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ONE HUNDRED TENTH CONGRESS

Congress of the United States

House of Representatives

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
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MEMORANDUM

March 6, 2008

To: **Republican Members of the Committee on Oversight and Government Reform**

Fr: **Minority Staff, Committee on Oversight and Government Reform**

Re: **Full Committee Hearing on Executive Compensation II: CEO Pay and the Mortgage Crisis**

OVERVIEW

On Friday, March 7, the Full Committee will hold the second in a series of hearings critical of executive compensation at public companies. At the first such hearing last December, the Majority alleged executive compensation consultants suffered from a conflict of interest – how could they objectively assess executive compensation if they sought to do other business with the company? For a detailed response to the majority's analysis, please review the Minority rebuttal document available online: http://republicans.oversight.house.gov/Media/PDFs/20071205staffresponse.pdf.

Friday's hearing takes a slightly different approach. It criticizes the compensation/ retirement packages of certain chief executive officers (CEOs) solely because their organizations were involved in the mortgage market, which has suffered serious hardship since the housing bubble burst of 2006. No one disputes the housing market is undergoing a significant correction or that many Americans have suffered from either foreclosure or depressed home values. But this doesn't mean executives in the industry have been inappropriately or excessively compensated. Was their compensation not determined through an arms-length negotiation? Was it not approved by a board of directors with interests beyond whether the CEO can make his yacht payments?

To demonstrate the extent of the logical fallacies committed by the majority, one must understand the complex nature of the events leading up to the subprime crisis and the bursting of the housing bubble. To assess blame to any one actor or factor, without examining the actions and incentives of all parties involved, is at least haphazard and quite possibly irresponsible.

In this case, as the minority will demonstrate, each of the companies involved here have an executive compensation policy designed to align compensation of top executives with the interests of shareholders. And given that all the CEOs involved have – or soon will be – ousted from their positions, it's hard to argue they are not being held accountable for their actions and salaries by the corporate boards and shareholders they serve. Contrary to allegations from the Majority, none walk away with golden parachute severance packages.[1]

Finally, Congress must continue to recognize competitive marketplaces function most efficiently when government stays out of the way. When market failures occur, government must act prudently and on the basis of the best information available. In December 2006, the SEC issued new disclosure rules for executive compensation, and public companies have complied.[2] Information from these disclosures – not overheated political rhetoric – should guide discussion on any further regulation of CEO pay.

PRIMER ON THE HOUSING MARKET, AS IT RELATES TO THE SUBPRIME CRISIS

The Evolution of the Modern Mortgage Market

Homebuyers apply for mortgages from primary market lenders, such as banks, thrifts, mortgage companies, credit unions and online lenders. Primary lenders evaluate borrowers' ability to repay the mortgage, based on information borrowers provide, then set repayment terms accordingly. A home purchase culminates with the "closing," where the lender agrees to fund the purchase, and the borrower agrees to pay the mortgage according to the negotiated terms. After the closing, the primary lender may hold the mortgage in its loan portfolio or sell it in the secondary mortgage market. If the primary lender sells the mortgage, it can use the proceeds to make loans to other homebuyers.

Before the 1980s, the vast majority of home loans were made by savings and loans, which originated, serviced and held these loans in their individual portfolios. Concentration of these functions meant these institutions bore all the risks associated with loan defaults. Moreover, lenders couldn't offer loans beyond funds actually in reserve.[3]

[1] Erin White, *Lavishly Rewarded Trio Faces an Embarrassing Day*, WALL ST. J., Feb. 23, 2008 (noting that neither O'Neal nor Prince will receive any severance and Mr. Mozilo has agreed to give up $37.5 million in post retirement severance, which he was entitled to collect under the terms of his employment contract.)
[2] http://www.sec.gov/answers/execomp.htm
[3] The concentration of 30 year fixed rate mortgages in the S&L's, and the subsequent mismatch of long-term fixed rate risk and short-term variable rate funding, led to the insolvency of thousands of S&L's in the

For decades, the home ownership rate in the United States hovered around 64 percent. But beginning in the 1970s, the Federal Home Loan Mortgage Corporation (Freddie Mac) the Federal National Mortgage Association (Fannie Mae) and the Government National Mortgage Association (Ginnie Mae) – collectively known as Government-Sponsored Enterprises or GSEs – began to securitize mortgages. The securitization of mortgages meant savings and loans, and other lenders, no longer had to hold on to the mortgages and the risk associated with default. Investment in the MBSs not only provided more capital for more loans to more homebuyers, it helped financial institutions meet the requirements of the Community Reinvestment Act ('CRA'), which requires lenders to provide credit, including home-ownership opportunities, to underserved populations.[4]

Securitization of Mortgages

After the primary transactions have occurred between borrower and lender, GSEs buy mortgages that meet their underwriting and product standards, package the loans into securities and sell the securities to Wall Street. GSEs use their resources to buy these financial instruments, known as Mortgage Backed Securities ('MBS'), and guarantee timely payment of principal and interest to investors, who purchase the right to receive a share of the payments on the underlying mortgages. Investors, in turn, accept lower yields because of the agency guarantees. Non-agency mortgage-backed securities must pay a much higher rate to compensate for the increased risk. Non conforming loans, such as jumbo loans, Alt.A and Subprime loans, usually are bundled by private entities, such as investment banks.

Since investors in both situations were removed from the lending and servicing process, they relied on credit agencies (e.g. Moody's and S&P) to accurately assess the quality of these securities. The credit rating attributed to MBSs was a significant factor in determining the quality of the investment.

The concept was popular. Shared risk meant less risk attached to individual loans and more capital available for new loans.[5] In 2000, the Federal Reserve Bank of New York praised securitization of mortgages thusly:

> *"The securitization of CRA mortgages now provides liquidity to the originating banks and signifies a new level of maturity in the affordable mortgage industry. As CRA portfolios have aged, lenders have quantified risks and identified some*

1980's. Because of the risk 30 year fixed-rate mortgages pose, without securitization they would not be widely available today.

[4] See, *A Message From the Community Affairs Officer*, BANK LINKS, FEDERAL RESERVE BANK OF NEW YORK, Winter 2000, http://www.newyorkfed.org/regional/commdev/Blinkswinter2000.pdf (stating that the product offered by Bear Stearns makes non-conforming CRA loans more liquid, making flexible and innovative mortgage products more attractive to lenders.")

[5] Press Release, Wachovia, First Union Capital Markets Corp, Bear Stearns Price Securities Offering Backed by Affordable Mortgages (Oct. 20, 1997), http://www.wachovia.com/inside/page/printer/0,,134_307%5E306,00.html (stating that, "the securitization of these affordable mortgages allows us to redeploy capital back into our communities and to expand our ability to provide credit to low and moderate income individuals.")

> *unique payment characteristics that enhance the value of the portfolios. One attractive characteristic has been low pre-payment rates associated with low and moderate income ('LMI') borrowers, who appear to be more payment-sensitive than rate-sensitive. As a result, broad concerns about the unknown risks of mortgage loans in LMI communities have given way to technical discussions about how securities backed by these mortgages can take advantage of their unique characteristics while mitigating recently quantified risks...<u>These transactions provide liquidity and increase the market's appetite for mortgages originated in LMI areas and to LMI consumers."</u>*

With more money available for loans and risks diversified, credit became more readily available and home ownership rates shot up 5 percent to a peak of 69.2 percent in 2004, then leveled off at slightly more than 68 percent.

Growth in Subprime Lending

According to Investopedia a subprime loan is "*A type of loan that is offered at a rate above prime to individuals who do not qualify for prime-rate loans. Quite often, subprime borrowers are turned away from traditional lenders because of their low credit ratings or other factors that suggest they have a reasonable chance of defaulting on the debt repayment.*"[6]

Subprime mortgage loans took off in 1995, rising from less than 5 percent of total originations in 1994 to more than 20 percent in 2006.[7] The share of subprime originations packaged into MBSs grew from 31.6 percent to 80.5 percent. Increased securitization meant the majority of subprime loans and their risk of default were not held by lenders. Yet, the wide use of credit scores for borrowers and credit ratings for bundled securities led investors to believe risks associated with the loans could be accurately assessed and priced.[8]

It seems obvious now the actual risk of these securities was not accurately assessed and the loans weren't accurately priced. Moreover, as housing prices continued to rise, borrowers and lenders worried even less about the ability to repay because they assumed they could sell the house for enough profit to cover all debts. For a long time, these assumptions seemed reasonable. Even bankers bought in. According to a publication by the Federal Reserve Bank of Dallas, "*Favorable home-price and interest rate developments likely led models that were overly focused on unemployment as a driver of problem loans to underestimate the risk of no- prime mortgages.*"[9]

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[6] http://www.investopedia.com/terms/s/subprimeloan.asp

[7] JAMES R. BARTH ET AL., PERSPECTIVES ON THE SUBPRIME MARKET 3 (Milken Institute 2008).

[8] The relatively low rate of return on the 10 year Treasury note, app. 4% in 2003, until rising to 4.8% in 2006, made investors hungry for higher yields. This demand was in large part met by subprime loans bundled into MBS.

[9] Danielle DiMartino and John V. Duca, *The Rise and Fall of Subprime Mortgages*, 4 Economic Letter, INSIGHTS FROM THE FEDERAL RESERVE BANK OF DALLAS, 2007.

Adjustable Rate Mortgages

Adjustable-rate mortgages (ARMs), another market innovation, allows lenders to adjust interest rates to reflect market conditions – shifting some risk to borrowers but making more credit available to low- and middle-income customers. ARMs accounted for 5 percent of the market in 1980 but had climbed to 64 percent of the market by 2006.[10] Many of these customers purchased 2/28s or 3/27s, also known as hybrid loans. With these loans, borrowers enjoyed a low introductory rate – lower than they would've received with a fixed-rate mortgage – on the assumption that when the "teaser" period expired and the rate went up, they would have improved their credit score sufficiently to qualify for a prime or fixed-rate loan or to refinance at a lower rate.

Alan Greenspan, then chairman of the Fed, said in February 2004 that ARMs had saved homeowners "tens of thousands of dollars over the past decade," that ARMs were much more common elsewhere in the world that the mortgage industry should create more such options. "The traditional fixed-rate mortgage may be an expensive method of financing a home," he said.[11]

Predictably, ARMs made more inroads in the sub-prime market than elsewhere. For prime borrowers between 1999 and 2007, 84 percent of mortgages were fixed-rates loans, 10 percent adjustable, and less than 5 percent hybrid. In the sub-prime market, fixed-rate loans accounted for 44 percent, adjustable for 16 percent and hybrid for 32 percent.

Collateralized Debt Obligations (CDOs)

Another factor in this is the development of collateralized debt obligations (CDOs). CDOs are derivative of mortgage-backed securities. They divide the streams of income owed under the MBS into tranches that absorb default losses according to a preset priority.[12] Usually, the lowest-rated tranche holds the highest risk of default, and the highest-rated tranche risked default only if losses were much greater than expected. Again, the market and investors had confidence risks were accurately assessed and priced.

The Bursting of the Subprime Bubble

Between 2004 and 2006, the Federal Reserve raised interest rates 17 times, chilling what had been an overheated housing market and leading, finally, to a reduction in home sales. This led to declines in home prices, which led lenders to tighten underwriting standards, which made refinancing difficult for troubled borrowers. These factors, in turn, led to increases in mortgage defaults, which led investors to realize they had purchased subprime MBSs with overly optimistic expectations. By June 2007, Moody's had cut the ratings of 131 securities backed by subprime mortgages and announced it was reviewing the grades of 136 others.[13] As the summer went on, several mortgage lenders who

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[10] Office of Thrift Supervision, 2006 Factbook: A statistical Profile of the Thrift Industry, June 2007 (note, these numbers are only

[11] Christopher Palmeri, *Homebuyers:ARMed and Dangerous?,* BUS. WK., April 12, 200, available at http://www.businessweek.com/magazine/content/04_15/b3878093_mz020.htm.

[12] DiMartino, *supra* note 9 at 3.

[13] *CSI: Credit Crunch, Central Banks Have Played a Starring Role,* THE ECONOMIST, Oct. 18, 2007 available at http://www.economist.com/specialreports/displaystory.cfm?story_id=9972489.

specialized in subprime loans filed for bankruptcy, and two hedge funds run by Bear Stearns were found to have suffered huge losses on subprime-backed securities. All the bad news made such securities increasingly hard to value and harder still to borrow against or sell.[14]

The statistics cited in the Majority Memo regarding foreclosure rates appears to be accurate. But the memo fails to discuss other important factors that remain highly correlated to high default and foreclosure rates. Trends in a region's housing values and local economy remain the best predictors of foreclosure rates. According to the chief economist of Freddie Mac, delinquency rates have jumped in markets with flat or falling house values. Florida, California, Nevada, Wisconsin, Maine and Massachusetts have high default rates, jumping by an average of 6 percent to 8 percent in the third quarter of 2007. Nationally, the rate of serious delinquencies averaged 4.6 percent. Poor employment growth also leads to high foreclosure rates. Michigan and Ohio had negative employment growth between November 2006 and November 2007, and both states suffer some of the nation's highest foreclosure rates.

<u>Summary</u>
It is unfortunate the Majority choose not to delve into the intricacies of the housing market before it elected to blame the housing market's problems on CEO salaries. As the above analysis clearly demonstrates, the mortgage market is extremely complex, and multiple actors believed these financial products were not only good investments, but also useful tools to expand home ownership opportunities to populations with lower credit scores and/or lower income. Even the federal government played a role in encouraging the development of these markets. Participants nearly universally encouraged the expansion and investment of innovative financing arrangements, which included subprime loans and the securitization of loans. Accordingly, it is inappropriate to conclude that participants in the mortgage industry acted contrary to the interest of the public and their shareholders simply because they were an actor in the subprime market.

<u>Executive Compensation</u>

The following is a brief overview of executive compensation practices of Merrill Lynch, Citigroup, and Countywide.

<u>Merrill Lynch</u>

Merrill Lunch submits its executive compensation policy is designed to align the long-term interests of the CEO with that of shareholders and to retain the best talent. Merrill Lynch points towards the following facts as evidence on this alignment:

- Senior executives at Merrill Lynch are required to maintain ownership of at least 75 percent of all stock awarded during their tenure, even if the shares have vested.
    - More than 80 percent of CEO Stan O'Neal's compensation resulted from merit-based bonuses.

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[14] *Id.*

- Stan O'Neal did not have an employment contract with the company, so the company was not contractually bound to offer him a severance payment upon his retirement.
  - On Oct. 30, 2007, Stan O'Neal announced his intention to retire and the board accepted his resignation.
  - Mr. O'Neal did not receive a severance payment.
  - Mr. O'Neal did not receive any bonus for his performance in 2007.
  - Mr. O'Neal did receive retirement based on retirement eligibility prior to his resignation.

- Merrill Lynch requires all members of the Compensation Committee to be independent directors. The compensation committee also retains an independent compensation consultant.
  - The Committee retains John England from Towers Perrin. Although Towers Perrin does other business with Merrill Lynch, the Compensation Committee is aware of all potential conflicts of interest and has been satisfied with the consultant's independence.

Citigroup

Citigroup claims its executive compensation policy is designed to compensate executives for demonstrable performance; in alignment with shareholders' long-term best interest. Citigroup points towards the following facts as evidence on the design:

- Charles Prince did not have an employment contract with Citigroup.
- Mr. Prince's salary was capped at $1 million, and most of his compensation came from incentive awards that linked pay with performance.
- At least 40 percent of awards came in the form of equity, which is either restricted or deferred stock that vests over the course of four years.
- All executives are required to retain at least 75 percent of equity awarded to them as long as Citi employs them.
- Compensation Committee is comprised entirely of independent directors, and the committee retains an independent compensation consultant, (Independent Compensation Consultant, LLP) who is not engaged by Citigroup in any other capacity.

Countrywide

Countrywide says its executive compensation policy is intended to enhance the interest of stockholders by attracting the highest level of executive talent, encouraging executives to remain with the company, rewarding financial and individual performance and aligning the interest of executives with those of stockholders. Countrywide points towards the following facts as evidence on the design:
- Executive Compensation is designed to use cash- and equity-based incentives that link executive compensation to the company's short- and long term performance.

- Compensation is strong enough to attract and keep the top talent needed to grow the company.
- CEO Angelo Mozilo's compensation is comprised of a base salary and a performance-based bonus tied to earnings per share. The performance-based compensation was approved by a vote of Countrywide's shareholders on two separate occasions.
- The Compensation Committee consists entirely of independent directors, who have the authority to retain the services of an outside consultant.
    - In 2006, the committee terminated it relationship with Hewitt Associates because it was engaged in other business with the company. The Committee has engaged Exequity to provide advice to the Committee on all matters relating to executive compensation.
- Mr. Mozilo voluntarily agreed to give up $37.5 million in cash severance payments, consulting fees and other perquisites that he was owed under the terms of his contract with Countrywide.
- Any remaining payments to Mr. Mozilo upon completion of the Bank of America merger and his retirement as CEO consist of deferred compensation earned in prior years and pension payments earned over nearly 40 years of service.

Minority Witness

The Minority has invited economist Anthony Yezer, Professor of Economics at George Washington University, to serve as an expert witness on issues relating to the Subprime Mortgage crisis. Professor Yezer is not an expert on issues relating to executive compensation.

If you have any questions regarding this hearing, please contact Kristina Moore or Larry Brady at x5-5074.