all. You are either standing behind the mandate of the Congress or the mandate of your stockholders, perhaps the mandate of your bonus packages.

And you are telling us that, in fact, everyone was doing it. Your whole excuse for going to risky and unreasonable loans that are defaulting at an incredibly high rate is, "Everyone is doing it. If we don't do it, we will be left out." Well, I am sorry that you wanted to be the most popular girl in the school and you forgot what your mother told you about your activities.

Mr. Mudd, you seem to have the clearest reason. And with Mr. Tierney's questions, you seem to be able to clearly articulate something I would like to have all four of you acknowledge today: that, in fact, there are compliant A conventional--I met the criteria loan--and then there were all others, Alt-A and subprime being the two best known of those. Is that correct?

Mr. MUDD. What I was hoping to describe, Congressman, was that the loans exist in a spectrum. And at the, sort of, core, heart and soul of the spectrum would be A loans. And the market operates, if you might imagine, in a series of concentric circles around that. The further out you go, the riskier the loans are.

Mr. ISSA. What I would like to do today--and we'll grapple with this for the next 2 years--is, Alt-A and subprime are substantially the same. You get credit if they are in underserved areas. And, in fact, since my understanding of a subprime is, if you have a FICO score of less than 660, you are essentially subprime, and a great many of Alt-A not only had a credit score of less than 660s but they didn't tell you what their income was, or they told you but they didn't prove it.

Now, that creates an Alt-A that is an Alt-A but it is also a subprime. Isn't that true?

Mr. MUDD. The way I would answer the question, Congressman, is that the combination of features in the loan defines the type of loan it is. So, yes, in the market there are Alt-A subprime loans, and in the market there are high-FICO subprime loans. Any of those things is possible, depending on the combination of the borrowers and the product features.

Mr. ISSA. So it is relatively fair, for those of us who don't do this every day, that this is a distinction without a real difference, relative to the default, relative to the problem, to the extent that these practices are part of the problem. They are reasonably equally part of the problem, because today they are equally part of the default; is that reasonably fair?

Can I get a consensus that--remembering that none of you said that you were part of the problem, but they are defaulting at substantially the same rate. Is that correct?

Mr. Mudd?

Mr. MUDD. I believe that it is more likely that the more variable features or the more credit characteristics that apply to a loan, those things can aggregate to increase the risk in that loan, yes.

Mr. ISSA. Mr. Raines, in your testimony, you said that Fannie Mae did not contribute significantly to the housing collapse. You acknowledge that your former company holds $300 billion of Alt-A, which do not verify the borrower's income.

Now, if those are defaulting and, in fact, were defaulting at a time in which unemployment was still at a historic low, then wouldn't the failure to verify income be a leading part of why you would have a default in a loan that, if the person's income was, in fact, honestly stated, they would be able to maintain? Meaning, if they didn't lie, they would make the payments and they wouldn't be in default. Isn't that true?

Mr. RAINES. It is a very complex question that you--

Mr. ISSA. Trust me, I spent a lot of time making sure it was as simple as can be.

If, in fact, unemployment was still at a historic low level when Alt-A's began defaulting but housing had stopped its precipitous rise, wouldn't you say, by any reasonable assessment, that, in fact, the liars getting loans was a significant part of it? Because those people, records are showing more and more, counted on a rise in value to make those loans, rather than a falsely stated income.

Mr. RAINES. I think that is correct. I think that the experience with Alt-A loans in that period--again, this is after I had left--and the period 2006-2007 was affected by fraud, where people did not tell the truth about their assets or their income and they obtained mortgages that they otherwise wouldn't have qualified for.

Mr. ISSA. So here, today, if we take with us one take-with, if you will, wouldn't it be fair to say, in retrospect--and I appreciate the fact that you had mixed signals sent from Congress and others. If you had it to do all over again, particularly Alt-A but to a certain extent subprime, wouldn't you, if you could have, ensured that people who were looking for a home greater than in retrospect they could afford if it didn't go up in value had been sent back to go find a home they could afford rather than the one they chose? Isn't that at the root of why we are here today?

You know, the demise of various financial institutions didn't start until the default started. We can appreciate the default is the beginning of this problem. So if default is the beginning of this problem, and default began--and I was with Mr. Kucinich in Cleveland well before this became described as a crisis: unemployment low, housing prices simply no longer going up, defaults begin to escalate.

In retrospect, would each of you say, both as observers and almost current CEOs, that, in fact, had people been told to go back and find a home they could better afford, thus not ratcheting down people to a liar mortgage, that this crisis could have been reduced or averted?

And I will take a "yes" from everyone and walk away happy.

Mr. BRENDSEL. I would like to comment on that.

Mr. ISSA. Although I will take first the yeses.

Mr. BRENDSEL. I think the failure to underwrite a mortgage loan properly is certainly at the core of what could be default on that mortgage loan. So the question is, to what are the underwriting requirements?

So, certainly making a mortgage loan to someone that can't afford that mortgage loan or who might be surprised by big payment shock down the road, a lender or investor in that mortgage loan has to be very cautious about that and, in my view, should do everything they can to at least educate the marketplace as to what is a sound mortgage loan and what is not.

With regard to documentation, that is a second question as to failure to document or to verify someone's income, which, again, I think a responsible lender should do.

Mr. ISSA. Mr. Raines, would you concur with that?

Mr. RAINES. I concur with what Mr. Brendsel just said, that underwriting standards, proper underwriting standards could have avoided many of the losses that were experienced on loans that were originated in 2005, '06, and '07.

Mr. ISSA. Would that pretty well summarize the other two?

We are looking back to make sure this doesn't happen again. Generally, those are the lessons we need to take with us for future legislation and messages to your former organizations.

Is that right? Is it?

Mr. MUDD. If you could go back and look at the loans that were made and pick out the ones that are delinquent or defaulted or too close to the loan-to-value ratio, yes, absolutely.

Mr. ISSA. Thank you.

I reserve the balance of my time.

Chairman WAXMAN. Mr. Towns, you are recognized for 5 minutes.

Mr. TOWNS. Thank you very much, Mr. Chairman.

Also, let me join in saying that it has been a delight working with you. And, of course, I am happy to know that you are not leaving the Congress and we will still be able to continue to work with you, probably in a different capacity, of course. So, again, you provided excellent leadership, and you have done a lot of major things for this committee, and, of course, we are very grateful for that. We look forward to seeing you on the other committee.

And, also, let me thank you for holding this hearing. I think it is very, very important that we have this hearing.

Let me just begin by saying, since the crisis started, I just want to ask all of you, we have heard some people claim that poor people are to blame for this. That is the problem, they are saying. And the way this argument goes, the Federal Government forced the banks to give mortgages when they shouldn't have--this is what they say--to people who were not creditworthy, then forced Fannie Mae and Freddie Mac to buy up those bad mortgages.

And you are the experts here. Is that the main reason that Fannie Mae and Freddie Mac had to be taken over, because they made too much financing available to low-income homeowners? Is that the problem?

Let me just run right down the line.

Mr. SYRON. Sir, I think the main reason for the problems with Freddie Mac and Fannie Mae, these are organizations that were not diversified and faced the most violent correction and the largest correction in 75 years in housing prices, which is, we were in the business of ensuring housing prices, in effect, when that happened.

I would think that it wasn't mostly trying to do things for poor people. I do think that we have to realize that we need a balanced housing program. And I personally am in favor of, in a progressive sort of way, good rental housing that people can have while they are getting ready to become homeowners.

Thank you, sir.

Mr. TOWNS. Mr. Mudd?

Mr. MUDD. I would just observe, Congressman, that when the market goes down, it is the folks who are the closest to the margin who get hurt first and longest every time. And that is what has produced the great human tragedy of this, which is the crisis of foreclosures in a lot of the towns and cities across the country.

Fannie Mae's business was to be able to provide lending all across the spectrum of affordable housing. And, as part of that, you had individuals who are in those communities. And now, and during my time, the company is doing everything it could to try to stem that wave of foreclosures and difficulties in those communities.

Mr. TOWNS. Mr. Brendsel?

Mr. BRENDSEL. As I testified, I was CEO of Freddie Mac for a long, long period of time. I cannot recall ever being forced to make or to purchase a mortgage loan that I didn't feel, as a matter of policy at Freddie Mac, was a good mortgage loan, a sound mortgage loan, and an attractive mortgage loan for the home buyer or the owner of an apartment building.

Mr. TOWNS. Mr. Raines?

Mr. RAINES. I do not believe that poor people are the cause of the current financial crisis, nor do I believe defaults on the loans that they might hold is the cause. They have much too small a share of the market. Most of the losses, as I read the record, have come on mortgages that were made to middle-class and upper-middle-class people, not to poor people.

And I do not believe that community reinvestment loans are the cause of the concern, and apparently neither does the comptroller of the currency nor the chairman of the Fed, each of whom have said that the act requirements had no role in the current financial crisis.

So I think I agree with you that it is just simply untrue to blame the current financial crisis on low-, moderate-income people or on the act or on Fannie Mae's affordable housing goals.

Mr. TOWNS. Let's face it, we do have a mess. What do we do now? What do you propose?

Mr. SYRON. I think what we need to do is first be cognizant, as some people have said, that if you want to have long-term fixed-rate mortgages, which the United States as an industrial nation is pretty unique as having, you need to have something like the GSEs. I think it is worth doing a very thorough review of how these organizations are structured and see what we can learn from this and how we can capture the benefits of the long-term fixed-rate mortgage and ameliorate some of the concerns that come out of being, for example, a mono-line company.

Mr. TOWNS. Mr. Mudd?

Mr. MUDD. Sir, my observation would be that there are, kind of, three tiers of homeowners out there right now. There is a tier of folks who are continuing to make payments, continuing to stay in homes. To get ahead of the problem there, things that Congress or these companies or the financial industry can do is to reduce the rates and reduce the monthly payments. Perhaps even using the Tax Code would be helpful in avoiding that segment becoming a problem.

There is a second tier who are folks that are maybe or maybe not making their payments, struggling but staying in the homes. That group needs not only the reduction in the monthly payments but probably some restructuring, such as, say, balloon note or reduction in principal.

Unfortunately, there is also a set of folks who are already in the process of default and foreclosure. And my recommendation there for society is we do everything we can to keep them in those homes--government relief programs, charitable relief programs, providing a conversion from ownership back into rental. Those types of things are probably going to be most successful.

So I think you have to attack the problem, because it is a little different depending on the type of homeowner you are addressing.

Mr. BRENDSEL. My response, to answer the question, would be I think, first, in agreement with Mr. Mudd, we need to take action to reduce the rate of mortgage home foreclosures. And, really, what results ultimately from that is that cascading effect on home prices and dumping of homes on the real estate market. So I think some careful review of foreclosure practices, loan workout practices and so forth, mortgage modification practices by all lenders and servicers and owners of these mortgage loans is extremely important. Our experience at Freddie Mac at a much earlier time was it is really important to the stability of the housing market as to how one reacts to it in a time of distress and increase in mortgage loan defaults.

Longer term, going forward, I think actions there need to look at, first, how to regulate better the origination practices in the country. I think they are doing spotty regulation over time as to the types of mortgage loans that get made, how they get made, the origination practices, and so forth.

Part of that goes to the definition even as to what is a subprime mortgage loan, what is covered under HOPE and what is not and all that. And I do think that there are parts of this market in terms of the origination practices that were really very flawed.

Finally, as I said explicitly in my testimony, I think one certainly needs to review, as part of the work of this committee and others, the appropriate structure of Freddie Mac and Fannie Mae and the regulation of them. I am absolutely convinced that preserving a viable fixed-rate mortgage market in the United States is critical to this Nation and that Freddie Mac and Fannie Mae, as government-sponsored enterprises with this public mission, relying on private capital is essential to it.

Mr. RAINES. I agree with much of what has been said, and I think there are four steps that--or, really, five steps that need to be taken to resolve the overall financial crisis but particularly with regard to housing.

Step number one is we have to provide financing to the system. The system is frozen up, piecemeal. The administration and the Fed have begun to provide financing, for the good and bad. That needs to expand.

Second, we need to separate the good assets from the bad assets and recapitalize financial institutions, such as Freddie Mac and Fannie Mae, but also the banks and others.

They need to recognize that the bad assets are bad assets and separate them, so people can look at these institutions without having to guess what their real financial condition is. They need to be recapitalized, because the bad assets--you need to replace that capital.

The third step is to work out the bad assets. To me, I have been stunned at the reluctance to actually work out these millions of loans, because houses as assets are depreciating assets. An empty house can overnight become worthless as people come in and strip out the copper, take out the plumbing, remove other things. The only thing you can do with that home is tear it down. To me, it is a crime that we are not investing funds to keep people in these homes. It is too late to worry about moral hazard with regard to these loans.

The last two things relate to regulation. We need to have more extensive regulation of big, leveraged financial entities, whether they are called GSEs or banks or insurance companies or hedge funds, whatever their name. If they are big enough to threaten the economy, there has to be intelligent regulation.

And the last point, there needs to be regulation to protect consumers. There is no way that the average consumer can understand the documents that are placed in front of them when they get a mortgage. I know I can't, and I have tried.

I made it through one time, and I got to all but one that I could understand. That one, to this day, I don't know what it said.

And every day we are asking ordinary consumers to understand negative amortization, to understand what it means for them to have a subprime versus a prime loan, to understand a 2/30 mortgage. It is impossible for the average person to keep up with this. We need to have more rigorous protection of consumers in the mortgage market.

Mr. TOWNS. Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Towns.

I would like to request members, if you have an open-ended question, to ask it in the beginning rather than at the end.

Mr. Mica?

Mr. MICA. Thank you, Mr. Chairman.

We have before us some of the perpetrators of the financial meltdown of our country. It is interesting how the committees operated. If you want to see where we are going today, read today's Washington Post. Commend the staff working diligently with The Washington Post to see where they are trying to lead the public. The committee tried to lead the public first in its Wall Street's fault. Today, we are going to concentrate on 2005 forward, or 2004 forward. But you have also heard some of the perpetrators, most recently named here, of our financial downfall blame it on somebody else. And Mr. Raines, of course his hands are clean, and he is telling us how to behave in the future.

Just for the record, let me read from Investor Daily a different take on this: "Fannie and Freddie, the main vehicle of Clinton's multicultural housing policy, drove the explosion of the subprime housing market by buying up literally billions of dollars of substandard loans, funding loans that ordinarily wouldn't have been made, based on much time-honored notions as putting money down, having sufficient income, and maintaining a payment record indicating creditworthiness."

With all the old rules out the window, Fannie and Freddie gobbled up the market. Using extraordinary leverage, they eventually controlled 90 percent of the secondary market mortgages. Their total portfolios top $5.4 trillion, half of all U.S. mortgage lending.

They told you that they were following Wall Street. Mr. Raines mentioned, just in his little commentary to us, that we had to have good underwriting standards. Actually, if we go back and look at some of the underwriting standards, they start deteriorating under the Clinton administration. But we don't want to talk about that today.

Mr. Raines, you were there when Mr. Cuomo decided to lower the reserve from 10 percent to $2.5 billion. That was a little bit of lowering some of the standard. And then you came and testified before Congress that the reserves were adequate before you left.

Mr. Raines went on to say in 1999--let me read this quote from September 30, 1999. "Fannie Mae has expanded homeownership for millions of families by the 1990s by reducing down payment requirements. 'I guess that wouldn't be lowering standards,' said Franklin Raines, Fannie Mae's chairman and chief executive officer." And continue to quote, "'Yet, there remain too many borrowers whose credit is just a notch below what our underwriting has required who have been relegated to paying significantly higher mortgage rates than the so-called subprime market.'"

Mr. Raines was indeed part of the problem. Mr. Raines was also found that, under his watch, the Office of Federal Housing Enterprise Oversight, regulating the body of Fannie Mae, found that Mr. Raines, under his directorship, he received $50 million in overstated--and he overstated earnings by some $50 million--is estimated to gain huge bonuses.

Mr. Raines, I have some of your compensation here. Could you tell the committee how much compensation that you received from 1998 through the time you left? Bonuses, compensation, benefits.

Mr. RAINES. I don't have that.

Mr. MICA. Would you say it is $90 million?

Mr. RAINES. OFHEO has estimated the number as $90 million.

Mr. MICA. And when you found that, under your leadership, that some of these factors had been fudged--well, first of all, the two fellows over here--Mr. Syron, you just left in September.

Well, let's go back to Raines. We said that, 2004, you are still getting bonuses. In 2008, so far, you have gotten $2,085,000--that is just year to date--in payments from Fannie Mae. Is that correct?

Mr. RAINES. That is what I am given. The number I think you are referring to is a result of the settlement I had with OFHEO.

Mr. MICA. It was a neat settlement, too, because you agreed to donate some of your stock rather than take the proceeds from the stock. Was that part of the settlement?

Mr. RAINES. That is part of the settlement.

Mr. MICA. That was pretty clever, because you had about a 1 1/2 in stocks. But if we get your tax returns, you donated that and then took an exemption for that. Is that correct?

Mr. RAINES. I didn't file tax returns for 2008. No.

Mr. MICA. I am talking about your settlement with--I need an additional minute.

Mr. ISSA. I will give the gentleman a minute.

Mr. MICA. So, again, I know what you did. The settlement, you really didn't pay anything. You probably took a tax deduction to deduct the amount that you said you were donating, and then the insurance company actually paid the fine. FannieMae's insurance paid the fine that was levied on you. Is that correct?

Mr. RAINES. There was no fine.

Mr. MICA. There was $3 million that was paid by the insurance. We can call it whatever you'd like.

The last thing--I don't have a lot of time here--is this is the bill Mr. Shays introduced in 1992 to further regulate some of the practices that were going on at Fannie Mae. And I know you helped to kill this. I was one of Mr. Shays's cosponsors. $175 million was spent in lobbying from 1998, a good portion of that under Mr. Raines's reign.

Is that correct?

Mr. RAINES. I am not familiar with that number, no, sir.

Mr. MICA. But you are familiar with the lobbying information that you had from 1998 until you left in 2004.

Mr. RAINES. Fannie Mae did have lobbyists, yes, sir.

Mr. MICA. And if I find some documents that showed you tried to influence killing legislation that would have regulated Fannie Mae, but that documentation doesn't exist?

Chairman WAXMAN. The gentleman's time has expired.

Mr. MICA. I want him to answer that last question.

Chairman WAXMAN. There is a pending question, and the gentleman will be given an opportunity to answer it.

Mr. RAINES. I have no idea what documentation you have. Fannie Mae, like any other corporation owned by shareholders, came to Congress and expressed its views. And we have done that consistently in another committee where I've had the opportunity to testify many times, and that is a matter of public record.

Chairman WAXMAN. The gentleman's time has expired.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

Maybe I should make an observation that I thought the purpose of this hearing would be to uncover the potential causes of the real estate disaster in the country, but it seems we are going over testimony that I have heard in another life before the Financial Services Committee.

And I suggest, if the members of this committee want to get a good history, go back and read the volumes and volumes of testimony from 2000 on until 2005, while the Financial Services Committee and the Congress of the United States was under the control of the Republican majority. And the piece of legislation that Mr. Mica refers to was introduced by a Republican while he was in the majority of the Congress and under a Republican President. It failed to move through. But I am not going to make those points about gaming the politics, because it is really unimportant.

The question is, and I think Mr. Towns put his hand on it: Are there any observations that you can make to help us out as to how we can stop?

And I think my first question would be, as I understand it, Fannie and Freddie would be in trouble today even if they had not been involved in subprime lending purposes. Is that correct? Assuming that you never had packaged a subprime situation and the real estate devaluation in this country fell by approximately 30 percent, as it has. Under the formula that we had studied on the Financial Services Committee for 5 years, it was indicated to be the perfect worst storm.

I think, Mr. Raines, you recall when Mr. Baker was holding those hearings. And we were all saying, what would happen if we had a perfect terrible storm? And if I recall, I think the testimony of yourself was: If the real estate deflation in this country amounted to more than 25 percent, all real estate and all of the GSEs would be in trouble. And, lo and behold, that is exactly what has happened.

So I re-pose the question: If there had never been subprime mortgages in the portfolio of Fannie and Freddie, would it still have difficulty because of the precipitous fall of the valuation of the real estate market of this country, particularly where you are so heavily involved, in California, Florida, Nevada, and States that have really suffered that devaluation?

Mr. MUDD. As an analogy, if you are in the business of insuring against hurricanes, and hurricanes hit a third of the country, you are going to suffer. If you are in the business--solely the business of financing U.S. housing, and the U.S. housing market goes down by 30 percent, you are going to suffer, yes, sir.

Mr. KANJORSKI. We all knew that, didn't we? That was brought out in testimony 4 or 5 years ago. Is that correct?

Mr. MUDD. It was modeled and discussed and disclosed.

Mr. RAINES. I completely agree with your characterization that it was well-known that a significant decline in housing prices would have a dramatic effect, not just on GSEs but on the entire financial system. The housing finance market is so big that you cannot have a major impact there without affecting the entire economy. So I think your characterization is exactly right.

Mr. KANJORSKI. We are thrusting around right now to find some underpinning to real estate valuation, stop the deflation in the real estate market, and to sustain people in houses, as you have all discussed, to prevent foreclosure. Hold the market and hold the house occupied, so that it doesn't depreciate in value.

Have either of you gentlemen participated in an analysis to see whether or not we could create a subsidiary corporation, a sponsored enterprise of the Federal Government, to aid or subsidize mortgages that are going underwater or going into foreclosure, to hold people in their homes, and what the relevant cost would be of doing that?

And would the value of rescue to the economy warrant taking that unusual action in the million or million and a half mortgages that probably could be held in residence or foreclosure tenants in residence?

Mr. RAINES. I have done a little analysis of that, but without the benefit of a lot of staff resources. But it is my view, and I think it is the view of a number of consumer-oriented groups, that amounts as small as $10,000 to $20,000 can go a long way to salvaging a lot of mortgages. In many cases, lenders and the homeowners are not that far apart in their ability to modify a loan and go forward.

And so, in my view, providing that kind of money at the table where there are negotiations going on to modify mortgages would have a substantial impact. And you can do that without having to go and buy up all the mortgages in the country. You can simply provide the additional funds to bridge the gap on a modification. I believe that would have a significant positive net present value for the taxpayer, as well as for the homeowner and the lender.

Mr. KANJORSKI. How would we get that analysis done quickly, and by whom?

Mr. RAINES. I think the best resources available to the Congress on understanding the housing market exists within Fannie Mae and Freddie Mac. And I believe that, through their contacts with their services, they can give you a pretty quick assessment of what level of funding would need to be available to greatly increase the rate of working out mortgages.

Mr. KANJORSKI. Could we take that action even though the real estate market has not ceased to deflate? In other words, could we do it at any point and plug in, or do we have to wait until we hit the bottom of the real estate market to start working the rescue?

Mr. RAINES. I think you can start now and work with those loans that are available to be modified. Certainly there are some where we will find that the market has gone down further. But trying to wait until the market hits bottom I think will only make the bottom deeper.

And, therefore, I think starting now and ramping up over time is the right way to do it. You can't charm the market back into having confidence, but if you start working out loans one by one, people will begin to have confidence.

Chairman WAXMAN. Thank you, Mr. Kanjorski. Your time has expired.

Mr. Burton?

Mr. BURTON. Have you ever heard a term, "Friend of Angelo" program?

Mr. RAINES. I have heard of that term in the newspapers.

Mr. BURTON. Have you ever had a home loan from Countrywide?

Mr. RAINES. Yes.

Mr. BURTON. Was this given to you through the term, "Friend of Angelo"?

Mr. RAINES. No.

Mr. BURTON. So you didn't get any preferential treatment?

Mr. RAINES. No, I did not, in terms of the terms of my mortgage.

Mr. BURTON. So you paid the same rate and same conditions as anybody else would under the same conditions?

Mr. RAINES. If they have the same credit profile, the same loan to value as I had, yes, sir.

Mr. BURTON. So if we checked on that loan that you got from Countrywide, we wouldn't find anything different from anybody that borrowed from Countrywide in the whole country? You would not get preferential treatment?

Mr. RAINES. I am unaware of any preferential treatment.

Mr. BURTON. Would it be possible to get copies of the mortgage papers that you had made with Countrywide?

Mr. RAINES. I am sure that Countrywide has copies.

Mr. BURTON. Do you have copies?

Mr. RAINES. I no longer own that property.

Mr. BURTON. I am sure you kept those documents--I keep mine for a long, long time--if you had a mortgage on a home. Could you provide those to the committee for the record?

Mr. RAINES. If I can find them, I will be happy to.

Mr. BURTON. Thank you very much.

Did you or anyone at your direction discuss with Angelo Mozilo--I guess that is how you pronounce his name--or his subordinates who might be candidates for this kind of preferential program? Did you ever talk to him about this special treatment for any government officials?

Mr. RAINES. No.

Mr. BURTON. You never did?

Mr. RAINES. Never.

Mr. BURTON. You are sure?

Mr. RAINES. Yes.

Mr. BURTON. None of the U.S. Senators or Congressmen or anybody in the government, that you know of, you never discussed their loans with Mr. Mozilo?

Mr. RAINES. No, I never did that.

Mr. BURTON. Okay.

Mr. Raines and Mr. Mudd, we have a September 2004 memo that discusses a 16-month outlook for Fannie Mae from Mr. Marzol, chief credit officer and later for financing credit. The memo was written to Mr. Mudd and was developed at Frank's request. I presume that was you, Mr. Raines. And Mr. Marzol writes that "the trend of rising home prices nationally will continue until near term, but the downside risk will be greater due to declining affordability and signs of frothiness."

This sounds like a clear warning as early as 2004 from him that a housing bubble is likely to occur. Yet, it was precisely in 2004 when Fannie Mae started increasing its purchases of risky subprime and Alt-A mortgages dramatically.

And I can't understand, why would anyone enter into a risky market like the subprime business when he knew there was a possible bust in the housing bubble? Can you explain that to me? I mean, he sent this memo to you, and yet you increased the risky mortgages and subprime Alt-A mortgages that you were supporting.

Mr. RAINES. If you are talking about 2004, when I was there, I can respond to that, which is, in fact--

Mr. BURTON. Mr. Mudd can respond subsequent to that.

Mr. RAINES. In 2004, Fannie Mae, in fact, lost a dramatic share of the market because it did not participate in these markets. And where we did buy subprime loans, we also sought to get insurance for covering those loans from mortgage insurance companies, where they would absorb the risk of these mortgages.

So we were very cautious about any entry into that market and how we did it. And I think it has been proven by the performance of those loans. They performed better than the loans in the market as a whole.

Mr. BURTON. According to Mr. Marzol, in 2004 he said there was a real problem, that a housing bubble was likely to occur. And according to the information we have, Fannie Mae increased its purchases of risky subprime and Alt-A mortgages dramatically after that.

Mr. Mudd, you were in charge after that. Do you want to respond?

Mr. MUDD. Yes. From 2004 to 2005, the purchases of subprime securities actually went down from $34.5 billion to $16.3 billion and then went up again in 2006, largely as a reflection of what was being--

Mr. BURTON. But was there a redefinition of subprime through your underwriting mechanisms? Your underwriting standards went down. So if your underwriting standard went down, then a mortgage that was considered a risk would no longer be considered a risk because you lowered your underwriting standards. Did that take place during that time frame? Did you change your standards at that time?

Mr. MUDD. The underwriting standards change constantly in response to a market.

Mr. BURTON. During the time when you were in charge, did the underwriting change dramatically so that the subprime risk went up?

Mr. MUDD. We did our best at the time to balance out both sides of the equation with respect to risk. The day you open--

Mr. BURTON. You were the ultimate person who made the decision on underwriting changes, were you not?

Mr. MUDD. Chief executive officer, so I am responsible, yes. And am I making--

Mr. BURTON. Were you, with change like that, when they changed the underwriting requirements--

Mr. MUDD. I think it is important, Congressman, to understand there are two sides to the underwriting equation. One is the risk side, and the other is the pricing side. So one has to look both at what is incremental risk, and secondly, are you pricing for it and are you getting appropriately compensated for that risk?

Based on everything we knew at the time, we did the best that we could to ensure that we were pricing for the risk that we were putting on the book, because the market had moved in a direction because of the affordability problem Mr.

Marzol referred to.

Chairman WAXMAN. Your time has expired.

Mr. BURTON. How about Mr. Kanjorski?

Chairman WAXMAN. He didn't have extra time.

Mr. BURTON. I saw the light.

Chairman WAXMAN. You've forgotten what it is like to be at the end of the line waiting for your turn.

Now I am going to recognize Mrs. Maloney. But before I do, I would like to ask unanimous consent that the documents from Fannie Mae and Freddie Mac productions, identified by the majority and minority as relevant to today's hearing, will be included in the record. Without objection, that will be the order.

You are recognized for 5 minutes.

Mrs. MALONEY. Thank you, Mr. Chairman.

You have been a spectacular chairman. It has been an honor to serve on this committee. And in your new position on the Commerce Committee, you will be trying, confronting, really, some of the most pressing issues we have: universal health care, health care for the 9/11 workers, global warming, energy independence. And my constituents wish you well, particularly those without health care. And I hope this committee can play a supportive role in the many challenges you confront.

My constituents are very angry about these bailouts, and they want to know why a $100 billion line of credit was given to Freddie and Fannie, and that Freddie has drawn down $15 billion of that $100 billion line of credit. We were looking at what happened. They want to understand what happened.

So in preparing, we interviewed your former chief risk officer, Mr. David Andrukonis, from 2003 to 2005. He said he held that position and reported directly to you. He told us that, during these years, mortgage lenders were making increasing demands for Alt-A loans, loans that had no documentation. He found them risky. I know that in New York many people said it was easier to get a loan with no documentation than to pay your rent during these days. And he said, "Wall Street became, I think, pretty adept at packaging securities of loans that we would have considered to be higher-risk; that is, reduced or very little documentation," end quote.

According to him, big mortgage lenders like Countrywide and Lehman put a lot of pressure on Freddie Mac to buy these risky, no-doc, Alt-A loans. And he said these lenders were constantly looking to reduce documentation because it was easier to produce the loans than sell them, get fees. And the toxic loans are now what we are confronting.

He said that he reached out to you. He said that he was opposed to these no-documentation loans, that he talked to you directly, that he sent you memo after memo outlining to you and the Board and others that this was risky and not the right way to go.

And I would like to put these memos in the record, along with the interview that was conducted with him and our staff.

Chairman WAXMAN. Without objection.

Mrs. MALONEY. And so, is it true that your chief risk officer advised you not to buy these reduced-documentation, Alt-A, no-doc loans?

Mr. SYRON. Well, first of all, I don't believe I have seen those memos that were addressed to me, but I am not sure.

Mrs. MALONEY. We will be glad to give them to you. Did he advise you to buy those loans? And then did he advise you that they might be risky?

Mr. SYRON. Yes, ma'am. But if you look--

Mrs. MALONEY. I only have 4 minutes.

Furthermore, I would like to say that he was right, because, under your leadership, Freddie Mac bought more than $150 billion of no-doc, Alt-A loans. And, according to your most recent SEC report, your company's Alt-A purchases have resulted in more than $8 billion this year in credit losses alone due to these risky products that your chief risk officer said do not buy.

Now, what happened to Mr. David Andrukonis? He was fired. He was fired. He felt that you agreed with him but that you still continued to buy what everyone was saying was high-risk. It is common sense: If you give a loan to someone and they don't even have to show you that they have a job, you are in trouble.

So my question to you now, and my basic question to you in light of all of the money that Freddie has lost and that taxpayer money that has been supporting you--and you have spent $15 billion of it--given the fact that you lost so much money on these Alt-A risky loans, wouldn't it have been better not to fire your risk manager but to fire your portfolio manager of your Alt-A loans?

Do you regret firing your risk manager who told you that you were moving in the wrong direction, that it was risky and toxic and not what you should be doing? Do you regret firing him? Do you regret buying these risky loans? Do you regret the way you led and, I would say, mismanaged your company?

Mr. SYRON. Well, ma'am, if you go back and look at the records in Freddie Mac in--I think you said 2000 but it is about right--

Mrs. MALONEY. 2003 to 2005.

Mr. SYRON. I am not sure of the exact time. But there was a long, long debate with people on both sides of what should be done with Alt-A. This was done, and the debate was in the context of an environment in which Freddie Mac's market share was declining and the question of our relevance and ability to influence markets--

Mrs. MALONEY. But, sir, with all due respect--

Chairman WAXMAN. Your question is pending, and the gentleman should answer, but then we have to move on. The time has expired.

The question is, do you regret the decision to fire the risk manager and not to fire the portfolio manager?

Mrs. MALONEY. And to buy the Alt-A loans that were risky and put the taxpayers' money at risk.

Mr. SYRON. First of all, Mr. Andrukonis was fired for a variety of reasons, and it was not primarily for his having a view on credit.

Second--I am trying to remember the different parts of the question. Second, in perfect hindsight, I think you always wish that any loan that went bad that we hadn't bought. But given the information that we had at the time and given the balance that we were trying to achieve, we thought we made the right decision at the time.

Chairman WAXMAN. The gentlelady's time has expired.

Mr. Westmoreland?

Mr. WESTMORELAND. Thank you, Mr. Chairman.

I am going to ask each one of you this question.

Mr. Syron, what was your salary from 2003 to 2008, your total salary? And do you get any pension?

Mr. SYRON. My total salary over that period of time was about $4 million a year. And I have pension rights that I am not quite sure but I think, after tax, are worth in the neighborhood of a little less than $2 million.

Mr. WESTMORELAND. About how much?

Mr. SYRON. I think a little less than $2 million.

Mr. WESTMORELAND. $2 million a year?

Mr. SYRON. No, no. The present value actuarial, depending on how long I live.

Mr. WESTMORELAND. Mr. Mudd, the same question to you. From 2005 to 2008, your total compensation?

Mr. MUDD. I have a different number, so if I can make an estimate to meet your request, it would be in the vicinity of probably $7 million or $8 million of compensation. That wouldn't be counting any stock, which obviously grants value, and very little value now.

Mr. WESTMORELAND. But, total, you are going to stay with $7 million or $8 million?

Mr. MUDD. I have numbers for 2004 to 2008. I would be happy to supply those later.

Mr. WESTMORELAND. Are you eligible for a pension?

Mr. MUDD. I believe so, yes.

Mr. WESTMORELAND. And what would that pension be?

Mr. MUDD. I can't be precise. I would have to research it.

Mr. WESTMORELAND. Did this pension come from just your

3 years of service?

Mr. MUDD. No. I had been with the company going back to 2000. So I would assume that it would have been throughout that period.

Mr. WESTMORELAND. And you are going to get a pension of somewhere--

Mr. MUDD. If I can get you a precise number?

Mr. WESTMORELAND. All right.

Mr. Brendsel, how about you?

Mr. BRENDSEL. Yes. Of course, I left the company in June of 2000. So, what years are you--

Mr. WESTMORELAND. From '87 to 2003.

Mr. BRENDSEL. That is a matter, certainly, of public disclosure.

Mr. WESTMORELAND. Can you give me a hint?

Mr. BRENDSEL. I would have to say that, in the last few years, the amount disclosed, reflecting stock grants and everything, based on the valuations used, about $10 million a year. Of that---

Mr. WESTMORELAND. About $10 million a year?

RPTS BINGHAM

DCMN BURRELL

[12:05 p.m.]

Mr. BRENDSEL. Yes, including the stock grants. The salary was about a million dollars in 2002 and 2003.

Mr. WESTMORELAND. They got you cheap.

How about the pension?

Mr. BRENDSEL. I am eligible for a pension, and I am receiving a pension.

Mr. WESTMORELAND. And how much is that?

Mr. BRENDSEL. It's reflecting my 21 years of service; it is about $400,000 a year.

Mr. WESTMORELAND. Now, Mr. Raines, I know it has been said that $90 million, and I notice in your testimony you got some explanation of that, that it really wasn't 90 million, but what was your total package for the time that you were there?

Mr. RAINES. I don't know off the top of my head. The number I referred to was a number that OFHEO has included in their documents.

Mr. WESTMORELAND. Well, you had had 90 million in there and then you said there was some discrepancy in that and because--

Mr. RAINES. Not a discrepancy. Accepting the OFHEO number as the beginning point, 40 percent of that has effectively been clawed back as a result of my settlement with OFHEO and the stock options that I was awarded becoming worthless. So 40 percent of the 90, if you accept the 90 as the number, has been clawed back by one means or another.

Mr. WESTMORELAND. That is still good money though, you know, it's still good money.

Mr. RAINES. Excellent money.

Mr. WESTMORELAND. What kind of pension do you get, sir?

Mr. RAINES. I am qualified for a pension based on my 11 years at Fannie Mae.

Mr. WESTMORELAND. And what would that be?

I know you got 3 million in one year, 400,000 one year.

Mr. RAINES. My pension is approximately $1.2 million.

Mr. WESTMORELAND. $1.2 million for the 11 years of service. That is not good, I mean that is good. That is good money. And let me say this, you know, I'm glad that I came to the hearing today to learn that none of you all had anything to with Fannie Mae or Freddie Mac going south, that you all were getting paid millions of dollars a year, millions of dollars a year, but you didn't know anything was wrong. You didn't have any idea that it was going south and none of you seem to have done anything about it. I haven't heard one person say today that you recognized that Fannie Mae or Freddie Mac was in trouble and that you did something about it. So it's quite extraordinary and I think the

American people and the taxpayers are going to be kind of miffed that you all's job was basically as CEOs of these companies was rearranging the deck furniture on the Titanic as it went down and didn't know it was going down. That is amazing.

Chairman WAXMAN. Gentleman's time has expired. If the witness, I don't know if it's a pending question or not but let's--

Mr. BRENDSEL. Mr. Chairman, I want to respond to that last comment.

When I left Freddie Mac in June of 2003, Freddie Mac was safe and sound and well-capitalized and had a high quality mortgage portfolio.

Chairman WAXMAN. Thank you. Now we go to Mr. Cummings.

Mr. CUMMINGS. Thank you very much, Mr. Chairman, and gentlemen, thank you for being here. I can tell you as I sit here I, you know, am just disturbed, and that is putting it lightly, because when I look at this fiasco I think both of these companies did have something to do with it. And I'm not going to sit here and act like it didn't. I think Tom Friedman in his article dated November 25, the New York Times, put it right. He said so many people were in on it. People who had no business buying a home with nothing down and nothing to pay for 2 years. People who had no business pushing such mortgages but made fortunes doing so. People who had no business bundling those loans into securities and selling them to third parties as if they were AAA bonds but made fortunes doing so. People who had no business rating those loans as AAA but made fortunes doing so, and people who had no business buying those bonds and putting them on their balance sheets so they could earn a little better yield but had no--but made fortunes doing so. And you know, the thing that gets me is that I have got constituents who, and I think Mr. Towns alluded to this, folks have tried to blame poor people and minorities, but a lot of those people, and I admire you for what you said, Mr. Raines, you talked about the dreams of folk and trying to help them get a home and how important it is, but what has happened as a result of all of these folks, including some of you guys, what has happened is that the people in my district have been left with two things, holding a bag. They have lost their houses, and they have got zero in one bag and debt in the other. That is what they have got.

And so I want to go to you, Mr. Syron, because you have said some very interesting things that I would just like to just hear a little bit more about. You know you talked about these no asset--no income, no asset loans. They call them NINA loans, is that correct?

Mr. SYRON. Yes, sir.

Mr. CUMMINGS. Keep your voice up. We want to hear clearly what you're saying. Banks use no income, no asset mortgage to lend money to a borrower, without requiring any information about the person's income or assets. This was an increasingly popular type of Alt-A loan in 2004, 2005, 2006, and Freddie Mac purchased a lot of them. Let me ask a common sense question. Why would anyone give a mortgage without requiring information on a borrower's income or assets? Help me with that.

Mr. SYRON. Well, sir, if you have information on their FICO score, right, and they have a strong FICO score and you have information on the loan-to-value ratio of the property and in many of these cases you would see that the risk for the loan shouldn't be that great. These loans were developed in the first place for what you might call borrowers that had special characteristics; i.e., uneven income flows, actors, waitresses--

Mr. CUMMINGS. Well, obviously you're not familiar with Mr. Raines' testimony because what I read in his written testimony, he said part of the problem was when we got into these subprimes. Before they were based on people had equity, and then when they didn't and when we moved to these kinds of loans, they were more based on score, so we got rid of the equity, a lot of times the equity that we really needed to secure these loans, I mean to truly secure them, and we went to this other form of basically what you're about to tell me now.

But so can you tell me why one of your top executives wrote in a memo to you on October 6, 2004, that Freddie should continue buying NINA loans because in his words, quote, it provides unique market growth opportunities to Freddie Mac.

Mr. SYRON. Sir, I don't have the memo before me but I will try to answer on the basis--

Mr. CUMMINGS. Briefly because they only gave me 5 minutes.

Mr. SYRON. I think what had happened is the market had migrated away from the traditional kinds of products that Freddie Mac and Fannie Mae had provided, and I think what he was--I'm speculating.

Mr. CUMMINGS. Let me speculate. Let me tell you what I speculate. I speculate it was about profit, I speculate that it was about agreed, because a top Freddie credit official, Ray Romano, explained the rationale for doing so in June 4, 2007, in a memo to the Freddie Mac board where he warned about the, quote, increased reputation, fraud, predatory lending and credit risk posed by our current program. How about that? Let's see you speculate.

Mr. SYRON. Sir, we're an organization that had to develop balance, and we had to balance between the needs of safety and soundness, the needs of our mission, and the needs also to be relevant from the perspective of our shareholders because we were like any other privately held company, and I checked a number of times and we had no ability to treat our shareholders differently than anyone else did.

Mr. CUMMINGS. I see my time is up. Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Cummings.

Mr. Souder.

Mr. SOUDER. Thank you I want to follow up justa little bit on a similar line that my friend, Mr. Cummings, just had. One of the extraordinary things about this series of hearings, whether it was the bond people or the AIG people or the hedge fund people, nobody takes responsibility for anything. Nobody comes up and says, I'm sorry, I may have made some judgments, I did the best I could. It's like, no, it wasn't us. And it gets very frustrating to figure out what to do next if nobody is responsible for anything.

I was really intrigued with the statement of with 20/20 hindsight it would be reasonable to say that people who didn't have credible income to meet their payments, who were depending on house values going up to meet it, or who lied, would have been higher in defaulting. You know, I would say with 20/20 hindsight; in fact, I would say the average American could figure that out with foresight and they don't need to get paid $7 million a year to figure that out with foresight, that your model was not working.

Now, what is disturbing to me is that you said, Mr. Mudd, that you weren't sure whether it was systemic or cyclical so that you plunged into it, separating now subprime and the Alt-A types of things, but then in addition to that, I think Mr. Syron said in his testimony and, Mr. Mudd, you said similar, that your organizations were there to make the market work, in order to provide somebody who supported affordable housing, Mr. Raines' statement really interested me because this isn't just about low-income housing, this is about what happened to the housing market as a whole, and if what you said--can I ask you a follow-up question to that? You said it wasn't just low income, it was higher. Are you saying that for Fannie and Freddie your problems aren't just low income, that Fannie and Freddie was also going far beyond affordable housing in giving risky loans?

Mr. RAINES. What I was saying is that Fannie Mae provided service to low, moderate and middle-income Americans, and I was saying in answer to the question, that low-income Americans have not contributed disproportionately to the problems at Fannie Mae or Freddie Mac.

Mr. SOUDER. Reclaiming my time, I just wanted to make that clear that it wasn't just the lowest housing portion here, that Fannie and Freddie were risking dollars as they moved up the scale because, in fact, there appears to have been as much of a profit motive as there was just to get people into homes. And that is important as we develop the--where we go next. And the challenge here is that since I understand Mr. Syron's testimony, he says, I want to make sure, yes, that you do this enabling banks to make new loans; in other words, part of the purpose of these agencies was to expand and enable. So when you went into this market you pretended like you came in late, reluctantly, you were worried whether your business model, whether it was systemic or cyclical, but in fact you're the enabler's agency, in fact your two agencies enabled this market and gave it a security that it didn't otherwise have or it might have flattened out.

In fact, they can put this up, Mr. Syron, March 30, 2004 e-mail from one of your executives. The author describes loosening of Freddie Mac's underwriting standards in order to accommodate risky mortgages that do not require verifying the borrower's income or assets, which is extraordinary. He goes on to write, these are largely driven by a need to allow lenders to compete with Countrywide's Fast and Easy program and Bank of America's Paper Saver programs. I view these programs as fundamentally changing the underwriting process for as much as 30-plus percent of the mortgage loans we purchase.

Now the question here is, is what were Fannie and Freddie trying to compete with Countrywide's Fast and Easy programs for? You're supposed to be the more--you're supposed to not be the enabler of risky programs. What was your check? Mr. Syron, do you want to--

Mr. SYRON. Sir, I would debate whether we were, that this market wouldn't have developed even if we weren't involved in it. I mean what we saw in the subprime market is the subprime market developed around that and so did the Alt-A market.

Mr. SOUDER. Let me ask a follow-up to that. Do you believe that if Fannie and Freddie would not have gotten involved in this market, that the market would have flattened? In other words, I'm not saying it wouldn't have started but would it have flattened or in fact did your involvement accelerate the market, give a glint of Federal, because people don't know whether you're private, public, or whatever, approval to that market in a different way and in fact the taxpayers have wound up now holding your share and in fact then wound up with a bigger problem than we would have had?

Mr. SYRON. Sir, in all due respect I think we would be speculating on my part whether the market would be flattened or not because other markets that we were not in expanded and expanded quite rapidly.

Mr. SOUDER. So you don't believe you had any basic responsibility for the crisis; that is your testimony? That you believed it was okay, you went and competed with Countrywide and put Fannie and Freddie at risk and gave the patina of cover for this for a profit motive?

Mr. SYRON. Sir, I can honestly say I am not saying we made decisions perfectly. We certainly didn't, as you pointed out. But I can honestly say that in what we were trying to do at the time we were trying to balance the interests of our mission, regulatory objectives, and our obligation to shareholders.

Mr. SOUDER. By taking in 20/20 loans that did not use reasonable standards, didn't have income verification and depended on--

Mr. TOWNS. [Presiding.] Thank you very much. Gentleman from Ohio, Mr. Kucinich.

Mr. KUCINICH. I thank the gentleman. I'm listening to my colleague, Mr. Westmoreland, and I want to pick up on something that he said. You know we've got some of the Representatives here who act like you just didn't know, that it's almost like hearing the response "I don't know nuttin," no responsibility, no accountability, stuff just happens, it's the housing market, it's the economy, it's the poor people wanting homes. But the facts show, gentlemen, that many of you at this table did know the risks and that you were warned not to take them, and that you ignored your internal adviser, your Chief Risk Officer.

Now, Mr. Mudd, the committee has been provided with an e-mail that your Chief Risk Officer sent to your CEO and copied you. You're dealing with hundreds of billions of dollars, and this memo from your Chief Risk Officer said the company has one of the weakest control processes I have ever witnessed in my career. He said the company really doesn't get it, it's scraping on controls.

Now it appears from the record that as CEO you were taking hundreds of billions of more risk, you were warned by your Chief Credit Officer not to do that, you're taking higher risks anyway, and then you cut the budget of your Chief Risk Officer by 16 percent, you took on more risk while cutting internal controls, and at the same time, you're telling your board you had all the research necessary to properly assess risk. Now you received an e-mail from your Chief Credit Risk Officer, Enrico Delvecchio, that said, I'm very upset, I had to stand at a board meeting and hear we have the will and money to support taking more credit risk.

Now Mr. Mudd, you testified that your investment strategy is to keep up with the market. Did you change, did you have a change in strategy that involved reducing the resources of your credit risk office which assessed the inherent dangers of your investment strategy while at the same time you're taking more external risk? Was that part of your strategy to reduce that credit risk office?

Mr. MUDD. No.

Mr. KUCINICH. Then why was there a budget cut occurring while you're involved in these great risks with billions of dollars?

Mr. MUDD. Congressman, I think the best response is to read my--

Mr. KUCINICH. The best response is the truth. Now did someone tell you to cut credit risk, to cut the credit risk office budget or did you make that decision?

Mr. MUDD. Let me read you what I wrote back to him.

Mr. KUCINICH. Can you answer the question? Who told you to cut the budget? Who told you to cut it? You're dealing with hundreds of billions of dollars. Can you answer the question? Who made the decision to cut the credit risk office's resources at the time that you're taking increased risk?

Mr. MUDD. The cuts in the budget that applied across the company were driven by the financial need to drive higher capital in the company and to maintain our regulatory capital standards. We started with the process--

Mr. KUCINICH. Holy smokes. Is anybody listening to this? He is cutting the one person that is telling him, hey, wait, you're going to go over a cliff cutting that, and he said we have to cut across the board.

Now your Credit Risk Officer told you in a memo that far from--he said that you are operating far from current market practices. He said--this is a direct quote--we are not even close to having proper control processes for credit, market, and operational risk. And then he went on to say, I get a 16 percent budget cut, and he suggested that there was malice involved.

Now what I want to find out, was this calculated? You know this is one of the concerns that we have. This isn't a case of a cop walking off a beat. This is a case of a cop being told don't go there by not giving him enough resources.

Why did you do that? Explain this to the American people. Why did you make a decision to cut your--

Mr. MUDD. I will explain it to you by reading to you a response to him which was part of a conversation, Representative. It is not fair to take an e-mail that is in a train of e-mails that has a response right behind it that says if you feel the process is not working you know my door, telephone and house are open to you. I'm not aware that you sought to do so on this topic. And if of course you may say that anything you believe to be true at any time to anyone on the board or anywhere else, this is my response to him, and I believe it is inaccurate for you to suggest anyone expressed a view there are enough resources for everyone to do everything necessary for the plan. Resources are tight. Everyone has cuts. Come and see me--

Mr. KUCINICH. Did you take responsibility for the risk--

Mr. MUDD. That is what we did. That was the process--

Mr. KUCINICH. Do you take responsibility for the risk--

Mr. MUDD. We sat down and did that--

Mr. KUCINICH. Your company took--when you ignored the advice of your Credit Risk Officer and when you cut the budget, do you take that responsibility?

Mr. MUDD. I followed the process to listen to all of my staff, not just the Chief Risk Officer.

Mr. KUCINICH. What did you do though? What did you do? Did you cut the budget of your Credit Risk Officer?

Mr. MUDD. Just like all budgets involving business, we negotiated the right number for the people we--

Mr. KUCINICH. Is the answer yes or no? Did you cut your Credit Risk Officer's budget?

Mr. MUDD. As you know, giving a yes or no answer to the question will not be accurate--

Mr. KUCINICH. Can you answer the question?

Mr. TOWNS. Gentleman's time has expired.

Mr. MUDD. I will give you an accurate response, and the answer is that budgets are determined as a result of a back and forth between executives that have purview on it. His budget was subsequently increased from where it had been placed. He could not hire everybody that he needed because there was huge demand for risk officers all around the financial markets. So we appropriately adjusted it and gave him the opportunity to come back in should he be able to hire above that rate. Yes.

Mr. TOWNS. The gentleman's time has expired.

Mr. KUCINICH. You testified you increased his budget; is that what you're telling this Congress?

Mr. MUDD. We negotiated the budget the same as we did every year from time immemorial.

Mr. KUCINICH. Incredible.

Mr. TOWNS. Mr. Shays, it has been a pleasure serving with you over the last 20 years. It has been a delight. Of course, we had an opportunity to work on many issues together.

Mr. SHAYS. I was reluctant to step up because I thought I might get a little teary eyed because I love this committee, and I congratulate you as being the new chairman, and ranking member, Mr. Darrell Issa, and I know this committee will do well.

I'm also reluctant because this issue is very sore to me because we knew a long time ago the train was going to crash. Everyone at this table knew the train was going to crash and the people who warned are the ones who took the hit, and you all just continued to make a lot of money and, ultimately, to the harm of the very people we wanted to help. It is kind of surreal, you had Richard Baker, who was pointing out that Fannie and Freddie had problems and they needed to have proper regulation. After the Financial Services Committee had a landmark hearing on Enron and we passed Sarbanes-Oxley, I said this is good, Fannie and Freddie are finally going to have to play by some rules, but then Richard said they are not under the 1933 and '34 act so they're not going to be under Sarbanes-Oxley. So I said, fine, let's deal with it, and Ed Markey, a Democrat, and I said, okay, let's regulate Fannie and Freddie like any other company. And in 2002 and 2003, well, I will tell you something hit the fan because every lobbyist that I have ever met was knocking down our door. Fannie and Freddie paid lobbyists to lobby for them and they paid lobbyists on retainer so they wouldn't lobby against them. And so we had $175 million spent in 10 years on lobbying Congress, and this is a quasi-government organization that felt it had to manipulate Congress, and it did. It had a hugely weak regulator with OFHEO and, Mr. Raines, you didn't want a stronger regulator, you didn't want the 2002 act, you didn't want the 2003 act. What fascinates me is you even argued that just to set aside 3 percent made sense, when banks have to set aside 8 or 9 percent and you're getting $90 million for your good work.

It just is almost surreal to be at this hearing and to hear you. If I were critical of this administration, I would say that they cared so much about loyalty that loyalty trumped the truth. And they failed to hold people accountable. But we're still in Congress failing to hold people accountable. Whether you're Republicans or Democrats, you're not being held accountable. I hope this new administration starts to hold people accountable.

Mr. Raines, do you still believe that setting aside less than 3 percent for potential losses was financially wise? You made that argument in the Financial Services Committee. Do you still believe that was a wise thing to do?

Mr. RAINES. I think we have some evidence on that with regard to Fannie Mae's portfolio, as I understand it. The requirement for capital was approximately 2-1/2 percent for the mortgage portfolio, the on-balance sheet portfolio, and there have not been losses in that area that have exceeded that capital. The losses that Fannie Mae has reported, as I understand them, have come from the credit side, not from the portfolio side. So based on this unique experience, it appears that that is sufficient capital for a portfolio.

Mr. SHAYS. Mr. Raines, you're not just speaking to this committee. You're speaking to the whole financial sector. You are making the argument that setting aside only 3 percent was financially a wise thing to do. I'm not going to change your answer. I just want to make sure that you with a straight face are saying that was a wise thing to do.

Mr. RAINES. It is proven in the current circumstances that--

Mr. SHAYS. I would like a yes or no. Yes, it was or no it wasn't.

Mr. RAINES. It has worked. Congressman, it worked with regard to the portfolio. On the credit business, it's a different thing. And we were talking in the committee, in Financial Services Committee, about the portfolio because ironically the criticism of Fannie Mae in those days was its on-balance sheet portfolio, which in fact has not been the problem now. The problem has been the credit business that people were arguing that is all that Fannie Mae should do, was the credit business.

Mr. SHAYS. Mr. Raines, when we finally got Fannie and Freddie to agree to be under the '34 act, we learned that both Fannie and Freddie had cooked their books, overstated income, and you ultimately had to leave. I'm just curious to know, do you still believe that Fannie shouldn't be under the '33 and '34 act and play by the rules that no one else has to play by?

Mr. RAINES. At this point I don't think it matters. Fannie Mae is already registered with the SEC, so including Fannie Mae as a registrant--

Mr. SHAYS. On the '34 act.

Mr. RAINES. I understand. I was going to get to that.

You mentioned both acts, I believe. With regard to the registration I don't think it matters a lot. With regard to the overall registration of its securities, particularly mortgage-backed securities, I think that the damage that I foresaw at that time would be less now given all the convulsions that have already gone on in the marketplace, I think that the market for mortgage-backed securities are going to have be to reconstructed anyway. So I think it's just a matter of process at this point. But I don't think it matters one way or the other.

Mr. ISSA. Mr. Chairman, I ask unanimous consent that Mr. Shays have just 1 additional minute. Thank you.

Mr. SHAYS. Just a bottom line question: In other words', the '33 and '34 act were designed to protect the public. Fannie and Freddie are not under the '33 act. They voluntarily got under the '34 act. Because they got under it is when we learned that they couldn't comply with basic accounting standards. That is when we learned it. Had we not put them under the '34 act we never would have learned that. And your comment to me is it doesn't matter if they're under the '33 or '34 act?

Mr. RAINES. No. I said that because Fannie Mae is now a registrant it would be redundant to include them. But if you would like to include them under the act, I think that is fine. I don't think it would change anything about the registration.

Mr. SHAYS. How about the '33 act?

Mr. RAINES. '33 act. As I said, I am fearful it would disrupt the mortgage-backed securities market. Right now the market is so disrupted I don't know adding a registration requirement would do any more harm.

Mr. TOWNS. Thank you.

Mr. Clay.

Mr. CLAY. Thank you, Mr. Chairman. Fannie and Freddie lost a significant share of the secondary mortgage market by 2004 as private Wall Street companies bought increased numbers of subprime and Alt-A loans. Mr. Mudd, I want to ask about decisions Fannie made to regain some of this ground.

On June 26th and 27 of 2006, Fannie Mae executives attended a retreat in Cambridge, Maryland for a senior management group. The committee obtained a document that lists the highlights from that meeting. The document was circulated to you and other top executives on July 7th, '06. The document summarizes what we accomplished, the key take-away from our sessions, the open issues to address and corporate strategies, next steps. Under the section titled "New Business Modeling Growth Initiatives," the memo describes a new approach for Fannie Mae's Single Family Mortgage Division. It says this. Single family strategy is to say yes to our customers by increasing purchases of subprime and Alt-A loans.

Mr. Mudd, based on this summary, there was detailed discussion at the retreat in '06 about whether to enter the subprime and Alt-A market, and the decision was made to say yes to these types of loans. The memo says this initiative will generate attractive returns, but was there any discussion about the increased risk involved?

Mr. MUDD. Yes, sir, that was an intimate discussion in the process and so when we first entered the subprime market, and I would fast forward to the end of the story to say once we got there we realized we didn't like it that much so it didn't grow very much, but the analysis that you're asking about at the time was if we enter this market what are the appropriate forms of risk mitigation and so forth. So typically what we did was we actually bought bonds in small numbers and we bought the highest rated AAA tranches of those bonds and in some cases actually bought supplemental insurance on top of these bonds. That then gave us some exposure to the marketplace that we could evaluate and assess whether it was a market we could be in. And by the way we also set standards that said those bonds had to be, the loans, any subprime loans we were involved in had to be originated under a very specific set of conditions that gave us some assurance there would be no predatory features in them.

So with those two pillars, we had some exposure to market. We saw it. We didn't like it that much, and that is why you see from the numbers it didn't grow very quickly.

Mr. CLAY. Okay. Fannie acted quickly on this new business model. For example, Fannie purchased more than $200 billion in Alt-A loans in '06 and '07, according to the data provided to this committee by the Federal Housing Finance Agency. In retrospect it seems that the decision made at this retreat in '06 to increase your company's purchases of subprime and Alt-A mortgages was a major mistake. Do you agree?

Mr. MUDD. Well, again, separating out the subprime and the Alt-A, now addressing the Alt-A, can you look back in retrospect and say that you wish you had less Alt-A business? Yes, absolutely.

Mr. CLAY. Well, the numbers speak for themselves. I think you know last month Fannie reported almost $4.3 billion in credit losses for '08 so far. Almost half of these losses came from your investments in the risky Alt-A mortgages, especially those that originated in '06 and '07. Do you agree with that?

Mr. MUDD. Certainly a high proportion of losses has come out of, has come out of the Alt-A book, yes, and certainly if you look back in retrospect and say based on what you know now would you have as much exposure in Alt-A, no, you wouldn't. But based on the information that we had at the time, based on where we saw the market at the time, based on the evolution of our own standards and based on the prudential things that we did and got a lot of criticism for, increasing price, increasing standards, requiring more documentation was there was important. And by the way, the Alt-A loans on Fannie Mae books have performed a factor of 2 better than any of the Alt-A loans in the marketplace at large. So I think some of those processes were helpful. Were they ultimately helpful enough? Goes to your question.

Mr. CLAY. Thank you very much for your response. The memo also said we discussed additional growth ideas that warrant further exploration, including a new acquisitions method to buy all loans. What does it mean to have a policy to buy all loans? That doesn't sound like risk is considered at all.

Mr. MUDD. No, it doesn't, and that wasn't in fact the policy, Congressman. The challenge that we were facing in the marketplace at that time was because of the footprint or, what we called it, the box of loans that Fannie Mae would actually accept. Originators were originating product that was outside that box. It was difficult for them to segregate the loans that they could only sell to Fannie Mae from the "all other" category. So we had a number of initiatives in place to say could we provide an upfront solution so they would have kind of one-stop shopping, but that we would never take on those risks that were either risks that we didn't like or risks that we couldn't price for or loans that were perhaps jumbos or something like that. That was the subject of that study.

Mr. TOWNS. The gentleman's time has expired.

But he can answer the question.

Mr. MUDD. I'm sorry, Mr. Chairman. I didn't hear the question.

Mr. CLAY. The question was you took bundles that were combined with good and bad mortgages, good and bad loans.

Mr. MUDD. No. The purpose of that project was specifically not to take the loans that we weren't comfortable with, but to continue to attract the business of our customers. That was the traditional business that we had done or the business that we could price and were comfortable with.

Mr. CLAY. Thank you, Mr. Chairman.

Mr. BRENDSEL. Mr. Chairman, I apologize. Could I take a brief break?

Mr. TOWNS. Sure.

Mr. SYRON. Mr. Chairman, while that is occurring may I accompany?

Mr. TOWNS. I'm sorry?

Mr. SYRON. May I do the same thing while that is occurring.

Mr. TOWNS. Why don't we just take a 5-minute recess.

[Recess.]

Mr. TOWNS. The committee will reconvene.

We will now recognize the gentleman from Ohio, Mr. Turner, for 5 minutes.

Mr. TURNER. Thank you, Mr. Chairman.

Mr. Raines, I want to read you a portion of your written testimony. You make a statement that I think is very important in your written testimony that I agree with about the CRA. In your statement you say a very common allegation that has been made is that the Committee Reinvestment Act forced mortgage originators to make loans that were too risky and burdened banks with assets that would later default. It's on page 11. This claim is incorrect. The most risky loans in the system tended to be originated by lenders not covered by CRA. The statement that you're making there. I hear from a lot of CRA-covered banks, lenders, who then go the next step though and say that they're not as at fault or at fault for the mortgage lending crisis because their loans which they originated were not those that many of us would identify as predatory or even in the subprime area.

My thoughts in that are that by their actually then buying the mortgage-backed securities of these subprime or these predatory loans, they're providing the fuel back for those types of loans that they claim that they weren't originating; in other words, from the back door buy those things that they're not selling out the front door, and then provide gasoline or fuel to allow more of those loans to occur, and so their having participated in purchasing those and then using their capital to buy them helped fund what was the practice--what were the practices that in fact were the problem. Would you agree with that?

Mr. RAINES. Well, I think you have a very legitimate point as to at what stage are you providing necessary funds to the market and at what stage have you moved over into encouraging practices that aren't good market practices? Most subprime loans go to people, you know, like my father, who simply didn't have a lot of income and didn't have a great credit rating and he had to go to the finance company to get financed. That is what an original subprime loan was, you went to HFC and they gave you a loan and it was backed by your house that you had some equity in. Over time, as I point out in my testimony these loans morphed into other things. Instead of it being a loan on your house that you already own, that you have equity, subprime loans became loans to buy houses where you had no equity. Instead of being people who had a long track record of paying their bills but just simply every now and then fell behind, it became people who have just gotten out of bankruptcy. So not all subprime loans are bad. A chunk of them have been very bad for consumers. And it's hard for your banker to know in the mortgage-backed security that he is buying, does this only include the good ones or does this also include predatory ones? That is why as early as 1999 we published standards on subprime lending as to what Fannie Mae would buy or wouldn't buy to try to establish some standards in the market.

Mr. TURNER. But they did know. They did know both from the information that was being received on the default rates, the foreclosure rates, the sloppy underwriting processes, the lack of documentation, the loan-to-value ratios that had been changed, they did know that these were the more risky ones and that these were those that you would not want to encourage either for a borrower or really for the assets for the overall bank. And I don't want to go to the next step, Mr. Raines, because you said exactly what I thought you would say, which I agree with, that where do you cross the line of actually encouraging bad behavior versus just participating in the market? And that is what I believe that Freddie and Fannie did. It's not just the CRA-covered bank that had one originating loan standard in the front door and bought mortgage-backed securities out the back that had bad standards. It was Freddie and Fannie also. You provided fuel, all of you gentlemen, by providing fuel for these loans. By buying them up, you encouraged an area of the market to both expand, recapitalizing them so that they can go out and do more of these, without providing the types of standards necessary to protect the borrowers, to protect the public or to protect your shareholders.

Mr. Syron, you stated that the market had migrated away from traditional loans. You're supposed to be an organization that has a knowledge that that tradition is not just based on some archaic structure that we all knew when my parents first went to buy their first home. It's based upon sound business principles. Mr. Syron, you went on to say we were doing what we needed to to serve our shareholders. Your shareholders haven't been served. I can't imagine one of you today can sit here today and say the conditions of your companies are such that you were following practices that were shareholder directed. They weren't borrower directed. They weren't, our Federal mortgage processes directed, and they certainly haven't served the taxpayer.

Mr. SYRON. Sir, a couple of points. First, I think you're absolutely correct that even though a lot of these changes provided other opportunities that in retrospect you would have been a lot better off if the market had stayed in its more traditional source. But neither Fannie--

Mr. TURNER. Didn't you have a role in that? Didn't you have an ability to raise your hand and say what needs to be done on the regulatory side to prevent the market from migrating there and have a role to not enter that market area by funding it and fueling it?

Mr. SYRON. Well, sir, we didn't have any capacity to constrain the growth of that market, is what I would say. And the second part of your question, I think that what we did, and I really firmly believe this, is I'm not saying we didn't make mistakes, we did what we thought was the right thing at the time, but you're absolutely right, it's hard to say that the shareholders or any of us who were shareholders have benefited from that.

Mr. TOWNS. The gentleman's time has expired.

Mr. TURNER. Thank you, Mr. Chairman.

Mr. TOWNS. The gentleman from Massachusetts, Mr. Lynch.

Mr. LYNCH. Thank you, Mr. Chairman, and briefly I just want to congratulate Chairman Waxman in his absence for his great work on this committee as well. He will be sorely missed. I want to thank you, Mr. Chairman, for the time, and also to the ranking member.

Mr. Chairman, I would ask that the American Enterprise Institute article entitled "The Last Trillion Dollar Commitment: The Destruction of Fannie Mae and Freddie Mac," by Peter J. Wallison and Charles W. Calomiris, be entered into the record.

Mr. TOWNS. Without objection, so ordered.

[The information follows:]

******** COMMITTEE INSERT ********

Mr. LYNCH. Thank you, Mr. Chairman. Just as an initial matter of clarification, it was asked earlier by the ranking member, I believe, whether 660 was used as your dividing line for Alt-A mortgages, Mr. Mudd, and probably you as well, Mr. Syron. I'm looking at some Fannie Mae and Freddie Mac documents here and it appears that you use the FICO score of 620 as the dividing line, is that right?

Mr. MUDD. In our case--

Mr. LYNCH. Please don't burn my time. This is just a simple matter. Is it 620 or 660?

Mr. MUDD. No.

Mr. LYNCH. No?

Mr. MUDD. No.

Mr. LYNCH. You use 660 then.

Mr. MUDD. No.

Mr. LYNCH. You don't use 660, you don't use 620. What do you use?

Mr. MUDD. The original definition of a subprime loan was based upon the originator. When the market developed other definitions we disclosed based on the other definitions that were used in the marketplace.

Mr. LYNCH. Okay. This is consistent. You know what I can tell you right now? If you have accomplished anything here today, you have made conservatorship look very, very good. I was very worried about that decision to put these organizations in conservatorship. But what I have seen here today, with the total denial that is going on here today and the refusal to answer simple questions whether you put the budget up or you put the budget down and you can't answer that, it just gives me great comfort, great reassurance that these two GSEs are now in the hands of the conservators because I can see what led us into this problem just by the way you have been failing to respond. Despite all the denials of what is going on here I happen to have some of the documents that were submitted here. This is a 10Q investor summary for the quarter ended June 30th, 2008 and, let's see, Fannie reported that, this is for Fannie Mae, that subprime characteristics, mortgages with subprime characteristics comprised substantial percentages of all 2005 through 2007 mortgages that the company acquired. And there's some tables here that are shown as well. If you add up, this is Fannie's report, if you add up the categories, and eliminate double counting, and this is also in the Wallison-Calomiris article, it appears that on June 30, 2008, the reporting date just after the time that you left, I believe, Mr. Mudd, around the time that you left, Fannie either held or had guaranteed subprime and Alt-A loans, however that is defined, with an unpaid principal balance of $553 billion. In addition, according to the same Fannie Mae report, the company also held 29.5 billion of Alt-A loans and $36.3 billion of subprime loans that it had purchased as private label securities. And these figures amount to the grand total of $619 billion and reflect a huge commitment to the purchase of mortgages of questionable quality between 2005-2007.

We also appointed, as I said before, we have a new regulator in town, a new sheriff, and I'm going to quote from him, this is Jim Lockhart, who now heads up the FHFA. Here is what he says. This is in a report that he gave. Fannie Mae and Freddie Mac purchased and guaranteed many more low doc, low verification and nonstandard mortgages in the 2006 and 2007 years than they had in the past, roughly 33 percent of the company's business involving buying or guaranteeing these risky mortgages compared with 14 percent in 2005. Those bad debts on mortgages led to billions of dollars in losses at these two firms and affected the capacity to raise capital to absorb further losses and force them to go to the Treasury for support.

Now, let me ask you, the way we set up this whole organization where you have, as we've said before, you have an obligation to your shareholders, and we've talked about that, my colleague previously mentioned that, there is also the liquidity function here and you're trying to shore up the markets. We're going to have to look further down the road at the possibility perhaps of going into a receivership, and Fannie and Freddie will go away.

Do you think, in looking back, that that created a conflict, your obligation to the shareholder where you're going for return, and I know that is what you were going for with some of this stuff here. This was making a lot of money at one point. Is that a core problem with the way these organizations are structured now? And I will just take my answer and yield back my time. Thank you.

Mr. MUDD. Congressman, first, I would apologize. I was--you asked a question about the definitions and I wanted to be as precise as I could, and if I can follow up by writing individually I will. I don't mean not to answer your question in any way.

Mr. LYNCH. That would be great.

[The information follows:]

******** COMMITTEE INSERT ********

Mr. MUDD. On the second question, what I found personally was that due to the hybrid nature of the company, a private company with a public mission, that charter, that structure gives rise to a number of challenges that become conflicts that become this very difficult balancing act that you describe between shareholders, homeowners, taxpayers, capital, liquidity, stability, which market to be in. In a good market, in a rising market, it's possible to make the trade-offs to keep that balance in a pretty effective place. In a crisis of these proportions, you can't manage the dial and, as you know from your work on the Financial Services Committee, you could see that some of the dials we had to sub-optimize, whether it was in terms of the affordable housing mission or the liquidity mission, at any given point in time.

So yes, I think the current structure needs to be revisited, but my hope would be to revisit it in the context of what Congress wants the overall housing finance market and the government's involvement in that to look like, thence how Fannie and Freddie fit into it rather than having an answer provided for Fannie and Freddie and then the rest of the market gets rebuilt around that without sufficient debate and examination.

Mr. LYNCH. Mr. Syron, would you like to have a crack at that just briefly?

Mr. SYRON. Yes, sir. I think, as I said, these organizations have provided a lot of value in the past. There has been a lot of change going on. I agree with Mr. Mudd completely that we have to look at how this fits into the whole system and with, very quickly with respect to the balancing of the three, I think in an up market it was a lot easier, but essentially what you were trying to do in these companies, you could never make any one of the three completely happy. It was how you could sort of minimize the unhappiness and make it feasible.

Thank you.

Mr. LYNCH. Mr. Chairman, I appreciate your forbearance. Thank you, sir. I yield back.

Mr. TOWNS. Gentleman from California, Mr. Bilbray.

Mr. BILBRAY. Thank you, Mr. Chairman. Gentlemen, a colleague of mine used the reference "perfect storm." Can we agree that this was not an act of God, it wasn't just something that happened, that this was a situation that was created, nurtured and triggered by human activity? Can we agree to that? Or do you agree with a perfect storm that just this happens and there was nothing anybody could do about it?

Mr. RAINES. Congressman, if you're addressing the question to me, I agree with you, it's a result of human beings making decisions, and I laid out in my written testimony how not only in this storm but in other storms it's going to result in human beings making a variety of decisions in the financial markets.

Mr. BILBRAY. My concern is I feel like in 10, 15 years I'm going to have power plant owners come to us for all of these grants because their power plants are being washed out by major storm activity and say we had nothing to do with this; greenhouse gases, who would have thought? But all I'm saying down the line there were contributing factors here. Okay, it wasn't an act of God. When you looked at the market, the residential housing market and the increase that we were seeing over a period of time, far beyond what we saw in the '70s, the other climbs we've seen before, was anybody suspicious at all that as we say in the environmental community, that this bubble was not sustainable, that if you look at the population growth, both birth rate and immigration, it didn't justify the market expansion that we saw? Did it? When we saw the way this market was growing, where was the market coming from? Where was the demand coming from?

Now Greenspan testified that there were two major factors: One, major portion of foreign investment coming in and buying paper and creating an artificial, basically the fact of sight unseen you get this paper out there, we will buy it, and the values kept going. A lot of that being our own petrodollars coming back from the third world. But the other part you have got to admit was that the expanded market that you were creating by going out on this thin ice with this Alt-A, this really was going out on ice.

Can you at least admit that a contributing factor was the entire industry going out on this thin ice and broadening the market that created the bubble? Because you keep saying once the bubble popped, what could we do? But the creation of the bubble itself, this artificial inflated market out there, was not an act of God. It was an act of foreign, massive foreign capital coming in far beyond what was reasonable, and the expansion of the market and not just to low income, but middle class. I have a constituent, five defaults, no, seven defaults she had on people buying and selling the market. Can youat least admit that the bubble was created partially by the institutions that were out there creating, giving loans to people who never should have qualified, thus broadening the market and inflating the value?

Mr. MUDD. I would say that the expansion of credit that went all the way back to the 1990s and went through the consumer sector as well as the commercial sector, combined with the lack of affordable housing and the increase in housing prices, all built up that bubble, yes.

Mr. BILBRAY. But Mr. Mudd, let's talk about self-creating the crisis. Didn't the availability and the expansion of the market through giving loans that weren't qualified was a major contributing factor to the acceleration, to the appreciation of residential housing? The cost was going up because you were responding to a tip.

Mr. MUDD. Congressman, I think you rightly describe it as a circular problem and the more one thing happened the more it led to the other thing. And the more the homes were unaffordable, the more the products got stretched in order to create products that people who 5 years before might not have been qualified, could be qualified today, and that then led to--

Mr. BILBRAY. Just by the act, be it good intention or not, be it Congress or be it the private sector, providing the market to people who couldn't afford it was causing the price of affordability to move out beyond them some more because it did contribute to the inflationary, the appreciation of real estate because you had more people that were in the market that could buy than you have otherwise, right?

Mr. RAINES. You were describing a classic financial bubble. And I think you're right. And as I tried to set forth in testimony, in my written testimony, we have seen this again and again and again, that this is how we end up in financial crises by ordinary products being morphed into something different and then it keeps feeding on itself until a point in which time when the market can no longer support it.

Mr. BILBRAY. Mr. Raines, I was involved 18 years with affordable housing. Explain to me how you can provide affordable housing to people who can't afford it normally, and at a time that income and salaries are static, basically static over 20 years, while the price of housing is skyrocketing, the gap was growing. How do you maintain the ability for that population to stay in the market that is moving beyond them without somewhere down the road subsidizing them one way or the other, filling that gap? How does the public sector do that without somebody filling that gap with a subsidy?

Mr. TOWNS. Gentleman's time has expired, but he can answer.

Mr. RAINES. I think you and I have probably spent a similar period of time with affordable housing, and I think the answer is in that circumstance there has to be a subsidy. We were lucky during much of the 1990s that we had incomes rising faster and therefore, with some engineering, you could help people who were close to the edge to get into housing. But at a time when home prices were rising as quickly as they were in the early part of this decade, it made it almost impossible for affordable housing to work.

Mr. BILBRAY. Mr. Chairman, let me point out that I think the bailout was the hidden subsidy, not just the low income but middle income, to go into markets that they shouldn't get into and this bailout ought to be recognized as the end product of the fact that there was a subsidy and that subsidy was the bailout and the taxpayers are paying right now to subsidize those decisions that were made over the last two decades.

Thank you very much, gentlemen. I appreciate it.

Mr. TOWNS. Thank you. The gentleman from Illinois, Mr. Davis.

Mr. DAVIS OF ILLINOIS. Thank you, Mr. Chairman. I too want to thank the gentlemen for being here. I have two basic questions for the panel. They are, what mistakes did you make that may have contributed to the current financial crisis? And what can we learn from these mistakes to guide us as we reform and reshape Freddie and Fannie?

Let me just begin with you, Mr. Mudd. You were quoted in the New York Times on August 5, 2008, as saying you have got the worst housing crisis in U.S. recorded history and we're the largest housing finance company in the country, so when one goes down, the other goes with it, end of the quotation.

Do you believe that your company's financial strategies played no role in its problems. Can you look back and identify any decisions you made that ultimately were harmful to your company and may have contributed to the crisis?

RPTS KESTERSON

DCMN MAYER

[1:01 p.m.]

Mr. MUDD. I can, Congressman. And thank you for the question.

I think that the structure of the companies as monoline companies in the housing industry, in a housing market like this, presents a challenge and ought to be considered going forward because you don't have the ability, as another financial institution would, to diversify. So when the housing market goes down, the commercial market goes up and there is some balancing.

In that light, what do I wish I had done differently? I wish I had gone earlier in the process to the regulator, to the Treasury Department and said, you know, we are--we are struggling to maintain this balance between affordability, liquidity and capital and funding and housing goals and cost. Which one do you want us to emphasize? Because the longer that we keep trying to balance these areas and be the sole source of support in a declining housing market, the more difficult challenge this becomes. So that is one thing that I wish I had done differently.

I wish I had stayed longer and had been able to help more with the foreclosure problem which has now come to the fore. That, as you know, is really the place where the rubber meets the road on this. When I was there, we were able to modify, I think, about 200,000 loans in order to help people either refinance and save for loans or avoid a foreclosure. I think it is apparent now, in retrospect, that more sooner to avoid those foreclosures would have been better for the overall market.

Mr. DAVIS OF ILLINOIS. Thank you very much. Let me ask you, Mr. Raines. I would like to hear your view about what mistakes were made either during your tenure or after you left.

Mr. RAINES. Well, I would--I'm sorry. I would point to a couple of things during my tenure that I wish had been done differently.

I wish we could have gotten a regulatory bill relating to Fannie and Freddie enacted earlier, because I think that the battle over Fannie and Freddie was a distraction to the companies, to our regulator, as well as to other parts of the financial system regulatory process. So I wish that we could have gotten that done at a much earlier stage in time, which I think would, in these times, have provided some real assurance to the market about the future of the companies.

I also wish that we had been able to complete, before I left the process, fully entrenching the risk management approach to credit that we had worked out over a couple-year period that I believe would have been helpful to my successors in managing the extraordinary credit issues that they had to face after I left.

With regard to my successors, I'm really not in a position to judge them. I don't have the facts. I wasn't there. It would be unfair for me to say, Well, sitting here today, here is what I would have done differently. I tried in my testimony simply to point out what I thought were the facts that the company has disclosed, but I don't truly feel in a position to critique what they are doing without knowing what they know.

Mr. DAVIS OF ILLINOIS. Thank you very much.

Let me just quickly ask Mr. Syron and Mr. Brendsel, answering the same questions, could you indicate any feeling of mistakes or errors or things that could have been done differently?

Mr. SYRON. Yes, sir. What I wish we had done--and we tried to do this--is insisted on more precision or some precision in how these tradeoffs should have been dealt with. For example, I had suggested that simple regulatory language that said that we should have--we needed to be fulsome on our mission, be safe and sound and provide a return to shareholders that was competitive.

I mean, I think something--something that would have helped in determining how this balance should be met over time.

Mr. BRENDSEL. Thank you. Yes, of course, I was the CEO of Freddie Mac for a long time, and over the course of those years I made many mistakes in the process. And I learned from mistakes as well. And I think certainly what I learned is, strong controls over credit and credit policies are critical to the long-term survival not only of the organization but also of homeowners and the Nation.

Beyond that, though, I left in 2003 and at the time I felt that our approach in the subprime market focusing, being very conservative and cautious was the appropriate one. And I think that has proven to be true.

I can't say really what has happened since then in terms of the decisions that were made. The appropriateness of the decisions is clear based on public statements that the subprime investments have proven to be a problem for Freddie Mac and Fannie Mae subsequently.

But certainly with regard to regrets, I think the issue about a strong, professional regulator that is credible and has the confidence of the public, of Members of Congress, and of investors is of critical importance and continues to be. And I think that that was at least a source of concern in the early 2000s that I would have--as Mr. Raines said, I think--I wish I had been more effective in working towards.

Finally, of course, as has been briefly mentioned, Freddie Mac did go through restatement in 2003. It is interesting, of course, that the statement resulted in Freddie Mac reporting more income rather than less. But nevertheless, that restatement happened under my watch as a CEO; and I wish that, number one, the restatement had not been necessary, and I still continue to kind of search through what I might have done differently in that regard.

Mr. TOWNS. [presiding]. The gentleman's time has expired.

Mr. DAVIS OF ILLINOIS. Gentlemen, thank you very much.

Thank you, Mr. Chairman.

Mr. TOWNS. Congressman Sali of Idaho.

Mr. SALI. Thank you, Mr. Chairman.

Gentlemen, I have to tell you I'm a little surprised that I'm getting this impression that all of you feel that Fannie and Freddie and the difficulties that we find ourselves in now are just because you were victims of a market.

Mr. Syron, I think you described the mission for your organization while you were there as liquidity, affordability and stability. Did I get those three right?

Mr. SYRON. Yes, sir.

Mr. SALI. Well, I think that each of you would agree that--I don't know what the exact numbers are, but somewhere around close to half of the residential market was funded through Freddie and Fannie together. In fact, it has been described as two GSEs that were too big to fail.

You do all agree with that characterization, don't you? Does anybody disagree with that characterization?

Okay, fine.

We heard a description earlier that there was this perfect storm, and I think, as Congressman Bilbray pointed out, the storm is an act of God and there is no control over that. You would all agree that as the biggest stakeholder in the residential mortgage market that you will have a significant impact on that market?

Does anybody disagree with that?

Okay.

And you probably agree that it is not unreasonable to give the biggest stakeholder in the residential mortgage market the mission of bringing stability to that market.

Does anybody disagree with that?

And given that the alt-A loans failed I think at something like 10 times the rate of other loans and that at the time they were being made they were mockingly referred to as "liar loans," none of you would disagree that both Fannie and Freddie really failed in their mission, their charge of adding stability to the market by trying to meet the market with those alt-A loans.

Does anybody disagree with that?

Mr. MUDD. Yeah, Congressman, I would disagree respectfully in the sense that it is necessary to maintain a balance during that. I don't think that market share is a primary indicator of whether the company is being successful or not. It is a secondary indicator that says, are you remaining relevant to the market. People continuing--

Mr. SALI. But we are not talking about success. We're talking about stability. And alt-A loans failing at 10 times the rate of other loans, that is not going to add stability to the market, is it? You'd agree with that?

Mr. MUDD. Yes.

Mr. SALI. Okay. Now, each of you would agree that during your time at Fannie and Freddie you received more in bonuses than you did in your salaries. That is a correct assessment, isn't it?

Does anybody disagree with that?

And that would be true, Mr. Raines, in spite of that claw back that took back part, you still received more in bonuses than you did your salary. And those bonuses increased at least in part on the pursuit and the resulting increased levels of alt-A and/or subprime loans.

Do any of you disagree with that?

Mr. RAINES. I would disagree with that.

Mr. SALI. There was no part of your bonuses that was based on increased levels of alt-A loans?

Mr. RAINES. That was not one of our goals in our compensation system to increase alt-A loans, no.

Mr. SALI. Because of the number of alt-A loans, your bonuses went up. Is that a fair statement? Because of the amount, the total amount of loans that were given?

Mr. RAINES. I don't believe so, no.

Mr. SALI. It didn't increase the amount of total loans that were given?

Mr. RAINES. Alt-A loans can increase the total volume of loans you have, but that doesn't--

Mr. SALI. Yes. And that increased your bonuses didn't it?

Mr. RAINES. No. It was not based on volume. It was based on profitability and pricing. So if you--

Mr. SALI. So if you have more volume, you have more profit; is that correct?

Mr. RAINES. Not necessarily. As we can see, having a lot of volume can create a lot of losses. So there was no necessary relationship between volume and profit. You hope you have both. But you have to work hard to get the profit part. The volume part is not that hard.

Mr. SALI. Okay. So your bonuses--you're saying that your bonuses are based on volume and that the alt-A loans had no bearing on--

Mr. RAINES. I said my bonuses were not based on volume.

Mr. SALI. Not based on volume, based on profitability;

and that the alt-A loans had nothing at all to do with the level of bonus that you got?

Mr. RAINES. I said that the profitability of alt-A loans, just like any other loans, would have an impact on the bonus.

Mr. SALI. Okay. Did the fact that there were more alt-A loans that were funded by Fannie and Freddie, did it increase your bonuses at all?

Mr. RAINES. In my case, I don't believe so, but I would have to go back to 2004. Remember, I left in 2004, so I would have to go back to 2004 to see what impact it had. Alt-A loans were a very small percentage of the book of business when I was there. So I don't believe it had any impact on my bonus.

Mr. SALI. It had no impact at all on the bonuses that you received? Is that your testimony today?

Mr. RAINES. I don't believe it did. That's what--I believe it did not, because it was such a small part of our business in 2004.

Mr. SALI. It had no impact on your bonuses?

Mr. RAINES. I don't believe it did.

Mr. SALI. Is that true for the rest of you as well?

Mr. BRENDSEL. Yes. The last time I received a bonus was for the year 2001 and certainly it wasn't based on the amount of alt-A mortgages that--

Mr. SALI. Okay. I'm not asking--I'm not asking about the level. I'm asking about the fact that there were more alt-A loans given, that you were trying to meet the market. Each of you agrees with me that is what you were trying to do, that that increased your bonus.

Do you disagree with that?

Mr. RAINES. I think you have to--in the case of Mr. Brendsel and myself, I think you have to separate--the alt-A market became dramatically larger later. It was growing during this time. But as a percentage of the book of business through 2004, the company's numbers show it was a small part of the business. My last bonus was 2003; his was 2001.

Mr. SALI. Let me ask Mr. Mudd and Mr. Syron. Is that true for you, that the alt-A loans increased your bonuses?

Mr. TOWNS. The gentleman's time has expired.

Mr. MUDD. No, Congressman, because the goals that I had for most of that period reflected a wide range of things that weren't simply financial and would have included restatement, regulatory settlements and a number of other things. So there weren't explicit goals tied to any given area, A.

And, B, the compensation was decided by an independent committee that I wasn't a member of. So part of the answer I think Mr. Raines and I, probably all of us would deal with is, we were not in the room at the time the discussion was being held. So you have to factor that in mind, I believe.

Mr. SYRON. Sir, we also had a compensation committee comprised of the independent directors. We had a balance scorecard, the most important things on the balance scorecard were becoming SEC registered and getting financial statements for 6 years supplied.

Mr. TOWNS. Thank you very much.

The gentleman from Kentucky, Mr. Yarmuth.

Mr. YARMUTH. Thank you, Mr. Chairman. And I'd like to also add for the record my congratulations and thanks to Chairman Waxman for the great leadership that he has provided this committee over the last 2 years.

To Mr. Syron and Mr. Mudd, you both said, and I think in response to Mr. Lynch's question, that you didn't have a problem handling things when values were going up; you could keep all these accounts in balance and so forth. And one of the things that I think we have learned in this series of hearings we have had on the financial crisis is that there are a lot of smart people when things are going well, and then people are smart until they are not smart; and one of the things that has happened is when things turn bad, and through across the spectrum, people have not been able to handle it well. Or the institutions haven't.

The other thing we have learned is, in case after case, we found institutions that were extremely highly leveraged.

I mean, the case of Lehman Brothers was basically a 30-to-1 leverage rate risk versus their capital. And that has been pretty consistent throughout--across the board. In May of this year, the New York Times reported that your companies had net capital of about 83 billion and that was against $5 trillion worth of debt which is a leverage ratio of more than 50 to 1.

In retrospect, to both of you, do you think your companies were overly leveraged? Is that a problem that--was that one of the contributing factors to this crisis that you find yourself in or found yourselves in?

Mr. SYRON. Well, I think in retrospect, sir, we've learned that the entire financial system, and if I may say so, the household sector and the government sector in the United States was overleveraged.

I think our concern about leverage was that we would have the same capital ratios, if you will--or leverage ratios, for the same type of assets is the point we made all the time--that our competitors would. I think they could have been higher for everybody.

Mr. YARMUTH. Mr. Mudd.

Mr. MUDD. If, hypothetically, I were running the company on a going-forward basis, and I had the benefit of being able to factor in the real-world experience of '07 and '08 into the models and into the estimates, that data would introduce--there is a much wider degree of variability than was ever seen in the history of the U.S. housing market. So some of the question you're asking is, I think, going to be self-solving not just for Fannie Mae and Freddie Mac, but for other financial institutions as well simply because the data of a crisis of these proportions didn't exist before, they say, 1938.

I learned the other day that the last time the Bank of England got rates this low was 1641. So people have gone back quite a long ways to try to find this level of dislocation.

Mr. YARMUTH. And going back to the question of leverage, though, was there ever any discussion internally in your operations about whether your risk was in excess of your--

Mr. MUDD. We actually had raised capital and were carrying capital during this past year that was significantly higher than regulatory standards, so--and we recognize that and I had said publicly this is the type of market in which you want to be low in capital.

So I think while--I don't know how you would debate the numbers, but the philosophy of wanting to go into a difficult market with strong capital is important; and also for folks to remember the reason that you have capital on the sunny days is so that you can weather the rainy days, and it shouldn't be a surprise that capital goes down as a crisis becomes more pointed.

Mr. YARMUTH. So I take it--and I'm not trying to say--I'm not questioning or second-guessing with hindsight your judgment at the time. But you had more leverage than you should have had? You were overleveraged in light of the circumstances?

Mr. MUDD. We were carrying the--we were carrying capital that was not only met, but exceeded all of the regulatory standards.

Mr. YARMUTH. I understand the regulatory standards. But doesn't leverage of this type, doesn't it rely on the bigger fool theory. When you're leveraged 50 to 1, doesn't that always assume there is somebody--there is a bigger fool that is going to continue to buy? Because if you have a normal default rate, if you have a 3 or 4 percent default rate and you're leveraged 50-to-1, you're going to dip into capital.

If you have a 10 percent leverage rate, you can experience a much higher default rate; isn't that right?

So you're assuming that this is almost an endless acceleration of prices to be able to leverage at that rate; is that not true?

Mr. MUDD. Sir, I definitely think that you're onto the right issue, and the ability of the level of capital in either a company or a GSE to be responsive to the market conditions is important. That is now, as I understand, in the regulatory regime.

And back to my earlier point, the fact that we now have more robust data that shows what capital should look like in various stress scenarios will inform--what were, after all, models designed by--won Nobel Prizes. So I think that will be helpful in that regard.

Mr. YARMUTH. Thank you.

Mr. TOWNS. Thank you very much.

The gentlewoman from North Carolina, Ms. Foxx.

Ms. FOXX. Thank you, Mr. Chairman. And I too want to congratulate you on your new position and tell you I look forward to working with you and our ranking member.

There is so much to talk about here and so little time to do it, as my colleagues have said. But Mr. Yarmuth has just injected an important issue into what we were talking about, as have some of my other colleagues.

I want to pose a question to you all that I'm not going to ask you to answer until after I make some more comments. But I want to follow up on what Mr. Yarmuth was saying about it seemed that, Mr. Mudd, you and others were always looking for things to get better because there is a quote here from the New York Times, "Almost no one expected what was coming. It is not fair to blame us for not predicting the unthinkable."

Well, the question I want to ask you is, how in the world can shareholders and even citizens of this country when they have so much at stake and entities such as Fannie Mae and Freddie Mac, how do we and--and back up. And you have all said that the main thing that you would have liked to have done was to have stronger regulatory control. And I will come back to that in a minute.

So how do--how do boards of directors test people coming into their positions? Not just as CEOs, but CFOs and these other positions. But you all have been CEOs, so that's what we are talking about.

How do we test for backbone? How do we test for ethics? How do we test for a sense of vision? And how do we test for people who are going to look at the full spectrum of issues, not just always looking for the sunny side of the street.

But we need people who understand how to deal with crisis. You're saying it is unfair to ask you to work in situations of crisis. What in the world were you getting paid millions of dollars to do, simply ride the gravy train and always be there when things were good? For heaven's sake, did you not have any sense that anything could ever go wrong under your watch and that you weren't responsible for that?

You have exhibited no sense of accountability for your actions here. None. And that is disturbing to me and the American people. They expect us to be held accountable. And I want to say I appreciate the bipartisan nature of this hearing today. It has been the most bipartisan, I think, that we have had because we all agree there are problems.

Administrations have created these problems too. This is not a Democrat/Republican issue. We have people--we have Members of Congress who are at fault too.

I wasn't here when these things were happening, but I want to come up to a point my colleague, Mr. Shays, brought up. And again I'm going to leave time for you to answer your question. He made a comment that really triggered my concern about this, We got them to agree to go under the '33 and '34 Act. You know, I'm just appalled as a Member of Congress that Members of Congress felt they had to get the agencies they regulate to agree to those regulations.

What a situation we find ourselves in. Members of Congress don't have enough backbone themselves to do the kinds of regulations--and you're telling me, Mr. Raines, that the regulatory bill should have been enacted earlier and yet you fought it tooth and nail. But now, in hindsight, you're willing to tell us it should have been regulated earlier, should have been more with risk management, but you fired the risk managers. So you were afraid of being regulated because, again as Mr. Shays said, much of what has been found out that was wrong came about as the first real regulation.

And, you know, it is not just your shareholders, it is not just the people you helped, but it is every American that is being affected by this because, as a result of your actions, home prices all over this country have gone down. You really have been irresponsible in what you have done, and the people who worked for you.

And I have quote after quote after quote. And I think part of the problem boils down to the amount of PAC money that was coming in from you guys and how much you spent to make sure that Members of Congress would go easy on you in their regulations. And I hope that what has come out about that has raised the awareness of the American people about the connection between those monies.

And I love this committee. I got on it because it has the ability to investigate these kinds of things, where the other committees have vested interests in what's happening and are often swayed by those very lobbyists that you hired to stop the kind of hearings going on today and the regulations.

But now with 20/20 hindsight, you want--

Mr. TOWNS. The gentlewoman's time has expired.

Ms. FOXX. We want the American public to know what your advice is on that.

Mr. TOWNS. Very quickly because time has expired.

Mr. RAINES. Congresswoman, first of all with regard to accountability, I have three full pages in my written testimony on the issue of my accountability. And therefore I would hope that you would recognize that I have not been silent on that. We simply are not allowed to testify to everything we have got in our written statements.

But I went to great lengths to point out that from the beginning when there was a question raised about Fannie Mae and its accounting, I said I hold myself accountable; if the SEC finds we have made errors, I will hold myself accountable and my board will.

I retired early. I've had compensation clawed back. So it is unfair to say that I have not accepted accountability for what happened when I was the CEO of the company.

Chairman WAXMAN. Mr. Brendsel.

Mr. BRENDSEL. Yeah. I certainly was accountable for what happened at Freddie Mac during my time--

Mr. TOWNS. Is your mic on? Is your mic on?

Mr. BRENDSEL. I'm sorry.

I am. And I was held accountable for what happened to Freddie Mac during my tenure at the company, which ended in June of 2003.

I do believe that with regard to the subprime market and that--I think Freddie Mac behaved very responsibly under my tenure. My greatest accountability and ultimately why I left--I resigned from the company, of course--was a result of the financial restatement that we had to go through during 2003, which fortunately left the company with more capital than before, but nevertheless it was still a restatement that the company should not have gone through.

Mr. TOWNS. Mr. Mudd.

Mr. MUDD. Do I expect sunny days? No. I went to Mexico when the peso was devalued. I went to Asia when the 1998 crisis hit. I went to Beirut when they were shooting there. People say that I like it too much when it is not a sunny day. So I would disagree with that.

I would say that this time through, reality exceeded my imagination. And with respect to the '33 and the '34 Act, we were agreeing to reverse a registration that a prior Congress had provided an exemption from.

Mr. TOWNS. Mr. Syron.

Mr. SYRON. Thank you, sir. With respect to foresight and seeing things going forward, I was not as pessimistic as things eventually turned out. What I expected to happen was that housing prices would go down to being about flat in nominal terms and decline in real terms, but not catastrophically.

Mr. TOWNS. Thanks very much.

Mr. Braley.

Mr. BRALEY. Mr. Chairman, Ranking Member Issa, thank you for holding this hearing. Mr. Chairman, there have been several references today during this hearing to a perfect storm. And I think it is important to remind everyone that in a perfect storm the entire crew of the Andrea Gail perished. And the purpose of this hearing is because we've got paddles on the chest of two patients, and we're trying to determine how much voltage to apply to resuscitate them.

Mr. Mudd, I'm going to start with you because you're one of the rare people that can say, My name is Mudd with a straight face. I want to start by asking you about an e-mail exchange you had with your chief risk officer, Enrico Dallavecchia.

For 6 months beginning in March of 2006, Fannie Mae implemented a new business initiative to buy subprime loans. And under this program, Fannie concluded one deal to buy $74 million in subprime loans from a company called New Century, and it also began negotiating new deals. On August 16, 2006, the corporate risk management committee approved a final plan to purchase up to $5 billion in whole subprime loans in 2006.

Two months later, on October 28, 2006, which ironically is the same day the Great Depression really began in earnest, Mr. Dallavecchia, your chief risk officer, sent an e-mail to you raising concerns about this huge increase in subprime purchases; and I'm going to ask them to put that e-mail up so that we can all take a look at it, and I want to read to you the portions that are in these callout boxes:

"Dan, I have a serious problem with the control process around subprime limits. Ramping up business much faster than we agreed upon less than 2 months ago is de facto preventing me to exercise my reserved authority to determine limits without damaging relationships with customers."

Mr. Mudd, Mr. Dallavecchia was saying you were ramping up too quickly on the subprime purchases and that this acceleration prevented him from determining appropriate risk limits. Isn't that true?

Mr. MUDD. I'm sorry, sir. Could you repeat the question--part of your question?

Mr. BRALEY. Yes. What he is saying here is that your company was ramping up too quickly on subprime purchases and this acceleration was preventing him from determining appropriate risk limits; isn't that true?

Mr. MUDD. I believe that's what he was saying in his note, yes, sir.

Mr. BRALEY. And then later in the e-mail, if we can go to the next slide, he says:

"We approved twice, in March and in June, to buy subprime loans without having completed the new business initiative." And then, in bold, "This is a pattern emerging of inadequate regard for the control process."

It seems like in this portion of the memo, your risk officer believed that you were rushing into billions of dollars worth of subprime loan purchases without really knowing what you were doing. Isn't that what he is saying here?

Mr. MUDD. Yes. And there is a part of the memo that is my response to him that is covered up by the box.

Mr. BRALEY. We are going to get to that.

Mr. MUDD. That furthers the conversation on the top.

Mr. BRALEY. When he sent this e-mail to you, did you agree with this assessment?

Mr. MUDD. That is why I wrote above it, "It is a serious matter, and if the facts are supportive, you and I will come down hard." That's what it says above that.

So he came and saw me. We went through the facts. We got the folks at the table, we had the discussion, and we went back to address those concerns. That was exactly the process, sir.

Mr. BRALEY. Right. So let's go to that portion of the memo that you replied and your reply was dated on Sunday, October 29th, at 12:42 p.m. As you indicated, you said, "This is a serious matter," so you agreed with his assessment that it was a serious matter, correct?

Mr. MUDD. Yes.

Mr. BRALEY. And then you said if the facts are supportive, we will come down hard. Were the facts supportive?

Mr. MUDD. As often happens in these types of situations, the facts were partially supportive. I would say in this case maybe even mostly supportive.

Mr. BRALEY. So did you come down hard?

Mr. MUDD. Yes, we did.

Mr. BRALEY. What did you do?

Mr. MUDD. We called all of the people that were involved in the process into the room, had a discussion, had a meeting, laid out the--if I can just rewind for one second.

The role of an independent chief risk officer at Fannie Mae and most financial institutions was a relatively new role. So the rules of the road were kind of being written in real time, and what I wanted to do was to make it very clear that the CRO not only reported to me but also reported to the board. I wanted to make it very clear in this process of coming down hard that that person was my right hand on risk, that person needed to be part of the process, that person needed to be heard; and if that person needed to discuss a report independently to the board, he or she had the ability to do so.

Mr. BRALEY. Well, Mr. Mudd, I think the American taxpayers are the ultimate jury on whether you came down hard, and I think the record indicates you didn't come down hard. Instead, you continued the acceleration. And let me show you a presentation made to the credit risk committee less than 3 months later on January 17, 2007.

Can we have that, please?

Well, in that presentation, management proposed expending the subprime business unit in 2007, purchasing $11 billion more in subprime loans and eliminating restrictions on the volume of mortgages you could purchase with lower borrower scores and unverified incomes. So, in effect, you were increasing your levels of risk rather than moderating them as your chief risk officer had recommended; and it looks to me, and I think it looks to a lot of taxpayers, like you were going in exactly the opposite direction of your risk officer's recommendations.

I yield back the balance of my time.

Mr. MUDD. Sir, if I may. His memo--I have a serious problem with the control process around the subprime limit. So he wasn't expressing a problem with subprime as a broad issue, as characterized. He was expressing a concern around the control processes--the sign-offs, the coding, the filing and so forth. And that control process was the subject of this discussion and of the remediation. And that is a separate issue than an entire, broader debate that we had in the company and with the board and with the regulator and elsewhere about the subprime market in general.

So I would just recommend it is important to keep the two issues somewhat separate.

Mr. BRALEY. I understand that. But the whole purpose of having control processes in place in a company like yours is to make sure you're making rational business decisions based upon the best information available and that you are following a rational process to make those decisions. So if the control processes are not in proper working order, it prevents you from following a rational decision-making model, doesn't it?

Mr. MUDD. Yes. And that's why it was important to fix them.

Mr. TOWNS. The gentleman's time has expired.

Mr. McHenry from North Carolina.

Mr. MCHENRY. I like the new chairman and congratulations to you. I look forward to working with you. We'll start with a simple yes or no question.

Ms. FOXX. Good luck.

Mr. MCHENRY. Good luck, I hear.

Okay, in order to fulfill your affordable housing goal, instituted and given to you by Congress, did you feel in order to fulfill that affordable housing goal, did you feel pressure from Congress to do riskier mortgages, perhaps more borderline mortgages?

We will start with Mr. Raines, and we'll go right down the list. Yes or no?

Mr. RAINES. I did not feel pressure from Congress because--

Mr. MCHENRY. So no? I'm asking--I only have 5 minutes.

Mr. RAINES. No.

Mr. MCHENRY. You have had a long day, so I'm trying to--

Mr. RAINES. No.

Mr. MCHENRY. No. Interesting.

Mr. BRENDSEL. No.

Mr. MCHENRY. No.

Mr. Mudd.

Mr. MUDD. No, because if the goals went up, the goals came from HUD, and meeting those HUD goals created pressure.

Mr. MCHENRY. Mr. Syron.

Mr. SYRON. As the goals went up and the goals were specified by HUD, you inevitably, to make more progress, had to take more risk.

Mr. MCHENRY. So in order to make more progress with your affordable housing goal, you had to make riskier mortgages?

Mr. SYRON. Buy riskier mortgages.

Mr. MCHENRY. Buy riskier mortgages. I think it is interesting Mr. Syron gave something more akin to what I was accustomed to as a member of the Financial Services

Committee. I have seen some of you before, and I don't know if you just refuse to listen to what happened in those hearings, but there was massive pressure from Members of Congress on your institutions to provide more affordable housing and, therefore, riskier mortgages.

Now, I'm not calling them riskier. Your risk officers called them riskier. And in Freddie Mac's case, Mr. Andrukonis wrote a memo in 2004--we can call that up--to push for "more affordable business." I guess that is your lingo for more affordable housing; and "increased share" means more borderline and unprofitable business will come in. "The best credit enhancement is a profit margin, and ours is likely to be squeezed in response to these market pressures."

So I think--it is interesting to me that in some respects and by your newspaper accounts, you acknowledge that there was pressure on you. And obviously pressure from Congress in terms of congressional efforts on HUD to raise those standards, but also on you all directly.

And I think it is pretty bizarre--I mean, the chairman of my committee, "financial services," Barney Frank, said, "I'm worried, quite frankly; there is tension here." This is from 2003. "The more people in my judgment exaggerate a threat of safety and soundness, the more people conjure up the possibility of serious financial losses to the Treasury which I do not see. I think we see entities that are fundamentally sound financially and we are seeing some of the disastrous scenarios. Congresswoman Waters, who I serve with on Financial Services, said, 'If it ain't broke, don't fix it.'"

We're still paying the price for that. But my point is, you did have pressure to meet your affordable housing goal. And that was done through Members of Congress, it was done through HUD; and that was conflicted with your delivery for your investors to produce profit. That's what your risk officer said.

Do you all disagree? Mr. Raines?

Mr. RAINES. I disagree. In my time that I was there, I did not feel pressured from the Congress to do riskier loans to meet housing goals. Our housing goals were ratcheted up administratively by HUD. Congress gave guidelines that I thought were quite reasonable to HUD. HUD, by the time I had left, was proposing to push those guidelines to a level to force the companies to begin to entertain loans that they otherwise wouldn't have entertained. So it really was more from a regulatory standpoint than Congress.

Mr. MCHENRY. And who funds HUD? Congress.

Let me just tell you--I hate to reference this, and Mr. Raines knows from his political background, but this is a political city. There was pressure from Congress.

Mr. RAINES. However, Congressman, at that time, just to be fair, Congress was in the hands of the Republicans. So I don't think that the Republicans were intending to force HUD to rachet up our goals to an unreasonable level.

Mr. MCHENRY. Reading from your quote in the Washington Post yesterday, you want to make this a partisan situation.

Mr. RAINES. Congressman, that is just not correct. I actually want it not to be a partisan situation.

Mr. MCHENRY. That's generous of you.

So I read in the Washington Post from yesterday, that same article I just referenced, what they say is, "People"--this is a quote from the article--"People familiar with the matter said Freddie was being pushed by advocacy groups to come up with new loan products to offer to low-income and minority borrowers." Is that true?

Mr. TOWNS. The gentleman's time has expired.

Mr. SYRON. By advocacy groups, yes, sir.

Mr. MCHENRY. Yes. And those same advocacy groups are closely aligned with some Members of Congress as well, and they are voices for that advocacy groups as well.

Mr. SYRON. I would be speculating to get into--

Mr. MCHENRY. Well, I will tell you, yes, they are. Thank you.

Mr. TOWNS. Mr. Sarbanes from Maryland.

I'm sorry. The gentlewoman from Washington returned.

Ms. NORTON. Thank you very much, Mr. Chairman. You don't want to start off making mistakes, do you?

Mr. TOWNS. That's exactly right. No doubt about it. I want to start this thing off right.

Ms. NORTON. Gentlemen, I have to confess my major concerns are going forward because the GSEs have been so important for low- and moderate-income housing in the United States for decades. Indeed, after we finally figure out how to get to the bottom of housing crisis, which is a subject of extreme frustration I must tell you here, I think the most important decision that we could make on housing has to do with the GSEs.

I'm very concerned about the ad hoc problem solving that is going on with respect to this crisis. Something pops up, somebody leaps on it; and I certainly hope somebody is working on this one right now.

You have got a twin identity that absolutely fascinates me. On the one hand, you have got a very important--indeed, the most important--public mission in housing, to assist low- and moderate-income families. On the other hand, you're like every corporation because you have got shareholders.

Mr. Paulson, when Fannie Mae went into conservatorship, was very plain about what he thought; and I want to quote from him. He said there was a, quote, "consensus." I don't know who the--but a "consensus that the GSEs"--and here I'm quoting from him--"hold a systemic risk." And he went on to say, "Government support needs to be either explicit or nonexistent, and structured to resolve the conflict between public and private purposes."

I would like to ask each of you whether you agree with Secretary Paulson. Do you think that the GSEs should be returned to the entities they were before? Do you think they should be part of government? Do you think they should be privatized?

And in giving your answer, I would like to know if you believe that they should be--GSEs, whether you would also make them exempt from local and State taxes, give them a line at the Treasury, exemption from at least certain kinds of regulations, which of course gave them an advantage when competing in the private market.

Why don't I start with you, Mr. Raines, because I noticed in your testimony that you did not apparently see inherent problems, and you say you don't think we can find a better model. Could you explain your view or is that still your view?

Mr. RAINES. Well, I can explain it, I think, very quickly.

The systemic risk to the system comes from any very large financial institutions that are highly leveraged, whether they are called GSEs or they are called insurance companies or they are called banks. Indeed, we saw in the current crisis that the most troubled entities and the ones that had the most extensive impact on the financial system weren't GSEs. The biggest one is an insurance company that had never been identified as a systemic risk.

Second, with regard to making the government support either explicit or nonexistent, I can agree with that. I think it can be explicit and not--I don't think it would be possible to go back to the implicit support that was there before. And I think the market should be told what the support is; and that should be it, and the investors should take the risk.

On the last point on resolving the conflict between public and private purposes, I think that is laudable, but impossible. And an example I would give you is a defense contractor. A defense contractor is only there to solve for a public purpose. They only sell to the government. They are there for national defense. That product is not really useful anywhere else in the economy.

But they are also for-profit companies. They are there to advance the interest of their shareholders.

Ms. NORTON. Would people invest in such a company?

Mr. RAINES. I think people invest currently in utility, they invest currently in defense contractors and they invest in banks that have the same conflict within themselves.

Ms. NORTON. So you think perhaps we should treat Fannie

Mae and Freddie Mac more like a utility then?

Mr. RAINES. I think treating them more like a utility may be politically much more comfortable than treating them in the current form.

Ms. NORTON. Let me go on to Mr. Mudd, who has indicated that Freddie and Fannie are in, quote, a "no-man's land." And you in your testimony, you advocate to make them either fully public or fully private. So which should they be? And why?

Mr. MUDD. The advocacy, Congresswoman, is to make it clear for a long time throughout--

Ms. NORTON. You don't care which it is, sir?

Mr. MUDD. I think at this point--I know a little bit more intimately the structure of the company, and there are different components of the company. One component, the mortgage portfolio is a liquidity provider fundamentally, the guaranty business is fundamentally a securitizer.

It seems clear to me now in the history of the past 6 or 8 months, that if there is a real crisis in the country, the liquidity provider is going to be the government. So that would give rise to a question of whether you want a private company to be a liquidity provider or whether that becomes a function of the government.

The other side of the business, the guaranty business that does work with lenders, provide services, does so at a fee might have another--might have another treatment.

So I don't think the same answer needs to be true for all components of the company if you're going to move it out of what you aptly described as "no-man's land."

Ms. NORTON. I would like to know if the other two gentlemen believe that an entirely private company could be trusted to provide the same protection to the consumer, particularly the consumers that the GSEs were specifically directed to help.

Mr. SYRON. Well, ma'am, Congresswoman, I don't think that--excuse me, gentlemen--I don't think a purely private company could generate long-term fixed-rate mortgages that are prepayable just because no other country, major country, has one.

I think, as some of my colleagues have said, the most important thing is getting a more precise definition, whether it is a defense company which operates on some sort of cost-plus, a utility with a specified rate of return, there needs to be less sort of swimming around and more definition of what the shareholders can expect.

Mr. TOWNS. Mr. Brendsel, and then--

Mr. BRENDSEL. I think one only has to look at the mortgage market of today and the mortgage market of the past 2 or 3 decades. And you can see where it is that part of the market is served by the purely private market. It doesn't work as well. It is more unstable, and you don't have the types of mortgage products that are consumer friendly.

I also happen to be of the--maybe the view in the minority. I don't see a fundamental conflict between the public purpose for which Freddie Mac is chartered, and was chartered, and its shareholder ownership. After all, we are chartered to bring stability and liquidity and availability of mortgage credit to low- and moderate- and middle-income families and to use private capital to do so. It is that one mission, unique mission.

Ms. NORTON. What about the shareholder mission?

Mr. BRENDSEL. Well, in order for--if the shareholders are served, they are only served by serving that mission of bringing mortgage credit to American homeowners at a profitable rate, but at a rate where it is the result in sound loans.

Ms. NORTON. Thank you very much, Mr. Chairman.

Mr. TOWNS. Thank you very much.

Mr. Garrett from New Jersey.

Mr. GARRETT. I thank the chairman and I thank the ranking member for the opportunity. I normally serve on the Financial Services Committee, so I appreciate this chance to be here for a few minutes--actually, for several hours now--because this has been a topic of most importance to me ever since I have been here, for the last 6 years.

I appreciate your testimony and also some of the questions. One point is, I appreciate the fact also that the panel is made up of members who are here with both organizations during different years. And so, therefore, it is probably unfair to use a broad-brush approach on any of the questions or some of the allegations that were made because you were in different spots.

To the point of who is responsible, which is a lot of the questioning, and the committee is evidencing the fact that we don't feel we don't get that back from the panel, let me just also say the flip side of that on this issue just for 30 seconds. And that is this: Just as the panel had the opportunity to address a number of the questions or issues during their tenure in office and some of the questions I will raise as well, let it not be forgotten that Congress also had the opportunity for the 6 years that I served, and prior to that as well, to address some of these issues--the systemic risk issues, the operation issues, the issues as far as where you were investing and the size of portfolio and what have you, and that was not done.

So I would ask each member who was raising those questions as who was responsible to look in their mirror on this panel to see, how did they vote both in committee and on the floor when the opportunity came for the House and the Senate to rein in, create new regulations for the GSEs in the past. So I think there is an adequate opportunity to see responsibility both in the panel and this committee as well.

Going to the GSEs, you make money in two different manners. One, of course, is by buying up securities, packaging mortgages and then selling them. The second way, of course, is by taking these mortgages and putting them into your portfolio.

That second way, in my understanding, is eight times more lucrative or profitable than the selling of the securities. The number in here that I have seen is, you had reached a high in 2003 of $1.5 trillion worth of securities in your held portfolio and 2008 went down to $1.4 trillion.

And interestingly enough on these numbers, in '05 to '07, this is what--the type of securities you were putting in there: 97 percent were interest-only securities; 85--or mortgages--85 percent were alt-A; 72 percent were negative amortization mortgages; 61 or 62 percent were with FICAs under 620.

Obviously these are, A, the more risky loans that were going on during that time; and in general, during the entire period of time for everyone when you were expanding your portfolio, that was more profitable on the one hand, but certainly riskier on the other hand.

The issues have already been raised as far as leveraged ratio on the capital levels, and this committee criticized

Lehman for a 31 ratio, and here you're leveraged at a 75-to-1 ratio.

One of the members of the panel said to all of these points--in general, and not specifically on one--that "we were doing the same as our competitors." So one of my first questions will be--and I'll get to this--allow you to answer in a second. Is it appropriate for a GSE, which has the backing implicitly now, implied at the time of the government, to simply be mirroring what the private sector is doing; or were you--should have been to a higher standard in each of these areas--your risk model, your capital model, what you were putting in the securities as well? And that will be the first question I would throw out to you.

Secondly, to the regulation aspect, but Ms. Foxx and Mr. McHenry raised this point very well. Mr. Raines, you were saying that you were looking for additional regulation. And I think you made the comment in your testimony--you didn't go in full detail, but I read your full testimony--OFHEO was not restraining credit risks, but they were limited to balance sheet and interest rates risk.

That may be, but I can tell you that certain members of the Financial Services Committee were looking at all of those areas. And you had Secretary Snow come in before the committee and testify. You had Alan Greenspan come in and testify on these points. You had Richard Baker when he was here testifying--not testifying, but raising these points. There was a focus, at least for the 6 years when I was in Congress, to try to do these things.

While perhaps you did come before the committee and say that we needed regulation in the House, we know for a fact that the House regulations were a lot softer, a lot easier than the regulations that were being proposed in the Senate. And what the GSEs did effectively through the lobbying mechanisms and otherwise was to kill effectively during the time the Republicans were in charge of those efforts in the Senate; and what we have ended up with now is regulation, albeit late and obviously way too late, but much softer regulations than should have been done in the past.

And finally, I guess on that point--since my time is just about out--to the point, you may have made the suggestion, Mr. Raines, that the problem was not a credit problem per se in the portfolios and the mortgage-backed securities. But really wasn't it a problem--and this is when the accounting irregularities came up and what have you--wasn't the problem underlined by the fact that because of the size of the portfolio and having to deal with interest-rate risks that you had to be getting involved with derivatives and other mechanisms in order to hedge against that; and that effectively led to some of the problems that we dealt with later on?

So I guess there are three questions there, two for Mr. Raines and the rest for the panel.

Mr. TOWNS. Let me say to the gentleman, I know you waited 2 hours, but your time has expired.

Mr. GARRETT. Thank you again for the opportunity, though.

Mr. RAINES. I believe there were two questions that were directed to me, one of them about regulation and Fannie Mae's activities with regard to legislation and the other related to derivatives; is that correct?

Mr. GARRETT. Yes.

Mr. RAINES. With regard to Fannie Mae and legislation, it was always my desire--and I worked very hard, but unsuccessfully--to try to get legislation passed because I believe that as legislation was passed, then all of the political swirl around Fannie Mae would subside for at least some period of time. And I was an advocate, and I think if you talk to the chairman of the committee, the relevant committee, even Mr. Baker would indicate that I wanted legislation.

Did we agree on all of the provisions? No. But the provisions we disagreed on did not relate to regulation; they related to our mission. There were efforts to try to try to constrain our mission. I opposed those. But where it came to a world-class regulator as defined by Congressman

Kanjorski and who pushed this over and over again, I was in favor of that.

I'm still in favor of it. And I'm still opposed to constraining the mission of the GSEs. So I think there has been a consistency across that time.

In terms of the derivatives, as you accurately point out, Fannie Mae used derivatives in order to enable to fund itself, including its own balance sheet portfolio. And the fact that Fannie Mae had to do a restatement is something that I have stated over and over again that I'm not only sorry for, but I hold myself accountable that we did not get it right, even though I was not involved in the accounting.

I would point out, however, this is not a problem that was unique to Fannie Mae. I think that upwards of 200 companies had to have restatements around derivatives in that time period. Some of them had to do it twice before they could do it properly, according to the SEC. So this difficulty of applying the FAS 133 standard was not unique to Fannie Mae, but it was widespread amongst financial firms during that era.

Mr. BRENDSEL. With regard to derivatives, we used derivatives at Freddie Mac to reduce risk, to manage interest rate risk and we didn't use it to manage credit risk or the risk of default on subprime mortgages, which I have already testified to reduce risk, to reduce interest rate risk. But that doesn't have anything to do really with the losses that are being taken on credit risks associated with subprime mortgages.

Mr. MUDD. I guess for the purpose of time, I would just address the risk question and the standards question. And I think in the context of the alt-A book, the ultimate measure there is the performance; and the performance of the alt-A loans that Fannie Mae guaranteed has been a factor to--better than the market. The FICAs were higher, the credit scores were higher, the loan-to-values were higher. The question was, was it ultimately good enough that it matched or exceeded the performance of the other 85 percent of the book, which is the old standard fixed rate mortgage. No. That is a reflection of the change in the marketplace.

Was there a role for the companies in terms of standard setting? Yes, Congressman, I think that expressly defines what we were talking about earlier about relevance. You can't set any standards whatsoever if you're irrelevant to the market because you're offering products that nobody wants.

Mr. SYRON. Mr. Congressman, I will try to quickly answer two of the questions.

One, should we have the same capital standards--not "we" anymore--but should there be the same capital standards? And I think that depends on the degree of the guarantee. I have sympathy for your argument that if there is an explicit guarantee for the GSEs in not--for the competing financial institutions, then maybe there is an argument for higher capital to protect the public. I think the reverse situation may actually apply now.

And second is, in terms of the willingness to take risks in where things were. Actually, if you look at the latest Mortgage Bankers Association figures on delinquencies, they show for the country as a--excuse me, for the industry as a whole--4.9 percent and for Freddie Mac 0.8 percent. So in terms of--far from perfect, but the level of delinquencies, about six times greater for the industry than for Freddie Mac.

Mr. TOWNS. Thank you very much. The gentleman from Maryland, Mr. Sarbanes.

RPTS JURA

DCMN SECKMAN

[2:05 p.m.]

Mr. SARBANES. Thank you, Mr. Chairman.

Thank you all. You have demonstrated extraordinary stamina here today. We have been here for four hours, one of the longest panels we have had over the past couple years. But I think it reflects the level of interest there is on the part of the committee.

I wanted to ask if you, and anyone can take a shot at this, but talk about the distinction--I am going to put this into lay person's terms--but the distinction between a good risky loan and a bad risky loan. Because you talked about how there was pressure from HUD, let's say, to make sure that affordable housing targets were being met and so forth. But certainly that wasn't an instruction to go find or buy or become entangled with the kinds of loans where all manner of conventional underwriting standards have been abandoned.

So I am curious to know how you would describe what was presented to you. Were you looking into a stew of good risky loans and bad risky loans? If we want to suggest that all of the ones that would take you into the more affordable housing arena would be characterized as risky, certainly your obligation to continue to differentiate between the ones that were extra risky or bad versus the ones that were good, that obligation should never have been surrendered.

So anybody can speak to that if they'd like.

We can start with you, Mr. Raines.

Mr. RAINES. Congressman, I like your division between good risky loans and bad risky loans, because all loans are risky. They all have some level of risk to them, and it is important to be able to measure that risk and to manage it.

When seeking to push the envelope of those who have access to home ownership, and I think this is an important distinction, we tried very hard to come up with loan products that we thought helped to make housing affordable and available without layering in so many things that the risk was unacceptable.

So, for example, if someone had good credit and they had a good steady income but they didn't have much in the way of savings, we would have a low down payment product. If someone had good credit but--had marginal credit but had substantial savings, we might say we will take on that marginal credit because they have offset it by having substantial savings that they could put into a down payment. So it is the layering of these factors.

When you put together negative amortization, interest-only, no documentation, low down payment, bad credit, that layering on gets you into bad risky loans. Those are loans that almost no one knows how they are going to perform, but you can assume it will be pretty bad.

So trying to figure out what that line is, when do you cross a line between acceptable risk that is advancing affordable housing and unacceptable risk that is putting families at severe risk to their futures? That is the art. No one can tell you exactly where that line is. But the policies that we tried to follow when I was leading the company was, keep experimenting. Do small experiments. None that could cause you a lot of harm if they go bad, but keep trying. Try this, try that. If it doesn't work, stop. If it does work, then double down and do more. And--

Mr. SARBANES. Let me go to your tenure, because Fannie Mae was purchasing more of these loans that appear to have departed from the conventional underwriting standards. Is that because you couldn't distinguish between a less risky loan? Or what was happening?

Mr. MUDD. What happened was that the market migrated to a wide array of loans with a wide array of features that Mr. Raines pointed out was driven by a multiplicity of factors that we could go into. But they certainly included the rising cost of a home. They certainly included the technology ability from lenders and servicers to offer more choices and more complicated products to individuals.

So I agree with what he said, that a number of features would take a risky loan and turn it into a bad risky loan.

And those would go to features that could put an unwary borrower into a difficult situation. Negative amortization was mentioned, prepayment penalties could be mentioned, required insurance, those types of things. But, to me, just stepping back for one second from a policy perspective, one of the starting points might ought to be disclosure, where all of us, when we get a mortgage, see a front page that says here's your rate, here's the maximum rate you might ever pay, here's your monthly payment, here's the maximum monthly payment you might ever pay, and that there be kind of a moment of truth between the originator and the borrower to make sure they understand.

Mr. SARBANES. This is really a question I have had in all these hearings, because it is not the case--if I am listening as a member of the public, it has never been the case in these hearings that anyone has suggested that there weren't warnings, and that is why all this stuff happened. It's always been the case that we have plenty of testimony that there were warnings, but they were not heeded. And I am not going to ask you to comment on why you didn't heed warnings within your own companies, within your own organizations. I am going to ask you this:

What does one do as a corporation--in other words, because it was in your interest not to get in. I mean, we talk about the effect on the public. But obviously you would have preferred that this didn't happen to Fannie Mae and Freddie Mac, and so would all these other companies that are going down the tank. What do you do inside an organization to make sure that the people that are raising the warnings can somehow impact the decisions that are being made? Because it seems, if I was a risk analyst from this period of time, I would be going through an existential crisis right now. Like what purpose are they serving? How do you protect their ability to sound the alarm and give it the kind of credence that might have changed the course of all of this? So I will give it to anybody who wants to answer.

Mr. MUDD. My answer would be that you have to create a culture that enables those people to get their voice heard. In a corporation, it doesn't mean that somebody always gets their way, but just like I suppose, in Congress, a legislative assistant doesn't get to decide what the member does. The chief risk officer doesn't always get to decide what the CEO does. But you have to make sure that all those voices are a part of the debate and that people have a view, no matter what their level or their rank or their position or their tenure in the company, have the ability to get their voice heard, get it considered, be respected. And sometimes they are right; sometimes they are wrong. Sometimes you are right; sometimes you are wrong. But you have to have that culture where you don't get a reinforcement of the wrong decisions.

That would be my experience, Congressman.

Mr. TOWNS. Thank you very much.

The gentlewoman from California, Ms. Speier.

Ms. SPEIER. Mr. Chairman, thank you.

And thank you to the members of our panel. Let me just ask a couple of really brief questions and then get to the core question I want to ask.

Are any of you now employed by the financial services industry?

Mr. SYRON. No.

Mr. MUDD. No.

Mr. BRENDSEL. No.

Mr. RAINES. No.

Ms. SPEIER. And in each of your cases, was your compensation in any way, whether it was bonus or stock options or salary, linked to the volume that was generated by the company?

Mr. SYRON. We had a balance scorecard, and I've been racking my mind going through here, whether share was any part of that. So indirectly there may have been, but I don't directly recall.

Ms. SPEIER. Mr. Mudd.

Mr. MUDD. We had a parallel process where there were a number of different objectives that needed to occur, and one of those was certainly revenues, which would tie to your question.

Ms. SPEIER. So there was a linkage?

Mr. MUDD. Revenues were a component of the overall consideration for bonuses particularly. Yes.

Ms. SPEIER. Mr. Brendsel.

Mr. BRENDSEL. First of all, my compensation was set by the board of directors and evaluated annually in my bonuses and so forth, and they considered many factors: certainly the profitability of the company, but also the capitalization, the safety, soundness, the risk profile, whether or not there were too many mortgage delinquencies or defaults. And so I always felt that my compensation was not at all linked to volume generated.

Ms. SPEIER. Mr. Raines.

Mr. RAINES. As I testified before, I don't believe that volume has played a role in the formula when I was there, but profitability did. And sometimes market share vis-a-vis Freddie Mac did. But volume by itself was not a factor, as I recall.

Ms. SPEIER. Thank you.

Mr. Mudd, I am referring now to an October 5th, 2008, New York Times article that focused on an exchange between you and Mr. Mozilo, formerly the head of Countrywide. And the article quotes Mr. Mozilo as telling you, "you are becoming irrelevant. You need us more than we need you, and if you don't take these loans, you will find you can lose much more."

In fact, I think you flew to California to have that conversation with him.

Can you please describe for the record the exchange you had with Mr. Mozilo?

Mr. MUDD. I can't, because I don't remember that exchange at all. I did look back through my records in preparation for the hearing. And I had a number of meetings with Countrywide. I had a number of meetings with Mozilo, as I did with all of our key customers. As it was described in the paper, that certainly would have been a memorable meeting, but it doesn't trigger my memory.

Certainly, with him as well as with other customers, there was a back and forth in terms of what was our eligibility, what was our pricing, what was our credit standard, what was the value of our guarantee, what was our pricing versus Freddie Mac, et cetera, et cetera. But particular conversation.

Ms. SPEIER. You don't recall him offering you a breath mint at the end?

Mr. MUDD. No.

Ms. SPEIER. There was a presentation from June 2005 titled, "Facing Strategic Crossroads." The presentation discusses how Fannie is losing market share to Wall Street. The slide is on page 27 and says, Primary market originations of products outside Fannie Mae's traditional risk appetite are on the rise.

Then the slide on page 32 says, This trend is increasingly costing us with our largest customer.

Now, as the slide shows, your largest customer was Countrywide. Isn't that right?

Mr. MUDD. Yes.

Ms. SPEIER. Did you lower your standards to accommodate the riskier loans from Countrywide?

Mr. MUDD. No, we established a set of standards. We had a debate that I have described during the course of the hearing that said the core of Fannie Mae business with all of its very attributes was shrinking, and our market share on that note had gone I think from 40 percent to about 20 percent. Meanwhile, the market for alternative products had gone from about 10 percent up to 40 percent.

So it was clear that there had been a change in the marketplace; that if our lenders, our seller servicers and others wanted to go around us to some different form of securitization, which typically was a rating agency sizing, set up and distributed through Wall Street; they had that alternative. And the continuation of market share trend that goes 40/20 is obviously quite low. So we made a prudent effort to figure out what we could do to recapture that business. And obviously, with Countrywide as one of the largest originators, they were part of that overall effort, as were other major financial institutions.

Ms. SPEIER. The documents the committee has received appears that the Alt-A mortgages that Fannie Mae bought between 2005 and 2007 in large measure from Countrywide had riskier terms and higher delinquency rates, and they contributed to more than 40 percent of Fannie's credit losses last quarter.

So my time is up, but I think it is interesting that, in the end, you did expand your portfolio of Countrywide loans, and it has in this last quarter created quite a bit of heartburn within Fannie Mae.

Mr. MUDD. I think the Alt-A loans--just to be clear, I think that is a representation of Alt-A losses as a total percentage of the book rather than Countrywide, although Countrywide would probably be a component of that total number.

Mr. TOWNS. Thank you very much.

Ms. FOXX. Mr. Chairman, I want to ask your indulgence on something. You were able to give Mr. Shays one extra minute; he is leaving the committee. Mr. Sali is about to leave us also, and he had one very, very important point he would like to make that has not been made today. It is not a repeat of anything. And I am wondering if you would indulge us with one more minute.

Mr. TOWNS. I would be delighted to do so, especially being he is leaving.

Mr. SALI. Thank you, Mr. Chairman.

It's the last time I will bother you. This would be for Mr. Syron, I guess. And I believe you should have a document that looks like this in front of you. And I assume you understand what that Credit Policy and Portfolio Department Report deals with for Freddie Mac.

I am looking on that second page there under priority number five, and if you go over to the right side of the page, there are four bullets there. And the third one talks about additional affordable type programs being considered. And in that third line, it talks about programs apparently for illegal immigrants. And I am wondering if you could describe what that proposed program was about? Why would a government-sponsored enterprise, one, engage in something like that? Was it implemented in any way? So how many loans were given? How many defaulted? Those kinds of things, can you give me an idea of what that program was about?

Mr. SYRON. You know, I am seeing this for the first time in some substantial period of time. And, unfortunately, I really--I am seeing this for the first time in some period of time, and, unfortunately, I don't remember.

Mr. SALI. Is that something you could provide in written form for the committee?

Mr. SYRON. Yes, sir.

Mr. SALI. If it was ever implemented, how many loans?

Mr. SYRON. Yes.

Mr. SALI. And those kinds of things.

Mr. Chairman, with that, I have one question that is in writing, and I ask unanimous consent to submit that to all the witnesses for a written response.

[The information follows:]

******** COMMITTEE INSERT ********

Mr. TOWNS. Without objection, so ordered.

Let me thank all the witnesses of course for your testimony. We appreciate the time that you've shared with us today. And of course, we look forward to continuing to work with you, because, as you know, there are a lot of things here that need to be fixed and I think we all agree on that in terms of we need for the work to make certain that we do. So thank you very much for coming, and thank you very much for your testimony.

We will take a 5-minute recess before going into our second panel. And then, of course, after that, we will a swear them in and receive their testimony. So, a 5-minute recess.

[Recess.]

Mr. TOWNS. The hearing will come to order.

STATEMENTS OF CHARLES CALOMIRIS, ARTHUR BURNS SCHOLAR IN INTERNATIONAL ECONOMICS, AMERICAN ENTERPRISE INSTITUTE; ARNOLD KLING, ADJUNCT SCHOLAR, CATO INSTITUTE; EDWARD PINTO, FORMER CHIEF CREDIT OFFICER, FANNIE MAE, AND REAL ESTATE FINANCIAL SERVICES CONSULTANT; AND THOMAS STANTON, FELLOW, CENTER FOR THE STUDY OF AMERICAN GOVERNMENT AT JOHNS HOPKINS UNIVERSITY

Mr. TOWNS. I want to point out that there is a longstanding tradition here in this committee that we swear all of our witnesses in. So please rise, raise your right hand.

[Witnesses sworn.]

Mr. TOWNS. Please let the record reflect that all the witnesses answered in the affirmative.

We are delighted to have with us Mr. Charles Calomiris. Mr. Calomiris is the Henry Kaufman Professor of Financial Institutions at Columbia Business School. And Professor Calomiris co-directs the project on financial deregulations at the American Enterprise Institute and is the Arthur Burns Scholar in international economics at AEI.

Mr. Arnold Kling is a former senior economist at Freddie Mac from 1986 to 1997. He also served as an economist at the Federal Reserve Board. He is currently an adjunct scholar at the Cato Institute.

Welcome.

Mr. Pinto served as the former chief credit officer of Fannie Mae from 1987 until 1989. He also was the head of the marketing and product management at Fannie Mae for 3 years. Since leaving the company in 1989, he has worked as a real estate financial services consultant.

Welcome.

Mr. Thomas Stanton. Mr. Stanton is a fellow of the Center for the Study of American Government at Johns Hopkins University. He was also a fellow of the National Academy of Public Administration.

Welcome to the committee.

And we will begin with you, Mr.--why don't we just go right down the line.

Mr. Pinto, right down the line.

STATEMENT OF EDWARD PINTO

Mr. PINTO. Mr. Chairman, thank you for the opportunity to speak today.

You have already noted my credentials, so I won't repeat them. I will only add that, prior to my starting at Fannie Mae in 1984, I had 10 years experience in affordable housing. I left the company in 1989, and since then, I have provided financial service consulting services, and I followed GSEs closely.

What I found in my study that I have done privately is that there is surprisingly little consistent information available about the size of the subprime market and the contribution that Fannie Mae and Freddie Mac made to its growth. My testimony today will bring together all the available information that I found through my research and will contain information that has not, to my knowledge, been published elsewhere.

In my prepared testimony, I show that there are a total of 25 million subprime and Alt-A loans outstanding in the United States, with an unpaid principal balance of $4.5 trillion. These 25 million default-prone loans constitute 44 percent of all mortgage loans by count in the United States. This is the largest percentage that has ever happened in our history. These loans are the source, although not the exclusive source, of the financial crisis that we face today, and they are currently defaulting at unprecedented rates.

Fannie Mae and Freddie Mac played multiple roles in what has come to be known as the subprime lending crisis. They loosened credit standards for mortgages, which encouraged and extended the housing bubble. They trapped millions of people into loans they knew were unsustainable. And they destroyed the equity savings of tens of millions of homeowners spread throughout every congressional district in the United States. They accomplished this while being permitted to operate at a 75:1 leverage ratio that makes Lehman Brothers look like they were operating conservatively.

Relative to some earlier testimony, I detailed the risks posed by Fannie Mae and Freddie Mac's portfolios in attachment number four to my submitted testimony.

While Fannie Mae and Freddie Mac may deny it, there can be no doubt that they now own or guarantee $1.6 trillion in subprime, Alt-A, and other default-prone loans and securities. These comprise over one-third of their risk portfolio, not the 15 percent that they kept referring to during earlier testimony. They were responsible for 34 percent of all the subprime loans made in the United States and 59 percent of all the Alt-A loans made in the United States. They were not bit players in this play.

These 10.5 million nonprime loans are experiencing a default rate that is eight times the level of their 20 million traditional quality loans. These 10.5 million loans include 5.7 million subprime, 3.3 million Alt-A, and 1.5 million loans with other high-risk characteristics. This 10.5 million total does not include FHA's obligations, which add another 3 million to the total and bring it to 13.5 million out of the 25 million subprime and other default-prone loans. That is more than half.

According to U.S. bank regulators, subprime loans are generally those with FICO scores below 660. An Alt-A, or liar loan, was the favorite of the real estate speculator. I estimate that 1 million of the GSE's Alt-A loans had no down payment.

The purchase of Alt-A loans was justified because they helped meet affordable housing goals. And contrary, again, to some earlier testimony, I believe that the Alt-A loans were particularly goal rich, because about 20 percent of them were made to investors; namely, that meant that properties were rental properties. So the fact that they were done as a no-income/no-asset was irrelevant. The location, based on zip code, would put them into affordable housing categories, and I believe they would get credit for that.

As a result, GSE's default rates are now skyrocketing. Although they are too new to predict default rates with any certainty, I would expect that those portions of Fannie Mae's and Freddie Mac's 2005 to 2007 books comprising of subprime and other default-prone loans experience default rates ranging from 8 percent for the 2005 originations to over 40 percent for the 2007 originations. I believe there is a chart that is available that shows the performance of their books, and you can see from the hockey sticks appearance of the 2007, 2006, and 2005 books what is happening.

One of the reasons that subprime, as it is traditionally called, has gotten more publicity is those loans are older. These loans are going bad at incredible percentages, but they are younger, so they still have a longer ways to go.

The losses likely to be suffered by Fannie and Freddie will be a terrible burden to the U.S. taxpayers. If the default rates I predict actually occur, U.S. taxpayers will have to stand behind hundreds of billions of dollars of Fannie Mae and Freddie Mac losses.

This could have been averted. They could have exercised leadership, and they had done that twice before, once in the mid-1980s and once in the early 1990s. And they could have stopped the mortgage madness that was developing in the industry. Instead, their response was to open the flood gates. And in the years 2005 to 2007, they bought over $1 trillion of these junk loans that are still on their books. Their purchases were a major factor in the development of the housing bubble and in the huge number of defaulted mortgages which are now causing massive declines in house prices. Without Fannie's and Freddie's actions, we would not have this unprecedented housing crisis.

A few more observations about Fannie and Freddie turning the American dream of home ownership into the American nightmare of foreclosure. They followed an origination model initially established by FHA. It enabled thinly capitalized mortgage bankers and mortgage brokers to take over virtually the entire origination market. These mortgage brokers and mortgage bankers were able to compete for mortgage originations with thousands of well capitalized community banks, banks that are conspicuously absent from the epidemic of default-prone loan problems Nationwide.

In late 2004, Richard Syron and Frank Raines both went to the meetings of the originator community and made clear that they were going to wrest back the subprime and Alt-A mortgage market from Wall Street. Syron said, "Our success in the future depends on our ability to serve emerging markets, and they've become the surging markets." Raines also said, "We have to push products and opportunities to people who have lesser credit quality."

These statements alerted the originator community that, if they could make subprime and Alt-A loans, there was a ready market for them. And this stimulated an orgy of junk mortgage development.

Fannie and Freddie used their automated underwriting systems to divert subprime and Alt-A loans from private label securitizers, driving up the value of these loans and making mortgage brokers even more eager to find borrowers regardless of their credit standing.

Why did Fannie and Freddie do this? First, they were trying to meet HUD's affordable housing goals which, by 2005, required 55 percent of all their loans that they purchased be affordable housing loans, including 28 percent to low-income and very low-income borrowers. Second, after their accounting scandals of 2003-2004, they were afraid of new and stricter regulation. By ramping up their affordable housing lending, that trillion dollars I mentioned earlier, they showed their supporters in Congress that they could be a major source on a continuing basis of affordable housing financing.

Mr. Chairman, there is much more in my prepared testimony, including my recommendations on how to meet this challenge, but that is the end of my oral statement. I look forward to your questions.

[Prepared statement of Mr. Pinto follows:]

******** COMMITTEE INSERT ********

Mr. TOWNS. Thank you very much, Mr. Pinto.

Mr. Kling.

STATEMENT OF ARNOLD KLING

Mr. KLING. Thank you, Mr. Chairman, distinguished members of the committee. I would like my written testimony to be entered as if I had spoken it.

Mr. TOWNS. Without objection.

Mr. KLING. It is a privilege to be asked to testify in this forum today regarding the collapse of Fannie Mae and Freddie Mac and the ongoing financial crisis.

My name is Arnold Kling. My training is in economics. And in the late 1980s and early 1990s, I worked at Freddie Mac, where I was present at the creation of several quantitative risk management tools that paved the way for innovations in mortgage finance.

Speaking as a former financial engineer, I have many regrets about the role played by modern financial methods in this crisis. Rather than speak defensively about financial innovation, I want to offer constructive suggestions for public policy going forward.

I emphatically disagree with the extreme partisan narratives of this crisis. To blame the Community

Reinvestment Act for what happened is wrong. To blame financial deregulation for what happened is wrong. The narrative I present in my written testimony describes a combination of government failure and market failure.

I want to focus on how both industry executives and regulators were fooled about the risks in the system. In particular, perverse incentives in bank capital requirements encouraged unsound lending practices and promoted excessive securitization. When a bank originates a low-risk mortgage, why would the bank pay Freddie Mac a fee to guarantee that mortgage against default? Freddie Mac has no intrinsic comparative advantage in bearing that credit risk. However, in practice, the bank was able to reduce its capital requirements by exchanging its loans for securities. Forbearing the exact same credit risk, Freddie Mac was allowed by its regulator to hold less capital than the bank.

By requiring Freddie Mac and Fannie Mae to hold less capital than banks, our regulatory system encouraged Freddie Mac and Fannie Mae to grow at the expense of traditional depository institutions. That turned out to be dangerous.

The perverse regulatory incentives were even more striking with high-risk loans. If a bank originates a high-risk loan, you would think that there is no way to avoid high capital requirements. But it turns out that when a high-risk loan has been laundered by Wall Street, it can come back into the banking system in the form of a AAA rated security tranche. And I should mention that you had the people here--I know this committee has discussed the problems with the rating agencies and that the ratings were bogus. You had the people here this morning who were in a position to call them out on it. They could have run these securities--Freddie Mac and Fannie Mae could have run these securities through their stress tests, reported that these securities were going to blow up, and put a stop to the private-label subprime market right then and there. They had the power to do that. But once they were laundered as AAA tranches, from the standpoint of capital requirements, bank regulators closed their eyes and pretended that the risk has disappeared.

My reading of the history of the secondary mortgage market suggests the following lessons:

One, capital requirements matter. Details that are easily overlooked by regulators can turn out to cause major distortions.

Two, securitization is not necessary for mortgage lending. On a level regulatory playing field, traditional mortgage lending by depository institutions probably would prevail over securitized lending. Rather than try to revive Freddie Mac and Fannie Mae, I would recommend that Congress encourage a mortgage lending system based on 30-year mortgages originated and held by old-fashioned banks and savings and loans. This would require instructing the regulators of Freddie Mac, Fannie Mae, banks, and savings and loans to all use the same capital standard for mortgages, one that is based on a stress-test methodology.

Three, subsidized mortgage credit is an inefficient tool for promoting home ownership. Unless what you want is home buyers who are buried in debt and speculating on house price appreciation, I recommend that Congress not try to create cheap mortgages but instead use other means to encourage home ownership.

Four, recent financial innovations, particularly credit default swaps, have changed our financial system in ways that current policymakers failed to recognize. Bailouts and rescues are counterproductive in today's financial crisis. Within the financial sector, deleveraging needs to slow down, and the process of shutting down failed institutions needs to speed up. Relative to these necessities, handouts from the taxpayers are a hindrance, not a help.

[Prepared statement of Mr. Kling follows:]

******** INSERT 5-1 ********

Mr. TOWNS. Thank you very much, Mr. Kling.

Mr. Calomiris.

STATEMENT OF CHARLES CALOMIRIS

Mr. CALOMIRIS. Thank you, Mr. Chairman. It is an honor and a pleasure to appear before you and the committee today to share my views on the role of the GSEs in the current financial crisis and the lessons for GSE reform going forward. I would like to ask that my written testimony and two background articles which provide more detailed analysis in support of my statement also be entered into the record.

Mr. TOWNS. Without objection.

Mr. CALOMIRIS. Mr. Chairman, before I begin, I would like to correct a typographical error in one of those background documents, the one authored by myself and Peter Wallison. I think I can just do it orally.

In that document, on page 8, in the second column, there are two sentences that need to be replaced. They read as follows: In the addition, Freddie Mac's disclosures indicate that, of the loans added to its portfolio of single family loans between 2005 and 2007, 97 percent were interest-only mortgages; 85 percent were Alt-A; 72 percent were negative amortization loans; 67 percent had FICO scores less than 620;

and 68 percent had original loan-to-value ratios greater than 90 percent. There were typos in that two-sentence excerpt, and that needs to be replaced with the following.

Mr. TOWNS. Let me say, based on that, let me read this and you can sort of respond to it as you do your presentation, Mr. Calomiris. The committee has received a letter from a former Fannie Mae executive, Mr. Barry Zigas. Mr. Zigas disputes the way you interpret Fannie Mae and Freddie Mac's financial data in a recent article you published with Mr. Peter Wallison of the American Enterprise Institute. So you can respond. Since the article is now a part of our hearing record, I am going to ask unanimous consent to submit Mr. Zigas's letter in the hearing record and ask that you respond to it for the record. So you can do that as you move forward.

Thank you.

[The information follows:]

******** COMMITTEE INSERT ********

Mr. CALOMIRIS. Thank you, Mr. Chairman.

Actually, it was through the kindness, I guess, of the Chairman who showed me that letter earlier or had it sent to me that I looked at the article and recognized these typographical errors. So this correction actually responds and completely corrects the article and deals with all of those things that that gentleman found, and I appreciate his pointing them out to me.

Mr. TOWNS. I will give you an extra minute in your testimony.

Mr. ISSA. Mr. Chairman, I might ask from a parliamentary standpoint, wouldn't it be in our best interest as a unanimous consent that we enclose that, that the two be placed next to each other in the record so that there not be a chance that this oral testimony would somehow not be exactly next to the written? Because I would like the record to be accurate as to the original and perhaps--

Mr. TOWNS. Without objection.

[The information follows:]

******** COMMITTEE INSERT ********

Mr. ISSA. Thank you.

Mr. CALOMIRIS. Now I will read the replacement text.

Tables one and two show that, for each category of mortgages with subprime characteristics, most of the portfolio of loans with those characteristics were acquired from 2005 to 2007. For example, 83.8 percent of Fannie's and 90 percent of Freddie's interest-only loans as of September 2008 were acquired from 2005 to 2007. And 57.5 percent of Fannie's and 61 percent of Freddie's loans with FICO scores of less than 620 as of September 2008 were acquired from 2005 to 2007.

That completes the correction, Mr. Chairman.

None of the rest of the article requires any correction. This apparently--I had not seen the final edits on this article. Apparently someone was confused and made some word changes that didn't make sense. I apologize for that. I also have to apologize to Mr. Garrett, because as I was listening to his questions I think--earlier, I think he actually was relying on that exact paragraph. And so my apologies to the committee for that mistake.

Given the time constraint of my oral testimony, I will summarize my written testimony by posing and answering a short list of questions:

Did Fannie and Freddie play an important role in the subprime crisis? Yes. As Ed Pinto has shown, they ended up holding about 1.6 trillion or roughly half of the total non-FHA exposure on subprime losses. And through their role as standard setters in the industry, they played a leading role in relaxing underwriting standards and promoting no-docs lending.

Was their involvement in subprime simply bad luck, or did it reflect purposeful willingness to undertake risks that they recognized as dangerous and that they recognized were arguably not in the interest of subprime borrowers? Yes. They were experienced in this area. They knew the dangers of no-docs lending, and they did it anyway. Their risk manager saw the losses coming. The risk managers also saw the potential human costs of no-docs lending coming and warned senior management about it in advance.

Was the GSE's willingness to undertake these uniquely large risk exposures through relaxed underwriting standards on subprime loans related to their GSE status and their affordable housing mandate? Yes. The GSE charters and the political deal between the GSEs and the government, which was understood in the marketplace, was that there was a clear quid pro quo connecting the implicit government guarantee of GSE's debts and other favorable treatment of GSEs with the GSE's willingness to expand their funding of affordable housing, and subprime with Alt-A was the means they chose to do it.

And, as the internal e-mails of Freddie Mac clearly show, although management recognized the dangers of subprime losses, because of the crucial need to preserve government support, at least in their minds, affordable housing goals, quote, tipped the balance, end quote, in 2004 in deciding to relax underwriting standards.

Would the subprime crisis have been different if the GSEs had not decided to enter subprime and Alt-A lending so aggressively in 2004? Yes. The GSEs were the dominant players in the mortgage market and also played crucial roles as standard setters. They recognized their, quote, market-making, end quote, role, and knew that, in the past, their decision to discontinue no-docs lending had led to the disappearance of the product in the market.

Furthermore, the timing of entry by the GSEs was important. They came into the subprime and Alt-A market as it was ramping up in 2004, and their entry was associated with the rapid escalation of lending in 2004 and 2005. Lending nearly tripled. Subprime lending nearly tripled in Alt-A from 2003 to 2005.

Finally, unlike some other market participants, they continued to buy long after clear signs of trouble had emerged in mid-2006 in the housing market, which meant that their market-making role grew over time, particularly so in late 2006 and 2007 when origination volumes remained very high despite the impending problems that were already visible in the housing market.

I conclude that, counterfactually, the crisis would have been less than half as large as the actual crisis if the GSEs has struck to their traditional roles as prime lenders. I would also note that the reason people like me didn't complain about this in 2005 and 2006 was that they had adopted accounting practices that masked these by the way they defined subprime and Alt-A lending.

Finally, my last comment is, it is worthwhile to promote home ownership in the U.S. This should be done, in my view, not through the GSEs. Their assets, their charters should be fully and credibly privatized. It should be done by the government on budget, in a transparent manner, befitting our democracy, and through direct subsidies, like down payment assistance, rather than in a way that encourages borrowers and lenders to increase leverage imprudently and therefore promote unwarranted foreclosure risk.

Thank you, Mr. Chairman.

[Prepared statement of Mr. Calomiris follows:]

******** COMMITTEE INSERT ********

Mr. TOWNS. Thank you very much, Dr. Calomiris.

Mr. Stanton.

STATEMENT OF THOMAS STANTON

Mr. STANTON. Mr. Chairman, I would ask that my written statement and two attachments be included for the record.

Mr. TOWNS. Without objection.

Mr. STANTON. Mr. Chairman, Ranking Member Issa, members of the distinguished committee, in 1991, I wrote a book called, "A State of Risk: Will Government-Sponsored Enterprises Be the Next Financial Crisis?" I then worked with a small group of reformers, including Congressman Jake Pickle of the House Ways and Means Committee, Democrat of Texas, and Representative Bill Gradison of Ohio, Republican. We tried to improve Federal regulation of Fannie Mae and Freddie Mac and their safety and soundness, but because of very strong lobbying by those two organizations, the regulator was created without adequate authority.

In my testimony today, I would like to make three basic points. One, while Fannie Mae and Freddie Mac did not cause the mortgage credit debacle, they did engage in risky practices that turned them into sources of vulnerability rather than strength for the mortgage market and the larger economy.

Two, as it becomes clearer that Fannie Mae and Freddie Mac in fact are insolvent, it would help to place them into receivership and thereby remove private shareholders from the two failed companies. Once shareholders are clearly gone, the next administration can use the two companies to provide much needed support and reform, including consumer protections for the home mortgage market. If the companies remain in conservatorship rather than receivership, then government will face conflicting objectives about the role of the two companies in serving urgent public purposes versus serving financial interests of the companies and their shareholders.

Three, Fannie Mae and Freddie Mac should not be restored to their previous status as privately-owned organizations that operate with pervasive Federal backing. The two companies and their powerful constituencies have consistently fought for higher leverage and against effective accountability. Even if a strong regulator were created initially, and somebody mentioned the concept of public utility regulation, the political power of the two companies can be expected to weaken accountability over time and restore the companies to their dominant market positions, high leverage and financial vulnerability.

Let me briefly talk about the first point and leave the rest for discussion.

Fannie Mae and Freddie Mac committed serious misjudgments that helped to bring about their insolvency. The most serious of these misjudgments involved the company's resistance to accepting more effective supervision and capital standards. For years the two companies exerted their influence to fend off capital standards that would have reduced their excessive leverage and absorbed potential losses. The two companies compounded the problem by taking on excessive risk just at the point that housing prices were peeking. Among other losing assets, the two companies held would over $2 billion of private-label mortgage related securities backed by Alt-A or subprime mortgages in 2007.

In making these mistakes, Fannie Mae and Freddie Mac revealed the inherent vulnerabilities of government-sponsored enterprise, or GSE, as an organizational model. First, the GSE can live or die according to its charter and other laws that determine the condition under which it operates. That means that GSEs select their chief officers in good part based on ability to manage political risk, as we saw in the first panel today, rather than on their ability to manage two of the largest financial institutions in the world.

Second, GSEs combine private ownership with government backing in a way that creates a virtually unstoppable political force. Because of their government backing and low capital requirements, Fannie Mae and Freddie Mac gained immense market power. They doubled in size every 5 years or so until this year the two companies funded over $5 trillion of mortgages, about 40 percent of the mortgage market. Their market power gave them political power, which is seen in the fact that the new regulator created by the Housing and Economic Recovery Act of 2008, enacted late July just before the companies collapsed, still failed to give the new regulator the full mandate, authority, or discretion over safety and soundness and systemic risk that is available to the Federal bank regulators. And if there is a question on this, I would be delighted to submit documentation to the record.

In short, the mix of private incentives and government backing created a dynamic that led not only to the hubris that brought about the meltdown of internal controls of both Fannie Mae and Freddie Mac several years ago but also their insolvency in 2008.

But Fannie Mae and Freddie Mac by themselves did not cause the housing bubble or the proliferation of subprime and other mortgages that borrowers could not afford to repay. In analyzing the two companies, I discovered a phenomenon can be called Stanton's law: Risk will migrate to the place where government is least equipped to deal with it. So the capital markets arbitraged across regulatory requirements and ultimately sent trillions of dollars of mortgages to Fannie Mae and Freddie Mac where capital requirements were low and Federal supervision was weak. But the capital markets also found other places where government could not manage the risk and also sent huge volumes of subprime, Alt-A, interest-only, and other toxic mortgages to structured investment vehicles of commercial banks, private securitization conduits, and collateralized debt obligations that were virtually unsupervised.

Mr. Chairman, I would like to end on a note about the human costs of Fannie Mae and Freddie Mac. Their actions led to hundreds of thousands of American families, and possibly more than a million, facing delinquency and default on their mortgages and potential foreclosure of their homes.

RPTS BINGHAM

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[3:01 p.m.]

Mr. STANTON. They funded the overbuilding of hundreds of thousands of homes that will be vacant or boarded up because no one wants to live there. The cost to the American taxpayer will run potentially to hundreds of billions of dollars. All of this harm occurred on the watch of the four men on the first panel. It could have been avoided with prudent lending, prudent capital and prudent management.

So thank you again for holding this important hearing on two financial institutions that used their high leverage and insatiable appetites to grow to an unmanageable size before they failed. I would be pleased to respond to any questions.

[Prepared statement of Mr. Stanton follows:]

******** INSERT 6-1 ********

Mr. TOWNS. Let me thank you very, very much for your testimony.

You know, I think it would have been wise for us to allow them to go first and then allow the others to stay and to listen and then respond, because I really think, in terms of the testimony and information that they have given us, it has been very, very, very helpful.

Mr. ISSA. Mr. Chairman, I totally agree with you, and, in fact, of all the things that my hope as ranking member and your hope as chairman that I would like to do is to make that reversal whenever possible so that, whether it's administration or other government witnesses, we're able to do just that. I think you're exactly right. It would have been very helpful today.

Mr. TOWNS. Thank you very much for your comment.

Let me move right along. I would like to ask, I guess, let me start with you, Mr. Stanton, being you just--and, of course, others to respond, in your testimony, of course, we talked about--I would like to ask I guess the panel about the affordable housing goal that the Department of Housing and Urban Development set for Fannie May and Freddie Mac. And, Mr. Stanton, in your testimony--I think it was page 5 and 6, I think it was--you explained that when Congress rechartered Fannie and Freddie in 1992 we asked them to devote some of their time and resources to finding ways to help low- and moderate-income Americans buy homes. But you said that these goals did not lead Fannie and Freddie to invest in risky mortgages. Can you explain to us your conclusion and how you arrive at that?

Mr. STANTON. Yes, sir. I would be delighted.

If you look carefully at the law--and I'm a student of the charters of the two companies and the legal frameworks surrounding them--you find that they are required to undertake activities--and I will quote--relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities. Close quote.

In other words, the law does not require them, they do not receive appropriations to take losses on the affordable housing loans they make. And if you follow that through to the 1992 Act, and it follows through to 2008, what you see is that the Department of Housing and Urban Development is not allowed to impose goals that would cause the companies to fall below that standard.

So, in fact, when you look, two things were probably going on. One, it's a more subtle point. These are political companies. Their leaders are retained to manage political risk. So that means they will engage in affordable housing beyond HUD in order to get favors for other parts of their charter, either to block things they don't want or to gain things they do want.

And, of course, they also had insatiable appetites. When you buy $200 billion of Triple-A-rated mortgage securities backed by Alt-A and subprime mortgages and you don't ask your own risk analysts to run those mortgages through the filter in order to do due diligence and check on the rating agencies, you're asking for trouble. But you're not doing that to support the affordable housing market. You're doing that because you expect that there are good returns on those investments.

Mr. TOWNS. Other members of the panel agree on that?

Mr. PINTO. I have a little different take on that.

When the original goals were set subsequent to the 1992 legislation, I believe HUD set them in '93, and they were set a little bit purposely low because they didn't quite know what was going to happen. And Fannie and Freddie sort of jumped over the hurdles very quickly; and that created a backlash that said, wait a minute, HUD, you set them too low. And HUD learned from that, and year after year they kept ratcheting them up and ratcheting them up.

Fannie and Freddie had to keep--remember, this is a duopoly. They're competing against each other for the same loans. They're also competing with FHA for the same loans. They're all considered goal rich. Ultimately, they were competing with subprime for the same loans. They were considered goal rich, and their regulators called all of these loans goal rich.

By the early part of this decade, you had situations where at the end of the year, if they were a little bit short, a bidding war would break out. In fact, Fannie rented some loans for a while. That was a scandal that developed 5 or 6 years ago where they rented some loans and then returned them later the next year in order to meet their goals.

So the pressures that were put on them were tremendous. But I would point out that I believe in the 2007 Freddie Mac document they concluded that the lowest 10 percent of their business was put on the books at a zero return on equity. That does not meet the standard that was in the charter. A zero return on equity, and that was calculated optimistically. It turns out if you were to do that calculation today, these loans were put on the books at tremendous losses.

Mr. TOWNS. Yes. Dr. Calomiris.

Mr. CALOMIRIS. I just want to add that I think that there are obviously other motivations, too, for getting involved in subprime and the e-mail correspondence that I saw from Freddie Mac indicated that. But I think that what was interesting is that in all those e-mails it was also reflected that affordable housing goals in this political sort of strategy that Mr. Stanton referred to were part of the mix and that one of the e-mails specifically said tip the balance when they were considering whether to get into the no docs area and Alt-A and subprime more broadly.

So I think it's important to mention both that there are multiple influences. Let's face it. There were a lot of managers who weren't JFCs who were pursuing this, too, based on short-term profits for themselves at the expense of their stockholders. I would say that the executives of the GSEs were guilty of that as well but that I think it's pretty clear from the e-mails that the affordable housing mandate and their, let's say, political manipulation of that was definitely part of the story.

Mr. TOWNS. Thank you.

Mr. STANTON. If I could add something, Mr. Chairman, these are two companies funding $5 trillion in mortgages. The whole point of trying to underwrite mortgages for people that are nontraditional borrowers is to do it carefully and really work at it so that you try to, in fact, make people eligible for mortgages. Because the normal FICO score, for example, is based on traditional borrowers, not on affordable housing borrowers. And that isn't what they did. They simply plunged in and bought huge volumes of mortgages without regard to the welfare of the people they could have underwritten more carefully. So that is part of the problem, too.

Mr. TOWNS. Mr. Issa.

Mr. ISSA. Thank you, Mr. Chairman.

This is a wonderful panel, and I appreciate your statements, and, obviously, we will be poring over them well into the next Congress.

I'm almost befuddled to try to come up with how many questions we could ask, but let me start with Mr. Pinto. The earlier panel--which I would have liked you first, but I'm also glad you're after--seemed to want to make a distinction between Alt-A and subprime; and even when we started asking about it we got told, well, some of the Alt-As are subprime, and some are the other. From a standpoint of deviating from sound practices that lead to reasonable default rates, is there any real difference?

Mr. PINTO. No. Alt-A actually stood--one of the meanings of it was Alt Agency. They were things that the agencies would not buy.

How do I know that? Because, in 1985, I was one of the authors of Fannie Mae's revised underwriting requirements; and in that revised underwriting statement, we said we were not going to do the kinds of loans that ended up being high-risk, too high a risk for Fannie Mae to undertake: investor loans, particularly three and four units, excess loans on condos. There were many different types: low start rates on ARMS, neg am ARMS--we called them gyp

ARMS--graduated payment ARMS. There were all kinds of loans, and those were the loans that became known as Alt-A.

I was happy to hear CEO Raines say earlier that Fannie actually remembered what had happened in the early '80s, in the mid '80s, and it happened in the late '80s when the no doc, low doc business blew up, that they remembered that, but they did not learn.

Starting in the early 1990s, they came back with a 97 percent mortgage which they had no basis for figuring out what the risks were. Freddie Mac, I put it in the record, had--showed a 95 percent loan. The default rates on those things were sky high. They just about go off the chart. Yet they were doing 97 percent loans on the basis of no data. And that was the beginning of this process.

So the Alt-A loans, the subprime loans, I lump them all together.

How did I end up coming up with 1.6 trillion? It's very simple. If you look at the kinds of risks--again, Frank Raines referred to them as what we learned in the '80s and early '90s. If you look at the kind of risks that they entered into on the 1.6 trillion, they knew those were risky loans. They performed under stress the same way. They all have incredibly high default rates, and they're performing that way exactly today. So every category I put on my chart ends up being in that same bucket.

Mr. ISSA. I appreciate that.

And, Mr. Calomiris, I see you're shaking your head yes, so I think we've established today that we're not going to find a difference in spite of the distinction being made by the earlier panel.

I would ask two things. First of all, would all of you be willing to answer additional questions for the record? Because I know I am running out of time, and I very much would like to get them in the record.

With that, I would ask a couple of questions that are not likely to be asked normally and the public has a right to understand..

The vast majority of States, including my own, California, have no recourse loans, meaning that no matter how much funding somebody has in their personal pocket, including that earlier testified roughly 20 percent who were speculators, they're able to get a no-money-down, no-stated-income loan, and they're able to never occupy that home, perhaps hold it for rental, or perhaps just hold it to flip.

At one of the points in this whole debacle, the turning back in or the failure to pay or in some cases--we've had it in California--people bought homes, rented them out, never made the payments, and waited for the foreclosure. They were guaranteed if they put nothing down and rented them out that they were going to make money, because they collected rent and paid nothing out.

And, Mr. Stanton, I know you're smiling, but as you see them you begin to realize that not everyone is a victim that in fact took out a loan. Should we on this dais look at a recourse structure to government-backed, government-guaranteed, government-underwritten loans so as to take the speculator who does have other assets out of the equation of taking this "heads I win, tails the government lose" situation?

Mr. Stanton, you were shaking your head earlier. Would you agree that that could be a tool that we would have a right to do since we, the people, we, the representatives of people, are paying out potentially trillions of dollars and, in some cases, the money is because of speculators who kept their money and, in fact, left us holding the bag?

Mr. STANTON. Absolutely, and that is the logic that led me to recommend these companies be removed from conservatorship now that they have an apparent negative value, put in receivership and used essentially as government corporations.

It was stunning to hear these CEOs say, gee, it would have been nice to have consumer protections. In fact, as a government corporation, without worrying about shareholders, there would be a way then to impose risk-sharing requirements on all the participants up and down the line, to structure much more sound ways of doing business and to add, if I can make a plug for a colleague, Alex Pollock of the American Enterprise Institute, basic consumer protections.

He has a one-page mortgage form; and one of the questions on the one-page mortgage form is what is the highest monthly payment that this mortgage could ever go to? That is a really simple question that reveals what happens when you have got these teaser rates. Because a whole bunch of those mortgages' answer might have been infinity; there are no natural limits.

So, as a government corporation, we could use both Fannie Mae and Freddie Mac to do the kind of risk sharing you're talking about, impose serious consumer protections, and create serious standards for the market going forward. Thank you.

Mr. Kling.

Mr. KLING. Congressman Issa, I hope that you will keep raising the issue of investor loans and nonowner-occupied loans. Because your colleagues often seem to forget, and they talk about foreclosure moratoriums and work-outs being a solution for this, but nobody has told me what the percentage of nonowner-occupied loans is. We know that 15 percent of the loans made in 2005 and 2006 were nonowner occupied.

And I would just step back and say, rather than make those recourse loans, ask why are they eligible for any government guarantee at all? If your goal is to promote homeownership, I assume you're not trying to promote home speculating. So why are they eligible for Freddie Mac, Fannie Mae, or any government guaranty at all?

Mr. ISSA. Thank you. Thank you, Mr. Chairman.

I think with that we will probably realize that home homeownership and being a homeowner and renting out to others is not quite the same thing, and I appreciate it. Homes ownership, as the chairman said.

Mr. TOWNS. Thank you very much.

Congressman Bilbray from California.

Mr. BILBRAY. Thank you very much. And let me thank the panel; and, Mr. Kling, thank you for throwing darts at both sides. It is kind of refreshing in this town.

There is a whole lot of things I would love to jump right into, but when we get into this issue of unsecured, basically, finding ways to be able to qualify people at any cost, I don't know if you guys are aware of it and the ranking member will say--will remember this.

In '05, in San Diego, there was a big deal about the fact that you not only did not have to be a U.S. citizen, you did not only not have to be legally in the country, you didn't even have to show a viable ID that you were who you said you were to get a loan. And many of those loans were through nonprofits that were getting grants from the Federal Government.

So this is how deep we got into this issue, and it wasn't just the nonprofits but it was the for-profits were searching out anybody and everybody that we can figure out how to get them to sign up on this program. Because they were--basically, seems like you create the paper and you have all these foreign investors love to buy sight unseen but to the point of where somebody wasn't even required to prove that they were whoever the name was on the loan, didn't even have to show a United States viable ID. They were using consulate cards from another country that is issued based on the honors system.

I only raise this to show you how far this goes. And I will be very interested to see, do we require legal status, viable identification under the REAL ID bill to participate in the bailout that is going on now or the refinancing and everything else? I don't hear anything about that. It's just like, well, anybody and everybody can got into the system. The more the merrier.

You brought up the credit default issue, the swaps. And I know that is not specific to here. But from the testimony we've seen, this is a huge ax hanging over our head right now. Anybody knows where it is? How many trillion--anybody got any idea how many trillions of dollars--what is the number that is floating around now with credit default swaps?

Mr. KLING. Sixty-two trillion or something? Sixty trillion outstanding as of the end of last year gross. It came from nothing 10 years ago.

Mr. BILBRAY. Which was really a product of our regulatory reforms squeezed off one side and left it wide open and the bulge started coming out there.

And, Mr. Chairman, I think that is one of the things the new Congress really has to look at. Here comes 60 trillion--think about that--is the culture shock we've had with the 1.3 we've issued since March but 60 trillion hanging out there and, basically, Vegas could give better odds. It's a lot of gambling out there.

So I want to just in this hearing point out, we have this huge, huge threat out there that nobody is really talking about because we're kind of responding to the problems of the past and not seeing this coming down the pike.

Guys, any comments about that? Because you have been frank and open about it, and I think it's important that the--hopefully, the future chairman and ranking member of this committee is here to hear it.

Mr. CALOMIRIS. Yes, I'd just like to say something briefly about that.

On an optimistic note, remember that credit default swaps are a zero net sum game. So even if there are 60 trillion in nominal exposure, the aggregate exposure in the financial system is always zero.

Now there is a problem, of course; and we saw that with AIG and its credit default swap position vis-a-vis Goldman Sachs. And that problem is that if somebody is on the brink of failing and they aren't properly collateralized in their positions, which was the case for AIG because it had AAA status, was not the case for Lehman Brothers, by the way, because it didn't have triplea status.

So we did have a problem with AIG because of its AAA status and its lack of collateralization; and so it could have added significantly tens of billions, maybe more, to the cost of a cleanup.

But, more generally, the problem isn't nearly as bad as the sort of headline numbers are indicating; and it was very particularly a problem for AIG precisely because of AIG's AAA status.

Mr. PINTO. And that was demonstrated by Lehman Brothers when they unwound. There was--I believe it was a nothing. It all happened, and everybody yawned, and the reason was exactly what Charlie just said. And they had a lot outstanding.

Mr. KLING. In my written testimony, I spell out what I think are the problems with credit default swaps. I don't think we in the economics and finance profession fully grasp the magnitude of what is going on and the implications of what is going on there. And I think it's quite possible that a lot of the panic deleveraging that is going on and the very strange relationships in security prices that we're seeing today, I strongly suspect that has a lot to do with the way the credit default swap market operates.

Mr. STANTON. I think the issue of credit default swaps has been covered, but I want to point out something else on the horizon that is worth looking at. Particularly since Charles was so optimistic, I can be a bit pessimistic.

We have seen a huge number of defaults now because of bad mortgages, mortgages that never should have been issued in the first place, subprime Alt-A, whatever we want to call them. What we have not seen yet is the full impact of defaults on homes because a recession hits, and that has been the traditional source of defaults on homes. So we can expect a second wave to be coming in.

And again I reiterate, it's time to take both GSEs in hand as government corporations. Stop this incessant, gee, do we price high? Do we price low? Because we have to satisfy shareholders because it's a conservatorship, not a receivership, versus we've got to support the housing market and start using the GSEs actively to start dealing with what is going to be a much worse problem.

Mr. BILBRAY. Mr. Chairman, I just want to say the three of us up here actually are sons of areas that were red-lined consistently before this; and I think we understand the challenges for the working class neighborhoods because it was our neighborhoods that were red-lined by these institutions before; and we need to address that.

I think we need to recognize, too, that a lot of this that we don't even talk about is that not just homeownership but what was perceived as a minimum homeownership back in the early '70s, late '70s, early '80s. You will remember that homeownership, the first step was usually into an attached condominium, something you could afford, build equity. You build your credit rating. You worked into it.

What we've seen in the last 10 years is don't even think about those things. They're going for the four, five bedroom detached house and whatever. And I think we have to understand a level of expectation needs to be reflected appropriately, especially for people trying to get out of those neighborhoods that we grew up in or to buy a home in those neighborhoods.

Mr. TOWNS. Thank you very much and thank you.

The gentleman from Idaho, Congressman Sali.

Mr. SALI. Thank you, Mr. Chairman.

Gentlemen, I'm sorry that I was gone for a short while while you were giving your testimony. I had looked at some of the information you had provided earlier, and I guess there are two pieces to the puzzle as Congress wrestles with what to do going forward.

The first one is, if you start today and you're going to make a sound loan, how do you do that? And I think most of your information goes to that.

Mr. Pinto, you have the chart that you talked about I think during your presentation, and I'm looking at the 2007 graph, and it doesn't look very rosy. Those loans already made, how do we get that bleeding stopped? Because this is going to impact--this piece is going to--if we started making good loans today, this piece will still impact things profoundly. What should we do to try and shore that up?

Mr. PINTO. Excellent question.

In my prepared remarks, I proposed two solutions, a short-term and a long-term. The short-term, and I liken it to you're fighting a forest fire, it's very simple. Where did you fight the fire? At the fire line or away from the fire line? If it's out of control, you have to fight it away from the fire line. You have to build a firebreak. And I have looked at all the different modification programs that are being proposed; and none of them establish a fire line, away from the firebreak, away from the line of fire.

I'm not one who normally espouses that the Federal Government spend a lot of money for something. However, the issue that we've got--it was just touched on by Mr. Stanton, about the second wave that is coming--it's actually a second and third wave. The second wave is, Fannie and Freddie's book of business is new, does things that have been causing the foreclosures to a large extent in the past, that were loans made earlier in this decade, the ones that were made in '05, '06 and '07 are just--you can see it--are just starting to go bad; and the ultimate foreclosure rates are going to be way up here. They're going to be way off the charts. And that is the second wave.

The third wave is what is known as the real economy, the people who actually played by the rules, and now they're losing their job or whatever. And I have estimated that by the end of next year, with the price declines that everyone is agreeing on, 1 percent a month to the end of next year, that there is going to be $12.2 trillion of mortgage debt outstanding and $11 trillion of home value. That is a national LTV on people--loan to value--on people that have homes of 111 percent.

That has never happened before, I will say, in the history of United States. I don't think it has ever happened before in the history of the world. In the Depression, it was 30 percent. So that is what we're looking at.

So the second and third waves are coming. So what do you do? You have to identify, and we can identify these loans. Fannie Mae has a great little chart. Freddie Mac has the same chart. Everybody else knows--the New York Fed has all these charts. Everybody knows where all these loans are, ones that are defaulted and not defaulted.

We know what the characteristics of the loans are. We know--I have identified there are $4.4 trillion of junk loans out there. We have to find a few trillion of those that are owner occupants, and we have to identify them, and we have to put together a program that has the five steps that I listed in my testimony and make an offer to those people to refinance them.

But you're going to have to bring down the principal amount substantially so that you create equity and create that cushion. You have to create a strong firebreak. But it's also very important that you don't put 50-year loans--I hear them talking about extending the term to 40 and 50 years. That is crazy. You want equity building back up, not pushing it way out.

You can't be pushing delinquencies on the back end. That doesn't create incentive to stay in these homes. We have to create hope for these people to continue with these loans and continue in their homes, and the way you do that is the proposal that I laid out in my testimony.

The second part which I will just reference is we have to deleverage the whole housing system. We have overleveraged the entire system starting with the homeowner, going to the banks, Fannie Mae, which now has no capital but they were overleveraged 75 to one all along, and then the mortgage-backed securities which were overleveraged. Congress created a system that overleveraged everything all the way through. We have to deleverage that.

If I would ask the committee to do anything, it is to look at the question of how do you deleverage the financial system of the United States. It used to work when the leverage was 3.7 to one. We've changed it to 30 to 40 to one. It's not sustainable.

Mr. SALI. You're suggesting that the mortgage lenders are going to have to take the loss of writing down the principal--

Mr. PINTO. Well, the Federal Government is on the hook for--I hate to tell you this. You already own 77 percent of all the mortgages in the United States, own or on the credit hook for them. Therefore, it comes back to us.

Mr. SALI. Well, we spent a half a trillion dollars in deficit in last year's budget. That doesn't count the 700 billion of bailout, the 85 for AIG, the other 35 for Bear Stearns; and, I mean, that list goes on and on and on. And now we're talking about the automakers. We don't have any money. What are we going to write down against, just more deficit spending? I realize the taxpayers are going to have to be on the hook--

Mr. PINTO. You already own these loans. You're responsible for them. 4.6 trillion of the 12 trillion is Fannie Mae and Freddie Mac. Who owns Fannie Mae and Freddie Mac?

Mr. SALI. But you're suggesting we can create value out of thin air.

Mr. PINTO. No. No. I'm not creating value out of thin air. You have to write down these mortgages to a level where the people that are in them, the homeowners, have an incentive for staying there. Putting them through the foreclosure process is slow death. It's letting the fire burn out of control. You're going to have 8 million, 8 million foreclosures if you don't get ahead of this rampaging fire. I'm telling you, there are going be to be, in the next 4 years, 8 million foreclosures. That is out of 57 million loans that we've already had two or three million foreclosures. That is 8 million more.

Mr. KLING. I'm going to disagree with that. We've agreed on a lot of stuff so far, but I'm going to disagree. Personally, my instinct is kind of yours, that the government--my concern is that if the government gets involved trying to bail out at the homeowner level, you don't know in Washington which homeowner can follow through with a mark, with a principal write down, which homeowner cannot.

You can't manage that from Washington.

The administrative expenses of that are going to be huge, and that is--I think 10 years from now all you're going to have to show for that is lots of administrative expenses, lots of repeat defaults and, worst of all, a housing market that is still out of balance because people don't know where the prices are, where the prices belong in the housing market.

I would say in the end it would be cheaper to take those 8 million people, pay for moving trucks, hold the door for them, get them out or turn them into renters than it will be to try to rework the mortgages. That is my prediction. I hope it's not correct, because I know that you're going to want to rework the mortgages, but that is my fear.

Mr. SALI. Aren't those same 8 million people going to live in those same houses, though? They're just going to trade addresses at the end of the day, aren't they? You're not going to build 8 million more apartments for them to live in.

Mr. KLING. Or they will rent their houses. But we have to get to a natural market with supply and demand in balance. Because as long as you try to prop up people in houses that they couldn't--that they didn't belong in in the first place, the rest of the market is not going to be cured. That is my fear. My fear is that 10 years from now we're still going to be arguing how to bail out the housing market because it will still be--the fire will still be raging.

Mr. CALOMIRIS. May I just talk briefly about this? Because I know we have a lot of other questions.

I think there are elements of what both of them said that make sense. First of all, as Ed said, the exit has to be viable; and I think also you know both of them agree on that. That is, you're not going to want to just paper this over without writing down principal substantially.

My own view, though--and here I disagree with Ed. I don't think that the home prices that he is taking for granted, which is I think probably derived from the Case-Schiller Index, I think that is an exaggerated measure of already where we are on the downside; and it's also exaggerated in its projections. So there are technical issues here. There is a huge uncertainty about what that home equity shortfall is going to be, and I don't agree with the numbers that he quoted.

But I would agree, though, also with what Dr. Kling said. We don't want to make the solution in Washington. But I think they are pieces of what Ed said that can be done in a decentralized way.

So here is the answer, basically, in one sentence according to me. Singling out owner-occupied homes, have a government-loss-sharing arrangement that would incentivize privately servicers or owners of mortgages to write down principal and interest quickly if the taxpayer is sharing some of those losses. So they did this in Mexico in 1999. It worked very well because the thing had a timeline.

If you want to participate in the loss sharing to mitigate the foreclosures, to avoid the foreclosures, you have to move very quickly. And what you really want to do is on the margin push the lenders with a little bit of money to decide to write down rather than foreclose. Because if they foreclose, they're going to lose a lot, too.

So you don't have to spend so much. You can get the private sector to spend a lot and let them decide the size of the writedown so long as it leads to a mortgage that is realistic. So that is my view, and I have written about it.

Mr. STANTON. And if I can supplement that, because my area is design of organizations and programs.

Once again, if Fannie Mae and Freddie Mac were government corporations, they have relations with lenders all over the country. In fact, as we saw in the colloquy between Mr. Issa and Dr. Kling, not all homeowners are alike. Some deserve one treatment. Some deserve another. And it has been suggested that we essentially provide some sort of legal insulation for the servicer of the mortgage and then have a trustee in localities to sit there and work out. And if a homeowner goes to that trustee, they bind themselves, whatever decision, and the decision can range from pay or be foreclosed on to you get bankruptcy with cramdown features, to we're going to restructure your mortgage. There could be a range of alternatives.

And if I have to think of two institutions that have the connections around the country to administer that kind of program and possibly with what some of the aspects that Charles Calomiris is talking about, Fannie and Freddie would be it. Before we can go there, we need to take those institutions formally into government hands so they're not all worried about, gee, do we have to satisfy those shareholders, that 20 percent of shareholders that are still there that are going to want value in their company in the future.

But they would be the administrative mechanism, and they would be the people I would consult with first once they were in government hands. How do we make this work?

And I agree with Charles. Housing prices are going to still go down. But at some point we can't afford to have 8 million people facing the disruption of their lives in foreclosure. There are cheaper ways to do it and less costly for people, lenders and the government.

Mr. TOWNS. Let me say to the gentlemen, your time has long expired.

Let me thank all the witnesses. I really appreciate your coming and sharing with us. And, of course, let me also add that we have 7 days for additional comments as well. So thank you very, very much for your testimony. We look forward to working with you in the days and months ahead. Thank you for coming.

[Whereupon, at 3:38 p.m., the committee was adjourned.]

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