Statement of

Edward J. DeMarco
Acting Director
Federal Housing Finance Agency

Before the U.S. House of Representatives

Committee on Oversight and Government Reform

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Chairman Issa, Ranking Member Cummings, and members of the Committee, I am pleased to be invited here today to discuss the Federal Housing Finance Agency's (FHFA) oversight of the executive compensation structure for Fannie Mae and Freddie Mac, (the Enterprises). In my testimony, I will explain how the Enterprises' executive compensation program supports the statutory mandates of the Enterprises in conservatorship, how it was developed, and how it is structured.

INTRODUCTION

It may be useful for me to begin with a brief overview of what it means for Fannie Mae and Freddie Mac to be in conservatorship and what legal responsibilities FHFA operates under as Conservator.

The determination to place Fannie Mae and Freddie Mac, or the Enterprises as I will refer to them, in conservatorship, was made as the financial crisis of the autumn of 2008 was taking shape. At that time, the private mortgage securitization market had already vanished, house prices were declining rapidly, and the Enterprises' eroding financial condition and inability to access capital markets threatened a collapse of the country's housing finance system. FHFA, with financial support from and substantial consultation with the Treasury Department, placed the Enterprises into conservatorship on September 6, 2008.

Conservatorship, along with financial support from Treasury, permitted the government to take greater management control of the Enterprises and give investors in the Enterprises' debt and mortgage-backed securities confidence that the Enterprises would have the financial capacity to honor their financial obligations. The alternative, receivership, was rejected at the time, in part because such action would have placed greater limits on the timing and approach for the Congress and the incoming Administration to analyze and respond to the problems confronted by the Enterprises and the country's housing finance system. At the time, Treasury Secretary Paulson referred to conservatorship as a "time-out" to allow markets to continue to function while policymakers considered and acted on a permanent resolution. More than three years later, we are still waiting for that resolution.

As Conservator, FHFA stands in the place of each company's shareholders, boards, and management, with the responsibility to "preserve and conserve the assets and property" of the companies. The statute also charges the conservator with the responsibility to place the

companies in "a sound and solvent condition." At the time the conservatorships were established, FHFA was less than six weeks old as an agency, and had fewer than 400 employees. To accomplish these responsibilities, FHFA made the practical judgment that the most effective means to carry out these functions was to replace the boards and senior management, and then delegate to new boards and management day-to-day responsibility. Since then, reconstituted boards of directors have worked with FHFA to define the operational goals in conservatorship and to support FHFA in its work to guide and oversee management in fulfilling these goals. Likewise, the new CEOs and executive officers have worked with FHFA to these same ends.

As Conservator and regulator, FHFA has three principal mandates set forth in law that direct and motivate FHFA's activities and decisions involving the Enterprises.

First, as I have noted, FHFA has a statutory responsibility as Conservator of the Enterprises to "take such action as may be: necessary to put the regulated entity in a sound and solvent condition; and appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity." As FHFA has stated on numerous occasions, with taxpayers providing the capital supporting the Enterprises' operations, this "preserve and conserve" mandate directs us to minimize losses on behalf of taxpayers.

Second, even though the Enterprises are in conservatorship, without further statutory changes they have the same mission and obligations as they did prior to being placed into conservatorship. FHFA has a statutory responsibility to ensure the Enterprises "operate in a safe and sound manner" and that "the operations and activities of each regulated entity foster liquid, efficient, competitive, and resilient national housing finance markets." We typically refer to this requirement as "supporting a stable and liquid mortgage market."

Third, under the Emergency Economic Stabilization Act of 2008, FHFA has a statutory responsibility to "implement a plan that seeks to maximize assistance for homeowners and use its authority to encourage the servicers of the underlying mortgages, and considering net present value to the taxpayer to take advantage of … available programs to minimize foreclosures."

These three mandates form the basis for how FHFA views its responsibilities as Conservator of the Enterprises. In view of the critical and substantial resource requirements of conserving assets and restoring financial health, combined with a recognition that the Enterprises operate today only with the support of taxpayers, FHFA has focused the Enterprises on their existing core business, including minimizing credit losses. This means that FHFA is not permitting the Enterprises to offer new products or enter new lines of business. Their operations are focused on their core business activities and loss mitigation. This type of limitation on new business activities is consistent with the standard regulatory approach for addressing companies that are financially troubled. And it is even more pertinent for the Enterprises given their uncertain future and reliance on taxpayer funds.

As a final introductory comment, the Enterprises' equity holders retain an economic claim on the companies but that claim is subordinate to taxpayer claims. As a practical matter, taxpayers are not likely to be repaid in full, so Enterprise stock lower in priority is not likely to have any value.

Prior to conservatorship, much executive compensation, and indeed some staff compensation, was in the form of company stock, so the value of such compensation has essentially vanished. Finally, the company leaders most responsible for the business decisions that led to the Enterprises ending up in conservatorship had either left the company before conservatorship, at the time of the conservatorship, or shortly thereafter. The boards of directors were also replaced.

Thus, the leadership working at the Enterprises today is not the same as those chiefly responsible for the business decisions that led to conservatorship and that continue to drive the financial results. Moreover, they are there to further the goals of conservatorship and ensure the country has a functioning secondary mortgage market while lawmakers deliberate the future structure for housing finance. The boards, executives, and staff have been and are working with FHFA in its efforts to minimize taxpayer losses, provide stability and liquidity to the market, and maximize assistance to homeowners to avoid foreclosure. They do so knowing that the long-term outlook is that neither Enterprise will continue to exist, at least in its current form, in the future.

EXECUTIVE COMPENSATION

You have asked me to address executive compensation for Fannie Mae and Freddie Mac executives. At the outset let me state that the best way to address concerns with executive compensation is action by Congress to restructure the nation's housing finance system and dissolve the conservatorships. In the absence of that resolution, FHFA will continue to evaluate the appropriateness of executive compensation at the Enterprises given their ongoing activities.

Before getting into the details, I would like to begin by sharing my own frustration with compensation issues in conservatorship. Nothing like this has been done before – placing two of the largest private financial institutions in the world into government conservatorship and then overseeing their operations in that state for multiple years. Determining appropriate compensation in this situation is vexing. As a career-long federal employee, I, too, perceive the compensation agreements as large. I also share the frustration of many that past leaders of these companies received enormous compensation pre-conservatorship. Yet, while frustration with the past business decisions of Fannie Mae and Freddie Mac leadership, past policy failures, and the resulting enormous taxpayer costs is understandable – and I share it – it cannot distract us from the task at hand.

As Conservator, I need to ensure that the companies have people with the skills needed to manage the credit and interest rate risks of $5 trillion worth of mortgage assets and $1 trillion of annual new business that the American taxpayer is supporting. I have concluded that it would be irresponsible of me to risk this enormous contingent taxpayer liability with a rapid turnover of management and staff, replaced with people lacking the institutional, technical, operational, and risk management knowledge requisite to the running of corporations with thousands of employees and more than $2 trillion in financial obligations each. That conclusion is further buttressed by the realization that, from an Enterprise executive's or staff's point of view, continued employment at an Enterprise risks substantial job and career uncertainty. The public scrutiny and criticism is often harsh, and almost everyone expects the Enterprises to cease to

exist, at least in their current form, in the future. At the same time, the taxpayer is backing Enterprise financial commitments that have 30-year lives, and we will need expert management of those guarantees for years to come. Given the amount of money at risk here, small mistakes can easily be amplified to losses far greater than the compensation paid to Enterprise executives.

In short, as Congress considers executive compensation at the Enterprises, the basic fact is that despite the large amounts of government support provided to the Enterprises they remain private companies with uncertain futures, not government agencies. They employ thousands of people. We cannot maintain operational effectiveness while suddenly treating them as ongoing government agencies – something they are not. Major changes to compensation, for executives or staff, cannot be done safely and soundly in a short period of time and attempting to do so would pose substantial risk to the mortgage market and a greater risk of loss to taxpayers. In the next section, I will review the history of how FHFA established the executive compensation program operating today, and describe the details of that program and how it has been working. I will then conclude with a few thoughts on the program going forward and the role Congress might play to bring this difficult matter to an end.

Initial Conservatorship Decisions

During FHFA's intense preparations for placing the Enterprises into conservatorship, we received some valuable insights from discussions we had with the Federal Deposit Insurance Corporation (FDIC). The FDIC's experience in bank failure resolutions, including conservatorships, supported our view that achieving the goals of conservatorship depended on retaining capable and knowledgeable staff. At the same time we sought to no longer employ those executives most responsible for the conditions leading to our action. As a part of our planning process, we hired Hay Group, a well-respected executive compensation consultant, to help us design a plan to encourage the best employees to stay, while not rewarding poor performance.

In placing the Enterprises into conservatorship, our foremost concern was that their troubled condition was leading them to withdraw their services from housing finance markets at a time when they were greatly needed. Their combined market share in 2008 was more than double what it had been two years earlier, as most other participants went out of business or sought to avoid new risk exposure to the mortgage market. For the sake of our country's economy and especially its housing sector, it was and remains essential that the Enterprises continue to bring liquidity, stability, and affordability to the mortgage market. Furthermore, the Enterprises' enormous size, including more than $5 trillion of mortgage credit risk, and taxpayer exposure to that risk in the face of rapidly deteriorating housing markets, made it imperative that the Enterprises strengthen their management in the areas of risk control and loss mitigation. In addition, it was and remains imperative that the Enterprises attract and retain the particular and specialized skills needed to manage these activities.

To address these concerns, FHFA discussed our retention approach in some detail with both new Chief Executive Officers (CEOs) on the day before their new jobs officially began. Both CEOs agreed with our view of the importance of such a plan, and over the next few weeks worked with

us, Treasury, and Hay Group to customize plans for their respective institutions. Payments under the plans were virtually the only non-salary compensation for Enterprise employees for the 2008 performance year, as no bonuses were paid for that year at either Enterprise.

At the inception of the conservatorships, we also announced that the incumbent CEOs would be leaving after a brief transition period. They received no severance payments. In prohibiting such payments, we relied in large part on the golden parachute provisions in the Housing and Recovery Act of 2008 (HERA). In addition, because most of their remuneration had been in the form of Enterprise stock, roughly two-thirds of their previously reported pay during their tenures as CEOs vanished with the collapse in the market prices of their shares. The golden parachute provisions were also helpful in other cases, as ultimately, five of the six Fannie Mae executives that were highest paid before the conservatorships and the top four Freddie Mac executives left in one fashion or another during the first months of conservatorship, but none of them received severance or other golden parachute payments. They also saw a substantial reduction in the value of their past compensation due to the collapse in their company's stock price. While I know all the attention today is on executive pay, I'd like to add that many of the more than 11,000 rank and file employees at the Enterprises also had large portions of their life savings in Enterprise stock and suffered accordingly.

New Compensation Structure

FHFA's development of a new compensation structure for senior Enterprise executives for 2009 and beyond was delayed, first by our appointment of new boards of directors at the Enterprises, with new compensation committees, then by the departure of the CEOs hired at the start of the conservatorships.

Additionally, FHFA had agreed, under the Senior Preferred Stock Purchase Agreements that control financial support to the Enterprises, to consult with Treasury about new compensation arrangements with executive officers at the Enterprises. We wanted to consider fully the approach being developed at the Treasury for institutions receiving exceptional assistance from the Troubled Assets Relief Program (TARP). After Kenneth Feinberg was appointed Special Master for TARP Executive Compensation, Treasury asked us to consult with him, and we began to discuss how we could adapt to the Enterprises the approach he was developing for TARP institutions.

In making that adaptation, a major consideration was that compensating Enterprise executives with company stock would be ineffective because of the questionable value of such stock. Further, large grants of low-priced stock could provide substantial incentives for executives to seek and take large risks. Accordingly, all components of executive compensation at the Enterprises are in cash.

Another consideration was and remains the uncertain future of the Enterprises as continuing entities, which is in the hands of Congress and beyond the control of Enterprise executives. It is generally best to focus management's incentives toward its institution's performance over the long-run rather than just the near-term. In the case of the Enterprises, that is nearly impossible.

Therefore, compensation for current work does not depend on results more than two years out. To encourage talent to stay put, FHFA made deferred payments generally dependent on an executive's continued employment at the Enterprise. We also made half of the deferred pay subject to adjustment based on corporate performance to partially simulate the effect of corporate performance on the corporate shares paid to executives at TARP firms for their deferred pay. That allows for reductions in deferred salary if the Enterprise's goals, as set by the Board with increasing input from FHFA, are not met. As I will explain further below, corporate performance in this context is tied to the goals of conservatorship.

FHFA also looked to existing practice elsewhere to determine the appropriate levels of total target compensation for the most senior positions. We considered data from consultants to both Enterprises, data received earlier from our own consultant, and the reported plans of TARP-assisted firms. It was important to set pay at levels sufficient to compete for quality talent because the Enterprises had many key vacancies to fill, potential departures to avoid, and pay has been a significant issue in some cases. That need was, as it must be, balanced by our efforts to keep the cost to taxpayers as low as we possibly could.

Based on review of past compensation, the market comparables identified by outside pay consultants, discussions with each board of directors, recent experience in recruiting CEOs, and consultation with the Treasury Department, FHFA settled on a target of $6 million a year for each CEO, $3.5 million for the Chief Financial Officers (CFOs), and less than $3 million for Executive Vice Presidents and below. That amount rolls back Enterprise CEO pay to pre-2000 levels. It is less than half of target pay for Enterprise CEOs before the conservatorships. For all executive officers, Fannie Mae and Freddie Mac have reduced target pay by an average of 40 percent.

The basic compensation structure for senior executives at both Enterprises, as at institutions receiving exceptional TARP assistance, comprises three elements: base salary, a performance-based incentive opportunity, and deferred salary. Salary scales have been sharply reduced from pre-conservatorship levels at both Enterprises. As at the TARP-assisted firms, base salaries generally are capped at $500,000 with a few exceptions. Before the conservatorships, the two Enterprises had 16 officers earning base salaries higher than that amount, now there are only four.

Both Enterprises' charter acts, which remain operational in conservatorship, require that "a significant portion" of executive compensation be tied to corporate performance. Consistent with that requirement, while also following the approach taken for TARP-assisted firms, target incentive pay for the Enterprises is limited to a third of overall compensation. Payment is based on Enterprise performance, as measured by scorecards developed by each Enterprise subject to FHFA approval, and individual performance. In reviewing scorecards, we are particularly sensitive to ensuring that executives are not given incentives to take inappropriate risks. Our special examinations of accounting failures at each Enterprise in 2003-2006 revealed that badly-constructed compensation incentives contributed significantly to excessive focus on near-term earnings reports to the serious detriment of the Enterprises.

Accordingly, FHFA has required a much broader focus that emphasizes remediation of operational and risk management weaknesses, loss mitigation, and mission achievement. For 2009, I approved for each Enterprise funding of incentive payment pools at 90 percent of aggregate targets. For 2010, I again approved Fannie Mae funding of its pool at 90 percent, and I approved funding of Freddie Mac's pool at 95 percent. Individual executives could receive more or less, as long as the aggregate did not exceed the pool amount. Both Enterprises made substantial progress in loss mitigation and risk management, while meeting the challenges of implementing Treasury's Making Home Affordable Programs. However, the boards of both Enterprises, with my encouragement, recognized that those successes needed to be tempered by consideration of the sizable contributions of taxpayers needed to offset Enterprise losses, which occurred despite the generally strong efforts of the executives. Next year's goals will emphasize not only loss mitigation and progress on REO disposition, but improvements that will benefit mortgage market functioning, whatever new structure Congress may ultimately decide on, such as improved servicing standards, improved securities disclosures, the Uniform Mortgage Data Program, and development of risk-sharing pilots.

The remaining portion of compensation is deferred salary, which is paid with a one-year lag to executives still working for their Enterprise at that time. For the highest paid executives, deferred salary is the largest component of their compensation. As noted earlier, deferred salary motivates retention. An executive that voluntarily departs forfeits their deferred but not-yet-paid salary. Any exceptions require FHFA approval, in consultation with the Treasury. Starting with payments made in 2011, the amounts are adjusted up or down, based on each Enterprise's performance on its deferred salary scorecard. I approved a 10 percent deduction for Fannie Mae and a 12 percent deduction for Freddie Mac.

The revised compensation structure was designed to align pay with taxpayer interests. Deferred salary and incentive pay for all executive officers are subject to claw backs by the Enterprises in the event of gross misconduct, gross negligence, conviction of a felony, or erroneous performance metrics. The structure also adopts and in some respects expands on reforms advanced by the Special Master for firms receiving exceptional TARP assistance. This structure, established in 2009, and the annual targeted compensation amounts for executive officers remain in place today. Whenever Congress acts to direct how and when the conservatorships end and to decide the ultimate resolution of the companies, these executive positions, and the compensation program, are subject to change or elimination.

News reports have described $12.8 million of 2010 pay as "bonuses." That number is the sum of $7.5 million in deferred salary and $5.3 million in target incentive opportunity payments.

Turnover and Compensation under the Program

Both Enterprises have experienced some increase in turnover. Freddie Mac's voluntary turnover rate over the past two quarters has averaged more than 13 percent compared to its five-year average of 8 ½ percent. Fannie Mae's has risen to about an 11 percent annual rate so far this year after averaging a bit above six percent over the preceding three years. Among officers at Fannie Mae, more than 11 percent have left so far this year. Five of Freddie Mac's 16 executive

officers have left voluntarily since the beginning of the year. Both Enterprises have experienced some difficulty filling vacancies from outside, as candidates have expressed concern about the Enterprises' future and the lack of any remuneration in the form of equity.

Compensation in the Near-Term

At the present, my plan for executive compensation is to continue to seek opportunities for gradual reductions, particularly when executives leave. This approach is consistent with the Administration's notion of a gradual wind down. I also believe it important for FHFA to continue to assess the corporate scorecards used to improve the alignment between the scorecards and the goals of conservatorship.

I have recently spoken publicly of my goal to bring greater private capital participation into the Enterprises' mortgage purchases so that the taxpayer is not the sole source of support. And I have spoken of my goal to continue a gradual program of guarantee fee increases by the Enterprises so that their pricing better reflects that one would expect from a purely private company operating with its own capital at risk. I believe the executive compensation program in place today would be enhanced by more tightly aligning corporate goals with the successful achievement of these recently established conservatorship goals. Likewise, I believe we should be striving to simplify and shrink the operations at each Enterprise, and should award successful steps toward those ends.

Executive Compensation – Concluding Thoughts

I am grateful for this opportunity to explain the program that is in place today, its rationale and its features. I hope that this explanation has cleared up some misunderstandings and placed the matter in a different light. I would like to close with a few final thoughts, respectfully submitted for your consideration.

I believe that commitments already made by the government through the compensation already awarded by FHFA should be respected, whether lawmakers completely agree with the judgments FHFA made or not. Changing compensation going forward, thereby allowing Enterprise employees to make an informed choice about their continued employment, is fair. Changing what has already been promised and earned is not.

Some have suggested that we should have no trouble maintaining adequate staffing at far smaller pay levels, pointing to outstanding cabinet members who serve or have served with distinction on government pay scales. I have serious doubts about taking this approach to the management of the Enterprises. People come to work for the government for a variety of reasons. The opportunity to serve our country is important for many of us. Some especially desire the relative job security of the career service, others the policymaking roles and the stature that comes with temporarily filling high-ranking jobs. If you want to influence the determination of our nation's financial and economic policies, a job in the government may well be what you want, despite better pay offers elsewhere. But if you are working at an Enterprise in conservatorship, you have less say in the direction or outcome of your company than in normal businesses. And one of our

first rules of conservatorship is that company employees may not lobby or participate in the policymaking process to decide the future of housing finance. At the same time, by working at Fannie Mae or Freddie Mac your work comes under a much higher degree of scrutiny and criticism, and with a lot less job security than comes with working for any other private firm engaged in housing finance. Executives who have spent a career developing their reputations risk tarnish to those reputations under the highly-charged environment in which these companies operate today, regardless of how well they perform their duties or how great a financial sacrifice they make forsaking other private sector opportunities to assist the country's housing finance system.

I do not question that, despite these drawbacks, some might be willing to sign up at Fannie Mae or Freddie Mac for relatively little pay, and I am committed to finding capable people willing to do so. But I have not seen, even in this marketplace, that people with the right skills to run these two companies, as they exist today with all the uncertainty involved and the negative atmosphere, are easy to find.

But even if it could be done, and I think it might be possible if the missions and operations of the Enterprises were sufficiently streamlined, it would require a careful transition over time. The people who are there now did not choose government jobs. A sudden and sharp change in pay would certainly risk a substantial exodus of talent, the best leaving first in many instances. The Enterprises likely would suffer a rapidly growing vacancy list and replacements with lesser skills and no experience in their specific jobs. A significant increase in safety and soundness risks and in costly operational failures would, in my opinion, be highly likely. Thus, sharp and sudden pay cuts should not be expected to lower taxpayer costs, but rather to raise them. Because of the huge size of these institutions, the potential consequences of any increases in risk are magnified. Additional losses amounting to just one basis point on their $5 trillion of assets and liabilities would translate to $500 million, nearly 40 times the "bonuses" that have received so much attention.

Should the risks I fear materialize, FHFA might well be forced to limit the Enterprises' business activities. Such cut backs likely would drive much larger business volumes to FHA and Ginnie Mae, potentially straining their capacities. Some of the business the Enterprises would be unable to undertake might simply not occur, with potential disruption in housing markets and the economy.

No one wants that. Whether you prefer that the secondary mortgage market be a purely governmental or a predominately private sector activity, we need to have an orderly transition, not a sudden shock. The best way to accomplish that is for lawmakers and the Administration to decide on the future structure of housing finance, especially as it regards the secondary mortgage market. Then we could have a final resolution of Fannie Mae and Freddie Mac in conservatorship, which would resolve the compensation issue once and for all.

Mr. Chairman, thank you again for this opportunity. I have tried to provide the Committee with a clear view of the critical issues associated with the Enterprises' executive compensation structure. I look forward to responding to the Committee's questions.