Embargoed until:
10:00 a.m.
December 9, 2008

Testimony by Franklin D. Raines
Before the House Committee on
Oversight and Government Reform
December 9, 2008, 10:00 a.m.

Introduction

Chairman Waxman and distinguished Members of the Committee, my name is Franklin D. Raines. Although I have had the opportunity to testify before congressional committees on many occasions, this is my first testimony before this committee. Let me introduce myself.

In the 32 years since I graduated from law school, I have practiced law for less than one year, served in government for four years, and worked in the financial services and investment industry for 27 years.

I have 12 years of experience in investment banking, having served as a financial advisor to state and local governments and agencies while a General Partner at Lazard Freres & Co. in the 1980s. Many of these clients faced financial crisis or needed to borrow large sums of money for investment projects. I assisted the cities of Chicago, Washington, D.C., and Cleveland and the states of Iowa and Texas to eliminate deficits, to finance their operations, and to restore their credit ratings. I advised on some of the largest public infrastructure projects in the country, such as the redevelopment of airports in Chicago, Washington, D.C., and San Francisco, and of the water, sewer, electric power, and transit systems in Seattle, Cleveland, and Milwaukee.

I have 11 years of experience in the mortgage industry as a Vice-Chairman and then as Chairman and CEO of Fannie Mae. I was appointed Chairman and CEO by the independent Board of Directors of Fannie Mae. This Board included Republicans, Democrats, and Independents, with 13 of 18 directors elected by shareholder vote.

In my six 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. The company became a leader in e-commerce with more than $1.6 trillion in transactions over the internet in 2004. Fannie Mae was cited as a *Fortune* magazine Most Admired Company, a *Business Ethics* 100 Best Corporate Citizen, and as a Best Company to Work For in several publications, including those reporting on minorities, women, working mothers, and information-technology employees. In 2003, the company received the Ron Brown Award from the U.S. Department of Commerce for corporate leadership.

I announced my retirement on December 21, 2004, and I have had no management role at the company since that time. For the past four years, I have been an investor in start-up businesses in the fields of health and financial services.

My national partisan political experience during my 32-year career is limited to having volunteered on the issues staff of Michael Dukakis when he was the Democratic nominee for President in 1988. I had no role in the recent presidential election. I did not contribute money to any candidate's presidential campaign nor did I advise any candidate.

My government experience includes service in the administrations of two Presidents. I was the Director of the Office of Management and Budget in the Cabinet of President Bill Clinton. In that position I was able to play a role in creating the first balanced federal budget in a generation. Earlier, I was a member of the Domestic Policy Staff and an Associate Director of the OMB under President Jimmy Carter. My service to these Presidents totaled four years.

As is readily apparent from this summary, my predominant career experience has been in business, and, in particular, in financial services. My experience in financial services, along with my tenure at OMB, will form the basis of much of my testimony today.

Causes of the Current Financial Crisis

The current financial crisis—which has now been confirmed as a recession—has a variety of complex sources. It did not result from Fannie Mae's recent business decisions or its accounting practices of four years ago. I will discuss my view of the separate causes of the financial crisis before I address the recent losses and conservatorship at Fannie Mae.

The crisis afflicting the national and international financial system is without precedent since the Great Depression. Everyone from large financial institutions to the families and businesses of Main Street has suffered dramatic reductions in net worth, and many face insolvency. Credit has dried up for banks, large corporations, small businesses, and consumers alike. The country faces a significant contraction in economic activity and perhaps the deepest and longest recession in a generation.

The federal government's policy in response has been large in dollars but limited in its success. As a former budget director, I can attest that the interventions by the Congress, the Treasury, and the Federal Reserve System involve staggering amounts. But the tepid response of the markets to the various rescue plans is not surprising given the lack of coordination between the plans.

Financial market convulsions are not new phenomena. The past quarter century alone has witnessed the Third World debt crisis, the junk-bond meltdown, the savings-and-loan collapse, the oil-patch debt bubble, the overextension of financial-derivatives trading, the municipal-market crunch, the international foreign-currency-reserve run, the internet-stock implosion, and the present mortgage and credit-derivatives crisis. These separate events have many features in common.

First, these cases all began when the financial markets discovered a new asset class that was not well understood. Because it was not well understood, the asset class was illiquid. The new asset class was usually growing or capable of great growth, and had profit margins that far exceeded those of other assets.

The lack of understanding about the asset class allowed financial-services companies to offer customers a differentiated product that had not yet been turned into a commodity. Banks and investment banks increased the asset's liquidity by making a market in the securities and by supporting the market with their own balance sheets. In this way, the banks could add value to the market, for which they would be handsomely compensated. While traditional asset classes tend to grow with the economy, the new class could be made to grow more quickly. Moreover, because there was initially less competition in trading in the new asset, the profit margin was wider than in commoditized asset classes.

The second common element is that the new asset class soon morphed from a prosaic form to a more exotic form, with greater potential for explosive growth. For example, junk bonds were originally corporate bonds issued by creditworthy companies that had fallen on hard times. These corporate debt securities were nicknamed "fallen angel" bonds because the debt, although backed by substantial assets and rated investment grade at issuance by the credit rating agencies, was now rated below investment grade. The track record for these bonds created a small but consistent market among specialist investors. Certain Wall Street entrepreneurs went one step—and then several steps—further. They reasoned that if investors would buy the junk bonds of established industrial companies, then perhaps they would buy the debt of companies with far fewer assets, or they would buy junk bonds issued as part of mergers or acquisitions. The entrepreneurs grew their new market by advertising the performance track record of fallen angel bonds as applying to these far riskier junk bonds. After a period of explosive expansion, this market caved in on itself.

The third commonality is financial leverage. An investment firm's use of a small base of equity capital and a large component of debt magnifies the returns derived from buying or trading in the new asset class but simultaneously magnifies the firm's exposure. A derivative trade, for example, might lead to a profit of only a few basis points and to a small return on equity if equity was the only source of funding. But if the firm uses financial leverage, those basis points would be multiplied into quite substantial sums of money. Long Term Capital Management employed this model to significant profit until the markets turned on its investments and the firm collapsed. Periods of easy credit and monetary liquidity amplify the temptation to add leverage.

The fourth and final commonality is commission-based compensation on Wall Street and in financial-services firms generally. Financial entrepreneurs are often paid by the volume of securities in a deal, rather than by the ultimate success of the transaction. Bankers who specialize in mergers, for example, are paid a percentage of the overall deal's value. Underwriters of bonds and stocks are paid similarly. This compensation structure causes the professionals to focus on the size and volume of deals, often to the exclusion of the deal's quality. The flow of deals, rather than their ultimate business success, is also the primary driver for many financial executives. Only an executive's own sense of professionalism and longevity tempers this attention to deal flow rather than to deal success. In periods in which a firm is making money-positioning deals on its own books, this focus on volume to the exclusion of success is exacerbated, and the "carry trade" needs constant nourishing through new deals.

It has been often said, and is generally true, that it is hard to spot a bubble contemporaneously. But it is my view that when these four common elements are present, history suggests a bubble is occurring and a bust is coming.

So how does this analysis explain the current subprime mortgage meltdown?

Subprime mortgages predate this current crisis. Mortgage-finance companies have long issued such mortgages to "house poor" homeowners who cannot find affordable credit elsewhere. The loans were almost always refinances because they were based on the assumption that the homeowner had substantial equity in their home. Lending under these circumstances at a 25 to 50 percent loan-to-value ratio, at very high interest rates, was a good business. If the borrower defaulted, the lender could seize and sell the house for more than the amount owed. To the financial entrepreneurs of the later part of the 1990s, this looked like a new, illiquid asset class. Not only did the profit margins look healthy, but, with a few innovations, this class of mortgages could be made to grow more rapidly than the sleepy conforming-mortgage market.

Similar to the transformation of fallen angel bonds into riskier junk bonds, subprime mortgages soon morphed from loans backed by substantial assets into loans used to buy new assets, with little in the way of equity or down payment. The whole theory of subprime loans had been that payment was assured by the low loan-to-value ratio. But the new subprime loans were backed by nothing but the credit of the borrower. And although the history of traditional subprime loans showed predictable performance, that performance was based on the strength of the collateral and not on the credit score of the borrower, someone who had already demonstrated an inability to manage consumer credit.

The mortgage originators who first offered this new form of subprime mortgage were not depository institutions with large balance sheets, and their lack of financial leverage restrained the growth of the asset class. The ratings agencies solved this problem when they agreed to give investment-grade ratings to mortgage-backed securities, or MBS, backed by these subprime loans—ratings equivalent to those given to MBS backed by prime loans. As subprime origination changed from asset-based lending to lending based on a credit score, the credit agencies did not substantially toughen the criteria for a triple-A rating on MBS backed by such riskier mortgages. With triple-A ratings and the creative financing of so-called "support" tranches, the entrepreneurs now had almost unlimited liquidity and leverage.

Finally, traditional subprime mortgages always had high interest rates, which lenders employed to offset the inherent credit risk of the loans. But the entrepreneurs behind the new subprime mortgages thought that if ratings agencies and MBS investors could be convinced that the credit risk was not in fact that high, then profits from the high interest rates consumers paid could be diverted from MBS investors to the loan originators and their intermediaries. The ratings agencies obliged, which resulted in a turbo-charging of volume for the new asset class. The rewards of originating a subprime loan versus a prime loan were so high that originators had a financial incentive to convince consumers to take a subprime loan even when they qualified for a prime loan. Indeed, lenders securitizing their subprime loans would boast in their offering documents that many of the loans were really of prime quality, and the lenders were often correct. The commissions on these MBS, in turn, were so large for Wall Street traders and salespeople that there was an enormous incentive to convince their asset-buying customers to load up on these new securities with impressively high credit ratings.

The same analysis explains the rise in origination and securitization of Alternative-A mortgages and option-adjustable-rate mortgages.

There is little new in the underlying causes of the current mortgage crisis. The global financial markets have seen such financial-product bubbles before and are likely to see them again, in the absence of any change in regulatory practice.

But note that prior financial-product dislocations did not have the widespread impact of the current mortgage meltdown. There are several reasons for the difference.

First, the market for residential property is enormous in this country, and residential mortgages are one of the nation's biggest asset classes. The value of American residential mortgages outstanding far exceeds the value of corporate bonds, consumer credit cards, or commercial loans. Even so, a meltdown affecting a discrete $500 billion market will not infect the entire international financial system. But the nation's mortgage market, even in normal times, requires substantial leverage in the origination, servicing, securitization, and guarantee of individual mortgages. A meltdown involving trillions of dollars of mortgage products closely tied to the asset-backed securities, commercial paper, bank deposits, and derivatives markets will have an effect several orders of magnitude larger than a problem in a discrete market alone. Beyond size, the interconnectedness of the residential-mortgage market and its supporting markets contributed to the breadth of the crisis.

A second reason for the magnitude of this crisis is that regulators significantly loosened the capital requirements for international banks and investment banks holding American mortgage assets. The Basel II capital standards first applied only to international banks, and the Securities and Exchange Commission's later decision to apply them to investment banks substantially reduced the amount of capital a bank was required to hold for each dollar of U.S. mortgages in its portfolio. This capital change greatly increased a bank's leverage to acquire American mortgage assets. The decision to apply Basel II to investments banks was based on the credit experience of Fannie Mae and Freddie Mac with these assets. But the GSEs employed strict credit standards for the mortgage assets they held, while, by contrast, banks and investment banks were not limited to holding mortgages that met those credit standards.

Third, the country's monetary policy also contributed to the size of the present financial crisis. Before 2005, central bankers in the United States and other industrialized nations were concerned about the prospect of deflation. To combat deflation, monetary policy leaned toward lower interest rates, which made it possible for commercial and investment banks to engage in a carry trade: borrowing at low, short-term rates and investing in higher-interest-rate bearing mortgages and mortgage securities. Mortgage originators began to alter the terms of the mortgages they offered to take advantage of these secondary-market investors. Adjustable-rate mortgages, with very low interest rates in the first two years that jumped to market rates for the next 28 years, became very popular with income-stretched consumers and with speculators in residential housing. Upon securitization, the secondary-market investors obtained assets with nominal, short maturities matching their short-term funding, and the borrower received a bargain-basement interest rate for two years with the clear expectation of refinancing before the higher, 28-year rate kicked in. (Of course, many borrowers found refinancing impossible as the financial crisis spread in 2007 and 2008.)

There is a fourth and final reason for the enormity of the present financial crisis emanating from the mortgage market meltdown. A large number and wide range of the financial institutions that invested in private-label MBS were new to the market, not natural holders of 30-year obligations, and unfamiliar with how to value the assets underlying the securities they purchased. When the market began to drop, these players panicked, drove down the prices of MBS, and dried up the liquidity of the market.

Fannie Mae and the Current Financial Crisis

This hearing is focused on Fannie Mae and Freddie Mac, so I should explain how my analysis of the causes of the financial crisis applies to those firms. I will focus on Fannie Mae.

Fannie Mae is, of course, not new to the mortgage business. Residential mortgages in the United States are the only asset class in which it is permitted to invest. The company had significant experience during the 1980s and early 1990s with the impact of falling housing prices on the value of mortgages. In the 1980s, the company experienced significant credit losses as a result of the economic meltdown in the oil patch areas of the Southwest. In the early 1990s, the overheated housing markets in California and New England also caused significant losses.

The company also studied the different credit performance characteristics of mortgages with certain features, such as adjustable rates or negative amortization; mortgages with certain underwriting approaches, such as no documentation of assets or income; and mortgages with certain borrower types, such as those with marginal credit or housing speculators. These features create greater credit risk. Furthermore, the layering of more than one of these characteristics on an individual loan greatly magnifies the risk. In many cases, there is no precedent to rely on to calculate the performance of such risk layering.

As a result of its experiences and research, Fannie Mae developed tools to evaluate and manage the new types of mortgages that began to come into the market in the early part of this decade. The automated underwriting system that Fannie Mae developed allowed the company to evaluate more precisely the risk of mortgage products and borrowers. Risk-based pricing insured that the company was compensated for the risk it took. Economic capital requirements and caps on the aggregate amount of risk limited the number of risky loans the company took onto its books. This risk management structure was put into place over a number of years and was formally adopted by the Board of Directors of the company in 2003, while I was CEO.

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. Indeed, during 2004 the company’s share of the overall secondary market in residential mortgages plummeted. Commercial banks and investment banks saw their share grow significantly as private-label MBS flourished.

So, before 2005, Fannie Mae had a limited market presence in promoting or investing in subprime or Alt-A loans. It had certainly not taken the lead in "morphing" these loans into riskier types.

Fannie Mae was certainly leveraged. The company typically held only 2.5% of capital for each dollar of assets it held on its books, and, over the last decade, regulators, commentators, and company executives paid an extraordinary amount of attention to Fannie Mae's leveraged investments held in its mortgage portfolio. However, the company avoided the largest problem with excess leverage, namely, a wide "duration gap," which is the gap between the duration of assets and liabilities. For example, the typical thrift institution might hold two or three times the percentage of capital as Fannie Mae, but it also might have a duration gap of a two- to three-year mismatch between its assets and liabilities, compared to a gap of one to six months for Fannie Mae. By holding down its duration gap, Fannie Mae significantly reduced the risk of its leverage, but at a great cost to its margins. This discipline held true both before and after 2005.

Fannie Mae's risk profile was not as affected by its compensation structure as were the risk profiles of most participants in the mortgage industry. Importantly, very few Fannie employees received commissions or deal-related compensation. While market share was one part of a comprehensive compensation scheme, Fannie Mae rewarded profitability of the book of business both in the short-run and the long-run and weighed risk management as a major factor in pay.

As explained below, the credit risk profile of Fannie Mae changed after 2004 because Fannie Mae, like a lot of smart investors, changed its appetite for credit risk in response to the changing market. Fannie Mae was a late entrant to the market for these risky mortgages, and, rather than lead the market in the direction of looser credit standards, Fannie Mae initially resisted pressures to relax its credit standards until 2006 to 2007. This helps to explain why Fannie's losses, while large in absolute dollar amount, are relatively small compared to mortgage credit losses suffered by the market as a whole. Indeed, even among the risky Alt-A loans the company acquired after 2004, the loans held by Fannie Mae performed better than Alt-A loans in general.

Causes of Conservatorship, 2005–2008

Fannie Mae did not cause the current crisis. By the time the GSE began its most significant investments in riskier loans in 2005, the roots of the present crisis had long taken hold. If anything, Fannie Mae played catch-up to the banks and investment banks who drove the securitization of the most toxic subprime mortgages. In fact, to this day, Fannie Mae has invested relatively little in subprime mortgages, which account for less than one percentage point of Fannie Mae's guaranty book of business. Most of Fannie Mae's losses are related to credit losses on Alt-A loans, not subprime loans, as I will explain.

Despite the size of its overall book of business, Fannie Mae is a small player in the present crisis. For example, the Troubled Asset Relief Program ("TARP"), the government's plan to purchase the nation's illiquid mortgage assets, is funded at $700 billion. Fannie Mae's total provision for credit losses in the first three quarters of this year are no more than $20 billion, less than 3% of TARP.

Fannie Mae did incur losses in the first three quarters of 2008, and its financial performance ultimately caused the federal government to step in and place the entity under the control of the newly-established Federal Housing Finance Agency ("FHFA").[1] I will give my understanding of the nature and cause of this situation, but I note at the outset that the losses Fannie Mae has reported, and the actions and events that resulted in those losses, occurred after I announced my retirement from Fannie Mae in December 2004. Since I retired from Fannie Mae, I have not been a manger, consultant, or employee of Fannie Mae. Accordingly, what I say today is based solely on what I have gleaned from my review of the public disclosures made by Fannie Mae.

A significant part of Fannie Mae's business is its so-called "guaranty business," also known as the "credit" business—that is, the business of assuming the credit risk of mortgages in exchange for a fee. Fannie Mae typically does so by taking a pool of mortgage loans from mortgage lenders and providing the lenders with Fannie Mae-issued mortgage-backed securities (known as "Fannie Mae MBS"), which are backed by the pool of mortgage loans and represent a beneficial ownership interest in each of the loans in the pool. Fannie Mae guarantees the timely payment of principal and interest on the mortgages underlying the Fannie Mae MBS. As of September 30, 2008, Fannie Mae's total guaranty book of business was $2.94 trillion, nearly all of that representing the unpaid principal on loans underlying Fannie Mae MBS or held in Fannie Mae's portfolio.[2] The vast majority of the loans in Fannie Mae's guaranty book of business are single-family conventional mortgages, which represented approximately $2.7 trillion of Fannie Mae's guaranty book of business as of September 30, 2008.[3]

The most serious losses reported by Fannie Mae in 2008 have stemmed from its guaranty book of business. Specifically, in the first three quarters of 2008, Fannie Mae was forced to recognize nearly $18 billion in credit-related expenses, of which nearly $17 billion was the result of provisioning for credit losses associated with its guaranty book of business.[4] By way of comparison, in 2004—my last year at Fannie Mae—the entity recognized only $352 million in credit-related expenses due to provisioning for credit losses, and only approximately $1 billion in total over the last *three years* of my tenure.[5] Similarly, as of September 30, 2008, Fannie Mae

[1] "Statement of FHFA Director James B. Lockhart," FHFA News Release (Sept. 7, 2008) (attached as Ex. 1).

[2] Fannie Mae 2008 Q3 10Q, at 17–18 (attached as Ex. 2).

[3] 2008 Q3 10Q, at 111–12; Fannie Mae 2008 Q3 10Q Credit Supplement, at 5, http://www.fanniemae.com/media/pdf/newsreleases/2008_Q3_10Q_Investor_Summary.pdf (attached as Ex. 3).

[4] 2008 Q3 10Q, at 56–57.

[5] Fannie Mae 2004 10K (restated), at F-4 (attached as Ex. 4).

estimated that, using its Credit Loss Performance Metrics—terms not defined within Generally Accepted Accounting Principles ("GAAP"), it had incurred approximately $4.3 billion in actual credit losses during the first three quarters of 2008.[6] By contrast, in 2004, Fannie Mae estimated only $221 million in credit losses, and only $550 million in total for 2002, 2003, and 2004.[7]

These losses are attributable in large part to Fannie Mae's guaranteeing of certain high-risk loans, largely so-called "Alt-A" loans, and, to a lesser extent, subprime loans. Although the public record is not entirely clear, it appears that at some point in 2005 or 2006, Fannie Mae began to increase substantially the number of Alt-A loans in its guaranty book of business.[8] In its report to Congress in 2007, Fannie Mae's regulator, the Office of Federal Housing Enterprise Oversight ("OFHEO"), noted that "[h]igher risk products such as interest-only, sub-prime, Alt-A and negative amortization loans are growing," although the regulator did not express any particular concerns.[9] By year-end 2006, Fannie Mae's guaranty business included approximately $257 billion in Alt-A loans, and by year end 2007 that number had grown to $318 billion.[10] Moreover, it appears that in taking on these loans, Fannie Mae had altered its underwriting standards by, for example, not running many of those loans through its DesktopUnderwriter ("DU") system, an automated tool that helps lenders evaluate and price credit risk.[11] Perhaps not surprisingly, Fannie Mae has now reported that its serious delinquencies are disproportionately represented by Alt-A loans from its 2006 and 2007 vintages, and that default rates for 2005 vintage Alt-A loans are increasing.[12]

The high-risk loans—in particular Alt-A loans—that Fannie Mae guaranteed from 2005 to 2007 have driven the losses the company has experienced this year. Over 70% of Fannie Mae's 2008 credit losses are attributable to high-risk loans.[13] Nearly half of Fannie Mae's 2008 single-family credit losses are attributable to its Alt-A loans even though those loans make up less than 11% of Fannie Mae's single-family conventional guaranty book of business.[14] Similarly,

[6] 2008 Q3 10Q, at 64–65

[7] 2004 10K (restated), at 151–52.

[8] Chares Duhigg, "Pressured to Take More Risk, Fannie Reached Tipping Point," *N.Y. Times* (Oct. 5, 2008) (attached as Ex. 5).

[9] OFHEO, *Report to Congress* 24 (March 2007) (attached as Ex. 6).

[10] Fannie Mae 2007 10K, at F-83 (attached as Ex. 7).

[11] Fannie Mae 2008 Q2 Investor Conference Call, at 25 (Aug. 8, 2008) (T. Lund: "Well just to be clear. A significant portion of Alt-A doesn't go through DU."), http://www.fanniemae.com/media/pdf/webcast/080808transcript.pdf (attached as Ex. 8); 2008 Q3 10Q, at 13 (discussing Underwriting Changes).

[12] 2008 Q3 10Q, at 58.

[13] 2008 Q3 10Q, at 65.

[14] 2008 Q3 10Q, at 115; 2008 Q3 10Q Credit Supplement, at 5.

approximately 2% of Fannie Mae's 2008 single-family credit losses are attributable to subprime loans, which make up only a third of a percent of its single-family book.[15]

These high-risk loans were mostly placed on Fannie Mae's books after 2004. Nearly three-quarters of the Alt-A loans in Fannie Mae's single-family book were originated from 2005 to 2007, as were over 80% of the subprime loans.[16] Similarly, of the non-Alt-A or subprime categories of high-risk loans, between approximately 60% to 80% were originated from 2005 to 2007.[17] Moreover, it appears that the loans generated in the 2005 to 2007 time period were riskier than their pre-2005 counterparts. For example, over 95% of the credit losses attributable to Alt-A loans this year are attributable to Alt-A loans guaranteed after 2004.[18] And, more generally, between 70-85% of the credit losses incurred in the first three quarters of 2008 are attributable to loans (of whatever quality) originated after 2004, even though only approximately 60% of the single-family book of business consists of post-2004 loans.[19] In short, it appears that the credit-loss expenses that Fannie Mae has recognized in the first three *quarters* of this year—nearly 17 times the total credit loss expenses incurred in the last three *years* of my tenure at Fannie Mae—are the result of a significant increase in the number of high-risk loans, and in particular Alt-A loans, guaranteed by Fannie Mae from 2005 to 2007.

In addition to the loans it guarantees, Fannie Mae also owns a portfolio of "private-label" MBS issued by third parties. As of September 30, 2008, Fannie Mae held approximately $117 billion of such securities.[20] Approximately $55 billion of those securities were backed by either Alt-A or subprime mortgages.[21] In the first three quarters of 2008, Fannie Mae recognized other-than-temporary impairment of approximately $2.4 billion related to its available-for-sale private-label MBS backed by Alt-A and subprime.[22] (Fannie Mae has not quantified publicly the extent to which fair value losses on trading securities are attributable to private-label MBS backed by Alt-A or subprime mortgages.[23])

Although these losses do not appear to be as significant as the losses in the guaranty business, it is clear that, like the credit losses, these securities losses are principally attributable to

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[15] 2008 Q3 10Q Credit Supplement, at 5.

[16] 2008 Q3 10Q Credit Supplement, at 5.

[17] 2008 Q3 10Q Credit Supplement, at 5.

[18] 2008 Q3 10Q Credit Supplement, at 11.

[19] 2008 Q3 10Q Credit Supplement, at 6.

[20] 2008 Q3 10Q, at 74.

[21] 2008 Q3 10Q, at 183.

[22] 2008 Q3 10Q, at 161–62.

[23] 2008 Q3 10Q, at 159–62.

investments made after 2004. Over 75% of Fannie Mae's holdings in private-label MBS backed by Alt-A or subprime mortgages are from a 2005 or later vintage.[24] Similarly, Fannie Mae has observed that its private-label Alt-A and subprime-backed MBS from 2005 to 2007 were subject to "relaxed underwriting and eligibility standards,"[25] and that the 2006 to 2007 loans underlying those securities "have experienced significantly higher delinquency rates than other vintages."[26]

Role of Regulation and Regulators

There have been many assertions made by commentators about the role of financial services regulation and regulators in the causation of the current financial crisis. While much of this commentary is erroneous, there are legitimate criticisms that can be made of the regulatory system.

A very common allegation that has been made is that the Community Reinvestment Act ("CRA") forced mortgage originators to make loans that were too risky and burdened banks with assets that would later default. This claim is incorrect. The most risky loans in the system tended to be originated by lenders not covered by the CRA. Also, both Ben Bernanke, the Chairman of the Federal Reserve, and, John Dugan, the Comptroller of the Currency, have stated that they have found no evidence that the CRA contributed in any substantive way to the current mortgage difficulties or is in any way to blame for causing the subprime loan crisis.[27] Indeed, an analysis by the Federal Reserve found that only a small portion of subprime mortgage originations are related to the CRA and that most foreclosure filings have taken place in middle- or higher-income neighborhoods.[28]

A variation on this accusation is that affordable housing goals caused Fannie Mae and Freddie Mac to acquire loans made to low- and moderate-income households that subsequently went bad. However, as presented earlier, the majority of losses at Fannie Mae came from Alt-A loans. Alt-A loans were disproportionately *not* made to low- and moderate-income borrowers. As such,

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[24] 2008 Q3 10Q, at 81–83.

[25] 2008 Q3 10Q, at 78.

[26] 2008 Q3 10Q, at 80.

[27] Letter from Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., to Hon. Robert Menendez, U.S. Senate (Nov. 25, 2008), http://menendez.senate.gov/pdf/112508ResponsefromBernankeonCRA.pdf (attached as Ex. 9); John C. Dugan, Comptroller of the Currency, Remarks Before the Enterprise Annual Network Conference (Nov. 19, 2008), http://www.occ.gov/ftp/release/2008-136a.pdf (attached as Ex. 10).

[28] Randall S. Kroszer, Bd. of Governors of the Fed. Reserve Sys., "The Community Reinvestment Act and the Recent Mortgage Crisis," Speech at the Confronting Concentrated Poverty Policy Forum (Dec. 3, 2008) http://www.federalreserve.gov/newsevents/speech/kroszner20081203a.htm (attached as Ex. 11).

Alt-A loans purchased actually hurt the ability of the GSE to meet its affordable housing goals, which were expressed as a percentage of Fannie Mae's total business. Moreover, a recent study by researchers at the University of North Carolina of a subset of affordable housing loans guaranteed by Fannie Mae found that these loans had performed as expected, with losses close to those of prime loans and substantially lower than subprime loans.[29]

No regulation or law forced banks or the GSEs to acquire loans that were so risky they imperiled the safety and soundness of the institutions. The acquisition of such loans was a business judgment made by management and the boards of directors. However, there remains the question of why regulators did not criticize or restrict the acquisition of such loans by regulated institutions.

Fannie Mae was clearly under close regulatory scrutiny from 2003 through 2008. In early 2004 the company entered into a series of agreements with its regulator, OFHEO, subjecting the company to unprecedented supervision of its business activities.[30] In the 2005 to 2007 time period, as Fannie Mae acquired the vast majority of the loans that caused its subsequent problems, OFHEO did not seek to restrict the amount of credit risk taken on by the company. The regulator limited its intervention to the size of the on-balance sheet mortgage portfolio and the attendant interest rate risk.[31] Indeed, right up until the time Fannie Mae was placed into conservatorship, the Director of OFHEO maintained that the company was well capitalized to withstand the losses it would face.[32]

While it is primarily the responsibility of the regulated financial institution to manage its own credit risk, 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 that regulator oversaw only two companies and was then enforcing a form of quasi-conservatorship.

While regulations did not *force* financial institutions to make bad loans, the absence of consumer protection regulation *allowed* many bad loans to be made to the detriment of consumers. The mortgage finance system does not have just one consumer protection regulator. That responsibility is divided among the Federal Reserve Board, the other bank regulators, the Federal

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[29] Lei Ding et al., "Risky Borrowers or Risky Mortgages?" at 11, Presentation at the HUD Tuesday Series (Oct. 28, 2008), http://www.ccc.unc.edu/documents/HUD_Oct2008_final.pdf (attached as Ex. 12); Lei Ding et al., *Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models* 16 (Ctr. for Cmty. Capital, UNC, Working Paper, Oct. 27, 2008), http://www.ccc.unc.edu/documents/RiskyBorrowers_RiskyMortgages_1008.pdf (attached as Ex. 13).

[30] 2004 10K (restated), at 1–4.

[31] 2007 10K, at 17.

[32] "Statement of OFHEO Director James B. Lockhart," OFHEO News Release (July 10, 2008) (attached as Ex. 14).

Trade Commission, the Department of Housing and Urban Development, and state and local officials. Fannie Mae and Freddie Mac exercise quasi-regulatory authority through the promulgation of their Seller/Servicer Guides. During the height of the mortgage boom the only entities actively seeking to protect consumers from abusive mortgage practices were the state and local officials and the GSEs. Fannie Mae began trying to improve consumer protection for impaired-credit borrowers as early as 1999. The company issued rules restricting the types of subprime loans it would purchase, and these rules led to major reforms in the market, such as the elimination of mandatory credit life insurance. The Federal Reserve Board did not exercise its statutory authority to regulate subprime loans until 2008.

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

Accounting Restatement, 2004–2006

On December 15, 2004, the SEC announced that certain of Fannie Mae's accounting practices did not comply with GAAP.[33] The SEC required Fannie Mae both to restate its financial statements to eliminate the use of hedge accounting and to reevaluate other information prepared under GAAP for possible restatement.[34] Fannie Mae completed its restatement on December 6, 2006.[35]

My understanding is that this restatement did not contribute to Fannie Mae's recent losses. The main result of the restatement was to eliminate hedge accounting, and this accounting change did not affect the credit-risk management function at Fannie Mae.

The large losses that Fannie Mae has reported so far in 2008 derive from its credit-guaranty activities. By contrast, the financial restatement announced in 2004 and completed in 2006 primarily related to accounting concerning Fannie Mae's mortgage portfolio. Indeed, most criticism of the company and of the risks it was undertaking before 2008 related to the portfolio, and some commentators even suggested that the company should solely focus on its financial guaranty activities as the safer of the two.[36]

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[33] "Office of the Chief Accountant Issues Statement on Fannie Mae Accounting," SEC Press Release 2004-172 (Dec. 15, 2004) (attached as Ex. 15).

[34] *Id.*

[35] 2004 10K (restated).

[36] Peter J. Wallison, "Regulating Fannie Mae and Freddie Mac: Now It Gets Serious," *Financial Services Outlook* (AEI May 2005), http://www.aei.org/publications/pubID.22514/pub_detail.asp (attached as Ex. 16).

While the actual restatement took two years, Fannie Mae had mitigated the economic consequences by the end of 2004. Just before I departed the company, Fannie Mae initiated the sale of $5 billion of new preferred stock that, together with a surplus of $6 billion on the books, restored the company's capital to meet regulatory requirements.[37] The company reported in its 2004 annual report to the SEC that it had capital surplus at year-end of $2.4 billion.[38] The stock price remained at about $70 per share both before and after the SEC ordered the restatement, proof that the restatement did not indicate a fundamental economic problem for Fannie Mae. The stock price did not decline until mid-January 2005 when the company—without my input or advice—made the business decision to cut its dividend in half and, later, when OFHEO placed additional restrictions on the company's business. In a related securities suit, a federal judge recently held that the relevant information about the restatement was available to investors shortly after the SEC decision was made public, when Fannie Mae filed an 8-K on December 22, 2004, advising investors that they should no longer rely on previously filed financial statements.[39]

Even under the restated financials, on a marked-to-market basis the fair value of Fannie Mae's assets and liabilities actually rose during the period I ran the company.[40]

Accountability

On September 20, 2004, OFHEO delivered to Fannie Mae's Board of Directors a report of the findings to date of its "Special Examination." The report raised questions about Fannie Mae's use of two accounting standards, FAS 91 and FAS 133. Fannie Mae requested that the SEC review Fannie Mae's accounting practices with respect to these two standards.

On October 6, 2004, I testified before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, of the Committee on Financial Services, and answered questions about the allegations in the OFHEO report. I told that Subcommittee that if "after a thorough review of all the facts, it is determined that our company made significant mistakes, our board and our shareholders will hold me accountable." I also said that "I will hold myself accountable. That comes with being a CEO. I accepted that burden on the day I took the job, and I accept it today."[41]

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[37] 2004 10K (restated), at 182.

[38] 2004 10K (restated), at 180.

[39] Mem. Op. 11, *In re Fed. Nat'l Mortgage Ass'n Sec., Derivative, and "ERISA" Litig.*, MDL No. 1668 [Dkt. No. 568] (RJL Jan. 7, 2008) (attached as Ex. 17).

[40] 2004 10K (restated), at 72.

[41] *The OFHEO Report: Allegations of Accounting and Management Failure at Fannie Mae: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Fin. Servs.*, 108th Cong. 76 (2004) (attached as Ex. 18).

On December 15, 2004, the SEC's Office of the Chief Accountant announced that its "review indicate[d] that during the period under [its] review, from 2001 to mid-2004, Fannie Mae's accounting practices did not comply in material respects with the accounting requirements" of FAS 91 and FAS 133. The SEC advised Fannie Mae that it should (i) restate it financial statements to "eliminate the use of hedge accounting," (ii) evaluate the accounting under FAS 91 and restate its financial statements "if the amounts required for correction are material," and (iii) reevaluate the information prepared under GAAP and non-GAAP information that Fannie Mae previously provided to investors.[42]

Following the SEC's announcement, I held myself accountable even though I never had personal knowledge that Fannie Mae's accounting practices failed to comply with GAAP, as was confirmed by the $80 million independent investigation of the accounting controversy. In February 2006, Senator Warren Rudman and the law firm of Paul, Weiss, Rifkind, Wharton & Garrison LLP, hired by Fannie Mae's independent Board members and approved by OFHEO, completed their investigation into OFHEO's allegations. Senator Rudman and his team "did not find that [Raines] knew that the Company's accounting practices departed from GAAP in significant ways."[43] In particular, Sen. Rudman "saw no indication that [Raines] knew that the Company's application of FAS 133 contained substantial departures from GAAP."[44]

Although I never had personal knowledge or independent reason to believe that Fannie Mae's accounting practices failed to comply with GAAP, I nevertheless announced my retirement from Fannie Mae on December 21, 2004, one week after the SEC's announcement regarding the Company's accounting. Through Fannie Mae, I released a public statement making clear that I was holding myself accountable:

> I have advised the Board of Directors today that I am retiring as Chairman and Chief Executive Officer of Fannie Mae.
>
> I previously stated that I would hold myself accountable if the SEC determined that significant mistakes were made in the Company's accounting. Although, to my knowledge, the Company has always made good faith efforts to get its accounting right, the SEC has determined that mistakes were made. By my early retirement, I have held myself accountable.[45]

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[42] "Office of the Chief Accountant Issues Statement on Fannie Mae Accounting," SEC Press Release 2004-172 (Dec. 15, 2004).

[43] Paul, Weiss, Rifkind, Wharton & Garrison LLP & Huron Consulting Group Inc., *A Report to the Special Review Committee of the Board of Directors of Fannie Mae*, *Executive Summary* 5 (Feb. 23, 2006) (attached as Ex. 19)

[44] *Id.* at 9.

[45] "Statement by Franklin D. Raines, Chairman and CEO, Fannie Mae," Fannie Mae Press Release (Dec. 21, 2004) (attached as Ex. 20).

I have held myself accountable for the accounting practices that led to the restatement because I was CEO during the time those practices were in use. I told the House Subcommittee in 2004 that I would hold myself accountable if the SEC found significant problems, and I acted on this commitment by announcing my retirement from Fannie Mae in December 2004.

I have been held accountable financially, as well.

OFHEO has stated that I was paid $90 million as Chairman and CEO of Fannie Mae, a period when the company earned in excess of $20 billion on a restated basis. At least $36 million, or about 40 percent, of the $90 million amount has been rendered worthless because the company's recent financial problems make the stock options awarded to me worthless. In addition, I gave up or did not receive approximately 351,127 of the shares of Fannie Mae common stock that were reported in the company's annual proxy statements as target Long-Term Incentive Plan Awards to me. According to those proxy statements, the expected payout of these stock awards would have totaled approximately $27 million. In addition to these amounts, I, along with other investors, lost millions of dollars on the shares of Fannie Mae stock that I held.

The large discrepancy between the reported expected value of my compensation and the compensation that I actually realized demonstrates that the Fannie Mae compensation system functioned as designed—to tie executive compensation to Fannie Mae's performance over a blend of short-term, medium-term, and long-term horizons, thereby ensuring that an executive's financial interest would never be disproportionately tied to any single period. When the company's performance faltered—in this case, years after my departure—the value of my previously awarded compensation was likewise reduced or clawed-back. It should not be surprising that Fannie Mae tied executive compensation to corporate performance—Congress mandated that the company do so. The company's charter requires "a significant portion of potential compensation" for its officers to be "based on the performance of the corporation," and the company complied.[46] The charter also requires the company to pay compensation "comparable with compensation for employment in similar businesses (including publicly held financial institutions or major financial services companies) involving similar duties and responsibilities."

OFHEO itself confirmed the reasonableness of Fannie Mae's compensation policies. OFHEO periodically reviewed Fannie Mae's executive compensation because OFHEO's statute required the agency to prohibit Fannie Mae from providing excessive compensation to any executive officer of the GSEs.[47] While I was CEO of Fannie Mae, OFHEO in fact retained expert consultants to help assess the GSEs' compensation. As OFHEO reported to Congress in 2003, "[i]n 2002, an executive compensation consultant retained by OFHEO completed a study initiated in 2001, which compared the components and levels of executive compensation of executive officers at the Enterprises with those of executive officers in other similar businesses

[46] 12 U.S.C. § 1723a(d)(2) (attached as Ex. 21).

[47] 12 U.S.C. § 4518(a) (attached as Ex. 22).

involving similar duties and responsibilities."[48] The study assisted OFHEO in its supervisory review of executive compensation, and OFHEO reported no problems to Fannie Mae or to Congress with the level of executive compensation while I was CEO.

OFHEO has also stated that it believes it has held me financially accountable. As part of a settlement of litigation that the agency initiated against me, OFHEO announced earlier this year that it had required me to forfeit or pay a total of $24.7 million. The bulk of this amount involved my surrendering and relinquishing claims to some of the stock and options referenced earlier.[49]

Role of Government Sponsored Enterprises

A number of commentators have suggested that there are inherent flaws in the government sponsored enterprise model. Some suggest these flaws merely lead to a lack of transparency regarding risk. Others have alleged that the GSE model caused the current financial crisis. I believe these views to be mistaken.

What exactly is a government sponsored enterprise? Originally that term was created merely as a convenient way to refer to a variety of entities in the federal budget process. These entities had in common a corporate form and the use of private shareholder capital to carry out, for profit, business activities that also advanced public policy objectives. The Federal National Mortgage Association was a subsidiary of a government-owned corporate entity at its birth in 1938. Over time, lenders who transacted business with the association were required to buy stock. In 1968, the government sold its remaining interest in Fannie Mae and the activities of the company were removed from the unified federal budget. The federal budget continued to report on Fannie Mae's activities in its appendix, therein referring to it as a government sponsored enterprise.

Once the government sold its interest in Fannie Mae, the company looked a lot like other government-chartered national associations—for example, national banks—except that the government retained the right to appoint members to the Fannie Mae board. The company did not have a safety and soundness regulator until 1992, lacked any explicit guarantee or insurance from the government, and had the ability to borrow up to $2.5 billion from the Treasury. Despite the lack of a formal guarantee of Fannie Mae's debt, the market assumed that the government would take steps to keep the company functioning if Fannie Mae threatened to fail. The ambiguity of this assurance meant that the company did not receive the full benefit of a guarantee in lower interest rates on its debt and that buyers of the company's debt were at risk for some unknown percentage of their investment.

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[48] OFHEO, *Report to Congress* 5 (June 2003) (attached as Ex. 23).

[49] "OFHEO Issues Consent Orders Regarding Former Fannie Mae Executives," OFHEO News Release (Apr. 18, 2008) (attached as Ex. 24).

Federal legislation in 1992 moved Fannie Mae closer to the traditional model of a regulated financial institution and made explicit that its public policy role went beyond providing liquidity to the general mortgage market to making affirmative efforts specifically to serve households below the median income. (A similar expansion of public responsibility was applied to depository institutions much earlier, through the Community Reinvestment Act.)

It has been argued that this mixing of public purpose with a for-profit enterprise leads to irreconcilable conflicts. However, such an admixture is not new or unique. As mentioned, depository institutions operate under government charters and receive substantial benefits from the government, including a full faith and credit guarantee of deposits. In return, they have been given certain obligations to serve their communities. Defense contractors primarily serve a public purpose with their production, but are, in most cases, ordinary, for-profit corporations. Deregulated electric energy companies can exercise certain governmental powers, such as eminent domain, while also earning private profits. This is not to say there are not conflicts to be resolved; only that the need to resolve those conflicts exists in many businesses whose work significantly affects public policy objectives. (The issue of conflicts does not go away simply by changing the ownership of the entity from common shareholders to a cooperative-type structure.)

It has also been argued that Fannie Mae receives a subsidy that is not adequately reflected in the budget or paid for by the company. First, there is no doubt that Fannie Mae receives a benefit from its status as a GSE. Second, if those benefits are treated as a subsidy there is already a mechanism for recording them in the federal budget. Under credit reform, the present value cost of a government guarantee is supposed to be recorded as an outlay in the budget. To date, this has not been done with Fannie Mae. One reason for that may be that, until recently, under the economic assumptions of the government and the risk-based capital rules imposed on Fannie Mae, the likely outcome of the calculation would be that there was no present value cost of the implicit guarantee. Finally, as a federal taxpayer, Fannie Mae was subject to the corporate income tax, which would have more than compensated the government for any reasonable cost of its implicit guarantee in the pre-financial-meltdown period. Obviously, no level of fee from Fannie Mae, commercial banks, investment banks, or insurance companies could have compensated the federal government for the extraordinary costs it has incurred in dealing with the financial crisis.

In light of the costs the federal government may incur in addressing the financial problems of Fannie Mae and Freddie Mac, some people have said that the GSEs had a deal where the profits they made were privatized and the costs were socialized. That, of course, can be said of any situation where the government bails out a for-profit enterprise. But the assertion is not entirely correct in the cases of Fannie and Freddie. When the government sold its interest in Fannie Mae in 1968, the company had less than $2 billion of equity capital. When I announced my retirement as CEO at the end of 2004, the company had $38.9 billion of equity capital. By the end of 2007, shareholder equity had risen to $44 billion. This capital, all the property of private shareholders, stood between the losses of the company and the U.S. Treasury as the company incurred losses in 2008.

Some might allege that stockholders prospered by receiving dividends from the company, which is true. However, the company paid out dividends equal to less than 25 percent of its after-tax income. That means that three-quarters of the profits remained in the company to absorb the risks of the business.

Moreover, at the end of 2004, the common stock of Fannie Mae had a market value of about $70 billion despite the accounting controversy. The stock value was 1.8 times the book value of the company measured by shareholder equity. That multiple indicated that common stock shareholders had high expectations for the future profitability of the company. The value of the company's stock has moved down over the last four years and is currently worth less than $1 billion. Thus, Fannie Mae shareholders can argue that they, not the government, have been the biggest losers from the company's current problems.

The GSE model is a far from perfect way to achieve the goal of using private capital to achieve the public purpose of homeownership and affordable rental housing. However, if the public policy goal remains the same, it will be hard to find a model that has more benefits and fewer demerits than the model that worked reasonably well for almost seven decades at Fannie Mae.

Conclusion

It has been almost four years since my decisions have had any impact on Fannie Mae, the housing market, or the global market for mortgages and mortgage-backed securities.

I continue to believe in the mission for which Congress created Fannie Mae and Freddie Mac, to expand middle- and low-income home ownership by providing liquidity to the primary mortgage market. This function frees capital so that lenders can help prospective home buyers into homes. I believe that, properly regulated, these entities have a more important role than ever to play in increasing the liquidity in the mortgage market and innovating solutions to today's mortgage-financing crisis.

Thank you, and I would be happy to answer any questions.