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FCIC memo of staff interview with Scott Smith, John Kerr, Steve Corona, Chris Dickerson, Federal Housing Finance Agency

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MEMORANDUM FOR THE RECORD

Event: Interview with FHFA re: Fannie Mae

Type of Event: Interview

Date of Event: March 19, 2010, 1:30-3:00 p.m.

Team Leader: Chris Seefer

Location: FHFA

Participants - Non-Commission: Alfred Pollard, FHFA General Counsel; Scott Smith, Associate Director; John Kerr, Senior Associate Director of Examination; Steve Corona, Examination Manager; Chris Dickerson, Deputy Director

Participants - Commission: Chris Seefer; Tom Stanton; Al Crego; Sarah Knaus

Date of MFR: March 24, 2010

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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 thanked the FHFA officials for meeting again and reminded the room that the last interview left off with FHFA staff walking the FCIC through the Fannie collapse chronologically. He offered to either pick that back up, ask specific questions, or to go through any documents prepared by the FHFA. Mr. Pollard replied that the previous discussion had ended with a review of an exam on non-traditional mortgages (NTM). Mr. Kerr suggested taking some portion of the interview to attempt a structured walk-through of documents. However, he wanted to start by going back to two statements that he previously made.

Rating Systems

First, at the close of the previous interview, Al Crego had asked for detail about Fannie being rated a "3," and Mr. Kerr wanted to make the reasoning absolutely clear. Chris Seefer chimed in that OFHEO rated Fannie a "3" in the 2005, 2006, and 2006 Exams. Mr. Kerr stated that a "3" was the worst rating OFHEO could give Fannie on the CAMELS rating system, because a "4" signaled that the entity would collapse in a year and a "5" signaled imminent collapse. This system was changed to give a worse rating without considering the failure factor. Al Crego requested a copy of the January 2007 Handbook that described the 5-point rating system. From everything he had read, a rating of "3" or "4" would not have a distinctive timeline, which a "5" does. The only handbook Al had read was from July 2008, and had only four ratings. Mr. Kerr explained that the original handbook was developed from nothing when he started at OFHEO. It was not a focused mission probably until 2006 when Jeff Spohn drafted an initial handbook. Chris Seefer asked whether the handbook would contain the 1-5 scale at the time of the January 2008 PowerPoint presentation. Mr. Kerr responded that in July 2007 OFHEO was still using the 1-5 scale and that the ratings changed towards the beginning of 2008. The1-5 applied to the 2007 year-end examination presented in 2008. Chris Seefer asked for clarification on the "3" rating for Fannie. Mr. Kerr repeated that a "4" indicated that the entity would fail within a year, and a "5" meant imminent failure. He reiterated his comment from the last meeting, that when he joined OFHEO Fannie was the worst run financial institution he had personally seen. However, Mr. Kerr corrected that the company's condition was not static and a tremendous amount of effort was made to improve, to the point of burnouts. He stated that a number of areas had improved, while a number of areas languished. Returning to the discussion of the rating system, Mr. Dickerson explained that on the 5-tier rating system, there would be great implications for publically reporting that Fannie would fail within the year. He mentioned the Central Bank of China. Chris Seefer replied that he would like to think that Mr. Dickerson did not mean to imply that even if Fannie was a "4", OFHEO would not rate it as such in May.

Chris Seefer continued the discussion, asking who makes the ultimate call on the ratings. Mr. Kerr replied that it is the director's call. OFHEO's model works a little differently than other agencies, because the director and not Mr. Kerr signed the exam reports.

Chris Seefer asked Mr. Kerr to walk through the process of preparing the rating and presenting it to Fannie. Mr. Kerr began by stating that the exam work attempts to understand the present and the future whereas the Reports of Examination are a backward look to determine what happened in the company. The 2007 composite rating is the rating for Fannie on December 1, 2007. Mr. Kerr presented an internal OFHEO document that was completed on a quarterly basis and included ratings. In a June 2007 document, OFHEO gave Fannie an aggregate of moderate risk, reporting that risk management needed improvement and within a year, the risk was likely to increase. Credit risk was low in 1Q2007, but OFHEO already recognized it as increasing in this document. Mr. Kerr said these internal reviews looked at both the present and future. The official reports focus on what happened during that year it covers.

Chris Seefer asked for a description of the rating determination process. To answer this question generically, Mr. Kerr said OFHEO completes a serious of target investigations and a series of tiny dives each quarter. The regulator meets with a number of Fannie people up and down the org chart and examines committee meetings to garner a broad picture of what is happening in the present and what is planned for the future. Mr. Kerr always viewed this as an on-going court case: there is greater incentive for Fannie to tell the truth if OFHEO stays on top of everything they produce. Eventually the regulator can convince Fannie to trust them with plans and goals for the future. According to Mr. Kerr, the goal of continuing supervision is to come up with a quarterly rating of the quantity of risk based on losses, SDQs, and interest rates.

Chris Seefer asked about the compilation of the annual composite rating. There was a difference, according to Mr. Kerr, between the approach of Mr. Lockhart and Mr. Falcon. Mr. Lockhart was very hands on, meeting 2-5 times a week with the examiners and wanting to hear or see everything available. Starting in April 2006, Mr. Kerr brought in bank reports and other market trends and compared these institutions against Fannie's own documents to ultimately pull together a "big picture" review. Mr. Kerr wrote up documents, like the quarterly report, suggesting ratings. Regardless of the Director, the ownership of the ratings and examination processes lies with the director. Mr. Kerr explained that his recommendations would be well documented. He described part of his job as getting into the concrete situation at the entity.

The rating system really did not take off until 2005, but resources continued to be limited due to the Special Examination. Mr. Kerr recognized that OFHEO needed to give a view of the present and future, to understand what is to come. Director Lockhart was very hands on and controlled much of the day-to-day operations for Mr. Kerr's team. The exam work was completed in the time leftover from completing the work required for the Director. Although Mr. Kerr made recommendations, the hands-on process ultimately led to the director making his own decisions. However, Mr. Kerr said that his recommendations were not vastly different from the final report. Chris Seefer asked for detail about the final decision on the composite score. Mr. Kerr replied that his team would write the report, recommending a rating. The Director then had the opportunity to make changes. Mr. Kerr was unsure whether he would still have the draft versions of the reports. At no time did Mr. Kerr recommend ranking Fannie a "4", because his understanding was that a "3" was the worst that could be used without heading to bankruptcy/default. Responding to a question from Tom Stanton, Mr. Kerr said that he would have ranked a large bank in the same condition as Fannie in 2007 at a "3".

OFHEO presented the 2007 report to the Fannie board of directors on February 29, 2008, which was followed by a two to three month lag before the release of the public report. Chris Seefer asked Mr. Kerr whether there was any change in Fannie's condition between the end of 2007 and the release of the report. According to Mr. Kerr, any of these concerns would be discussed at the board meeting in February. He stated that OFHEO would not ignore the present, even though it was presenting a report from 2007. Mr. Kerr would not have the call to take any steps beyond conversations with Fannie about OFHEO's growing concerns. However, Director Lockhart could send letters or make public comments, as he did with the 2006 Interagency Guidance in 2006. Mr. Smith chimed in that the director has the ability to release a capital classification determining whether Fannie is appropriately capitalized under the statute at any time. The statute gives the director the discretion to downgrade the rating by one without time limits or constraints.

Mr. Kerr voiced his concern that he was being judged for improperly rating Fannie in 2007. He again confirmed that he rated Fannie based on OFHEO's ratings scale. Chris Seefer replied that he was not casting aspersions. Al Crego just wanted to know the details of the rating system. Mr. Kerr reminded the FCIC that there was "worse than nothing" at OFHEO when he arrived and that he had built up the rating system. Mr. Pollard interjected that the Report of Examination covers a set period, but that the Director has an opportunity to address additional concerns in the cover letter.

Replying to a question, Mr. Kerr said that although Fannie was badly run in most areas, a crash was not eminent. Even if Fannie "got it wrong", they had a program, which would continue to work. Mr. Kerr said that most financial institutions fail due to credit risk. Through the Special Exam, OFHEO attempted to get Fannie to fix their risk management and operation issues. He said that there was talk going back to 2005 about the increasing level of risk and non-traditional loans and the characteristics of these loans. The exposure for these loans did not really take off until later. OFHEO's concerns grew in 2006, and were defined in the letters from Director Lockhart requesting the same guidance as regulators of banks. OFHEO concentrated on the areas they considered high risk, and followed trends. By the time credit was "really coming off the hinges," it was too late. Chris Seefer asked about the letters sent from Director Lockhart. Mr. Kerr replied that there was certainly pushback from Fannie.

Responding to a question, Mr. Corona said that credit risk was not an issue from a quantitative standpoint in the 2005 timeframe. Mr. Kerr said that OFHEO was trying to cast a wide net to include credit risk. In 2005, he hired Phil Nelman, who had PLS expertise and cut him loose. Part of Mr. Kerr's job is to stay on top of the emerging risks for Fannie, and OFHEO focused as much attention on the credit risk as it could with the projects they were getting from the front office. Responding to a question from Chris Seefer, Mr. Kerr explained that Mr. Nelman was hired not just to look at the relatively small portion of PLS, but a wider set of products. In filling out his team, Mr. Kerr's goal was to hire a mix of examiners and industry experts, some of whom would have a narrow but deep knowledge.

Credit Risk

Returning to the credit issue, Mr. Corona explained that credit risk was not a quantitative issue from 2004-2005, although Fannie did have some qualitative issues on the risk management sides. Quantitative issues would include delinquencies, losses, and portfolio makeup. OFHEO began to dive deeper into Fannie's qualitative issues in 2004, because the risk management function was not as strong as it should have been. Chris Seefer asked about the problems Fannie needed to correct, which Mr. Corona said were inconsistencies in policies, and inaccuracies in their reporting. The company drastically increased risk management under Mike Shaw, but around that time quantitative issues began to increase. Enrico Dallavecchia started to expand the risk management function in May or June 2006. Responding to a question from Chris Seefer, Mr. Corona said that Mr. Shaw made tremendous effort to improve the risk management function, but one concern was that Mike was too ingrained in the business function. Tom Stanton asked about Tom Lund's skills at assessing risk. Mr. Corona said that Mr. Lund was stronger in marketing, sales, and customer relations than risk management. According to Mr. Kerr, this issue emerged in 2005 when Fannie wanted to substantially increase the risk management level related to PLS products. Mr. Corona stated that the focus at the time was on market share and Mr. Lund was good at developing that, even if it was not necessarily good market share. Fannie felt that residential mortgages were the least risky products and therefore needed lower risk management. Mr. Lund was more focused on attracting business then on risk management.

<u>Counterparties, including Countrywide</u>

Chris Seefer explained that the FCIC has learned from public documents that Mr. Lund said in summer 2005 that he did not like the non-traditional products and advised Fannie to not enter the market. According to Mr. Corona, this was inconsistent with what happened. He said that he was "poking around" Fannie to talk about risk management and found that the large counterparties, including Countrywide, were uncontrolled. Mr. Corona and Mr. Lund held a few heated discussions about setting up a business plan for Countrywide, because the latter did not think that Fannie needed one. Mr. Corona explained that Countrywide had the largest number of outstanding purchasing requests, because they had a large staff that would nitpick on contract agreements. When Bank of America purchased Countrywide, they cleared up the purchase requests with Fannie. Mr. Corona said that it took a lot of high power involvement from Mr. Lund and Mr. Levin to negotiate the settlement. In the end, Fannie settled for 17 cents on the dollar, an agreement that Mr. Kerr said was based on principal and not loss.

One of the things that surprised him when he joined OFHEO is that the market power lies with the servicers. He said that Fannie developed the idea of having a contract to lock in one firm's business for a period. Although the two sides would negotiate the guarantee fee and building variances, Fannie knew that if they lost their contract with Countrywide, they would lose 25% of their business. Additionally, this business would go directly to their competitor. Mr. Kerr pointed to an internal Fannie letter documenting the debate over business with Washington Mutual. The letter stated that Washington Mutual knew their market power, and therefore told Fannie to take their junk or else it would lose all of the bank's business. Fannie ultimately decided that they would rather miss the market share than take the junk, and the contract went to Freddie. Fannie CEO Dan Mudd ultimately made this decision, according to Mr. Kerr. He was unsure if Countrywide offered a similar proposal to Fannie. They did however hold back payment for some loans, which affected the Bank of America sale. Mr. Kerr stated that Fannie was not a complete lapdog, and would ask for credit enhancement as protection. Fannie also completed some due diligence and looked at county records, to find out if lenders were great offenders. Mr. Kerr and Mr. Corona agreed that they had heard Countrywide would not close a first and second loan on the same day.

Mr. Corona said that the Countrywide relationship was not well managed from a traditional risk management perspective. He also stated that he was told that the Countrywide relationship made Fannie a lot of money, but after the conservatorship, he was told by Board Chairman Stephen Ashley that the relationship was not profitable. Mr. Corona quoted the Chairman as saying, "in the industry nobody could manage Countrywide."

Tom Stanton asked whether OFHEO would have a document summarizing Fannie's book of business, including the number of Alt-A, subprime, and PLS loans acquired from 2005 to 2008 or 2009 and the losses the company ultimately took or continue to take from these loans. Mr. Corona answered that he had documentation up until 2007 from the cancelled examination of NTM products that would provide a breakdown on the various levels of credit enhancements and breakdowns of product points.

Responding to a question, Mr. Corona explained that the Interagency Guidelines came out in 2006 and Director Lockhart gave his recommendation for the GSEs to follow the guidelines in 2007. At some point after this, OFHEO launched a special mini-target examination to examine compliance with the interagency documents. Mr. Pollard noted that he would provide this for the FCIC. Mr. Corona was pretty certain that information on defaults and early losses would be provided in these reports. Mr. Corona reminded the FCIC that OFHEO was aware of the higher risk of the non-traditional products, but it was not clear early on where the market would head. Tom Stanton interrupted, asking whether he had heard correctly that Fannie was not necessarily aware of the profitability of the products versus the exposure. Mr. Corona was not sure if Fannie maintained this analysis.

Responding to another question from Tom Stanton, Mr. Dickerson stated that the numbers clearly show that Countrywide had twice the losses on the average book at Fannie through 2005-2006. Fannie produced CRAM reports show the performance of loans by originator. According to Mr. Smith, the CRAM reports also contained the loss severities. He said that Fannie's overall loss severities were 11%, 12%, and 15% in early 2008, whereas today they are in the thirty and forty percentiles. Mr. Smith attributed the dramatic increase in losses and delinquencies to the precipitous decline in housing prices. According to Mr. Dickerson, the CRAM reports would show the performance of the mortgage as it is being serviced. Mr. Corona explained that the CLM reports would offer back-end losses. Tom Stanton asked whether Fannie was monitoring the losses by loan type. According to Mr. Corona, they looked at losses on a more global level, and did not segment their portfolio in that manner. However, Mr. Corona believed that Fannie understood the concerns early on. To go back to segmenting into non-traditional products, the negative amortizations were credit enhanced and none of the categories of loans were less than 30% neg-am.

Responding to a question from Chris Seefer, Mr. Corona stated that OFHEO did not have the ability to look at the counterparties early on. From an early exam, the regulator found errors in the Risk Net data around the aggregation of counterparty risk. These issues have improved because of Mr. Shaw, but in 2005, this aggregation was still a problem. Mr. Kerr added that OFHEO required a more robust process for reporting counterparty risk, which Mr. Shaw supported and told people to fix the faulty data. OFHEO ensured the entity did enough as far as credit risk examinations rather than go out and analyze the risk themselves. When OFHEO found problems, they would write up a Matters Requiring Attention (MRA) memo and tell Fannie to fix the problems. Chris Seefer requested these MRAs, quarterly targeted exams, and the reports calling for Fannie to stop buying certain loans. Mr. Kerr showed one such MRA from Mr. Corona to Fannie management about horrible internal conditions. According to Mr. Kerr, in the first few years of his tenure, MRAs to the Board of Directors were the forward-looking piece within the Report of Examination. They did not necessarily state a deficiency on the board's part but identified issues OFHEO wanted board to focus on in the coming year. At some point, these turned into MRAs that stated specific deficiencies needing response. The MRA section of this year's report does not have MRAs because it had become too confusing. OFHEO and Fannie hold conversations about what management needs to do.

Mr. Kerr wanted to begin an overview of the documents he had pulled for the interview. Chris Seefer explained that he wanted to understand what OFHEO found and the changing concerns over time. The FCIC is very interested in seeing what Fannie knew and when, and what OFHEO knew and when. Mr. Pollard stated that this is the sort of work the director talked about the previous week, to get the information down with both a narrative and the documents.

Capital requirement

Tom Stanton asked how Fannie started out with $45ish billion in capital early 1Q 2008 and burned through that capital, beyond the recession answers. He said he was interested in trying to figure out what in Fannie's book of business went bad and the percentages of these products. According to Mr. Kerr, half of Fannie's losses came from Alt-A and subprime. However, even if Fannie had never bought a single riskier loan, losses from the prime products would have wiped out their capital. Charter restraints make the GSEs monolined, with no diversification. JPMorgan survived because it had a strong capital markets to offset other losses. Both Mr. Kerr and Mr. Smith agreed that the downward spiral would have taken longer, but a collapse was inevitable. Mr. Kerr stated that his personal opinion is that even if Fannie ran their book their well, we would still be sitting here today. According to Mr. Smith, as of June 30 2008, Fannie had $47 billion in statutorily defined core capital. He was unsure of the amount of DTA, which could be as much as $20 billion. Mr. Smith also pointed to Fannie's accounting. When the markets crashed and there was no market for PLS and Alt-A, Fannie marked these products down on their book.

Responding to a question from Al Crego, Mr. Smith stated that the most recent 10-K has a schedule for the credit-related losses and their OTTI, but before a redress in accounting standards, the numbers flowed right down to losses. He acknowledged that this was overkill for a buy and hold institution. Tom Stanton asked if Fannie had not taken any losses on the prime book and these accounting measures were in place, would they have been saved. Mr. Smith warned against trying to separate this out. The one thing that can never be separated out is the contagion, which caused the whole economy to seize up. Additionally, Mr. Smith said that under the accounting rules, Fannie front-loaded their losses in terms of burning through the income. When Fannie was placed into a conservatorship, the actual cash flow book had not yet gone negative. Mr. Dickerson added that it is hard to tease out Fannie's level of capital absent of the Treasury infusions.

Document Review

Chris Seefer asked to go through the documents pulled by Mr. Kerr, who said he would not cover the Reports of Examination and Board presentations.

- Outline for a meeting between Mr. Kerr and Fannie CEO Dan Mudd in June 2005, with items listed by importance: key management position, Sarbanes-Oxley, top third option arm, credit risk, REO growth, competitive issues, Countrywide, market share issues, independent and single-family loan pricing, problems with independence. According to Mr. Kerr, Mr. Lund ran everything right down to operations, as did Mr. Nicelescu and Marcus. He also said that if your boss is trying to make money there is an issue with fair pricing. Mr. Kerr made sure that Mr. Mudd heard his concerns over the controls of personnel. They also discussed product risks, credit reputation, setting market standards, new products, and the issue with First Beneficial's monitoring of servicers.

- Letter written by Lockhart in Nov 2006 to Mudd about his desire to increase the dividend. Fannie was pushing to get changes quickly as they made improvements in their operations. In the letter, Lockhart says that Fannie is not there yet. Chris Seefer had a vague recollection that Fannie said OFHEO did not want us to change the dividend but the regulator did not have the power to stop them, so they were going to do it anyway. Mr. Kerr was directly involved. Something was done but not what Fannie wanted.

- Draft copy of a package of items regarding risk. By the time the Special Report was released in 2006, the weekly briefings with Mr. Lockhart had ultimately gotten bigger. OFHEO pulled together everything that they had been discussing for a year, including credit risk ratings and ratings drivers.

- Document produced with help from Steve and his team in September 2007, discussing Fannie activities in the risk and credit arena and emerging risks in an attempt to talk about where we are today. Shows a breakdown of geography and how long it takes to sell a house. According to Mr. Corona, numbers are off the CRAM and CLM reports. At this point, resets were an issue as was unemployment and declining in housing prices. Presents vintage years and SDQs for mid 2007.

Tom Stanton asked whether OFHEO could have predicted in Summer 2007 that things were getting difficult from credit standpoint. Mr. Kerr replied that SDQs stayed consistent until December 2007. Tom Stanton asked if OFHEO had been monitoring asset classes including PLS, when they realized that the company could not quite handle the loss. Mr. Dickerson replied that Jim Lockhart was pinging the OFHEO staff continuously from late 2006 onwards about Alt-A and non-traditional mortgage product. Beginning around the last week in July, OFHEO started meeting in the Director's conference room daily. At this point, Countrywide was blowing up. Mr. Lockhart held a notorious conference call with Mr. Mozilo who swore and said running Countrywide was like turning around a battleship. Chris Seefer asked what Fannie was telling OFHEO during summer and fall 2007, as their market share of NTM products increased. Mr. Dickerson said that the GSEs were begging OFHEO to release them from their portfolio limits, because they had to take the mortgage products into their books. Responding to a question from Chris Seefer, Mr. Dickerson said that the GSEs were not playing up the fact that they thought they could make money off the market's collapse, but that it was clear this could be profitable if handled correctly. Mr. Kerr explained that the Fannie model allowed them to make a bundle when the market returned, after providing the last resort of liquidity. The GSEs had made a lot of money in every other market cycle before this one.

- September 2007 slide presentation: the first slide shows profitability, which gets back to the negative model gap versus the G-fee. This was certainly getting worse but they were making a risk-adjusted return. Fannie made a decision not to change the guarantee fee as the market was changing based on an analysis that showed they would make money over time. Mr. Dickerson demonstrated that a zero gap actually included profit. Fannie said that even a -8 could mean break even or profit, although Mr. Dickerson said this was a highly modeled opinion. Mr. Kerr continued his review of the slides, saying that in response to the changing environment Fannie completed some pricing adjustments in certain products, to tighten up eligibility. The Credit Loss Management strategized on all of this.

<u>Housing Goals</u>

Chris Seefer asked whether OFHEO ever observed Fannie lowering underwriting standards for certain loans to meet affordable housing goals. Mr. Corona replied that he was not sure if they did it to meet goals. Fannie granted variances based on counterparty specifics, but he thought this was more relationship and not goal focused. The goals relate to the issue of market power, because the servicers knew they had to meet HUD's goals and would literally hold back goals-rich loans until the end of the year to sell to Fannie at a premium. Mr. Smith added that it was not the percentage that HUD raised the housing goals each year, but that on the margin the extra percents are exponentially difficult. Fannie could probably get to 40 without even trying. Responding to a question from Chris Seefer, Mr. Smith said that Fannie had information judging the goal loans from a safety and soundness standpoint. FHFA's Office of Policy Analysis and Research (OPAR) has analyzed this as well, according to Mr. Dickerson.

Chris Seefer explained that thus far, he has heard that Fannie's normal product could satisfy part of their housing goals, but there was a gap. The entity established programs to fill the gap, including My Community Mortgage (MCM), Expanded Approval (EA), and other programs involving community outreach. He wants to see how Fannie priced the special outreach loans and if they ever priced them at a loss. Some believe that the affordable housing goals encouraged the GSEs to buy or guarantee loans, which drove the housing bubble. Chris Seefer said that the FCIC is interested in learning how much of the entity's NTM deals were made to satisfy goals. Mr. Dickerson replied that FHFA's Office of Policy Analysis and Research recently conducted a study on goals loans versus non-goals loans. OPAR did not look into whether Fannie would have entered into the NTM market without the goals. Mr. Dickerson sensed that it is correct to suggest that there is a niche product to plug the housing goal gap. When Mr. Smith worked for the Mortgage Partnership Finance Program, they completed an analysis of the housing goals demonstrating that MPF could cream skim the market and still meet 38% of the housing goals. That suggested to Mr. Smith that it was not hard to reach a goal of 40%, but to go above this is exponentially more difficult, especially if the brownie points are removed. The MPF example was from the early 2000s. According to Tom Stanton, EA began in 1999, but it was started to make money and happened to turn out goals rich.

- November 2007 letter from Director Lockhart to Sens. Chris Dodd (D-CT) and Richard Shelby (R-AL), encouraging them not to pass a bill to remove the GSE caps.

Responding to a question, Mr. Dickerson explained that there was a detailed mid-year letter sent in late August/early September 2007. Mr. Pollard will produce this letter for the FCIC. According to Mr. Dickerson, the letter was a long, detailed list of problems. Mr. Pollard called the letter the basis for the supervisory letter.

2007 Report of Examination

Chris Seefer changed topics and asked about the loss severity models present in the 2007 Report of Examination. It struck a number of people that the model looks back to 2002, although Fannie is increasing the amount of riskier product and the market is declining. Mr. Kerr said OFHEO asked Fannie to fix this. He also said that there was a problem with the model itself, but Mr. Kelly would have to discuss the details of this. Mr. Smith said that the "OFHEO satisfied" statement comes from the accounting section of the report and suggests that the accounting standards were bad. It was not intended to address the underlying model. Mr. Smith said that he has heard this finding from Mr. Kelly before.

OCC/FRB investigation

Responding to a question about Morgan Stanley's examination of the GSEs around this time, Mr. Dickerson said that the firm's work was self-contained. The OCC and FRB were working with OFHEO, but OFHEO only transmitted some documents to Treasury for Morgan Stanley. Mr. Dickerson understood that they were crunching numbers of multiple systems and trying to do some detailed work to come up with a loss-forecast and size of the GSEs' hole. Ken Posner was not on the Morgan Stanley team for this project. A Federal Reserve team visited OFHEO around the second week of July 2008, and with several officials, including Mr. Corona. They asked OFHEO to explain what they knew about the situation. At that point, it was mostly an oral run-through. The FRB participation was in stages: they came in early July, and at some point conducted an intense review of the loan-losses for the GSEs. Mr. Dickerson characterized the FRB people as very intense and urgent because there was concern throughout the government about the GSEs' ability to absorb the growing delinquencies in the housing market. Mr. Corona added that the Fed conducted research on mortgage insurance that OFHEO was not privy to. He said that the Fed did not think the mortgage insurers had strength, which impacted their view of the GSEs' loan-loss reserve. Chris Seefer asked for documents that detail the use of mortgage insurance to cover loan-losses.

Responding to another question, Mr. Dickerson stated that Ambac and the GSEs were doing deals on synthetic CDOs, which generated a lot of concern in late 2007. He added that information from the GSEs around this time was not quite good. A credit person told OFHEO in the summer of 2008 that an excel capital called Secora, was rated CCC but Fannie was "money good." Mr. Dickerson continued, saying that the GSEs were approaching the line of death on capital and trying to do everything to stay above. They were telling OFHEO that the wrap on their debt was good even though their insurers were CCC.

Although the tone improved within Fannie after Mr. Raines and Mr. Howard departed, there were pockets into many layers of management that were difficult to fix. Mr. Dickerson did not want to make Mr. Mudd out as innocent, because a lot the problems related to the superficial changes in how Fannie dealt with OFHEO, although "all of these guys are motivated by profit." Mr. Kerr said it was like trying to move a big ship. He received a lot of cooperation from the Chief Risk Officers. When Mr. Raines was in charge, information was withheld from OFHEO. The PLS did not change as fast as it should, which was an issue within the people who worked for Mr. Nicelescu. Mr. Corona said the ADC and multifamily divisions provide a good example. OFHEO received pushback from mid-level and lower management, until Ken Bacon decided to fix the problem and succeeded.

Mr. Dickerson described a meeting at the Federal Reserve in either the second or the third week of August 2008, where the OFHEO staff ran through a "state of the GSEs" report and forecast for some Fed and Treasury people. Tim Clark from the Fed gave his own projection based on estimates of mortgage insurers' claims paying ability, which he ranked as impaired. Mr. Dickerson said the Fed analysis was worse than OFHEO's, partially based on the mortgage insurers, but also due to the Fed's forecast on cumulative defaults of primary mortgages. Based on their estimates and Fed's own internal analysis of prime mortgages, the group thought the enterprises might be undercapitalized. Chris Seefer asked for a draft of Mr. Clark's report. Right after this meeting, Mr. Dickerson said OCC and FRB people went to speak with Fannie's modelers about the reliance on old data. The modelers, Eric Schuppenhauer and Shelley Klein, kept saying their model was great. When Mr. Kerr and Mr. Dickerson first arrived at OFHEO, Fannie was saying that their capital was steady and could meet their losses. OFHEO told them the model was not industry standard, so Mr. Klein put together a model using a standard that was not the most used within the industry. Fannie has now changed to a different standard model. Mr. Dickerson added that in the process of looking at GAAP loan loss reserves, you are restrained by the fact that under GAAP you cannot assume a change in housing prices. If you are doing a more safety and soundness type of examination, you may try to extrapolate trends in housing prices. This is what OFHEO ended up spending a lot of time on in the last part of August and first part of September.

Responding to a question from Chris Seefer, Mr. Dickerson said that the OCC and the FRB had issues with the loss-forecasting models at Fannie, including the way that the various cohorts of mortgages were segregated. He explained that there were some problems with Fannie not segregating their loan portfolio for their loan analysis. Mr. Corona said the regulators thought there needed to be more granularity in the various processes of the portfolio. Chris Seefer asked whether the concern was that these people were not looking at Alt-A as a cohort or that they needed to be sliced and diced. Mr. Dickerson was unsure of the answer, but Mr. Kerr responded that the regulators were concerned about the roll rate, with Mr. Corona adding that they worried about how far Fannie was looking back in time. The OCC did not have issues with OFHEO's in-house models, according to Mr. Pollard.

Home Savers Advance Program

Mr. Dickerson next explained the Home Savers Advance program. Under the GSEs' charter, if Fannie modified their mortgage that was in one of their MBS or if they were to change any of the terms of the note, they would have to pull the mortgage out of the MBS and put it on the balance sheet. This created problems. In 2008 as they were closing in on the line of death for capital, they came up with the solution to put the amount in an unsecured loan to the borrower. This allowed Fannie not to have to alter their note. These unsecured loans were limited to $15,000 or some percentage of the UPB of the mortgage, whichever was less. The unsecured loan was put on the balance sheet at 10% of face value. The HSA program acted as a stopgap for Fannie. According to Mr. Kerr, the program was established to bring Fannie closer to Freddie's more relaxed contract for removal of loans from trusts. Under their contract, Freddie could modify the loan in the trust and not take a capital hit. HSA did not change the rule that loans within the trusts had to be pulled out at 24 months. At some point prior to the establishment of HSA, Fannie had eased their policy of pulling loans automatically at 120 days. The program was touted as a home segregated rule, according to Mr. Dickerson.

According to Mr. Corona, the default rate was around 70%, but the re-default agencies said the default rate was not out of line. The program, according to Mr. Smith was designed to protect capital, and not the homeowners. The high delinquency rate partially was due to Fannie not having seller-systems to appropriately deal with the program. Fannie did not create a guide for servicers. Details on the program were listed in the ROE for the year. OFHEO was not sure about the volume of MBS involved. Mr. Dickerson added that the haircut for the program was about $9 billion for payments "deferred."

Tom Stanton asked whether the regulators thought the GSEs would bet the bank. Mr. Smith answered that the GSEs were not hiding the ball. Mr. Dickerson said the $11 billion is the first lien mortgage, not the actual advance. Mr. Kerr added that the HSA part was written down immediately. Mr. Dickerson said it was around 30-40% of a haircut. Mr. Corona said Fannie contemplated a Home Saver Advanced Plus.

Responding to a question from Chris Seefer, Mr. Pollard answered that OFHEO gave the SEC an initial briefing on Fannie's business lines, but have not asked for anything since. The investigators went directly to Fannie, because they see OFHEO as a conservator and not advisor.