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The Mystery Of The FHFA: New Leader Or Rogue Agency?

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<u>*REQUIRED READING*</u>: On March 25, the Financial Times published an interview with Edward J. DeMarco, acting director of the Federal Housing Finance Agency (FHFA). In the interview, DeMarco acknowledged the heavy pressure aimed at his office from a variety of sources.

"Certainly, the environment of the last number of months has shown substantial attempt to influence or direct an independent regulator," he said.

Indeed, the FHFA has found itself at the center of the politics surrounding the state of the housing market. DeMarco's policy decisions over the past year have earned the wrath of both Republicans and Democrats in Congress, and even the Obama administration has expressed agitation on FHFA actions.

Within the mortgage banking industry, however, the FHFA is mostly seen through a prism of respect. While some of DeMarco's recent decisions have created a degree of debate, his stewardship and the agency's handling of the housing finance market are widely respected.

"I think the FHFA was given an almost impossible task," says Rick Sharga, executive vice president at Carrington Mortgage Holdings, based in Santa Ana, Calif. "In many cases, it is running at cross purposes: It has to keep the housing market stable while, at the same time, wind down Fannie Mae and Freddie Mac."

The FHFA was created by the Federal Housing Finance Regulatory Reform Act of 2008, which realigned the regulatory authority of the government-sponsored enterprises (GSEs) through a merger of the Office of Federal Housing Enterprise Oversight (OFHEO) and the Federal Housing Finance Board. David Kittle, past chairman of the Mortgage Bankers Association and the Washington, D.C.-based senior director of industry relations for IMARC, recalls the FHFA as being something of an answered prayer.

"The industry always wanted a new and stronger regulator of GSEs since the 1990s," he says. "If we had a stronger regulator, we would not be in the position we're in today."

James Lockhart, the head of OFHEO, became the first director of the FHFA. On Sept. 4, 2008, Lockhart published a "notice of establishment" in the Federal Register, announcing the FHFA was operational. Three days later, Lockhart announced that the agency seized Fannie Mae and Freddie Mac and placed them in federal conservatorship.

Lockhart stayed at the FHFA helm until August 2009, when he announced he was leaving the office. On Aug. 25, 2009, President Obama named DeMarco acting director. DeMarco was previously the agency's chief operating officer and senior deputy director for housing mission and goals.

However, the president did not propose a successor to Lockhart until November 2010, when he offered the position to North Carolina Commissioner of the Banks Joseph A. Smith Jr. Smith's candidacy was cleared by the Senate Banking Committee, but Sen. Richard Shelby, R-N.C., put a "hold" on Smith's nomination, calling him a "tool of the Obama administration." The Senate adjourned without voting on Smith, who withdrew his candidacy.

To date, the Obama administration has not put forward another candidate to serve as FHFA director. The administration has never publicly stated why it has waited so long to fill Lockhart's vacancy, although industry experts have their suspicions.

"I can imagine many people turning down that job offer," says Dr. Linda M. Hooks, professor of economics at Washington and Lee University in Lexington, Va. "It is a daunting job with such a huge presence. One mistake could mess things up."

"It has probably got to be the most complicated job - dealing with the recovery and reforming the GSEs," adds Ruth Lee, executive vice president of Denver-based Titan Lenders Corp. "Who wants to take that job anyway?"

Kittle expresses concern that the agency is approaching its third year without a formal director.

"When you're an interim anything, I don't think anyone really feels comfortable," he says. "It is something that should have been addressed. DeMarco has done a good job, but this is his third year as acting director. It is a total letdown for him and for us."

However, Alberta Hultman, executive director and CEO of Orange, Calif.-based USFN, notes that the absence of a formal director does not mean that the agency is running at half speed.

"It has not been a problem," she says. "We wouldn't be picking up the phone and calling DeMarco, anyway. We deal with people within the FHFA that work on issues that are important to us."

And no one considers DeMarco to be doing a part-time job.

"DeMarco is doing everything he's supposed to be doing without the official title," says Les Kramsky, general counsel to The Money Store and a real estate attorney based in Florham Park, N.J.

Change of PACE

In any event, DeMarco has made a significant impact on the housing finance market, and some of his decisions during the last two years have reverberated into political controversy.

In July 2010, for example, the FHFA stated that the nation's energy retrofit loan programs, specifically those denominated as Property Assessed Clean Energy (PACE), posed safety and soundness concerns for Fannie Mae, Freddie Mac and the Federal Home Loan Banks, because the first liens established by PACE loans generated significant risk management challenges for lenders, servicers and securities investors. The FHFA decision effectively halted the PACE program, which had been gaining popularity across the country.

The FHFA's decision embarrassed the Obama administration, which had made green energy a keystone of its domestic economic policy. According to The New York Times, the U.S. Department of Energy (DOE) unsuccessfully tried to change the FHFA's decision by offering a two-year reserve fund to guarantee against PACE-induced losses.

The FHFA and the GSEs were subsequently sued by then-California Attorney General Jerry Brown, who alleged that the federal entities violated California laws by interfering with municipal programs that allowed homeowners to finance energy retrofits through property taxes - a key component of the PACE program. In August 2011, the U.S. District Court for the Northern District of California ruled that the FHFA violated the Administrative Procedure Act in its decision to force the GSEs not to purchase residential mortgages with PACE assessments.

On Jan. 26, 2012, the FHFA published an advanced notice of proposed rulemaking in the Federal Register relating to mortgage assets affected by the PACE programs. The comment period concluded on March 26. Last month, the FHFA issued a notice of proposed rulemaking that would prevent Fannie Mae and Freddie Mac from purchasing loans that are subject to liens under the PACE program.

Within the industry, however, DeMarco's action was viewed positively.

"That was very controversial," recalls Joey McDuffee, head of sales and marketing at

Wipro Gallagher Solutions, based in Franklin, Tenn. "But from the FHFA's perspective, they needed to take a step backward because of the lien position. The agency went back to its original mandate. It was a necessary decision, no matter how unpopular."

"Adding senior liens to property during times that prices and values are soft and the portfolio is burdened with negative equity is a serious reason to reconsider [the PACE program's] employment," says Richard Rydstrom, chairman of the Coalition for Mortgage Industry Solutions. "As a stand-alone decision, it may - at this time - pose substantial concerns. But as part of a comprehensive solution at another point in time, it could be a solution."

Bonus brouhaha

Last fall, DeMarco found himself at the center of another political storm when news reports revealed that 10 GSE executives were slated to receive nearly $13 million in bonuses. A bipartisan group of 60 senators, noting that the GSEs were still losing billions of dollars, demanded an explanation from DeMarco.

In testimony delivered before the U.S. Senate Committee on Banking, Housing and Urban Affairs, DeMarco defended the GSE compensation structure, stating that it was incorrect to assume qualified GSE leadership could be achieved by paying modest salaries.

"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," DeMarco said. "I have serious doubts about taking this approach to the management of the enterprises.

"By working at Fannie Mae or Freddie Mac," he added, "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."

The backlash, however, was swift and harsh. Rep. Darrell Issa, R-Calif., the committee chairman, issued a report entitled "Government-Sponsored Moguls: Executive Compensation at Fannie Mae and Freddie Mac," which said the GSE executive salary structure was created in comparison to compensation policies at profitable private-sector corporations and not federal regulatory agencies. The report also noted that the GSEs are guaranteed financial rewards, even though Fannie Mae and Freddie Mac continue to register billions of dollars in losses.

In March, DeMarco did an about-face and announced a new GSE executive pay program that caps chief executives' salaries at $500,000 and eliminates bonuses.

"I believe the new compensation program strikes the balance between prudent executive pay, including the elimination of bonuses, with the need to safeguard quality staffing in order to protect the taxpayers' investment and achieve the objectives in the conservatorship scorecard," he said. "A sudden and sharp change in pay from these levels would certainly risk a substantial exodus of talent - the best [executives] leaving first, in many instances. A significant increase in safety and soundness risks and in costly operational failures would, in my opinion, be highly likely."

In May, the FHFA reversed itself again by approving a $600,000 salary for the new Freddie Mac CEO, Donald H. Layton - $100,000 above the previously announced salary cap. No public explanation was provided for this policy switch.

Jordan Brown, CEO of Ponte Vedra Beach, Fla.-based MarketWise Advisors LLC, believes that DeMarco found himself in an impossible situation on this issue.

"I think it is tough to defend extraordinary compensation packages for executives running a government entity where the taxpayers have had to pay multibillion-dollar bills under their watch," he says. "I understand that pay needs to be competitive. There is a balance between private- and public-sector compensation that needs to be struck. The GSEs now find themselves part of the public-sector domain, so their executives should be subject to scrutiny and be in line with other top department heads of public-sector agencies."

John Walsh, president of Total Mortgage Services in Milford, Conn., is supportive of the logic behind DeMarco's initial position.

"You get what you pay for," he says. "If the GSE executives go into the private sector, they may lose some qualified people. They need the best people for the job, and typically, the best people want to be compensated fairly."

But Matthew C. Clark, chief operating officer at Brentwood, Tenn.-based Churchill Mortgage Corp., is somewhat less sympathetic.

"This is like any other business," he says. "When companies do well and make a lot of money, executives deserve good compensations. When companies are run poorly and lose money, the executives don't deserve to make a lot of money."

Cut the principal?

DeMarco has also been at the center of another political storm: the question of mortgage principal reduction for loans owned by the GSEs.

"If you do principal forgiveness, who is it benefiting?" DeMarco asked in his Financial Times interview. "Doing principal forgiveness is what would protect the big banks."

Congressional Democrats have been critical of DeMarco's stance.

"Even though commercial banks have implemented their own principal-reduction programs, FHFA stubbornly continues to favor massive waves of foreclosures," said Rep. Elijah Cummings, D-Md., ranking minority member of the House Oversight Committee. "It's high time to see the actual data and analyses behind this policy, and to work toward new approaches that finally put American homeowners and our nation's economy first."

"He's been too rigid in refusing to help on foreclosures," said Rep. Barney Frank, D-Mass., ranking member of the House Financial Services Committee. "He's acting as if he was head of two private companies called Fannie and Freddie and not taking into account the impact this has on the economy, and I think he should be more cooperative with efforts to reduce foreclosures."

Frank went further, stating it would be no great loss if DeMarco were removed from office. When asked by a reporter if DeMarco should be fired, Frank said, "Since he won't be more flexible, yes."

But in an April 4 speech before the Boston Security Analysts Society, DeMarco suggested that he might change his mind about principal reductions. He cited recent Treasury Department changes to the Home Affordable Modification Program (HAMP) regarding principal forgiveness, and stated that he was re-evaluating the situation and was expected to make a decision by the end of April. However, the FHFA later announced that it was putting its final decision on indefinite hold - to date, there has been no ruling on the matter.

Among industry experts, DeMarco's initial reluctance to follow that strategy gets mixed feedback. Rydstrom questions the FHFA's unwillingness to consider the option.

"The FHFA has a safety and soundness duty to define the problem and available solutions comprehensively," he says. "There is no justification for not considering all available solutions, including principal-reduction techniques - in conjunction with other solutions - to maximize the performance of the national mortgage portfolio, for the purpose to stabilize housing finance and mitigate overall taxpayer losses or interests.

"That analysis cannot be limited to whether or not one solution (principal reduction) will cause a loss of taxpayer money," Rydstrom continues. "Safety and soundness of the mortgage industry cannot be determined one issue or solution at a time - to oversimplify the principal-reduction analysis with reliance on the moral hazard and taxpayer loss arguments is simply no longer acceptable."

IMARC's Kittle is somewhat more cautious to the subject.

"Price reductions should be on a case-by-case, not broad-based," he says. "It should be decided by the lender, servicer and investor.

Other industry experts are more supportive of DeMarco's reluctance.

"This conjures up some form of the moral-hazard issue," says Bob Dorsa, president of the American Credit Union Mortgage Association. "I would hate to think that we would put homeowners up against each other because someone got their principal reduced. People would believe that others got preferential treatment because they stopped making their mortgage payment."

"Principal reduction represents a fundamental change to the legal structure of the mortgage market," warns Washington and Lee University's Hooks. "It could have long -term repercussions."

"Principal reduction will help very few people," says Adam Leitman Bailey, a New York -based real estate attorney and law professor at New York University. "It will help the president, but it will not help the economy. Most programs since 2008 have not helped in any way, except to assist underwater borrowers who cannot afford homes."

The next act

As for the near future, the proverbial 800-pound gorilla in the room is GSE reform. Although tasked with winding down the GSEs, the FHFA did not seem to make the question of reform a priority. In fact, DeMarco did not publicly present the agency's plan for the future of Fannie Mae and Freddie Mac until Feb. 21.

Under the FHFA's plan, a "mortgage market of the future" would include a centralized securitization platform backed by national standards for mortgage securitization, a standardized pooling and servicing agreement, data transparency for investors, unambiguous servicing requirements, and a competitive servicing compensation structure. In tandem, credit risk would shift from Fannie Mae and Freddie Mac to private investors.

The catch: Don't expect things to happen quickly. DeMarco, in presenting the agency’s plan, acknowledged that there was "no near-term resolution in sight." DeMarco was also vague about whether the current GSEs would still exist, or if a new entity would succeed them.

"Achieving these strategic goals will fulfill the legal requirements Congress assigned FHFA as conservator and also prepare the foundation for a new, stronger housing finance system," the DeMarco plan said. "That future may not include Fannie Mae and Freddie Mac, at least as they are known today."

Also missing is the private-label secondary market, which has not returned to anything even vaguely resembling its pre-recession prominence.

"If the economy changes and we get rid of Fannie and Freddie, who comes to the rescue?" asks Ralph Sells, president and CEO of eMortgage Logic in Fort Worth, Texas, and a former Freddie Mac director. "I struggle with the idea of people saying, 'Get rid of Fannie and Freddie.' But there is no secondary market to take over for them. It would take a minimum of three to five years for the FHFA to wind down the GSEs, and a lot of economic events need to occur first in order to make that happen."

Titan Lenders' Lee is concerned about continuing the current housing finance market schematic.

"The FHFA is trying to create a healthy and robust securitization market where there is none," she says. "And no one is stepping up to the plate, which makes the GSEs more of a placeholder instead of moving the market back to where it needs to be."

"Fannie and Freddie will be replaced at some point," says Total Mortgage Services’ Walsh. "But it is easier said than done. I don’t see this as a short-term goal - it will take a long time to replace what Fannie and Freddie do for the mortgage market."

For Carrington Mortgage Holdings' Sharga, the problem is that the current focus is only on the short term.

"It is still not clear what FHFA has for a long-term plan, other than a vague plan of bringing capital back into the market," he says.

Yet eMortgage Logic's Sells wonders if too much pressure is being dumped on the FHFA to lead the way.

"The FHFA is not the be-all/end-all," he says. "It does not have all the answers. I think they're just as confused as anyone else in the industry. They are in almost an unfair and unenviable position."

Phil Hall is editor of MortgageOrb. He can be reached at hallp@mortgageorb.com.

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