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FCIC memo of staff interview with Kenneth Bacon, Fannie Mae

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MEMORANDUM FOR THE RECORD

Event: Kenneth J. Bacon, Executive Vice President, Fannie Mae Housing and Community Development

Type of Event: Interview

Date of Event: March 5, 2010, 9:30 – 11:00 a.m.

Team Leader: Chris Seefer

Location: FCIC, small conference room

Participants - Non-Commission: Kenneth J. Bacon, Fannie Mae Executive Vice President, Housing and Community Development; Jeff Kilduff, Fannie Mae outside counsel (O'Melveny & Myers); Anne McCulloch, SVP & Deputy General Counsel at Fannie Mae; Julie Katzman, Fannie Mae Vice President and Deputy General Counsel; Lauren Strauss, O'Melveny & Myers.

Participants - Commission: Chris Seefer; Tom Stanton; Clara Morain

Date of MFR: March 5, 2010

This is a paraphrasing of the interview dialogue and is not a transcript and should not be quoted except where clearly indicated as such.

Summary of the Interview or Submission:

Chris Seefer opened the meeting by summarizing the mandate of the Financial Crisis Inquiry Commission, noting specifically its statutory requirement to look into the GSEs' role in the financial crisis. He then asked Mr. Bacon to provide a general overview of his professional experience.

Mr. Bacon's Professional Background

- Previously, he worked for the Resolution Trust Corporation (RTC) in its Office of Securitization.
- Before joining RTC, the worked for eight years as an investment banker at Kidder Peabody & Co. and Morgan Stanley & Co. in New York.
- Mr. Bacon joined Fannie Mae in 1993 as the Senior Vice President of the North East Regional Office located in Philadelphia, where he said he had general manager-type responsibilities for customer relationships in the Single Family business. His customers then included GMAC and the old Chemical Bank, he said.
- Mr. Bacon moved to Washington D.C. in 1998 to run the Community Development Capital Corporation as its SVP.

- In 2000, he moved to the Multi-Family business and served as the SVP of Multi-Family Lending and Investment until January of 2005.
- After the changes at the company in 2005, Mr. Bacon said that his boss became the acting CFO, and he became the acting Executive Vice President for his division in January 2005. In July of 2005, he became EVP of Housing and Community Development Business, the position he holds currently. Mr. Bacon said that this main job responsibilities focus on ensuring that the entire Multi-Family business goes well, but that he also spends a significant amount of time in neighborhood stabilization and community development efforts.

<u>Background on the Multi-Family Business</u>

Mr. Bacon stated that he has restructured the business unit several times, but that it has remained generally the same since he became acting EVP in 2005. Mr. Bacon explained that the Multi Family business has several sections, and that Multi-Family loans is the largest component of the business. He also stated that his unit is a major investor in low-income housing tax credits and community investment tax credits. Mr. Bacon said that the business also engages in community development activities, and cited the group's work after Hurricane Katrina – using a retail approach to help people who wanted to refinance their mortgages – as an example.

Mr. Bacon stated that approximately 85 to 90 percent of Multi-Family housing production qualifies for some type of HUD housing goals, but that tax credits, equity investments, and loans to public housing agencies do not. He said that "the Multi-Family business is a very goals-driven business, although it's not solely driven by HUD." He said that the business has $180 billion in assets, and 97-98% of that amount is in tax credits and Multi-Family loans.

Mr. Bacon explained that the Housing and Community Development unit (HCD) is clearly small compared with the entire company, but that because most of his business counts towards housing goals, HCD accounts for between 20 and 30 percent of housing goals. Chris Seefer asked if the company's segment reporting in their annual reports would give a clear picture of the HCD business's size, and Mr. Bacon said it would, and recommended that the FCIC also look at the AHAR report to get a sense of the business profile.

Mr. Bacon stated that there are "tremendous differences in business models and performance between us and Single Family." He explained that while Single Family transacts with many different companies, he does most of his business through 25 lenders, "so if you want to deliver loans to Fannie Mae on a regular basis, we do business with a restricted number. We take most of the risk, but our lender partners share in the risk." He said that "another key difference between us and Single Family is that while we do have a lot of big banks, our customers are mostly independent mortgage companies, mostly entrepreneurial companies."

Tom Stanton asked how much risk those lenders are able to share, and Mr. Bacon said that it varies but usually, Fannie Mae assumes two-thirds of the risk and the lender assumes one-third of the risk. Mr. Bacon said that the lenders have to put up capital and they have to have insurance. He explained that HCD's business model was born out of the financial crises of the 1980s when Freddie Mac's Multi-Family lending business "blew up." He said that there were too many apartments then and that the company was in the market when values dropped to almost zero. He said that the current business model is designed "for everyone to have skin in the game, because if a lender had something at risk, they would do a better job of underwriting. Our default rate is 60 basis points now."

Chris Seefer asked if there is a CRAM report for the Multi-Family business, and Mr. Bacon said that there may be an internal report that contains the same data but that he could not recall a single report generated on a regular basis. He said one difference with the Multi-Family business is that there are fewer loans but more complex data. He said that he is "sure something's out there" that would allow the FCIC to see performance of the Multi-Family book over time by product, vintage, etc.

Noting that there has been a large increase in Fannie Mae's loss allowance, primarily driven by the Single Family guarantee book, Chris Seefer asked if there has been a similar increase in the Multi Family book. Mr. Bacon said there was, and explained that "there's a recession, and apartment performance is driven by job growth, so if you look at both GSEs our delinquencies, they're up. But looking at us versus Single Family, the growth rate has been a lot more than our delinquency rate. We had a positive credit expense. So we've had spectacularly good performance, and even now we're at 60 basis points. Am I happy with it? No. But relative to other asset classes, we're ok."

Housing Goals

Tom Stanton asked if one of Mr. Bacon's functions was to represent Fannie Mae with respect to housing goals. Mr. Bacon explained that HCD had a Housing Goals steering committee and that he would often be involved in housing goals matters. He said that during the 2006-2007 timeframe, he went often to HUD to meet with [Sandra] Fostek and Brian Montgomery to go over performance.

In response to a follow-up question from Tom Stanton, Mr. Bacon said that he occasionally met with OFHEO regulators. He explained that he had "several types of interactions [with OFHEO]: exam interactions and interactions with the business in general." He said that he did not meet with OFHEO regarding housing goals for the most part. "HUD was the primary place for Housing Goals. I met with OFHEO about the business, and with HUD about housing goals," he said.

Tom Stanton asked if Mr. Bacon was ever in a meeting where Fannie Mae tried to tell OFHEO that the housing goals would be financially deleterious for the company. Mr. Bacon said that he did not recall a specific meeting but that when Fannie Mae would brief OFHEO, they would explain what the housing goals required the company to do, and explain what the credit impact would be of those requirements.

Referring back to Mr. Bacon's comment on the Housing Goals steering committee, Tom Stanton asked if anyone on that committee ever said that the housing goals would drive Fannie Mae to lose money. Mr. Bacon responded saying that "there was always tension, ever since I joined the company, about how far you go to meet goals. That began in 2005 after the restatement. Before that it was kind of an academic issue. People would look at the opportunity cost of doing deals – you've only got so much capital and you have to hold surplus at that time, so at that time it was more a Single Family concern but yes, it was a concern." In response to a question by Mr. Stanton on concerns over costs going negative, Mr. Bacon continued, "I don't know about it going negative – There was a concern as goals ratcheted up that it was tough to find product that fit our credit box. If you go back earlier in the decade, we used to track minority lending, and about 12% of African American borrowers were sub-prime. Then by '05-'06, they were one-third sub-prime. So the issue was - and this was the topic of a lot of meetings at HUD - we'd say look here's the goal, and here's what the production coming in through normal channels looks like. A lot of demographics you want served are not coming through our channels. So we bought securities, but even then there was a question of the underlying collateral. So we'd say to HUD - what can we buy, how do we meet the goals within constraints of normal business practices? So yes, it was always a source of tension."

<u>Fannie Mae's Increased Investment in Risky Products</u>

Tom Stanton asked if Mr. Bacon attended the company retreats at end of June, and referenced the 2005 strategy document that says that Fannie Mae has some strategic choices: to stick to underwriting standards, or to follow the market, and asked Mr. Bacon to comment. He said that the FCIC could likely get more color on that issue from Tom Lund, who Mr. Bacon said always urged staying in the "normal credit box." He did respond that "again, you had the pressure of housing goals, and people were always saying 'you have to do more.' [We] had customers saying 'we're taking our product to a relevant player, and are you going to be a player in this market.'" Mr. Bacon said there were additional pressures, because if Fannie Mae was going to follow the market, the company had to learn how to adjust to new modeling and servicing challenges.

Tom Stanton asked to what extent housing goals figured in to the conversation about following the market. Mr. Bacon said that investors were on a three-legged stool: "There were housing goals, there were investors, and there were customers. And housing goals were not just about goals themselves, but about what politicians wanted Fannie Mae to– under Bush it was an ownership society – no matter who's in power, everyone says homeownership is great and do more of it. No one ever said let's ratchet goals down. I can't tell you how to weigh [those pressures] because we had customers saying clearly 'If you don't buy [this product], I'm going to Wall Street. And investors wanted to see market share and returns." Mr. Bacon continued to state that "every big lender said that [they would take their product to Wall Street]. In the Single Family business, the lenders had a lot of power. Countrywide and Wells Fargo had power. And it was fungible – there were five or six big lenders and most had other product lines and other channels for Single Family business." He said that he could not give a weight to exactly how much any one of those factors influenced Fannie Mae's decision to ratchet-up its risk. Mr. Bacon noted that housing goals and business goals are often at cross-purposes.

Chris Seefer asked if leading up to the June, 2005 presentation Fannie Mae was losing market share. Mr. Bacon said that "that was the message Tom [Lund] was giving – if you look at Fannie Mae, Freddie Mac, FHA relative to the market, we were losing market share and it was a tough thing for us. You can look at [Fannie Mae's] market share relative to Freddie, but you also have to look at our share versus overall market," he said.

Mr. Bacon stated that the conversation about whether or not to follow the market was a "constant conversation with Tom [Lund]. He was very concerned about chasing the market, and it wasn't something he was excited about. As a guy who had to deliver a lot of housing goals, it was a cause for concern among a lot of people. And it was getting harder, because there were penalties for failing to meet the goals." Mr. Bacon said that "over time, we began to do more and more private label securities purchasing and other things we hadn't done before. And we had several conversations with HUD about what to do with it and how to deal with it. We were telling HUD that the goals were hard to meet, and they didn't back off the goals."

Mr. Bacon said that the June 2005 retreat was not a decision-making meeting and no official vote was taken. "It was a discussion," he said. "But at that time, I think the consensus was: let's stick with what we got while keeping a look at the market." He said that the credit committee would make a formal decision. Chris Seefer asked when Fannie Mae changed its position and started to purchase riskier products. Mr. Bacon stated that he could not put a date on the decision, but he noted that Fannie Mae did start to buy more products, such as subprime, to meet its housing goals. Mr. Bacon reiterated that although Fannie Mae voiced its concerns about meeting housing goals, HUD did not change its positions.

Chris Seefer noted that in 2006, riskier products comprised an increasing amount of the Single Family Book, and that public filings show that those riskier products led to a disproportionate amount of the company's losses. He asked if there was a similar change in type of product purchased in HCD Multi-Family book. Mr. Bacon said no, explaining that "I've been able to operate under the radar. There wasn't the political pressure on my business and so we've been able to say: 'We have a model and it's hard for me to ramp up in the same way.'" He also stated that "fewer people understood my business," which reduced pressure on him to ramp up in the same way the Single Family business did. "We bent our underwriting stuff but we didn't change our business model and you can see the effect of that. We've never had the equivalent of reduced documentation loans, for example. We got somewhat more aggressive, but not tons.

There were losses coming from 2007 book, but we responded in pricing – my returns went down, but I could mostly fend off the pressures at issue in the Single Family business," he said.

Tom Stanton asked Mr. Bacon what his policy was on buying loans that would trigger HMDA 3%. He responded that "in general, we didn't want to buy predatory loans. I can't comment with any degree of confidence on triggers, however." He said that "there was always – and you see it in Tom [Lund]'s perspective – it wasn't good for us but it also wasn't good for consumers. You have to draw the line, but it's always very had to draw that line."

Referencing the 2007 strategic retreat that included presentations expressing that "now's the time to take more risk," Tom Stanton asked Mr. Bacon to comment on the change in strategy. He said that he could not answer with particularity, but that "there was heated debate about taking more risk. Hindsight is 20/20, but there had been a shift in the market. Alan Greenspan was saying that people should get adjustable rate mortgages. You had *everyone* saying "you've *got* to do more." There was a consensus that we had to take more risk because we were falling behind the market, and with investors and customers." He continued to state that "starting in 2004, we were operating under a consent order," and that "you look at things very differently by 2005" when Fannie Mae was falling behind as everyone else in the market – including Wall Street, rating agencies and regulators – were encouraging Fannie Mae to assume more risk. "We are secondary market, and we buy what our customers originate," he said. "And what they originated drifted farther and farther away from our traditional credit box. And then there was a movement from, at least from Tom [Lund]'s perspective. He wasn't saying 'let's lead the parade,' but it became clear that we needed to go there," Mr. Bacon said.

Chris Seefer asked if Mr. Bacon could provide a narrative of when the strategy shift occurred between 2005 and 2007. Mr. Bacon said that he could not give a date, and said "we were in the midst of a restatement and frankly, the most dominant thing was to get out of accounting and regulatory hell, which was a huge undertaking." He continued to state, "I can tell you that in 2005, goals got harder and business with customers got harder. There was a sense that if you were going to be relevant you had to move. But I can't give you a date." He said that by 2008, Fannie Mae clearly bought more private-label securities and Alt-A whole loans. "We had plenty of product that we didn't have in '05. It's not as much that Fannie Mae changed radically, it's that the market changed and we joined the parade later on," he said.

Mr. Bacon noted that subprime and Alt-A loans had been around a long time. He said that what changed was their explosive growth. He said that Fannie Mae gradually increased its presence and that, in hindsight, the company increased its presence toward the end.

Tom Stanton asked again if Mr. Bacon could provide any clarity on the how much of a role the housing goals played in Fannie Mae's decision to "join in the parade." Mr. Bacon said in response that "I know for your purposes everyone likes a sound-bite but it's very difficult to untangle. Again, you've got one of your regulators who has the ability to enforce civil penalties saying ‘do more.’ You have customers who have the ability to make you irrelevant saying ‘do more.’” He mentioned that Alt-A was more of a customer-driven issue because it did not qualify for goal credit, but that the specific motivations for obtaining other loan products were more difficult to assess.

Referring again to the 2007 strategic plan that came out of the retreat, Tom Stanton asked how Fannie Mae balanced the need to provide mission-related affordable housing with profit. Mr. Bacon said that “I can tell you that in my division, one of the things I believe is that financial discipline is very important and that you can do good things for people, but you need discipline. For my division, we wanted to do more for reservations, public housing, and the homeless, but the question is how to do that for a business. Again, you had equity projects, but you had credit standards, and pricing discipline. There were attempts in 2007 to make programs like My Community Mortgage more accessible. You had products like Expanded Approval. There were a suite of products that people said, ‘if this is where the market is, go there.’”

Chris Seefer asked what voices, if any, spoke out against “joining the parade.” Mr. Bacon said that “ever since I’ve been with the company there has always been a healthy tension between the credit people and business people.” Mr. Bacon said that “Tom [Lund] is a conservative guy with very good credit judgment. [Adolfo] Marzol always wanted us to get more mortgage insurance. Enrico [Dallavecchia] always wanted more insurance.” But, he said, “We couldn’t control the pace. There was stuff out there, and we had to adjust to market.”

Chris Seefer asked if any of those people said “get out” in addition to “get insurance,” and Mr. Bacon said that he did not recall specifically.

Mr. Bacon stated that Rob Levin, Fannie Mae’s Chief Business Officer, never pressured Mr. Bacon do things he was not comfortable with in the process of supporting goals. Mr. Bacon also noted that Mr. Levin had to deal with pressure from the Board of Directors and investors more than Mr. Bacon did. He also said that when it came to the Single Family business, “everyone weighed in. Everybody had an opinion about what Tom [Lund] should do, and anyone who’s ever owned a home thinks they can run [his] business.”

Tom Stanton asked if any members of Congress contacted Mr. Bacon to pressure him about his business strategy. He said that “they didn’t *call* me but all you need to do is look at the speeches. Nobody criticized the company for being too liberal with credit. They always said ‘do more’ – and even the Republicans pushed their ‘ownership society’ agenda. And just look at the housing goals - they were executive branch policy, but I think it reflected Congress’s will.” Mr. Bacon stated that he never felt pressure to close a deal for a district, and that most of his direct interaction with members of Congress came in the wake of Katrina.

When asked about interactions with regulators, Mr. Bacon said that “Brian Montgomery wanted the goals met – I wouldn’t say he pressured us. He listened, he understood the concern. He tried to change the way FHA operated, but he was unsuccessful. This was a situation where he said, ‘look, these goals were important, but we’ll work with you about how you get there.’ It wasn’t adversarial. He was our regulator, he wanted us to meet goals, and he wanted us to come in if there was a problem.” Mr. Bacon said that he has “a lot of respect for [Mr. Montgomery]” and that “there was a regulatory regime in place. Nobody said back off. Their [FHA’s] thing was how can we work with you to achieve goals.”

Chris Seefer asked if Mr. Bacon recalls any discussion with Tom Lund that led him to think that Mr. Lund was pressured to get into product he did not want. Mr. Bacon did not answer specifically, but said that “if you look at [Daniel] Mudd’s speeches, it’s clear that he felt pressure. I know, again, people want the smoking gun but I just think it was an environment. I can’t comment on pressure on him from one individual. I do know that the CEO grappled with how to balance the competing pressures.” He continued, saying “it’s very hard for anyone person to sit as the market moves and say ‘I’m smarter than everyone in this market.’ Everyone was getting into the market, and I just can’t give you a breaking point. Over time, we started doing things we used not to do.”

Capitalization Levels

When Chris Seefer asked Mr. Bacon what his impression was of Fannie Mae’s level of capital, Mr. Bacon said that “at retreats, we talked about risk tolerance level. When you talked about risk and capital, it was a question of how much risk to lay off. No rating agency or internal analysis said that [Fannie Mae] needed more capital. The question was more or less about mortgage insurance. When we went through the accounting restatement, our regulator added a 30% surcharge, and there was not a lot of debate about undercapitalization. Our regulator answered that for us.” Mr. Bacon also stated that at the time they “joined the parade,” they believed that AAA-rated products were ok.

Chris Seefer asked if he recalled any efforts by regulators to increase capital requirements. Mr. Bacon said that he could not comment on any specific Congressional efforts, but said that he recalls the 30% surcharge as the regulator’s attempt to deal with capital. He also stated that the regulators looked at liquidity and market tolerance, and that people are children of their experience, and that they were unprepared when certain axioms – i.e., that people pay their mortgage before their credit cards, and that although there are regional recessions, home prices don’t fall nationally – turned out not to be true. He said he recalled that there was conversation about capital but that even as late as 2006 when home prices began to flatten, no one thought prices would drop off a cliff.

Chris Seefer asked if Mr. Bacon recalled any efforts within the company to oppose increases in capital. Mr. Bacon said that there was “always discomfort with 30% - some people thought it was a good cushion, other people feared it would hurt the returns, but no one said let’s decrease base capital.”

Following up, Chris asked if Mr. Bacon recalled any discussion of lobbying to kill legislation that would have raised capital. Mr. Bacon said that under Mr. Mudd's leadership, the company embraced reform publicly and privately and backed off of lobbying efforts. In addition, Mr. Bacon noted that Fannie Mae was under a consent order so they were restricted in their lobbying. "Mudd said when he came in that he wanted good reform, and that led to a cultural change within the company. I never recall Dan saying anything like 'let's kill a bill.' That just wasn't him personally," Mr. Bacon said.

Chris Seefer asked if Mr. Bacon had ever heard customers telling Fannie Mae that it needed to buy risky product or they would take their business to Wall Street. Mr. Bacon said that that position was always implicit. "The Wall Street thing was not a threat; it was just a viable alternative. That was just real – when you gave a bid to somebody, you knew that they were getting a bid from someone else too. It was just a fact. I don't view it as a threat; it was that customers had new alternatives, which created a pressure on Fannie," he said.

Chris referenced the New York Times article that reported that Angelo Mozilo told Dan Mudd that if Fannie Mae did not "expand the credit box," Countrywide would sell all of its product to Wall Street. Chris noted that before Fannie Mae "joined the parade," Countrywide was the biggest seller of Single Family product to Fannie Mae, and asked Mr. Bacon if he ever heard of an originator saying that Fannie Mae would lose its businesses if Fannie Mae did not purchase from the "larger credit box." Mr. Bacon replied that "the way the Single Family business works, you do a contract with certain credit parameters and guarantee fee. When people went in to do contracts, the impression I got was that these guys say 'this is my product, here's what I want to sell you.' [Fannie Mae] can't just cherry pick." He said that originators want a partner, and they have incentive not to work with ten different other companies, so it makes sense that originators would want Fannie Mae to purchase as much of their product as possible.

Mr. Bacon continued, saying that "before, it was [Fannie] or Freddie. Later on, a few things changed: vertical integration changed nature of our conversations [with originators]. But from a bottom line perspective, it is reasonable to assume that originators said 'how much of my business can you do at what price,' and in an industry that's concentrated, that can have a big impact on your results." He said that "my impression is what began to happen is that what had been outside the box was being brought in. We weren't bigger than the market."

When Chris asked Mr. Bacon to comment on his view of what went wrong, Mr. Bacon said that "the market went wrong. What happened at Fannie and Freddie happened because we're monoline companies - we were concentrated." He said that "[political] campaigns and the public blame [Fannie Mae], but Alt-A and subprime had been around a long time. I didn't invent it. The market went wrong and I'll leave it to people such as yourselves to figure it out. We had standards for mortgages that influenced the market but at the end of the day, we weren't the regulator for any bank so we didn't have the power to regulate the primary market. You have to look at primary market. That gets you into a whole public policy question. In general, people thought homeownership was good and they put more emphasis on ends than the means. To me, that's just my two cents about what went wrong – it was the market."

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