CEO PAY AND THE MORTGAGE CRISIS

HEARING

BEFORE THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

MARCH 7, 2008

Serial No. 110–81

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CEO PAY AND THE MORTGAGE CRISIS

FRIDAY, MARCH 7, 2008

HOUSE OF REPRESENTATIVES,
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
Washington, DC.

The committee met, pursuant to notice, at 10:06 a.m., in room 2154, Longworth House Office Building, Hon. Henry A. Waxman (chairman of the committee) presiding.

Present: Representatives Waxman, Towns, Kanjorski, Cummings, Yarmuth, Norton, Welch, Davis of Virginia, Cannon, Issa, McHenry, and Bilbray.

Staff present: Phil Schiliro, chief of staff; Kristin Amerling, general counsel; Karen Lightfoot, communications director and senior policy advisor; David Rapallo, chief investigative counsel; Roger Sherman, deputy chief counsel; David Leviss, senior investigative counsel; Velvet Johnson, counsel; Earley Green, chief clerk; Teresa Coufal, deputy clerk; Caren Auchman and Ella Hoffman, press assistants; Zhongrui "JR" Deng, chief information officer; Leneal Scott, information systems manager; Kerry Gutknecht and William Ragland, staff assistants; Matt Seigler, investigator; Allison Cassady, professional staff member; Larry Halloran, minority staff director; Jennifer Safavian, minority chief counsel for oversight and investigations; Keith Ausbrook, minority general counsel; Kristina Moore, minority counsel; John Cuaderes and Larry Brady, minority senior investigator and policy advisor; Patrick Lyden, minority parliamentarian and member services coordinator; Brian McNicoll, minority communications director; Benjamin Chance, minority clerk; and Ali Ahmad, minority deputy press secretary.

Chairman WAXMAN. The meeting of the committee will please come to order.

Today the committee is holding its second hearing on executive compensation. Our subject is the compensation of executives who preside over billion-dollar losses.

There seem to be two different economic realities operating in our country today, and the rules of compensation in one world are completely different from those in the other. Most Americans live in a world where economic security is precarious and there are real economic consequences for failure. But our Nation's top executives seem to live by a different set of rules.

There is no better way to understand these two worlds than to look at real examples. Last year, Circuit City cut costs by arbitrarily firing its most successful retail sales employees. Any employer and any employee in computer sales who was earning more than $16 per hour was fired. It didn't make any difference that some of

the employees had years of service and a superb performance record. This was their firsthand lesson in market forces. Every fired employee was then given a chance to reapply for their jobs at lower pay. Those, unfortunately, are often the rules for typical employees: They can work hard, be loyal and do everything right and still lose ground.

The world for executives is quite a bit different. Last year, one of our Nation's highest-paid executives was Ray Irani, chief executive officer of Occidental Petroleum. His total compensation was more than $320 million, which roughly comes out to $154,000 an hour.

By any measure, executive pay is rising rapidly and dramatically. The CEOs of the 500 largest American companies received an average of $15 million each in the year 2006, and that was a 38 percent increase in just 1 year. In 1980, CEOs were paid 40 times the average worker; today they are paid 600 times more. And incredibly, 10 percent of corporate profits are now flowing to the top executives.

Now, at first blush, it is hard to reconcile $154,000 an hour with $16 an hour, but CEOs and salesmen have different roles. And the argument, as I understand it, is that a CEO who adds value to the company and its shareholders is worth every penny. I think there is merit to pay for performance. But it seems like CEOs hit the lottery when their companies collapse. As the financial columnist Allan Sloan put it, "Even if you flame out in Wall Street, you still get to keep the money."

Today's hearing will examine this issue. The question we will ask is a simple one: When companies fail to perform, should they give millions of dollars to their senior executives?

Our particular focus is the debacle with subprime mortgages. The mortgage crisis and credit crunch is devastating to both homeowners and our Nation's economy. Over 7 percent of all mortgages are delinquent or in foreclosure—the highest rate ever recorded. Almost 9 million families now owe more on their mortgages than their homes are worth.

Banks in the United States have written off more than $120 billion in assets, mortgage companies have gone under or are on the brink, yet thousands of Americans have lost their jobs and their homes, and the economic spillover is being felt throughout the world.

Three companies that gambled heavily on the subprime bet are Countrywide Financial Corp., Merrill Lynch and Citigroup. And I want to thank the chairs of their Compensation Committees and their CEOs for being here today and for their cooperation.

All three companies have suffered enormous losses. Countrywide lost $1.6 billion in 2007, and its stock lost 80 percent of its value. Merrill Lynch lost $10 billion, and its stock lost 45 percent of its value. Citigroup also lost $10 billion, and its stock lost 48 percent of its value.

In light of that terrible performance, the CEOs of Merrill Lynch and Citigroup resigned last year. Mr. Mozilo, the CEO of Countrywide, is also making plans to step down if Countrywide is acquired by Bank of America.

But the pay they received from their companies and their stock sales was extraordinary. Any reasonable relation between their compensation and the interests of their shareholders appears to have been broken down.

Mr. O'Neal left Merrill Lynch with a $161 million retirement package. Mr. Prince was awarded a $10 million bonus, $28 million in unvested stock options and $1.5 million in annual perquisites when he left Citigroup. And Mr. Mozilo received over $120 million in compensation in sales of Countrywide stock.

Well, the obvious question is, how can a few executives do so well when their companies are doing so poorly?

Mr. Mozilo, Mr. O'Neal and Mr. Prince are each classic American success stories. Mr. Prince was the first in his family to go to college. Mr. Mozilo started his company sitting at a kitchen table in a small New York City apartment. And Mr. O'Neal's grandfather was born into slavery, and his parents worked several jobs at once to give their children the American dream. Mr. O'Neal himself worked his way through college by working at a General Motors plant.

Each of these men achieved incredible success through hard work and ability, and each was richly compensated when their companies prospered. And on behalf of this committee, I want to commend them and thank them for their many contributions to our country.

The questions we ask today are not in any way intended to disparage their records. But what we are trying to understand is fundamental to our Nation's values, and it is also of central importance to the effective functioning of business and our economy.

Are the extraordinary compensation packages these CEOs receive reasonable compensation? Or does the hundreds of millions of dollars they were given represent a complete disconnect with reality?

This isn't a hearing about illegality or even unethical breaches. It is a hearing to examine how executives are compensated when their companies fail. And it is a hearing to help us understand whether the situation is good for the companies, the shareholders and for America.

The testimony today is something those Circuit City workers I spoke of a few minutes ago would be interested in. It is something the millions of Americans who are going through the pain of foreclosure of their homes would be interested in. And it is something every Member of Congress should also be interested in.

I want to now recognize Mr. Davis for an opening statement.

[The prepared statement of Chairman Henry A. Waxman follows:]

Opening Statement of Rep. Henry A. Waxman
Committee on Oversight and Government Reform
Executive Compensation II: CEO Pay and the Mortgage Crisis
March 7, 2008

Good morning. Today the Committee is holding its second hearing on executive compensation. Our subject is the compensation of executives who preside over billion-dollar losses.

There seem to be two different economic realities operating in our country today. And the rules of compensation in one world are completely different from those in the other. Most Americans live in a world where economic security is precarious and there are real economic consequences for failure. But our nation's top executives seem to live by a different set of rules.

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The testimony today is something those Circuit City workers I spoke about a few minutes ago will be interested in. It's something the millions of Americans who are going through the pain of foreclosure will be interested in. And I think it's something every member of Congress should be interested in.

Mr. DAVIS OF VIRGINIA. Thank you, Mr. Chairman.

When asking questions about corporate governance, executive pay and the performance of national financial markets, this committee should proceed very cautiously. Shareholders have the most direct stake in these issues. Ours, at best, is a derivative and potentially damaging role in the discussion of complex transactions, proprietary business decisions and marketplace dynamics. The last thing union pension funds and other investors want is Congress second-guessing and micromanaging the people looking after their money.

That said, there is no dispute the housing market is undergoing a significant contraction, and many Americans are suffering the combined hardships of foreclosure and depressed home values. Causes of the unfolding credit crisis involve an intricate web of actions: incentives and assumptions by lenders, mortgage brokers, fund managers, credit rating agencies and many others.

In that long chain of causation, the impact of corporate executive compensation is debatable. And that appears to be at least part of the debate we will have today. Fine. But that debate should not degenerate into a sanctimonious search for scapegoats.

If every corporate executive of every company involved in subprime lending and securities had worked for the minimum wage or for nothing, the macroeconomic trends and cyclical forces that drive booms and busts could still vex our economy today. Punishing individual corporate executives with public floggings like this may be a politically satisfying ritual, like an island tribe sacrificing a virgin to a grumbling volcano. But, in the end, it won't answer the questions that need to be answered about corporate responsibility and economic stability.

Boards and shareholders have already begun to answer these questions for themselves. They have taken steps to assign responsibility and hold corporate managers accountable. CEOs have resigned. Potential payouts have been surrendered or reduced, and so-called golden parachutes trimmed. Investor groups are suing to recoup funds, alleging violations of regulatory and fiduciary duties.

It is in those forums that the sad story of the subprime industry should be litigated. We should never substitute our judgment for determination by those with real equities at stake, nor should we allow the committee to be used as a discovery tool for plaintiffs.

Our previous hearing on executive compensation consultants failed to find much evidence of the claimed conflicts or self-dealing that could distort salary and perk decisions to the detriment of stockholders. Today's attempt to wrap that unproven premise in the much larger subprime crisis only seems to muddle the issue further.

Subprime lending expanded mortgage loan availability to underserved groups, as Congress mandated. With the encouragement of regulators, innovative financial instruments increased liquidity and spread subprime risk across a broader range of supposedly savvy investors.

But almost everyone involved became entranced over time by the unsustainable promise of ever-rising home prices. We have seen this before. When the music stopped and real estate markets fell,

foreclosures escalated and holders of subprime-backed securities lost billions.

In that context, the case studies on corporate compensation the committee released yesterday have much more to do with changing market conditions, flawed economic assumptions and rosy risk assessments than with inappropriate compensation incentives. Remember, when viewed in the rear-view mirror, objects are closer than they appear.

At our request, one of the witnesses on today's first panel will describe the interrelated functions and dysfunctions in subprime markets. We appreciate his being included in this hearing.

Mr. Chairman, as the minority does not have a witness at the table who is an expert on questions on executives compensation, we would like to enter into the record a publication by the Business Roundtable explaining best practices on executive compensation.

Chairman WAXMAN. Without objection, that will be made part of the record.

[The information referred to follows:]

Business Roundtable™

Executive Compensation

Principles and Commentary

January 2007

Business Roundtable™

Business Roundtable (www.businessroundtable.org) is an association of chief executive officers of leading U.S. companies with $4.5 trillion in annual revenues and more than 10 million employees. Member companies comprise nearly a third of the total value of the U.S. stock market and represent over 40 percent of all corporate income taxes paid to the federal government. Collectively, they returned more than $112 billion in dividends to shareholders and the economy in 2005.

Roundtable companies give more than $7 billion a year in combined charitable contributions, representing nearly 60 percent of total corporate giving. They are technology innovation leaders, with $90 billion in annual research and development spending — nearly half of the total private R&D spending in the U.S.

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Executive Compensation

Principles and Commentary

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Principles of Executive Compensation

1. *Executive compensation should be closely aligned with the long-term interests of shareholders and with corporate goals and strategies. It should include significant performance-based criteria related to long-term shareholder value and should reflect upside potential and downside risk.*

2. *Compensation of the CEO and other top executives should be determined entirely by independent directors, either as a compensation committee or together with the other independent directors based on the committee's recommendations.*

3. *The compensation committee should understand all aspects of executive compensation and should review the maximum payout and all benefits under executive compensation arrangements. The compensation committee should understand the maximum payout and consequences under multiple scenarios, including retirement, termination with or without cause, and severance in connection with business combinations or sale of the business.*

4. *The compensation committee should require executives to build and maintain significant continuing equity investment in the corporation.*

5. *The compensation committee should have independent, experienced expertise available to provide advice on executive compensation arrangements and plans. The compensation committee should oversee consultants to ensure that they do not have conflicts that would limit their ability to provide independent advice.*

6. *The compensation committee should oversee its corporation's executive compensation programs to see that they are in compliance with applicable laws and regulations and aligned with best practices.*

7. *Corporations should provide complete, accurate, understandable and timely disclosure to shareholders concerning all elements of executive compensation and the factors underlying executive compensation policies and decisions.*

Introduction

Business Roundtable, an association of CEOs of 160 leading corporations, is committed to policies and actions that stimulate economic growth and foster investor confidence and public trust in businesses. Roundtable CEOs take seriously their responsibilities to improve corporate governance and promote the highest standards of accountability and ethical behavior.

Business Roundtable CEOs lead companies with more than $4.5 trillion in annual revenues and more than 10 million employees. Member companies comprise nearly a third of the total value of the U.S. stock market, collectively returned more than $110 billion in dividends to shareholders and the economy in 2005, and represent nearly a third of all corporate income taxes paid to the federal government. The CEOs advocate public policies that encourage economic growth in the United States and across the world and have been leaders in developing the well-trained and productive U.S. workforce essential for future competitiveness.

For the past three decades, compensation has played an increasingly significant role in attracting, retaining and motivating executive officers and employees at all levels. In March 1992, when Business Roundtable released *Executive Compensation/Share Ownership,* we noted the intense interest in compensation paid to corporate executives. The stock market boom of the late 1990s and the corporate failures in the early part of this decade have heightened the focus on executive compensation. Moreover, there has been a growing concern among investors and the public that pay has not always been commensurate with performance, with a perception that some executives have reaped substantial financial rewards even at times of declining stock prices and large losses to employees and shareholders. Roundtable CEOs share that concern and believe that executive compensation should be clearly linked to company performance.

Since the publication of our executive compensation principles, there has been continuing scrutiny of executive compensation and developments relating to compensation committees. Major securities markets have adopted listing standards that require compensation committees' or independent directors' oversight of executive compensation, along with prescribed minimum responsibilities for compensation committees.

Given the ongoing development of best practices in executive compensation, Business Roundtable is updating our principles of executive compensation. In addition, the Roundtable urges all corporations to make their compensation policies and practices as responsible and transparent as possible.

Compensation should serve the objectives of a corporation's business. Accordingly, the structure and components of an appropriate executive compensation program will vary widely among corporations due to such factors as a corporation's size, industry, competitive challenges and culture. Nevertheless, the executive compensation program of every publicly owned corporation should adhere to two fundamental characteristics. First, it should reflect the core principle of pay for results. Although this concept is not new, it means that a corporation's executive compensation program not only rewards success, but also incorporates a meaningful element of risk. Additionally, it should reflect the performance of the corporation, not just the stock market in general. Second, the executive compensation program of every publicly traded corporation should be established and overseen by a committee comprised solely of independent directors who, among other things, set the goals and objectives for executive compensation and determine whether those goals and objectives have been achieved. In doing so, compensation committees should be aware of all aspects of their corporation's executive compensation and see that the compensation arrangements are in the best interests of shareholders.

Building on these characteristics as a foundation, Business Roundtable has developed seven interrelated principles to serve as best practices for the design, implementation and oversight of executive compensation programs at publicly held corporations.

We urge all corporations and their compensation committees to consider these practices as they develop and implement executive compensation arrangements.

Commentary on Executive Compensation Principles

1. *Executive compensation should be closely aligned with the long-term interests of shareholders and with corporate goals and strategies. It should include significant performance-based criteria related to long-term shareholder value and should reflect upside potential and downside risk.*

   - Compensation is a primary tool for attracting and retaining the highly qualified individuals necessary for a corporation to succeed in a competitive world economy. The board of directors is responsible for adopting and overseeing the implementation of compensation policies that support the corporation's ability to compete successfully in the marketplace.

   - Executive compensation should directly link the interests of executive officers, both individually and as a team, to the long-term interests of shareholders. Equity-based compensation can be effective in accomplishing this objective. Establishing a meaningful link between executive officer and shareholder interests requires careful consideration of the incentives created by different forms of compensation.

   - Compensation committees and boards of directors should establish meaningful goals for performance-based compensation; payment should be tied to the achievement of those goals. A failure to meet performance goals should reduce or eliminate payments.

   - Once performance goals have been established, corporations should adhere to them. A corporation should not adjust previously established targets or reprice options prior to the end of a performance measurement period or the options' term simply because it appears that results for that period or term may fall short of the goals.

   - In setting performance goals, corporations should look beyond short-term market value changes and focus on metrics related to long-term shareholder value creation. Compensation plans should further both the near-term objectives and the corporation's long-term strategy, and they should be consistent with the culture of the corporation and the overall goal of enhancing sustainable shareholder value. They should avoid windfalls due solely to general stock market performance.

- In setting performance measures, consideration should be given to a variety of performance metrics, both qualitative and quantitative. These metrics should not be tied solely to the corporation's short-term stock price. Examples of quantitative metrics that may be used include such items as cash and debt management, cost containment, dividends and earnings per share, labor relations, margins, market share, mergers and acquisitions, return on equity, revenue and profit growth, sale of assets, stock price, and significant reorganizations. Qualitative metrics include such items as community relations, crisis response, customer satisfaction, employee development and relations, ethics and a culture of integrity, leadership, legal compliance, product quality, succession planning, and workforce diversity. In addition, consideration of performance relative to peer groups as well as absolute performance may be appropriate measures.

- Performance-based incentives should reflect both business and individual accomplishments. Incentives should be tied not only to the corporation's operating results, but also to the executive's distinctive leadership in managing the corporation effectively and ethically, which creates long-term value for shareholders.

- A meaningful portion of executive compensation should be performance based, thereby incorporating a greater element of downside risk into compensation arrangements. This can be accomplished, for example, by linking the granting or vesting of equity compensation to the achievement of meaningful performance targets, including a meaningful vesting period. Performance-based or performance-vested stock options, performance share units, or stock appreciation rights that are payable in the corporation's stock or cash — only if targets are met — put equity-based compensation "at risk" and link pay to performance.

- Restricted stock can be an alternative or supplement to stock options and other equity-based compensation. Although restricted stock can be an appropriate and effective retention device, it also can be more effective as a long-term incentive if it is paid or vests based on the achievement of specified performance targets.

- Performance-based incentives often will measure accomplishments over several years. For example, in a year when the corporation experiences declining financial results, the CEO may receive performance-based

compensation keyed to a previously established multiyear target. Similarly, gains realized from option exercises and stock sales in a given year may be the result of options granted over many years and several years' appreciation in the underlying stock. Corporations should take steps to enhance investor understanding of the relationship between pay and performance by providing meaningful disclosure about this relationship in the corporation's Compensation Discussion and Analysis (CD&A).

2. *Compensation of the CEO and other top executives should be determined entirely by independent directors, either as a compensation committee or together with the other independent directors based on the committee's recommendations.*

- Directors who sit on a compensation committee should be independent in both fact and appearance. Committee members should have, and be perceived to have, the ability to exercise independent judgment free from any relationship or influence that could appear to compromise their ability to approach compensation issues decisively and independently.

- In recommending directors to serve on the compensation committee, the corporate governance/nominating committee should consider the following:

  - A diversity of professional backgrounds is important to the effective functioning of a compensation committee.

  - Periodic rotation of members and the chair can bring fresh perspectives to the compensation committee.

  - All members of the committee should have sufficient knowledge of executive compensation and related issues to perform their responsibilities effectively. In-depth orientation should be provided to new committee members, and all committee members should be encouraged to participate in continuing education programs related to executive compensation.

- The particular duties and responsibilities that are delegated to the compensation committee will depend on the corporation and should be set forth in the committee's written charter. At a minimum, the duties and responsibilities of the compensation committee should include:

  - Overseeing the corporation's overall compensation structure, policies and programs;

- Reviewing and approving corporate goals and objectives relating to executive compensation;
- Evaluating executive officers' performance in light of those goals and objectives;
- Determining and approving (either as a committee or together with the other independent directors) executive officers' compensation level based on this evaluation; and
- Setting or making recommendations to the board with respect to executive compensation and compensation plans.

- The compensation committee should play an integral role in the preparation of the CD&A to be included in a corporation's proxy statement or annual report, and it should see that the CD&A effectively explains the material aspects of the corporation's compensation objectives and the factors underlying executive compensation decisions. The compensation committee also must indicate in its committee report whether it has reviewed and discussed the CD&A with management and recommended to the board that the CD&A be included in the corporation's proxy statement or annual report.
- The compensation committee should perform an annual evaluation of its performance and review the adequacy of the committee's charter. In light of this review, the compensation committee should consider appropriate changes in its practices and recommend any necessary changes in its charter to the board.
- Corporations should consider having compensation committee chairs speak for the corporation on executive compensation matters and be available at annual meetings to address executive compensation.

3. *The compensation committee should understand all aspects of executive compensation and should review the maximum payout and all benefits under executive compensation arrangements. The compensation committee should understand the maximum payout and consequences under multiple scenarios, including retirement, termination with or without cause, and severance in connection with business combinations or sale of the business.*

- The compensation committee should fully understand all the benefits and consequences to the executive and the costs to the corporation of the compensation arrangement under various circumstances, including under a

range of economic results and severance scenarios. The committee should understand how the various elements of cash and noncash compensation, including benefits, deferred compensation arrangements and supplemental retirement benefits, are allocated and work together. In addition, the committee should understand the accounting and tax aspects of different types of arrangements. Executive compensation arrangements should not be unduly complex.

- The compensation committee should be aware of all elements of the compensation of each executive officer; there should be no surprises. This may be facilitated by the use of tally sheets, which should include all forms of compensation.

- In structuring a compensation arrangement, consideration should be given to whether the amount and mix of compensation is reasonable, appropriate and fair in light of the roles, responsibilities and performance of the individual, the corporation's circumstances and overall compensation structure, and the need to attract and retain high-quality executive officers.

- The committee should consider building into executive compensation agreements the right to review and consider changes at appropriate time intervals. When a compensation arrangement is modified, the committee should assess and understand how the change will affect the overall compensation of an executive officer.

- Particular attention should be paid to severance arrangements and to all benefits provided to executive officers in connection with termination of employment. Corporations should review such arrangements on a regular basis. They should not offer excessive severance packages that reward executives who have not met performance goals and objectives during the term of their employment. Employment contracts, if any, should clearly articulate the consequences of termination and the circumstances in which an executive can be terminated for cause.

4. *The compensation committee should require executives to build and maintain significant continuing equity investment in the corporation.*

- The compensation committee should establish requirements that executive officers and members of the board of directors acquire and hold a meaningful amount of the corporation's stock to align executive and director interests with the interests of shareholders.

- Stock retention requirements can foster a long-term stake in the corporation among executive officers. The compensation committee should require that executive officers hold a specified amount of the stock for a period of time until they meet the corporation's stock ownership guidelines or until they leave the corporation.

- To minimize questions and possible concerns about the propriety of particular stock trades, corporations should make available to executive officers and directors prearranged trading plans to the extent they determine to sell some portion of their stock. When executive officers and directors enter into such trading plans, they should be disclosed.

5. *The compensation committee should have independent, experienced expertise available to provide advice on executive compensation arrangements and plans. The compensation committee should oversee consultants to ensure that they do not have conflicts that would limit their ability to provide independent advice.*

- The compensation committee should have the authority to retain compensation consultants, counsel and other outside experts in compensation matters to provide the committee with independent advice for performing its responsibilities. Nevertheless, decisions with respect to executive compensation are the ultimate responsibility of the compensation committee and the the board.

- The compensation committee should retain and oversee any compensation consultants hired to assist with executive compensation matters, approve the terms of their retention and fees, and evaluate their performance. In doing so, the committee should consider any other work that the consultants may perform for the corporation and whether such work has any impact on the advice provided to the compensation committee. The compensation committee should consider whether it should preapprove any other work the consultant does for the corporation.

- The compensation committee should use information from a variety of sources in determining compensation levels. The committee should resist an over-reliance on surveys and other statistical analyses in determining compensation levels. Although such information can be used as a tool, company-specific factors should be given significant weight in determining

executive compensation. In addition, the compensation committee should carefully examine the composition of any peer groups used in considering executive compensation and consider, among other things, the performance of the other corporations included in the peer group.

- The compensation committee should retain independent counsel that reports directly to the committee to assist in negotiation of the CEO contract and benefits and to assist the committee in addressing its other responsibilities as appropriate.

6. *The compensation committee should oversee its corporation's executive compensation programs to see that they are in compliance with applicable laws and regulations and aligned with best practices.*

- The compensation committee should assess whether executive compensation programs are consistent with the corporation's goals and strategies.

- The compensation committee should review on an ongoing basis its policies and practices with respect to the granting of stock options and other forms of equity compensation to see that they are in accord with state corporate law, Securities and Exchange Commission (SEC) rules, accounting standards, Internal Revenue Service regulations, and any other applicable requirements. The committee should be sensitive to the timing of such grants (e.g., no "back dating") and maintain consistent practices.

- Corporations should consider adopting policies and/or provisions in compensation plans or agreements that permit them to seek the return of bonuses and equity compensation from executive officers in the event of a financial restatement or fraud resulting from an executive's misconduct or fraudulent activity.

- The compensation committee should carefully examine executive perquisites and determine whether they are appropriate and in the interest of shareholders. If not, the corporation should not bear the cost of personal expenses.

- Benefits granted to executive officers should not be safeguarded to a greater extent than regular employee benefits.

- Corporations should be sensitive to the appearance of executive compensation practices, and special attention should be given to such controversial practices as:

- Tax gross-ups and supplemental retirement plans beyond those provided to other employees and
- Preferential investment or above-market interest for deferred compensation.

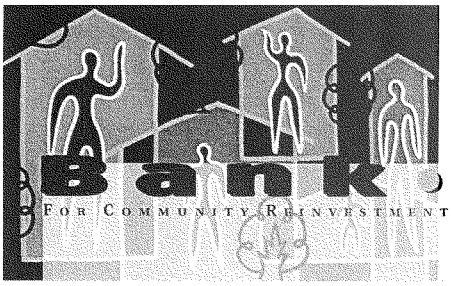
7. *Corporations should provide complete, accurate, understandable and timely disclosure to shareholders concerning all elements of executive compensation and the factors underlying executive compensation policies and decisions.*

- Disclosure about executive compensation should be transparent and understandable to shareholders and in plain English. Corporations should disclose the terms of executive officer employment arrangements when they are entered into or materially changed. Disclosure about a corporation's executive compensation arrangements, as a whole, should address not only the form and amount of executive compensation (including projections of future benefits), but also the interaction of the different elements of compensation, the economic impact of the compensation (such as any dilution resulting from stock options) on the corporation and its shareholders, the material factors underlying compensation policies and decisions, why specific elements of compensation were awarded, and the relationship of executive compensation to corporate goals and strategy.
- Corporations also should disclose the criteria used in performance-based awards to executives and the measurement methods used to determine whether those criteria have been met, unless disclosure of the criteria involves the disclosure of trade secrets or confidential information that could cause competitive harm.
- As required by SEC rules, the CD&A included in the proxy statement or annual report should provide shareholders an explanation of all material elements of compensation for executive officers. The CD&A should include information explaining the objectives of the compensation program, what the compensation program is designed to award, and how each element fits into the corporation's overall compensation objectives and affects other elements.
- Corporations should use the CD&A to provide shareholders with meaningful and understandable disclosure about their executive compensation philosophy, policies and practices; the factors that the compensation committee and the board consider in making compensation decisions; and the relationship between executive compensation and corporate performance.

Mr. DAVIS OF VIRGINIA. Mr. Chairman, I would also like to enter into the record a publication from the Federal Reserve Bank of New York, published in 2000, which praises the securitization of low- to moderate-income mortgages as a means of increasing the capital available to those communities. I believe it sheds some light on the role the Federal Government played in encouraging the securitization of subprime mortgages.

Chairman WAXMAN. Without objection, that will also be made part of the record.

[The information referred to follows:]



WINTER, 2000

BankLinks

For Community Reinvestment and Economic Development

The Office of Regional & Community Affairs
of the Federal Reserve Bank of New York

A MESSAGE FROM THE COMMUNITY AFFAIRS OFFICER

CRA Securities and Good News About LMI Mortgage Lending

Over the last decade, flexible and innovative mortgage lending in low- and moderate-income ("LMI") communities has resulted in lenders holding growing numbers of non-conforming mortgage loans, made specifically to promote access to homeownership by LMI borrowers. Often referred to as CRA mortgages, these loans are held in CRA portfolios. The mortgages are non-conforming because they do not meet FannieMae, FreddieMac, or GinnieMae guidelines and cannot be easily converted to mortgage-backed securities. As these CRA portfolios age and the banking industry learns more about their performance, however, it has become possible to securitize these mortgages.

This issue of BankLinks considers the significance of CRA mortgage-backed securities, takes a look at how they are used in various ways by banks with different needs, and provides a regulator's viewpoint on CRA mortgage-backed securties in the context of the Community Reinvestment Act.

There always have been opportunities for lenders to sell individual CRA mortgages to other banks, but without solid knowledge about how the portfolios would perform over time the mortgages were poor candidates for securitization, the main source of liquidity in the conventional mortgage market. As a result, CRA loans were generally excluded from the secondary market and banks were expected to hold the loans for their entire term.

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 unique payment characteristics that enhance the value of the portfolios. One attractive characteristic has been low pre-payment rates associated with 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.

At the same time, the CRA regulation encourages banks to seek investment instruments that meet the needs of LMI communities. This has created a market for customized securities backed by mortgages in specific geographic areas that correspond to the CRA assessment areas of individual banks, whether those mortgages are special CRA products or conforming loans that happen to be in LMI areas, or to LMI consumers.

Whether lending institutions sell CRA portfolios to non-bank investors or buy custom-ordered securities backed by mortgages originated by other lenders, these transactions provide liquidity and increase the market's appetite for mortgages originated in LMI areas and to LMI consumers. The modernization of the structure of the financial services industry opens the way for more creative securitization strategies, building on innovations like the ones described in this newsletter, as the relationships between commercial and investment banks evolve.

Elizabeth Rodriguez Jackson
Assistant Vice President

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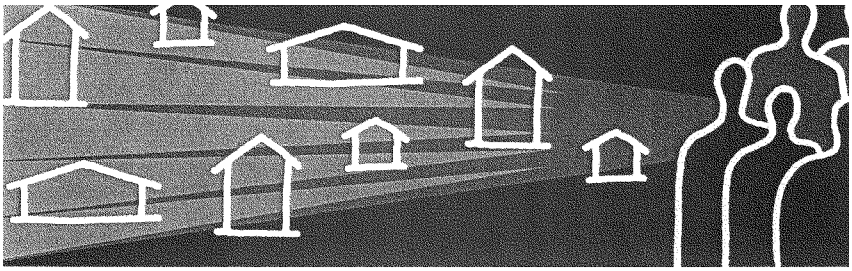
Compliance Examiners Review Targeted Mortgage-Backed CRA Securities Securitizing Small Business Loans 4



Meeting Bank Liquidity and Investment Needs:

Mortgage-Backed CRA Securities Demonstrate Flexibility and Creativity

CRA securities can be structured to meet a variety of specific needs for both lenders and investors and innovation is taking place on many fronts. The following is a discussion of two different approaches, one by Advest, Inc. and one by Bear Stearns.

Advest structures mortgage pools that allow banks to invest in securities backed by CRA eligible mortgages in targeted geographic areas, according to Richard Fuchs, senior vice president for Advest. Since 1997, Advest has completed more than 400 CRA-related transactions in 48 states.

Bear Stearns buys and converts existing CRA portfolios into mortgage-backed securities for sale to non-bank investors, according to Richard Ruffer, managing director of Bear Stearns. Since 1997, Bear Stearns has structured and managed almost $2 billion of CRA loan securitizations for several institutions.

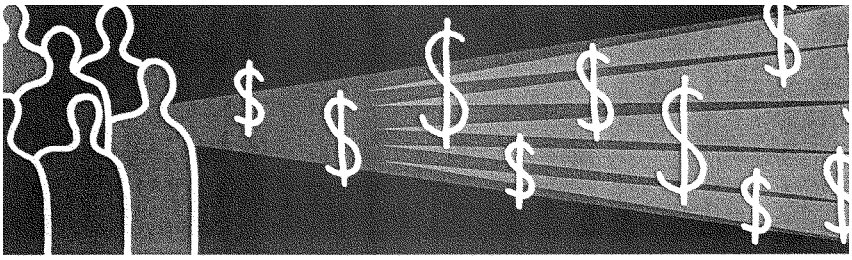
These products respond to two different but pressing CRA issues: the Advest product creates new CRA qualified investments that are customized for individual banks, while the Bear Stearns product makes non-conforming CRA loans more liquid, making "flexible and innovative" CRA mortgage products more attractive to lenders.

Any mortgage-backed security requires a pool of underlying mortgages. Bear Stearns creates this pool by purchasing entire portfolios from a lender. Advest's approach is to assemble a pool of LMI mortgages that conform to FannieMae, FreddieMac, or GinnieMae guidelines, and that also meet the geographic criteria of a given bank investor.

Bear Stearns focuses on a single CRA portfolio of non-conforming loans made by one institution. That CRA portfolio may be small ($20 million) or large ($750 million). Before a bank is willing to sell its portfolio to Bear Stearns, it must have the support of several departments, including the bank's treasurer, community lenders, and loan servicing representatives. Some banks are reluctant to sell their CRA portfolios because they incorrectly believe that to receive CRA credit those loans must be held on the books.

Advest does not purchase the mortgages but works with a network of originators to assemble a pool of mortgages that meet the geographic criteria of the investor. Because all the loans in the resulting pool are conforming, the originator is able to follow a standard securitization process with the agencies, making the securities AAA-rated or the equivalent. Advest then brokers the purchase for its client, the bank investor.

The mortgages in a Bear Stearns pool are typically non-conforming, therefore, the assets underlying the security must be analyzed and the security rated by an independent rating agency. The creation of different classes of securities, or tranches, with different credit ratings to isolate risk, is a necessary credit enhancement for a pool of non-conforming loans perceived as risky.



The two products have different pricing strategies. The investor pays a premium for the Advest product because it is a highly customized investment vehicle. Much of that premium is passed on to the originator, which has gone to the trouble of assembling a special pool of conforming mortgages that could easily have been part of a typical FannieMae, FreddieMac or GinnieMae security. Investors do not pay a premium for the CRA content of the Bear Stearns pooled product. Bear Stearns profits when it purchases the loan portfolio at a discount from an originator seeking liquidity, and because the historically low pre-payment rate enhances the value of the security.

Finally, the securities are sold to investors. Advest has had a bank investor lined up since the process was initiated, and has been working to meet the CRA needs of that particular bank investor, collecting only mortgages that lie within the bank's geographic assessment area(s). Bear Stearns sells the loans to many investors, almost all of which are non-bank entities, and few, if any, are motivated by CRA concerns.

The information in this article and the accompanying charts are drawn from presentations by representatives of Advest and Bear Stearns at a March 18, 1999, conference sponsored by the Federal Reserve Bank of New York. For more information on these products contact Mr. Fuchs at Advest, Inc. (212) 238-4563, or Mr. Ruffer at Bear Stearns (212) 272-3173.

ADVEST

1. Mortgages Originated

Numerous lenders make conforming mortgage loans in LMI areas or to LMI borrowers.

2. Mortgages Pooled by Originator

A network of originators pool loans that meet the geographic needs of a specific bank investor. Using specialized software, Advest sifts through many loans to determine which should be included in the final pool.

3. Credit Enhancement and Securitization

The originator, holding the completed pool, securitizes the pool through FannieMae, FreddieMac or GinnieMae, which provide a guarantee making the issue AAA-rated or the equivalent. The security is highly liquid due to the established market in this type of security.

4. Pricing the Security

Due to the agency guarantee, the yield for the CRA securities is close to that of other mortgage-backed securities. Investors pay a premium for customization, typically 2 basis points a year, based on the average life of the security.

5. Who the Investors Are

The issue is sold to a single bank investor as a CRA investment. It includes documentation for CRA purposes. Banks of all sizes can invest without originating mortgages themselves.

BEAR STEARNS

1. Mortgages Originated

One lender builds a CRA portfolio over time of non-conforming mortgages to LMI borrowers or in LMI areas.

2. Mortgages Purchased by Investment Bank

In a single transaction, Bear Stearns purchases an entire CRA portfolio to convert to mortgage-backed securities and sell to numerous, unspecified investors. Some banks will sell at a discount for the benefit of increased liquidity.

3. Credit Enhancement and Securitization

The portfolio is securitized and the issue separated into higher risk and lower risk tranches. Most investors purchase AAA-rated shares, while the risk is concentrated in a small number of very speculative tranches.

4. Pricing the Security

The issue is rated by an independent rating agency. The rating determines the price. While the lower-rated tranches trade below par, most trade at par. The historically low pre-payment rates among LMI borrowers can enhance the value of the tranches.

5. Who the Investors Are

A typical issue is sold to many investors, 95% of whom are not banks, but are insurance companies, pension funds, etc., which invest based on their portfolio needs.

Compliance Examiners Review Targeted Mortgage-Backed CRA Securities

Prompted by the revised Community Reinvestment Act ("CRA") regulation effective in 1997, banks are seeking CRA qualified investment opportunities for which they will receive a market or near market return. In response, a handful of new investment products have been created over the last two years, including targeted mortgage-backed securities.

Banks that invest in targeted mortgage-backed securities will receive CRA credit if regulators determine that a majority of the mortgages backing the security: a) provide affordable housing (including multi-family rental housing) for low- or moderate-income individuals, and b) benefit the bank's assessment area(s) or a broader statewide or regional area that includes the bank's assessment area(s), according to John R. McAteer, a bank examiner at the Federal Reserve Bank of New York.

When evaluating a bank for CRA credit, regulators require that it meet tests in three categories—lending, investment, and service. The maximum number of points a bank can get under the lending test is 12, while the maximum number of points a bank can get under the investment and service tests is six in each category. To receive an outstanding rating, a bank must receive 20 or more points in the combined classifications.

Banks receive CRA investment credit for buying targeted mortgage-backed securities for which the originating bank has already received CRA credit under the lending test. Although this is a form of double counting, regulators give the investing banks credit because they assume that not all banks have the same appetite for making loans and that the investing banks are increasing liquidity for the housing loan originators. Mr. McAteer said he believes that banks that convert their low- and moderate-income loan portfolios to securities and sell them on the secondary market to investors outside their assessment area are the most successful in increasing liquidity in their communities.

Mr. McAteer said some regulators, however, question whether a bank selling targeted mortgage-backed securities to another bank within the same assessment area is an effective way to create liquidity. This investment meets community needs best when the bank selling the securities uses the additional liquidity to make new affordable housing loans.

Other types of investments that are responsive to the credit needs of an area include: grant donations that provide low-income housing or job training, an investment in a rental housing project, or an investment in a security derived from a housing loan made by a community group.

SECURITIZING SMALL BUSINESS LOANS

As community development investments in mortgage-backed securities increase, so does interest in securitizing small business loans as potential CRA investments. In 1994, the Riegle Act removed regulatory obstacles to the securitization of small business loans, extending to those securities the same benefits extended to mortgage-backed securities. However, the market for securitized small business loans (apart from those backed by SBA guarantees) has not grown as fast as that for other asset-backed securities.

This developing market is discussed in a paper that was presented at the Federal Reserve System's 1999 Business Access to Capital and Credit Conference. The paper, "Development and Expansion of Secondary Markets for Small Business Loans," by Zoltan J. Acs, University of Baltimore and full conference proceedings are available on the Internet at the Federal Reserve Bank of Chicago's Community and Economic Development Research Center (CEDRIC), at www.frbchi.org.

In addition, the Federal Reserve Bank of Boston has published an article, "The Growing Securitization of Small Business Loans," by Luxman Nathan. A copy of the article, which appeared in the Summer 1998 issue of the Boston Fed's *Communities and Banking* magazine, is available at www.bos.frb.org/comaff/c&b.htm.

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Mr. DAVIS OF VIRGINIA. We may not like it, but markets at times produce inequities, and they correct them. Government involvement in that process generally makes matters worse, not better.

The professional baseball player with a $17 million contract who hits only 0.200 in a season still gets paid. Jennifer Lopez and Ben Affleck didn't have to pay reparations for moviegoers after "Gigli." But, in both cases, their value in the marketplace returns to equilibrium relative to performance without government intervention.

That is the hard lesson underlying all the testimony today. And we look forward to a frank and informative discussion.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Tom Davis follows:]

HENRY A. WAXMAN, CALIFORNIA
CHAIRMAN

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RANKING MINORITY MEMBER

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Statement of Rep. Tom Davis
Ranking Republican Member
Executive Compensation II: CEO Pay and the Mortgage Crisis
March 7, 2008

When asking questions about corporate governance, executive pay and the performance of national financial markets, this Committee should proceed very cautiously. Shareholders have the most direct stake in these issues. Ours is, at best, a derivative, and potentially damaging, role in the discussion of complex transactions, proprietary business decisions, and marketplace dynamics. The last thing union pension funds and other investors want is Congress second-guessing and micro-managing the people looking after their money.

That said, there is no dispute the housing market is undergoing a significant contraction and many Americans are suffering the combined hardships of foreclosure and depressed home values. Causes of the unfolding credit crisis involve an intricate web of actions, incentives, and assumptions by lenders, mortgage brokers, fund managers, credit rating agencies, and many others. In that long chain of causation, the impact of corporate executive compensation is debatable, and that appears to be at least part of the debate we'll have today.

Fine. But that debate should not degenerate into a sanctimonious search for scapegoats. If every corporate executive of every company involved in subprime lending and securities had worked for the minimum wage, or for nothing, the macro-economic trends and cyclical forces that drive booms, and cause busts, would still vex our economy today. Punishing individual corporate executives with public floggings like this may be a politically satisfying ritual – like an island tribe sacrificing a virgin to a grumbling volcano. But in the end, it won't answer the questions that need to be answered about corporate responsibility and economic stability.

Boards and shareholders have already begun to answer those questions for themselves. They've taken steps to assign responsibility and hold corporate managers accountable. CEOs have resigned. Potential payouts have been surrendered or reduced, and so-called "golden parachutes" trimmed. Investor groups are suing to recoup funds, alleging violations of regulatory and fiduciary duties. It is in those forums that the sad story of the subprime industry should be litigated. We should never substitute our judgment for determinations by those with real equities at stake. Nor should we allow the Committee to be used as a discovery tool for plaintiffs.

Our previous hearing on executive compensation consultants failed to find much evidence of the claimed conflicts or self-dealing that can distort salary and perk decisions to the detriment of stockholders. Today's attempt to wrap that unproven premise in the much larger subprime crisis only seems to muddle both issues further. Subprime lending expanded mortgage loan availability to underserved groups, as Congress mandated. With the encouragement of regulators, innovative financial instruments increased liquidity and spread subprime risks across a broader range of supposedly savvy investors. But almost everyone involved became entranced over time by the unsustainable promise of ever-rising home prices. When the music stopped, and real estate values fell, foreclosures escalated and holders of subprime-backed securities lost billions.

In that context, the "case studies" in corporate compensation the Committee released yesterday have much more to do with changing market conditions, flawed economic assumptions, and rosy risk assessments than with inappropriate compensation incentives. Remember, when viewed in the rear view mirror, objects are closer than they appear.

At our request, one of the witnesses on today's first panel will describe the interrelated functions, and dysfunctions, in subprime markets. We appreciate his being included in this hearing.

We may not like it, but markets at times produce inequities. And they correct them. Government involvement in that process generally makes matters worse, not better. A professional baseball player with a $17 million contract who hits only .200 in a season still gets paid. Jennifer Lopez and Ben Affleck didn't have to pay reparations to moviegoers after *Gigli*. But in both cases, their value in the marketplace returns to equilibrium relative to performance without government intervention. That's the hard lesson underlying all the testimony today, and we look forward to a frank and informative discussion.

Chairman WAXMAN. Thank you, Mr. Davis.

On our first panel, the committee will hear testimony from five individuals with expertise or experience related to the mortgage crisis: Dr. Susan M. Wachter, the Richard B. Worley professor of financial management at the University of Pennsylvania's Wharton School; the Honorable William Francis Galvin, the Secretary of State for the Commonwealth of Massachusetts and the State's chief securities regulator; the Honorable Brenda Lawrence, the mayor of the city of Southfield, MI; Dr. Anthony Yezer, professor of economics at the George Washington University; and Ms. Nell Minow, editor and cofounder of the Corporate Library.

We want to thank each of you for being here today.

It is the practice of this committee that all witnesses testify under oath. So I would like to ask you if you would please rise and raise your right hands.

[Witnesses sworn.]

Chairman WAXMAN. The record will indicate that each of the witnesses answered in the affirmative.

Yes, Mr. Issa?

Mr. ISSA. Mr. Chairman, I would ask unanimous consent that all Members be allowed to put their opening statements into the record in the appropriate position.

Chairman WAXMAN. Without objection.

Mr. ISSA. And, Mr. Chairman, I would also ask that, because it is pertinent information, that the material from the AFL–CIO Web site "2007 Executive PayWatch" also be put in the record in the same location.

Chairman WAXMAN. Without objection.

Mr. ISSA. Thank you, Mr. Chairman.

[The prepared statement of Hon. Darrell E. Issa and the information referred to follow:]

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Opening Statement of Darrell Issa
March 7, 2008

Because of the widespread damage to home ownership associated with the subprime mortgage meltdown, this hearing has the potential to be the most important this Committee has held this Congress. But sadly, for the American people, I predict that instead of substance most of what we will hear today is rhetoric based on an unrelenting attack on private sector pay for performance incentives.

This Committee, under Democratic leadership, has devoted itself to advancing the talking points of trial lawyers, big labor and radical organizations such as Code Pink, indeed, the AFL-CIO has long focused and has an entire section on its website devoted to this issue. The issue of executive compensation is not new.

Today, we have before us a number of individuals who can help us understand the myriad of factors that caused the mortgage meltdown. However, this hearing attempts to unfairly link the subprime crisis to excesses in corporate executive compensation. Don't get me wrong, I'm not here to defend executive pay. But, by unfairly linking the issue of executive pay with the subprime meltdown we send the wrong message to the American people: That only a handful of people are responsible for this housing crisis. I wish this were as simple as the majority makes it out to be, but as is often the case, the problem is much more complex with a myriad of actors, not just the few, who shoulder the blame.

Mr. Chairman, like it or not, there are many to blame for the subprime meltdown. Let's start first by looking in the mirror and what you will see is that we in Congress share some of the blame.

In 1977, Congress passed the Community Reinvestment Act, although well intended, which required banks to make loans to underserved low- to moderate-income communities.

By passing legislation like the CRA, Congress set in motion the fundamental tools for lenders to use, sometimes rightly and sometimes wrongly. This ultimately contributed to the housing problems we are talking about today. Our zeal was to get every family in their own home without understanding that not every family could actually *afford* their own home.

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Next in line are the regulators. By adopting credit-scoring techniques first used by subprime auto loans, Mortgage lenders found a way to qualify people for a loan that under normal circumstances would have been impossible. Lenders also found innovative ways to "securitize" these loans even though many knew these loans were based on questionable credit worthiness. Regulators at the Federal Reserve and the Securities Exchange Commission weren't just asleep at the switch but in many ways they gave the green light for these practices, even when many knew this was akin to a ponzi scheme. For example, the Federal Reserve Bank of New York praised the securitization of low to moderate income (LMI) mortgages saying, "These transactions provide liquidity and increase the market's appetite for mortgages originated in LMI areas and to LMI consumers."

The Housing crises of 2007 and 2008 have a lot of similarities with the dot-com bubble of 2000 and 2001. Then, like now we search for answers of how and why. Then, like now we seek out scapegoats, when in all reality the problem is just as deep as it is wide.

We haven't learned our lesson. The American people want answers but we shouldn't treat them as simpletons. The home ownership problem isn't as easy as tying it to one's executive compensation. The problem is deeper and there are many to blame. Of course, if any criminal wrongdoing associated with the subprime meltdown is discovered, it needs to be investigated and, if necessary prosecuted. But the problem starts and ends with the federal government – we in Congress and then the regulators. The problem won't be solved until we realize this, and then we can truly work together to prevent this from happening in the future.

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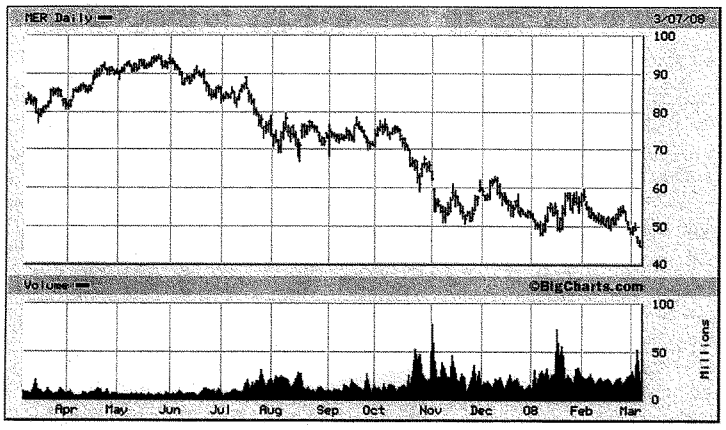
MER Merrill Lynch & Co., Inc 3/7/2008 1:41 PM

Last:	Change:	Open:	High:	Low:	Volume:
44.75	-1.11	45.12	46.47	44.60	18,621,521
	Percent Change:	Yield:	P/E Ratio:	52 Week Range:	
	-2.42%	3.13	n/a	45.70 to 95.00	



Company Data

Company Name:	Merrill Lynch & Co., Inc
Dow Jones Industry:	Investment Services
Exchange:	NYSE
Shares Outstanding:	969,007,000
Market Cap:	43.4 Billion
Short Interest:	31,081,744 (3.21%)
52-Week EPS:	-10.73
52-Week High:	95.00 on Thursday, May 31, 2007
52-Week Low:	45.70 on Thursday, March 06, 2008
P/E Ratio:	n/a
Yield:	3.13%
Average Price:	52.92 (50-day) 67.64 (200-day)

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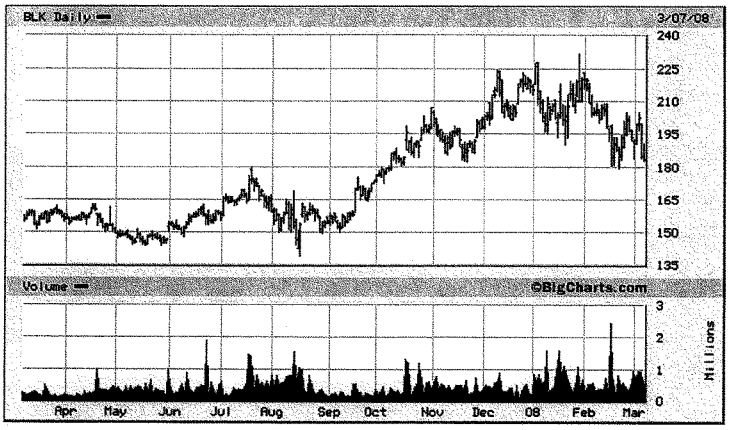
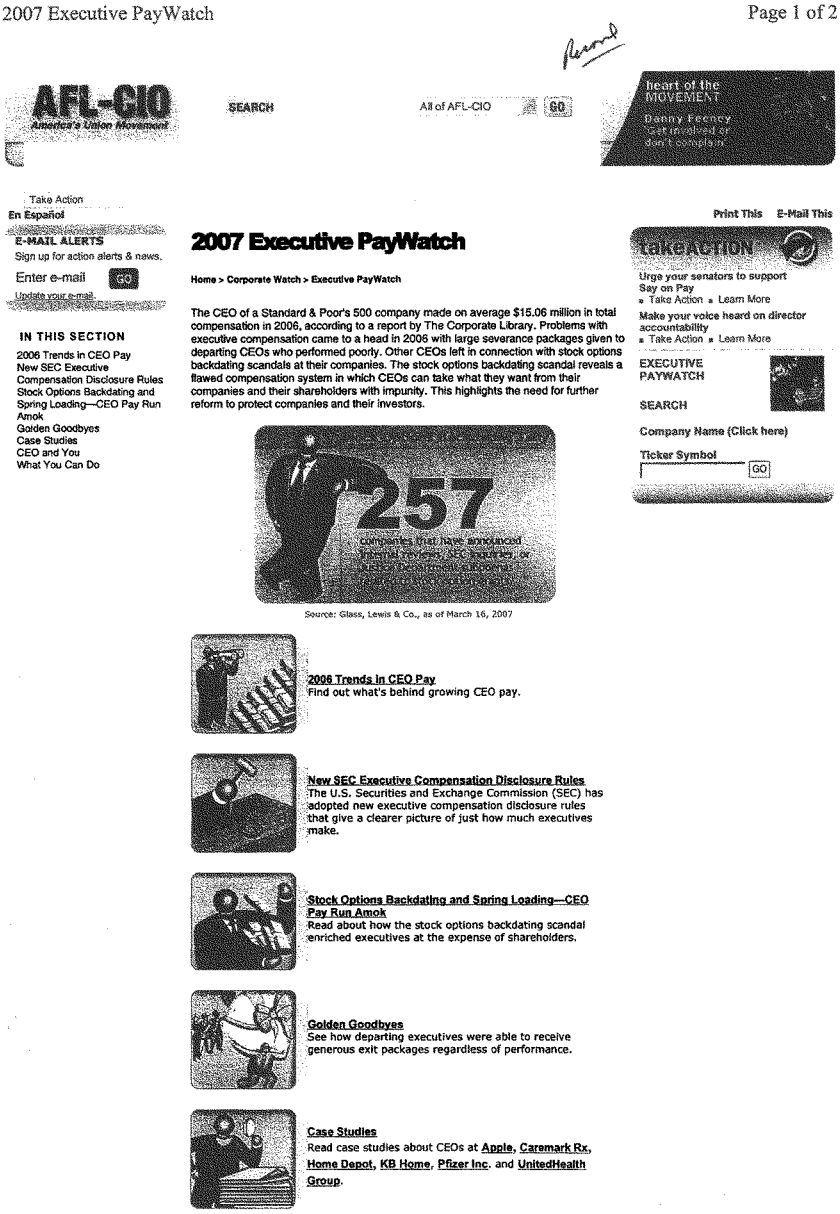
BLK BlackRock Inc 3/7/2008 1:39 PM

Last:	Change:	Open:	High:	Low:	Volume:
183.41	-1.58	184.77	190.65	182.49	530,181
	Percent Change: -0.85%	Yield: 1.70	P/E Ratio: 23.73	52 Week Range: 139.20 to 231.99	



Company Data

Company Name:	BlackRock Inc
Dow Jones Industry:	Asset Managers
Exchange:	NYSE
Shares Outstanding:	117,283,000
Market Cap:	21.5 Billion
Short Interest:	2,513,991 (2.14%)
52-Week EPS:	7.73
52-Week High:	231.99 on Wednesday, January 30, 2008
52-Week Low:	139.20 on Thursday, August 16, 2007
P/E Ratio:	23.73
Yield:	1.70%
Average Price:	205.23 (50-day) 181.98 (200-day)



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2007 Executive PayWatch

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The CEO of a Standard & Poor's 500 company made on average $15.06 million in total compensation in 2006, according to a report by The Corporate Library. Problems with executive compensation came to a head in 2006 with large severance packages given to departing CEOs who performed poorly. Other CEOs left in connection with stock options backdating scandals at their companies. The stock options backdating scandal reveals a flawed compensation system in which CEOs can take what they want from their companies and their shareholders with impunity. This highlights the need for further reform to protect companies and their investors.

Source: Glass, Lewis & Co., as of March 16, 2007

2006 Trends in CEO Pay
Find out what's behind growing CEO pay.

New SEC Executive Compensation Disclosure Rules
The U.S. Securities and Exchange Commission (SEC) has adopted new executive compensation disclosure rules that give a clearer picture of just how much executives make.

Stock Options Backdating and Spring Loading—CEO Pay Run Amok
Read about how the stock options backdating scandal enriched executives at the expense of shareholders.

Golden Goodbyes
See how departing executives were able to receive generous exit packages regardless of performance.

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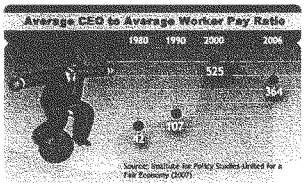
In 2006, the average CEO of a Standard & Poor's 500 company received $15.06 million in total compensation, according to a report by The Corporate Library. This represents an 11.5 percent increase in CEO pay over 2005.[1]

A reasonable and fair compensation system for executives and workers is fundamental to the creation of long-term corporate value. However, the past two decades have seen an unprecedented growth in compensation for top executives and a dramatic increase in the ratio between the compensation of executives and their employees.



Boards of directors are responsible for setting CEO pay. Too often, directors award compensation packages that go well beyond what is required to attract and retain executives and reward even poorly performing CEOs. These executive pay excesses come at the expense of shareholders as well as the company and its employees.

Excessive CEO pay takes dollars out of the pockets of shareholders—including the retirement savings of America's working families. Moreover, a poorly designed executive compensation package can reward decisions that are not in the long-term interests of a company, its shareholders and employees.

Some CEOs may have far greater control over their pay than anybody previously suspected. The past year has witnessed a stock options backdating scandal that has resulted in U.S. Securities and Exchange Commission (SEC) investigations at as many as 160 companies[2] and the departure of many CEOs, such as William McGuire of UnitedHealth Group.

Also in 2006, departing CEOs Henry McKinnell of Pfizer and Robert Nardelli of Home Depot both received exit packages of more than $200 million.[3] Both companies underperformed during their tenures, although their excessive pay was an issue in itself.

In some cases, CEOs were entitled to receive generous exit packages, despite their involvement in the stock options backdating scandal. Former CEO Bruce Karatz departed because of options backdating at KB Home, but because he retired and was not fired for cause, the terms of his employment agreement entitled him to an exit package worth as much as $175 million.[4]

Karatz's compensation is frozen until an agreement is reached between him and KB Home on how much he will actually receive.[5] Investors have urged the company not to pay Karatz. However, because of the legally binding employment agreement, KB Home has a weakened case if it decides not to pay him

Excessive CEO pay is fundamentally a corporate governance problem. The board of directors is supposed to protect shareholder interests and ensure that CEO pay reflects performance. However, at approximately two-thirds of companies, the CEO also chairs the board. When a single person serves as both chair and CEO, it is impossible to objectively monitor and evaluate his or her own performance.

CEOs also dominate the election of directors. The vast majority of directors are hand picked by incumbent management. Because of the proxy rules, it is prohibitively expensive for long-term shareholders to run their own director candidates. Moreover, even if a majority of shareholders withhold support from directors, they still are elected to the board at many companies.

Ultimately, shareholders have to be able to trust their boards of directors to set responsible CEO pay packages. For this reason, CEO pay will be reformed only when corporate boards become more accountable. Until then, CEOs will continue to influence the size and form of their own compensation, and CEO pay will continue to rise.

The good news is that investors may finally get the tools needed to make boards of

directors more accountable. Last year, a historic court decision at American International Group ruled that shareholders have the right to reform the way that directors are nominated for election.

The business community has been pushing the SEC to undo this decision through regulatory action. Hopefully the SEC will resist this pressure and ensure the protection and expansion of long-term shareholders' rights to participate in corporate board elections.

[1] *The Corporate Library's Annual CEO Pay Survey 2007*, The Corporate Library, December 2007.

[2] Remarks by Linda Chatman Thomsen, director, SEC Division of Enforcement, at the March 19, 2007 conference of the Council of Institutional Investors.

[3] Pfizer 8-K, Dec. 21, 2006; and Home Depot 8-K, Jan. 4, 2007.

[4] "Exiting Under a Cloud, with $175 Million," *Los Angeles Times*, Nov. 20, 2006.

[5] "U.S. Prosecutors Examining Options Case at KB Home," *The New York Times*, Feb. 24, 2007.

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Several CEOs departed in 2006 who received generous exit packages despite their poor performance, costing companies and their investors millions of dollars. Pfizer's Henry McKinnell and Home Depot's Robert Nardelli received exit packages of more than $200 million each, despite poor stock performance during their tenures.[1]

These large exit packages are due primarily to executive employment agreements. Employment agreements are legally binding contracts that spell out the terms under which executives are hired. The problem is that they may guarantee a specified level of compensation regardless of performance, as in the case of Robert Nardelli.[2]

Average Worker vs. Average CEO Severance Pay

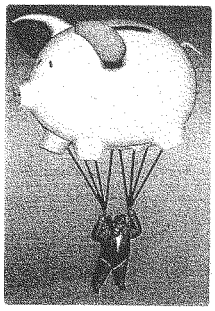
Who	Weeks of Salary for Each Year Worked
Average CEO ousted in 2006	170
Average CEO without a contract	18
Average Worker	2

Source: "Has the Exit Sign Ever Looked So Good," *The New York Times*, 4/8/2007.

Employment agreements also spell out what executives will receive under different termination scenarios. Such employment agreements often include what has become known as a "golden handshake" in which the company promises payment upon retirement or termination. Executives also may receive "golden parachute" payments if the company undergoes a change in ownership or if the executive is terminated because of a change in control.

Supporters of such severance agreements argue that they provide managers with the incentive to maximize shareholder wealth without worrying about losing their job as a result of a change in control. However, the amounts guaranteed by golden parachutes and golden handshakes may add up to millions of dollars. When these packages become excessive, they may motivate executives to engage in a merger, even though it may not be in the interests of shareholders. Golden parachutes also may result in lower firm valuation, according to Harvard professor Lucian Bebchuk.[3]

Typically, exit packages involve a cash severance of two or three times salary plus bonus. These agreements also often call for accelerated vesting of stock awards, option awards and pension benefits, quickly boosting the size of the total payment. Sometimes the termination terms for stock awards, option awards and pension benefits are not included in the employment agreement, but in the individual plans for each of those benefits.



Moreover, if the golden parachute payment received upon a change of control exceeds 2.99 times the executive's average annual salary and bonus for the five preceding years, then the amount exceeding the average annual salary and bonus cannot be deducted by the company, meaning that it must pay taxes on it.[4]

The executive also must pay a 20 percent excise tax for golden parachutes on everything over his or her average base salary and bonus for the preceding five years, though many companies offer to "gross up" or pay that tax as well,[5] costing shareholders even more.

Because executive employment agreements are legally binding, companies must pay the executives according to the terms specified under them. In the case of KB Home, former CEO Bruce Karatz could collect as much as $175 million, despite his involvement in backdating stock options at the company. That's because the company accepted his retirement, and he was not fired for cause.[6]

Karatz's compensation is frozen until an agreement is reached between him and KB Home on how much he actually will receive.[7] Investors have urged the company not to pay Karatz. However, because of the legally binding employment agreement, KB

Home has a weakened case if it decides not to pay him. It is all the more important for shareholders to be cognizant of the terms of exit packages when they are drawn up, not when the executive receives the payment.

In previous years, it was difficult to ascertain the value of executive severance packages, until an executive actually left a company. The new U.S. Securities and Exchange Commission (SEC) executive compensation disclosure rules now require companies to disclose the terms of written or unwritten arrangements that provide payments in case of the resignation, retirement or termination of the "named executive officers" or the five highest-paid executives of a company. The SEC rules also require companies to detail the specific circumstances that would trigger payment and the estimated payment amounts for each situation.

Though the new SEC disclosure rule will show whether an executive has an excessive severance package, it does not provide investors with a way to limit them. Congress is considering legislation that will require public companies to hold a non-binding vote on executive pay plans, including an advisory vote if a company awards a new golden parachute package during a merger, acquisition or proposed sale.

This advisory vote will give shareholders a way to voice their support or opposition to a company's golden parachute. Knowing they will be subject to some collective shareholder action will encourage boards of directors to address shareholder concerns before approving a questionable golden parachute.

---

[1] "An Ousted Chief's Going-Away Pay Is Seen by Many as Typically Excessive," *The New York Times*, Jan. 4, 2007.

[2] Employment Agreement between Robert Nardelli and Home Depot.

[3] Bebchuk, Lucian Arye; Cohen, Alma; and Ferrell, Allen, "What Matters in Corporate Governance?" (September 2004). Harvard Law School John M. Olin Center, Discussion Paper No. 491.

[4] Treas. Reg. §1.280G-1, Q&A 30(b), Example 1.

[5] See note 4.

[6] "Exiting Under a Cloud, with $175 Million," *Los Angeles Times*, Nov. 20, 2006.

[7] "U.S. Prosecutors Examining Options Case at KB Home," *The New York Times*, Feb. 24, 2007.

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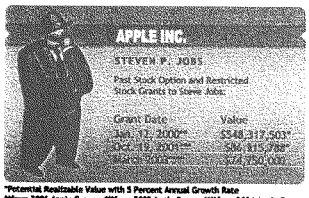

*Potential Realizable Value with 5 Percent Annual Growth Rate
**from 2001 Apple Proxy ***from 2003 Apple Proxy ****from 2004 Apple Proxy

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Considering Apple Inc. CEO Steve Jobs' salary of $1,[1] some may argue that his compensation ought to be a model for other executives. However, his modest cash compensation is more than offset by his past equity awards, including stock options that were backdated. The U.S. Attorney's Office has opened a criminal investigation into the stock options backdating scandal at Apple.[2] Unfortunately for Apple shareholders, the company has been less than forthcoming about Jobs' involvement in any improper backdating.

In June 2006, Apple announced that some of its past stock option grants were backdated, including options awarded to Jobs.[3] The company stated that it found no misconduct among its current management, though separately it announced the departure of one of its directors and former CFO Fred Anderson. Apple also admitted that Jobs was aware that "favorable grant dates had been selected," but then emphasized that he did not benefit from them.[4]

Apple later noted there were two questionable grants to Jobs. One of them, dated Jan. 12, 2000, was not backdated, even though it received approval six days after it actually was granted.[5] Apple's stock price on Jan. 12 happened to be its lowest level for a six-month period.[6]

Apple noted that the other grant, dated Oct. 19, 2001, was backdated. This grant was approved at a meeting that did not even take place, though no member of current management was aware of the "irregularity," and resulted in a $20 million charge to the company.[7] Throughout this affair, Apple has continued to maintain that Jobs did not benefit from this backdated grant; however, a closer look suggests otherwise.

In January 2000, Jobs received a stock option mega-grant potentially worth $548 million if Apple's stock price increased just 5 percent a year.[8] He also was given an aircraft that year worth $90 million.[9] By October 2001, these options were underwater, meaning that the stock options would have no cash value if they were exercised.[10] Jobs received a new grant of stock options that month potentially worth $86 million.[11]

By 2003, both of Jobs' 2000 and 2001 option grants were underwater, and he cancelled these grants.[12] Though they were cancelled when they were underwater, they were not worthless because they did not expire until 10 years from their grant date. *The Washington Post* has reported the estimated value of the two option grants was $81.3 million when they were cancelled.[13]

After Jobs cancelled his option grants, Apple awarded him restricted stock worth $74 million "in exchange."[14] The language used suggests that Jobs replaced one form of compensation for another, and according to the director of Institutional Shareholder Services, these awards were exchanged on a "roughly value-for-value basis."[15]

Thus it would be disingenuous to say that Jobs did not profit from the backdated options. According to executive compensation expert Graef Crystal, backdating options could have translated into more shares of restricted stock when the options were exchanged.[16] Apple has not yet revealed who was responsible for the backdated stock options.

Despite Apple's effort to proclaim Jobs' innocence, new details have emerged questioning his role, including statements that the backdated options were approved by higher-ups[17] and revelations of stock options backdating at Pixar, a company co-founded by Jobs.[18]

[1] 2006 Apple Inc. proxy, page 14.

[2] "U.S. Attorney Opens Probe Into Apple Options Rigging," *San Jose Mercury News*, Jan. 13, 2007.

[3] "History of Apple Options Controversy," *The Washington Post*, Dec. 30, 2006.

[4] Apple Inc. 8-K, Oct. 4, 2006.

[5] 2006 Apple Inc. 10-K, page 5.

[6] "Apple Chief Benefited From Options Dating, Records Indicate," *The Washington Post*, Jan. 11, 2007.

[7] See note 5.

[8] 2001 Apple Inc. proxy, page 9.

[9] 2001 Apple Inc. proxy, page 8.

[10] Yahoo! Finance, Apple historical pricing.

[11] Potential realizable value with 5 percent annual growth rate, 2003 Apple Inc. proxy, page 13.

[12] 2003 Apple Inc. proxy, page 11.

[13] "Apple Chief Benefited From Options Dating, Records Indicate," *The Washington Post*, Jan. 11, 2007.

[14] 2004 Apple Inc. proxy, page 10-11.

[15] "U.S. Attorney Opens Probe Into Apple Options Rigging," *San Jose Mercury News*, Jan. 13, 2007.

[16] See note 13.

[17] See note 2.

[18] "Disney Says Pixar Options Were Backdated," *The Wall Street Journal*, March 17, 2007.

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THE HOME DEPOT, INC.

ROBERT L. NARDELLI'S EXIT PACKAGE

Cash Severance Payment	$20,000,000
Earned Bonus and Long-Term Incentive Awards	$9,000,000
Acceleration of Unvested Deferred Stock Awards	$77,000,000
Payment of Vested Deferred Shares	$44,000,000
Unvested Options	$7,000,000
Other Settlements	$18,000,000
401(k) and Other Benefit Plans	$1,000,000
Retirement Benefit	$12,000,000
Total	$210,000,000

Source: Home Depot 8-K, Jan. 4, 2007

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The Home Depot's stock price fell 8 percent under the six-year tenure of former CEO Robert Nardelli. During those same six years, he received more than $240 million in compensation. In January 2007, Robert Nardelli resigned, but not before taking an exit package worth approximately $210 million.[1]

This huge exit package was made possible thanks to an employment agreement, which Nardelli entered into when hired in 2000. Such employment agreements are binding legal contracts that are difficult, if not impossible, for companies to break and are common among many corporations. Employment agreements spell out what an executive receives and sometimes guarantees payment regardless of an executive's performance.[2]

For example, among other benefits, Nardelli's contract called for an annual salary of at least $1.5 million, an annual bonus of at least $3 million, an annual stock option grant of at least 450,000 shares and a grant of deferred stock units corresponding to 750,000 shares of stock, regardless of performance. His employment agreement also stipulated how much compensation he would receive in each possible termination scenario.[3]

In the case of Nardelli's recent resignation, part of his agreement stated that he would receive $20 million in cash severance. The agreement also called for accelerated vesting of options and deferred stock awards that he received throughout his employment. Thus, 40 percent of Nardelli's $210 million exit package, or $84 million, was due to accelerated vesting in options and stock awards.[4] Some of this amount consists of the annual compensation guaranteed by his contract.

Making matters worse, Nardelli received a grant of stock options during the brief market slide shortly after the terrorist attacks on Sept. 11, 2001, which broke Home Depot's regular pattern of issuing options.[5] Granting stock options during a temporary decline in stock prices can result in a windfall profit unrelated to company performance.

The Home Depot revealed in June 2006 that the U.S. Securities and Exchange Commission initiated an informal inquiry in connection with past stock option grants.[6] Backdated stock options from 1981 to 2000 resulted in $200 million in overstated earnings.[7] The backdating ended the month before Nardelli became CEO.[8] Though an internal review concluded there was no wrongdoing by any current management or board members, it does not state who was responsible.[9]

At Home Depot, the Leadership Development and Compensation Committee of the Board of Directors reviews and recommends the compensation of executive officers and makes grants of stock and option awards.[10] John Clendenin is the only member of the board who has served on the committee during part of the period in which Home Depot backdated stock options. He also was chair of the committee when Nardelli began as CEO and was a member when Nardelli resigned.[11]

Board member Kenneth Langone, chairman of the New York Stock Exchange's compensation committee in 2003 when then-chairman and CEO Dick Grasso was forced to resign over a $140 million compensation package,[12] was on the Home Depot Stock Options Committee[13] during part of the period in which Home Depot backdated stock options. He also recruited Robert Nardelli to be CEO of Home Depot.[14]

Both Clendenin and Langone, as well as the rest of the Home Depot board of directors outside of Nardelli, were noticeably absent from Home Depot's 2006 Annual Shareholders' Meeting.[15]

[1] "Behind Nardelli's Abrupt Exit," *The Wall Street Journal*, Jan. 4, 2007.

[2] "CEOs Get Big Bucks If They Fail," *The Atlanta Journal-Constitution*, Jan. 5, 2007.

[3] Employment agreement between Robert L. Nardelli and The Home Depot Inc.

[4] Home Depot 8-K, Jan. 4, 2007.

[5] "Executive Pay: The 9/11 Factor," *The Wall Street Journal*, July 15, 2006.

[6] Home Depot 8-K, June 16, 2006.

[7] "Home Depot Backdated Options From 1981 to 2000," *The Wall Street Journal*, Dec. 7, 2006.

[8] Home Depot 10-Q, Dec. 6, 2006.

[9] See note 7.

[10] Home Depot 2006 proxy, page 7.

[11] Home Depot 2000 proxy, page 6; 2001 proxy, page 6; 2006 proxy, page 7.

[12] "Activists Seek More Scalps At Home Depot," *Financial Times*, Jan. 5, 2007.

[13] Home Depot 2001 proxy, page 6.

[14] See note 12.

[15] "Home Depot Pins Hopes on Charm," *Financial Times*, July 12, 2006.

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Severance Lump Sum*	$11,941,000
Severance Bonus	$2,158,300
Unused Vacation	$305,644
Nominal Value of Benefits	$576,573
Restricted Stock and Stock Unit Awards*	$5,783,156
Unvested Options**	$5,789,372
Performance Shares (assuming goals achieved)	$18,268,943
Deferred Compensation (total)	$27,909,041
Total Compensation	$[illegible]

Source: Pfizer 8-K, Dec. 21, 2006 *as of Dec. 13, 2006 **as of Dec. 31, 2005

Former Pfizer Inc. CEO Henry "Hank" McKinnell is a prime example of pay for failure.[1] During his tenure as CEO, Pfizer's stock dropped nearly 40 percent. During that same period, McKinnell received $60 million in salary and other compensation.[2] In December 2006, McKinnell left the company but not before taking an exit package of more than $200 million, including an $82 million pension.[3]

If you ask McKinnell though, he probably wouldn't think his compensation was excessive. The Business Roundtable, under its then-Chairman McKinnell,[4] commissioned a report on executive compensation, which stated that the media has been "flooded with multitude of distorted, misleading and oftentimes erroneous statistics to portray U.S. CEOs and board governance in a negative light."[5]

But when one considers that compensation consultant Frederic W. Cook & Co. Inc. prepared the report, its objectivity becomes questionable. Frederic W. Cook & Co. also is the "independent outside compensation consultant" for Pfizer.[6]

One might think that McKinnell would be a strong supporter of Social Security's defined benefit structure given his large pension. But under McKinnell, the Business Roundtable also supported groups in favor of Social Security privatization.[7]

Part of McKinnell's exit package was guaranteed by his employment agreement that he entered into when he became CEO in 2001.[8] However, an executive does not need an employment agreement to be entitled to a large severance payment.

Most of McKinnell's exit package—his $82 million pension, continued participation in the performance shares plan and deferred compensation—were provided for by the terms for those particular benefit plans. Another benefit not included in McKinnell's employment agreement, but given to him anyway, is continued health benefits under Pfizer's retiree medical program.[9]

New Pfizer CEO Jeffrey Kindler does not have an employment agreement, but he does have a change in control severance agreement, which Pfizer estimates will pay out about $25 million, a dramatic decrease from McKinnell's severance. However, because this amount is more than 2.99 times Kindler's average earnings over the past five years, the Internal Revenue Service may assess Kindler an excise tax of $7 million. Pfizer has agreed to pay (or gross-up) Kindler's tax, in addition to the tax the company would have to pay due to exceeding the 2.99 limit.[10]

Investors generally do not support including tax gross-ups as part of an executive's severance package. Moreover, the AFL-CIO generally supports shareholder approval of golden parachutes that exceed 2.99 times an executive's base salary and bonus. Institutional Shareholder Services (ISS), a leading proxy advisory service, believes companies should not have to pay taxes incurred on golden parachute payments awarded to executives and tends to support policies that ensure this. ISS also believes companies should not have to pay a CEO's excise tax gross-ups incurred on golden parachute payments.[11]

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The AFL-CIO has asked Pfizer to reconsider these issues, and Pfizer's management has indicated they will be bringing these matters before Pfizer's board.

[1] "Pay for Failure," The Corporate Library, March 2006.

[2] "A Long Shot Becomes Pfizer's Latest Chief Executive," *The New York Times*, July 29, 2006.

[3] Pfizer 8-K, Dec. 21, 2006.

[4] Business Roundtable press release, Aug. 9, 2006.

[5] Business Roundtable press release, July 5, 2006.

[6] 2007 Pfizer proxy, page 17.

[7] "Trade Groups Join Bush on Social Security; Though Individual Firms Are Wary, Nearly 100 Associations Answer a White House Battle Cry," *Los Angeles Times*, April 11, 2005.

[8] Employment Agreement between Henry McKinnell and Pfizer.

[9] 2007 Pfizer proxy, page 57.

[10]2007 Pfizer proxy, pages 71-73.
[11]*ISS U.S. Corporate Governance Policy 2007 Updates.*

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Robert Rubin on the job he never wanted

The reluctant chairman tells Fortune's Carol Loomis why Citi didn't see the subprime mess coming.

By Carol Loomis, Fortune senior editor at large

(Fortune Magazine) -- When the new chairman of Citigroup, Robert Rubin, is asked why he was so tenacious and outspoken in supporting the chairman who just left, Charles "Chuck" Prince, Rubin delivers a typically introspective answer: "People are what they are, and that's what I am." Besides, he asserts, Prince deserved to stay: "He was doing what was right and what needed to be done."

Rubin, 69, goes on to recall that he similarly supported Larry Summers in 2006 when the Harvard president was about to be forced out and that he also defended President Clinton in September 1998 during the bonfire days of the Monica Lewinsky affair. Just after prosecutor Kenneth Starr submitted his inflammatory report to Congress, Secretary of the Treasury Rubin declared on Tom Brokaw's NBC Nightly News that, regardless of the obvious problems, he believed Clinton to be doing "a very good job" as President.

An extreme irony in all this is that it is Rubin who could right now use a Rubinesque defender. On Sunday, Nov. 4, the same day Rubin reluctantly moved from the job of chairman of the executive committee to chairman of the board, the company announced the startling news that it had $55 billion of collateralized debt obligations (CDOs) and other subprime-related securities on its balance sheet and that large write-offs of an estimated $8 billion to $11 billion were imminent.

Within Citi, many employees - highly aware that Rubin was a risk wizard at both Goldman Sachs (Charts, Fortune 500) and the Treasury - are angry at what he didn't do to avoid both this disaster and earlier write-downs that Citi reported. Yes, the critics know Rubin has adamantly restricted himself to playing a nonoperating role at Citi, sticking mainly to advising the troops, from CEO on down, and dealing with important clients. Still, the burning question being asked today, outside Citi as well as in, is how all this CDO stuff could have gone on under his nose.

Though surely detesting the mere utterance of this question, Rubin contents himself with dismissing it. "The answer is very simple," he says. "It didn't go on under my nose." At Citi, as in any large company, he explains in a Business 101 way, you have people who are specifically responsible for certain areas - trading and risk, for example - and you have senior management making sure that they are highly qualified for the job and monitoring their work. And, Rubin says, "I am not senior management. I have this side role."

Okay, noted - except that this sideman of the dissonant Citi orchestra was paid $17.3 million last year. Rewards of that variety in other years have ordinarily left Rubin trailing only Prince and his predecessor, Sandy Weill, in compensation. That sure leaves Rubin looking a lot like senior management. In addition, what more important assignment could a consigliere to the CEO have than trying to anticipate risks? Both Prince and Weill, in fact, have talked in the past about the value of their conversations with Rubin, though Prince isn't available to be queried about that matter now.

A larger part of Rubin's explanation as to why Citi (Charts, Fortune 500) failed to avert its CDO train wreck concerns the sheer difficulty of heading it off. True, worries about a "housing bubble" abounded. Rubin himself gave countless speeches in recent years that talked about investors, in all manner of asset classes, "underweighting" risk - that is, sloughing off its importance. But he wasn't on the trading floors where the mortgage-related decisions had to be made, and he knows from deep experience that's where the buck stops.

Only the rare investor, Rubin points out, was able to anticipate the collapse. As an illustration, he refers to the New York private equity and hedge fund community, which he knows well. In the first six months of this year, he says, there may have been a few people in this club who positioned themselves to profit when things went bad. He measures them as no more than "a handful." Ditto the people who successfully hedged their positions, thereby offsetting some of the trouble in July and August. That would be another handful, he thinks.

Rubin doesn't need the reminder, but this writer injects it into the conversation anyway, remarking that the handful included Goldman Sachs, which this year has made large profits by shorting mortgage-related securities. Rubin acknowledges the fact quietly: "Some people did."

Goldman appears also to have scored by hedging long positions early this year. At a Citi analyst call on Nov. 5, just after the impending write-downs had been announced, Citi CFO Gary Crittenden said the company did some hedging in the first part of the year too. But by July and August, when the need for protection was terrifyingly apparent, the ability to hedge, especially in the large amounts that Citi needed, was virtually nonexistent. Citi had by that time, starting in July, organized daily meetings in which Rubin participated. He says, "I tried to help people as they thought their way through this. Myself, at that point, I had no familiarity at all with CDOs."

At bottom, the countdown to both Prince's exit and Citi's November shocks began in that summer crisis period for the credit markets. Citi started then to have ominous dealings with CDOs that carried a "liquidity put." Never heard of a liquidity put? Google will give you a few uninformative references. But it is testimony to the obscurity of this term that Rubin says he had never heard of liquidity puts until they started harassing Citi last summer.

What Citi did a couple of years ago was insert a put type of option into otherwise conventional CDOs that were backed by subprime mortgages and sold to such entities as funds set up by Wall Street firms. The put allowed any buyer of these CDOs who ran into financing problems to sell them back - at original value - to Citi. The likelihood of the put being exercised, however, was regarded as extremely remote because the CDOs were structured to be high-grade entities called "super-senior."

Meanwhile, you might think the existence of the put would make it impossible for Citi to get those CDOs entirely off its balance sheet. But in fact Citi found a complex accounting rationale for doing exactly that, and the CDOs jumped entirely to somebody else's balance sheet. All that remained in Citi's realm was this sticky little matter of the puts - which, as we shall immediately see, ultimately worked to get these CDOs right back to their creator, Citi.

Last summer, with the whole world suddenly unwilling to finance CDOs, the holders of the liquidity-put CDOs began to return them to Citi. And that's where they now reside - $25 billion of them, a very large lump in Citi's $55 billion of subprime-related securities. That entire package of trouble was the subject of Citi's Nov. 5 analyst call. This was the third presentation that Citi had made to analysts in five weeks - each of these confessionals more anguished than the last - and in that time Citi's stock and Prince's credibility had been punished.

But remarkably, Nov. 5 was the first time that Citi mentioned liquidity puts to the world. CFO Crittenden says the need to make disclosures about the puts did not arise until the last part of October, because until then the super-senior status of the put-laden securities made it appear they would largely hold their value. But that didn't take into account the rating agencies, which suddenly went on a downgrade binge. Their rating changes made it clear that Citi's super-seniors would have to be written down.

Crittenden and his staff met late on Thursday, Oct. 25, to begin sizing up the damage. Crittenden left the meeting not yet certain about the numbers. But he knew enough to tell Prince on Friday that the news would be very bad. With that, the beleaguered Prince recognized that his credit line of goodwill was used up. On the weekend, he called Rubin to say that he thought the only "honorable" action for him to take was to resign. Rubin urged Prince to stay, an expression of continuing support implying that Rubin, as a Citi director - an influential one - was prepared, despite the fresh onset of bad news, to keep backing Prince at the board level. Prince nonetheless remained determined to exit.

Rubin says unequivocally that Prince's resignation "was a Chuck-made decision." A modified view, though, is suggested by *Fortune*'s interview with Prince Alwaleed bin Talal bin Abdul Aziz al Saud (see the full text), who with a nearly 4% ownership, is Citi's biggest single shareholder. Alwaleed stayed supportive of Prince right through Citi's second earnings call, on Oct. 15.

But when word began to leak in late October that Citi would report huge new write-offs, Alwaleed was outraged and called Prince to tell him he would "withdraw" his support. That didn't necessarily mean curtains for Prince. Citi's board could conceivably have stuck with him. But it is easy to imagine that the prospect of a fight with Alwaleed was one big negative on Prince's mind as he proceeded to resign.

From that weekend when Rubin and Prince talked, it took another week of board and internal meetings for the financial news to be released and for the management scheme that included a foot-dragging Rubin to be crafted. He has been joined at the top by the head of Citigroup Europe, Sir Winfried Bischoff, 66, who will be interim CEO until the board finds a permanent boss.

Rubin has by these events been plunged into a job he wished above all to avoid: the top post in a major financial company in a period of crisis. But having made the wrenching decision to disturb what he calls "the arc of my life," Rubin seems bent on dragging this monster company out of the ditch. He says, "This is an important institution - not just to a lot of people, but also to the economy, globally. I think that this institution needs what Win Bischoff and I can bring to it." He pauses slightly: "And that's where my head is at the moment." ■

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Insights from the
FEDERAL RESERVE BANK OF DALLAS

The Rise and Fall of Subprime Mortgages

by Danielle DiMartino and John V. Duca

Past behavior suggests that housing markets' adjustment to more realistic lending standards is likely to be prolonged.

After booming the first half of this decade, U.S. housing activity has retrenched sharply. Single-family building permits have plunged 52 percent and existing-home sales have declined 30 percent since their September 2005 peaks (*Chart 1*).

A rise in mortgage interest rates that began in the summer of 2005 contributed to the housing market's initial weakness. By late 2006, though, some signs pointed to renewed stability. They proved short-lived as loan-quality problems sparked a tightening of credit standards on mortgages, particularly for newer and riskier products. As lenders cut back, housing activity began to falter again in spring 2007, accompanied by additional rises in delinquencies and foreclosures. Late-summer financial-market turmoil prompted further toughening of mortgage credit standards.

The recent boom-to-bust housing cycle raises important questions. Why did it occur, and what role did subprime lending play? How is the retrenchment in lending

activity affecting housing markets, and will it end soon? Is the housing slowdown spilling over into the broader economy?

Rise of Nontraditional Mortgages

Monitoring housing today entails tracking an array of mortgage products. In the past few years, a fast-growing market seized upon such arrangements as "option ARMs," "no-doc interest-onlys" and "zero-downs with a piggyback." For our purposes, it's sufficient to distinguish among prime, jumbo, subprime and near-prime mortgages.

Prime mortgages are the traditional—and still most prevalent—type of loan. These go to borrowers with good credit, who make traditional down payments and fully document their income. Jumbo loans are generally of prime quality, but they exceed the $417,000 ceiling for mortgages that can be bought and guaranteed by government-sponsored enterprises.

Subprime mortgages are extended to applicants deemed the least creditworthy because of low credit scores or uncertain income prospects, both of which reflect the highest default risk and warrant the highest interest rates. Near-prime mortgages, which are smaller than jumbos, are made to borrowers who qualify for credit a notch above subprime but may not be able to fully document their income or provide traditional down payments. Most mortgages in the near-prime category are securitized in so-called Alternative-A, or Alt-A, pools.

Some 80 percent of outstanding U.S. mortgages are prime, while 14 percent are subprime and 6 percent fall into the near-prime category. These numbers, however, mask the explosive growth of nonprime mortgages. Subprime and near-prime loans shot up from 9 percent of newly originated securitized mortgages in 2001 to 40 percent in 2006.[1]

The nonprime boom introduced practices that made it easier to obtain loans. Some mortgages required little or no proof of income; others needed little or no down payment. Homebuyers could take out a simultaneous second, or piggyback, mortgage at the time of purchase, make interest-only payments for up to 15 years, skip payments by reducing equity or, in some cases, obtain a mortgage that exceeded the home's value.

These new practices opened the housing market to millions of Americans, pushing the homeownership rate from 63.8 percent in 1994 to a record 69.2 percent in 2004. Although low interest rates bolstered homebuying early in the decade, the expansion of nonprime mortgages clearly played a role in the surge of homeownership.

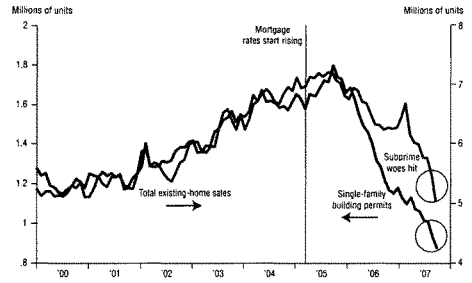
Two crucial developments spurred nonprime mortgages' rapid growth. First, mortgage lenders adopted the credit-scoring techniques first used in making subprime auto loans. With these tools, lenders could better sort applicants by creditworthiness and offer them appropriately risk-based loan rates.

By itself, credit scoring couldn't have fostered the rapid growth of nonprime lending. Banks lack the equity capital needed to hold large volumes of these risky loans in their portfolios. And lenders of all types couldn't originate and then sell these loans to investors in the form of residential mortgage-backed securities, or RMBS—at least not without added protection against defaults.

The spread of new products offering default protection was the second crucial development that fostered subprime lending growth. Traditionally, banks made prime mortgages funded with deposits from savers. By the 1980s and 1990s, the need for deposits had eased as mortgage lenders created a new way for funds to flow from savers and investors to prime borrowers through government-sponsored enterprises (GSEs) (*Chart 2, upper panel*).

Fannie Mae and Freddie Mac are the largest GSEs, with Ginnie Mae being smaller. These enterprises guarantee the loans and pool large groups of them into RMBS. They're then sold to investors, who receive a share of the payments on the underlying mortgages. Because the GSEs are federally chartered, investors perceive an

Housing Activity Drops Off



SOURCES: National Association of Realtors; Census Bureau; authors' calculations.

implicit government guarantee of them. Fannie Mae and Freddie Mac, however, haven't packaged many nonprime mortgages into RMBS.

Lacking the same perceived status, nonagency RMBS—those not issued by Fannie Mae, Freddie Mac and Ginnie Mae—faced the hurdle of paying investors extremely large premiums to compensate them for high default risk. These high costs would have pushed nonprime interest rates to levels outside the reach of targeted borrowers.

This is where financial innovations came into play. Some—like collateralized debt obligations (CDOs), a common RMBS derivative—were designed to protect investors in nonagency securities against default losses. Such CDOs divide the streams of income that flow from the underlying mortgages into tranches that absorb default losses according to a preset priority.

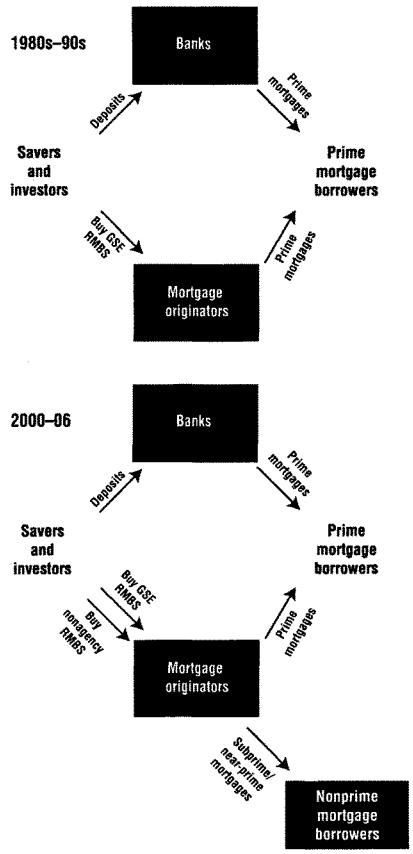
The lowest-rated tranche absorbs the first defaults on the pool of underlying mortgages, with successively higher ranked and rated tranches absorbing any additional defaults. If defaults turn out to be low, there may be no losses for higher-ranked tranches to absorb. But if defaults are much greater than expected, even higher-rated tranches may face losses.

Having confidence in the ability of quantitative models to accurately measure nonprime default risk, a brisk market emerged for securities backed by nonprime loans. The combination of new credit-scoring techniques and new nonagency RMBS products enabled nonprime-rated applicants to qualify for mortgages, opening a new channel for funds to flow from savers to a new class of borrowers in this decade (*Chart 2, lower panel*).

Nonprime Boom Unravels

As problems began to emerge in late 2006, investors realized they had purchased nonprime RMBS with overly optimistic expectations of loan quality.[4] Much of their misjudgment plausibly stemmed from the difficulty of forecast-

Mortgage Financial Flows



Failure to appreciate the risks of nonprime loans prompted lenders to overly ease credit standards. The result was a huge jump in origination shares for subprime and near-prime mortgages.

ing default losses based on the short history of nonprime loans.

Subprime loan problems had surfaced just before and at the start of the 2001 recession but then rapidly retreated from 2002 to 2005 as the economy recovered (*Chart 3*). This pre-2006 pattern suggested that as long as unemployment remained low, so, too, would default and delinquency rates.

This interpretation ignored two other factors that had helped alleviate subprime loan problems earlier in the decade. First, this was a period of rapidly escalating home prices. Subprime borrowers who encountered financial problems could either borrow against their equity to make house payments or sell their homes to settle their debts. Second, interest rates declined significantly in the early 2000s. This helped lower the base rate to which adjustable mortgage rates were indexed, thereby limiting the increase when initial, teaser rates ended.

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 nonprime mortgages. Indeed, swings in home-price appreciation and interest rates may also explain why prime and subprime loan quality have trended together in the 2000s. This can be seen once we account for the fact that past-due rates—the percentage of mortgages delinquent or in some stage of foreclosure—typically run five times higher on subprime loans (*Chart 3*). When the favorable home-price and interest rate factors reversed, the past-due rate rose markedly, despite continued low unemployment.

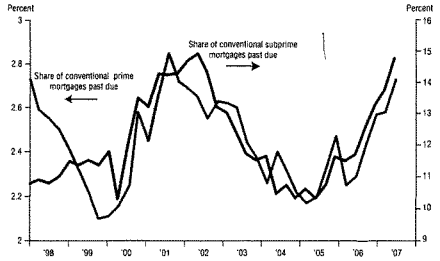
Failure to appreciate the risks of nonprime loans prompted lenders to overly ease credit standards.[4] The result was a huge jump in origination shares for subprime and near-prime mortgages.

Compared with conventional prime loans in 2006, average down payments were lower, at 6 percent for subprime mortgages and 12 percent for near-prime loans.[4] The relatively small down payments often entailed borrowers' taking out piggyback loans to pay the portion of their home prices above the 80 percent covered by first-lien mortgages.

Another form of easing facilitated the rapid rise of mortgages that didn't require borrowers to fully document their incomes. In 2006, these low- or no-doc loans comprised 81 percent of near-prime, 55 percent of jumbo, 50 percent of subprime and 36 percent of prime securitized mortgages.

The easier lending standards coincided with a sizeable rise in adjustable-rate mortgages (ARMs). Of the mortgages originated in 2006 that were later securitized, 92 percent of subprime, 68 percent of near-prime, 43 percent of jumbo and 23 percent of prime mortgages had adjustable rates. Now, with rates on one-year adjustable and 30-year fixed mortgages close, ARMs' market share has dwindled to 15 percent, less than half its recent peak of 35 percent in 2004.

Quality of Prime and Subprime Mortgages Deteriorates



NOTES: Conventional mortgages are those not insured by the Federal Housing Administration or guaranteed by the U.S. Department of Veterans Affairs. Data are seasonally adjusted. Shaded area indicates recession.

SOURCE: Mortgage Bankers Association.

In early 2007, investors and lenders began to realize the ramifications of credit-standard easing. Delinquency rates for 6-month-old subprime and near-prime loans underwritten in 2006 were far higher than those of the same age originated in 2004.

Other signs of deterioration also surfaced. The past-due rate for outstanding subprime mortgages rose sharply and neared the peak reached in 2002, with the deterioration much worse for adjustable- than fixed-rate mortgages. In first quarter 2007, the rate at which residential mortgages entered foreclosure rose to its fastest pace since tracking of these data began in 1970.

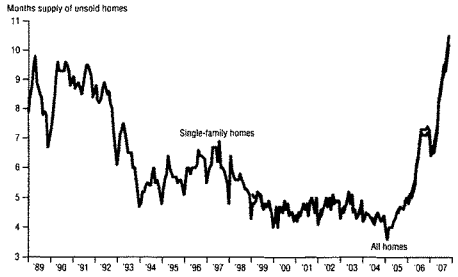
Lenders reacted to these signs by initially tightening credit standards more on riskier mortgages. In the Federal Reserve's April 2007 survey of senior loan officers, 15 percent of banks indicated they had raised standards for mortgages to prime borrowers in the prior three months, but a much higher 56 percent had done so for subprime mortgages. Responses to the July 2007 survey were similar.

However, in the October 2007 survey the share of banks tightening standards on prime mortgages jumped to 41 percent, while 56 percent did so for subprime loans. Many nonbank lenders have also imposed tougher standards or simply exited the business altogether. This likely reflects lenders' response to the financial disruptions seen since last summer.

The stricter standards meant fewer buyers could bid on homes, affecting prices for prime and subprime borrowers alike. Foreclosures added to downward pressures on home prices by raising the supply of houses on the market. And after peaking in September 2005, single-family home sales fell in September 2007 to their lowest level since January 1998.

The number of unsold homes on the market has risen, sharply pushing up the inventory-to-sales ratio for existing single-family homes from their low in January 2005 to their highest level since the start of this series in 1989 (*Chart 4*). Condominium supply, which is reflected in the all-home numbers, has experienced an even sharper increase since early 2005.

Existing-Home Inventories Rise from Late-2004 Lows



NOTE: The all-homes category covers single-family homes, condominiums and nonrental apartments. Shaded areas indicate recession.

SOURCE: National Association of Realtors.

In the absence of home-price appreciation, many households are finding it difficult to refinance their way out of adjustable-rate mortgages.

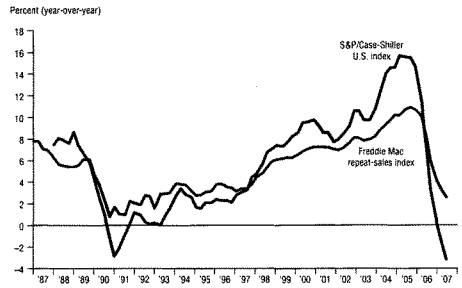
These high inventories will likely weigh on construction and home prices for months to come. After peaking in early 2005, the Standard & Poor's/Case-Shiller index of year-over-year home-price appreciation in 10 large U.S. cities was down 5 percent in August—its biggest drop since 1991. While a Freddie Mac gauge of home prices posted a small year-over-year gain in the second quarter, the pace was dramatically off its highest rate, reported in third quarter 2005 (*Chart 5*).

In the absence of home-price appreciation, many households are finding it difficult to refinance their way out of adjustable-rate mortgages obtained at the height of the housing boom. Larger mortgage payments could exacerbate delinquencies and foreclosures, especially with interest rate resets expected to remain high for the next year (*Chart 6*). This suggests mortgage quality will likely continue to fall off for some time.

Financial Turmoil

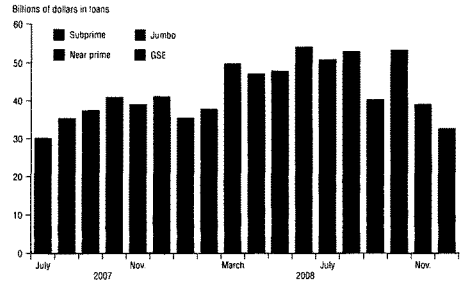
By August 2007, the housing market's weaknesses were apparent: loan-quality problems, uncertainty about inventories, interest rate resets and spillovers from weaker home prices. These, coupled with ratings agencies' downgrading of many subprime RMBS, led to a dramatic thinning in trading for subprime credit instruments, many of which carried synthet-

Home-Price Appreciation Plunges into Negative Territory



NOTE: Shaded areas indicate recession.
SOURCES: Freddie Mac; Standard & Poor's/Case-Shiller.

Scheduled Resets on Adjustable-Rate Mortgages Remain High



SOURCE: Bank of America estimates based on LoanPerformance data.

ic, rather than market, values based on models because of the instruments' illiquidity.

On Aug. 14, the paralysis in the capital markets led three investment funds to halt redemptions because they couldn't reasonably calculate the prices at which their shares could be valued. This event triggered widespread concern about the pricing of many new instruments, calling into question many financial firms' market values and disrupting the normal workings of the financial markets.

Investors sought liquidity, putting upward pressure on overnight interest rates and sparking a sharp upward repricing of risk premiums on assets, particularly those linked to nonprime mortgages. One outcome was an interest rate spike for both mortgage-backed commercial paper and jumbo mortgages, which heightened financial market uncertainty. In this environment, nonagency RMBS were viewed as posing more liquidity and default risk than those packaged by Fannie Mae and Freddie Mac.

Facing greater perceived default risk, investors began demanding much higher risk premiums on jumbo mortgage securities, pushing up the cost of funding such loans via securitization and encouraging lenders to incur the extra cost of holding more of these loans in their portfolios. This contributed to a 1 percentage point jump in jumbo interest rates between June and late August, an especially important increase given that jumbos accounted for about 12 percent of mortgage originations last year.

Although spreads between jumbo and conforming loan rates have fallen off their late-summer highs, they're still elevated. The higher rates have dampened the demand for more expensive homes, just as tighter credit standards reduced the number of buyers for lower-end homes.

Macroeconomic Effects

A housing slowdown mainly affects gross domestic product by curtailing

housing construction and home-related spending. It also reins in spending by consumers who have less housing wealth against which to borrow.[5]

Residential construction likely exerted its largest negative effect in third quarter 2006, when it subtracted 1.3 percentage points from the annual pace of real GDP growth. Last year, many forecasts predicted home construction would stop restraining GDP growth by the end of 2007 and the industry would start recovering in 2008. These predictions were made before the tightening of nonprime credit standards began in late 2006. The change in standards will likely prolong the housing downturn and delay the recovery, although it's hard to tell precisely for how long. Since single-family permits have already fallen 52 percent from their September 2005 peak, however, the worst of the homebuilding drag may be behind us.

The same may not be true for housing's indirect effect on consumption. Since the late 1990s, many homeowners have borrowed against housing wealth, using home equity lines of credit or cash-out refinancing or not fully rolling over capital gains on one house into a down payment or improvements on the next one. These mortgage equity withdrawals gave people access to lower cost, collateralized loans, which bolstered spending on consumer goods. By one measure, these withdrawals were as large as 6 to 7 percent of labor and transfer income in the early to mid-2000s.

The magnitude and timing of these withdrawals may have changed in hard-to-gauge ways. New research suggests housing wealth's impact on consumer spending grew as recent financial innovations expanded the ability to tap housing equity.[6] This is consistent with prior research on housing's connection to U.S. consumer spending.[7] Aside from the interest-rate-related refinancing surge of 2002 and 2003, mortgage equity-withdrawal movements have become increasingly sensitive to swings in home-price appreciation since a 1986 law granted a federal income tax deduction for home equity loans (*Chart 7*).

Compounding the uncertain outlook for consumption is the likely reversal of the early 2000s' mortgage credit liberalization.[8] This will put further downward pressure on home prices and housing wealth and may curtail home equity loans and cash-out refinancings. Finally, the homebuying enabled by the easing of credit standards in recent years may have been at the expense of later sales, further dampening the market going forward.

The timing of housing wealth's impact on consumption may have also changed. For example, before the advent of equity lines and cash-out refinancings, housing wealth increases may have affected U.S. consumption mainly by reducing homeowners' need to save for retirement. Since then, such financial innovations have enabled households to spend their equity gains before retirement. It's unclear how much this may be reversed by the 2007 retrenchment in mortgage availability.

Looking Ahead

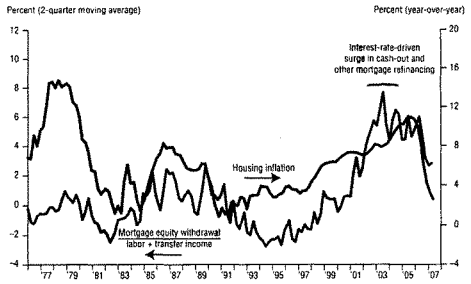
The rise and fall of nonprime mortgages has taken us into largely uncharted territory. Past behavior, however, suggests that housing markets' adjustment to more realistic lending standards is likely to be prolonged.[9]

One manifestation of the slow downward adjustment of home prices and construction activity is the mounting level of unsold homes. The muted outlook for home-price appreciation, coupled with the resetting of many nonprime interest rates, suggests foreclosures will increase for some time.

The sharp reversal of trends in home-price appreciation will also dampen consumer spending growth, an effect that may worsen if the pullback in mortgage availability limits people's ability to borrow against their homes.

Although recent financial market turmoil will likely add to the housing slowdown, there are mitigating factors.

Mortgage Equity Withdrawals Increasingly Move with Housing Inflation and Mortgage Refinancings



NOTE: Shaded areas indicate recession.

SOURCES: Freddie Mac, Bureau of Economic Analysis; Federal Reserve, flow of funds data; authors' calculations.

First, the effect of slower home-price gains on consumer spending is likely to be drawn out, giving monetary policy time to adjust if necessary.

Second, the Federal Reserve has been successful in slowing core inflation while maintaining economic growth. This gives policymakers inflation-fighting credibility, which enables them to coax down market interest rates should the economy need stimulus.

Third, even if the tightening of mortgage credit standards undesirably slows aggregate demand, monetary policy could still, if need be, help offset the overall effect by stimulating the economy via lower interest rates. This would bolster net exports and business investment and help cushion the impact of higher risk premiums on the costs of financing for firms and households.[10]

DiMartino is an economics writer and Duca a vice president and senior policy advisor in the Research Department of the Federal Reserve Bank of Dallas.

Notes

The authors thank Jessica Renier for research assistance.

[1] See "The Subprime Slump and the Housing Market," by Andrew Tilton, *US Economics Analyst*, Goldman Sachs, Feb. 23, 2007, pp. 4–6. Securitized mortgages account for roughly 70 to 75 percent of outstanding, first-lien U.S. residential mortgages, according to estimates in "Mortgage Liquidity du Jour: Underestimated No More," Credit Suisse, March 13, 2007, p. 28.

[2] See, for example, Federal Reserve Chairman Ben Bernanke's remarks, "Housing, Housing Finance, and Monetary Policy," at the Federal Reserve Bank of Kansas City's Economic Symposium, Jackson Hole, Wyo., Aug. 31, 2007.

[3] Part of the reason lenders eased credit standards was that they planned to sell, rather than hold, the mortgages. The earlier easing of standards may have partly owed to the potential moral hazard entailed when nonconforming loans are originated with the intent to fully sell them to investors. Bernanke discusses this in his remarks at the 2007 Jackson Hole symposium (note 2).

[4] The figures are for securitized mortgages. See "Mortgage Liquidity du Jour" (note 1).

[5] "Making Sense of the U.S. Housing Slowdown," by John Duca, Federal Reserve Bank of Dallas *Economic Letter*, November 2006.

[6] See "How Large Is the Housing Wealth Effect? A New Approach," by Christopher D. Carroll, Misuzu Otsuka and Jirka Slacalek, National Bureau of Economic Research Working Paper no. 12746, December 2006; and "Housing, Credit and Consumer Expenditure," by John Muellbauer, paper presented at the Federal Reserve Bank of Kansas City's Economic Symposium, Jackson Hole, Wyo., Aug. 31–Sept. 1, 2007. Also see "Booms and Busts in the UK Housing Market," by John Muellbauer and Anthony Murphy, *Economic Journal*, vol. 107, November 1997, pp. 1701–27; and "House Prices, Consumption, and Monetary Policy: A Financial Accelerator Approach," by Kosuke Aoki, James Proudman and Gertjan Vlieghe, *Journal of Financial Intermediation*, vol. 13, October 2004, pp. 414–35.

[7] "Estimates of Home Mortgage Originations, Repayments, and Debt on One-to-Four-Family Residences," by Alan Greenspan and James Kennedy, Finance and Economics Discussion Series Working Paper no. 2005-41, Board of Governors of the Federal Reserve System, September 2005; and "Mutual Funds and the Evolving Long-Run Effects of Stock Wealth on U.S. Consumption," by John V. Duca, *Journal of Economics and Business*, vol. 58, May/June 2006, pp. 202–21.

[8] This is a possibility to which Muellbauer (2007, note 6) alludes.

[9] See Duca (note 5).

[10] For a discussion of the channels of monetary policy, see "Aggregate Disturbances, Monetary Policy, and the Macroeconomy: The FRB/US Perspective," by David Reifschneider, Robert Tetlow and John Williams, *Federal Reserve Bulletin*, January 1999, pp. 1–19.

Next EconomicLetter

Related Article: **From Complacency to Crisis: The Rise and Fall of Risk Taking in the Early 21st Century**

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Mr. Chairman and Ranking Member Davis,

Will Rogers wrote once, "About all I can say for the United States Senate is that it opens with a prayer and closes with an investigation." The same could be said for the honorable body in which those of us on this dais serve.

Today we're meeting to review the compensation of three executives who have served with firms whose financial standing has, in recent months, come under close public scrutiny.

The problem of mortgage companies loaning money to under-qualified homebuyers is a serious one. Yet I'm not sure we'll get any closer to resolving that issue by holding this hearing.

Instead, our purpose, I guess, is to make some prosperous men squirm. Perhaps there is some merit in that, but so far, its value eludes me.

We meet today not to consider seriously how to help homeowners in crisis but to flay certain business leaders for their perceived overpayment. How interesting, especially from a Congress that refuses to take its own fiscal stewardship seriously – a failure with implications for our current and future economy far more vast than anything allegedly perpetrated by the firms represented before us today.

Since the new majority took office, it has passed at least $998 billion in new spending. That's $30,000 for every person in America. We are encumbering our children with a financial burden that will cripple our economic well-being for decades to come.

In 2005, President Bush proposed a modest solution to the fiscal crisis inherent in the Social Security system. He was vilified by his political opponents, who themselves offered no coherent alternative to his plan. So between wild overspending here in Congress and the looming penalty of unfunded entitlement spending, we are careening toward fiscal collapse.

Instead of working to solve these problems, we hold yet another substantively unproductive, media-driven event whose occurrence largely is a means by which Congressmen can look righteously indignant for the cameras.

I think the Founders of our country had something else in mind when they formed the House of Representatives. As Fisher Ames said on the floor of the House in 1789, and I quote: "We are not to consider ourselves, while here, as at church or school, to listen to the harangues of speculative piety; we are here to talk of the political interests committed to our charge."

To put it more simply, we're not here to point fingers and pump our arms and pound our chests. The purpose of the House of Representatives is not to trumpet its own moral superiority. We're here to act in the public interest. I'm not at all sure, Mr. Chairman, that that's what we're doing today.

Excessive executive compensation is a matter that, perhaps, this body should examine, although I note with interest that no one here has called for an investigation as to why Steve Spielberg earns hundreds of millions of dollars for making movies or whether the hedge funds of George Soros have really benefited ordinary Americans.

Home mortgages are vital to tens of millions of American families. But what possible help are we providing to anyone by scoring political points against our witnesses today?

With that question, I yield back.

Chairman WAXMAN. We're pleased to have you with us today. We've received your prepared testimony. What we'd like to ask you to do in your oral presentation is to try to stay within 5 minutes. We'll have a clock. It will be green, and then 1 minute before the 5 minutes are up it will turn yellow, and then red at the end of 5 minutes. We'd like to ask you, when you see the red, to try to summarize. But your whole statements will be in the record.

Ms. Wachter, why don't we start with you? There's a button on the base of the mike. Be sure to push it in. And pull it close enough to you so we can hear everything you have to say.

STATEMENTS OF SUSAN M. WACHTER, RICHARD B. WORLEY PROFESSOR OF FINANCIAL MANAGEMENT, THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA; WILLIAM F. GALVIN, SECRETARY OF STATE, COMMONWEALTH OF MASSACHUSETTS; BRENDA L. LAWRENCE, MAYOR, CITY OF SOUTHFIELD, MI; ANTHONY YEZER, PROFESSOR OF ECONOMICS, THE GEORGE WASHINGTON UNIVERSITY; AND NELL MINOW, EDITOR AND COFOUNDER, THE CORPORATE LIBRARY

STATEMENT OF SUSAN WACHTER

Ms. WACHTER. Chairman Waxman and distinguished members of the committee, thank you for the invitation to testify at today's hearing and to provide my perspective on the ongoing mortgage debacle and the resulting credit crunch.

I am Susan M. Wachter, the Richard B. Worley professor of financial management at the Wharton School at the University of Pennsylvania. Formerly, I served as the Assistant Secretary of Policy Development and Research at the U.S. Department of Housing and Urban Development.

Incentives are an important element of the current debacle in subprime mortgage markets. The focus of subprime market participants on short-term compensation through fees rather than long-term loan performance is central to the outcome we see today of unprecedented foreclosure rates in an economy that is, as of now, not in recession.

The current crisis is a textbook demonstration of how misaligned incentives can cause financial markets to fail. In my testimony, I will draw on and briefly describe research that shows why and how misaligned incentives generate financial crisis and why these often lead to housing market crises.

Financial crises and collapsing housing markets often occur together. The combined mortgage credit crisis and housing market recession that we currently are in is not a first. The two phenomena are correlated in remarkable number of instances, as in the Great Depression, the Asian financial crisis and the U.S. Savings and Loan crisis. Our current collapse in the subprime mortgage market is yet another example. Such combined crises often result from the misalignment of incentives in financial markets. This misalignment of incentives can be seen today, as well, in the current debacle.

Dysfunctional compensation schemes operated at every stage of the subprime mortgage securitization process. Short-run volume

drove up compensation and, therefore, provided incentives to produce throughout the subprime mortgage supply chain. Long-term loan performance and the likelihood that loans would fail did not slow down the production process until the failures actually did occur.

As the drive to expand markets and garner additional volume-driven fees, loans were underwritten at ever-riskier terms and with fewer controls and less information on the borrower's ability to repay. Information that pointed to greater risk was ignored, and these loans were originated, underwritten and securitized, generating unprecedented growth in fees.

Compensation structures that are driven by short-term volume production often lead to financial crises. Such crises may, in fact, be inevitable in the absence of market or other institutions that force consideration of long-term performance and profitability.

In the short run, weakened lending standards fuel demand, which actually drives up housing prices. The result, in this case, was higher housing prices which temporarily supported the market but which caused today far higher than anticipated foreclosures. This occurs when it becomes apparent that the price rises are artificial.

Loans made at previous high housing prices with high loan-to-value ratios are now under water, with loan amounts near to or exceeding mortgage balances. This is where we are today in much of the 2006 book of business of subprime adjustable rate mortgages. And overall we have seen today, for the first time since World War II, the lowest percentage of home equity in American homes.

This lending crisis has been centered in securitized subprime mortgages. In a well-functioning securities market, as loans become riskier, the price of securities composed of pools of these mortgages should drop, reflecting their poor quality and heightened risk. In efficient markets, this would have caused demand for and production of such lending to decline and market self-correction before the crisis occurred.

We must ask why, despite the increased production of poorly underwritten loans, this market-correcting decline of prices of the securities backing the loans did not happen. Markets failed to signal the heightened riskiness of securities until the loans actually went into default rather than when the riskier loans were being produced.

But the incentives to generate short-term fees without properly pricing or underwriting for long-term performance operate, as I noted, throughout the supply chain. At origination, mortgage brokers were incentivized to produce. Mortgage brokers were paid for loan closings, not for detecting and rejecting a poorly underwritten loan that was likely to fail. This payment structure meant that the broker had little incentive to restrict issuance only to mortgages of high quality. The losses from bad mortgages that would fail would fall only on the lender or the investor. Yield spread premiums also widened the incentive gap between broker and lenders.

Mortgage brokers had little risk for collecting fees up front and passing faulty loans off to lenders and investors. Lenders knew they, too, could pass on the risk of these loans onto the investor and be paid up front for their services. Investment banks and rat-

ing agencies were mostly indifferent to the risk of these loans as well, because they also knew their revenue would be generated by the securitization process. The increasing demand for these high-yield securities ultimately led to an increasing flow of borrowers into subprime loans.

Where were the investors, the ultimate holders of the risk, in this process? Surely they were incentivized to seriously evaluate the risk-return tradeoff of the securities they were purchasing and holding. While this would seem self-evident, this did not occur.

Rather, investors were purchasing mortgage-backed securities and collateralized debt obligation interest in mortgage-backed securities, which were highly heterogeneous with risk specific to the mortgages in the pool. Without standardization, there was limited liquidity and these securities did not trade. They were not marked to market; rather, they were marked to model.

The models were approved by rating agencies that, as I just noted, limited incentives to evaluate their flaws. There was little incentive for traders to consider the negative outlook for these securities since they did not trade. For many investors who were looking for yield yet needed to be in investor-grade triple-A securities, these MBS and CDOs were too good to turn down as long as they were rated triple-A.

But for some investors, the short-term excess return, while invested in seemingly secure instruments, was good enough and no further investigation of risk was necessary. For investors who would have wished to profit from mispricing of this risk, for the "A" and the riskier "B" and well-named "toxic waste" pieces of these securities, there was little option to once again take advantage of information, once again since the securities traded very little.

In our current situation, it was ultimately the increase in supply of credit that enabled the production of what I have elsewhere called aggressive lending instruments. Industry sources suggest that aggressive lending instruments, such as interest-only loans, negative amortizing loans, zero equity loans, and teaser-rate adjustable rate mortgages accounted for nearly two-thirds of all U.S. loan origination since 2003.

In 2004, there was a huge growth in the number of mortgages extended to people with nonprime credit, and, particularly, there was a ramp-up in the number of negatively amortizing loans and teaser-rate mortgages.

This weakening of lending standards, coupled with increased production, resulted in mortgages that were structured to fail even in the absence of intent or fraud. The result, as we've seen, has been the massive failure of these loans. For example, recent data that was released by the Mortgage Bankers Association reveals that, in the third quarter of 2007, more than 40 percent of the adjustable rate mortgages extended to subprime borrowers have started the foreclosure process.

Chairman WAXMAN. Ms. Wachter, if you want to quickly sum up.

Ms. WACHTER. It is my pleasure to do so. Thank you, sir.

The ultimate question before us is, do we want a system that produces risks such as those that we have seen in the current market? It is clear that Wall Street will underwrite any risk. Risk-taking with the home, through instruments such as I have described,

expose borrowers and investors to risk, but they also expose all homeowners and the overall economy to increased house-price volatility and risk.

Such lending, financed through MBS, even with diversified loan portfolios, is nonetheless completely exposed to the risk of the business cycle. Negatively amortizing and teaser-rate mortgages that ultimately require refinancing for sustainability have similar systemic risk to the kind of mortgages which prevailed during the Great Depression, which also needed to be refinanced, whether the markets were friendly and allowed the refinancing or not.

We, as a society, will have to decide whether we wish to encourage such financially vulnerable lending as backing to the asset which we also call home.

Thank you, Mr. Chairman.

[The prepared statement of Ms. Wachter follows:]

"Incentives and the Current Crisis"

Prepared for

HEARING ON MARCH 7, 2008
BEFORE
THE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
U.S. HOUSE OF REPRESENTATIVES

WRITTEN TESTIMONY OF SUSAN M. WACHTER
Richard B. Worley Professor of Financial Management;
Professor of Real Estate and Finance
The Wharton School, University of Pennsylvania, Philadelphia, Pennsylvania

I: Introduction

Chairman Waxman and distinguished members of the Committee:

Thank you for the invitation to testify at today's hearing on "Executive compensation, CEO Pay and the mortgage crisis" and to provide my perspective on the ongoing mortgage debacle and the resulting credit crunch. I am Susan M. Wachter, the Richard B. Worley Professor of Financial Management and Professor of Real Estate and Finance at The Wharton School of the University of Pennsylvania. Formerly, I served as Assistant Secretary of Policy Development and Research at the U.S. Department of Housing and Urban Development. My testimony is based on studies that I and others have authored on the causes and consequences of the subprime crisis.

Incentives are an important element of the current debacle in subprime mortgage markets. The focus of subprime market participants on short term compensation through fees rather than long term loan performance is central to the outcome we see today of unprecedented foreclosure rates in an economy that is currently not in recession. The current crisis is a textbook demonstration of how misaligned incentives cause financial markets to fail. In my testimony I will draw on and briefly describe research that my colleagues and I have done that shows why and how misaligned incentives generate financial crises and why these often lead to housing market crises. I will then discuss the specific role of compensation driven misaligned incentives in the current crisis. Finally, I will briefly describe the origins of the current crisis and end by summarizing implications for short term and long term policy responses.

II: Why Incentives Matter

Financial crises and collapsing housing markets often occur together. The combined mortgage credit crisis and housing market recession that we are currently in is

not a first. The two phenomena are correlated in a remarkable number of instances, such as the Great Depression, the Asian Financial Crisis, and the US Savings and Loan collapse. Our current crisis in the subprime mortgage market is another example.

Such combined crises often result from the misalignment of incentives in the financial markets that fund housing debt. This misalignment of incentives can be seen in the current debacle. Dysfunctional compensation schemes operate at every stage of the subprime mortgage securitization process. Short run volume drives compensation and therefore incentives to produce throughout the subprime mortgage supply chain. Long term loan performance or the likelihood that loans would fail did not slow down the production process until the failures actually did occur. Quite the contrary as the drive to expand markets and garner additional volume driven fees, loans were underwritten at more risky terms and with less controls and less information on the borrower's ability to repay. Information that pointed to greater risk was ignored, and these loans were originated, underwritten and securitized, generating unprecedented growth in fee.

In research done with my colleague, Andrey Pavlov, (Pavlov and Wachter, 2006) we show why and how compensation structures that are driven by short term volume production lead to financial crises. We show the conditions under which such crises are actually inevitable, the most important of which is the absence of market or other institutions that force consideration of long-term performance and profitability.

Misaligned incentives in compensation systems are at the core of the current financial market and housing market linked crises. The incentive to generate increased loan volume erodes lending standards, leading to loans that are designed to fail.

In the short run, weakened lending standards expand the market, fueling demand which drives up housing prices to unsustainable levels. The result is higher housing prices in the short run which temporarily supports the market but which cause far higher than anticipated foreclosures when it becomes apparent that the price rises were artificial and prices fall. Loans made at high previous housing prices often with high loan to value ratios are now "under water," with loan amounts near to or exceeding mortgage balances. This is where we are today in much of the 2006 book of business of subprime adjustable rate mortgages.

This too has happened before. In our work referenced above, we show direct evidence that erosion of lending standards initially impacts underlying housing markets through higher prices. As financial institutions erode lending standards in an attempt to increase origination volume, housing markets incorporate this mistake into asset prices. This generates housing price inflation beyond what can be justified by the fundamental economic conditions. Sooner or later this mechanism runs its course and home prices stagnate. When these poorly underwritten loans began to fail, price declines are inevitable and these price declines drive a spiral of increasing foreclosures. As this begins, lenders are no longer able to further relax their lending standards, and, in fact, withdraw the supply of funds to the housing market for fear of default losses. It is this

erosion and later tightening of lending standards that cause the real estate market to crash.

Nonetheless, the credit induced price bubble temporarily increases the perceived value of loans collateralized by real estate which provides ammunition to falsely support claims that risks have not increased. Thus the compensation driven production of loans, with lower loan quality, goes on. This, in turn, leads to further increases in the price of real estate, with the requisite fall to fundamental price level steeper as a result, and the consequence increased foreclosures. Eventually, the process becomes unsustainable as lending standards cannot be further eased, price increases halt, and the poorly underwritten loans cannot be rescued by ever increasing prices. This leads to a system breakdown.

In the presence of defaults, the mechanism of eroding and later tightening of lending standards is even more pronounced. First, the mere reduction of supply of funds for real estate limits the choices homeowners in financial difficulty have and forces them into default. Second, defaults generate a negative pressure on all surrounding properties, further magnifying the real estate cycle, which, in turn, further reduces the availability of credit.

Using both international and domestic real estate and financial availability data in research with colleagues we empirically demonstrate that the erosion of lending standards is linked with excessive home price increases, followed by credit tightening and deeper price declines than could be explained by changes in the underlying economic fundamentals.

In our current crisis, actors lacked incentives to underwrite loans carefully so that they would be sustainable; rather the incentive was to produce loans whatever their ultimate performance, with the consequence of loans that were designed to fail, failing in unprecedented numbers.

This lending crisis has been centered in the securitized subprime mortgages. In a well functioning securities market, as loans became riskier, the price of the securities, composed of pools of these mortgages should drop, reflecting their poorer quality and heightened risk. In efficient markets, this would have caused demand for and production of such lending to decline and market self-correction, before a crisis production level of these loans occurred.

We must ask why, despite the increased production of poorly underwritten loans and the deterioration of overall credit standards, this market correcting decline in prices of the securities backing the subprime credit did not happen. Markets failed to signal the heightened riskiness of securities backed by subprime loans until the loans actually began to go into default, rather than when the riskier loans were being produced. If the latter had occurred this would have allowed self-correcting feedback. This is another component of misaligned incentives which I will address below.

III: Mechanisms

I would now like to focus on the mechanisms that caused a short term focus on volume and fee driven compensation. As noted above, the incentive to generate short term fees without properly pricing or underwriting for long term performance operated throughout the subprime mortgage production supply chain. At origination, mortgage brokers were incentivized to produce as many mortgages as possible. Mortgage brokers were paid for loan closings, not for detecting and rejecting a poorly underwritten loan that was likely to fail. In the case of subprime, mortgage brokers were paid exclusively with fees issued at closing. This payment structure meant that the broker had no incentive to restrict issuance of mortgages to those of high quality. The losses from bad mortgages would fall only on the lender or the investor. Yield spread premiums also widened the incentive gap between brokers and lenders. Lenders would pay these premiums to brokers for loans that included excessive prepayment penalties and interest rates in excess of what the borrowers' credit scores dictated.

These incentives lead to subprime brokers taking extreme measures to close a loan. In many cases these measures included inflating the borrower's income or assets either with or without the borrower's involvement. Brokers would also use inflated appraisal values or commit borrowers to overpriced mortgages. Some of these borrowers had credit scores that qualified them for prime loans with much lower rates. Furthermore, if a borrower was put into a loan that they could not afford, the broker could always help refinance the loan, which lead to even more broker fees. In these ways, brokers had an incentive to heighten the risk of subprime loans and pass that risk on to borrowers, lenders and investors. Lenders had no incentive to stop the brokers from these dubious practices. Through securitization, they planned on passing these risks on to the investors and therefore lowered their underwriting standards on loans to increase the volume of mortgages being produced.

Mortgage brokers held no risk by collecting fees up front and passing faulty loans off to lenders or investors. Lenders knew that they could also pass on the risk of these loans onto the investor and be paid upfront for their services. Investment banks and rating agencies were indifferent to the risk of these loans as well because they knew their revenue would be generated by the securitization process. Investors did not scrutinize the ratings of loan pools in their rush for high returns. Their increasing demand for these high-yield securities ultimately lead to an increasing flow of borrowers into subprime loans.

Why were the investors, the ultimate holders of the risk, along with borrowers, in this process? Surely they were incentivized to seriously evaluate the risk/return trade-off of the securities they were purchasing and holding? While this would seem self-evident, the markets that could have encouraged and enabled identification of risk through incorporation of all information were not operating. Rather investors were purchasing mortgage backed securities (MBS) and Collateralized Debt Obligations (CDOs), interests

in MBS which were highly heterogeneous with risk specific to the mortgages in the pool. Without standardization, there was little liquidity and these securities did not trade. They were not marked to market; rather they were marked to model. The models were approved by rating agencies that had few incentives to evaluate their flaws. There was limited incentive for traders to consider the negative outlook for these securities, since they did not trade. For many investors who were looking for yield yet needed to be in investor grade triple "A" securities, these MBS and CDOs were too good to turn down, as long as they were rated triple A. The fact that the rating rather than their underlying risk was what made them investment grade securities may or may not have been known. But for some investors the short term excess return while invested in seemingly secure instruments was good enough and no further investigation of risk was necessary. For investors who would have wished to profit from the mispricing of this risk, for the "A" and the riskier "B" and well named, toxic waste, pieces of these securities, there was no option to do so since the securities did not trade.

IV: The Current Crisis: Origins and Outcomes

In our current situation, it was ultimately the increase in the supply of credit that enabled the production of what we have elsewhere called aggressive lending instruments. Industry sources suggest that aggressive lending instruments, such as interest only loans, negative amortization loan, low or zero-equity loans, and teaser-rate adjustable rate mortgages (ARMs), accounted for nearly two-thirds of all U.S. loan originations since 2003. Furthermore, in 2004, there was a huge growth in the number of mortgages extended to people with non-prime credit. There was a particular ramp up in the number of negative amortizing loans and teaser rate ARM mortgages offered in the subprime market. This weakening of lending standards coupled with increased production resulted in mortgages which were structured to fail, even in the absence of intent or fraud, although fraudulent lending also did increase.

The result, as we have seen, has been the massive failure of these loans. For example, recent data that was released by the Mortgage Bankers Association reveals that in the 3rd quarter of 2007, 43% of the adjustable rate mortgages extended to subprime borrowers started the foreclosure process. In early February, Fitch Ratings predicted that fully 48% of subprime loans securitized by major financial institutions in 2006 will go into default. As described by Pat McCoy, in her testimony entered into the record for today's hearing, 2006 was nevertheless an extremely profitable year for financial institutions; Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers and Bear Stearns posted record net earnings.

Further evidence of aggressive lending practices is that in 2006, in some offering documents for securitized subprime bond offerings failed to state that exceptions to underwriting standards, or loans that actually flunked the underwriters' standards far outweighed the number of loans which met underwriting standards. Ratings agencies now assert that investment banks withheld from them due diligence reports which quantified the extent of these underwriting exceptions. On the other hand, rating agencies

were also motivated by the same misaligned incentives; the major ratings agencies also had financial incentives to understate the risks embedded in subprime mortgage-backed securities and collateralized debt obligations. Basically, the investment banks underwriting securitizations hired rating agencies to evaluate their loan pools, but the more good, investment grade ratings the agencies issued, the more deals that were sold by the banks and hence, greater profit was shared by both the investment banks and the rating agencies which they hired.

How did we get here? While securitization has and continues to serve an important role in the mortgage system, the securitization process that has enabled the production of subprime loans with ever increasing levels of risk is a departure from traditional securitization processes. In a joint paper with Richard Green, written for the 2007 Jackson Hole Conference, we describe how securitization transformed mortgage markets for the good, allowing recovery from the Savings and Loan crisis without undue negative consequences for the overall economy, and a period of stability from the 1980s until the early 2000s. Such securitization has enabled the funding of long term fixed rate mortgages, a key pin of our historically stable and affordable mortgage system, without putting banks, with short term deposit based liabilities at risk. The MBS that backed these long-term mortgages were standardized and traded in liquid markets, with little disruption even in periods of financial turmoil.

The new form of securitization, beginning in the mid-1990s that enabled the growth of the private label secondary market which funded the new subprime mortgage debt, was different in one critical respect: The lack of standardization which would have allowed trading and the use of available information to self-adjust from excesses. The subprime mortgages were priced not through standard lending criteria but rather at least ostensibly on borrower risk; nonetheless since MBS would vary greatly based on risk characteristics of the specific pooled loans, there was no standardization and therefore limited trading of whole pools.

The market for subprime MBS failed to incorporate information that pointed to the likelihood that low defaults through the end of 2006 were not sustainable, given erosion of lending standards and layering on of additional risks through high loan to value ratios, low-doc and no-doc loans, and teaser rates. Under appropriate market conditions, such MBS would be marked to market, and there would be incentives to use all available information to price the risk embedded in these mortgages, as opposed to ignoring such risks in order to book short term gains.

There are always optimistic investors who are willing to provide funding for financial instruments; financial markets when they work well also provide incentives for those who understand the risks to impact pricing and to counter overly optimistic or uninformed investment pricing. These incentives to value the MBS for the long run were absent. The results that we see today are a direct consequence of the absence of incentives to identify and price these risks. The lack of standardization is thus a key to the inability to trade and contrary to the purpose of securitization as it was introduced and continued in the US up until the beginning of the recent crisis.

In the long run solution, if we are to maintain a private label market, this will have to be addressed. Even in the short run, a solution to the problem will also have to rest on how these pools are dealt with. As of now, there is little and slow modification of nonperforming loans that would be in the interest of maximizing the value of the pool as well as assisting borrowers about to lose their homes. Such resolution in the interests of the pool as a whole as well as borrowers and the overall economy has been limited and occurring only very slowly. In part, this is because the MBS and related securities have been sliced and diced and resold so that securities are not actually composed of liquid assets of similar risk. Rather tranches based on different risk classes have created investor classes with different risk exposure and different incentives to resolve the nonperformance of these assets. This places servicers of the trusts responsible for resolving borrower default, in a difficult position to operate in the interest of the whole pool, despite the favorable consequences for investors as a group, and borrowers, of doing so. A policy response to this issue is necessary both to resolve the problem of limited liquidity for refinancing subprime mortgages and to stop the process of borrowers' falling further behind in their loan payments. Otherwise, with less and less opportunity to become current, more and more foreclosed properties will come onto the market, further pushing down prices, and increasing the likelihood of additional foreclosures, with no end in sight. If we are to avoid this we will have to address the issue of the role of securitization and incentive for efficient loan performance and resolution of nonperforming assets both in the short run and the long run. Nonetheless such an approach, while necessary, will be insufficient to avoid replication of the current crisis.

The ultimate question before us is do we want a system that produces risks such as those that we have seen in the current market. It is clear that Wall Street will underwrite any risk. Risk taking with the home, through instruments, such as, negatively amortizing and teaser rate loans, expose borrowers and investors in these instruments to risk but they also expose all homeowners and the overall economy to increased house price volatility and risk. Such lending, financed through MBS even with diversified loan portfolios is nonetheless completely exposed to the risk of the business cycle; in financial terms, the beta of such securities is high. Negatively amortizing and teaser rate mortgages that ultimately require refinancing for sustainability have similar systemic risk to the kind of mortgages which prevailed during the Great Depression (bullet loans) which also needed to be refinanced, whether the markets were friendly and allowed the refinancing, or not; in which case, foreclosure was the only recourse. We as a society will have to decide whether we wish to encourage such financially vulnerable funding as backing to the asset which we also call home.

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Chairman WAXMAN. Thank you very much.
Mr. Galvin.

STATEMENT OF WILLIAM GALVIN

Mr. GALVIN. Good morning. I am William F. Galvin, Secretary of State and chief securities regulator of the Commonwealth of Massachusetts.

I commend the committee's decision to ask those who have profited from this mortgage bubble to explain how it happened. I'm here to give specific examples as to its destructive effect on citizens and communities, but I would respectfully suggest that it's not enough to simply ask how it happened and who profited, but it also must be asked, did the regulatory process fail? Why was this bubble allowed to build? And are we prepared to prevent another destructive speculative bubble, not just in mortgages or housing, but in any area of our economy that affects the day-to-day lives of our citizens? Commodities such as oil and wheat come to mind.

With respect to mortgages, there has been a growing awareness of CDOs and collateralization of pools of mortgage loans. We have seen the bursting of the credit bubble and frozen credit markets. I would like to testify as to my experience, as the head of the Massachusetts securities division, about some of the consequences of these events to individual investors, small businesses and local governments.

CDOs are artificially fabricated financial instruments, collateralized by certain assets such as pools of subprime mortgage loans. In certain CDOs, the collateral consisted of pieces of other CDOs, which can magnify the risk exponentially.

A recent administrative complaint filed by my office involved the sale of CDOs to the city of Springfield, MA. Springfield had struggled financially over the last decade. In 2004, it had a $20 million operating deficit, but with an intensive restructuring, it staged a miraculous recovery, resulting in a surplus at the end of the 2006 fiscal year.

The city hired two agents of Merrill Lynch to invest its hard-earned surplus cash. The city's goal was to invest in safe cash-like investments. However, according to the allegations in our complaint, which Merrill of course has the opportunity to rebut, Merrill's representatives invested much of the city's money into three highly risky CDOs, including CDOs collateralized by other CDOs. Merrill received underwriting fees and remarketing fees in connection with these CDOs.

We have also alleged that, at the time of the sale, the Merrill agents did not discuss the risks of owning the CDOs with the city. Shortly after the sale of these CDOs to the city and despite their alleged triple-A rating, the market for them began to dry up, and their market value began to plummet. The estimated market value of one of the CDOs dropped in a couple of months to 5 percent of the purchase price. Merrill initially disclaimed responsibility for these sales. But after my office and other regulators began to investigate, it agreed to buy these instruments back.

The Springfield case is not unique. In November, we filed an administrative complaint against Bear Stearns with respect to two

failed hedge funds that invested heavily in mortgage-related CDOs. The allegations involved improperly disclosed conflicts of interest.

We're also looking into the sale to the State of Maine by a Massachusetts-based broker of approximately $20 million of structured investment vehicles, commercial paper backed by subprime mortgages, that has precipitously dropped in value.

These cases have also spawned a number of investigations by my office. We are examining other CDO sales to governmental entities in Massachusetts. We are also examining how some of the riskier CDOs managed to receive a triple-A rating.

In addition, we are inquiring as to the effect of the bond insurers' insuring of risky CDO transactions on the value of insured municipal bonds and the impact of downgrades on bond insurers. We are particularly concerned about the frozen auction markets on the borrowing costs to municipalities.

I believe when the final tally is taken, the magnitude of investor loss will be breathtaking. And I fear that such losses will not be limited to wealthy, savvy risk-takers but the small, risk-averse investors and local governments who have been unwittingly caught up in this rampant web of risk-taking will incur significant and unnecessary cost.

The cumulative effect on our overall economy has been paralysis and decline. In my opinion, what you are examining today is nothing less than the roots of recession. The effects of the reckless mortgage lending that was enabled and fed by the securitization of these mortgages is now being felt by homeowners across the country.

Recently a land registration division in my office prepared an analysis of foreclosures in Lowell, MA, which is another Massachusetts city. From 2000 to 2005, there were fewer than 50 foreclosures per year in Lowell. In 2006, there were 93. In 2007, there were 283. The report anticipates that foreclosures in Lowell will continue to spike in 2008, as the interest rates of many adjustable mortgages begin to reset.

Some common attributes of those mortgages include no-money-down mortgages, interest-only mortgages and mortgages with very low introductory teaser rates. Often these loans were made by national, not local, lenders. The traditional relationship between lender and borrower with respect to a particular piece of property has been severed. National lenders made unsuitable loans to lower-income borrowers, knowing they would not have to live with the mortgage loans for their entire lifespan. Instead, many of those loans were bundled into mortgage-backed securities and CDOs and sold to cities, towns, individual investors and pension plans.

The middle men profited in these transactions from a wide variety of fees, including mortgage origination fees, investment banking fees for underwriting the securities, and the sales and commission for selling pieces of them.

Finally, the recent freezing of the auction market appears to be yet another after-effect of the subprime lending excesses and the CDO market meltdown. Within the last couple of weeks, my office has received calls from people who thought they were investing in safe liquid investments only to find that they, in fact, have pur-

chased auction market securities that are now frozen and cannot be liquidated.

We received calls from a young saver whose house downpayment is now frozen; two siblings whose family trust is now frozen; a small-business owner who finds their business interrupted because money they thought was liquid is tied up in frozen auction market securities. My office will be investigating these cases in order to determine whether investors were informed their investments might become illiquid.

In addition, we are looking into the role of the major investment banks that sold these securities had in these events—such as the CDO auction market crashing; the triple-A rating proving to be all but meaningless; bond insurance becoming very tenuous—that led to the freezing of these markets.

What we are left with is mortgage originators, investment banks and their CEOs walking away with profits derived from subprime lending and securitization, and deceived investors and would-be homeowners trying to repair the damage to their lives and communities.

I respectfully urge this committee and Federal and State regulators to work together to continue to uncover the details of the harm suffered by investors and mortgage borrowers, and to hold the promoters of these exploitative financial arrangements responsible and to demand greater and continuing scrutiny by regulators.

Thank you for the opportunity to provide this testimony today.

[The prepared statement of Mr. Galvin follows:]

DRAFT

TESTIMONY OF WILLIAM FRANCIS GALVIN

Secretary of the Commonwealth of Massachusetts

Before the
United States House of Representatives
Committee on Oversight and Government Reform

Hearing to Examine Mortgage CEO Severance Packages

March 7, 2008

I am William F. Galvin, Secretary of State and chief securities regulator of The Commonwealth of Massachusetts. I want to commend Chairman Waxman and Representative Davis for calling today's hearing to examine the disparate impact on certain market participants of the subprime mortgage crisis and the related collapse of certain portions of the credit markets.

There has been a lot of public discussion of CDOs and collateralization of pools of mortgage loans and other assets. We have seen the bursting of a credit bubble and frozen credit and auction markets. I would like to testify as to my experience, as the head of the Massachusetts Securities Division, with some of the consequences of these events to individual investors, small businesses and local governments. I would also like to relate my experience as the overseer of many Massachusetts registries of deeds as to the plague of foreclosures we've recently seen resulting from the rampant and reckless mortgage lending that was fueled by the securitization process.

My testimony will begin by describing recent investigations and administrative actions by the Massachusetts Securities Division in connection with sales of highly complex and risky collateralized debt obligations to cities, towns and other investors in The Commonwealth of Massachusetts. CDOs are esoteric financial instruments that function as debt instruments collateralized by certain assets. Many CDOs are collateralized by pools of subprime and other mortgage loans. In certain CDOs the collateral consisted of pieces of other CDOs and other complex products known as "synthetic securities", which can magnify the risk exponentially. The business of packaging and issuing CDOs had been a highly lucrative one for investment banks until large parts of the CDO market froze and crashed in the summer of 2007.

I would now like to describe the sale of CDOs to the City of Springfield, Massachusetts. Springfield had struggled financially over the last decade. In 2004, it had a $20 million operating deficit, but with an intensive restructuring it staged a miraculous recovery, resulting in a surplus at the end of the 2006 fiscal year. The City hired two agents of Merrill Lynch to invest its hard-earned surplus cash.

The City's goal was to invest in safe, liquid, short-term, cash-like investments. However, Merrill's representatives in charge of the account invested approximately $14,000,000 of the City's money into three highly-risky CDOs, including CDOs collateralized by other CDOs. The Springfield CDOs were purchased from Merrill's own inventory. The largest position was $12,600,000 invested in the Centre Square CDO, which had been underwritten by Merrill Lynch. Merrill received underwriting fees in connection with underwriting the CDO and remarketing fees in connection with selling pieces of it. We have alleged that at the time of the sale, the Merrill agents did not discuss the risks of owning CDOs with the City, even though those risks were well known. The basic fact that these instruments were CDOs was not disclosed to the City until months after the sales. At the time of the sales, disclosure documents for these CDOs were not provided to the City and no attempt was made to discuss the risks associated with owning them with City officials.

Within months after the sale of these CDOs to the City, and despite their triple-A rating, the auction market for them began to dry up and their market value began to plummet. For example, the estimated market value of one of the CDOs dropped, in a couple of months, to 5 percent of the purchase price. Other CDOs sold to the City by Merrill's brokers experienced similar extreme downward spirals. The City requested that these CDOs be sold, but City officials were informed that the auctions had failed and that there were no buyers. Merrill initially disclaimed responsibility for these investments. Subsequently, after these transactions began to receive scrutiny from my office and other regulators in Massachusetts, Merrill agreed to buy back the troubled CDOs. These allegations are all public record, as disclosed in our Administrative Complaint. Merrill will have the opportunity to address these allegations before an administrative hearing officer.

The Springfield case is not unique. In November, we filed an administrative complaint against Bear Stearns with respect to two failed hedge funds that had heavily invested in mortgage-related CDOs. The allegations involved improperly disclosed conflicts of interest. We are also looking into the sale to the State of Maine by a Massachusetts-based broker of approximately $20 million of commercial paper issued by a Structured Investment Vehicle that used subprime mortgage-backed securities and other troubled assets as their collateral. This paper has also precipitously dropped in value.

These cases are troubling on a number of levels and have spawned a number of investigations by my office. We are, obviously, looking at other CDO sales to governmental entities in Massachusetts. In addition, we are looking at sales practices with respect to highly risky CDOs. We are also in the early stages of examining how some of the more speculative and high-risk CDOs managed to receive a triple A rating from the rating agencies, which enabled underwriters and broker-dealers to unload much of this highly-risky inventory. Another investigation by my office is examining the effect of the bond insurers' insuring of risky CDO transactions on the value of insured municipal bonds that tend to be held by risk-adverse investors. In addition, we are looking at the impact of downgrades to bond insurers—as well as frozen auction markets--on borrowing costs of issuers such as cities and towns and other governmental

authorities. As one example, the Massachusetts Turnpike Authority has reportedly stated that it might have to raise highway tolls to compensate for a predicted increase in interest expense due to the turmoil in the credit markets. This would affect consumers far removed from the originators of the CDOs and auction market securities that have caused this problem.

As we are likely to see as these investigations progress, the events described above are only the tip of the iceberg. I fear that when all is said and done, the magnitude of investor loss will be breathtaking. And I fear that such losses will not be limited to wealthy, savvy risk-takers, but that small, risk-adverse investors and local governments have also been caught up in this widespread web of greed that certain investment banks have spun.

In addition, the effect of the rampant and reckless mortgage lending that enabled and was fed by the securitization of these mortgages is now being felt by homeowners across the country. My duties as Secretary of the Commonwealth include oversight of many of the Massachusetts registries of deeds. The staff of the registries gets a close view of the foreclosure crisis as plays out, because the legal paperwork for these foreclosures is filed with the registries. In January of this year, the Register of Deeds for Middlesex County North in Massachusetts prepared a Statistical Analysis of Foreclosures in Lowell, Massachusetts, which is another Massachusetts city with an economically diverse population that has struggled financially. The information and conclusions in this report are telling and tragic.

From 2000 through 2005, there were fewer than 50 foreclosures per year in Lowell—in some years the number was far lower. In 2006 there were 93 foreclosures in Lowell. In 2007, there were 283. These were loans made by national—not local--lenders. In 66% of these foreclosures, the property buyer borrowed the entire purchase price. Of these mortgages, the average foreclosure took place within two years of the purchase of the property.

The report anticipates that foreclosures in Lowell will continue to spike in 2008 as the interest rates of many adjustable mortgages begin to reset. Clearly, lending practices and lending standards in Lowell were not what they should have been. National mortgage lenders were consistently involved in helping purchasers buy homes they could not afford. Some of the common attributes of those mortgages included: no money down or low money down mortgages, interest-only mortgages, and mortgages with very low introductory "teaser" interest rates. Many of these borrowers were told that they could refinance their mortgages when the interest rate was due to reset, or that they would profit from these arrangements because of rising property values. However, in 2006 and 2007 many of these borrowers found they had no escape from these mortgages and they lost their homes.

The lending practices that were prevalent in Lowell were a foreseeable consequence of how many national lenders carried out their subprime lending business. The traditional relationship between lender and borrower with respect to a particular

piece of property has been severed. These national lenders made unsuitable loans to lower income borrowers knowing they would not have to live with those mortgage loans for their entire lifespan. Instead, those loans were sold, and many of those loans were bundled into mortgage-backed securities. These securities were sold to cities and towns, individual investors and pension plans. These low-quality loans ended up damaging both the borrowers and many of the ultimate holders of the loans. The middlemen profited in these transactions from a wide variety of fees, including mortgage origination fees, investment banking fees for underwriting the securities, and sales commissions for selling pieces of them.

Finally, the recent freezing of the auction markets appears to be yet another after-effect of the subprime lending excesses and the CDO auction market meltdown. Within the last couple of weeks, my office has received a flood of calls from people who thought that they were investing in safe, liquid investments only to find that they, in fact, have purchased auction market securities that are now frozen and cannot be liquidated. The frozen markets now are not limited to only mortgage-related securities or CDOs, but include wide range of other auction rate securities. As one example, we received a call from a young saver whose house down payment is now frozen in an auction rate security. We have heard from two siblings whose family trust is now frozen and cannot be distributed to other siblings. We have heard from a number of small business owners who find their businesses interrupted because money they thought was liquid is tied up in frozen auction markets. We have also heard from a 71-year-old retiree who sold a house in order to take the money and build his dream house. Like the others, he thought he was making a liquid and accessible investment but now cannot access his money.

My office will be investigating these cases in order to determine whether investors were informed that the money they were investing might become illiquid and inaccessible. In addition, we are looking into the role that the major investment banks that sold those securities had in the events—such as the CDO auction market crashing, the triple A rating proving to be all but meaningless, bond insurance becoming very tenuous and underwriters suddenly refusing to support the auction markets they created--that led to the freezing of these markets.

Many of these investment banks reaped enormous profits from the rampant mortgage lending and securitization described above, and their executives have been handsomely rewarded. We, however, are now left sorting out the ongoing damage that is rippling through our financial system.

What we are left with, when the dust settles, is mortgage originators, investment banks and their CEOs walking away with unworldly profits derived from subprime lending and securitization—and unwitting investors and would-be homeowners trying to repair the damage to their lives and communities.

I respectfully urge this committee to look into certain structural regulatory questions that necessarily arise in connection with this subprime crisis. What role did the repeal of the Glass-Steagall Act in late 1999—which had for over sixty years placed

certain barriers between commercial banks and investment banks--have in enabling the rampant lending and securitization of mortgage loans? Has the role of state banking regulators been preempted in such a way as to limit their ability to effectively address problems such as these? In addition, I respectfully urge this committee and federal and state regulators to work together to continue to uncover the details of the harm suffered by investors and mortgage borrowers and to hold the promoters of these exploitative financial arrangements responsible. In addition, I support legislative efforts to promote comprehensive disclosure of, and enhanced shareholder awareness of and influence with respect to, executive compensation.

Thank you for the opportunity to provide this testimony today.

William F. Galvin
Secretary of the Commonwealth
Commonwealth of Massachusetts

Chairman WAXMAN. Thank you very much, Mr. Galvin.

Mayor Lawrence, pleased to have you with us. Be sure that the button is pressed.

STATEMENT OF BRENDA LAWRENCE

Ms. LAWRENCE. I'm pleased to be here. Good morning, Chairman Waxman and honorable members of this committee. Thank you for inviting me to discuss the problem of foreclosures, as a mayor, in the city of Southfield, a problem that, as you know, is dramatically impacting cities across the country.

My city, Southfield, is a racially and ethnically diverse city with a population of 80,000. We are a middle- and upper-class community that has been known for having strong and vibrant neighborhoods. We are not the type of city that one would expect to confront serious problems with residential foreclosures.

But, unfortunately, the foreclosure crisis that is spreading throughout this country has not passed us by. We currently have 500 vacant Southfield homes in foreclosure, representing approximately 3 percent of our single-family residential housing stock. In our county of Oakland, by median income the fifth-wealthiest county in the country, 8,000 homes went into foreclosure in 2007. And in metro Detroit, the metropolitan area, 47,000 homes are now in foreclosure.

Not surprisingly, home values are falling throughout our region, with Southfield experiencing a 3.2 decrease in the year 2007. We now have residents whose mortgage balances exceed their home values, and they're simply abandoning their homes, rather than go through the foreclosure procedure.

Even though we have already reached a critical level, the bad news is that the situation is likely to get worse. With a wave of adjustable rate mortgage resets expected this year, the number of foreclosures is certain to accelerate.

The negative impacts of these mortgage foreclosures and the vacant homes that result is being felt by cities all over this country in many ways: homes and landscaping not being maintained, adversely affecting the neighborhood's appearance and creating blight; vacant homes attract criminal activity, requiring increased police surveillance and reducing the sense of security of residents; these homes have become attractive nuisances for children; foreclosed and vacant homes frequently require immediate attention from public works because of burst pipes and other dangerous building conditions; vacant homes are potential fire hazards; foreclosed homes drive down property values in neighborhoods; these homes result in a loss of property tax revenues for a city, while at the same time causing an increase in city expenditures; foreclosed and vacant homes erode the fabric and the morale of a neighborhood; foreclosed homes result in a disruption to families with the associated financial, social and emotional consequences.

In a word, foreclosed and vacant homes are a cancer in any city's neighborhoods.

In Southfield, we're using our best efforts to deal with these problems. As soon as we identify a foreclosed or vacant home, it is immediately inspected and ensured—if need be, we will board that home, if necessary. We check to see if the utilities are operable,

and, if not, we shut the water off to avoid freezing pipes, which will cause additional damage to the home.

We identify the mortgage lender from the foreclosed posting so that we can have an entity to hold accountable if the property is not maintained. This information is put into a data base, and then we reinspect on a monthly basis. A list of these properties is provided to our police department so they can increase patrols in the neighborhoods where they're located.

With our city's tax revenues already diminished by declining property values and by the economic conditions which has caused a reduction in State aid, the cost of these efforts is an untimely burden on our city's and every city in this country's budget.

Notwithstanding our efforts to deal with foreclosure-related issues on a local basis, it is clear that this crisis must be dealt with on a larger scale.

I joined the U.S. Conference of Mayors last November for a home foreclosure summit in Detroit. We met with representatives from the mortgage industry to discuss our concerns. The bottom line, we told the industry, they had to respond aggressively with loan modifications out of their own enlightened self-interests and on behalf of the 2 million American families that are predicted to face foreclosure in 2008.

The mayors convened again in January and requested Congress to take several actions, including providing Community Development Block Grant funds to help cities monitor and maintain foreclosed and vacant homes; reforming the Federal Housing Administration so that it can help more homeowners in trouble; and increasing the funding for housing counseling agencies.

Finally, let me say that, as a mayor, one of my greatest fears is the negative impact foreclosures will have on the tax base of local government. Property tax is the principal source of revenue for cities, counties and school districts throughout the country. Revenue which is used to fund municipal budgets for schools, parks, libraries, police stations, fire stations, hospitals, and maintenance of sewers, roads and bridges. If foreclosures lead to a continued and prolonged decline in property values with a corresponding decrease in tax revenues, the level and quality of the essential public services local governments provide will decline.

And thus, while local officials will serve on the front line, as mayors do every day, to continue to address foreclosed issues at home, the Federal Government needs to act swiftly and decisively to confront the growing issues on a national level.

In closing, I want to say, while it's on the headlines every day, I talk to mayors every day, and this issue is one that we have to touch, smell and deal with on a daily basis. We are truly in a crisis.

And I thank you for the opportunity to speak today here.

[The prepared statement of Ms. Lawrence follows:]

Testimony
Of

The Honorable Brenda L. Lawrence
Mayor of Southfield, Michigan

Before the Committee on Oversight and Government Reform
U.S. House of Representatives

March 7, 2008

Good morning Chairman Waxman and members of the Committee. Thank you for inviting me to discuss the problem of home foreclosures in the City of Southfield, a problem that as you know is dramatically impacting cities across the country. Southfield is a racially and ethnically diverse city with a population of 80,000. We are a middle/upper-middle-class community that has long been known for having strong and vibrant neighborhoods. We are not the type of city that one would expect to have to confront serious problems with residential mortgage foreclosures. But, unfortunately, the foreclosure crisis that is spreading throughout the country has not passed us by. We currently have 500 Southfield homes in foreclosure, representing approximately 3% of our single-family residential housing stock. In our county of Oakland, by median income the fifth wealthiest county in the country, 8,000 homes went into foreclosure in 2007 and 47,000 in total in the three county Detroit metropolitan area. Not surprisingly, home values are falling throughout our region with Southfield experiencing a 3.20% decrease in 2007. We now have residents whose mortgage balances exceed their home values and they are simply abandoning their homes rather than going through foreclosure. Even though we have already reached a critical level, the bad news is that the situation is likely to get worse. With a wave of adjustable rate mortgage resets expected this year the number of foreclosures is certain to accelerate. The negative impact of these mortgage foreclosures and the vacant homes that result is felt by cities in many ways:

- Homes and landscaping are not maintained, adversely affecting a neighborhood's appearance.
- Vacant homes attract criminal activity, necessitating increased police surveillance and reducing the sense of security for neighboring residents.
- These homes become attractive nuisances for children.

- Foreclosed and vacant homes frequently require immediate attention from public works because of burst pipes or other dangerous building conditions.
- Vacant homes are potential fire hazards.
- Foreclosed homes drive down property values in a neighborhood.
- These homes result in a loss of property tax revenues for a city while at the same time causing an increase in a city's expenditures.
- Foreclosed and vacant homes erode the fabric and morale of a neighborhood.
- Foreclosed homes result in disruption to families with the associated financial, social and emotional consequences.

In a word, foreclosed and vacant homes are a cancer in a city's neighborhoods.

In Southfield, we are using our best efforts to deal with these problems. As soon as we identify a foreclosed and vacant home it is immediately inspected to ensure that it is secure. If not, we secure it, including boarding the home if necessary. We check to see if the utilities are operable and, if they are not, we shut off the water to avoid freezing pipes. We identify the mortgage lender from the foreclosure posting so that we have an entity to hold accountable if the property is not maintained. This information is put into our database and we then re-inspect the homes on a monthly basis. A list of these properties is provided to our police department so they can increase police patrols in the neighborhoods in which they are located. With our City's tax revenues already diminished by declining property values and by economic conditions which have caused a reduction in state aid the cost of these efforts is an untimely burden on the City's budget.

Notwithstanding our efforts to deal with foreclosure related issues on a local basis, it is clear that this crisis must be dealt with on a larger scale. I joined the U.S. Conference of Mayors last November for a home foreclosure summit in Detroit. We met with representatives from the

mortgage industry to discuss our concerns. The bottom line was that we told the industry they had to respond aggressively with loan modifications out of their own enlightened self-interest and on behalf of the 2 million American families that are predicted to face foreclosure in 2008. The Mayors convened again in January and requested Congress to take several actions including providing community development block grant funds to help cities monitor and maintain foreclosed and vacant homes; reforming the Federal Housing Administration so that it can help more homeowners in trouble; and increasing the funding for housing counseling agencies.

Finally, let me say that as a mayor, one of my greatest fears is the negative impact foreclosures will have on the tax base of local governments. The ad valorem property tax is the principal source of revenue for cities, counties and school districts throughout the country. Revenue which is used to fund municipal budgets for schools, parks, libraries, police stations, fire stations, hospitals, and maintenance of sewers, roads and bridges. If foreclosures lead to a continued and prolonged decline in property values with a corresponding decrease in tax revenues, the level and quality of the essential public services local governments provide will inevitably decline. And thus, while local officials who serve on the front line, continue to address foreclosure related issues at home, the federal government needs to act swiftly and decisively to confront this growing crisis on a national level. Thank you.

Chairman WAXMAN. Thank you very much, Mayor Lawrence.

Mr. Yezer.

STATEMENT OF ANTHONY YEZER

Mr. YEZER. Thank you, Mr. Chairman and members of the committee, for inviting me today.

I'm going to make five basic remarks and then five recommendations, not that there's anything in the fives to recommend itself. It just so happens, as I edited my remarks here, I came up with five and five.

First, my five basic points. Point No. 1: The market for mortgage credit consists of the prime or "A" market, the government-insured market, called "A", subprime and "brand X." And there tends to be no attention to brand X. If we observe property records, there are a lot of brand X mortgages. And my suspicion is that people who are in the brand X market are not well-served. Expanding the subprime market tends to get people out of the brand X market. I would like to do more research on the brand X market. My limited inquiries indicated to me it might not be safe. So that's my point No. 1. There are, in fact, four markets. We should never forget the brand X market.

No. 2, second point: There's a sound economic rationale for having subprime mortgage market of limited size, particularly concentrating on households that need to refinance out of what I call the home equity trap. You lose your spouse, you lose your health, you lose your job, you have a lot of home equity. Guess what? Prime lenders won't touch you. You can't do a cash-out refinancing. Now you can go for a soft second or something like that, but basically you've got to sell your house. Well, I don't think that's appropriate. Subprime market helps you out of that.

It's not uncommon for new markets to overshoot. I remember the NASDAQ in the late 1990's. This corrects. Look at the NASDAQ today.

In the case of subprime, the normal market overshooting was supplemented by government, sort of, pushing the lenders on the back and saying, "Go out there and serve all the underserved." As one of the people who, when the government was saying that, said, "I think the people who are underserved may be underserved for a reason and watch out," I could say I told you so, but I'm not that kind of guy.

Nevertheless, I really think that in the area of bank examination we should concentrate on safety and soundness a little more. I'm especially worried about depository institutions taking lots of risk. When depository institutions are taking lots of risk, that becomes a general risk for society. That's what Professor Wachter means about the link between housing prices and general financial collapse.

OK, my third point is that, until recently, the subprime market looked pretty well-behaved. In my testimony, I have some nice prepayment and default equations. They look really good, really good. I know you're not excited, but that's really good. Even things like for the 2/28 ARM, do you get a spike in prepayment or default at 24 months? The answer is a spike in prepayment at 24 months. It looks like the folks were using it wisely.

So then, what happened? Point No. 4, what happened? Well, the answer is, according to the research that we've been able to do recently, is that basically the bottom dropped out of prices. I actually did the prices for—I couldn't get your district, Chairman Waxman, but this is all of LA. OK, for everybody in the room, your house price increase looks like the Matterhorn—by the way, not just now. It's like the Matterhorn. You've had three collapses, OK, since the late 1970's in house prices in LA. Guess what happens when you fall off the cliff? A lot of subprime goes bad.

So my fourth point is basically, yeah, it's house prices and, yes, it's going to happen periodically. Subprime is a little bit like providing disaster insurance. You are fine and fine and fine and fine, and then the hurricane hits.

OK. Fifth point is, I mean, let's not forget that we also have a government sector here that hasn't done so well. I mean, if you look at, you know, delinquency and default on FHA, it's not a pretty story. And we're actually paying for that publicly. And, let's see, management of FHA—I guess we'll blame it on Mr. Bush. OK, so Mr. Bush—excuse me—President Bush, blame it on him.

In addition, when you look at these numbers for FHA, FHA compared to subprime is much worse than the numbers show because subprime mortgages, the best ones, prepay quickly. So, actually, the performance of FHA compared to sub should be much better than subprime, and, in fact, it isn't that much better. So we really have an issue with FHA, keeping things in perspective, and with management of FHA.

All right. Five recommendations, OK. What I really wanted to do with these recommendations is to prevent recurrence.

The first thing is the current emphasis on borrower education and financial literacy is misplaced. You can't teach someone financial literacy if they're not mathematically literate. And the people are not mathematically literate, so they can't become financially literate. All right? Maybe some other committee can make them mathematically literate, and then we can worry about that.

Two: If you want people to make good decisions, have a standardized mortgage product. I have a recommendation for the Waxman mortgage here. Be a standardized mortgage product. All lenders who provided it would have to quote prices in a certain fashion and disclose them to people. And people could comparison-shop and keep themselves from being taken to the cleaners. How hard is this? By the way, FHA could pick up the Waxman mortgage as something they would do.

Third point is let's examine banks for safety and soundness, and not for capital allocation.

Fourth point is, actually, all our mortgage products now are not what economists would recommend. We actually need some innovative mortgage products. And down the line, I'd hope people would think about that and let some economists talk about what a really neat mortgage would be.

And the fifth point is we ought to give more attention to the efforts of lenders at loan modification or forbearance. I'm really impressed with the significant numbers of loans where we have modification of forbearance. But I'm also impressed with the survey

data that indicates lots of people who are in financial trouble don't contact their lender. And they could get in on these programs.

OK, so I made five points, basically, about the current situation, and then I had five recommendations. That's certainly more than any individual should be entitled to. Thank you.

[The prepared statement of Mr. Yezer follows:]

Written Testimony By Anthony M. Yezer
Professor of Economics
George Washington University

U.S. House of Representatives
Committee on Oversight and Government Reform

March 7, 2008

Mr. Chairman and members of the Committee, thank you for this opportunity to discuss what economic research has been able to determine about the role and function of the market for subprime mortgage credit. I have done research on high-risk lending for over 25 years, beginning with my work as for the Federal Trade Commission as an external consulting evaluating the economic effects of the Credit Practices Rule. Along with Michael Staten I edited the papers for two special issues of the *Journal of Real Estate Finance and Economics* on the topic of subprime lending. My remarks here will be based on these papers and on subsequent research done at George Washington University as well as recent important work done elsewhere much of which is currently in working paper form and awaits publication in refereed journals. Much of this research was produced by economists at various Federal Reserve Banks.

My comments are particularly directed on the reasons for the rise and sudden decline of the subprime mortgage market and the relation of those events to recent issues of corporate performance. I have some suggestions for changes that might prevent a recurrence of the events of the past few years that I hope will be considered insofar as they imply some changes in government policy. You should understand that my expertise does not extend to compensation of corporate officers in the area of commercial banking and finance.

.I. There is an advanced academic literature on subprime mortgage lending

Economic analysis of mortgage markets in general is quite advanced and involves rather advanced mathematical and statistical models. There has been less work on subprime mortgages but recent advances have been made that give an excellent picture of the nature of the market and the risks involved.

I-1. Because of the complex nature of mortgage markets, it is important to know the literature on how they function before considering regulations or policy interventions because ***changes in these markets can easily cause unintended consequences that are very damaging to borrowers. I suggest the following label – "WARNING: Subprime markets should not be regulated or evaluated without first consulting a professional economist".***

II. Definition(s) and measurement of the subprime market

A first task is definition of what is meant by prime versus subprime mortgage lending and measurement of the volume and characteristics of lending. It appears that the academic literature has decided to define subprime lending in terms of the characteristics of the borrower – specifically a FICO score below 620 with at least case of a seriously delinquent payment in the past 12 months. Subprime

mortgage lending relies heavily on low-cost statistical credit scoring and features different loan pricing based on the estimated risk of the borrower. This contrasts with the prime mortgage market where underwriting is more elaborate and costly and all borrowers face similar loan costs save for the need for mortgage insurance in cases of high loan/value ratios.

Because this definition of subprime lending is based on borrower credit score and history, we have no precise measure of the amount of subprime lending in the U.S., However, estimates of subprime lending appear to be getting more precise and recently, tests of alternative measures have produced comparable estimates. Accordingly many researchers believe that subprime lending increased from less than 5% of mortgages in 1995 to more than 15% of mortgages in 2005. Note that, initially, subprime mortgages were generally used to refinance residences and more recently became a significant part of the new purchase market.

These measures of the fraction of newly endorsed mortgages that are subprime are estimates and are also subject to the following cautionary points:

II-1. Property transfer records indicate that many mortgages are what I call "brand X" mortgages. These are mortgages that are either taken back by sellers or made by very small scale mortgage lenders. Because these loans are not registered with HMDA or sole into national mortgage pools, we know virtually nothing about their characteristics. I personally suspect that most predatory lending falls into this brand X mortgage market. Indeed, one positive function of subprime lending is that it may have reduced the size of the brand X market but I know of no research on this topic. ***An effort to understand brand X lending and its relation to subprime and predatory lending problems is long overdue.***

II-2. The flow of new mortgages does not reflect the stock of outstanding mortgages because subprime mortgages prepay far faster than prime mortgages. Indeed, one motivation for subprime borrowing is to establish a credit history or repayment that allows refinancing to lower cost prime credit. ***Thus, if subprime mortgages start out as 20% of new mortgages, after 2 years, subprime mortgages will be far less than 20% of outstanding mortgages due to faster prepayment.***

II-3. Subprime mortgage pools are subject to adverse selection over time. The best credit risks prepay leaving the pool of outstanding mortgages with an unusually high fraction of the worst risks. Also there is evidence that subprime borrowers linger in default and have more spells of serious delinquency before foreclosure.

III. There is a sound economic rational for having a subprime mortgage market

The rise of subprime lending fills an obvious need that can be demonstrated using sound economic theory. Differences between subprime lending and prime lending that may appear curious to those unacquainted with economic models can be understood and even predicted as necessary characteristics of subprime lending. For example, the fact that subprime lending has much lower cost and simpler underwriting procedures and yet has higher rejection rates than prime lending may appear curious or even suspicious and yet these differences have been shown to be theoretically necessary for the subprime market to function.[1]

[1] See the theoretical model developed in Joseph Nichols, Anthony Pennington-Cross and Anthony Yezer, "Borrower Self-Selection, Underwriting Costs, and Subprime Mortgage Credit Supply," *Journal of Real Estate Finance and Economics*, (2004).

IV. The economic rational for subprime refinancing is stronger than for new purchase

The economic rational for the existence and expansion of subprime lending over the 1994-2005 period is stronger for refinancing than for new purchase lending. Subprime refinancing served an important role by allowing households to escape from the "home equity trap" which caused many forced sales in the past. Households in the U.S. hold a substantial portion of their wealth in the form of home equity. Indeed, the proportion of home equity appears so large that understanding this behavior has been a significant preoccupation in recent economic research. For example, the median home-owning household in the U.S with head under 50 years of age holds zero percent of its portfolio in common stocks, and virtually all of its portfolio in home equity and government-guaranteed assets. Quite frankly, to many economists this appears to be an obvious misallocation of resources and contradicts what we teach our students in class.

Since the 1930's, the prime mortgage market has been dominated by the long term (first 15 and then 30) year fixed-rate, self-amortizing, mortgage. This one-size-fits all approach to mortgage credit supply along with the substantial cost of refinancing has made accumulation of housing equity an automatic feature of household budgeting. While there has been dramatic innovation elsewhere in financial markets, attempts to change mortgage characteristics have been conspicuously unsuccessful - although things may be changing. The current mortgage instrument has the property that prepayment which raises home equity, changes the date of maturity but not the monthly payment or the requirement for prompt payment to avoid delinquency and technical default.

This strange preference for housing equity and the self-amortizing mortgage, taken together give rise to what I call the "home equity trap." Households who experience what economists call a negative income shock - lose your job, health, or spouse - and whose wealth consists of government-guaranteed assets and home equity will find themselves caught in a home equity trap. Their first adjustment to the income shock will be a combination of spending the government-guaranteed assets and raising consumer credit obligations. Given high transactions costs or cash-out refinancing and the penalty for missing a mortgage payment, they view housing equity as illiquid. However, when they have exhausted liquid assets, they find that lack or income and rising consumer credit make it impossible to do a cash-out refinancing in the prime mortgage market. Accordingly they must turn to subprime lenders for refinancing or sell their homes to raise cash. This is the basis of the home equity trap.

Homeowners act as if home equity is equivalent to stocks, bonds, and other risk assets as a store of value. In fact it is not equivalent because cash out refinancing in the prime market is usually not possible when the funds are most desperately needed. I would be remiss if I did not also note that, from the point of risk diversification, home equity is inferior to other risk assets.

***IV-1.* The existence of the subprime refinance market gives households caught in the home equity trap an alternative to selling their home to obtain liquid assets when problems strike. Note that this benefit tends to be most valuable to low and moderate income households and those whose credit is marginal.**

V. The effects of regulations on the subprime market tend to be misunderstood

There seems to be confusion regarding the effects of regulations on subprime lending. Understanding the effects of regulation requires careful economic analysis.

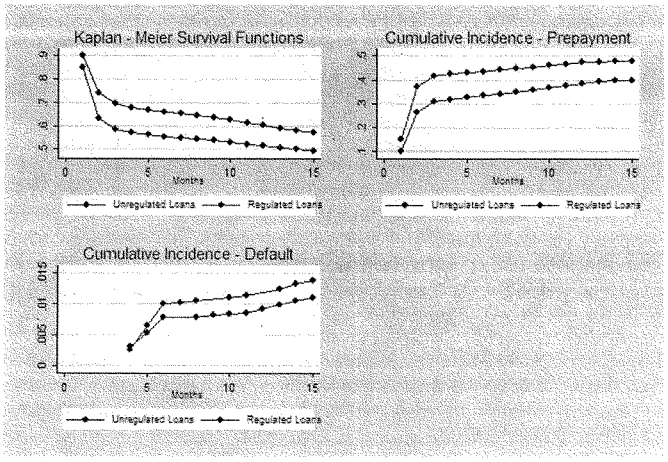
***V-1.* For example, it is possible to demonstrate both theoretically and empirically that**

restricting prepayment penalties on subprime mortgages tends to raise the price of credit, and reduce access to credit to those borrowers who have lower income and have the worst credit problems.[2]

VI. Until recently, the behavior of subprime mortgages was quite predictable indicating that subprime borrowers were well informed

It is always difficult to evaluate a new asset class. Substantial attention was paid to the prepayment and default loss characteristics of subprime mortgages and they appeared to be well understood through 2004. Consider Figure 1 below, which shows the pattern of termination of a cohort of subprime mortgages that were endorsed between June and December, 2002. Termination takes the form of prepayment or default (foreclosure, deed in lieu transactions, short sales, etc). Regulated loans are made in states that restrict prepayment penalties and they prepay faster than loans in states with no restrictions. Note how well behaved and smooth the functions are. Also note that half of the mortgages terminate (generally through prepayment) within 18 months of endorsement. As mentioned above this rapid termination rate of great importance in understanding data on subprime performance. Cumulative default losses on these subprime cohorts are significantly above those of prime loans but overall they are not large compared to recent measured rates of default loss which will be discussed below.

Figure 1: Termination of Subprime Loans Endorsed June-December 2002[3]



[2] See, for example, Jevgenijs Steinbuks, "Essays on Regulation and Imperfections in Credit Markets" Ph.D. Dissertation, George Washington University, December, 2007.

[3] Figure 1 is taken from Jevgenijs Steinbuks, "Credit Regulation and the Termination of Subprime Mortgages," George Washington University Working Paper, (May, 2007). These results are common in the literature that is referenced below.

An excellent recent paper by Pennington-Cross and Ho estimates a model of prepayment and default for hybrid arms and fixed rate subprime loans.[4] They examine differences in the pattern of prepayment and default over time for the hybrids that adjust and produce a "payment shock" after two years versus the fixed rate loans with no shock. Again the statistical inference is complex and requires joint estimation of prepayment and default. The results are that the payment shock after two years produces a spike in prepayment of the hybrid arms but not a spike in defaults. This indicates that borrowers are well aware of the provisions of their mortgages and exploit the lower rates on the hybrid arms by refinancing when they reprice. Note that this formal statistical evidence is in sharp contrast to assertions that borrowers will be caught unaware by payment shock and massive foreclosures will result from use of this loan product.

VI-1. Subprime lending losses were higher than prime but, through 2004, appeared to be quite predictable and small enough to justify lending at the higher rates of subprime loans. **In view of this performance, it is not surprising that subprime lending expanded.**

VI-2. Prepayment and default equations estimated for subprime borrowers using the 2/28 arm a spike in prepayment at 24 months and no spike default which **indicates that the borrowers were using these 2/28 arms intelligently and refutes claims of misinformation and the existence of a payment shock effect.**

VII. Government policies encouraged the expansion of subpirme lending

Between 1995 and 2005, homeownership rates in the U.S. rose from about 64% to almost 70%. It is not clear how much of this increase was due to subprime lending which raised homeownership first by allowing homeowners to use cash out refinancing to stay in homes rather than having to sell and second by facilitating home purchase for households with poorly documented income and low credit scores. Further research on this question is needed but innovations in mortgage lending, particularly subprime lending, appear to be a leading reason for the rise in homeownership and the progress toward this politically important policy goal.[5]

VII-1. Government regulators encouraged lenders and the GSEs to expand lending to "underserved" borrowers and census tracts. The rise in subprime lending was the banking sectors answer to this government request. **Congress had a major role in promoting the rise in subprime lending.** As someone who teaches money and banking, I found it difficult to explain to my students why the textbook said that bank examiners checked institutions for safety and soundness and at the same time examiners were giving low CRA ratings to depositories who failed to make enough loans to the underserved – evidently a group who, as it has turned out, are neither safe nor sound. **In the future, I suggest that depository institutions not be encouraged to take additional risk by their regulators. The standard textbook view that regulation and examination should promote safety and soundness appears, in retrospect, to be the best policy.**

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[4] Anthony Pennington-Cross and Giang Ho, "The Termination of Subprime Hybrid and Fixed Rate Mortgages," (2007).

[5] For examples of studies that conclude mortgage innovation was central in the rise in homeownership see Carlos Garriga, William Gavin, and Con Schlagenhoff, "Recent Trends in Homeownership," *Federal Reserve Bank of St. Louis Review*, (Sept/Oct, 2006) 397-411 and Raphael Bostic, Paul Calem, and Susan Wachter, "Hitting the Wall: Credit as an Impediment to Homeownership," in *Building Assets, Building Credit: Creating Wealth in Low Income Communities,* (Brookings Institution). 2005.

VII-2. There is a literature which suggests that both **the Basel I and Basel II risk weights used to set capital requirements for depositories did not treat mortgages in general and subprime mortgages in particular correctly.** In part, this is a new asset problem and, apparently, it was assumed that default loss on subprime mortgages was largely idiosyncratic – i.e. not correlated with the business cycle. That assessment is presumably being revisited.[6]

VII-3. Monetary policy from 2002 to 2005 departed significantly from the Taylor rule that had guided the great moderation of business cycles. This along with statements from the Chairman of the Federal Reserve advocating the ARM as an attractive instrument for homeowners helped to spur increases in demand for mortgage credit and housing prices that, in retrospect, could not be sustained.[7]

VII-4. It appears to be a bit unfair to criticize the management of mortgage lenders now for actions which they took to promote homeownership **given that government asked for increased lending to the underserved in order to raise homeownership rates and Basel I & II capital standards reinforced the changes in lending practices.**

VIII. Putting the problem in perspective: comparing prime, subprime and FHA performance

Given that there is a government mortgage insurance program which operates in parallel with conventional prime and subprime mortgage lending, it is useful to compare the performance of the three. Here I rely on the *National Delinquency Survey* of the Mortgage Bankers Association. The most recent data available to me, presented in Table 1, is for the quarter ended September 30, 2007.

Table 1

Mortgage Type	Percent Past Due	Percent Foreclosures Started	Percent Foreclosures Inventory	Seriously Delinquent	Number
All Prime Conventional	3.12	0.37	0.79	1.31	35,224,689
Prime Conventional ARMs	5.14	1.02	2.04	3.12	6,346,076
Prime Conventional FRMs	2.54	0.22	0.48	0.83	27,599,715
All Subprime	16.31	3.12	6.89	11.38	5,990,253
Subprime ARMs	18.81	4.72	10.38	15.63	2,858,267
Subprime FRMs	12.36	1.38	3.12	6.61	2,751,751
All FHA	12.92	0.95	2.22	5.54	3,089,370
FHA ARMs	15.32	1.48	3.30	7.43	180,593
FHA FRMs	12.24	0.78	2.02	5.08	2,786,317

Clearly delinquency and foreclosure problems are much lower for prime conventional loans than for

[6] Studies suggesting capital standards encouraged mortgage lending include: Paul Calem and James Follain, "Regulatory Capital Arbitrage and the Potential Competitive Impact of Basel II in the Market for Residential Mortgages," *Journal of Real Estate Finance and Economics*, (August 2007) 197-219, and Paul Calem and Michael Lacour-Little, "Risk-Based Capital Requirements for Mortgage Loans," *Journal of Banking and Finance,* (March, 2004), 647-672.

[7] For a discussion of these issues, see John B. Taylor, "Housing and Monetary Policy," Working Paper 13682, NBER, December 2007.

subprime or FHA loans. Repayment problems on FHA-insured loans are far closer to those of subprime loans than they are to prime conventional. Consider further that these statistics are based on the percentage of outstanding loans in difficulty. But, earlier sections noted that, from a given cohort of subprime loans, prepayment is far higher than usual for mortgages – more than twice as fast. Furthermore, prepayment of subprime loans is often prompted by improved credit history – i.e. refinancing into lower cost prime mortgages which takes the best risks out of the pool.[8]

VIII-1. Therefore, simple comparison of overall delinquency and foreclosure rates in the outstanding stock of subprime, prime, and FHA mortgages is a misleading indicator of their relative credit risk because the subprime stock is seriously depleted by prepayment of the best risks. Correction for this sample selection effect would move the performance of subprime mortgages very close to the government's FHA program. In view of this, it is inappropriate to concentrate only on subprime lending as source of default and foreclosure problems in housing market today. There will be more on this in the policy suggestions below.

`IX. Why has there been such a quick rise in mortgage delinquency and foreclosure?

Again, relying on the survey from the Mortgage Bankers' Association, I find that subprime mortgages past due and starting foreclosure rose from 10.78% and 1.32% in the first quarter of 1998 to the numbers reported in Table 1 and similarly FHA-insured mortgages past due and starting foreclosure were only 8.36% and 0.31% respectively at that time. Certainly fraudulent behavior by applicants, and loan officers appears to have played a role in these increases as well as the increasing share of subprime lending for new purchase and investor loans. However, an excellent study by the staff of the Federal Reserve Bank of Boston, has demonstrated that the major factor influencing default on subprime loans is the change in house prices.[9] This paper notes an important difficulty in understanding the contribution of subprime lending to foreclosure. Because households with prime mortgages who are having payment difficulties, often refinance into subprime mortgages, this has the effect of lowering prime defaults and raising subprime foreclosures. For example, the authors find that 44% of all foreclosures in Massachusetts were subprime mortgages, only 30% of foreclosures were on borrowers who started with a subprime mortgages. The other 14% were original prime borrowers who refinanced into subprime before eventually defaulting. Thus 70% of foreclosures were on properties initially purchased with prime mortgaes. Furthermore the authors find that, over the entire sample period analyzed, the cumulative probability of foreclosure on a home purchased originally with a subprime mortgage is 18% compared to 3% for a prime mortgage. However, these probabilities are very sensitive to house price appreciation over the period. Negative appreciation rates increase foreclosure sharply.

IX-1. While other factors may have some influence, the rise in subprime foreclosure is largely the result of flat or falling house prices. In this sense, it appears that subprime lending has risk characteristics not unlike disaster insurance. Losses are moderate in "normal" housing markets (prices increasing with inflation) but very large when house prices turn down. Unfortunately, just as we may have estimates of the general frequency of disasters and housing market downturns, forecasting the timing of these events still eludes meteorologists

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[8] This point has been made by many authors, and is a standard caution given by the MBA in reporting data on delinquency and foreclosure rates.

[9] The discussion in this paragraph is largely based on Kristopher Gerardi, Adam H. Shapiro, and Paul S. Willen, "Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures," Federal Reserve Bank of Boston, Working Paper No. 07-15 (December 2007)

and economists.[10]

IX-2. Statistical evidence suggests that subprime foreclosures are caused by falling house prices but that subprime foreclosures do not cause falling house prices.[11]

IX-3. There is evidence that increasing subprime lending was, by itself, responsible for price increases in credit constrained (underserved) areas. This rise in prices was sufficient to lower default rates for a time but when subprime lending slowed dramatically, the process reversed.[12]

X. In retrospect, average subprime lending rates have been too low, not too high

Given the lack of profitability of subprime lenders, it appears that, on average, mortgages have been priced too low rather than too high given the level of credit risk. This does not mean that there were not cases in which prices were too high, simply that these cases were apparently more than matched by transactions on which price was below average cost. This is consistent with evidence from high-risk automobile lending where profitability of firms appears to be lower for those in the highest risk and highest price segment of the market. One reason for the low returns to subprime mortgage lenders may have been the pressure (see VII above) of regulators to expand high risk lending.

XI. There is evidence that subprime lenders securitized the "worst performing" loans

Recent evidence indicates that subprime lenders securitized the worst performing loans and traded their own collateralized mortgage obligations (CMOs) based on information not available to others. One important innovation of the subprime market was the ability of investors to use individual loan-level detailed data from Loan Performance (LP) to forecast the likely prepayment and default performance of the loans packaged in a CMO. The initial lender, of course, retained some information in the loan file that was not in LP data and sometimes retained the servicing on the loans, which provided very timely information on payments received. The payment updates in LP data were monthly (I believe).

Two papers have independently tested the proposition that the LP data available to the pubic were able to predict performance as well as the initial lenders.[13] Both of these papers conclude that the securitization and trading decisions of subprime lenders were based on superior information than that in LP. While there was no guarantee that this would not be the case, it appears that market participants were not aware that their own trading based on LP data was less well informed than that of the initial

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[10] Actually forecasts of housing price movements might be "self refuting" because, if they were believed by investors, prices would never be bid up in the first place. This is a general problem in forecasting business cycles that does not encumber the meteorologist.

[11] See Gerardi, Shapiro, and Willen, ibid.

[12] This point is suggested in the Boston Fed paper but demonstrated explicitly in Atif Mian and Amir Sufi, "The Consequences of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis," University of Chicago, Graduate School of Business, (December 2007)

[13] Benjamin Keys, Tanmoy Mukherjee, Amit Seru, and Vikrant Vig, "Did Securitization Lead to Lax Screening? Evidence from Subprime Loans 2001-2006?" Working Paper, University of Michigan, (January 2008) and Stephen Drucker, and Christopher Mayer, "Inside Information and Market Making in Secondary Mortgage Markets," Working Paper, Columbia University Business School (January 2008).

lender. It may well be that part of the sudden drop in the market value of CMOs securities was based on the realization that models using LP did not contain all the information available to other traders. If this was the case, then the lenders who traded on additional information produced an externality for the rest of the market. I believe that the arguments made in this paragraph are plausible and consistent with recent research but more work on the issue of trading with asymmetric information and its effects on pricing of CMOs is needed.

Suggested Changes Under the Umbrella of "Government Operations"

I have some suggestions for changes in government operations that could improve the performance of mortgage markets in the U.S. A modest list of these is provided below. I have made most of these points for many years.

A. Financial literacy and disclosure are not keys to the problem of mortgage choice

There is a major effort underway to produce a new and improved HUD-1 form and to change required disclosure under Truth in Lending. At the same time survey results demonstrate a general lack of financial literacy in the public and there are efforts to remedy that.[14] In my view much of this well-meaning effort is misplaced. Americans lack mathematical literacy. In view of that, achievement of financial literacy is problematic. Indeed, returns to remedying mathematical illiteracy would likely produce far higher social returns.

The mortgage instrument is far too complex for borrowers to understand in general if they are not mathematically literate. I have seen results of experiments with alternative disclosure forms and, while some can improve choice over current disclosures, the overall performance of a significant proportion of the population tested is dismal.[15]

A-1. Accordingly I have concluded that attempts to solve bad mortgage choice with education and disclosure, without the changes proposed under "B" below, is a fool's errand.

B. Product standards will help consumers make price comparisons

The problem with pricing mortgage products is the lack of standardized products to serve as the basis for comparison. Consumers buy complex products which they do not fully understand every day but, because these products are standardized, they are able to make reasonable cost comparisons.

B-1. I propose that the industry along with the regulators promulgate a small number of standardized mortgage products. For example, the Waxman Mortgage (WM) could be a 30 year, level payment, self-amortizing, fixed rate instrument. Any firm offering a WM would agree to disclose pricing on a standard form which included the interest rate, 30-year APR and 5-year APR for a zero point, zero fee mortgage with no prepayment penalties, credit life insurance, etc. Then incremental pricing for WM with one, or more points would be disclosed, and alternatives with fees would also be disclosed in incremental values of points. **The applicant would then be able to directly compare**

[14] See, for example, Annamaria Lusardi, "Financial Literacy: An Essential Tool for Informed Consumer Choice," Working Paper Presented at the Joint Center for Housing Studies Conference, revised (February 2008).

[15] I could also add to this my experience in teaching economics for over 30 years.

the WM price quotations from one lender with another and make an informed choice regarding both the lowest price and combination of rate, points, fees, and prepayment provisions. The WM could serve prime and subprime borrowers, with subprime borrowers quoted higher rates, etc. Again, if a borrower was classified as Alt-A by one lender and A by another, this would appear in the pricing. Another mortgage type would be selected for ARMs of different types, and hopefully for other alternatives that will arise in the future.

B-2. Instruction, particularly web-based, should be devised to train borrowers in pricing of WM products as well as choice between the WM and other supported standardized mortgage products. A pricing schedule for WM product for A, Alt-A, and various subprime borrowers could also be made available to the public through media outlets.

B-3. Lenders complying with the above system and offering WM products should be given some type of distinctive certification appropriately named.

B-4. FHA insurance should be based on these stylized mortgage products and steps to curtail the high delinquency and foreclosure rates on FHA mortgages should be taken.

C. Bank regulators should concentrate on safety and soundness

Banks should not be encouraged to take additional risk. Given the current state of world capital markets it appears that finding funds for risky lending is not a problem. This has the virtue of allowing those of us who teach money and banking to return to our old lecture notes.

D. Innovative mortgage products are needed

The current range of mortgage products offered in the U.S. is limited and not particularly consistent with the recommendations of economists. In particular, we encourage household to hold too much housing equity in their portfolios and too few risky financial assets.

D-1. In designing mortgage types under proposal "B" above, attention should be paid to recommendations of professional economists that provide for flexible and even negative amortization and other features that time and space do not permit me to elaborate.

E. Current efforts at loan modification and forbearance need to be communicated

In the third quarter of 2007, there were 54,000 loan modifications and 183,000 repayment plans put into effect.[16] Many distressed borrowers fail to take advantage of these programs. Some effort at government-industry cooperation to raise awareness and improve outreach would benefit the general population.

Thank you again for allowing me the opportunity to present these thoughts.

Anthony M. Yezer
Professor of Economics
George Washington University
Washington, D.C.

[16] See the discussion in Jay Brinkmann, "An examination of mortgage foreclosures, modifications, repayment plans and other loss mitigation activities I the third quarter of 2007," Mortgage Bankers Association working paper (January 2008).

Chairman WAXMAN. Thank you, Mr. Yezer.

Ms. Minow.

STATEMENT OF NELL MINOW

Ms. MINOW. Thank you very much, Mr. Chairman, members of the committee. It's a great honor to be here, and I appreciate it very much.

I'm here on behalf of capitalism. I represent and provide services for the providers of capital, investors. And we providers of capital, we want CEOs to be paid hundreds of millions of dollars. Nothing makes us happier than when CEOs earn hundreds of millions of dollars, because they earn it by creating wealth for shareholders.

It's when they get paid that kind of money for destroying shareholder value that I think we have a problem. And that is the situation we are going to be talking about today. It's an outrage, it's appalling, that people should get paid like this for the kind of performance that they turned in.

And when that happens, it undermines the credibility of the American capitalism. In global markets, that's a risk that we literally cannot afford. There's an outrageous disconnect between pay and performance.

At the Corporate Library, we provide research on issues of corporate governance, and the most reliable predictor of the potential for litigation, liability and loss is excessive CEO compensation.

So I think it's fair to say, with respect to Mr. Davis, that we're not talking—these guys that are going to be on the next panel, these are not scapegoats, and they're certainly not virgins. Yeah, there's a lot of blame to go around. There are a lot of people involved in this mess, and you heard about all the different parts of it. It takes a village to create this kind of disaster. But certainly these people are a part of it. And certainly the pay created perverse incentives that poured gasoline on the fire and, if I can switch metaphors in the middle of a sentence, put a lot of economic crack into our system.

If we paid Congress—we could never pay you for performance, because you perform vastly in excess of anything we could pay you. But if we paid Congress—[laughter]—if we paid Congress by the numbers of pieces of legislation you passed, I can guarantee you we would have more pieces of legislation. However, that would not necessarily be better pieces of legislation. And that's what we did with this incentive pay. We paid people based on how much business they generated, not how good it was.

And the first thing they did, always—people in politics know this—the first thing they did, they changed their vocabulary. They used to be called high-risk mortgages. Now they're called subprime. It doesn't sound so bad, and then they were able to sell them to everybody.

There's a market failure here because the providers of capital have no way to respond to these outrageous pay packages. There's no way to replace the boards of directors. There is a very good piece of legislation that already passed the House with a very strong majority on "Say on Pay." We would love to see that pass through the Senate. That would help a lot.

Another issue is the ability to replace directors, either through majority vote or proxy access. When you hear about the pay plans today, they will tell you that they're based on the market. They are not. They're based on comparables, not results. They're comparing X to X. It doesn't mean anything. They can show you all the pie charts in the world, there is no market basis for this pay. And there's no excuse for paying people so much for doing so little.

Put these pay plans under a microscope, as this committee's report has done very well, and you will see that they don't work. You have to look at pay, you have to ask just one question. Just like any other asset allocated by the board of directors, what is the return on investment of the pay? The return on investment for these pay packages is less than a piggy bank. And what you want is a pay package that pays off. This current system is not. It may be legal, as we've heard, but it is not right, It is not efficient, it is not the market, and it is not capitalism.

[The prepared statement of Ms. Minow follows:]

United States House of Representatives
Committee on Oversight and Government Reform

Nell Minow
Editor, The Corporate Library
March 7, 2008

Thank you very much for inviting me to appear today. I am very pleased that this committee is looking into this vital area of concern, and especially grateful to you for including on your panels not only the former chief executives but members of the boards of directors. It is not the executives, but the board members who are ultimately responsible for determining the levels and structure of executive compensation. The more regulators, shareholders, and legislators put the focus on the members of the board, the better we will be able to make sure that impediments to market forces are removed or at least minimized, and links between pay and performance are strengthened.

I am a passionate capitalist. I have helped to create three small businesses, and helped to sell the first two to large businesses. I know what it is to meet a payroll. More important, I know what it is to almost not meet one. Most important, I know what it is to be on the line of credit; nothing creates a more direct sense of personal responsibility. Over the past 20 years, my focus has been on corporate governance, particularly on strengthening the oversight by the board and the shareholders of public companies. My interest is in making sure that our capital markets are vital, vigorous, competitive, and credible.

At The Corporate Library, we rate board effectiveness at public companies for clients that include director and officer liability insurers, investors, search firms, universities, law firms, and journalists. Unlike other firms that award positive governance grades based on structural indicators like the number of "independent" directors and whether the company's governance policies are on their website, our grades are based on how effective the board is in making the most challenging decisions, including decisions about CEO pay. My colleagues and I have found that there is no more reliable indicator of investment, litigation, and liability risk than excessive CEO compensation. It may be that it is a symptom of poor oversight by the board. It may be that it creates perverse incentives. Possibly both. But over and over again, we find, unsurprisingly, that with executive compensation you get what you pay for and you pay for what you get. If you make the compensation all upside and no downside, that will affect the executive's assessment of risk – or, rather, it will make it clear to him that he can easily offload the risk onto the shareholders without much in the way of adverse consequences to himself. It is heads they win, tails we lose.

That is what happened with subprime mortgages. CEOs were guaranteed outsized exit and separation packages, regardless of how they or their firms

performed. And now that many of them have been shown the door, there is little hope that shareholders or directors could claw back any of that pay.

Over the last few years, CEOs at companies involved in the subprime mess received excessive compensation largely based on performance measurements linked to inflated earnings targets. For 2006, Angelo Mozilo's total actual compensation was valued at over $102 million. His annual bonus for that year was based on a performance target of diluted earnings per share, or "EPS." For Fiscal 2006, Countrywide Financial's reported EPS was $4.30, which was an increase of 4.62% over Fiscal 2005 EPS of $4.11, resulting in a cash incentive award of $20.5 million to Mr. Mozilo. These inflated earnings forced the company's stock up by 26%.

But by the end of 2007, when Countrywide finally revealed the losses it had previously obscured, shareholders lost more than 78% of their investment value. Meanwhile, in early 2007 Mr. Mozilo sold over $127 million in exercised stock options before July 24, 2007, when he announced a $388 million write-down on profits. On August 16, Countrywide narrowly avoided bankruptcy by taking out an emergency loan of $11 billion from a group of banks. Mr. Mozilo continued to sell off shares, and by the end of 2007 he had sold an additional $30 million in exercised stock options. Mr. Mozilo received more than $102 million in compensation and $157 million in exercised stock options, while total shareholder return was negative 78% over the same period. He is expected to receive another $58 million in non-qualified deferred compensation and supplemental pension benefits when he retires in connection with the Bank of America merger in 2008.

At Citigroup, Charles Prince received total compensation valued at over $25.9 million in 2006. His incentive awards for that year totaled more than $23 million and were based on multiple performance measurements. Specifically, the company stated that "revenues grew 7%, almost all of which was organic," "net income from continuing operations grew at about the same rate as total revenues (about 7% in each case)," "the 2006 return on equity was 18.8%," and "total return to stockholders was 19.6%." Then in 2007, the company announced its $24.1 billion write-down in connection with sub-prime lending. Soon after, Charles Prince announced his resignation and left the company with $40 million in severance. Shareholders lost 45% of their investment value by the end of the year.

At Merrill Lynch, former-CEO Stanley O'Neal received total compensation of more than $91 million for 2006. His incentive compensation was also based on multiple performance measurements. The company stated the following about the Mr. O'Neal's performance against objectives:

> The Committee considered performance against the CEO objectives determined at the beginning of the year and noted that all financial targets

were met or exceeded and all strategic and leadership objectives were met with distinction. This review included consideration of numerous objectives but focused in particular on the following achievements:

Financial Objectives

- Year over year Net Revenues increased by 26% to $32.7 billion (on an operating basis), significantly exceeding targeted growth;
- Pre-tax earnings growth of 44% (on an operating basis), a growth rate near the top of the Peer Group, with a year-over-year improvement in the Company's share of overall Peer Group Pre-Tax Profit; and
- Return on Equity of 21.6% (on an operating basis) for 2006 - an increase of 5.6 percentage points, nearly twice the Peer Group median increase.

In its discussion of ROE performance, the [Management Development and Compensation Committee] focused on the importance of this measure, which had been identified as a high priority for the CEO and the members of executive management. They noted that the improvement had been driven substantially by the achievement of record earnings of $7.6 billion (on an operating basis), which represented a 48% increase over the previous year's record. The Committee also noted that these record results reflected solid execution around several specific growth imperatives outlined to the Board over the past three years.

On October 24, 2007, Merrill Lynch reported an $8.4 billion subprime mortgage-related write-down. Just days later, Stanley O'Neal announced his retirement. He received more than $160 million in stock and retirement benefits in connection with his departure, while shareholder lost more than 41% of their investment value over the year. On January 17, 2008, Merrill Lynch took an additional $14.1 billion write-down, bringing its subprime mortgage-related losses to nearly $23 billion.

During 2006, management at New Century Financial Corp issued false and misleading statements about the company's financials to boost earnings, which allowed New Century stock traded at artificially inflated prices. On March 2, 2007, the company announced that it was the subject of federal criminal probes related to securities trades and accounting fraud. On April 2, 2007, the company filed for Chapter 11 bankruptcy. Over the three year period prior to filing for bankruptcy, Robert K. Cole, Chairman and CEO of New Century Financial Corp, received over $22 million in total compensation, most of which he received from exercised stock options that he sold at artificially inflated stock prices.

In 2006, management at Novastar Financial Inc. reported a rise in earnings after the company originated a record $2.8 billion in loans, boosting the company's stock price to inflated levels. Then in February 2007, the Novastar's stock fell by

42% after announcing fourth quarter and year-end 2006 results, and warned that NovaStar was expecting to earn little or no taxable income in the next five years. In November 2007, Novastar stock plunged after the subprime mortgage lender posted a $598 million third-quarter loss and said that bankruptcy was possible. Over the three-year period leading to the enormous losses, Scott F. Hartman, Chairman and CEO of Novastar, received more than $13.6 million in total compensation.

In January 2007, American Home Mortgage earnings soared 288% after the sub-prime lender originated a record $15.5 billion in loans during the fourth quarter of 2006. Just eight months later, on August 6, 2007, American Home Mortgage Corp filed for bankruptcy. The stock was at 44 cents a share, down from an annual high of $36.40. Total compensation awarded to Michael Strauss, Chairman and CEO of American Home Mortgage, over the three-year period prior to the bankruptcy was over $8 million, largely based on bonuses tied to inflated earnings targets.

There is an obvious disconnect between the performance of these CEOs and the compensation they received. They led the companies in a risky strategic direction that resulted in significant losses for investors across nations. Incentive compensation based on earnings and revenue increases is problematic in a situation like that of sub-prime mortgages. Principal officers, for themselves and in particular for those down the line who are similarly incentivized, can push "sales" without adequate concern for quality. There is a disconnect in that bonuses are "earned" as business is booked; only when it is clear that the business is defective – and that such defect should have been apparent at the outset – is the hit to earnings recognized. By that time, the CEO has been paid based on the inflated numbers.

The undue compensation awarded to these failed CEOs should be returned to shareholders. In addition, they should be liable for providing false and misleading statements to investors and held accountable for the impact of their poor strategic decision-making policies. That is first and foremost the responsibility of the directors. If they fail, it is up to the shareholders to replace the board and it is up to lawmakers and regulators to make sure they have the power to do that.

Thanks to Sarbanes-Oxley, and market forces, boards are doing a much better job than they did a few years ago. They're providing much more diligent oversight. But these kinds of anomalous results demonstrate that there is still something wrong. Executives and directors will shrug their shoulders and tell you that executive compensation is determined by market forces and that these downside-protected pay plans are necessary to attract top talent, which otherwise would go to the even higher-paid positions in private equity or hedge funds.

That is not true.

These all-upside, no downside pay plans may possibly attract top talent, but they then communicate very powerfully to the talent they attract that performance is not relevant. They are indeed incentive compensation, but the performance for which they provide incentives is contrary to long-term, sustainable creation of value for shareholders. The incentive they provide is for an "après moi, le deluge" focus on short-term tricks and a sort of financial reporting shell game – the bad news is always under the shell you don't pick up, until it is too late. Harvard Business School professor Rakesh Khurana documents in his brilliant book, Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs the single most important factor in looking at corporate pay: it must be looked at like any other asset allocation, in terms of return on investment. On that basis, executive compensation is too often a poorer investment than a piggy bank.

Let me be very clear on this point. I understand opportunity costs. If there was any evidence that these pay packages produce the kinds of results they purport to be designed to, I would support them. But they do not. And I do not understand how compensation committees can continue to approve them. Compensation committees too often rely on comparables based on sectors and market capitalization. They too seldom rely on a results-based analysis of what actually works. They too often rely on compensation consultants whose continued employment relies on their proposing ever-increasing pay with ever-decreasing connection to performance. Those consultants are very good at making charts and PowerPoint presentations that can show a hundred different reasons why the CEO needs to be paid more, mostly by comparing him to other executives rather than by comparing the money invested in him to the money he adds to shareholder value. The question boards should ask is not "What will it take to get the person we want to accept the job?" but "What kind of pay plan will most effectively communicate the board's strategic, operational, and reputational priorities?"

You can't do better than what Warren Buffett said at Salomon Brothers many years ago: "If you lose money for us, we will be forgiving. If you lose reputation for us, we will be ruthless." Boards must state their intentions clearly and back them up in the design of the compensation program. If there is any suggestion of bad behavior, the money must go back to the company. That's the only fair and credible way. Any CEO who will not accept the job on that basis is somebody we do not want to bet on because he is not willing to bet on himself.

The market failure here is that the consumers of executive compensation, the shareholders, have no effective way to respond to outrageously excessive pay packages approved by boards of directors. I do not expect the playing field to be level, but right now it is close to perpendicular. I do see some prospects for improvement.

First, there is a growing trend toward adoption of "majority vote" requirements for election of directors. I believe this will be the most significant of the post-Enron reforms. . Right now, under the law, a director who is unopposed can get elected with one vote because voters have only two options: to affirm a candidate or not to vote at all. Thus, it's not very meaningful to withhold a vote. But as companies adopt the rule that a director must receive a majority of the votes cast in order to win, directors will know they can be voted out. No director should be permitted to serve unless he or she receives a majority of the votes cast. This will permit shareholders to eject compensation committees who approve of excessive pay plans without undue cost or disruption.

Second, the SEC's decision to require mutual funds to disclose their proxy votes is making it harder for money managers to ignore the importance of proxy voting as an investment decision. I would like to see ERISA fund managers have the same obligation and I would like to see the Department of Labor strengthen its oversight of this essential fiduciary obligation. And I would like to see the New York Stock Exchange move forward on its long-promised broker vote rule so that actual shareholders, or beneficial holders, will vote for directors. Currently, in many cases, large brokerages hold shares for individual investors and vote on their behalf without consulting with their clients; frequently, they join management in supporting their board slate and opposing shareholder resolutions.

Third, there is some support for better oversight by shareholders through access to the proxy or reimbursement for contested elections. This committee well understands the benefits of an election with more than one candidate.

Finally, the legislation that has passed overwhelmingly in the House that would give shareholders a non-binding "say on pay" would be a very important step in the right direction. Now, shareholders only vote on stock options and have no say over any other aspect of compensation. So directors have nothing to lose by approving pay plans that pay off like perpetual pin-ball machines, designed so that everything you hit rings a bell, and loaded up like a hot fudge sundae, with a topping for every category of achievement, including showing up (signing bonuses) and sticking around (retention bonuses). Just one more word on this problem: "retirement plans" are about income replacement, not about adding another tens of millions of dollars to the already over-stuffed bank accounts of failed executives.

One way or another, shareholder votes are going to become much more meaningful. If compensation committees start getting voted out for signing off on outrageous pay packages, then boards will start to do a better job. That is what I call a market test.

My long-time colleague Robert A.G. Monks says in his new book, Corpocracy:

> The simple face is that the CEO market that the business Roundtable loves to cite was contrived by the chief executive officers operating through their lobbying wing. It is a market that has been polluted by the secrecy that surrounds the cost of option grants, the lack of any disclosure of even the most enormous retirement benefits, and, recently, the obfuscation of the date when options were granted and became effective so as to fix a price.

Our shareholders, our employees, our communities, and the working people of this country deserve better. In our increasingly global markets, if they do not find credible business leadership here, they will send their capital elsewhere. If we want our capital markets to be credible and competitive, we must stop paying executives who destroy shareholder value.

My thanks again to the committee and staff for inviting me to participate in this hearing. I would also like to acknowledge my thanks to my colleagues Paul Hodgson, Alexandra Higgins, and the staff of The Corporate Library for their assistance in preparing this testimony. I would be happy to respond to any questions.

Chairman WAXMAN. Thank you very much, Ms. Minow.

I want to thank all the panelists for your testimony.

We are now going to recognize members of the committee for 5 minutes of questioning, and I want to start off with Ms. Norton.

Ms. NORTON. Thank you very much, Mr. Chairman.

I think I'd like to direct this question to Ms. Minow.

Ms. Minow, I'm interested in the role of the board in all this. It's very easy to, of course, look to the guys who cleaned up. I served on the board of three Fortune 500 companies before I was elected to Congress. I must tell you that none of my experience equips me to understand the role of the board and the compensation or severance packages in these cases.

Let me ask you about Mr. Mozilo's severance, because we got a copy of his severance agreement that Countrywide signed with him. It gives Mr. Mozilo cash severance that would be worth $36 million if the company experiences a change in control, such as the pending Bank of America merger.

Now, if you look at the terms of this agreement, I, at least, find them quite amazing. If Mr. Mozilo leaves Countrywide, he would, it seems, almost automatically leave with millions of dollars.

If—and here I'm quoting—if the board takes any action which, "results in the diminution of the executive's status, title, position and responsibilities"—well, whatever lawyer wrote this, my hat is off to him. Because he appears to have made the board a captive to this executive, rather than his employer.

But let me ask you. It appears that, if you read this language, "results in any diminution of his status, title, responsibilities," that they can't take anything away from him, maybe even his private aircraft.

It looks like they can terminate him without severance. Indeed, I'm not sure the agreement says this, but it appears that they could terminate him if he committed a felony or acted in bad faith.

Now, even if his decisions cause his company, Countrywide, to lose billions of dollars and send the economy into a recession, it appears, under this agreement, that they cannot terminate him without paying him millions in severance. This kind of cause agreement, you know, you expect for judges maybe, not CEOs.

Now, I want to be fair to Mr. Mozilo, because he apparently has announced that he wouldn't seek the $36 million in severance, I suppose given what's happened, if the pending merger is finalized. But, of course, this doesn't change the terms of the agreement and doesn't tell me whether or not there are such agreements floating out there more generally in our country.

I would like your evaluation of this agreement. Make me understand why a board would have negotiated an agreement. I understand what the competition is, of course, for executives of this kind, the size of the company and all of that.

Is there any way in which these severance terms could be considered justifiable from a corporate governance perspective, looking to the board and its actions?

Ms. MINOW. Thank you for that question.

It's not the worst severance agreement I've ever seen. I think that would go to Tyco, where Dennis Kozlowski's contract provided

that even conviction of a felony was not grounds for termination. So that was probably the rock-bottom.

But the general idea about severance agreements——

Ms. NORTON. How typical is this?

Ms. MINOW. It is very typical, with one small exception, which I will get to.

But the general idea about severance agreements is that we want to align the interests of the executives with the interests of the shareholders. We don't want them to say, "Well, this deal would be good for the shareholders, but I would lose my job, so I'm not going to vote for it." And there are ways to structure the pay that does that.

However, this is the one exception that I would say, is that if the CEO is also the founder and is a massive, massive shareholder, as Mr. Mozilo is, then I don't really see that there is that justification for a severance package of this kind, and I would be opposed to it.

Furthermore, I feel very strongly, as you suggested, that CEO contracts should provide that termination for cause includes doing a bad job. I think every other job in the world you can get fired for doing a bad job and not get severance. It's only in the wacky world of CEOs where you get severance for failing.

Chairman WAXMAN. Thank you, Ms. Norton.

Mr. Issa.

Mr. ISSA. Thank you, Mr. Chairman.

I understand the boards aren't working. So would you put that up, and would you give that to Mr.—is it Yezer?

Mr. YEZER. As if the first "e" were an "a."

Mr. ISSA. OK, Yezer.

I don't need more help. I'm already doing badly enough as it is.

You know, Mr. Chairman, it was interesting that in your opening statement you picked on two companies that aren't here—Circuit City, who I'm well aware of in my prior life, in the real world, and their problems and the reasons for their layoffs and so on.

Sadly, what you probably don't know is that Circuit City has been beat, if you will, to a certain extent, in the marketplace. When they had employee compensation, salesmen compensation, that were commission-based, Best Buy went to a practice of paying a less-than-$16-an-hour flat wage, no commissions, bragged about it that there was no high pressure, and did better.

So, ultimately, Circuit City, who had a system of compensation, commission compensation, lost out in the marketplace. And I'm sad to see that, because I would prefer to see that kind of direct benefit to the sales force. But, clearly, the last effect that you talked about, the layoff of $16-an-hour flat-rated people, once again, in a vacuum, sounded terrible but, in reality, was the result of their losing in the marketplace.

Mr. Yezer, before you got to Occidental Petroleum, Mr. Ray Irani being the chairman who got, you know, in 2005, $64 million in compensation, can you note that the stock value there went from, in 2000, about $6, $7, to about $80, roughly, today?

Mr. YEZER. I'm sorry. When did you say he got the compensation?

Mr. ISSA. According to—I did some quick work here. Total compensation of $64 million——

Mr. YEZER. I'm——

Mr. ISSA. I'm sorry. That was in 2005. His 5-year compensation ended up being about $127 million, almost all in stock appreciation. If you were at the helm of a company in 2000 that was at $7 and you were able to successfully take it to—approaching $100, over $80 in those 8 years, what do you think the benefits should be when you're the fourth largest oil company and a total stockholders return of over 30 percent per year? What do you think the benefit should be? And do you think that Mr. Ray Irani's benefit was at least in some part tied to the success of his company during that period?

Mr. YEZER. I'm—OK. I'm not an expert on benefits, but I'll make two comments about this. The first thing I might do is an event study that is, when this was announced, see what happened to the share price. If the announcement resulted in the share price going down, then, you know, I wouldn't be too happy about it. If the announcement resulted in the share price staying flat or going up—I mean, the announcement of the compensation. By the way, can I tell you—put this in perspective. Occidental favorite—this is my favorite Occidental Petroleum story. You know, Armand Hammer was the chairman for a long time.

Mr. ISSA. Until he was 90 and dying, yes.

Mr. YEZER. Right. Yes. And then he died. Do you know what happened to the share price the day after he died? It went up significantly. You know, a lot of the most overpaid chief executives of firms are people who actually even collect a nickel and their firm doesn't perform at all.

Mr. ISSA. Right. And I appreciate that. Ms. Minow——

Mr. YEZER. I'm not an expert on this.

Mr. ISSA. Because I think you're probably the yin and yang of this debate here today, when you look at the performance of a company—my understanding is Mr. Irani has been—Dr. Irani has been at the helm of the company as chief operating officer and chief executive officer since 1983, took a long-term approach and even bought out Mr. David Murdoch so that he would not have to move the stock price up in the short run. But just looking at somebody with several decades at a company and the performance from 2000 to 2008, all—virtually all tied to stock appreciation and grants that he accumulated over decades, in this case, isn't that a fairly reasonable—regardless of the dollars that result—but a reasonable relationship in a positive way and something that this committee should know positively?

Mr. YEZER. Obviously, this——

Mr. ISSA. No, Ms. Minow——

Mr. YEZER. If this——

Mr. ISSA. I'm sorry. I have very limited time. But, Ms. Minow——

Mr. YEZER. If this company——

Mr. ISSA. I have limited time. I appreciate your answering that.

Ms. MINOW. Mr. Issa, as I said, nothing makes me happier than seeing a CEO earn hundreds of millions of dollars. In Mr. Irani's case, I would have preferred to index his pay against his competition. I think that he benefited tremendously from oil prices, which didn't really have a lot to do with his leadership. But, in general,

yes, I agree that is—you want to talk about yin yang, that might be the yin to the yang that we are talking about today.

Mr. ISSA. Thank you. I'm sorry. We've run out of time. And I appreciate the chairman's indulgence in my showing that perhaps your two examples were in a vacuum inappropriate, and I yield back.

Chairman WAXMAN. The gentleman's time has expired.

The Chair now recognizes Mr. Welch.

Mr. WELCH. Thank you.

Thank you, Mr. Chairman. I want to thank the witnesses. You all are on the frontlines. I really appreciate your leadership in trying to get some relief and also frame the issues. Let me ask a couple of questions. One of the things that was occurring with Mr. Mozilo is that, between November 2006 and December 2007, he sold about 5 million shares of his stock and that was occurring at a time when Countrywide under his leadership had designed a plan to buy back over $1 billion worth of stock and borrowed money in order to do that. As an expert on corporate governance, Ms. Wachter—I'll ask Ms. Minow. I'll start with you first. What is your reaction to that apparent contradiction?

Ms. MINOW. I find that to be possibly the most deeply concerning of all of the facts that have come out about his pay package. I have to tell you, Mr. Welch, I'm a very, very hard liner on this. I don't like to see executives sell stock at all. He had a substantial stock holding, and I think he would have done better in being a steward of the company's assets if he had to hold on to it.

Mr. WELCH. Mr. Galvin, how about you?

Mr. GALVIN. Well, I think it points out the conflicts that are inherent in this whole situation. You raised a point that many of the lenders here, the people who packaged these things, who allowed this process to go on, were publicly traded corporations. So that is another whole dimension. When you look at the coverage they received, once again, there are many elements of conflict. They were often times receiving coverage from some of these same investment banking houses that were engaging in business with them. So I think the bigger question I guess is, we recognize that housing is a fundamental need, a necessity of life. And the impact of this crisis that I think is evidenced by the testimony you've heard this morning has been not only devastating to those who need housing but also to our economy. And the question is—and that's what I tried to raise in my original testimony—is, how do we make sure that this doesn't happen again? I understand the mission of this commission—committee rather is to look at oversight with a view toward making sure it doesn't happen again. And how do you fix what has happened? And so I think there is a real problem when you have this type of activity on the part of CEOs. I share Ms. Minow's concern, when you see a sale—we regulate—I regulate securities in Massachusetts. When you see this kind of sale, it raises red flags.

Mr. WELCH. Thank you.

Professor Wachter, how about you? You have the chief executive implementing a plan for buy back and—and letting—for the company and a personal plan for his own finances to sell.

Ms. WACHTER. Of course, that was his right. Unfortunately, in this setting, there were decisions that every—by many people at every stage was their right. But the question is, what should it mean for the entire system? And I think we have to step back and look at the systemic problems here. At that point, Mr. Mozilo really could not have—it appears that this may not have been a very good thing to have done. But at that point, the system was already in failure. I think we also have to step back. I'm not commenting on the ethics of what he did.

Mr. WELCH. Well, you know, my experience around here is that most of the really bad things that happened are legal. That is the problem. Mr. Mozilo had a—the—Countrywide hired a firm to give, quote, compensation advice to the board. And as you know, they hired Ross Zimmerman, who came to the conclusion Mr. Mozilo's pay was significantly inflated. Countrywide then hired another compensation consultant, Towers Perrin. And internal e-mails show that John England, a Towers Perrin advisor, was acting as Mr. Mozilo's personal representative. And there is an e-mail that I think is on display over here where Mr. England wrote to Mr. Mozilo that his concern about the board's proposal was that it lowered Mr. Mozilo's maximum opportunity by lowering the target bonus and reducing the maximum bonus.

Ms. Minow, what is your view about this arrangement? They first consult and gave an opinion that said the pay was too high. Countrywide then capitulates and gets a second consultant. And then that consultant has personal and direct interaction with the person whose compensation is in question.

Ms. MINOW. Yes. That is exactly——

Chairman WAXMAN. Make sure—be sure your mike is on.

Ms. MINOW. That is exactly the question. And the—the only amendment I would make to the way you framed it is to say it is not Countrywide that did that. It is the Compensation Committee of the board. And I trust that you're going to present that same question to the chairman of that committee. That is—that is unthinkable to me that the CEO would be allowed to say, I don't want this compensation consultant because he is not offering me enough money; I want that compensation consultant.

That is the job of the board, and I believe that is a classic example of a failure of a board.

Chairman WAXMAN. Thank you, Mr. Welch. Your time has expired.

Mr. Davis.

Mr. DAVIS OF VIRGINIA. Well, thank you very much. I mean, I look back to the Fed and some of their publications in 2000. They were embracing subprimes. They looked at this as a way to make housing more available to people that otherwise wouldn't have had it. The real problem here is the market turned down. We've gone through these—I've been in office 29 years. I've seen boom and bust. I was in local government for 15 years. And we were reliant on the real estate values. And when you go through a bust in the marketplace, our budgets were put into turmoil. We went through this in Fairfax in 1991 and 1992. So the real problem here when you look at all of the other—a lot of issues, was the fact that the market turned down.

Ms. Minow, isn't that what happened actually.

Ms. MINOW. Mr. Davis, let me—let me assume that is correct for a moment because it could be. That would be fine with me. But why are we paying these CEOs as though they were successful? I wouldn't—I understand that no one can predict the future, even the people at the very, very top of the economy. But we are paying them as though——

Mr. DAVIS OF VIRGINIA. That is a separate issue and I'll get to that. That is a separate issue.

Ms. MINOW. OK. But I'll accept your point.

Mr. DAVIS OF VIRGINIA. But if you didn't pay them anything, you still would have had this crisis?

Mr. Yezer, isn't that basically——

Mr. YEZER. Yes, this——

Mr. DAVIS OF VIRGINIA. I mean, you're looking for a lot of culprits when things go wrong.

Mr. YEZER. Well, because look at what happened—you've got the losses in FHA, right?

Mr. DAVIS OF VIRGINIA. Right. I mean, across the board. In fact, there are players who are probably equally or more culpable when you talk at some of the lenders, the appraisers, the rating agencies. I mean, there are a lot of folks that got caught up in this, including the Federal Government, who was encouraging this type of thing. But let's talk a minute about compensation. There is a claim—the majority says that the compensation wasn't in line with performance at these companies. But even their own charts showed that Mr. Mozilo—his total compensation was $42 million in 2006 and roughly half that in 2007. And that is even using some sleight of hand to include $20 million in stock sales as compensation. So his compensation was cut in half. Mr. O'Neal's compensation was $48 million in 2006. Only slightly more than a million in 2007. And Mr. Prince's compensation was $25 million in 2006 and less than half that in 2007. Isn't it also true that any stock options that were not exercised when the stock price was high are then much lower later on? So they had—in some of these instances, they had to keep 75 percent of their stock under—you know, under the rules. So as the stock—they suffered, too, now. They started out with a much higher base than the average person, and you can argue that was good or bad. But the argument is that they took a hit, too, relative to everybody. It is a higher percentage hit in some cases. They just start at a much higher base.

We see that by the way not just in corporate America; we see it in sports, athletics, entertainment across the board if you ask what is good compensation. So this value of the stock that they were not allowed to sell while they were employed was vastly reduced. And as the performance went down, they took huge hits. They would have had a huge upside had the economy come in. I'm not saying this isn't a lot of money, but to take a look at—they did take a hit.

Now, Ms. Minow, in your testimony, you repeatedly used the term "inflated" in talking about the earnings or stock prices which were the bases for what you considered to be excessive compensation paid for the executives. Would you define the term "inflated" for us?

Ms. MINOW. Yes. I would define the term to say numbers that had to be corrected later on either because of poor judgment or fraud.

Mr. DAVIS OF VIRGINIA. Yeah. Well, in some cases—you know, you make decisions every day in business and factors get outside your control. High/low prices, interest—things outside your control. When things go wrong, we're all looking for somebody blame. But as you take a look at this whole issue, there are a lot of people to blame, including the people who signed on the mortgages, in some cases, that they couldn't possibly have taken.

Ms. MINOW. I said that in my remarks.

Mr. DAVIS OF VIRGINIA. I know you did. I'm just saying, we're looking here at just one aspect of this, and I think it is much more complex than that. And ultimately, of course, the shareholders, this is their duty to look at what the compensation is. They have that right, pension funds——

Ms. MINOW. All I'm asking is that they have the ability to respond to it in market terms.

Mr. DAVIS OF VIRGINIA. Let me ask this. I'll ask Mr. Yezer. The popular media has spoken at length about the effect of subprime mortgage—adjustable rate mortgages. Some have suggested that the subprime lending will have resulted in a net decline in home ownership when the current cycle is completed. Do you concur with that, or do you think subprime lending has contributed and expanded home ownership when this is all said and done? I'll ask you. You're the economist.

Mr. YEZER. OK. Well, Susan is also.

Mr. DAVIS OF VIRGINIA. OK. I'll just ask you both.

Mr. YEZER. OK. Let me just make one previous point because I think I didn't made it clear.

Mr. DAVIS OF VIRGINIA. Sure.

Mr. YEZER. There is something in financial economics called an event study in which you basically say that news gets capitalized in the share prices. So, essentially, I just look at what happened to the share price when an announcement was made. And if the share price goes down, I begin to think that the compensation was overly generous. And if it doesn't go down, I think the judgment of the market was that it was appropriate. Every day the market votes on every corporation in the United States and all aspects of its management. And we study this through event studies. That's how the SEC decides to prosecute people in the case of insider training; they look for the information leaking early.

So this is a well established academic method in which you could have someone, even a graduate student employed and study this issue of whether or not you got a—you got a bump in the share price one way or another. And I don't know how it would come out. But that's the way a professional economist does it.

As to the issue of home ownership, there was a huge increase in home ownership, 64 percent to almost 70 percent. It is a tough—you know, it is tough to attribute that to things—the literature generally thinks that a lot of it was due to credit restraints being eased by the subprime market. Are we likely to go back to 64 percent? I don't think so. I mean, I'd actually probably be willing to bet a lunch that we won't go back to 64 percent.

Ms. WACHTER. Mr. Davis, if I may respond. The home ownership rate has already declined to the levels before subprime took off. So, although there was this dramatic increase from 2001 until now, we are back down to the 2001 levels. We've lost all the gains of the period of the subprime growth. So, in fact, home ownership is still declining. So net—I do believe subprime will decline.

Second, if I may, on an earlier point, and with all due respect, the price rises that occurred in the year 2006 were because of subprime. So subprime created the price rise that is now putting homeowners under water with loan-to-value ratios under one.

Mr. DAVIS OF VIRGINIA. Good point.

Chairman WAXMAN. Thank you, Mr. Davis of Virginia.

Mr. Yarmuth.

Mr. YARMUTH. Thank you, Mr. Chairman. And thanks to all the witnesses. I come at this from a kind of schizophrenic perspective. I was a journalist for many years and wrote columns. And I find many of this—much of this information would be wonderful fuel for columns. I mean, I could look at Mr. Prince getting a $10 million bonus when his company lost $10 billion and say, that is a wonderful column and it is a wonderful one-liner.

But on the other hand, my father was a CEO of a Fortune 500 company. My brother is a CEO of a public company. And I know that, in fact, that $10 billion loss could have been an excellent performance because if the company maybe was scheduled to lose $11 billion, then he might have saved the company $1 billion. So that extra $990 million saved would have been worth it. So I guess my question is that when we look at compensation and we can be—we can interpret it many different ways, and Ms. Minow, you referenced that. I did a radio interview this morning, and I was asked about this hearing. They said, what business is it of the government and where is the public stake in this? Now, separating the housing crisis portion and just dealing with the overall broad question of employee—CEO compensation, what is the public stake in this question?

Ms. MINOW. First, I would like to say, with regard to your hypothetical, I'm in favor of paying somebody $10 million for losing $1 billion less than he was scheduled to. As I mentioned earlier, when we were talking about Occidental, I'm in favor of indexing pay to the peer group or to the market as a whole. And I think that is how you handled that problem.

With regard to the overall public interest, as I said, this undermines the credibility of our capitalist system. In global markets, the money is going to go to the system that has the most credibility and the most accountability. And so I think that is a huge public interest. Now, does that mean that Congress should legislate how much people get paid? Of course not. That has turned out to be a mistake every time it has been tried. That is why my emphasis has been on giving the market a chance to work by removing the obstacles to shareholder oversight.

Mr. YARMUTH. And would you repeat what some of those obstacles are?

Ms. MINOW. Sure. Right now—you know, I always like to say when I'm testifying, nobody understands the word election better than Members of Congress. And yet we call it an election when

management picks the candidates, no one runs against them, and management counts the votes. You know, I don't know what other country would consider that an election. Right now there is no way for shareholders to remove directors. And so one of the policies that I'm in favor of is what is called majority vote. That is someone doesn't get over 50 percent of the vote, they should not be allowed to serve. That would allow shareholders to replace boards of directors and particularly Compensation Committees that agree to these abusive plans.

Mr. YARMUTH. But isn't the reality that most shareholders don't care enough and probably shouldn't care that much if you have 100 shares of a company and you have a life or most of the stocks are owned by mutual funds, institutional investors, that the actual shareholders really don't have any way of doing that anyway? I mean, isn't there a structural impediment to what—the kind of democracy you're talking about?

Ms. MINOW. As you just indicated, more than half of the stock in this country is held by institutional investors who actually are very big, very smart, and very sophisticated and do know how to vote. And as you can see, the votes have become more and more rational over the past few years as there has been more scrutiny of those votes.

Mr. YARMUTH. Dealing now on the foreclosure side and the impact on communities. I've talked to people around my community in Louisville, Kentucky, and our foreclosures are up significantly over the last 2 years. We're now to 3,700, I think, for this past year. And we were in the 500 to 600 range 2 years ago. But the people I talked to in the banking industry in my community and in the real estate community and the realtor community and also in the home builders community say it has very little to do with subprime mortgage, in my market, that this is much more a general economic squeeze issue than it is a subprime crisis. I understand that this differs around the country.

And, Mayor Lawrence, I understand it differs in your community.

But how much—have you been able to determine whether this really—the subprime crisis is the major factor in the foreclosures or whether it is a broader economic issue?

Ms. LAWRENCE. You're absolutely right. There is a portion of it that is directly related to subprime. But, however, our slump in the housing market—if I lose my job, the norm was that I would sell my home, readjust my financial situation, buy a cheaper home, and make other options. Right now—usually the mortgage now is higher than the price of the home. And in addition to that, you can't sell the home. So then you have that component of this walk-away which is something that is very new to communities, especially to the middle class community. Someone will walk away from usually the highest investment you have in your portfolio as an investor or buyer.

The other thing that is happening is that when you look at the job loss and the credit ratings—now, I will give you an example. This is one that really kind of floored me. Two-family income, one of the family members lost their job, couldn't find a job and eventually found a job in Arizona. They couldn't sell their house. They walked away from the house. Their credit was still good, bought a

house in Arizona and left the one that was here. One of the things that come from that is zero down. If I have nothing, no equity or nothing invested in a home, what am I losing? It is like having an apartment, you just walk away from it. So there are a lot of components—I mean, our economy, the housing slump, the subprime, all of that together is creating the crisis.

Mr. YARMUTH. Thank you very much.

Chairman WAXMAN. Mr. Yarmuth, your time is up.

Mr. Bilbray.

Mr. BILBRAY. Mr. Chairman, I'd like to yield my time to Mr. Issa.

Mr. ISSA. I thank the gentleman. Professor Wachter, I am thrilled that you did such a great job of expressing sort of the history of how we got here. And somewhat rhetorical but I think important, when did you first write or publicly say that we were heading for the meltdown that you now went through the whole how we got there? When did you see it and say it?

Ms. WACHTER. 2005, in—beginning of 2006, the end of 2005.

Mr. ISSA. OK, which is interesting, because if you look on the board here, Alan Greenspan almost at that exact same time, as probably one of the most trusted economists in America, was saying that these products were still good. When did it become—obviously not then. But when did it in your mind become pretty universally understood by economists and the academic community that, in fact, we had gone down the wrong road in allowing the growth of subprime through these mechanisms?

Ms. WACHTER. Not yet today. We actually have well respected economists on this panel, Tony Yezer, who would disagree. I think he has just said that these are useful instruments.

Mr. ISSA. Well, I think he also said that the meltdown—I'll get back to you in a second. I'm going to very much give you both time that I have. I think there is an important point here, though. All the way back in 1977—and what I wanted—can you see that board from where you are? I know it is a ways off. But all the way back in 1977 when Mr. Waxman was not yet the chairman, the Congress passed the Community Reinvestment Act. The median price of a home was about $38,000. Today, it is, even after the shrinking, it is around $217,000. There has been a steady escalation—this is the national—I have to tell you, as a Californian, there has not been a steady escalation. It has been up and down a little bit more. But it is on the board now. That escalation—at some point, the question is all the way back in 1977 and in 1993 and at each juncture, the government—we on the dais take responsibility—said to banks and other institutions, you must have a portfolio of these high risks, you must find ways to get to underserved—underserved not because nobody wants to loan them money, but underserved because they are less credit worthy. Do you believe that going forward, because you did a great job of telling us how we got here, that we need to look at other mechanisms to deal with low-income or poor-credit individuals and their desire to have home ownership and how we facilitate that when appropriate?

Ms. WACHTER. Thank you very much. It is an extremely important question. May I just as background—that chart looks like a steady increase in house prices. The reality is you correct for inflation. House prices did not increase in the United States for con-

stant quality home until recently, until 2000. We actually have had relatively steady, although slightly increasing about 1 percent a year. There has been a dramatic rise nationally since 2000. I'll come back to that because that is related but not the essence of your question.

The essence of your question has to do with homeownership, access to home ownership and the importance of increasing home ownership for all in our society, those who may not be able to access it, also have opportunity to build wealth and have their——

Mr. ISSA. And I'm going to hold you at that point. The opportunity to build wealth, isn't that an inherent problem that we have—economists and yourself included—have come to assume that somehow you leverage home ownership, you leverage the interest rate against inflation, against the appreciation in order to create wealth? Here today are you willing to say that kind of leveraging is what we should continue to encourage, or should we look at home ownership as an alternative to rent and in fact a place you live and not your primary leveraged investment? Because I'm a Californian. During the same period of time that we went from $38,000 to $228,000, California went from $50,000 to $450,000 in median price. California has gotten to where this Ponzi scheme that just collapsed in the last few—last year or so, year and a half, in fact is nearly twice the national average.

And part of it is exactly what you're saying, that we're somehow saying this is about investment rather than affordable homes for people to live in. Isn't that one of the things government should get back to?

Ms. WACHTER. Yes. But this is not Community Investment Act. This is not FHA. This is coming from instruments that were introduced in 2000. This is not the legislation that Congress passed with government insurance. It is the option ARMs. It is the subprime teaser rate ARMs. It is these new instruments——

Mr. ISSA. I appreciate all that in your testimony. My question really was, as late as 2005, you've got Alan Greenspan still saying that these devices are a good thing.

Ms. WACHTER. I absolutely agree with you.

Mr. ISSA. And you said—Mr. Yezer you said——

Ms. WACHTER. So I am saying there is still this disagreement. I personally—you asked for my views. I personally viewed these—I've called them aggressive mortgages, the high-leverage mortgages—I do want to be clear by what I mean. We're not talking about FHA. We are not talking about the CRA loans that were invested by community lender banks. We're talking about highly leveraged, negatively amortized ARMs, these subprime mortgages, these teaser rate ARMs, all of these instruments are simply inappropriate. That doesn't mean that they have to regulate it to zero. But they became—their use was completely inappropriate in terms of the importance in today's—in the economy of these past years.

Today the market is completely shut down for much of this subprime. We now have to be very careful that we don't completely shut off the liquidity for the appropriate use of adjustable rate mortgages and jumbo loans. So we're now in a different part of the curve. But absolutely I've said in writing and I myself have a quar-

terly product that comes out which points to the inappropriateness of these very mortgages.

Chairman WAXMAN. The gentleman's time has expired.

The Chair recognizes himself for 5 minutes.

Ms. Minow, you've been critical of the corporate governance practices of Citigroup. During our committee's investigation, we learned that when the former CEO of Citigroup, Charles Prince, left the company in November 2007, he was given a $10 million bonus in cash. He wasn't entitled to this because he had no employment contract with Citigroup.

Now, at the time Mr. Prince left Citigroup, the company was losing $10 billion as a result of decisions made while he was CEO. Did this make sense? Was it appropriate to give Mr. Prince a $10 million bonus when Citigroup had just lost $10 billion?

Ms. MINOW. Mr. Chairman, I feel a little bad picking on him. I don't think it was appropriate. But his sins are so much smaller than the other people we are talking about that it almost seems like $10 million isn't that much. Overall, his pay package was not as far out of whack with performance as the other people that we've been discussing. And I will say that it is not unusual for CEOs without a contract to be given that kind of money because the board feels bad about their exit, and it is not their bank account, so they're happy to write a check on it.

Chairman WAXMAN. Well, from a shareholder perspective, what rationale would there be to give a former CEO who had just presided over a loss a $10 billion, perks of $1.5 million, a cash bonus of $10 million? From a shareholder—because the board is supposed to represent the shareholders, aren't they?

Ms. MINOW. That is my belief. It doesn't always work that way. From a shareholder perspective, I do not think it is possible to justify that payment.

Chairman WAXMAN. Mr. Galvin, you represent an institutional investor. Do you have a comment on this?

Mr. GALVIN. Yes. I'm concerned about this because it continues—the continuation of this practice or the acceptance of these practices may well lead to additional abuses in the future. One of the big problems in the whole financial services area historically, I believe, is that there has been a history here of allowing people at great public expense to make big mistakes and simply either be dismissed with pay or the company to pay a fine and move on their merry way until they do it again. And one of my greatest concerns about this is obviously the crisis we've all been speaking to this morning as far as the housing market.

But it also is, what are we learning from this? What are we doing about—to make sure this type of problem doesn't occur again? One of the issues that came up in the context of Congressman Issa's questions is the whole issue of securitization. The reason this big pool of money was available was because of securitization. Severing the link between a specific value for a home and, in fact, the pool of money that was available that fostered the abuse of loans that were just chronicled by the professor. So the question is, if you continue to reward people for making mistakes, if you continue to reward people for screwing up, you know what? They're going to screw up again. It may be in a different con-

text, a different company, but it is going to happen. And the question is, what are we doing about it? And I'm particularly concerned when it affects things that are essential to life, shelter, fuel, things that we all need and things that destroy our economy overall. And I think that is what we're seeing now.

Chairman WAXMAN. Well, it has enormous impact on the economy and on communities, as we've heard from Mayor Lawrence. It has a rippling effect in confidence in the whole economic system. But I'm not picking on anybody.

Ms. Minow, when I ask about these compensation—and it may not be as much as others. I mean, after all, they can point to some of the others in financial areas where they make even more money. I don't have any problem with people making money. I just want some alignment, some rationality where the shareholders and everybody else are protected. There is—our workers in this country are looking to their retirement to 401(k) plans. That means investment in public corporations. And therefore, they want American corporations to succeed. Is this giving the right incentives for corporations to succeed when we're overcompensating the executives in a way that doesn't seem to have a rationality to it?

Ms. Wachter, do you want to comment on that?

Ms. WACHTER. Well, I do think it is extremely important that, as Mr. Galvin said, that the incentives be in place and we do need to seriously look at the lessons learned from this crisis. This crisis is the first one that has involved homes in America as well as individual—not large investors only, but small investors, pension funds, cities. And it is coming home to cities in two ways in communities, both housing and funding. So it is really grave concern for cities. We must learn the lessons. And if the decisionmakers don't have failure incentives to watch success in terms of their own personal remuneration, then, indeed, the mistakes will be made again.

Chairman WAXMAN. And we're not discussing this whole question in the abstract because we're talking about a specific crisis that has resulted from these—from these collateralized loans. And you've studied that. Can you tell us in layman's terms how the practices of Merrill Lynch and Citigroup and other investment banks contributed to this mortgage crisis?

Ms. WACHTER. On the one hand, they were innovators and that is their job. And on the other hand, they were creating high-risk instruments, and that is their job. So, actually, on some levels, they were doing the job. But the question we have to ask is two: One, as a society, do we want to allow and encourage the home to be backed by very volatile, risky investments that will actually potentially cause not only the people who were securitized by these instruments, that borrowed these, but indeed all homeowners to be exposed to this kind of risk? We are the only country in the world that is so exposed.

Chairman WAXMAN. Well, I thank you very much for your response to the questions of all of our members of the committee and for your presentation. I would like to ask you if you would be willing to respond to questions in writing that might be submitted to you for the record. Thank you very much for being here today.

Mr. ISSA. Mr. Chairman, I'd like to ask unanimous consent that the Carol Loomis article from Fortune Magazine be included in the

record because it is pertinent to this portion—the pay and compensation portion.

[The information referred to follows:]

Robert Rubin on the job he never wanted

The reluctant chairman tells Fortune's Carol Loomis why Citi didn't see the subprime mess coming.

By Carol Loomis, Fortune senior editor at large

(Fortune Magazine) -- When the new chairman of Citigroup, Robert Rubin, is asked why he was so tenacious and outspoken in supporting the chairman who just left, Charles "Chuck" Prince, Rubin delivers a typically introspective answer: "People are what they are, and that's what I am." Besides, he asserts, Prince deserved to stay: "He was doing what was right and what needed to be done."

Rubin, 69, goes on to recall that he similarly supported Larry Summers in 2006 when the Harvard president was about to be forced out and that he also defended President Clinton in September 1998 during the bonfire days of the Monica Lewinsky affair. Just after prosecutor Kenneth Starr submitted his inflammatory report to Congress, Secretary of the Treasury Rubin declared on Tom Brokaw's NBC Nightly News that, regardless of the obvious problems, he believed Clinton to be doing "a very good job" as President.

An extreme irony in all this is that it is Rubin who could right now use a Rubinesque defender. On Sunday, Nov. 4, the same day Rubin reluctantly moved from the job of chairman of the executive committee to chairman of the board, the company announced the startling news that it had $55 billion of collateralized debt obligations (CDOs) and other subprime-related securities on its balance sheet and that large write-offs of an estimated $8 billion to $11 billion were imminent.

Within Citi, many employees - highly aware that Rubin was a risk wizard at both Goldman Sachs (Charts, Fortune 500) and the Treasury - are angry at what he didn't do to avoid both this disaster and earlier write-downs that Citi reported. Yes, the critics know Rubin has adamantly restricted himself to playing a nonoperating role at Citi, sticking mainly to advising the troops, from CEO on down, and dealing with important clients. Still, the burning question being asked today, outside Citi as well as in, is how all this CDO stuff could have gone on under his nose.

Though surely detesting the mere utterance of this question, Rubin contents himself with dismissing it. "The answer is very simple," he says. "It didn't go on under my nose." At Citi, as in any large company, he explains in a Business 101 way, you have people who are specifically responsible for certain areas - trading and risk, for example - and you have senior management making sure that they are highly qualified for the job and monitoring their work. And, Rubin says, "I am not senior management. I have this side role."

Okay, noted - except that this sideman of the dissonant Citi orchestra was paid $17.3 million last year. Rewards of that variety in other years have ordinarily left Rubin trailing only Prince and his predecessor, Sandy Weill, in compensation. That sure leaves Rubin looking a lot like senior management. In addition, what more important assignment could a consigliere to the CEO have than trying to anticipate risks? Both Prince and Weill, in fact, have talked in the past about the value of their conversations with Rubin, though Prince isn't available to be queried about that matter now.

A larger part of Rubin's explanation as to why Citi (Charts, Fortune 500) failed to avert its CDO train wreck concerns the sheer difficulty of heading it off. True, worries about a "housing bubble" abounded. Rubin himself gave countless speeches in recent years that talked about investors, in all manner of asset classes, "underweighting" risk - that is, sloughing off its importance. But he wasn't on the trading floors where the mortgage-related decisions had to be made, and he knows from deep experience that's where the buck stops.

Only the rare investor, Rubin points out, was able to anticipate the collapse. As an illustration, he refers to the New York private equity and hedge fund community, which he knows well. In the first six months of this year, he says, there may have been a few people in this club who positioned themselves to profit when things went bad. He measures them as no more than "a handful." Ditto the people who successfully hedged their positions, thereby offsetting some of the trouble in July and August. That would be another handful, he thinks.

Rubin doesn't need the reminder, but this writer injects it into the conversation anyway, remarking that the handful included Goldman Sachs, which this year has made large profits by shorting mortgage-related securities. Rubin acknowledges the fact quietly: "Some people did."

Goldman appears also to have scored by hedging long positions early this year. At a Citi analyst call on Nov. 5, just after the impending write-downs had been announced, Citi CFO Gary Crittenden said the company did some hedging in the first part of the year too. But by July and August, when the need for protection was terrifyingly apparent, the ability to hedge, especially in the large amounts that Citi needed, was virtually nonexistent. Citi had by that time, starting in July, organized daily meetings in which Rubin participated. He says, "I tried to help people as they thought their way through this. Myself, at that point, I had no familiarity at all with CDOs."

At bottom, the countdown to both Prince's exit and Citi's November shocks began in that summer crisis period for the credit markets. Citi started then to have ominous dealings with CDOs that carried a "liquidity put." Never heard of a liquidity put? Google will give you a few uninformative references. But it is testimony to the obscurity of this term that Rubin says he had never heard of liquidity puts until they started harassing Citi last summer.

What Citi did a couple of years ago was insert a put type of option into otherwise conventional CDOs that were backed by subprime mortgages and sold to such entities as funds set up by Wall Street firms. The put allowed any buyer of these CDOs who ran into financing problems to sell them back - at original value - to Citi. The likelihood of the put being exercised, however, was regarded as extremely remote because the CDOs were structured to be high-grade entities called "super-senior."

Meanwhile, you might think the existence of the put would make it impossible for Citi to get those CDOs entirely off its balance sheet. But in fact Citi found a complex accounting rationale for doing exactly that, and the CDOs jumped entirely to somebody else's balance sheet. All that remained in Citi's realm was this sticky little matter of the puts - which, as we shall immediately see, ultimately worked to get these CDOs right back to their creator, Citi.

Last summer, with the whole world suddenly unwilling to finance CDOs, the holders of the liquidity-put CDOs began to return them to Citi. And that's where they now reside - $25 billion of them, a very large lump in Citi's $55 billion of subprime-related securities. That entire package of trouble was the subject of Citi's Nov. 5 analyst call. This was the third presentation that Citi had made to analysts in five weeks - each of these confessionals more anguished than the last - and in that time Citi's stock and Prince's credibility had been punished.

But remarkably, Nov. 5 was the first time that Citi mentioned liquidity puts to the world. CFO Crittenden says the need to make disclosures about the puts did not arise until the last part of October, because until then the super-senior status of the put-laden securities made it appear they would largely hold their value. But that didn't take into account the rating agencies, which suddenly went on a downgrade binge. Their rating changes made it clear that Citi's super-seniors would have to be written down.

Crittenden and his staff met late on Thursday, Oct. 25, to begin sizing up the damage. Crittenden left the meeting not yet certain about the numbers. But he knew enough to tell Prince on Friday that the news would be very bad. With that, the beleaguered Prince recognized that his credit line of goodwill was used up. On the weekend, he called Rubin to say that he thought the only "honorable" action for him to take was to resign. Rubin urged Prince to stay, an expression of continuing support implying that Rubin, as a Citi director - an influential one - was prepared, despite the fresh onset of bad news, to keep backing Prince at the board level. Prince nonetheless remained determined to exit.

Rubin says unequivocally that Prince's resignation "was a Chuck-made decision." A modified view, though, is suggested by *Fortune*'s interview with Prince Alwaleed bin Talal bin Abdul Aziz al Saud (see the full text), who with a nearly 4% ownership, is Citi's biggest single shareholder. Alwaleed stayed supportive of Prince right through Citi's second earnings call, on Oct. 15.

But when word began to leak in late October that Citi would report huge new write-offs, Alwaleed was outraged and called Prince to tell him he would "withdraw" his support. That didn't necessarily mean curtains for Prince. Citi's board could conceivably have stuck with him. But it is easy to imagine that the prospect of a fight with Alwaleed was one big negative on Prince's mind as he proceeded to resign.

From that weekend when Rubin and Prince talked, it took another week of board and internal meetings for the financial news to be released and for the management scheme that included a foot-dragging Rubin to be crafted. He has been joined at the top by the head of Citigroup Europe, Sir Winfried Bischoff, 66, who will be interim CEO until the board finds a permanent boss.

Rubin has by these events been plunged into a job he wished above all to avoid: the top post in a major financial company in a period of crisis. But having made the wrenching decision to disturb what he calls "the arc of my life," Rubin seems bent on dragging this monster company out of the ditch. He says, "This is an important institution - not just to a lot of people, but also to the economy, globally. I think that this institution needs what Win Bischoff and I can bring to it." He pauses slightly: "And that's where my head is at the moment." ■

Chairman WAXMAN. Without objection, it will be made part of the record. We'll take a 5-minute break while our next panel comes in to take their places.

[Recess.]

Chairman WAXMAN. The meeting of the committee will please come back to order. On our second panel, we will hear testimony from Mr. Charles Prince, the former chairman and chief executive officer of Citigroup, Inc.; Mr. Richard D. Parsons, chairman of Time Warner and the chairman of Citigroup's Personnel and Compensation Committee; Mr. E. Stanley O'Neal, the former chairman and chief executive officer of Merrill Lynch; Mr. John D. Finnegan, chairman of the Management Development and Compensation Committee for Merrill Lynch and the chairman and chief executive officer of the Chubb Corp.; Mr. Angelo Mozilo, chairman and chief executive officer and co-founder of Countrywide Financial Corp.; and Mr. Harley Snyder, the chairman of the Countrywide Compensation Committee, as well as that company's lead director. Among other real estate ventures, Mr. Snyder is the president of HCS, Inc.

We're pleased to welcome all of you to our hearing. I appreciate your being here. It is the practice of this committee that all witnesses that testify before us do so under oath. So now that you're seated, I would like to request that you stand up and please raise your right hands.

[Witnesses sworn.]

Chairman WAXMAN. The record will indicate that each of the witnesses answered in the affirmative. Your prepared statements will be in the record in full. We will have a clock that right now has a red light on, but it will be 5 minutes: green for 4; yellow for 1; and then, it will turn red at the end of 5 minutes. When you see that, we'd like to ask you to summarize, if you would, but we're not going to be so strict that we're going to cut anybody off.

Mr. Prince——

Mr. DAVIS OF VIRGINIA. Mr. Chairman, can I just ask unanimous consent that we enter the minority memorandum in the record that is containing discussion of the timeline of the subprime crisis?

[The information referred to follows:]

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MEMORANDUM

March 6, 2008

To: Members of the Committee on Oversight and Government Reform

Fr: Majority Staff, Committee on Oversight and Government Reform

Re: Supplemental Information on CEO Pay and the Mortgage Crisis

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On Friday, March 7, 2008, at 10 a.m. in room 2154 of the Rayburn House Office Building, the Oversight Committee will hold a hearing to examine the compensation and retirement packages awarded to the CEOs of three companies implicated in the mortgage crisis: Angelo Mozilo of Countrywide Financial Corporation, E. Stanley O'Neal of Merrill Lynch, and Charles Prince of Citigroup.

In preparation for the Committee's hearing, the Committee has received thousands of pages of documents from the three companies, including board minutes and internal company e-mails. The Committee staff also has reviewed hundreds of public Securities and Exchange Commission (SEC) filings and consulted with leading experts in executive compensation. This memorandum summarizes some of the questions raised by the materials reviewed by the Committee staff.

I. EXECUTIVE SUMMARY

The March 7 hearing provides Committee members the opportunity to examine three case studies in CEO compensation. A common element in the case studies is that each of the CEOs presided over multi-billion dollar losses in the mortgage market. Collectively, the companies run by Mr. Mozilo, Mr. O'Neal, and Mr. Prince lost more than $20 billion in the last two quarters of 2007 alone as a result of investments in subprime and other risky mortgages.

While Countrywide, Merrill Lynch, and Citigroup prospered, Mr. Mozilo, Mr. O'Neal, and Mr. Prince received lucrative pay packages. During the five-year period from January 2002 through December 2006, the stock of Countrywide, Merrill Lynch, and Citigroup appreciated, and the three CEOs collectively received more than $460 million in compensation.

Any alignment between the compensation of the CEOs and their shareholders' interests appears to breakdown in 2007, however. Despite steep declines in the performance and stock price of the three companies resulting from the mortgage crisis, Mr. Mozilo, Mr. O'Neal, and Mr. Prince continued to be well rewarded: Mr. Mozilo received over $120 million in compensation and sales of Countrywide stock; Mr. O'Neal was allowed to leave Merrill Lynch with a $161 million retirement package; and Mr. Prince was awarded a $10 million bonus, $28 million in unvested stock and options, and $1.5 million in annual perquisites upon his departure from Citigroup.

A. Questions about Mr. Mozilo's Compensation

In the case of Mr. Mozilo, the Committee received and analyzed information about both his 2001 and his 2006 employment contracts. Both contracts raise issues about the level of compensation Mr. Mozilo received. In addition, Mr. Mozilo's decision to sell almost $150 million in Countrywide stock from November 2006 through the end of 2007 also raises questions, particularly as many of these sales occurred at the same time the company was borrowing $1.5 billion to repurchase its shares.

Under Mr. Mozilo's 2001 contract, which governed his pay from 2002 through 2006, Mr. Mozilo received total compensation of $185 million in cash, stock, and stock options. In 2004, a compensation consultant hired by the board, Pearl Meyer, raised concerns about the compensation package Mr. Mozilo would receive after his planned retirement as CEO at the end of 2006. The board appears to have accepted some of Pearl Meyer's recommendations and rejected others; it then ended its relationship with the consultant. In 2006, a new compensation consultant, Exequity, raised new questions about Mr. Mozilo's compensation package. According to Exequity, Mr. Mozilo's compensation was based on a flawed "peer group" of companies that inflated his pay and inappropriately placed him at the top of this peer group in terms of salary and bonus.

Countrywide renegotiated and extended Mr. Mozilo's employment contract in the fall of 2006, effective January 2007. The new contract revised Mr. Mozilo's peer group and reduced his compensation. Yet despite these steps, the 2006 contract and the negotiations that defined its terms contain unusual components. Key questions about the 2006 contract include:

- **The Retention of Towers Perrin.** After the board's compensation consultant, Exequity, recommended significant reductions in Mr. Mozilo's compensation, Countrywide management hired a second compensation consultant, Towers Perrin, to review the Exequity proposal. Although the company retained Towers Perrin, internal e-mails show that the consultant appeared to serve as Mr. Mozilo's personal advisor with the goal of achieving "maximum opportunity" for Mr. Mozilo. The final contract was significantly more generous to Mr. Mozilo than Exequity originally recommended.

- **Mr. Mozilo's Separation Package.** Under the "change in control" provisions in Mr. Mozilo's contract, Mr. Mozilo was entitled to a $36 million cash severance. The terms of this agreement appeared to heavily favor Mr. Mozilo. Under the contract, Mr. Mozilo

could terminate his employment and receive severance if the board took an action that "results in the diminution of Executive's status, title, position and responsibilities" or that "results in the Executive not being able to travel by private aircraft at Company expense." In contrast, the board could terminate Mr. Mozilo without paying him cash severance only if Mr. Mozilo is convicted of a felony or acts in "bad faith."

- **The $10 Million Pension Replacement Award.** Under the contract, Mr. Mozilo received $10 million in restricted stock units to compensate him for payments he would have received under his retirement plan if he had retired at the end of 2006. It is unusual to include compensation for not retiring in the pay package of an actively employed CEO.

- **The Calculation of the Cash Bonus.** Under the terms of the 2006 contract, Mr. Mozilo is entitled to a cash bonus (not to exceed $10 million) calculated as a percentage of Countrywide's net income if the company's return on equity (ROE) exceeds 10%. At the time the contract was negotiated, Countrywide was regularly achieving a ROE of over 20%, so the 2006 contract provided Mr. Mozilo with a large bonus even if the company's ROE dropped significantly. One Countrywide official wrote in an internal e-mail: "I can't believe how low the ROE measures are. ... [S]hareholders or newspapers might comment all over this evident fact."

Mr. Mozilo's pattern of stock sales in late 2006 and 2007 raise additional questions. During this period, Mr. Mozilo made three revisions to his stock trading plan, in each case increasing the amount of stock he was authorized to sell. In total, Mr. Mozilo sold 5.8 million shares between November 2006 and December 2007 for almost $150 million. Mr. Mozilo made the first change in his stock trading plan three days after Countrywide announced a $2.5 billion plan to buy back Countrywide stock, which was financed in part by $1.5 billion in new debt. The Countrywide board knew of the changes to Mr. Mozilo's stock trading plan but did not act to prevent Mr. Mozilo's sales. Several board members also made large stock sales during this period.

Particularly in 2007, the discrepancy between Mr. Mozilo's compensation and Countrywide's performance is striking. In 2007, Countrywide announced a $1.2 billion loss in the third quarter and an additional loss of $422 million in the fourth quarter. By December 31, 2007, the company's stock had plummeted 80% from its five-year peak in February. During the same period, Mr. Mozilo was paid $1.9 million in salary, received $20 million in stock awards contingent upon performance, and sold $121 million in stock.

Countrywide's losses have continued in 2008. In SEC filings last week, Countrywide reported a large increase in delinquencies on its pay option adjustable-rate mortgages. Its stock is now trading at $5.70 per share, a drop of more than 87% from its high of $45.03 per share during the stock buyback in early 2007.

B. Questions about Mr. O'Neal's Compensation

The major questions about Mr. O'Neal's compensation surround the terms of his retirement as CEO of Merrill Lynch in October 2007. During 2007, Merrill Lynch reported $18 billion in write-downs related to subprime and other risky mortgages. By the end of 2007, the company's stock had fallen 45% from its five-year peak in January. Yet when Mr. O'Neal departed the company in October, Merrill Lynch awarded him a retirement package worth $161 million.

The largest component of Mr. O'Neal's retirement package was the award of $131 million in unvested stock and options. If the Merrill Lynch board had terminated Mr. O'Neal for cause, he would have forfeited these stock and options because they had not yet vested. Allowing Mr. O'Neal to retire instead of terminating his employment for poor performance significantly inflated the value of Mr. O'Neal's retirement package. It is unclear why this decision was in the interests of Merrill Lynch shareholders.

The Merrill Lynch board also decided to loosen the non-competition restrictions in Mr. O'Neal's retirement contract. An agreement that Mr. O'Neal signed in 2004 prohibited Mr. O'Neal from working for a competitor of Merrill Lynch for approximately three years after his retirement. In October 2007, the Merrill Lynch board approved a new non-competition agreement that cut the duration of the non-competition clause in half and significantly narrowed the companies to which it applied. Only one board member raised an objection to this revision in the agreement.

C. Questions about Mr. Prince's Compensation

After Mr. Prince left Citigroup in November 2007, he received a cash bonus worth $10.4 million. The board also allowed him to retain more than $28 million in unvested restricted stock and stock options. It is unclear how these decisions were related to Mr. Prince's performance or benefited Citigroup shareholders. During 2007, Citigroup announced more than $18 billion in write-downs related to subprime and other risky mortgages, and its stock dropped by 48% from its five-year peak in December 2006. Unlike Mr. Prince, neither Mr. Mozilo nor Mr. O'Neal received a performance bonus in 2007.

The board also awarded Mr. Prince perquisites, worth $1.5 million annually, upon his retirement in November 2007. These perquisites included an office, an administrative assistant, and a car and driver for five years, as well as a commitment to pay taxes associated with the award of these benefits. Mr. Prince had no employment contract entitling him to these benefits upon his retirement from Citigroup.

Earlier this week, Citigroup's stock fell to a nine-year low after foreign investors predicted more losses for the company. Citigroup's stock has now fallen 61% since its high in December 2006.

II. BACKGROUND

By any measure, executive pay is rising rapidly and dramatically. According to *Forbes* magazine, CEOs of the largest 500 U.S. companies received an average of $15.2 million each in 2006, a collective raise of 38% over 2005.[1] Many experts believe there is a growing disconnect between CEO pay and performance, as increases in executive pay cannot be explained by factors such as changes in firm size or performance.[2] In a recent survey of more than 1,000 directors at large U.S. companies, 67% said that they believe boards are having difficulty controlling the size of CEO pay packages.[3]

The large increases in executive compensation also have widened the gulf between CEO pay and that of the average worker. In 1980, CEOs in the United States were paid 40 times the average worker.[4] In 2006, the average Fortune 250 CEO was paid over 600 times the average worker.[5] While CEO pay has soared, employees at the bottom of the pay scale have seen their real wages decline by more than 10% over the past decade.[6]

Last year, the Oversight Committee initiated an investigation into rising executive compensation. In a December hearing, the Committee examined the role played by compensation consultants in setting CEO pay. At the hearing, Chairman Waxman released a report that analyzed conflicts of interest among compensation consultants. This report found that more than 100 large publicly traded companies hired compensation consultants in 2006 with significant conflicts of interest. In many cases, the consultants hired to advise on executive pay were simultaneously receiving millions of dollars from the corporate executives whose compensation they were supposed to assess.[7]

Tomorrow's hearing continues the Committee's inquiry into executive compensation. It will allow the Committee to examine three case studies of executive compensation: the compensation and separation packages awarded to Angelo Mozilo, the Chairman and CEO of Countrywide Financial Corporation; E. Stanley O'Neal, the former Chairman and CEO of Merrill Lynch; and Charles Prince, the former Chairman and CEO of Citigroup.

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[1] *Big Paychecks*, Forbes (May 3, 2007).

[2] Lucian Bebchuk and Yaniv Grinstein, *The Growth of Executive Pay*, Oxford Review of Economic Policy, Vol. 21, 283-303 (2005).

[3] Corporate Board Member and Pricewaterhouse Coopers, *What Directors Think: Annual Board of Directors Survey* (Oct. 2007).

[4] Institute for Policy Studies and United for a Fair Economy, *Executive Excess 2007: The Staggering Social Cost of U.S. Business Leadership* (Aug. 2007).

[5] *Id.*

[6] The current minimum wage is $5.85 — adjusted for inflation, $4.49 in 1997 dollars. The actual minimum wage in 1997 was $5.15.

[7] Majority Staff, House Committee on Oversight and Government Reform, *Executive Pay: Conflicts of Interest Among Compensation Consultants* (Dec. 2007).

The three CEOs are linked by their involvement in the mortgage crisis. Countrywide, Merrill Lynch, and Citigroup all profited enormously in the short term from their investments in subprime and other risky mortgages, and all three companies are suffering now as a result of these investments. Collectively, the three companies recorded losses of more than $20 billion in the last two quarters of 2007: Countrywide lost $1.6 billion;[8] Merrill Lynch lost $10.3 billion;[9] and Citigroup lost $9.8 billion.[10] The hearing provides a lens through which to examine whether the executive compensation and severance arrangements at these companies provided appropriate incentives to protect shareholders from these losses.

In preparation for the hearing, the Committee requested that each company provide internal documents related to the compensation and severance packages of their CEOs. The Committee staff reviewed thousands of pages of company e-mails, board minutes, and other internal documents. The staff also reviewed public SEC filings and interviewed dozens of experts regarding executive pay practices. This memorandum summarizes the compensation and retirement packages awarded to each CEO and identifies questions about whether the terms of the packages advanced the shareholders' interests.

III. MR. MOZILO'S COMPENSATION

Angelo Mozilo co-founded Countrywide in 1969, becoming its CEO in February 1998 and Chairman of the Board in March 1999. Table 1 summarizes the compensation that Mr. Mozilo received while serving as Chairman and CEO.

Mr. Mozilo has been richly compensated by Countrywide, receiving almost $250 million in total compensation since becoming CEO. He also has collected an additional $406 million from the sale of his Countrywide stock. The company prospered during the first ten years Mr. Mozilo served as CEO. Since February 2007, however, Countrywide's stock has fallen by 87% to $5.70 per share.

Three aspects of Mr. Mozilo's compensation raise the most concerns. These are (1) the terms of his 2001 compensation agreement; (2) the terms and negotiation of his 2006 compensation agreement; and (3) his stock sales since October 2006. In each area, there are questions whether the actions of Mr. Mozilo and the board advanced the interests of Countrywide's shareholders.

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[8] Countrywide Financial Corporation, *Countrywide Reports 2007 Fourth Quarter & Year-End Results* (Jan. 29, 2008).

[9] Merrill Lynch, *Merrill Lynch Reports Full Year 2007 Net Loss from Continuing Operations of $8.6 Billion* (Jan. 17, 2008).

[10] Citigroup, *Citi Reports Fourth Quarter Net Loss of $9.83 Billion, Loss Per Share of $1.99* (Jan. 15, 2008).

Table 1. Compensation Awarded to Angelo Mozilo, 1998-2007[11]

Year	Base Salary	Cash Bonus	Other Compensation	Restricted Stock/SARs*	Grant Date Value of Options*	Total Compensation
1998	$1,400,000	$3,935,821	$707,804	$0	$0	$6,043,625
1999	$1,400,000	$4,210,970	$509,031	$0	$0	$6,120,001
2000	$1,650,000	$3,756,377	$570,227	$0	$5,344,850	$11,321,454
2001	$1,458,333	$4,653,601	$570,368	$0	$12,732,305	$19,414,607
2002	$2,041,667	$7,763,976	$733,394 (Includes $133,524 in personal use of company aircraft and related gross-up payments, $37,627 for country club dues, and $26,034 for car use.)	$0	$4,341,295	$14,880,332
2003	$2,266,667	$19,890,455	$641,589 (Includes $78,192 in personal use of company aircraft and related gross-up payments, $95,135 for country club dues, and $27,072 for car use.)	$1,072,827	$9,116,597	$32,988,135
2004	$2,466,667	$17,273,290	$621,241 (Includes $155,542 in personal use of company aircraft and related gross-up payments, $31,249 for country club dues, and $27,150 for car use.)	$2,826,900	$29,806,000	$52,994,098
2005	$2,666,667	$19,557,361	$726,314 (Includes $230,452 in personal use of company aircraft and related gross-up payments, $40,282 for country club dues, and $26,660 for car use.)	$0	$18,360,300	$41,310,642
2006	$2,866,667	$20,461,473	$643,205 (Includes $89,939 for personal use of company aircraft, $15,481 for country club dues, and $27,010 for car use.)	$0	$19,012,000	$42,983,345
2007	$1,900,000	$0	Unknown	$20,000,000	$0	$21,900,000
TOTAL	$20,116,668	$101,503,324	$5,723,173	$23,899,727	$98,713,347	$249,956,239

** The value of stock awards and option awards is based on grant date fair value. Stock awards would be worth less today given decline in stock price. Unexercised options are currently underwater.*

A. The 2001 Compensation Agreement

The terms of Mr. Mozilo's compensation, retirement, and severance are defined in compensation agreements with Countrywide. In March 2001, Mr. Mozilo and Countrywide entered into an agreement that specified the terms of his compensation through February 2006.[12] In 2004, this agreement was extended with modest modifications through December 2006.

In 2004, as Countrywide was considering the extension of Mr. Mozilo's compensation agreement, the board retained the services of Pearl Meyer, a leading compensation consultant. Pearl Meyer raised concerns about the provisions of the contract that governed the pay Mr. Mozilo would receive if he stepped down as CEO at the end of 2006 but retained his position as Chairman of Board, as the company's succession plan anticipated. Pearl Meyer recommended

[11] Salary, bonus, and equity data are extracted from Countrywide proxy statements and confirmed by Countrywide documents provided to the Committee (CFC BATES No. 0001016-0001017). "Other compensation" data are extracted from Countrywide proxy statements.

[12] Countrywide Financial Corporation, 2007 Proxy Statement, Form DEF14A (Apr. 27, 2007), 50-54. (hereinafter "Countrywide 2007 Proxy").

reducing Mr. Mozilo's salary and bonus as a "non-employee" chairman. The consultants wrote that Mr. Mozilo should not receive a $1 million base salary but "should be compensated the same as the Company's other outside Board members, plus an annual retainer as Chairman."[13] Pearl Meyer also argued that Mr. Mozilo should not be eligible for severance as a non-employee chairman: "While severance protection may be appropriate for the period in which Mr. Mozilo serves as Employee Chairman, we do not advise protecting his term as an outside Board member of Countrywide."[14]

In the final 2004 extension agreement, the board aligned Mr. Mozilo's pay as non-employee chairman of the board with the pay of other outside directors but declined to address Mr. Mozilo's potential compensation as an employee chairman.[15] The board subsequently ended its relationship with Pearl Meyer.

In 2006, as the board was renegotiating Mr. Mozilo's compensation, the board hired Ross Zimmerman from the firm Exequity as a compensation consultant. Mr. Zimmerman's analysis raised multiple questions about the terms of the 2001 compensation agreement. He questioned the "peer group" that the board had used in establishing Mr. Mozilo's compensation. He also objected to paying Mr. Mozilo at the 90th percentile of this peer group.[16]

B. The 2006 Compensation Agreement

In 2006, Mr. Zimmerman recommended several specific changes to Mr. Mozilo's pay package to address increasing public scrutiny and shareholder activism concerning executive compensation. First, he proposed revising the peer group of companies used to target Mozilo's compensation by removing investment banks and focusing instead on diversified financial institutions, which represented a more appropriate comparison to Countrywide's business areas. Second, he proposed reducing Mr. Mozilo's compensation from the 90th percentile to between the 50th and 75th percentile of CEO compensation at peer group companies. Third, he proposed tying Mr. Mozilo's cash and equity bonuses to attainment of objective financial metrics and setting maximum awards. In dollar terms, these recommendations would have targeted Mr. Mozilo's annual compensation at $14,250,000 and set a maximum of $27,250,000.[17]

After Mr. Zimmerman and the compensation committee proposed cuts in Mr. Mozilo's compensation, Countrywide management hired a competing compensation consultant, John

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[13] Fax from Claude Johnson and Garry Rogers to Michael Dougherty and Harley Snyder, *Countrywide CEO Employment Agreement* (June 11, 2004) (CFC BATES No. 0000786).

[14] *Id. at 788.*

[15] Countrywide Form 8-K, *Entry into a Material Definitive Agreement* (Oct. 20, 2006).

[16] *Revised Pay Proposal for Angelo Mozilo* (Sept. 19, 2006) (CFC BATES No. 0011023-0001035).

[17] *Revised Pay Proposal for Angelo Mozilo* (Sept. 19, 2006) (CFC BATES No. 0011023-0001035).

England of Towers Perrin, to evaluate the board's proposal. In an e-mail from Mr. England to Mr. Zimmerman, Mr. England asserted:

> Towers Perrin has been retained by Countrywide Financial, not by any individual at Countrywide. ... To Towers Perrin, it is irrelevant who hires us — our role is to provide appropriate counsel for decision-making, independent of influence.[18]

Mr. Mozilo, however, regarded Mr. England as his personal representative, even though he was being paid by Countrywide. In an e-mail to Susan Bow, the Senior Managing Director, General Counsel and Corporate Secretary of Countrywide, Mr. Mozilo wrote: "Approximately two weeks ago, [the head of the compensation committee] and I agreed that it would be best if I obtained a compensation consultant. Since that time I brought in John England (consultant-Towers Perrin) and Jim Barrall (attorney-Latham Watkins)."[19]

Other documents appear to substantiate Mr. England's role as personal advisor to Mr. Mozilo. Mr. England and his colleagues at Towers Perrin appear to have discussed the terms of a possible counter-proposal only with Mr. Mozilo, rather than with other Countrywide management. Mr. England submitted his preliminary proposal to Mr. Mozilo on October 4, 2006, copying only Mr. Mozilo's attorney and other Towers Perrin employees and no members of Countrywide's management.[20] In an October 15, 2006, e-mail, Mr. Mozilo noted that Mr. England transmitted the revised proposal to the Countrywide board only after being "instructed" to do so by Mr. Mozilo.[21]

In the counter-proposal to the board, Mr. England proposed multiple changes to Mr. Zimmerman's original compensation proposal. On the issue of the peer group against which Mr. Mozilo's compensation should be measured, Mr. England suggested dropping Sun Trust, BB&T, and Fifth Third Bancorp, all of which better matched Countrywide's size and had lower paid CEOs, and replacing them with Goldman Sachs, Merrill Lynch, and Bank of America, all of which are large investment banks with higher paid CEOs.[22] He also proposed that Mr. Mozilo receive a $15 million "sign-on equity award."[23]

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[18] E-mail from John England to Ross Zimmerman (Sept. 28, 2006) (CFC BATES No. 0000798).

[19] E-mail from Angelo Mozilo to Susan Bow (Oct. 15, 2006) (CFC BATES No. 0000660).

[20] E-mail from John England to Angelo Mozilo (Oct. 4, 2006) (CFC BATES No. 0000803).

[21] E-mail from Angelo Mozilo to Susan Bow (Oct. 15, 2006) (CFC BATES No. 0000660).

[22] Towers Perrin, *Countrywide Financial: Competitive Compensation Arrangement for the Chairman of the Board and CEO* (Oct. 4, 2007) (CFC BATES No. 0000858).

[23] *Id.* at CFC BATES No. 0000848.

In the end, the board made a number of revisions to accommodate Mr. Mozilo and Mr. England. On the issue of the appropriate peer group, the board dropped BB&T and Fifth Third Bancorp and added Merrill Lynch.[24] Noting its discomfort with giving Mr. Mozilo a $15 million "contract renewal" bonus, as Mr. England advocated, the board instead gave Mr. Mozilo $10 million and positioned it as reimbursement for retirement payments he could have received had he retired.[25]

After receiving the board's final proposal, Mr. England e-mailed Mr. Mozilo:

> My primary unhappiness with what the Board has put forth is that it lowers your maximum opportunity significantly. That's been accomplished by lowering the target bonus and reducing the maximum bonus. ...
>
> That being said, given your desire to sign an agreement today, the Board's proposal is not unreasonable. It's a significant enhancement from what Zimmerman had the first time around.[26]

In response, Mr. Mozilo e-mailed Mr. England:

> I appreciate your input but at this stage in my life at Countrywide this process is no longer about money but more about respect and acknowledgement of my accomplishments. ... Boards have been placed under enormous pressure by the left wing anti business press and the envious leaders of unions and other so called "CEO Comp Watchers" and therefore Boards are being forced to protect themselves irrespective of the potential negative long term impact on public companies. I strongly believe that a decade from now there will be a recognition that entrepreneurship has been driven out of the public sector resulting in underperforming companies and a willingness on the part of Boards to pay for performance.[27]

The final 2006 compensation agreement reflected an effort by the Countrywide board to reduce Mr. Mozilo's compensation. Even so, several components of the final agreement appear to benefit Mr. Mozilo while offering little value to Countrywide and its shareholders. These include the $81 million separation package, the $10 million pension replacement award, the calculation of the cash bonus, and the perquisites.

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[24] *Countrywide Financial Corporation, Overview of Pay Package for Angelo Mozilo, as Approved by Countrywide's Board of Directors* (Oct. 20, 2006)) (CFC BATES No. 0000883-886).

[25] *Id.*

[26] E-mail from John England to Angelo Mozilo (Oct. 20, 2006) (CFC BATES No. 0000888).

[27] E-mail from Angelo Mozilo to John England (Oct. 20, 2006) (CFC BATES No. 0000888).

1. The $81 Million Separation Package

Mr. Mozilo's 2006 employment agreement outlines the terms of his compensation in the event of his resignation, termination, or a "change in control" at the company. The company has estimated the value of his benefits upon separation at $81 million, including $37.5 million in severance and benefits. Table 2 summarizes the components of Mr. Mozilo's separation package.

Table 2. Estimated Value of Angelo Mozilo's Separation Package[28]

Type of benefit	Value
Cash severance	$36,392,209
Pension/retirement benefits (SERP)	$22,340,419
Deferred compensation	$20,604,877
Equity acceleration (at $7 per share)	$1,609,148
Consulting agreement (per year)	$400,000
Perquisites*	$45,651
Estimated Benefits for Separation of Employment	$81,392,304

** The value for perquisites only includes the value of "health and welfare" benefits. Under the contract, Mr. Mozilo is also entitled to other perquisites, including use of the company airplane, payment of country club dues, office space, and other benefits. The monetary value of these perquisites is unknown.*

The separation terms of the employment agreement heavily favor Mr. Mozilo. Under the agreement, Mr. Mozilo can terminate his employment under a wide range of circumstances and receive cash severance. According to the agreement, Mr. Mozilo can terminate his employment and still receive cash severance and other benefits if Countrywide "takes any action … which results in the diminution of Executive's status, title, position and responsibilities."[29] He can even terminate his employment with severance if the company "takes an action that results in Executive not being able to travel by private aircraft at Company expense."[30]

On the other hand, Countrywide appears to have little, if any, authority to reduce the size of Mr. Mozilo's separation package for poor performance. The compensation agreement does authorize the board to revoke certain components of the separation package "for cause."[31] But "cause" is defined so narrowly that it does not appear to include poor performance. Under the contract, "cause" is defined as a conviction for a felony or a material breach of the employment

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[28] Based on data provided in Countrywide documents provided to the Committee (CFC BATES No. 0000672) and Countrywide's 2007 Proxy.

[29] Countrywide Form 8-K, *Compensatory Arrangements of Certain Officers*, 13 (Dec. 26, 2006).

[30] *Id.*

[31] *Id at 12.*

agreement "committed in bad faith or without a reasonable belief that such breach is in the best interests of the Company."[32]

In his prepared testimony, Harley Snyder, the current chair of Countrywide's compensation committee, asserts that Mr. Mozilo's compensation agreement "aligned Mr. Mozilo's interests with that of the shareholders."[33] But the terms of Mr. Mozilo's compensation agreement appear to sever this purported alignment during periods of declining stock value. Under the agreement, the Countrywide board does not appear to have had the authority to terminate Mr. Mozilo's employment and revoke his cash severance for poor performance.

On January 11, 2008, Bank of America announced plans to acquire Countrywide.[34] Under the terms of Mr. Mozilo's compensation agreement, this change in control entitles Mr. Mozilo to a large cash severance. On January 28, after the Committee informed Mr. Mozilo that he would be called as a witness, Mr. Mozilo announced he would forfeit his cash severance and the consulting agreement and perquisites following the anticipated Bank of America merger. The value of his forfeited severance and benefits is $37.5 million.[35]

2. The $10 Million Pension Replacement Award

Mr. England proposed giving Mr. Mozilo a one-time $15 million grant of restricted stock to provide an incentive for the new three-year term and recognize his "significant concessions" in target compensation.[36] The board agreed to a $10 million annual equity award but resisted giving Mr. Mozilo $15 million and indicated that it was not "comfortable" with the positioning of the award proposed by Mr. Mozilo; instead, it opted to offer Mr. Mozilo a one-time equity award of $10 million to reimburse him for foregone retirement benefits.[37] This payment was to be made in addition to the other components of Mr. Mozilo's compensation, including his salary and any bonus.

After realizing that he was eligible to collect $3 million per year under his Supplemental Executive Retirement Plan (SERP), Mr. Mozilo suggested to Mr. England in an e-mail that

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[32] *Id.*

[33] House Committee on Oversight and Government Reform, Testimony of Harley Snyder, *Executive Compensation II: CEO Pay and the Mortgage Crisis,* 110th Cong. (Mar. 7, 2008).

[34] Bank of America, *Bank of America Agrees to Purchase Countrywide Financial Corp* (Jan. 11, 2008).

[35] Countrywide Financial Corporation, *Countrywide CEO Angelo Mozilo Announces Decision to Voluntarily Relinquish Rights to Approximately $37.5 Million in Cash Severance Payments, Consulting Fees and Perquisites* (Jan. 28, 2008).

[36] Towers Perrin, *Countrywide Financial: Competitive Compensation Arrangement for the Chairman & CEO* (Oct. 24, 2006) (CFC BATES No. 0000861).

[37] Countrywide Financial Corporation, *Overview of Pay Package for Angelo Mozilo, as Approved by Countrywide's Board of Directors* (CFC BATES No. 0000883-0000886).

"[a]lthough it may be unusual," he wanted to collect these retirement payments while continuing his employment with Countrywide.[38] Mr. England did not believe this was a good idea. He wrote: "We can troll through proxy statements but I have never heard of a CEO receiving a pension payment in addition to earning salary, bonus, and long-term incentives."[39] In the end, Mr. Mozilo agreed to accept the $10 million pension replacement award offered by the board.

3. The Calculation of the Cash Bonus

Another noteworthy component of the 2006 compensation agreement is the formula used for calculating Mr. Mozilo's cash bonus. According to the agreement, Mr. Mozilo would receive a cash bonus calculated as a percentage of net income based on the company's return on equity (ROE). If Countrywide's ROE was lower than 10%, he would not receive a cash bonus. If ROE was between 10% and 12%, he would receive a bonus calculated as 0.44% of the company's net income over 10% ROE. If ROE exceeded 12%, he would receive a cash bonus equivalent to 0.44% of Countrywide's net income over 10% ROE, plus 0.64% of Countrywide's net income over 12% ROE, with a maximum value of $10 million.[40]

Through the second quarter of 2007, Countrywide's ROE was 23% over the previous five years, nearly double the threshold set in the agreement.[41] As a result, the new formula had the effect of rewarding Mr. Mozilo even if ROE declined significantly. One member of Countrywide's human resources department wrote in an e-mail: "I can't believe how low the ROE measures are. Over the past three years CFC's ROE has been in excess of 17%. ... [S]hareholders or newspapers might comment all over this evident fact."[42]

4. The Perquisites

One point of contention during the contract negotiations was the level of perquisites Mr. Mozilo would receive. Mr. Mozilo emphasized on several occasions that he expected his new contract to provide explicitly for reimbursement of any taxes owed when his wife traveled with him on the Countrywide jet. In one e-mail to Mr. England, Mr. Mozilo wrote: "in order to avoid extraordinary travel expenses to be incurred by [the President and Chief Operating Officer] and me the spouses would have to travel commercial or not at all, which is not right nor wise."[43]

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[38] E-mail from Angelo Mozilo to John England (Nov. 24, 2006) (CFC BATES No. 0000953).

[39] E-mail from John England to Angelo Mozilo (Nov. 24, 2006) (CFC BATES No. 0000953).

[40] Countrywide Form 8-K, *Compensatory Arrangements of Certain Officers* (Dec. 26, 2006).

[41] *Mozilo Wins Even if Countrywide's Profits Plummet*, Reuters (July 25, 2007).

[42] E-mail from Tara Nadaf to Chuck Quon (Nov. 17, 2006) (CFC BATES No. 0000650).

[43] E-mail from Angelo Mozilo to John England (Nov. 23, 2006) (CFC BATES No. 0000952).

At the end of this e-mail, Mr. Mozilo raised the possibility of retiring if the board did not address this and other concerns:

> The Board must understand that if I were to retire today I would be receiving the SERP, receive approx. $15 million in deferred comp., get Directors fees and be able to liquidate my 12 million shares without restriction. More importantly I wouldn't have to continuously travel all over the world on behalf of the shareholders.[44]

The final compensation agreement obligated Countrywide to pay any taxes due when Mr. Mozilo's wife accompanied him on business trips on the corporate jet.[45]

C. Mr. Mozilo's Stock Sales

In addition to his compensation in the form of salary, bonuses, and other compensation, Mr. Mozilo has made hundreds of millions of dollars by exercising stock options and selling shares. In total, as shown in Table 3, he has made more than $400 million by exercising stock options and selling shares since he became CEO in 1998.

Table 3. Money Earned Upon Exercise of Stock Options, 1998-2007[46]

Year	Value Realized Upon Option Exercise	Year	Value Realized Upon Option Exercise
1998	$0	2004	$48,591,496
1999	$0	2005	$119,024,772
2000	$416,823	2006	$72,214,959
2001	$0	2007	$121,726,054
2002	$10,420,372		
2003	$34,361,357	Total	$406,755,833

Mr. Mozilo's transactions in 2006 and 2007 raise particular questions because during this period, Mr. Mozilo made three changes to his stock trading plan, called a "10b5-1 plan," to increase the volume of shares he could sell. The Securities and Exchange Commission (SEC) authorizes the use of 10b5-1 stock trading plans by corporate executives as an affirmative defense or "safe harbor" against insider trading allegations. Under these plans, executives must

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[44] *Id.*

[45] Countrywide Form 8-K, *Compensatory Arrangements of Certain Officers*, 10 (Dec. 26, 2006).

[46] Data for 1998-2006 extracted from Countrywide proxy statements; data for 2007 calculated based Committee analysis of Countrywide Form 4 filings with the SEC for Jan. 4, 2007 through Oct. 12, 2007, the date of Mr. Mozilo's last sale.

set the dates or prices of their trades in advance and cannot set up a plan when they possess material knowledge not available to the public.[47]

On October 24, 2006, Mr. Mozilo announced that the company would execute a board-approved plan to repurchase up to $2.5 billion in Countrywide stock.[48] The day after, Countrywide's stock price jumped $1.41, almost 4%.[49] Just three days later, on October 27, 2006, Mr. Mozilo adopted a new 10b5-1 plan allowing him to sell 350,000 shares a month.[50] In November, the company repurchased 38.6 million shares of its common stock for $1.5 billion, financed through the issuance of new debt.[51]

On December 12, 2006, Mr. Mozilo filed another stock trading plan to increase his sale of shares.[52] On February 2, 2007, Mr. Mozilo amended this new trading plan to increase once again the number of shares he could sell. He now was allowed to sell 580,000 shares each month.[53] On the same day of this last change, Countrywide shares reached an all-time high of $45.03 per share.

On May 16, 2007, Countrywide announced plans to buy back 23 million more shares for about $1 billion.[54] The company executed this buy back immediately in May.[55] Countrywide's stock prices increased by almost $1 per share the day after the announcement.[56]

In total, Mr. Mozilo sold approximately 5.8 million shares between November 2006 and the end of 2007, realizing almost $150 million.[57]

The Countrywide board was aware of the revisions to Mr. Mozilo's stock trading plan, but took no steps to prevent Mr. Mozilo from selling shares while the company implemented its share buyback plan. In fact, several board members also sold millions of dollars worth of shares

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[47] 17 C.F.R. Section 240.10b5-1(c)(2006); Jesse M. Fried, *Insider Abstention*, 113 YALE L.J. 455, 487 (2003).

[48] Countrywide, *Countrywide Reports 2006 Third Quarter Results* (Oct. 24, 2006).

[49] Committee analysis of Merrill Lynch's stock prices, obtained from www.nasdaq.com.

[50] Committee analysis of Countrywide Form 4 filings with the SEC.

[51] Countrywide Form 10-K, 42 (Mar. 1, 2007).

[52] Committee analysis of Countrywide Form 4 filings with the SEC.

[53] *Id.*

[54] *Countrywide Financial rises on plan to buy back 23 million shares*, Associated Press (May 17, 2007).

[55] Countrywide Form 10-Q, 103 (Aug. 9, 2007).

[56] Committee analysis of Merrill Lynch's stock prices, obtained from www.nasdaq.com.

[57] Committee analysis of Countrywide Form 4 filings with the SEC between Nov. 1, 2006 and Oct. 12, 2007.

during the same period.[58] Harley Snyder, the current chair of the compensation committee, was among the board members making stock sales during this period.[59]

IV. MR. O'NEAL'S COMPENSATION

Stanley O'Neal joined Merrill Lynch in 1986, rising to CEO in December 2002 and Chairman in 2003; he resigned in October 2007. He did not have an employment agreement while serving as CEO and Chairman.

Mr. O'Neal was well compensated by Merrill Lynch. During Mr. O'Neal's six-year tenure as CEO, he received more than $163 million in cash, stock, and stock options. Table 4 summarizes the details of Mr. O'Neal's compensation during this period.

Table 4. Compensation Awarded to Stanley O'Neal, 2002-2007[60]

Year	Base Salary	Cash Bonus	Other Compensation	Restricted Stock*	Stock Options*	Total Compensation
2002	$500,000	$7,150,000	$77,553	$5,355,000	$2,295,000	$15,377,553
2003	$500,000	$13,500,000	$312,299 (Includes $114,158 in personal aircraft use and $167,838 for car use)	$11,200,000	$2,800,000	$28,312,299
2004	$700,000	$0	$334,517 (Includes $119,395 in personal aircraft use and $185,033 for car use)	$31,300,000	0	$32,334,517
2005	$700,000	$14,100,000	$500,294 (Includes $163,685 in personal aircraft use and $198,394 in car use.)	$22,200,000	0	$37,500,294
2006	$700,000	$18,500,000	$375,298 (Includes $149,133 in personal aircraft use and $212,505 in car use.)	$28,800,000	0	$48,375,298
2007	$584,000	$0	$593,691 (Details will be revealed in 2008 proxy.)	$0	0	$1,177,691
Total	$3,684,000	$53,250,000	$2,193,652	$98,855,000	$5,095,000	$163,077,652

** The value of stock awards and option awards is based on the grant date fair value. Stock awards would be worth less today given the decline in stock price. Some unexercised options are currently underwater.*

[58] *Id.*

[59] *Id.*

[60] Salary, bonus, and equity data are extracted from Merrill Lynch proxy statements and confirmed by a Merrill Lynch document provided to the Committee, "E. Stanley O'Neal Six Year Total Compensation History" (No BATES number). "Other compensation" data are extracted from Merrill Lynch proxy statements.

For most of Mr. O'Neal's term as CEO, Merrill Lynch prospered. In the fourth quarter of 2007, however, Merrill Lynch reported a net loss of $10.3 billion, the largest quarterly loss in the company's history.[61] The company also recorded write-downs of $7.9 billion in the third quarter and $11.5 billion in the fourth quarter.[62] These losses were related to sub-prime mortgage exposure accumulated under Mr. O'Neal's leadership. By the end of 2007, the company's stock had fallen 45% to $53.68 per share from its five-year peak of $97.53 per share in January 2007.[63] Merrill Lynch stock closed at $49.32 per share on March 5, 2008.[64]

When Mr. O'Neal departed Merrill Lynch in October 2007, the board faced four key issues: (1) whether to allow Mr. O'Neal to retire; (2) whether to renegotiate his noncompetition agreement; (3) whether to offer him continuing perquisites; and (4) whether to pay him any special severance. The decisions the board made significantly enriched Mr. O'Neal at a time when Merrill Lynch and its shareholders were absorbing large losses. It is questionable whether these decisions served the interests of Merrill Lynch and its shareholders.

A. The Award of $131 Million in Unvested Stock and Stock Options

In dollar terms, the biggest decision the board made upon Mr. O'Neal's departure was its decision to allow him to retire rather than to terminate him for cause.[65] In total, Mr. O'Neal's retirement package was worth $161 million at the time of his departure, which included $24.6 million in pension, retirement, and annuity benefits. This total also included $5.4 million in deferred compensation, which he stood to collect regardless of the circumstances of his termination.[66] By far the largest component of Mr. O'Neal's retirement package was $131 million in unvested stock and options.[67] If the board had terminated Mr. O'Neal for cause, he would have been required to forfeit these unvested stock and options.

The terms of Merrill Lynch's equity grants to employees provide that the board has "sole, absolute, and unreviewable discretion" to cancel unvested grants by terminating employees for cause.[68] During the Committee's investigation, Merrill Lynch's representatives told staff that the company could have been subject to litigation if the board had dismissed Mr. O'Neal for

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[61] Merrill Lynch, *Merrill Lynch Reports Full Year 2007 Net Loss from Continuing Operations of $8.6 Billion* (Jan. 17, 2008).

[62] *Id.*

[63] Committee analysis of Merrill Lynch's stock prices, obtained from www.nasdaq.com.

[64] *Id.*

[65] Document provided to the Committee entitled "ESO Holdings and Valuation" (value as of Oct. 29, 2007) (No BATES number).

[66] *Id.*

[67] Merrill Lynch estimates that Mr. O'Neal's package is now worth about $107.7 million, as of Mar. 3, 2008, as a drop in the company's stock price has lowered the value of his equity holdings. E-mail from Raymond S. Calamaro to Committee staff (Mar. 4, 2008).

[68] Policy language provided to Committee by Merrill Lynch (Feb. 8, 2008).

cause and canceled his unvested stock and options because Mr. O'Neal's actions did not meet the company's definition of "cause." The document authorizing certain equity grants defines termination for cause as follows:

> "Cause" shall mean a determination by a committee ... that in its sole, absolute, and un-reviewable discretion: (i) at the time of the termination of your employment, you had committed: a) any violation of Merrill Lynch's rules, regulations, policies, practices, and/or procedures; b) any violation of the laws, rules, or regulations of any governmental entity or regulatory or self-regulatory organization, applicable to Merrill Lynch; or c) criminal, illegal, dishonest, immoral, or unethical conduct reasonably related to your employment; and (ii) as a result of such conduct, it is appropriate to disqualify you from Career Retirement treatment with respect to the Restricted Shares covered by this Grant Document.[69]

It is unclear how this definition would be interpreted in litigation, and it is also unclear what role, if any, legal considerations played in the board's decisions. No documents were provided to the Committee that indicated that the board ever debated terminating Mr. O'Neal for cause or considered withholding all or part of Mr. O'Neal's $131 million in unvested stock and options. From a shareholder perspective, there appears to be no justification for precluding the board from recouping unvested stock and options in cases of poor performance.

B. Reduction in Noncompetition Provisions

Another action taken by the board at Mr. O'Neal's departure was the renegotiation of his noncompetition agreement. A covenant agreement Mr. O'Neal signed in 2004 prohibited him from working for any Merrill Lynch competitor, defined broadly, until all of his stock and options had vested or expired.[70] This is estimated to be three to four years from the time of his retirement.[71]

According to company documents, Mr. O'Neal's attorneys proposed reducing the noncompetition term to one year and limiting the scope to a specific list of companies.[72] Ultimately, the board and Mr. O'Neal agreed to modify his noncompetition agreement to apply

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[69] *Id.*

[70] Merrill Lynch Form 8-K, *Entry into a Material Definitive Agreement*, 4 (Sept. 17, 2004).

[71] According to company documents provided to the Committee entitled "ESO Holdings and Valuation" (value as of Oct. 29, 2007) (No BATES number), the last of Mr. O'Neal's restricted stock vests in Jan. 2011.

[72] Draft separation agreement sent as an attachment via e-mail from Joseph E. Bachelder to Robert D. Joffe at Cravath, Swaine & Moore LLP (Oct. 27, 2007) (Merrill Lynch BATES No. 0001353-0001372).

to only nine specific companies for a period of 18 months. These new terms superseded and replaced all prior noncompetition obligations.[73]

These changes in the noncompetition agreement were approved at a special meeting of the compensation committee on October 29, 2007, and at a meeting of the full board the next day. Only one board member, Aulana Peters, raised any objection to loosening Mr. O'Neal's noncompetition restrictions.[74] The documents the Committee received provide no explanation why the narrowing of Mr. O'Neal's noncompetition agreement was determined to be in the interests of Merrill Lynch and its shareholders.

C. Post-Retirement Perquisites

Because Mr. O'Neal had no employment agreement with Merrill Lynch, Mr. O'Neal was not entitled to continued perquisites after his departure. Nonetheless, the board agreed to provide Mr. O'Neal with office space in New York City for his personal use and the full-time services of an executive assistant for up to three years.[75] The monetary value of this benefit is unknown. The documents do not reflect what shareholder value the board hoped to obtain by providing these perquisites to Mr. O'Neal.

D. Severance Payment

At the time of his retirement, Mr. O'Neal's attorneys proposed that Mr. O'Neal receive a $45 million cash severance payment.[76] The final separation agreement did not include the cash severance payment sought by Mr. O'Neal.

V. MR. PRINCE'S COMPENSATION

Charles Prince worked for Citigroup or its predecessor companies for 29 years, becoming CEO in October 2003 and Chairman in April 2006. He did not have an employment agreement while Chairman and CEO. Table 5 summarizes the details of Mr. Prince's compensation during his time as Chairman and CEO.

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[73] Merrill Lynch Form 8-K, *Compensatory Arrangements of Certain Officer*, 3-4 (Oct. 30, 2007). In notable contrast, Mr. Prince's termination agreement includes a significant non-competition and non-solicitation clause, saying Mr. Prince will not solicit certain Citigroup employees and clients or engage in any competition with the company for a period of five years.

[74] Merrill Lynch document provided to the Committee, *Excerpts from Meeting Minutes from the Merrill Lynch and Management Development and Compensation Committee and the Merrill Lynch Board of Directors* (No BATES number).

[75] Merrill Lynch Form 8-K, *Compensatory Arrangements of Certain Officers*, 3 (Oct. 30, 2007).

[76] Draft separation agreement sent as an attachment via e-mail from Joseph E. Bachelder to Robert D. Joffe at Cravath, Swaine & Moore LLP (Oct. 27, 2007) (Merrill Lynch BATES No. 0001353-0001372).

Table 5. Compensation Awarded to Charles Prince, 2003-2007[77]

Year	Base Salary	Cash Bonus	Other Compensation	Stock Awards*	Option Awards*	Total Compensation
2003	$638,636	$6,965,375	< $50,000	$19,207,706	$2,396,634	$29,208,351
2004	$983,333	$9,690,000	$123,290 (Includes $108,208 in transportation expenses, such as personal use of company aircraft.)	$7,805,833	$1,320,485	$19,922,941
2005	$1,000,000	$12,000,000	$328,062 (Includes $133,114 in transportation expenses, such as personal use of company aircraft.)	$9,666,667	$0	$22,994,729
2006	$1,000,000	$13,200,000	$395,779 (Includes $258,338 for personal use of company aircraft.)	$10,633,333	$746,607	$25,975,719
2007	$1,000,000	$10,400,958	$234,643 (Details to be reported in 2008 proxy).	$0	$337,367	$11,972,968
TOTAL	$4,621,969	$52,256,333	$1,081,774	$47,313,539	$4,801,093	$110,074,708

** The value of stock awards and option awards is based on grant date fair value. Stock awards would be worth less today given decline in stock price. Unexercised options are currently underwater.*

Mr. Prince's compensation history is similar to Mr. Mozilo's and Mr. O'Neal's. Mr. Prince was well paid by Citigroup, receiving more than $110 million in cash, stock, and stock options during his five years as CEO. For most of this period, there is no obvious disconnect between the compensation Mr. Prince received and the performance of the company.

In 2007, however, Mr. Prince's compensation and the performance of Citigroup diverged. Mr. Prince continued to be well compensated in 2007, even receiving a lucrative bonus for that performance year. Yet Citigroup's performance suffered. In 2007, Citigroup's net income dropped by more than $17 billion from 2006.[78] The company was forced to write off more than $18 billion in losses due to its exposure to the subprime mortgage market.[79] By the end of 2007, the company's stock had fallen to $29.44 per share, a 48% decline from its peak of $56.41 per share in December 2006.[80] Citigroup stock closed at $22.15 per share on March 5, 2008.[81]

The Citigroup board made three decisions in November 2007 that significantly enriched Mr. Prince despite the poor performance of the company under his leadership: (1) the board

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[77] Obtained from Citigroup proxy statements and confirmed by a document provided to the Committee by Citigroup, *Chuck Prince: Compensation 2003-2007* (No BATES number).

[78] Citigroup, *Citi Reports Fourth Quarter Net Loss of $9.83 Billion, Loss Per Share of $1.99* (Jan. 15, 2008).

[79] *Id.*

[80] Committee analysis of Citigroup's stock prices, obtained from www.nasdaq.com.

[81] *Id.*

awarded him a pro-rata cash bonus for the 2007 performance year, amounting to $10.4 million; (2) the board allowed him to retain almost $28 million in unvested stock and stock options by letting him retire rather than terminating him for cause; and (3) the board granted him perquisites worth $1.5 million annually. Questions can be raised whether these decisions were in the interests of Citigroup and its shareholders.

A. The $10 Million Bonus

Because Mr. Prince had no employment contract with Citigroup, he had no contractual entitlement to a bonus when he stepped down as CEO in November 2007. The board, however, decided to award Mr. Prince a pro-rata cash bonus for the 2007 performance year. This award, paid in early 2008, amounted to $10.4 million.[82] The amount of the bonus was equal to his 2006 compensation pro-rated for the date of his departure and decreased by the total shareholder return percentage for 2007.[83]

Of the three CEOs who will testify before the Committee, Mr. Prince is the only one to receive a performance bonus for 2007. The documents provided to the Committee do not explain why the board determined that awarding Mr. Prince a $10 million bonus advanced shareholder interests.

B. Award of Unvested Stock and Stock Options

When Mr. Prince became CEO in 2003, he was given a "retention award" of restricted stock valued at $15 million. This "retention award" did not vest until July 2008 and was therefore valueless at the time of Mr. Prince's resignation.[84] According to the company's 2007 proxy statement, if Mr. Prince had voluntarily resigned at the end of the year, he would have forfeited the entire 2003 retention award.[85]

Nevertheless, the board elected to grant Mr. Prince a pro-rata portion of the retention award on his retirement in November 2007. The value of the retention award the Board gave him was $10.7 million.[86]

In addition, Citigroup's board treated Mr. Prince's departure as a retirement as opposed to a termination for cause. This had an effect similar to the decision of the Merrill Lynch board to treat Mr. O'Neal's departure as a retirement rather than a termination: it gave Mr. Prince

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[82] *COP Tally Sheet, Estimate of Termination of Employment Obligations* (calculated as of Nov. 2, 2007) (Citigroup BATES No. 00000001-00000002).

[83] Citigroup Form 8-K (Nov. 4, 2007).

[84] *COP Tally Sheet, Estimate of Termination of Employment Obligations* (calculated as of Nov. 2, 2007) (Citigroup BATES No. 00000001-00000002).

[85] Citigroup *Form Def 14A*, 58 (Mar. 13, 2007).

[86] *COP Tally Sheet, Estimate of Termination of Employment Obligations* (calculated as of Nov. 2, 2007) (Citigroup BATES No. 00000001-00000002).

ownership of about $16 million in previously unvested stock and $1.3 million in unvested options.[87]

If Citigroup had terminated Mr. Prince for cause, he would have lost all unvested equity positions, and he would not have been eligible to receive the additional retirement awards provided by the board. As with Merrill Lynch, however, Citigroup restricted its own ability to revoke Mr. Prince's unvested stock.[88]

C. Post-Retirement Perquisites

In November 2007, the Citigroup board agreed to provide Mr. Prince with an office, an administrative assistant, and a car and driver for five years or until he finds another full-time job. The company also agreed to pay Mr. Prince's taxes associated with these post-termination benefits. The company estimates the value of these perquisites at $1.5 million annually.[89]

Because Mr. Prince had no employment contract with Citigroup at the time of his departure, Mr. Prince was not entitled to these perquisites. None of the documents provided to the Committee by Citigroup explain why providing $1.5 million in annual perquisites to Mr. Prince in retirement benefited Citigroup shareholders.

VI. CONCLUSION

The three case studies reveal important differences in the compensation packages and actions of Mr. Mozilo, Mr. O'Neal, and Mr. Prince. Mr. Mozilo stands out as the only CEO who sold large numbers of shares in his company while the company was engaged in a stock buyback plan. Mr. O'Neal stands out for the size of his retirement package, $161 million. And Mr. Prince stands out for the $10 million performance bonus he received for a performance year in which the company's stock floundered.

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[87] *Id.* The value of the stock and option awards is based on the value as of the retirement date. Under the Citigroup plan, these equity awards vest immediately upon retirement. The stock awards would be worth less today given a decline in the stock price. Unexercised options are currently underwater.

[88] Under the company's Capital Accumulation Program, employees terminated for "gross misconduct" lose any unvested stock and stock options they hold. The Capital Accumulation Program prospectus defines "gross misconduct" as follows:

> The Committee determines what constitutes competition and gross misconduct. Gross misconduct includes, but is not limited to, conduct that is in competition with the Company's business operations, that breaches any obligation to the Company or duty of loyalty, or that is materially injurious to the Company, monetarily or otherwise.

Definition provided by Citigroup via e-mail to Committee staff (Mar. 4, 2008) (citing CAP Prospectus, 32 (Oct.1, 2006)).

[89] *COP Tally Sheet, Estimate of Termination of Employment Obligations* (calculated as of Nov. 2, 2007) (Citigroup BATES No. 00000001-00000002).

At the same time, there are also striking similarities in the three case studies. In 2007, as the mortgage crisis developed, Countrywide, Merrill Lynch, and Citigroup all suffered major losses. Yet Mr. Mozilo, Mr. O'Neal, and Mr. Prince continued to receive lucrative pay and retirement packages. The financial benefits realized by the CEOs as the subprime mortgage crisis unfolded do not appear to have been aligned with the interests of the shareholders.

At the hearing tomorrow, members may want to explore the causes of this disconnect between pay and performance and examine what steps company boards could take to address the issue.

HENRY A. WAXMAN, CALIFORNIA
CHAIRMAN

TOM DAVIS, VIRGINIA
RANKING MINORITY MEMBER

ONE HUNDRED TENTH CONGRESS

Congress of the United States
House of Representatives

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
2157 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515–6143

Majority (202) 225–5051
Minority (202) 225–5074

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]

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[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... These transactions provide liquidity and increase the market's appetite for mortgages originated in LMI areas and to LMI consumers."

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.

Summary

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.

Executive Compensation

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

Merrill Lynch

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.

[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.

Chairman WAXMAN. All of the memos prepared by staffs and the committee will be entered into the record. Without objection, so ordered.

Mr. Prince, we're going to start with you. There is a button on the base of the mic. Be sure it is on and have it close enough so that it can pick everything up.

STATEMENTS OF CHARLES PRINCE, FORMER CHAIRMAN AND CEO, CITIGROUP; RICHARD D. PARSONS, CHAIR, PERSONNEL AND COMPENSATION COMMITTEE, CITIGROUP; E. STANLEY O'NEAL, FORMER CHAIRMAN AND CEO, MERRILL LYNCH; JOHN D. FINNEGAN, CHAIR, MANAGEMENT DEVELOPMENT AND COMPENSATION COMMITTEE, MERRILL LYNCH; ANGELO R. MOZILO, FOUNDER AND CEO, COUNTRYWIDE FINANCIAL CORP.; AND HARLEY W. SNYDER, CHAIR, COMPENSATION COMMITTEE, COUNTRYWIDE FINANCIAL CORP.

STATEMENT OF CHARLES PRINCE

Mr. PRINCE. Chairman Waxman, Congressman Davis, and members of the committee, good afternoon.

In November of last year, I voluntarily stepped down as Citigroup's chairman and chief executive officer. I started working for the company as an attorney at one of Citigroup's predecessors in 1979. Over nearly 30 years I worked my way up first to general counsel, then to chief administrative officer, chief operating officer, chief executive officer of one of Citigroup's major businesses and, finally, to CEO and then chairman of the board.

As the first member of my family to go to college, I'm extremely grateful for the opportunities that Citigroup gave to me. I also am truly proud of Citigroup and its employees. It is a company that I helped to build. When I started the company, it had about 60,000 employees, made about $20 million a year in profit. In 2006, my last full year as CEO, we had about 325,000 employees and we made about $20 billion in profit. The first 6 months of 2007 were the best 6 months in the company's 200-year history. I'm proud of what I accomplished. To be a part of Citigroup for nearly 30 years and finally to serve as its CEO was a true honor and privilege.

During my tenure as CEO, Citigroup achieved several noteworthy accomplishments. I'll give one or two examples. As one example, we repaired our extremely important relationships with regulators around the world. Citigroup is a company that is regulated in almost every way and in almost every country that we operate in. And these relationships, unfortunately, had deteriorated. In addition, early in 2005, we embarked on a comprehensive corporate governance and ethics initiative, something we called the five-point plan, which focused on expanding employee training, enhancing the emphasis on talent and development, strengthening performance appraisals and connecting ethical conduct directly to compensation, improving communication and tightening internal controls. I took the lead in designing the implementing the five-point plan. And each year I met with more than 50,000 of our employees to emphasize the high priority Citigroup placed then and places now on ethics and best business practices.

Citigroup's efforts on this front have been recognized. Over the past several years, the Institutional Shareholder Services, the leading independent analyst on corporate governance, including executive compensation decisionmaking, has rated Citigroup's corporate governance practices in the top 10 percent of all S&P 500 companies. In 2007, ISS rated Citigroup in the top 2 percent of diversified financial services companies. The founder of ISS, Robert Monks, has described Citigroup's corporate governance practices as unique, cutting-edge and exceeding the best practices currently required by law and in the industry. I'm proud and Citigroup is justifiably proud of its corporate governance practices.

The Citigroup board of directors has also instituted processes designed to ensure fair executive compensation, as you'll hear in more detail from Mr. Parsons in just a moment. The board conducts an independent assessment of executive performance and relies on a fully independent compensation consultant. And I note that a recent hearing of this committee highlighted the importance of independent compensation consultants. Citigroup has worked very hard to align the interests of management with the interests of shareholders. Citigroup executives are required to take and hold substantial portions of their annual compensation in the form of stock. Then our stock ownership commitment requires those senior executives to retain on a long-term basis at least 75 percent of the stock awarded to them while employed by Citigroup. The primary purpose we had in mind when we imposed this requirement was to tie our executives' long-term personal financial interests with those of the company and its shareholders. We couldn't sell down. Over time, we would experience exactly what the shareholders experienced. And that is exactly what happened to me.

Now well recognized as a corporate compensation best practice, Citigroup has had this requirement in place for more than a decade. Citigroup also has been a leader in community lending and investment. And Citigroup's leadership in this area predates the current crisis by decades. As one example, in September 2003, after I was named CEO, Citigroup made a $200 billion commitment to affordable mortgage lending to low- and moderate-income families. Last year we met that commitment ahead of schedule, and we continue to support affordable mortgage programs. We've also formed many partnerships with community groups. As examples, we have worked with ACORN, the National Urban League, the National Council of La Raza and Neighbor Works America to support affordable lending, financial education and community development.

Mr. Chairman, in light of the red light, I'll skip that if I may and finish up? Yeah?

Personally I've spoken out on mortgage issues. Just last year, in an address to the Greenlining Institute in Los Angeles, I criticized the current patchwork of regulatory rules that permit certain mortgage brokers and lenders to pursue regulatory arbitrage, seeking out areas of weaker banking regulation often to the detriment of consumers, and called for closing the regulatory loopholes that permit these issues to develop.

I recognize how incredibly fortunate I am to have had the opportunity to lead Citigroup. It is never easy to retire from a company to which one has devoted one's entire career. And my retirement

from Citigroup was no exception. Last fall it became apparent that the risk models which Citigroup, the various rating agencies and frankly the rest of the financial community had used to assess certain mortgage-backed securities were wrong. As CEO, I was ultimately responsible for the actions of the company, including the risk models that we used. While I wasn't the trader and I wasn't the risk officer, I was the chief executive officer. And this happened on my watch. In the interest of the company I had worked so hard to build, I immediately submitted my resignation and the board of directors accepted it a few days later. I recognize some questions have been raised about my compensation, much of the information that has been reported is incomplete or inaccurate, and I welcome the opportunity to provide the committee with the complete information. Thank you.

[The prepared statement of Mr. Prince follows:]

Testimony of

Charles Prince

before the

Committee on Oversight and Government Reform
U.S. House of Representatives

March 7, 2008

Chairman Waxman, Congressman Davis, and Members of the Committee, good morning.

In November of last year, I voluntarily stepped down as Citigroup's Chairman and CEO. I started working for the company as an attorney at one of Citigroup's predecessors in 1979. Over nearly thirty years, I worked my way up, first to General Counsel, then to Chief Administrative Officer, Chief Operating Officer, Chief Executive Officer of one of Citigroup's major businesses, and finally to CEO and then Chairman of the Board.

As the first member of my family to go to college, I am extremely grateful for the opportunities Citigroup gave me. I am also truly proud of Citigroup and its employees – it is a company that I helped to build. To serve as Citigroup's CEO was an honor and a privilege.

During my tenure as CEO, Citigroup achieved several noteworthy accomplishments. For example, we repaired our extremely important relationships with regulators around the world, which had unfortunately deteriorated. In addition, in 2005, we embarked on a comprehensive corporate governance and ethics initiative – what we called the "Five-Point Plan" – which focused on (1) expanding employee training; (2) enhancing the emphasis on talent and development; (3) strengthening performance appraisals and connecting ethical conduct directly to compensation; (4) improving communication; and (5) tightening internal controls. I took the lead in designing and implementing the Five-Point Plan, and I met

with more than 50,000 employees each year to emphasize the high priority Citigroup places on the best business practices.

Citigroup's efforts on this front have been recognized. Over the past several years, Institutional Shareholder Services, a leading independent analyst on corporate governance – including executive compensation decision-making – has rated Citigroup's corporate governance practices in the top 10% of S&P 500 companies. In 2007, ISS rated Citigroup in the top 2% of diversified financial services companies. ISS's founder, Robert Monks, has described Citigroup's practices as "unique, cutting edge," and exceeding "the best practices currently required by law and in the industry." Citigroup is justifiably proud of its corporate governance practices.

The Citigroup Board of Directors also has instituted processes designed to ensure fair executive compensation. As you will hear in more detail from Mr. Parsons, the Board conducts an independent assessment of executive performance and relies on an independent compensation consultant. (A recent hearing of this Committee highlighted the importance of independent compensation consultants.) Citigroup has worked hard to align management's interests with the interests of shareholders. For example, Citigroup's Stock Ownership Commitment requires senior executives to retain at least 75% of the equity awarded to them while employed by Citigroup. Citigroup executives are required to take and hold substantial portions of their annual compensation in stock awards. The primary purpose in mind when we imposed this requirement was to tie our executives' long-term personal financial interests with those of the company and its stockholders. Now well-recognized as a corporate compensation best practice, Citigroup has had this requirement in place for more than a decade.

Citigroup has also been a leader in community lending and investment, and Citigroup's leadership in this area predates the current crisis by decades. Citigroup's long history of supporting underserved communities was highlighted by a $200 billion commitment, in 2003, to affordable mortgage lending to low and moderate income and minority households. Last year, we met that commitment – ahead of schedule – and Citigroup continues to support affordable mortgage programs. We have also formed partnerships with community groups. We have worked in partnership with ACORN, the National Urban League, the National Council of La Raza, and NeighborWorks America to support affordable lending, financial education, and community development.

More recently, Citigroup has worked to assist homeowners facing foreclosure. In July 2007, Citigroup launched the Office of Homeownership Preservation. The Office works closely with Citigroup businesses and a loss mitigation team to meet the needs of distressed borrowers, offering broad based financial education and one-on-one counseling through nonprofit counseling organizations. Additionally, through our ongoing relationship with the Neighborhood Assistance Corporation of America, Citigroup will fund up to $1 billion worth of mortgage refinancing for homeowners at risk of foreclosure.

Personally, I have spoken out on mortgage issues. Last year, in an address at the Greenlining Institute in Los Angeles, I criticized the current patchwork of regulatory rules that permit certain mortgage brokers and lenders to pursue regulatory arbitrage – seeking out areas of weaker banking regulations, often to the detriment of consumers – and called for closing the regulatory loopholes that permit these issues to develop.

I recognize how incredibly fortunate I am to have had the opportunity to lead Citigroup. It's never easy to retire from a company to which one has devoted one's entire career,

and my retirement from Citigroup was no exception. Last fall, it became apparent that the risk models which Citigroup, the various rating agencies, and the rest of the financial community used to assess certain mortgage-backed securities were wrong. As CEO, I was ultimately responsible for the actions of the company, including the risk models that eventually proved inadequate. In the interests of the company I had worked so hard to build, I immediately submitted my resignation, and the Board of Directors accepted it a few days later.

I recognize that some have raised questions about my compensation, and much of the information reported in the media is incomplete or inaccurate. I therefore welcome the opportunity to provide the Committee with the complete information. I am happy to answer any questions. Thank you.

Chairman WAXMAN. Thank you very much, Mr. Prince.

Mr. Parsons.

Mr. PARSONS. Mr. Chairman——

Chairman WAXMAN. There is a button on the base of the mic.

STATEMENT OF RICHARD D. PARSONS

Mr. PARSONS. Mr. Chairman, Mr. Ranking Minority Member, and distinguished members of the committee. I'm Richard Parsons, and I'm the chairman of Time Warner. I appear before you today, however, in my capacity as a member of the Citigroup board of directors and chairman of the board's Personnel and Compensation Committee to address your questions about executive compensation.

Executive compensation levels, particularly in the financial services arena, are driven by highly competitive markets to attract and retain talent. The competition for talent is especially for a company with the scope and scale of Citigroup, the leading global financial services company competing, serving customers and conducting business in more than 100 countries around the world. A compensation approach that allows Citi to attract and retain the top financial services industry talent around the world is a core responsibility of the Compensation Committee.

I believe good corporate governance requires that public companies be as transparent as we can be about the processes we use to determine executive compensation. We strive to make the descriptions of our compensation philosophy and process that are contained in our public filings clear, detailed and thorough.

Let me highlight briefly a few important aspects here. The starting point for compensation decisions regarding Citi executives is an objective assessment of both the competitive landscape and the individual's performance and achievement in enhancing the company's ability to grow, compete in the global financial markets, serve its customers and generate shareholder value. By tying compensation to performance, Citi aims to attract and retain the best talent and to align the interests of senior executives with the interest of stockholders.

Performance has several important aspects, quantitative, as well as qualitative. Individual rewards reflect the overall performance of the company, as well as the performance of an executive's particular business. Further, we are concerned with more than just Citi's short-term financial results. A large portion of executive compensation is tied directly to the creation of long-term shareholder value.

We consider nonfinancial measures as well, including the ability to execute strategic alternatives, to maintain regulatory relationships, to position the company for future growth and to invest in and deliver first-rate customer service, to navigate complex legal issues and to develop talent. While these measures may not produce immediate financial results, they are still very important factors that help drive Citi's long-term success and build long-term value for shareholders.

Moreover, Citi focuses not just on the business results achieved by senior executives but on how they do business. As part of its business culture, Citi believes each employee has certain responsibilities to customers, to one another and to the enterprise itself.

And it evaluates its senior executives and other employees on how well they meet those responsibilities. Compensation decisions for senior executives at Citi are the result of independent review and analysis undertaken by the Personnel and Compensation Committee, which consists solely of independent directors. The committee regularly reviews the company's compensation programs, evaluates performance and determines compensation of the CEO in the operating committee and approves the compensation structure for other senior executives of the company. In carrying out these responsibilities, the committee relies on a variety of benchmarking and performance data provided by the company and compensation consultants. In addition, the Compensation Committee uses an independent outside consultant who does no other work for Citi and reports directly to the Compensation Committee to review, analyze and advise the committee about its compensation decision—about its compensation decisions, including whether those decisions are reasonable.

The committee is well aware that executive compensation must be competitive with pay at peer companies if Citi is going to attract and retain the kind of talent needed to successfully manage and grow the company. Benchmarking for Citi is difficult, because the combination of lines of business at Citi is not precisely replicated at any other company. For compensation benchmarking purposes, we look at a group of leading companies with significant financial services operations, including many with global presence, companies such as Bank of America, Deutsche Bank, General Electric, Goldman Sachs, JPMorgan Chase and Merrill Lynch. The complete list can be found in Citi's publicly filed proxy. The committee uses its business judgment and discretion to assess the performance measures, the input from the independent consultant and the benchmarking data that collectively help determine compensation decisions.

The committee does not use a formulaic approach to weigh performance criteria because the committee and the company believe that the adoption of any given formula could inadvertently encourage undesirable behavior; for example, favoring one financial measure to the exclusion of other important values. Rather, we use a balanced approach that considers in the context of a competitive marketplace factors contributing to the financial performance of the Citigroup over time and the individual leadership of senior executives.

My statement is on file. I will simply conclude by saying that we appreciate the opportunity to be here today to address the questions of this committee and as they relate to how we at Citi go about determining compensation measures. Thank you.

[The prepared statement of Mr. Parsons follows:]

Statement of Richard D. Parsons

Committee on Oversight and Government Reform
U.S. House of Representatives
March 7, 2008

Mr. Chairman and Members of the Committee: I am Richard Parsons and I am Chairman of Time Warner. I appear before you today in my capacity as a member of the Citigroup board of directors and Chairman of the board's Personnel and Compensation Committee, to address your questions about executive compensation.

Executive compensation levels, particularly in the financial services industry, are driven by a highly competitive market to attract and retain talent. The competition for talent is especially important for a company with the scale and scope of Citi -- the leading global financial services company competing, serving customers, and conducting business in more than 100 countries. A compensation approach that allows Citi to attract and retain the top financial services industry talent around the world is a core responsibility of the Compensation Committee.

I believe good corporate governance requires that public companies be as transparent as we can about the processes we use to determine executive compensation. We strive to make the descriptions of our compensation philosophy and process contained in our public filings clear, detailed, and thorough. Let me highlight briefly a few important aspects here.

Testimony of Richard D. Parsons
Committee on Oversight and Government Reform
March 7, 2008

Objectives of Citi's Executive Compensation Programs

The starting point for compensation decisions regarding Citi executives is an objective assessment of both the competitive landscape and the individual's performance and achievement in enhancing the Company's ability to grow, compete in the global financial marketplace, serve its customers and generate shareholder value. By tying compensation to performance, Citi aims to attract and retain the best talent and to align the interests of senior executives with the interests of stockholders.

Performance has several important aspects, quantitative as well as qualitative. Individual awards reflect the overall performance of the company, as well as the performance of an executive's particular business. Further, we are concerned with more than just Citi's short term financial results. A large portion of executive compensation is tied directly to the creation of long term shareholder value. We consider non-financial measures as well, including the ability to execute strategic initiatives, to position the Company for future growth, to build and maintain regulatory relationships, to invest in and deliver first-rate customer service, to navigate complex legal issues, and to develop talent. While these kinds of measures may not produce immediate financial results, they are all very important factors that help drive Citi's long-term success and build long-term stockholder value.

Moreover, Citi focuses not just on the business results achieved by its senior executives, but on *how* they do business. As part of its business culture, Citi believes each employee has certain responsibilities to customers, to one another and to the enterprise itself, and it evaluates its senior executives and other employees on how well they meet those responsibilities.

Executive Compensation Process at Citi

Compensation decisions for senior executives at Citi are the result of independent review and analysis undertaken by the Personnel and Compensation Committee, which consists solely of independent directors. The Committee regularly reviews the company's compensation programs, evaluates performance and determines compensation of the CEO and the Operating Committee, and approves the compensation structure for other senior executives in the Company.

In carrying out these responsibilities, the Committee relies on a variety of benchmarking and performance data provided by the company and compensation consultants. In addition, the Compensation Committee uses an independent outside consultant, who does no other work for Citi and reports directly to the Committee, to review, analyze and advise the Committee about its compensation decisions, including whether those decisions are reasonable.

The Committee is well aware that executive compensation must be competitive with pay at peer companies if Citi is going to attract and retain the kind of talent needed to successfully manage and grow the Company. Benchmarking for Citi is difficult because the combination of lines of business at Citi is not precisely replicated at any other company. For compensation benchmarking purposes, we look at a group of leading companies with significant financial services operations, including many with a global presence: companies such as Bank of America, Deutsche Bank, General Electric, Goldman Sachs, JP Morgan Chase, and Merrill Lynch. The complete list can be found in Citi's publicly-filed proxy.

The Committee uses its business judgment and discretion to assess the performance measures, the input from the independent consultant and the benchmarking data that collectively help determine compensation. The Committee does not use a formulaic approach to weight performance criteria because the Committee and the Company believe that the adoption of any given formula could inadvertently encourage undesirable behavior, for example, favoring one financial measure to the exclusion of other important values. Rather, we use a balanced approach that considers, in the context of a competitive marketplace, factors contributing to the financial performance of Citigroup over time and the individual leadership of senior executives.

Elements of Compensation

Executive compensation at Citi generally consists of two components: base pay and discretionary incentive awards. Base pay, which the company caps at $1 million, is paid out over the course of a year. In order to motivate performance and align the interests of senior executives and stockholders, however, most executive compensation is in the form of discretionary incentive awards. In addition, although there are circumstances when they are warranted, Citi disfavors employment agreements that include some form of guaranteed compensation.

With respect to the discretionary incentive awards, in past years these typically have included an award for senior executives that is 40% equity and the remainder cash. This mix is designed to recognize short term performance over the preceding year, which is the fundamental consideration for determining the size of the cash component, and recognizing contributions to the Company's long term growth and value through equity awards.

As a further incentive for Citi senior executives to achieve strong shareholder returns over time, all senior executives are subject to a Stock Ownership Commitment – that is, they are required to retain at least 75 percent of their Citigroup stock as long as they are members of senior management.

Although Citigroup's Stock Ownership Commitment has been in place for over a decade, more recently such programs have come to be recognized as a best practice in good corporate governance because they ensure that senior executives, as significant stockholders, will experience events such as a decline is share price or changes in dividend policy right along with other stockholders.

I appreciate the opportunity to address this Committee, and I am happy to take any questions you may have.

Chairman WAXMAN. Thank you very much for your testimony.
Mr. O'Neal.

STATEMENT OF E. STANLEY O'NEAL

Mr. O'NEAL. Chairman Waxman, Mr. Davis, members of the committee, good afternoon. Whatever I have achieved in life has been the result of a unique combination of luck, hard work and opportunity that I think can only exist in this country.

My grandfather, James O'Neal, was born into slavery in 1861. He was eventually able to carve out a life for himself and his family through hard work and perseverance. Over time, he acquired some farmland and was able to donate a small parcel for the construction of a one-room schoolhouse in a small town in rural Alabama called Wedowee. It served students in the first through the sixth grades, all taught by one teacher. And like our home in Wedowee, it had no indoor plumbing or running water. That was the town where I grew up, and that was the school that I attended.

My parents never had an opportunity for higher education. They both worked hard, each of them at times holding more than one job. When I was 13 my father moved us to Atlanta so he could take a job in a factory at General Motors nearby. For a time, we lived in a Federal housing project, which was all my parents could afford. Eventually they were able to save enough money to make a down payment on their first house. They lived in that house for 30 years, eventually paying off the mortgage.

Watching my parents work and save to afford their own home gave me an appreciation of the unique pride and satisfaction that comes with home ownership. I worked my way through college by working at the same GM factory where my father had worked.

In 1987, I joined Merrill Lynch and spent close to the next 21 years of my life there, eventually being named president in the summer of 2001. Within weeks of becoming president, Merrill Lynch and the American economy faced a crisis. When terrorists attacked the World Trade Center on September 11th, we had to evacuate all 9,000 of our employees from our offices directly across from the Twin Towers. Over the following days and weeks I led the firm's efforts to assist its employees and to manage its business in the aftermath of the attacks. Our employees were scattered in locations throughout New York and New Jersey, and at the time many people thought that the future of Merrill Lynch was in doubt. But we survived, and in fact we flourished.

After I became CEO I led Merrill through a period of rapid growth. Our revenues grew dramatically from $18.3 billion in 2002 to $32.7 billion in 2006. Net income more than quadrupled from $1.7 billion to $7.6 billion. Shareholder return on equity virtually tripled from 7.5 percent in 2002 to 21.3 percent in 2006. And our stock price rose from $28 in October 2002 to $97 in January 2007.

And even with the losses sustained in the second half of last year and the broad-based sell-off in financial service stocks over the last few months, Merrill Lynch closed yesterday at a price 60 percent higher than it was at its low point shortly after I took over.

As a result of the extraordinary growth at Merrill Lynch during my tenure as CEO, the Board saw fit to increase my compensation each year. The financial services industry has a long history of pay-

ing many individuals high, not just senior executives. Most of my compensation consisted of restricted stock and options, and I was required to hold the majority of the stock I was awarded. My assets and my compensation increased only when shareholders and employees benefited and decreased when it did not. In fact, I initiated a requirement that senior management hold at least 75 percent of the stock and options that were awarded.

It is important to note that the compensation of senior management at Merrill Lynch was determined by the Board of Directors upon recommendation of the Compensation Committee, which is composed exclusively of independent directors, and an independent and rigorous process was used, and pay levels were determined consistent with levels in the industry generally. Performance was measured against targets such as revenues, return on equity, and some strategic objectives, all established at the beginning of each year.

In 2007, Merrill, along with and many other financial services firms, encountered difficulty as a result of the unprecedented meltdown in credit markets, including mortgage-backed securities. I am not in a position to comment in depth on the subprime crisis, especially because of pending litigation matters. I can say, however, that Merrill Lynch held mortgage-backed securities that, like many other financial institutions and the rating agencies, as well as others, we believed carried low risk. Unfortunately, due to a number of unforeseen factors, that turned out not to be the case.

There has been some press about my so-called severance packages. These stories are inaccurate. The reality is that I received no bonus for 2007 and no severance pay. The amount disclosed in the press consisted mainly of deferred compensation, stock and options that I had earned during the years prior to 2007, in part reaching back several years to 2000 and earlier.

Had I received all my compensation in cash during my tenure, I would have received no so-called payout upon retirement. But having given me a significant part of my compensation in stock and options, the Board ensured that my personal financial interests were closely aligned with those of the shareholders of the company. To the extent that Merrill's stock has decreased in value since my departure, so too has the value of the consideration I received.

I am not aware of any fact that should raise a concern about whether there was an appropriate process in place for determining senior executive compensation at Merrill. The company recruited sophisticated, independent individuals to its board through a careful nominating procedure. To my knowledge, the independent directors of the Compensation Committee compensated senior management in accordance with their independent judgment about the company's performance.

I just want to end by saying that because of my own personal history, I understand, as well as anyone, the importance of home ownership, not only financially, but also socially, emotionally, and I would never do anything knowingly that would deny anyone else that privilege.

[The prepared statement of Mr. O'Neal follows:]

STATEMENT OF E. STANLEY O'NEAL

BEFORE THE
UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

MARCH 7, 2008

Good morning Chairman Waxman, Mr. Davis and Members of the Committee. I am glad to help the Committee in any way that I can.

Whatever I have achieved in life has been the result of the unique combination of luck, hard work and opportunity that can only exist in this country. My grandfather, James O'Neal, was born into slavery in 1861. He was eventually able to carve out a life for himself and his family through hard work and perseverance. Over time, he acquired some farm land and was able to donate a small parcel of it for the construction of a one-room schoolhouse in a small town in rural Alabama called Wedowee. It served students in the first through sixth grades, all taught by one teacher. Like our home in Wedowee, it had no indoor plumbing or running water. That was the town where I grew up and that was the school that I attended.

My parents never had an opportunity for higher education. They both worked hard, each of them, at times, holding more than one job. When I was 13, my father moved us to Atlanta so he could take a job on the assembly line at a nearby General Motors plant. For a time, we lived in a federal housing project, which was all my parents could afford. Eventually they were able to save enough money to make a down payment on their first house. They lived in that house for 30 years, and eventually paid off their mortgage. Watching my parents work and save to afford their own home gave me an appreciation of the unique pride and satisfaction that comes with homeownership.

I worked my way through college by working at the same GM plant where my father worked. I participated in a General Motors program in which I alternated working for six weeks (sometimes in the office, sometimes on the factory floor) and taking classes for six weeks. After I finished college and received my MBA, I went to work for GM full time, eventually becoming director of GM's treasury division. I joined Merrill Lynch in 1987 and spent close to the next 21 years of my life there.

I am proud of my many years at Merrill. I first joined the Firm as a vice president and held a number of positions in various departments throughout the Company. In 1998, I was asked to be Chief Financial Officer. Two years later, I became president of Merrill's private client group, and, in 2001, President of the Company.

Within weeks of my becoming President, Merrill Lynch and the American economy faced a crisis. When terrorists attacked the World Trade Center on September 11, we had to evacuate all 9,000 of our employees from our offices directly across the street from the Twin Towers. Over the following days and weeks, I led the Firm's efforts to assist its employees and to manage its business in the aftermath of the attacks. Our employees were working at scattered locations throughout New York and New Jersey. At the time, many people thought that the future of Merrill was in doubt. But we survived, and, in fact, flourished.

After I became CEO in 2002, I led Merrill through a period of rapid growth. Our revenues rose dramatically from $18.3 billion in 2002 to $32.7 billion in 2006, while net income more than quadrupled from $1.7 billion to $7.6 billion. Shareholder return on equity virtually tripled, from 7.5% in 2002 to 21.3% in 2006, while our stock price rose from $28 in October 2002 to $97 in January 2007. Naturally, these achievements benefited all Merrill shareholders and employees.

I was fortunate to have wonderful opportunities at Merrill Lynch, including the chance to earn significant compensation. Of course, I am not unique in this respect, as the financial services industry has a long history of paying high compensation.

I think it is also important to note that the compensation of senior management at Merrill was determined through a rigorous and independent process, and consistent with pay levels in the industry. In January of each year, after a review of the Company's performance during the prior year, the Board of Directors set performance targets for the following year for all of senior management, including me. Those targets included a mix of revenue objectives, return on equity measures, and some strategic objectives. At year end, the Compensation Committee of the Board, which consisted exclusively of independent directors, met with senior executives to discuss their performance. The Committee then met by itself to set compensation.

Following those meetings, the Board of Directors informed me what my total compensation would be for that year and what my base salary would be for the following year. As a result of the extraordinary growth at Merrill during my tenure as CEO, the Board saw fit to increase my compensation each year. Most of that compensation consisted of restricted stock and stock options. I was required to hold the majority of the stock and options that I was awarded. In fact, I myself initiated a requirement that all of senior management hold onto at least 75% of their stock and options. Therefore, my compensation and my assets increased only when Merrill Lynch performed well for its shareholders and employees, and decreased when it did not.

I am aware that the Compensation Committee did retain Towers Perrin, a compensation consulting firm, to advise it, but I did not select Towers Perrin for that work or any other work it might have done at Merrill.

As we all know, in 2007, Merrill – and many other financial services firms – encountered difficulty as a result of the unprecedented meltdown in credit markets, including mortgage-backed securities. I am not in a position to comment in any depth on the sub-prime crisis, particularly because of pending litigation. I can say Merrill held mortgage-backed securities that we believed carried low risk.

Unfortunately, due to unforeseen factors, that was not the case. We, and many other financial institutions, big and small, did not foresee the magnitude of what happened. Nor did the rating agencies foresee the magnitude of the risk. While I was in charge of Merrill overall, I did not manage the day-to-day aspect of Merrill's business that invested in mortgage-backed securities. However, the sub-prime issues at Merrill arose during my tenure. Thus, when the Board asked me to retire shortly after we announced a large sub-prime related write-down in late 2007, I agreed to step down.

There has been some press about my so-called "severance package." These stories are inaccurate. The reality is that I received no severance package. I received no bonus for 2007, no severance pay, no "golden parachute." The amount discussed in the press consisted mainly of deferred compensation, stock and options that I had earned during the years prior to 2007, in part reaching back several years to 2000 and earlier. In fact, if I had received all of my compensation in cash during my tenure, I would have received no "payout" at all upon retirement. By having given me a significant part of my compensation in stock and options, the Board ensured that my personal financial interest was closely aligned with the shareholders of the Company. If the shareholders did well, I would do well too. And to the extent that Merrill Lynch stock has decreased in value since my departure, so too has the value of the consideration

I received. My interests and the interests of Merrill Lynch's shareholders remain entirely aligned.

It is true that top executives at public companies in the United States, especially in the financial services industry, are highly compensated. But a great percentage of that compensation, certainly for me, was and is at risk. When the business does well, all shareholders do well. But if the business does not do well, the value of that compensation can plummet. I also am not aware of any fact that should raise a concern about whether there was an appropriate process in place for determining senior executive compensation at Merrill. Merrill recruited sophisticated, independent individuals to its Board through a careful nominating procedure. To my knowledge, the independent directors on the Compensation Committee compensated senior management in accordance with their independent judgment about the Company's performance. I know this first hand because I did not receive any bonus for 2007 or any severance whatsoever. In short, I believe the compensation process was independent and functioned to ensure that my interests and those of Merrill's shareholders were closely aligned and remain closely aligned.

I want to end by saying that, because of my own personal history, I understand as well as anyone the importance of home ownership, not only financially but also socially and emotionally, and I would never do anything knowingly that would deny anybody that privilege.

Thank you.

Chairman WAXMAN. Thank you very much, Mr. O'Neal.

Mr. Finnegan.

STATEMENT OF JOHN FINNEGAN

Mr. FINNEGAN. Chairman Waxman, Ranking Minority Member Davis, and members of this distinguished committee, I thank you for the opportunity to testify before you today. I am the chairman of the Board and chief executive officer of the Chubb Corp. I became a member of Merrill Lynch's Board of Directors and a member of the Board's Management Development and Compensation Committee in 2004. I became chairman of the Compensation Committee in April 2007.

Mr. Chairman, your letter requests that I address how the compensation of Merrill Lynch's former chairman and chief executive officer, Stanley O'Neal, was determined and the basis for Mr. O'Neal's separation agreement. As requested, I will summarize here and explain in greater detail in my written statement the process employed by the Compensation Committee.

I will start by addressing two important factual matters: First, Mr. O'Neal's 2007 compensation, and second, other compensation amounts earned in prior years to which Mr. O'Neal was entitled when he left the company.

With respect to 2007, the Board determined unanimously that Mr. O'Neal would receive no bonus of any kind for 2007 and no severance payment. For executives at Mr. O'Neal's level, the bonus constitutes the overwhelming proportion of annual compensation. Mr. O'Neal's total compensation for 2007 was only his base salary, which had been paid biweekly during the year until his termination on October 30th. Aside from his base salary, a compensation of benefits retained by Mr. O'Neal at his departure had been earned and awarded to him in prior years. The $161 million figure disclosed in our public filings, and highlighted by the media at the time of his departure reflects compensation and benefits, over 80 percent Merrill stock, all earned over the course of his career at Merrill Lynch prior to his separation from the company.

O'Neal accomplished a great deal for Merrill Lynch in the years before 2007. He was elected president and COO in July 2001. Immediately prior to Mr. O'Neal's appointment as president, the company's results for the first 6 months of that year had declined by 30 percent. But Mr. O'Neal acted quickly and decisively to restructure the company. Management was reshaped. Operations were streamlined and a long-term recovery strategy was put in place.

Mr. O'Neal's leadership positioned the company for what was to be a period of significant growth and profitability. Over this period, Mr. O'Neal's leadership qualities and achievements were widely recognized by the markets, clients, analysts, competitors and the media.

The Compensation Committee has established a formal process aimed at measuring and rewarding tangible results against performance objectives. This process starts at the beginning of each year and continues throughout the year. The committee develops its annual compensation determination for senior management with three primary objectives in mind. First, we pay for performance. Second, we try to ensure that compensation for the company's

executives is competitive with that of key competitors in our industry. And third, we emphasize stock-based compensation, support alignment of our executives' financial interests with those of shareholders, and to encourage retention.

Returning to the specifics regarding Mr. O'Neal in the fall of 2007, as chairman of the Compensation Committee, I presided over the process that the Board used to determine his separation agreement. The Board determined that while Mr. O'Neal up until the mortgage crisis had achieved outstanding results as CEO of Merrill Lynch, he was not the right person to take the company forward. New leadership was required. Mr. O'Neal received no bonus and no severance and he also lost his job. However, the Board recognized that Mr. O'Neal was entitled to retain the compensation and benefits that he had earned in prior years and that he was eligible to receive under the company's retirement provisions. This is what the Board believed it could do and what it should do.

In conclusion, Mr. O'Neal's 2002 to 2006 compensation was on a scale of that of other CEOs of major investment banks. In those years, he provided strong and decisive leadership during a phase of significant restructuring, repositioning and growth for the company. Although his legacy is marred by deep losses in very specific parts of our business, the overall health and vitality of the rest of the company's global franchise is due in large part to the strength of leadership and direction that he provided. And Mr. O'Neal's compensation from 2002 to 2006 reflect these results. In 2007, when tangible results were not delivered, Mr. O'Neal lost his job and received no bonus and no severance.

Thank you for providing the company with an opportunity to explain our process and decisions, and I will do my best to answer any questions you might have.

[The prepared statement of Mr. Finnegan follows:]

Statement of John Finnegan
before
The House Committee on Oversight and Government Reform
March 7, 2008

Chairman Waxman, Ranking Minority Member Davis, and Members of the Committee on Oversight and Government Reform, I thank you for the opportunity to testify before you. Today, I will address issues related to the compensation of Merrill Lynch's (the "Company") former Chairman and Chief Executive Officer, Mr. Stanley O'Neal, and issues related to his separation from the Company.

I am currently the Chairman of the Board and Chief Executive Officer of the Chubb Corporation. Before joining Chubb in 2002, I was the Chairman and President of General Motors Acceptance Corporation, a financing subsidiary of General Motors Corporation. I first became a member of the Company's Board of Directors (the "Board") in 2004, and I have been a member of the Board's Management Development and Compensation Committee (the "Compensation Committee") since that time. I became Chairman of the Compensation Committee in April 2007.

Mr. O'Neal's 2007 compensation and other amounts to which he was entitled upon his departure

I would like to start by addressing three important factual matters that are key to the subject matter of this hearing: first, Mr. O'Neal's 2007 compensation; second, other compensation amounts, earned in prior years, to which Mr. O'Neal was entitled when he left the Company; and third, a brief outline of the reasons for his compensation for those prior years. I will then provide the context for these matters.

Mr. O'Neal's compensation for 2007

The Board determined unanimously that Mr. O'Neal would receive no bonus of any kind for 2007 and no severance payment. Mr. O'Neal's sole compensation for 2007

was his base salary, which had been paid bi-weekly during the year until his termination on October 30, 2007.

Other amounts, previously earned, to which Mr. O'Neal was entitled when he left the Company

Aside from his base salary, anything else retained by Mr. O'Neal at his departure had been earned and awarded to him in prior years. The amount disclosed in our public filings and highlighted by the media at the time of his departure relates entirely to compensation and benefits that he earned over the course of his career, and in all events, prior to his separation from the Company. Over 80% of the amount consists of Company stock he received as part of his annual bonuses for 2006 and prior years. Those bonuses were paid because of the Company's and Mr. O'Neal's strong performance during those earlier periods. These stock bonuses were made subject to our customary vesting and holding requirements, which are in place to align the executive's long-term financial interests with those of shareholders and to provide retention value. All of the compensation and benefits that make up the disclosed amount had been awarded to Mr. O'Neal through decisions of the Board that were taken before 2007, and before I became Chairman of the Compensation Committee. At the time of his departure, Mr. O'Neal was entitled under the terms of the Company's various plans and agreements to all of these items which previously had been reported in the Company's proxy statements.

Mr. O'Neal's pre-2007 compensation

During Mr. O'Neal's tenure as first, President and Chief Operating Officer from 2001 to 2002 and, later as Chief Executive Officer from 2002 to 2006, the Company showed significant and measurable improvement in financial and other performance indicators, which was a direct result of the restructuring, diversification and growth strategy that Mr. O'Neal initiated and led. Mr. O'Neal was elected as President and COO in July of 2001. Immediately prior to Mr. O'Neal's appointment as president, the

Company's results for the first six months of that year had declined by 30% from the same period in the prior year. Subsequently, the events of September 11, 2001 displaced Merrill Lynch from its world headquarters for over two months. The combination of September 11th and the already difficult market environment created uncertainty about, and challenges for, the securities business. Against this backdrop, Mr. O'Neal acted quickly and decisively to restructure the Company. Management was reshaped, operations were streamlined and a long-term recovery strategy was put in place. Mr. O'Neal's leadership positioned the Company for what was to be a period of significant growth and profitability. For example, return on equity increased from 7.5% in 2002 to 21.3% in 2006. The Company's net revenues grew from $18.3 billion in 2002 to $32.7 billion in 2006 and net earnings grew from $1.7 billion to $7.6 billion over the same period, while the Company's pre-tax profit margin expanded from 12.6% to 31.9%. Additionally, the Company diversified its global franchise, increasing the Company's non-US share of Company revenues from 25% in 2002 to 37% in 2006. Over this period, Mr. O'Neal's leadership qualities and achievements were widely recognized by the markets, clients, analysts, competitors and the media.

In addition to these important considerations, as explained further below, the compensation awarded to Mr. O'Neal during this period was based in part on what the Board considered to have been in a range with that of Mr. O'Neal's peers. In short, during the pre-2007 period, the Company wanted very much to keep Mr. O'Neal.

I will now try to put these matters in context by providing a review of the Company's executive compensation governance process and related compensation programs and describe why they are in the best interests of our shareholders. I will then comment in detail on Mr. O'Neal's separation agreement, including a breakdown of the amount and a description of the historic stock grants and benefits that comprise the total reported amount retained by him. I will address Mr. O'Neal's separation after his twenty-one years of service at the Company, then offer a brief conclusion.

The executive compensation process

The Board, in fulfilling its executive compensation responsibilities, adheres to the highest standards of corporate governance. The Board has delegated to the Compensation Committee the responsibility to oversee, in the best interest of shareholders, the use of corporate assets in compensating executives. The members of the Compensation Committee and its Chairman are appointed by the Board on the recommendation of the Nominating and Corporate Governance Committee of the Board. All members of the Compensation Committee have been determined by the Board to be independent and in compliance with the rules of the New York Stock Exchange, and also to meet the independence requirements of applicable SEC and IRS rules.

Under the Compensation Committee charter adopted by the Board, the Committee is responsible for determining the compensation to be paid to individual members of executive management (including the chief executive officer). The Compensation Committee's determinations for the chief executive officer and other officers identified in our annual proxy statement are submitted to the full Board for ratification. As described in the Company's proxy statement, the Compensation Committee develops its annual compensation determinations with three primary objectives in mind:

- First, we pay for performance. Our executives must produce tangible results measured against pre-established performance objectives.
- Second, we try to ensure that compensation for the Company's executives is competitive with that of key competitors in our industry after adjusting for performance. In our industry, talented executives are in great demand and paying competitive compensation is essential to prevent our competitors from hiring them away.
- Third, we emphasize stock-based compensation to support alignment of our executives' long term financial interests with those of shareholders and to encourage retention. In the case of Mr. O'Neal, more than 50% of his compensation as chief

executive officer was delivered in stock awards subject to multi-year vesting and holding requirements.

With respect to measuring and rewarding tangible results against performance objectives, the Compensation Committee has established a formal process. This process starts at the beginning of each year. Management, in dialogue with the Compensation Committee, proposes a series of specific financial, strategic and leadership goals for the Company and individual business units. Examples of these objectives are:

(1) Financial (e.g., revenues, pre-tax profits, return on equity, balance sheet and capital management)

(2) Strategic Objectives (e.g., organic growth, acquisition targets, brand management)

(3) Leadership Objectives (e.g., strategic hires, leadership model)

(4) Specific Business Unit Objectives, (e.g., geographic expansion, new markets)

(5) Execution (e.g., realize targeted returns on investments made in prior years)

The Compensation Committee reviews and ultimately approves performance objectives for the year, and then shares these objectives with the full Board. Over the course of the year, management provides the Compensation Committee with regular updates on their progress and the Company's performance against these objectives.

At the end of the year, the Compensation Committee reviews the results for the Company, compares those results with the reported results of the peer group companies, and conducts a final review of management's performance against its financial, strategic and other objectives.

With respect to the Compensation Committee's goal of providing competitive pay for competitive performance, an independent compensation consultant comprehensively reviews competitive pay levels for executives. Since 2003, the Compensation Committee has directly retained Mr. John England, an independent compensation consultant from Towers Perrin, to ensure that it has access to an objective perspective and independent data. Mr. England attends all Compensation Committee meetings and is available individually to all its members. The Company does some other business with Towers Perrin – for example it purchases general compensation surveys, routine reports and business-related consulting assignments. To assure itself of the independence of Mr. England, the Company determined that Mr. England receives no compensation for any other services provided by Towers Perrin and reviews such services to ensure they are a statistically immaterial amount of Towers Perrin's annual revenues. The Compensation Committee is therefore satisfied with Mr. England's independence.

The companies that comprise the peer group for performance and compensation comparison purposes include those companies who participate in the same core businesses as Merrill Lynch, have a similar business mix and compete directly for the same talent pool globally. The Compensation Committee is also mindful that other non-traditional competitors, such as hedge funds and private equity funds, also compete for the same talent and offer compelling compensation opportunities. However, these companies do not make their compensation information publicly available and so cannot be compared systematically.

After assessing Company and individual performance and the compensation practices of industry peers, the Compensation Committee also considers the Company's historical compensation practices. On the basis of all this information, the Compensation Committee makes annual pay decisions with the objective of rewarding competitive performance with competitive pay. Most importantly, the Compensation Committee makes a decision regarding annual bonuses. These bonuses typically are

by far the largest component of an executive's, and indeed most key employees', compensation. By reserving the ability to vary the amount of our executives' year-end bonuses, which is the bulk of their pay, the Compensation Committee has great flexibility to meet its objectives regarding competitive pay for competitive performance.

Once the amount of annual compensation has been determined, the Compensation Committee considers the form in which it should be delivered. The Compensation Committee has a long standing philosophy of delivering a significant portion of annual bonuses in Company stock. Providing compensation in a combination of cash and stock, instead of all in cash, helps protect the interests of shareholders in a number of ways. First, it promotes the retention of key employees because all or a portion of the stock will be forfeited if they leave the Company before they are eligible for retirement. Second, paying a meaningful portion of the annual bonus in stock aligns the financial interests of executives with those of shareholders over the long term. Because the value of a stock bonus earned for one year increases or decreases based on stock price performance over the four-year vesting period (as well as over any subsequent holding period), executives are encouraged to take a long term view to business planning and decision making.

The Company's executive management team, including the chief executive officer, receives stock bonus grants with the same terms, conditions and forfeiture provisions as the other 10,000 annual stock bonus recipients. However, in addition to the normal vesting restrictions, executive management is subject to stock ownership guidelines that require executives to hold a portion of their stock bonus even after the shares have vested, which serves to further align the long-term interests of executives with those of shareholders.

Mr. O'Neal's separation agreement

In the fall of 2007, as Chairman of the Compensation Committee, I presided over the process that the Board used to determine the separation agreement for Mr. O'Neal. This agreement was reached after careful deliberation by the Board. At the time, the Board was balancing the circumstances of Mr. O'Neal's departure and the performance of the Company in 2007 with the need for closure and a rapid transition to a new chief executive officer. In reaching the agreement, the Board retained and was advised by an independent compensation consultant and independent legal counsel.

The press has reported the value of Mr. O'Neal's separation agreement as $161.6 million. There is no disputing the number; it comes directly from the Company Form 8-K filing at the time of his departure. The value was based on the Company's stock price on October 29, 2007, the day prior to Mr. O'Neal's departure. To understand the reported value of the agreement, it is necessary to examine its specific components. However, before I do so, it is important to highlight that his separation agreement does not include any bonus compensation for 2007 or any severance payment. Upon Mr. O'Neal's departure in October, the Board unanimously determined that no bonus would be paid to him for 2007 and no severance payment (in either cash or stock) could be given in light of the Company's performance in 2007.

At the time Mr. O'Neal left, the Board had determined that, while Mr. O'Neal, up until the mortgage crisis, had achieved outstanding results for the Company, he was not the right person to take the Company forward and that new leadership was required. Based upon the Company's performance in 2007 and taking into consideration the amounts the Company paid Mr. O'Neal in prior years, the Board decided not to give Mr. O'Neal a bonus in 2007 or pay him severance. In making these decisions, the Board recognized that Mr. O'Neal was entitled to retain the compensation and benefits that he earned in prior years and that he was eligible to receive under the Company's retirement provisions. Consequently, the value disclosed and retained by him after his departure is entirely attributable to compensation and benefits earned by him from 1987 to 2006.

These items include benefits payable to him under general employee plans, deferred compensation from 1997 and 1998, annual stock bonus awards made for performance in 2006 and prior years and a supplemental executive annuity plan.

In 2006 and earlier years, annual stock bonuses were awarded to Mr. O'Neal in lieu of paying his bonus entirely in cash to ensure that his long-term financial interests were aligned with those of shareholders. For the 2004 performance year, for example, Mr. O'Neal's entire bonus was paid in stock. If the Board had paid Mr. O'Neal all the prior annual bonuses in cash, instead of stock and cash, the amount reported as being retained by him at the time he left the Company would have been limited to $25 million (attributable to benefits) and $5 million (deferred compensation), and Mr. O'Neal would not have been adversely affected, as he in fact has been, by the decline in the Company's stock price since his departure.

Instead, the Compensation Committee paid a significant amount of Mr. O'Neal's annual bonus in stock with vesting over a four year period in order to align Mr. O'Neal's interests with those of the Merrill Lynch shareholders. This alignment can be seen in the effect of the decline in Merrill Lynch's stock price in 2007 on Mr. O'Neal's stockholdings. Mr. O'Neal had a beneficial ownership of 3,214,358 shares as of February 28, 2007, as reported in the Company's 2007 Proxy Statement. At Merrill Lynch's stock price as of year-end 2007 Mr. O'Neal's holdings declined by over 55%, or $117 million compared with their value in February 2007. I believe the Compensation Committee's approach of paying a significant portion of the annual bonus in stock with vesting and holding restrictions accomplished our goal of aligning Mr. O'Neal's interests with the long-term financial interests of shareholders.

In each of the years that Mr. O'Neal received a stock bonus award, the Compensation Committee and the Board followed the process I described at the beginning of my remarks. In each of those years, Mr. O'Neal's compensation reflected

the Company's performance against pre-established goals, its results compared to key competitors, and the compensation of key industry peers.

Mr. O'Neal's departure after 21 years with the Company

In October of 2007, in accordance with the terms of our stock and benefit plans, Mr. O'Neal already was entitled to retirement treatment because of his age and length of service with the company. The benefit plans in which Mr. O'Neal participated are generally broad-based plans, and he participated on the same terms as all other employees. The terms of these plans were written to be fair to the broad Company employee population. Because the Board never entered into any type of employment contract with Mr. O'Neal, it retained the flexibility at the time he left to determine that he would not receive a bonus for 2007 and that no severance would be paid to him.

Mr. O'Neal joined the Company in 1986, 21 years ago. He met the eligibility requirements for retirement within the meaning of the Company's stock award plans before he ever became chief executive officer. Given his retirement rights, Mr. O'Neal's unvested stock and unexercised stock options continue to vest and are exercisable under the retirement provisions of the stock award plans. More specifically, the vesting of his stock grants was not accelerated in connection with his retirement, and they will continue to vest over time subject to the restrictive covenants that govern them, such as his agreements not to compete with the Company and not to solicit employees. Breach of these covenants will result in the forfeiture of the unvested stock awards. In addition, the Company did not provide Mr. O'Neal with a release of any claims that the Company may have against him.

Beyond these stock grants, the remainder of the reported amount is the $30 million attributable to the Executive Annuity Agreement, various benefits, and deferred compensation. Under the federal regulations that govern the status of the Company's 401(k) plan, the Employee Stock Ownership Plan and the Retirement Accumulation Plan, employee balances are protected from forfeiture by the Company for any reason.

The deferred compensation plan, representing compensation Mr. O'Neal previously earned in 1997 and 1998 and irrevocably deferred by him to be received after retirement, is protected in a similar way by New York state law.

The only benefit plan in which Mr. O'Neal participated that was not broad-based is the Executive Annuity Agreement. Since 1991, the Company has provided Executive Annuity Agreements to the Company's chief executive officers. Messrs. Schreyer, Tully and Komansky, the three chief executive officers prior to Mr. O'Neal, all have similar agreements. These agreements were drafted as a retention device to reduce the possibility that the CEO would leave the Company prematurely without the approval of the Board. The agreements provide for supplemental retirement payments to be made to the former chief executive officer after he retires based on pay levels in prior years, length of service at the Company and age at retirement. The annuity payment is reduced by any other Company funded retirement benefits. The agreement requires the Company to pay supplemental retirement payments to Mr. O'Neal if he retires after age 55, with the approval of the Board. After consideration of the purpose and terms of the agreement and the immediate need to stabilize the Company and transition to new leadership, the Board concluded that it would not be in the Company's best interest to assert that Mr. O'Neal's departure was anything other than a retirement within the meaning of the agreement.

Conclusions

I would like to conclude by saying that I realize that many Americans have difficulty in understanding how compensation in the range of Mr. O'Neal's can be justified. On the other hand, it is important to understand that the compensation he earned over his long career in an industry in which executives and top producers are well paid, stemmed from tangible results and the need for the Company's compensation to be competitive with that of comparable companies in its industry. During Mr. O'Neal's first five years as CEO, he provided strong and decisive leadership during a phase of significant restructuring, repositioning and growth for the Company. Although his legacy

is marred by the deep losses in very specific parts of our business, the overall health and vitality of the rest of the Company's global franchise is due in large part to the strength of leadership and direction that he provided, and Mr. O'Neal's compensation from 2002 to 2006 reflected those results. In 2007, when tangible results were not delivered, Mr. O'Neal lost his job and received no bonus and no severance.

In developing separation arrangements for Mr. O'Neal the Board acted in the best interests of the Company's shareholders. In all years, the Board followed an established process in compensating Mr. O'Neal. It is a process that was designed to adhere to the best corporate governance practices. The other members of the Board and I believe we met our responsibilities honorably and appropriately.

Thank you for providing the Company with this opportunity to explain our process and decisions, and I will do my best to answer any questions you may have.

Chairman WAXMAN. Thank you very much, Mr. Finnegan. Mr. Mozilo.

STATEMENT OF ANGELO R. MOZILO

Mr. MOZILO. Chairman Waxman, Ranking Member Davis, and members of the committee, you have invited me here today to participate in a hearing on issues related to CEO compensation and severance arrangements against the backdrop of our pending sale to Bank of America and the ongoing housing crisis.

The current crisis is very serious, and homeowners, both subprime, more recently prime borrowers, are suffering from rapidly declining home prices. The primary cause for increasing delinquencies and foreclosures is that for the first time since the Great Depression, there's a nationwide deterioration in single family real estate values combined with now increasing unemployment.

First, I would like to address your specific questions related to both my compensation and the exaggerated reports concerning my severance. I am receiving no severance or change of control payments whatsoever. I waived any and all severance, in addition canceled the consulting agreement included in my contract. In total, I gave up $37.5 million which under my contract I was to receive upon the closing of the Bank of America transaction.

During my 40-year career with Countrywide, I invested in the pension plan and participated in a 401(k). In some years I had deferred parts of my compensation and at various times I have been awarded stock options. None of these are severance. All were earned over a 40-year period of service. I waived my severance benefits because I didn't want the issue of my change of control payments to impede the important task of completing the BofA's acquisition of Countrywide, a transaction that I believe is critical for our 40,000-plus employees, our shareholders, our customers, and for our country.

Turning to my own compensation, Countrywide's board has aligned the interests of our top executives, including me, with shareholders by making our compensation primarily performance based, mainly tied to earnings per share and share price appreciation. Since 1982, through early 2007, Countrywide stock appreciated over 23,000 percent, reaching a peak market value of over $25 billion from a starting value of zero. As a result, over recent years, I received substantial income from bonuses under a formula that was approved by our shareholders on at least two occasions. Another significant portion of my compensation over the past 30 years has been in the form of stock options, options that required the price of the stock to rise above the option price before any income could be realized, thereby aligning me squarely with our shareholders. Therefore, as a stock price appreciated, the value of my personal holdings also grew in value.

Since I planned to retire at the end of my contract, which expired in 2006, and based upon the advice and guidance of my financial adviser, starting in 2004 I commenced a process of exercising options earned in earlier years. Notwithstanding these sales, today I remain one of the largest individual shareholders with approximately 6.5 million shares in vested options. In short, as our company did well, I did well, as did our shareholders. But when our

company did not do well, like in 2007, my direct compensation and the value of my holdings declined materially, which is as it should be.

My experience is not unlike many other American CEOs. I co-founded Countrywide 40 years ago. We started with less than five employees. I literally put up all the money that I had both saved and borrowed to start Countrywide. In these last 4 decades, I have devoted my life to building a mortgage banking company that focused on extending home ownership opportunities to all Americans, including minority families who had been largely left behind by traditional mortgage lenders.

I am very proud of the home ownership opportunities that Countrywide has provided for over 20 million families, and I am equally proud of the 39 years of success that we have had as a company. But there's no question that the past 6 months have been horrific for many of the homeowners that we served, for our shareholders and certainly for our employees.

In my 55 years in the industry, this by far is the worst housing crisis I have ever seen, combined with an unprecedented collapse of the credit and liquidity markets. I want to underscore, however, what is perhaps the most important goal going forward is to keep families in their homes. Although subprime loans never exceeded more than 10 percent of our business, at Countrywide we have substantially enhanced our efforts to assist financially distressed homeowners to keep their homes, particularly those who are facing loss of income, a personal tragedy, and no longer have the safety valve of stable or increasing home prices.

In 2007 we helped more than 81,000 families avoid foreclosure, completed more than 50,000 loan modifications, and refinanced more than 50,000 subprime borrowers into prime or agency eligible loans. In addition, we committed $16 billion to a home retention initiative focused on providing assistance to subprime borrowers facing rate resets. We have played a leading role in the HOPE NOW alliance and have partnered with over 40 home ownership counseling agencies around the country, including NACA and ACORN.

I am concerned that the recent tightening of underwriting criteria has potentially gone too far. For the housing market to recover, underwriting guidelines need to strike a better balance between providing borrowers with access to loans and lenders and investors with the assurance that these loans will be repaid. Families should be given the opportunity to own a home, and they, not speculators, should be the beneficiaries of the current lower housing prices.

Finally, my greatest concern as I come to the end of my 55 years in providing home financing to families living out their dream of home ownership is that the reaction to current events will take us back to the early 1990's when minorities and lower income families did not have the opportunity to own a home and that the disparity between white and minority home ownership will again widen.

I believe that Countrywide is a great only in-America story. My immigrant grandfather was right when he told me that he came to America because anything is possible in this great country. I hope and trust as we come through this difficult time that at the end

of the day the unbridled ability of one to achieve and succeed irrespective of their heritage will remain a cherished American hallmark. Thank you very much.

[The prepared statement of Mr. Mozilo follows:]

Testimony of Angelo Mozilo

Before the Committee on Oversight and Government Reform

March 7, 2008

Good morning Chairman Waxman, Ranking Member Davis, and Members of the Committee. My name is Angelo Mozilo, and I am a founder and Chief Executive Officer of Countrywide Financial Corporation, the nation's largest single family residential mortgage originator and servicer. You invited me to participate in a hearing on issues relating to CEO compensation and severance arrangements against the backdrop of the ongoing housing crisis. This housing crisis is real and many homeowners are hurting, and later I will describe some of the steps our company is taking to be part of the solution.

COMPENSATION AND SEVERANCE

I will begin by giving you the facts about my compensation and my decision to give up my severance. My personal experience as a CEO is unlike that of many other American CEOs. As a founder of the company, I was not brought in to serve as the CEO of an existing major enterprise, nor did I start out as an employee of an established company and then work my way up. My partner and I created our Company in 1969 sitting in the kitchen of his small, New York apartment. We shared a dream to create the first national mortgage banking company focused on

providing homeownership opportunities to all Americans, including families who had been largely left behind by traditional mortgage lenders. I raised the $100,000 I needed to help start the company by using all of my assets which amounted to $25,000 and borrowing the rest.

That was just about forty years ago and for the last four decades, I have devoted my life to building from the ground up a mortgage banking company focused on providing homeownership opportunities to all Americans. We are the nation's largest lender to white as well as minority homeowners in virtually every major metropolitan area in the country. I am proud of the homeownership opportunities Countrywide has provided for more than twenty million Americans. I am also proud of the 39 years of success our company has had, and while the last 6 months have been the most challenging in our history, I am certain that the company will return to its leading position in the market, particularly as part of the Bank of America family.

With respect to Countrywide's compensation philosophy, the Board has adopted a compensation policy that aligns the interests of top executives with shareholders by making compensation largely performance based. That philosophy guided my compensation. From 1982 through April 2007, our stock price appreciated over 23,000 %. As a result, earlier in this decade, I received substantial income from

performance based bonuses earned under a formula based on earnings per share. This bonus formulation was approved on at least two separate occasions by the company's stockholders.

Over the years, a significant portion of my compensation was in the form of stock options rather than cash. As the stock appreciated, the value of my own holdings also increased in value. In December 2004, in consultation with my financial advisor as we prepared for my retirement, I exercised a number of outstanding options, a significant number of which were about to expire, and sold the underlying stock pursuant to plans established with the advice of counsel. Notwithstanding these sales, today I remain one of the company's largest individual shareholders, because I believe in Countrywide.

In short, as our company did well, I did well. But when the company last year experienced the unanticipated and unprecedented seizing-up of the capital and credit markets, we suffered a loss for the first time in 30 years. As a result, my direct compensation and obviously the value of my own Countrywide stock holdings declined substantially, which is as it should be. I have not received, and will not receive, a bonus for 2007 or 2008.

In recent years, the issue of executive compensation and severance pay has been a focus of governance experts, regulators, the media and the general public. In my case, there have been reports that I stood to collect $115 million in severance.

While those numbers were grossly exaggerated, I have voluntarily elected to forego the specific severance payments that had been included in my contract in the event of a transaction like the one with Bank of America. As I reported in a press release, upon completion of the Bank of America transaction, I will give up approximately $36.4 million in severance payments, and an additional $1.1 million in future consulting fees and other perquisites, for a total amount foregone of approximately $37.5 million. I will continue to receive my pension, which accrued over my almost 40 year career with the company, as well as several prior years' earned compensation which I had voluntarily deferred. Neither constitutes severance, and both would be payable to me on my retirement, whether or not the company entered into a transaction with Bank of America or any other entity.

I voluntarily gave up these benefits because I did not want this issue to detract from, or in any way to impede, the important task of completing the Bank of America transaction, one that I believe is critical for our employees, our shareholders, our customers and the economy in general.

HOUSING CRISIS

Mr. Chairman, I would now like to turn my attention to the current housing crisis. The foreclosure and default problems in general are due to the decline in housing values caused by an unprecedented series of economic shocks to the housing and capital markets. No single entity or industry sector is responsible for the collapse in housing prices. It is the lack of liquidity and credit tightening resulting from the seizing of the credit markets that has cut off buyer demand.

I have spent 55 years of my life in this industry, and this is the worst housing market I have ever seen. People are hurting, businesses and their employees are hurting, indeed the whole economy is hurting. The reasons for this crisis are many and complex. Like Federal Reserve Chairman Bernanke observed, this housing crisis has many fathers. In my testimony, I'm going to provide, with the benefit of hindsight, my perspective on what has occurred. But first I want to underscore what for me personally is perhaps the most important goal going forward, namely to keep as many people as possible in their homes. In that effort, Countrywide has been a leader.

WHAT COUNTRYWIDE IS DOING TO HELP

At Countrywide, we have enhanced our efforts to help financially distressed homeowners keep their homes. In 2007, we helped more than 81,000 families

avoid foreclosure, including making more than 55,000 loan modifications that adjust the loan terms to provide long term affordability. In addition, in 2007 we refinanced more than 50,000 of our subprime borrowers into prime loans.

In addition to our own efforts, we have played a leading role in the industry's Hope Now Alliance, and we have partnered with over 40 homeownership counseling agencies around the country, including the Homeownership Preservation Foundation and Neighborworks. We also recently announced two groundbreaking initiatives with leading non-profit community housing organizations – the Neighborhood Assistance Corporation of America (NACA) and ACORN.

Our efforts include:

- In October 2007, we announced a $16 billion home retention initiative focused on providing assistance – whether in the form of refinancing or loan modifications – to subprime borrowers with hybrid adjustable rate mortgages. This effort is backed up by an outbound calling initiative to reach out to such borrowers.
- Also in October 2007 we signed a groundbreaking agreement with NACA to help more borrowers stay in their homes. Under this program, NACA will work with Countrywide borrowers who come to NACA for assistance to develop an effective plan to remain in their homes. Options available include payment plans, loan modifications, and loan restructuring. Once a plan is developed, it will be submitted to Countrywide for approval and implementation of the workout plan.
- On February 11 this year we announced an agreement on home retention best practices with ACORN, one of the nation's largest housing and community organizations. The agreement will extend the reach of our earlier workout programs (a) to borrowers with all kinds of subprime loans, not just those with

hybrid ARMS with pending rate resets; and (b) for borrowers in various stages of mortgage delinquency, not just borrowers who are current. Solutions include refinancing borrowers into prime loans, where possible, and loan modifications that can include offering a five-year extension of a borrower's interest rate prior to the reset, capitalizing arrearages, a temporary interest rate freeze or an interest rate reduction.

- In addition, we are a founding member and active participant in The HOPE NOW Alliance and Project Lifeline initiatives. Through HOPE NOW and Project Lifeline, the industry and non-profits are reaching out to borrowers well before their rates reset to devise solutions to help keep borrowers in their homes, whether through loan modification or freezing interest rates. In addition, we are aggressively reaching out to seriously delinquent borrowers to help them save their homes, including offering a 30-day pause on foreclosure so that borrowers can work with a lender to save their home.

Beyond these activities, I and others from the company have met with the leaders of Congress and the Administration urging that prompt steps be taken to inject as much liquidity as possible into the market so that more credit can start to flow and we can begin to right the imbalance between supply and demand in the housing market. For example, I have urged that the Fannie Mae and Freddie Mac loan limits be increased. I appreciate that such a provision was included in the stimulus package recently passed by Congress. But it is equally important for this increase to be implemented as soon as possible to create much needed liquidity in the residential mortgage market.

There are other ideas being discussed both on Capitol Hill and among regulators. We are strong proponents of aggressive action, and stand ready to work with

public officials and the various constituents within our industry in advocating for and implementing programs that will help solve this crisis. The truth is that the last thing we ever want is for people to lose their homes. Our core commitment is to put people in homes and to keep them there. We only do well when our customers do well. It just never serves our company to make a bad loan.

THE COUNTRYWIDE STORY

Now let me step back for a moment and provide a short focus on Countrywide itself. When we started the company we believed that the only opportunity most lower and middle-income families had to create savings for their children's education, for starting or enhancing their own businesses and for providing for their own retirement was by owning a home and building equity in that home.

Initially, Countrywide originated only FHA and VA loans and over time we became the nation's largest originator of such loans. In the mid 1970s, when Fannie Mae and Freddie Mac were permitted to purchase conventional loans and ultimately to guaranty securities for such loans, we became a major lender in that sector as well. In the late 1970s, we started focusing intensively on the idea of lowering financing costs by bringing technology into what was historically a pen and paper process, and, as a result, we became known as the most technologically advanced mortgage provider in the industry.

By the early 1990s, the government had recognized the obvious truth that our housing finance system was leaving major segments of society behind. In 1992, a landmark study by the Federal Reserve Bank of Boston made it clear that there were systemic underwriting issues relating to the treatment of African American and Hispanic borrowers. Policymakers called upon the mortgage industry to change their practices and redouble their efforts to better serve minorities and underserved communities.

While many in the industry discounted the Boston Fed study as flawed, at Countrywide, we stepped up to the challenge by creating our affordable lending initiative known as "House America." It began in 1992 with a goal to provide $1.25 billion in home loans to low- and moderate-income and minority families. That commitment was met, revised and extended several times, and in 2004, the company set a target of $1 trillion in lending to the underserved during the first decade of the 21st Century – at the time the largest such corporate commitment of its kind. To date, we have met $850 billion of that goal, and we remain committed to beating the goal by 2010.

With the mission of extending homeownership in mind, I gave a speech in February 2003 – the Dunlop Lecture to the Joint Center for Housing Studies of Harvard University – in which I talked about steps we need to take to lower

barriers for low-income and minority borrowers. I talked about the "money gap," noting that down-payment requirements of, say, 10 percent, present one of the biggest barriers to this population, but add no real value to the quality of a loan. What matters is the willingness and ability of a borrower to make monthly payments. I also said that we must make the whole process easier to understand and reduce the documentation needed for loans as well as the time needed to approve and close loans. And I also noted the importance of providing more flexible underwriting standards, because I believed that some elements of the traditional, automated standards effectively disqualified people who were in fact good candidates for homeownership.

Fundamentally, steps of this kind were positive, opening the door to homeownership for millions of people who previously would have been shut out. As I stated above, over Countrywide's almost 40 year history, we have made more than 20 million loans and amassed a loan servicing portfolio of $1.5 trillion. And significantly, during the entire history of Countrywide's loan production activities, less than 1 percent of our total loan production has resulted in completed foreclosures.

THE SUBPRIME AND NON-TRADITIONAL LOAN MARKET

For Countrywide, subprime lending has always constituted a relatively small part of our business, exceeding an annual rate of 10 percent only once. While, given our size, this still represents a significant portion of the subprime market, the share of our lending that is subprime is about half the industry average, and generally over time, between 75% and 80% of Countrywide's subprime production has been in the top two tiers of subprime lending quality. Our experience with subprime products had demonstrated that such loans provided a path to improved credit and/or more sustainable credit for the subprime borrower. Between 2000 and 2006, 80% of our subprime borrowers refinanced within 36 months of loan origination (interestingly, this number is approximately the same for ARM and fixed rate borrowers). For these subprime refinances, of those homeowners who stayed with Countrywide, 50% received a prime loan, and 25% refinanced into a fixed rate subprime loan.

It is interesting to note the views expressed by Chairman Bernanke in May of last year:

> The expansion of subprime mortgage lending has made homeownership possible for households that in the past might not have qualified for a mortgage and has thereby contributed to the rise in the homeownership rate since the mid-1990s. In 2006, 69 percent of households owned their homes; in 1995, 65 percent did. The increase in homeownership has been broadly based, but minority households and households in lower-income census

> tracts have recorded some of the largest gains in percentage terms. Not only the new homeowners but also their communities have benefited from these trends. Studies point to various ways in which homeownership helps strengthen neighborhoods. For example, homeowners are more likely than renters to maintain their properties and to participate in civic organizations. Homeownership has also helped many families build wealth, and accumulated home equity may serve as a financial reserve that can be tapped as needed at a lower cost than most other forms of credit.

Non-traditional mortgages such as pay option ARMs also played an important role in assisting borrowers with home purchases and helping them manage their finances. It is important to note that the Pay Option is not a new product and was not invented by Countrywide. In fact, the product has a long and positive history in California. The product offered borrowers lower rates than comparable fixed rate loans, while providing banks and thrifts with a variable rate mortgage asset that they could hold in portfolio without taking undue interest rate risk. The product performed well for nearly two decades, and gained broader acceptance in both the primary and secondary markets during the run-up in home prices earlier this decade. The product helped borrowers qualify for mortgages in a rising interest rate and home price environment by providing lower interest rates and a variety of payment options that borrowers could use to match their monthly payments to their changing economic situations.

At Countrywide, we began offering the Pay Option ARM in 2001 as a portfolio product for our recently-acquired bank. Our Pay Option loans were made only to prime borrowers with high credit scores and generally higher incomes and were underwritten to the fully amortized rate. As both interest rates and home prices rose at a rapid clip at the peak of the housing boom in 2005, a higher proportion of borrowers at Countrywide and at other lenders began to choose the Pay Option ARM for its affordability benefits.

As the product became more popular with borrowers, Countrywide took steps in 2006 to enhance the initial disclosures of both the risks and benefits of the Pay Option ARM. The company also enhanced its monthly statements to better highlight for borrowers the options available and the impact of minimum payments on the borrower's loan balance. These changes were made in advance of subsequent disclosure enhancements required by the federal banking regulators.

THE CURRENT HOUSING CRISIS

Recently, we have seen an historic crisis in the housing market. The reasons are complicated and there are obviously differing views, but here, with the benefit of hindsight, is mine. Starting in 2002, after the Federal Reserve Board

implemented a series of post 9/11 interest rate cuts to stimulate the economy, low rates and reasonable housing prices combined to produce a housing boom. Home builders couldn't build fast enough, housing prices rose briskly, and speculators played an increasing role in driving the market.

In June 2004, however, the Fed commenced what turned out to be 17 consecutive interest rate increases. The combination of increasing interest rates and higher home prices initially prompted a still higher spike in demand, as many borrowers rushed to buy homes for fear of getting priced out of the market.

In the short term, builders kept on building and homeowners continued to put homes on the market, thereby increasing supply while demand shrank, resulting in lower home prices. When prices began to decline, it took an important safety valve away from borrowers in financial distress. As borrowers have an interruption in their earnings – typically the result of a disastrous life event, such as the loss of a job, serious illness or divorce – and their homes are suddenly worth less than their mortgages, they no longer have the option to refinance or quickly sell at a profit. In addition, as prices began to decline, the real estate speculators, who view the property merely as a financial investment and not as their home, simply walked away from their properties and their loans.

These factors, all stemming from the decrease in housing values across the country, resulted in an increase in defaults, confirming the statement former Fed Chairman Greenspan made in February of this year: "Unless we stabilize the price level of homes, you're going to continue to get loss estimates from banks and other financial institutions." And until we can provide liquidity to the consumer so that they can enter the home buying process, we will have further deterioration in real estate values and further increases in defaults and foreclosures.

Meanwhile, the secondary market, which had purchased many of these mortgages, lost its appetite for these loans. Eventually, the credit rating agencies sharply downgraded their earlier high ratings of many mortgage backed securities, and the credit markets abruptly seized-up so that mortgage lenders were unable to access the credit they needed to make new loans. This seizing-up of the capital and credit markets impacted Countrywide directly, reducing our ability to raise money for new loans.

The problem that we face today was unanticipated and is much more severe than any cycle in the past because not only did we have a sudden decline in home purchases but, at the same time, the liquidity that feeds the mortgage market

deteriorated. The complete collapse of the secondary market for non-Fannie Mae or Freddie Mac mortgages combined with the downgrades by the rating agencies of existing mortgage backed securities sharply curtailed the availability of mortgage credit.

Making things still worse, the psychology of homebuyers went from wanting to get a home quickly before prices went higher to wanting to delay purchases in the belief that prices would fall still further. That reversal of psychology and the severe lack of liquidity for mortgage loans continues to weigh heavily on the market and has caused many mortgage lenders, large and small, to be driven from the market.

Much blame has been leveled lately at the variety of products, such as adjustable rate mortgages. Before the onset of the current housing crisis, these products were widely offered by industry because they made homes more affordable for more people and helped homeowners consolidate other, more expensive debt. In fact, adjustable rate mortgages had been popular with both borrowers and lenders for many years. From my perspective, then, the issue is not so much the products, but the housing market.

It bears noting that no one predicted the severity and force of the housing market downturn that followed. Recall that we have not seen an extended downturn in housing prices across the nation since the Great Depression, but we are experiencing this phenomenon today.

Foreclosing on a mortgage hurts everyone—it hurts the homeowners who would prefer to stay in their homes, it hurts the community and it hurts lenders. However, of greatest concern is the impact on the families that see their personal financial world at risk. This is why Countrywide remains committed to initiatives to help borrowers avoid foreclosure and stay in their homes.

Homeowners experiencing difficulties in making their mortgage payments should reach out to the company servicing their mortgage. At Countrywide, we have over 3,000 employees dedicated to helping those in need. While we are calling and writing in our effort to reach people, I urge those Countrywide borrowers who need assistance to call our Home Retention Division. We have learned that some people do not want to talk to their mortgage servicer when they are having problems. Accordingly, any one who would prefer to deal with a third party not affiliated with their lender should call such organizations as ACORN, the Housing Preservation Foundation, NACA or Neighborworks. In addition, we recently delivered a postcard to every Member's office with critical contact information for

Countrywide Home Retention division, ACORN, NACA, as well as the members of the HOPE NOW Alliance to help you and your staffs assist your constituents.

Over the years, the men and women who worked for Countrywide have dedicated their lives to helping millions of Americans realize the American Dream of homeownership. For many families, the equity in their home provides the best chance to achieve the things all of us want for our families: to send our children to college, to start a business, to provide a leg up when our kids start their own families, to have some resources to meet the challenges of growing old. I am proud of what our company has done to be a part of that.

But these are difficult times for many homeowners. I am extremely concerned that the recent tightening of underwriting criteria across the entire industry has gone too far. For the market to recover, underwriting guidelines need to strike a better balance between providing borrowers with access to loans and lenders and investors with the assurance that these loans will be repaid. This is a time when families, not speculators, should be the beneficiaries of lower housing prices. Now is the time for industry and Congress to work constructively together to take the kind of aggressive action needed to revitalize the housing and housing finance markets. For example,

- The Federal Reserve should continue to ensure that there is sufficient liquidity in the markets;
- Congress should consider enacting the following legislative solutions to preserve and increase homeownership:
    - FHA reform legislation;
    - Expansion of tax-exempt mortgage revenue bonds for both home purchases and refinancings; and
    - Tax credits for first-time homebuyers;
- Federal regulators should take the following actions:
    - Quickly implement higher FHA and GSE loan limits;
    - Further expand FHA to facilitate refinancing for borrowers whose home values have declined;
- Industry should take the following steps to address the housing crisis:
    - Remove remaining impediments to loan workout transactions that provide better solutions to investors and borrowers than foreclosure;

- Redouble efforts to combat fraud and eliminate undisclosed speculative housing purchases; and
- Work with community groups and local housing officials to ensure the efficient maintenance and resale of foreclosed homes.

We at Countrywide are doing our best to be a leading part of the solution and look forward to working with others in business and government to do still more.

In crafting solutions, we should make certain that we maintain a robust home finance market for all Americans. My greatest fear as I come to the end of my 55 years in providing home financing to families living out their dream of homeownership is that the reaction to current events will take us back to the early 1990's when minorities and lower income families did not have the opportunity to own a home of their own, and that the disparity between white and minority homeownership will again widen.

Finally the current crisis can be reversed if we seek ways to structure underwriting guidelines so as to lower the barriers to entry to mortgage finance and to continue to encourage capital to flow into the single family mortgage market. It is most unfortunate that because of current conditions, legitimate borrowers are unable to buy homes the values of which have become much more affordable. But instead, speculators are again rushing to the market to capitalize on the expanded

foreclosure inventory. This is a time when families should be given the opportunity to own a home, and they should be the beneficiaries of depressed housing prices, rather than the speculators. I also want to strongly suggest that traditional guidelines be reexamined relative to the appraised value of a home versus the outstanding mortgage so that current borrowers can refinance at lower interest rates irrespective of the fact that the value of the home is at or below the mortgage amount. Loan to value ratios should not be an unreasonable impediment. The FHA, VA, GSEs and the bank regulators should be able to accommodate this situation until we get through this crisis.

Thank you.

Chairman WAXMAN. Thank you very much Mr. Mozilo. Mr. Snyder.

STATEMENT OF HARLEY W. SNYDER

Mr. SNYDER. Chairman Waxman, Ranking Member Davis, members of the committee, my name is Harley Snyder from Valparaiso, IN. I spent my entire adult life in the real estate business and related real estate industries. I am a director of the National Association of Realtors and served as president of that association in 1983. I'm a member of the Board of Countrywide Financial Corp., and I currently serve as the lead director and Chair of the Compensation Committee.

The committee has asked me today to discuss the compensation and severance of Countrywide CEO Angelo Mozilo. Let me first reinforce from a board perspective the comments made by Mr. Mozilo. The Board understands that a significant number of borrowers across the country are finding it increasingly difficult to keep their homes in the current economic environment. Countrywide is committed to being the leader in the effort to help as many of those borrowers as possible keep their homes. The Board is fully supportive of the steps taken by the company management to significantly increase our own efforts to help and to work with the community groups, government and others in our industry to assist homeowners.

I will in the short term, with the short-term 10-month contract, I would like to begin discussion of that. The Board negotiated with Mr. Mozilo in 2004. Mr. Mozilo had an employment agreement that was set to expire in February 2006. The contract expired at the end of February because the company's fiscal year end was previously the last day of February. After the company changed its fiscal year, the Compensation Committee, which at the time I was a member of though not the Chair, thought that it made sense to have the expiration date of the contract changed as well. As such, the Board asked Mr. Mozilo to postpone his anticipated retirement from full-time CEO duties for approximately 10 months. Given our objectives and the short-term duration of the extension, we reached a conclusion that the most practical and appropriate business approach was to simply extend the contract on the same underlying economic terms and conditions. These terms included an incentive bonus program that was tied to the earnings per share performance of the company which was consistent with a program structure that had previously been approved by the shareholders on at least two separate occasions. The Board also awarded Mr. Mozilo additional payment in consideration of his agreeing to contract extension and postponing his retirement.

The Compensation Committee was advised by the Pearl Meyer consulting firm during these negotiations. On the specific question of extending his contract at the existing economic terms, we further sought and received an opinion from the executive compensation consulting firm of Hewitt Associates.

When the contract extension was signed, we expected Mr. Mozilo would retire as CEO in December 2006. It turned out that during that year the Board determined that the company would be best served by having Mr. Mozilo continue as CEO rather than retiring

as he had planned. By then the individual that we thought would succeed Mr. Mozilo as CEO had left the company. Accordingly, we once again asked Mr. Mozilo to postpone his retirement.

As with many companies the Board's compensation philosophy had continued to evolve to reflect changes in compensation practices and norms. During the 2006 negotiations, we made significant changes to Mr. Mozilo's contract. We substantially reduced the guaranteed portion of Mr. Mozilo's cash compensation by decreasing his base salary from nearly $2.9 million to $1.9 million annually. The new contract also included provisions that would require that certain return on equity and net income targets be met before he would be eligible to receive an annual bonus. A maximum cap was also added to the bonus payout, and a portion of the annual equity-based award was made in restricted stock instead of stock options.

These restricted stock units contain new performance-based requirements that provided that the stock units would not vest unless the company achieved an annual return on equity of 12 percent or greater. The balance of his equity award was paid in stock appreciation rights, which by design have a built-in performance component as they have no value unless the company's stock price increases. As with the earlier contract, we believe that this aligned Mr. Mozilo's interest with that of the shareholders.

I would point out that our bonus formulations, which had produced bonuses for Mr. Mozilo for the years the company was highly profitable, resulted in no bonus for 2007. That was the only time in the last 30 years in which the company suffered an annual loss.

Finally, the contract negotiations between Mr. Mozilo and the Compensation Committee took place against the backdrop of significant and sustained achievement by the company and a broad recognition throughout the business community that Angelo Mozilo's tenure as CEO had been a remarkable success. This is reported in the general business press, where Barron's hailed Mr. Mozilo as one of the world's best CEOs, or Fortune, which had headlined an article on the company, "Meet the 23,000 Percent Stock." This was also recognized in the banking and mortgage communities, which honored Angelo with American Bankers Lifetime Achievement Award.

Recently, Mr. Mozilo made the decision independently to voluntarily forego severance payments that he would have been entitled to receive under his contract in the event the Bank of America transaction closes. That was his decision. And the Board simply entered into an agreement with Mr. Mozilo to implement his decision.

Mr. Chairman, that concludes my remarks, and I stand prepared to the best of my ability to respond to your questions.

[The prepared statement of Mr. Snyder follows:]

Written Testimony of Harley Snyder

Before the Committee on Oversight and Government Reform

March 7, 2008

Chairman Waxman, Ranking Member Davis, and Members of the Committee. My name is Harley Snyder and I am a businessman from Valparaiso, Indiana. Many years ago, when I returned from active duty in the United States Army in 1954, I joined my father's small real estate company. After a few years, I assumed the running of that company. That company grew to become four real estate oriented companies with approximately 250 employees. I am also active in a number of other businesses and organizations in Indiana. I am a director of the National Association of Realtors and served as President of the Association in 1983. I have been a member of the Board of both Countrywide Bank and Countrywide Financial Corporation and I currently serve as the lead director and chair the Board's Compensation Committee.

The Committee has asked me to discuss the compensation and severance provisions of the employment contract of Countrywide's CEO, Angelo

Mozilo. I am happy to do so. Before I do so, however, let me first reinforce from a Board perspective the comments made today by our CEO. The Countrywide Board understands that a significant number of borrowers across the country are finding it increasingly difficult to keep their homes in the current economic environment. Countrywide is committed to being a leader in the effort to help as many of those borrowers as possible keep their homes. The Board is fully supportive of the steps taken by company management to significantly increase our own efforts to help and to work with community groups, government and others in our industry to assist homeowners.

To give you some history and perspective, I will start with a short term, ten-month contract extension that the Board negotiated with Mr. Mozilo in 2004. During 2004, Mr. Mozilo had an employment agreement that was set to expire in February 2006. The reason the contract expired at the end of February was that the Company's fiscal year end was previously the last day of February. After the Company changed its year end, the Compensation Committee, of which I was a member at the time,

though not the Chair, thought that it made sense to have the expiration date for the contract changed as well. As such, the Board asked Mr. Mozilo to postpone his anticipated retirement from full-time CEO duties for approximately ten months. Given our objectives and the short term duration of the extension, we reached the conclusion that the most practical and appropriate business approach was to simply extend Mr. Mozilo's contract on the same underlying economic terms as his existing contract. These terms included an incentive bonus program that was tied to the Earnings per Share performance of the Company. This EPS bonus program structure had been specifically approved on at least two separate occasions by the company's shareholders. The Compensation Committee was advised by the Pearl Meyer consulting firm during these negotiations. On the specific question of extending his contract at the existing economic terms, we further sought and received an opinion from the executive compensation consulting firm of Hewitt Associates. Mr. Mozilo was separately represented in these negotiations by his personal attorney.

As I mentioned earlier, when the contract extension was signed, we expected Mr. Mozilo would retire from the CEO position in December, 2006. It turned out that during that year, the individual we thought would succeed Mr. Mozilo as CEO had left the company. As a result, it was the Board's judgment that retaining Mr. Mozilo as CEO for an additional three-year term was in the best interests of the company and the shareholders, and would allow for an orderly transition to a new successor. We once again asked Mr. Mozilo to postpone his retirement

As with many companies, the Board's compensation philosophy had continually evolved to reflect changes in compensation practices and norms. During the 2006 negotiations, one of our objectives was to examine the structure of Mr. Mozilo's compensation package and make any necessary adjustments in his new contract. The Compensation Committee was advised, with respect to both the overall compensation philosophy and the specifics of Mr. Mozilo's new contract, by Mr. Ross Zimmerman, an executive compensation consultant who was a partner at Hewitt Associates and then at ExeQuity. Mr. Zimmerman was an

independent consultant who reported to, and worked exclusively for, Countrywide's Compensation Committee. During these negotiations Mr. Mozilo was separately advised by his personal attorney and also worked with Towers Perrin, an executive compensation consulting firm hired by Countrywide's management, to assist in the alignment with the company's benefit plan and his evaluation of the proposal. The roles of both ExeQuity and Towers Perrin were disclosed to our shareholders.

After reviewing the contract with Mr. Zimmerman, we made some important changes. These changes included a significant reduction in the guaranteed portion of Mr. Mozilo's cash compensation by reducing his base salary from nearly $2.9 million to $1.9 million. Mr. Mozilo's new contract also included provisions that would require that certain return on equity and net income targets be met before Mr. Mozilo would be eligible to receive an annual bonus. A maximum cap was added to the bonus payout. Other important changes were made to the equity-based awards. A portion of the annual equity-based award was made in restricted stock units instead of stock options. These restricted stock

units contained new performance based requirements that provided that the stock units would not vest unless the Company achieved a return on equity for the year of 12% or greater. The balance of his equity-based award was paid in stock appreciation rights which, by design, have a built in performance component as they have no value unless the Company's stock price increases.

As with the earlier contract, we believed that this aligned Mr. Mozilo's interests with that of the shareholders. I would point out that our bonus formulations which had produced bonuses to Mr. Mozilo for the years the company was highly profitable resulted in no bonus for 2007. That was the only time in the last 30 years in which the company suffered an annual loss.

Historically, the contract negotiations between Mr. Mozilo and the Compensation Committee took place against the backdrop of significant and sustained achievement by the Company and a broad recognition throughout the business community that Angelo Mozilo's tenure as CEO had been a remarkable success. This was reported in the general

business press such as in Barron's which hailed Mr. Mozilo as one of the "World's Best CEOs" and Fortune which headlined an article on the company, "Meet the 23,000% stock." This was also recognized in the banking and mortgage communities which honored Angelo with the American Banker's Lifetime Achievement Award.

Recently Mr. Mozilo made the independent decision to voluntary forego severance payments that he would have been entitled to receive under his contract in the event the Bank of America transaction closes. That was his decision, and the Board simply entered into an agreement with Mr. Mozilo to implement his decision.

I am happy to respond to any questions you may have.

Chairman WAXMAN. Thank you very much, Mr. Snyder, and all of you. We are going to now start with questions and we're going to do 12 minutes controlled by the chairman and 12 minutes controlled by Mr. Davis.

I will start off first.

Mr. Mozilo, and Mr. Snyder, I want to ask you about Countrywide. It is the largest mortgage lender in the Nation, and it is the company most identified with the mortgage crisis. Both you in your roles as CEO and board member have an obligation to act in the best interests of your shareholders. But I am having a difficult time reconciling that issue with Mr. Mozilo's compensation.

In October 2006, for instance, before the mortgage crisis erupted, Mr. Mozilo filed a stock trading plan, and this plan allowed him to sell 350,000 shares per month. Over the next few months, Mr. Mozilo revised his plan twice. In December he amended his plan so that he could sell 465,000 shares per month. And then on February 2, 2007, Mr. Mozilo increased his stock sales to 580,000 shares per month. That was the same day that Countrywide's stock hit a record high of $45 a share.

In total, I believe Mr. Mozilo sold 5.8 million shares for $150 million between November 2006 and the end of 2007.

Does that sound right to you, Mr. Mozilo?

Mr. MOZILO. Congressman, I don't know the number. As I stated in my verbal remarks, the goal was to reduce my holdings because of my retirement. I ended up with 6½ million shares. We were trying to sell half the holdings, so it may be around that number.

Chairman WAXMAN. Mr. Mozilo, you had good timing because Countrywide's stock has fallen nearly 90 percent since you amended your stock trading plan. But what is most unusual about these sales may be that they occurred at the same time that Countrywide decided to spend $2.5 billion to buy its stock back. Countrywide didn't have enough money to buy back the stock, so it actually borrowed $1.5 billion to finance the stock repurchases. The stock buyback plan appeared to have a significant effect on Countrywide's stock. The plan was announced on October 24, 2006, when Countrywide's stock was selling at $37.33. By February, Countrywide's stock had increased in value to $45 a share.

Mr. Mozilo, help me understand why these stock sales were in the best interest of shareholders. You were using shareholder and borrowed money to buy back Countrywide's stocks and keep the price up, at the same time you were selling your own personal shares. How did this help the shareholders?

Mr. MOZILO. Well, first of all, I would like to frame it the way it was. As I stated in my verbal remarks, I started in 2004 with the pending 10b(5–1) plans and reason why I went that route rather than selling all the stock at once, as I could have, was to continue to stay in line with the shareholders because those plans required the shares be sold over a period of time and some of the numbers that you noted.

If one was to take advantage of the situation, they would sell the stock all at once, rather than over a period of time. I wanted to stay in line with the shareholders. So that began back in 2004. That was shares that I had held for over 10 years, options that I

held over 10 years, that were expiring. So the first group of options had to be sold, otherwise they would go worthless.

I would be happy to provide this to the committee. There is absolutely no relationship between the buyback of stock and my sale of options, exercise buys and sale of stock, no relationship whatsoever. Again, if one was to do that, they would just take advantage of that event and sell all the stock at one time. And of course the result of that had ended up not selling a significant amount of shares with the stock severely depressed.

Second, the buyback of stock was a process that went on for well over a year. It was a proposal made by our Treasurer and our CFO, and the question was what to do with our capital. We are a company for 30 some odd years that was a user of capital and never accumulated it. We invested it in our own business, a servicing business. We came to the point where the company was exceedingly profitable, generating capital, and the question in any company is what is the best use of that capital? How do you provide the greatest return to the shareholders? The buyback of that stock was designed to increase return on equity for our shareholders. There is a variety of ways of doing it. And you can replace that type of capital with borrowings. That happened some time ago. I am not familiar with all of the mechanics that we went through. But the purpose of it was to benefit the shareholders and increase the return on equity.

Chairman WAXMAN. I want to ask you to look at what happened. It was an absolute disaster for Countrywide and its shareholders because Countrywide's stock fell through the floor after February 2007. It is now worth only $5.20 per share and in fact the stock price has dropped 87 percent since its peak. We don't have exact figures, but it looks like Countrywide's shareholders lost almost all of the $2.5 billion the company spent on repurchasing shares when you were selling stock.

Mr. Snyder, our investigation has shown that it wasn't just Mr. Mozilo who was selling shares during this time period. It was also the board members. One board member exercised 228,000 options between November 2006 and June 2007, making almost $7 million. In fact, you sold yourself 170,000 shares in 2006 for more than $6 million. And you sold 20,000 shares in December 2006 during the stock buyback, earning more than $800,000.

How were those sales in the best interests of the shareholders?

Mr. SNYDER. Mr. Chairman, the shareholders had the same opportunity to sell their stock as we had. Our stocks were sold, my stocks, like Mr. Mozilo's, were sold under a 10b51 plan under a prearranged selling order that you state that when stock reaches a certain price which is prearranged, pre-set, that is when the stock is sold. In fact, I think as you pointed out, Mr. Chairman, that I sold stock at a price in November, December 2006. Had I waited until February, I could have sold it at a substantially higher price.

Chairman WAXMAN. Mr. Parsons and Mr. Finnegan, I understand that Merrill Lynch and Citigroup have different policies on this issue. You have taken steps to prevent executives from selling shares without approval. You require your CEOs to obtain the ap-

proval of the General Counsel before altering their stock trading plans.

Mr. Parsons, if the CEO of Citigroup proposed to sell $150 million worth of stock at the same time Citigroup was engaged in a massive stock buyback, would this raise any red flags for you?

Mr. PARSONS. Well, Mr. Chairman, as you've pointed out, we have procedures in place that would first flag it, second, cause counsel to opine on it, and perhaps more importantly to your question—I didn't address it in my opening remarks, it is in my statement, but Mr. Prince addressed it in his opening remarks—we have a stock ownership requirement that would probably preclude the CEO, such as Mr. Prince, from doing just what your question implied; namely, all senior officers and all board members have to retain during their term of service at least 75 percent of all of the equity compensation that they received over the course of the years they have worked for the company. So unless someone has literally billions, they wouldn't be in a position to move on that level of stock that you just indicated.

But beyond that answer, what we would do, I am sure, is we would consult with counsel, we would consult to understand the reasons, and we would make a judgment based on the facts as we found them then.

Chairman WAXMAN. And you would do that to protect the shareholders, isn't that the whole idea?

Mr. PARSONS. And the process. And the process, if you will. Because frequently appearance is equally important with substance and reality.

Chairman WAXMAN. Mr. Finnegan, you are a board member at Merrill Lynch. I am going to ask you the same questions.

Would this kind of transaction raise a red flag for you?

Mr. FINNEGAN. Let me echo Mr. Parsons' remarks first. The fact is that we have stock retention requirements, so it would be purely hypothetical. Mr. O'Neal never had that kind of stock holdings that Mr. Mozilo had such that he could have been selling $150 million worth of stock and complying with our stock retention requirements. Like at Citi, if Mr. O'Neal wanted to sell stock, he would have come to the Compensation Committee, and we would have talked to the General Counsel, and it would have required approval. Again the magnitude here, because of the difference in stock holdings, really, you know, isn't—wouldn't have been relevant at the time.

I also think that I have no reason to believe nor do I have any reason to believe our board members would see anything inconsistent with selling stock when you are doing a stock buyback. Stock buybacks are put in place, they are generally considered very investor friendly. Investors like to see them. They improve earnings per share, they improve return on equity. We wouldn't necessarily make any decision on a proposed stock sale because we are in a stock buyback situation.

Again, the issue there would be magnitude; is it within the rules, and what would the perception be. And we would consult with General Counsel on the matter and make a decision.

Chairman WAXMAN. Here is the problem I have with stock sales. Mr. Mozilo and Mr. Snyder seem to be saying two completely in-

consistent things. You tell the shareholders that Countrywide's stock was undervalued and a great investment for the company and its shareholders to make, the reason for them to buy the shares. But when you acted in your personal capacities, you were selling millions of shares. And that doesn't speak well of your faith in the company's stock.

I would like to hear you respond to that.

Mr. MOZILO. Mr. Chairman, I was with the company 40 years. I was going to retire. Almost all of my net worth was in Countrywide. I had come to a point on diversifying my investments, my assets, and at that point came to 2004, and I consistently followed that plan. It was my belief that every time I set the plan in place, one, it is not my belief, it is fact, that the shareholders knew exactly what I knew. I set them in place after earnings were announced and any plans were announced. They were aware of the buyback. They were aware of earnings in the previous quarter. And our projections for the ensuing years demonstrated that we were going to increase capital because the company was doing extremely well throughout that whole period of time.

Chairman WAXMAN. I think the reason Mr. Parsons indicated it might not look good is the whole example of what happened with Enron. Because with Enron, they were selling the stock, the executives were selling the stock, and they often had knowledge that no one else would have, and I think all of this is still being investigated. But the appearance is not a good appearance if you are telling the shareholders it is a good investment to buy the stock for the corporation at the same time you are selling the stock to benefit yourself at that higher price.

Mr. MOZILO. I think again the investors, who are mostly institutions, made the decision to buy or sell the stock based upon the information we provided. I never asked anybody to buy the stock. Nor did I ask anybody to sell the stock. We presented our performance, we had a 30-year performance of no losses.

Chairman WAXMAN. Well, my time here has expired. But I must say your timing is awfully good for yourself but not particularly for some of the other shareholders.

Mr. Davis.

Mr. DAVIS OF VIRGINIA. Let me just say this is not an Enron situation. This is a 10b51. This is in fact to protect people. Enron was insider trading. I was a general counsel for a public company before I came to Congress and I just have a different bent and understanding of this.

Longstanding law is under a case that goes back almost a century, the *Dodge Brothers* v. *Ford Motor Company*. Corporations exist to make money for their shareholders. That is law. That is your fiduciary duty. It is not other. All of these executive compensation packages, to my understanding, were negotiated in accordance with guidelines outlined by the Business Roundtable.

Mr. Parsons, is that true in the case of Mr. Prince?

Mr. PARSONS. Well, sir, it happens to be true that our practices and procedures are congruent with the Business Roundtable. I think we got there first. I think we actually got there before they did.

Mr. DAVIS OF VIRGINIA. That's fine. I admit some people may not like the Business Roundtable, but I think that is kind of definitive in terms of the gold standard.

Mr. Finnegan, were yours in accordance with—did you look at the compensation package with Mr. O'Neal?

Mr. FINNEGAN. Yes, sir.

Chairman WAXMAN. Is it also congruent?

Mr. FINNEGAN. Yes, sir. Again, we developed our own practices, but I would say they are largely congruent with the Business Roundtable.

Mr. DAVIS OF VIRGINIA. I am trying to understand that this was not some kind of special deal that you had worked out. This is normal business practice, that is—Mr. Snyder, is that the same in this case?

Mr. SNYDER. Absolutely true.

Mr. DAVIS OF VIRGINIA. So as I understand these packages, when the company does poorly the CEO also takes a hit. It costs the CEO money because their compensation goes up, the stock price goes up, it goes down, stock price goes down, a lot of their compensation is in shares. Shareholders' price rise, they do well. Shareholders, including unions' pension funds, State employee pension funds, retirees, global investors, stock prices going up, CEO is compensated, nobody is complaining at this point. And if they do, the shareholders have an avenue for doing that, don't they, through the annual shareholders meeting and election of directors?

Mr. SNYDER. Yes.

Mr. DAVIS OF VIRGINIA. Isn't that the way it works, in my understanding?

Mr. SNYDER. Yes.

Mr. DAVIS OF VIRGINIA. Not unlike, by the way, movie stars or professional athletes who will negotiate a deal and if they have a bad year—like down here in Washington we have seen a lot of bad professional athletes' deals where they are over—Albert Bell comes to mind—$14 million for sitting on the bench all year and you are stuck with it. And in this case I don't think anybody was given a bonus for this, but their compensation, as I understand it, was basically preordained under their deals. And some of the money that they got was basically what they had accumulated through the years in deferred compensation.

Mr. Parson, is that correct basically?

Mr. PARSONS. In the main, sir. In the case of Mr. Prince, there was in fact a bonus component to his separation. I won't call it severance. At the time of his separation we had to make a calculation as to what, if any, bonus Mr. Prince would be entitled to for the year 2007. We made a judgment, but that judgment was consistent with your earlier stated principle that when the shareholders don't do well, the executives don't do well and his bonus was basically leveraged off of the loss of value of shareholders.

Mr. DAVIS OF VIRGINIA. What troubles me about it is the focus here where if you take a look at the whole subprime mortgage market, there was so many different components and you are a very small piece of this. You can look at the mortgage lenders. You can look at the appraisers. You can look at the Fed itself in some statements they made praising this as an innovative avenue to be able

to get people with lower incomes home ownership. You can look at the rating agencies. It is hardly confined to your corporations in particular. And, in point of fact, if your CEOs had made nothing during this time, I don't think it would have saved one home or any decisions would have been different. That is what—that is my understanding of what I take away from this hearing.

But I am going to yield the balance of our time to Mr. Issa.

Mr. ISSA. I thank the gentleman. You know it is amazing. This is a hearing in search of, you know, bad guys. And I have listened so far to the chairman and to the ranking member, and I am just trying to see one more time, are there bad guys in front of me? And I am not seeing it.

Mr. Prince, you had a substantial piece of skin in Citibank. Are you completely out today?

Mr. PRINCE. No, Congressman.

Mr. ISSA. How much skin do you still have in Citibank? How many shares do you still own approximately that are subject to the performance of the company you were so critical in for so many years?

Mr. PRINCE. I own about a million shares. And except for a few shares I sold in 1999 I haven't ever sold any shares.

Mr. ISSA. So the fact is you were aligned with the performance of an organization, did the best you could to make it succeed.

Mr. Parsons, I am going to ask you because you undoubtedly interacted with former Treasury Secretary Robert Rubin, who is I believe still a board member who certainly enjoyed Mr. Prince's performance because he made about $17.3 million, according to our figures, as a result of his board membership and stock appreciation. But more importantly, I understand that at the time Mr. Prince offered his resignation, Bob Rubin was saying, "don't let him go, we need him at the helm"; isn't that roughly true?

Mr. PARSONS. My recollection.

Mr. ISSA. OK, so here we have somebody who did a great deal of good, got caught up in what is an implosion, and one of the most respected people, at least to us here on the dais, and somebody who understands the bigger financial picture was fighting to keep him and keep him for a reason, which was the future of Citibank. So I don't see a villain here. I would like to. I would like to find somebody I could blame for the meltdown of home mortgage values and actually home mortgages. I don't see it there.

Mr. O'Neal, you were 2 decades with your company. Do you have stock left in Merrill Lynch?

Mr. O'NEAL. Yes, including stock that I own plus options, approximately 2.8 million shares.

Mr. ISSA. And every time the stock goes down a buck, you lose $2 million on paper.

Mr. O'NEAL. Yes, Congressman.

Mr. ISSA. So you have always had skin in the game in your 21 years plus affiliated with Merrill Lynch?

Mr. O'NEAL. That is correct.

Mr. ISSA. Now isn't it true that roughly—and these figures may not be accurate—roughly 20 percent of the stock owned by Merrill Lynch is owned by the most sophisticated possible group, and that is the brokers and employees of Merrill Lynch?

Mr. O'NEAL. I think that is approximately correct.

Mr. ISSA. OK. Mr. Finnegan, I will go to you. I am going to assume that the employees, stockbrokers, people particularly in the retail end at Merrill Lynch, they are going to be very active in the upcoming board decisions and so on, but this was a sophisticated group that understood 10b5s, understood open periods and closed periods and understood the underlying value of institutional paper, is that right?

Mr. FINNEGAN. I think that would be fair to say.

Mr. ISSA. So unless we want to blame all our individual brokers and everybody whose skin was in this, 40 percent of it, in addition to Mr. O'Neal's, we are not going to find a villain today at Merrill Lynch. OK.

Mr. Mozilo, you are an interesting case because the company of Countrywide and you are one and the same. You are the most recognized person here relative to a tremendous success story. I want to put in perspective, though, because they are talking about, you know, these figures over $100 million that they quote you got out. Let me ask a couple of questions. If I put, let's say, $10,000 in in 1982 into your company, my figures show that I would have made $230 million when I sold that stock the same day that your 10b5 allowed you to sell. Is that right roughly?

Mr. MOZILO. USA Today did an article on that.

Mr. ISSA. OK, so what we are talking about is a man at the helm 40 years building a company, and the $10,000 put in when you went, when you served your company and Microsoft started, and I would have gotten $230 million for my $10,000 after 40 years, I think that is more than inflation. So I have a hard time seeing the dollars you got for your stock.

But let's go into something, and my colleague will probably pick it up more because he is a Financial Services Committee member, but 10b5, as I understand it—Mr. Snyder, I am going to sort of go to you a little bit—10b5 is an instrument designed to protect the stockholders and to cause sales made, particularly during not open periods, to be arm's length. Isn't that right?

Mr. SNYDER. Absolutely, Congressman.

Mr. ISSA. And the open periods, if either one of you, that occurred at Countrywide, were they typically the 7 to 10 days or a little longer often in which there was no reason to close the trading window?

Mr. SNYDER. I'm sorry, Congressman?

Mr. ISSA. In other words, is your quarterly "open to sell periods" that occur in public companies, do you happen to know, Mr. Mozilo, do you know, did you typically have an open period every quarter?

Mr. MOZILO. We had an open period. I don't know the extent of the open period, but I know that our counsel advised me within 3 days after our earnings announcement where everything was known to do it then.

Mr. ISSA. Right. That is the best, the sweetest part of an earnings announcement because there is nothing that hasn't been said.

Mr. MOZILO. That's correct.

Mr. ISSA. And if you had sold 3 days after your announcements, each of these, all the sales that were being made, if you will, under the scheduled 10b5, if you had sold them on those days, would

there have been, to the best of your knowledge, any substantial difference in how much you would have received if you had simply sold them during your open periods?

Mr. MOZILO. If I had just sold it then without engaging in a 10b51, yes, it would have been substantially higher because the last 10b51 came to zero, as the stock dropped, because I would not sell under $28 a share. That was built into my 10b51.

Mr. ISSA. I don't know if I am the only one here but I know I am the only Member of Congress that is on a public board and have availed myself of 10b5s on behalf of my foundation in the past. These are part of a public process. There is transparency on those very filings and on each of the subsequent sales that occurs, isn't that right?

Mr. SNYDER. Yes, sir.

Mr. MOZILO. That's right.

Mr. ISSA. Mr. Mozilo, either you or people on your behalf in the company, every time one of these sales occurred didn't you typically find institutions calling to inquire to do their due diligence of how many, why were these sales made, not just as to you, but as to any executive with potential inside information?

Mr. MOZILO. They were, and as a result of that we continuously made my plans public so at least they understood the plans were in existence, that I had no control over the sales, because again my choice was to sell all of it at once. I could have done it at $45 a share. I chose not to. I chose to keep it, to stay with the shareholders and do it over a period of time.

Mr. ISSA. I am looking at three corporations here in which you all had skin in the game, you all still have skin in the game, you all suffered the losses, all of you complied with the transparency rules and the best practices rules, all of you—and I am not trying to defend you. I would make you the victims if I could possibly blame the meltdown on you. I really would love to do it. It would make it easy on us because we wouldn't be culpable—you had exercised exactly the types of things we asked for in transparency and yet we are putting you here today and asking you why you were so foolish as to agree with Greenspan and Bernanke and continue selling these products that ultimately we are now saying led to a meltdown of subprime.

Mr. Chairman, I look forward to finding out if there is actually something wrong here. So far, Mr. Chairman, you certainly have not found it.

Chairman WAXMAN. Gentleman's time has expired. Mr. Yarmuth.

Mr. YARMUTH. Thank you, Mr. Chairman, and I want to thank all the witnesses for being here. This is a rare opportunity to have what I think what anyone would call giants in American business. And I think there are some questions here that really are larger than what any of your individual situations might present. I understand Mr. Davis' comment about athletes performing poorly and still being paid and other analogous situations, but I think we are dealing with a totally different picture here, and so I would like to broaden it slightly because we have had evidence of those of you who had losing years in your companies still being compensated

very generously and severance packages that are outside the comprehension of most Americans.

But there is a bigger picture that I think concerns my constituents, many of them and many people throughout the country, because they look at the enormous salaries, and I am not referring to any one of you specifically, and I will reiterate that no one is accusing any of you of doing even anything unethical not to speak of illegal, but when we see a situation in which corporate executives make tens of millions of dollars for enhancing stock price and at the same time we see layoffs of 3,000 employees, we see companies moved overseas, we see plants closed and companies merged and jobs ended in this country, we see an income picture nationally in which over the last 5 or 6 years all of the income growth in this country has gone to the top 5 percent of the population and none to the remaining 95 percent, and you all know the numbers in terms of disparity of executive salaries versus employees salaries and how that has gone over the last few decades from a factor of 30 times to now pick a number, 400, 500 times are various estimates. So my question is all of you have had experience with Compensation Committees and some of you are on them.

When you meet in these Compensation Committees, is there any discussion of the impact that your decisions have on essentially consumer attitudes about the relative value of what you are paying your executives and what the average worker in your company makes, what that does to employee morale, what your impact on communities might have if you tie compensation to stock performance, which often means that you close plants and sever jobs. I want to know from those of you, Mr. Prince, Mr. Parsons, Mr. O'Neal, if these type of conversations take place, or is this all about how you enhance the executive salaries and executive compensation? Mr. Prince, you want to deal with it first?

Mr. PRINCE. I will, Congressman. You are raising very important and significant societal issues, and I would say that there was a trend perhaps 10, 15 years ago to broaden the base of consideration to what were called stakeholders, communities and so forth. And there was a great deal of controversy at the time about that subject and whether or not decisions should be made in the interest of entities other than stockholders. You are raising that question again.

I believe it is fair to say that today the standard of corporate governance pretty much focuses people on what is best for stockholders; that is to say, the holders of capital are the ones who are favored in these decisions. And it is, I think, a very fair and appropriate question to raise as to whether or not that focus ought to be broadened to communities and so forth.

Mr. YARMUTH. Thank you. And if I could get somebody else to respond. I just want to add one thing, and now when we are dealing with companies, $30 billion, so forth, it is not a small matter because the impact can be society wide, as it may have been in the mortgage situation, more than just on one small company or one community. Mr. Parsons, would you like to respond?

Mr. PARSONS. Well, the specific response to the question asked was yes. We in the Citigroup Compensation Committee actually discussed the very question that you are raising. Where is the balance point? How do we remain competitive without contributing to

something that could be tearing at the fabric of society? So, yes, we do discuss it, and essentially our guideposts are—as Mr. Prince indicated, our job is to make sure we have the talent that can manage and move forward this giant globally leading enterprise, and in so doing, we have to be competitive with what it takes to get that talent, and we have to orient it toward pay for performance.

But the thing that, the back end of your question, the thing that is going through my mind, when you say how do you balance this against the reaction of the masses, we are a market economy. And essentially what we do is we look to the market to make those judgments as to where the balance has to be. You have to be competitive. You have to be in the marketplace. And my own impression is that with all its flaws, the market economy still works best out of all the models we have out there to look at and to choose from.

I didn't know all these stories when I showed up this afternoon, but Mr. Prince is the first college graduate in his family. Mr. O'Neal is the grandson of a slave. Mr. Mozilo is the son of an immigrant who founded the company 40 years ago. These are American stories and it is because the market works. It has imperfections. We try and moderate and mitigate them, but we look to the market for our primary source of input in terms of what is competitive.

Chairman WAXMAN. Thank you, Mr. Yarmuth. Your time has expired.

Mr. McHenry.

Mr. MCHENRY. Thank you, Mr. Chairman. I serve on the Financial Services Committee, so I follow these issues pretty substantially. I have read numerous stories about many of you that are here before us today. And there is a question that this today is about CEOs' profits and their performance in the marketplace. So I would like to ask about another market driven connection between profit and performance.

Several articles have been written about a hedge fund manager named John Paulson who bet against borrowers in housing market. He actually made a bet that the housing market would go down. In return for that financial bet he has netted out $3 to $4 billion in 1 year, which is regarded, and many sources would refer to that, as the largest individual gain in Wall Street history in any 1 year.

Now here is a hedge fund manager who bets against the interests of the American economy, who bets against growth, in fact bets against all you gentlemen here before us today and the companies you represent, much less individual homeowners. What is also interesting is a connection between Mr. Paulson and a group called Center for Responsible Lending.

Mr. Paulson gave them a $15 million gift in order to encourage them to advocate for more restrictive lending practices when it comes to the mortgage industry; in particular, forcing public policy that would force, allow bankruptcy judges to cram down the value of mortgages. So therefore companies like your former companies would lose more money under this proposition, therefore he would receive more benefits, Mr. Paulson would receive more financial gain in this matter.

Now I am curious to know your thoughts on this matter, especially you, Mr. Mozilo, with your long history in the mortgage in-

dustry, your leadership on these innovations, and especially this idea that you have someone who funds advocacy in order to undermine the American economy and home ownership. Would you comment on that?

Mr. MOZILO. Well, Congressman, in my verbal comments, I talked about my deep concern as to what is happening with respect to the underwriting of loans today. I have spent my life trying to lower the barriers of entry for Americans to own homes because I think that is what drives families and drives neighborhoods and drives communities and drives this country, and to the extent that these restrictions now relative to underwriting has materially impacted the ability of low and moderate income and minorities to own a home, this kind of action you are talking about—I didn't know anything about Paulson. I know another Paulson, but it is not the same person—that it is discouraging to me. You know, the capitalistic system when not abused is a wonderful system, but when abused it is terrible. And I was unaware of this hedge fund and what it did and the contribution to the nonprofit, the alleged nonprofit to impact underwriting.

The problem we face is, and again in my remarks I stated it is the deterioration of value of homes. As values were going up, we had no problem. We had no delinquencies and no foreclosures because people had options, because people run into three things in their lives generally, loss of job, loss of marriage, loss of health. When that happens, and they own a home, and it impacts their income, they generally have a way out, sell the house, refinance, do something. That equity that they have in the homes is virtually wiped out, and that is what is exacerbating this whole foreclosure problem.

I think it is despicable for people to play on the troubles of others. In fact in Countrywide's case one of the most disturbing things is that we have not individuals who are calling to try to take advantage of these low priced homes now, but speculators accumulating dollars. It is horrible.

Mr. MCHENRY. My time is wrapping up here. Can you just answer yes or no. Do you profit by people losing their homes?

Mr. MOZILO. By the billions of dollars that we have written off, the answer is clearly no.

Mr. MCHENRY. Mr. O'Neal, did your firm profit by people losing their homes?

Mr. O'NEAL. Clearly, no.

Mr. MCHENRY. Mr. Prince, did your firm?

Mr. PRINCE. Absolutely not.

Mr. MCHENRY. Let me ask the Compensation Committee Chairs here a question, simple yes or no answer. Mr. Parsons, Mr. Finnegan, Mr. Snyder, do you seek to pay your CEOs—let me ask this way. Do you try to get the best performance with the least amount of cost to your shareholders when you hire executives? Meaning, do you seek to pay them a lot more for bad performance or do you seek to get the best performance with the least amount of costs?

Mr. PARSONS. The latter, sir.

Mr. MCHENRY. Mr. Finnegan.

Mr. FINNEGAN. Yes, sir. We clearly seek to pay for performance and to pay no more than the market would demand.

Mr. MCHENRY. Mr. Snyder.

Mr. SNYDER. Clearly the latter.

Mr. MCHENRY. So clearly the idea is you get the largest value per shareholder as possible, therefore the initial understanding of this hearing, the initial premise of this hearing is false, that you actually are trying to do the best interests for your shareholders.

Thank you for testifying.

Chairman WAXMAN. Gentleman's time has expired.

Mr. Welch.

Mr. WELCH. Thank you, Mr. Chairman. I want to thank the members of the witness panel and congratulate each of you for the successes you have had in your career. I have a few questions.

Mr. Prince, when you were chief executive, was one of your principal responsibilities having a risk management model to protect the assets of your company?

Mr. PRINCE. Yes.

Mr. WELCH. And did you have a risk management model that forecast what would be the upside and downside for the bank plunging into the subprime market?

Mr. PRINCE. With all due respect, Congressman, we didn't plunge into the subprime market. But clearly our risk model did not forecast what happened.

Mr. WELCH. Now my understanding is Goldman Sachs in fact dodged the bullet and perhaps as a peer to folks at Goldman Sachs you could perhaps, with, the benefit of reflection, tell us what decisions they made that in retrospect might have been good for the CEO at Citi to have made to protect asset value?

Mr. PRINCE. Well, Congressman, that is a good question. Alone among the major participants on Wall Street, Goldman Sachs, as you say, seems to have dodged the bullet. So it is not simply the one-on-one comparison.

Mr. WELCH. Does that suggest that at least for some what happened was foreseeable and it was possible to take action to avoid it, the consequences——

Mr. PRINCE. I really don't know, Congressman. You'd have to ask the people at Goldman. They're not here today.

Mr. WELCH. Mr. Parsons, you had different executives at high levels making different decisions based on a risk assessment. And my question is, first of all, is it, as chair of the Compensation Committee, your view that one of the principal responsibilities of the chief executive of a company—and, of course, you were a chief executive of one of our major American companies—to manage risk of shareholders' assets?

Mr. PARSONS. To oversee the maintenance of a risk-management function, and particularly in a financial services institution, yes, that's an important responsibility.

Mr. WELCH. And with respect to some of these—risk management would include that, if you are going to extend credit, that you would have an assessment of the credit-worthiness of the borrower, which is not a moral term, it's an ability-to-repay term, correct?

Mr. PARSONS. Yes. Now, this is a much more, as you know, Mr. Congressman, nuanced problem than the question implies, because

there are people who make the initial lending judgment and then those instruments get rolled into other instruments.

But, as a general proposition, a financial services institution ought to maintain, and Citi did maintain, a very robust risk-management process.

Mr. WELCH. I'm having a little trouble with how nuanced it is.

First of all, there's plenty of blame to go around with the subprime crisis—a lot of failures in government, in the regulatory agencies, all around. So this is not just about the gentlemen who are at the table. But there's an immense amount of suffering.

But capitalism oftentimes gets in the worst trouble when it can't regulate itself, and restraint gets thrown out the window most often when a lot of money is to be made.

But what's happened here with the compensation is that some did get it right. Goldman Sachs did get it right. And they're in the same business that each of you are in, and that is making money for the long term. Yet the folks who made decisions, in retrospect, wish they made different ones and received pretty generous compensation packages. And I think that's the disconnect that a lot of us are feeling.

So I just want to go back to you, Mr. Parsons. You are a very respected person in the world of finance and in corporations, and you've served with great distinction on many boards. And I know you take all this seriously.

What happened to focusing on an assessment of risk when loans that were being extended were no money down, no requirement that you show ability to pay, no closing costs? It was essentially, to a consumer, this pot of gold where they might be able to buy a home that they never were able to have. But, clearly, whether you originated the loan, as was the principal job at Countrywide, or you packaged and then sold those loans on the secondary market, what happened to the obligation to make a hard-headed risk assessment?

Mr. PARSONS. Well, the obligation, Mr. Congressman, that's a large and important question, and probably worthy of a hearing like this before another panel. What happened? Because, clearly, it was a systemwide failure, right? If the only financial services player that anyone can identify who dodged this bullet——

Mr. WELCH. I'm going to interrupt. It is a systemwide—and I want to stipulate that we all, every institution, the government, the Fed can be held accountable for its share of the blame. But each of us in our own areas of responsibility, if you're the CEO of a company, if you're on the Compensation Committee, you've got to focus on your share. And it's not helpful to say that it's just systemwide. We're asking what you could do as a CEO, what one could do as the chair of a Compensation Committee.

Mr. PARSONS. As was pointed out, I think by the chairman or, if not, by the ranking member, you're asking an accountability question. And as you know, each of the CEOs who were running companies that hit this iceberg, in his own way, has taken accountability, had accountability imposed on him.

And what we're doing now at Citi is we're going back and we're reworking the entire risk-management, risk-assessment process.

Because while we had one and we thought it was robust, we, as an institution, missed this pitch.

Mr. WELCH. All right. Thank you.

Chairman WAXMAN. The gentleman's time has expired.

Mr. Cannon.

Mr. CANNON. First of all, I would like to apologize to the panel. I've been in the other room listening, to some degree, but this is a hearing that normally we don't have on a Friday. We appreciate your being down here. And rather than going home, I decided to stay, because I think these issues are very important. But I had other things I needed to attend to. So I would ask your forgiveness for not being here through the whole hearing.

And let me also add that I am very proud to be sitting here with such a distinguished panel of people who run the country, who run the business of the country, at least some of the important businesses of the country. And I've followed your careers in business publications, and I want to thank you for coming down here and taking your time.

We had a hearing yesterday where Mr. Chertoff was asked to have his staff stand up, and a couple of our members of the committee pointed out that he only had white men working for him. And it was a big issue that actually didn't really relate to much. But I make that point to say that you guys on this panel are an amazing panel, because what you represent is the selection of the best. We're not here—color, background or circumstances in which you were born is not what got you where you are. It's competency over a long period of time. And that is because, in the market, for capability, capable leadership, you all have emerged.

And it seems to me that one of the problems with this hearing is that it has a tendency to attack people who succeeded rather than—and blame people when there's a market. What I hope young people in America, who may see or may not see this, take home is that the opportunity to be a leader is great and the compensation is really great. And so there's an incentive to be assiduous and work and in developing the skills that you all have.

Now, I would like to just—if any of you have—I have some questions I want to ask, but if any of you have something you'd like to say that you haven't had the opportunity to say yet, I'd like to give you that opportunity.

Thank you. Let me ask Mr. Finnegan a couple of questions, then.

Mr. Finnegan, you've said that most of what Mr. O'Neal left with was represented by stock awards earned in prior years which vested over a period of time. What was the committee's objective in making such a substantial portion of the awards in stock? And did it, in fact, work?

Mr. FINNEGAN. I think the committee's objective in making a substantial portion of our annual incentive award was two-fold. One was, because the stock vested over a number of years, it was a retention device. And second, it was to establish a congruence of interest with the shareholders, so that while the award related to the current period, the actual ultimate dollar amount payable to the executive was a function of future stock performance.

I think it worked very well. I mean, in Mr. O'Neal's case, for a number of years, he benefited from the fact the stock went up after

receiving the award. But in 2007, when Merrill Lynch stock declined precipitously, he suffered an economic penalty which probably today is about $125 million.

Mr. CANNON. So that the $161 million he took out, none of that was a severance bonus?

Mr. FINNEGAN. Out of the $161 million Mr. O'Neal took away as part of his departure, all but $30 million of it—we had $130 million of it essentially related to prior stock period awards based on previous awards, $5 million was deferred comp and retirement plan benefits to which he was entitled, and $25 million was a supplemental executive retirement plan payment.

Mr. CANNON. So the vast bulk of that was the result of the increased value in stock that Mr. O'Neal was a principal factor in creating.

Mr. FINNEGAN. All of the $161 million related to prior period performance and all were amounts to which Mr. O'Neal was entitled as a retirement-eligible employee.

Mr. CANNON. Let me get one more question in, while I still have some time.

On page 17 of the majority's supplemental memo, the majority states that, "The biggest decision the board made upon Mr. O'Neal departure was his decision to allow him to retire rather than to terminate him for cause." That's quoting the majority's supplemental memo.

Is that true? In fact, let me just drop a couple of questions——

Mr. FINNEGAN. That was the determinant decision, as it relates to Mr. O'Neal's package as he left. For Mr. O'Neal to have forfeited the bulk of his awards, which were the stock awards, we would have had to terminate him for cause.

The provisions related to cause in Mr. O'Neal's agreement—and it is the same provisions as it relates to all executives at Merrill Lynch, with respect to the stock awards—are very specific and basically cover misconduct, not unsatisfactory future financial performance.

Mr. CANNON. Thank you.

Chairman WAXMAN. The gentleman's time has expired.

Mr. CANNON. I yield back, Mr. Chairman.

Chairman WAXMAN. We have several other Members who want to ask questions in 5-minute rounds. But let me ask if any of you need a break, a little recess? Don't be embarrassed.

OK. If not, then we're going to continue.

Ms. Norton.

Ms. NORTON. Thank you, Mr. Chairman.

First of all, I want to thank all of you for agreeing to testify today.

At this hearing I have been perhaps as interested, maybe even more interested, in the role of the board and the Compensation Committees, because, after all, they're the agents of the shareholders of the pension plans of the institutional investors, and they have a very specific fiduciary duty.

Mr. Snyder, you are a member, you were a member of the Compensation Committee when Mr. Mozilo began his discussions, his contract discussions in 2006, were you not?

Mr. SNYDER. I was a member of the Compensation Committee, ma'am.

Ms. NORTON. It's in that role that I want to question you.

Countrywide hired a compensation consultant—that does seem to me to be regular order—Ross Zimmerman from Exequity to help advise them on the compensation package. Now, the committee has documents that show that Mr. Zimmerman recommended to reduce Mr. Mozilo's compensation to bring it in line with his peers—in other words, that Mr. Mozilo was overpaid.

At that point, a competing consultant was brought in. John England from Towers Perrin was hired by Countrywide. First, it's important to try to establish who John England worked for, believed he was working for, and, for that matter, who Mr. Mozilo believed he was working for. Of course, in today's paper, Towers Perrin is quoted as saying he was working for the company. But the documents do not seem to indicate that or that Mr. Mozilo thought that.

Mr. Mozilo, let me quote from an e-mail you wrote, October 15, 2006, to Countrywide's general counsel, "approximately 2 weeks ago, the head of the Compensation Committee and I agreed that it would be best if I obtained a compensation consultant. Since that time, I brought in John England, consultant of Towers Perrin."

Your e-mail, Mr. Mozilo, says that Mr. England was brought in to serve as your consultant. Isn't that correct? I mean, isn't that what those words seem to mean?

Mr. MOZILO. You know, I'd like to just give a little background on that. The Compensation Committee asked me to bring in someone to assist. The memo clearly is confusing, you know, in retrospect. I had been familiar with Mr. England from another life. I asked the company if he could be hired to assist me. I asked our general counsel.

Ms. NORTON. Why was he assisting—Mr. Snyder, why wasn't he assisting you? How can Mr. Mozilo be self-dealing about his own compensation?

Mr. SNYDER. In fact, Congresswoman, the at-that-time chair of the Compensation Committee suggested to Mr. Mozilo that he hire an attorney and a consultant, or secure the services of an attorney and a consultant, to advise him in the contract discussions.

Ms. NORTON. Well, who paid for him?

Mr. SNYDER. I'm sorry?

Ms. NORTON. Did the company pay this additional consultant?

Mr. SNYDER. The company engaged Mr. England for the purposes of advising Mr. Mozilo, yes, ma'am.

Ms. NORTON. So he was advising Mr. Mozilo; he wasn't advising the company. But the company was paying, after they already paid for a compensation consultant?

Mr. SNYDER. Yes, ma'am.

Ms. NORTON. Now, I note that Mr. Mozilo's consultant proposed many, many changes—this is a consultant he brought in about his salary—many changes in the compensation package that had been recommended by the company's consultant. For example, he did not want the salary compared to the salaries paid to CEOs in medium-sized companies like BB&T and SunTrust, according to the documents we have. He wanted the salary to be based on compensation paid to the head of Goldman Sachs and Bank of America.

And he wanted Mr. Mozilo to get a $15 million sign-on equity award. Now, that's really interesting. He's a founder of the company, and he's getting a sign-on award of $15 million.

In one e-mail, this second consultant said he was unhappy with the board proposal because—oh, I'm sorry—I believe this is Mr. Mozilo, said he was unhappy with the board proposal because it did not achieve a maximum opportunity for Mr. Mozilo.

Now, look, none of this makes sense to me. I want to know how it makes sense to you, since obviously you are responsible, have a fiduciary obligation to the shareholders, which means you are trying to keep costs down. Why does it make sense, after hiring Mr. England to advise, that you then hire—I'm sorry—are hiring one consultant to advise, that you then hire a consultant for the CEO whose compensation package is at issue, pay for it to advise, and then adopt the compensation package of Mr. Mozilo's agent?

Mr. SNYDER. Congresswoman, Mr. Zimmerman was—his services were acquired by the Compensation Committee. He served the Compensation Committee. Mr. England was hired by the company to advise Mr. Mozilo.

Ms. NORTON. Yeah. And why was it more appropriate to adopt the package at considerably more expense to the company that was advised by Mr. Mozilo's agent?

Mr. SNYDER. I respectfully disagree, Congresswoman. We did not. In fact, Mr. Mozilo's annual compensation was reduced from $2.9 million annually to $1.9 million.

Ms. NORTON. It was increased above what your own consultant advised.

Mr. SNYDER. Again, I would respectfully disagree, Madam Congresswoman, because we did have support of our consultant in our proxy for the compensation package that was——

Ms. NORTON. Which consultant?

Mr. SNYDER. Mr. Zimmerman of Hewitt Associates, at that time Exequity.

Chairman WAXMAN. The gentlelady's time has expired.

But just for the record, Mr. Finnegan, is this the same Mr. England that Merrill Lynch hired to advise Merrill Lynch in setting Mr. O'Neal's compensation as CEO?

Mr. FINNEGAN. Merrill Lynch hired Mr. England I think in 2003 before I was on the Compensation Committee.

Chairman WAXMAN. Mr. Issa.

Mr. ISSA. Mr. Snyder, I just want to followup on the gentlelady's question. Were you desirous of keeping your 40-year tenured CEO for a period of time longer?

Mr. SNYDER. Congressman, the short answer is yes, but I'd like to take a moment to explain.

Mr. ISSA. Well, no, no. I'm just trying to correct her, as I really have another line.

Mr. SNYDER. Yes.

Mr. ISSA. So you were desirous of keeping him. He wanted more money. You hired someone that said less. You tried to work out the difference. You came to something amicable. And the president insisted, Mr. Mozilo insisted that it go to a shareholders' vote, if I understand these parts of the history. Is that right?

Mr. SNYDER. Typically, the chairman's compensation has always been approved by the shareholders, yes.

Mr. ISSA. OK. Again, you know, I'm looking for the villain here; I don't see it. And I want to see it if it exists. But you did have an arm's length relationship. You each were represented by their experts. You came to a common number, and the stockholders agreed on it.

Mr. SNYDER. Yes.

Mr. ISSA. OK. I apologize, but I want to move on to a couple other areas.

Mr. Parsons and Mr. Prince, I'm going to come back to you for a second, and actually Mr. O'Neal. Now, I guess, Secretary Paulson but, in 2005, then Goldman Sachs CEO was Paulson, and he earned $16.4 million, according to Forbes, for being smart enough to stay out of subprime.

And I apologize, I can't read the writing here, but Lloyd Blankfein is now the CEO, and he earned $600,000 and got a bonus of $2.7 million, because, in spite of this, it hasn't been a great year for Goldman compared to 2005.

Would you say—and I really go to Mr. Parsons and Mr. Finnegan—I mean, it sounds like Goldman has good years and people make a lot of money and, in later years, maybe they don't make as much. They link it to compensation, and even though they dodged the bullet, you don't necessarily see the guy that dodged the bullet somehow getting a big windfall, nor the guy who comes after him getting the benefit.

I mean, that happens in business. It's based on how the years are working and then how the subsequent years are working. So Goldman Sachs looks like it's following somewhat the same pattern as the other two companies. Would you say that's roughly correct?

Mr. PARSONS. As a general proposition, I would say the proposition you articulated is roughly correct. I don't——

Chairman WAXMAN. Be sure the button is pushed in.

Mr. PARSONS. I don't know the accuracy of any of the numbers that you just stated, so I can't speak to that.

Mr. ISSA. OK, and I grabbed it from Forbes, so we'll just assume for a moment that those numbers are as good as we can get.

And, Mr. Chairman, I'd like to insert into the record any corrections if we find better numbers.

I want to kind of do a recap, because this is going to be my last round here, and we'll be wrapping up soon. From what I can see here today, none of you foresaw this debacle the way apparently Goldman Sachs did. Therefore, you did not make adjustments by getting out of this market.

Two, all of the individuals here, compensation was linked to performance, I think pretty well-established. If anyone disagrees, I'd like to know it.

Three, because of the very nature of pay for performance and delay the payout to make sure, if you will, that it's not a quick blip and you run with your money, all of you received money in years that were not as good for years that were better because it was delayed. Is that correct?

So, in every case, what we're seeing is large amounts of dollars linked to a bad date, but, in fact, if we simply aligned the dollars

back to the dates of the performance in which it was earned, what we see is a curve that matches properly. Isn't that correct?

Mr. O'NEAL. That's correct.

Mr. FINNEGAN. That's correct.

Mr. ISSA. Mr. Chairman, I would like to ask unanimous consent that the economic letter from November 2007 from the Dallas Federal Reserve be included in the record, because it's very pertinent to this cycle of the Subchapter S.

Chairman WAXMAN. Without objection, that will be the order.

[The information referred to follows:]

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EconomicLetter

Insights from the
FEDERAL RESERVE BANK OF DALLAS

The Rise and Fall of Subprime Mortgages

by Danielle DiMartino and John V. Duca

Past behavior suggests that housing markets' adjustment to more realistic lending standards is likely to be prolonged.

After booming the first half of this decade, U.S. housing activity has retrenched sharply. Single-family building permits have plunged 52 percent and existing-home sales have declined 30 percent since their September 2005 peaks (*Chart 1*).

A rise in mortgage interest rates that began in the summer of 2005 contributed to the housing market's initial weakness. By late 2006, though, some signs pointed to renewed stability. They proved short-lived as loan-quality problems sparked a tightening of credit standards on mortgages, particularly for newer and riskier products. As lenders cut back, housing activity began to falter again in spring 2007, accompanied by additional rises in delinquencies and foreclosures. Late-summer financial-market turmoil prompted further toughening of mortgage credit standards.

The recent boom-to-bust housing cycle raises important questions. Why did it occur, and what role did subprime lending play? How is the retrenchment in lending

activity affecting housing markets, and will it end soon? Is the housing slowdown spilling over into the broader economy?

Rise of Nontraditional Mortgages

Monitoring housing today entails tracking an array of mortgage products. In the past few years, a fast-growing market seized upon such arrangements as "option ARMs," "no-doc interest-onlys" and "zero-downs with a piggyback." For our purposes, it's sufficient to distinguish among prime, jumbo, subprime and near-prime mortgages.

Prime mortgages are the traditional—and still most prevalent—type of loan. These go to borrowers with good credit, who make traditional down payments and fully document their income. Jumbo loans are generally of prime quality, but they exceed the $417,000 ceiling for mortgages that can be bought and guaranteed by government-sponsored enterprises.

Subprime mortgages are extended to applicants deemed the least creditworthy because of low credit scores or uncertain income prospects, both of which reflect the highest default risk and warrant the highest interest rates. Near-prime mortgages, which are smaller than jumbos, are made to borrowers who qualify for credit a notch above subprime but may not be able to fully document their income or provide traditional down payments. Most mortgages in the near-prime category are securitized in so-called Alternative-A, or Alt-A, pools.

Some 80 percent of outstanding U.S. mortgages are prime, while 14 percent are subprime and 6 percent fall into the near-prime category. These numbers, however, mask the explosive growth of nonprime mortgages. Subprime and near-prime loans shot up from 9 percent of newly originated securitized mortgages in 2001 to 40 percent in 2006.[1]

The nonprime boom introduced practices that made it easier to obtain loans. Some mortgages required little or no proof of income; others needed little or no down payment. Homebuyers could take out a simultaneous second, or piggyback, mortgage at the time of purchase, make interest-only payments for up to 15 years, skip payments by reducing equity or, in some cases, obtain a mortgage that exceeded the home's value.

These new practices opened the housing market to millions of Americans, pushing the homeownership rate from 63.8 percent in 1994 to a record 69.2 percent in 2004. Although low interest rates bolstered homebuying early in the decade, the expansion of nonprime mortgages clearly played a role in the surge of homeownership.

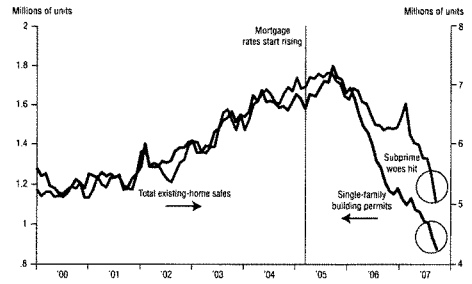
Two crucial developments spurred nonprime mortgages' rapid growth. First, mortgage lenders adopted the credit-scoring techniques first used in making subprime auto loans. With these tools, lenders could better sort applicants by creditworthiness and offer them appropriately risk-based loan rates.

By itself, credit scoring couldn't have fostered the rapid growth of nonprime lending. Banks lack the equity capital needed to hold large volumes of these risky loans in their portfolios. And lenders of all types couldn't originate and then sell these loans to investors in the form of residential mortgage-backed securities, or RMBS—at least not without added protection against defaults.

The spread of new products offering default protection was the second crucial development that fostered subprime lending growth. Traditionally, banks made prime mortgages funded with deposits from savers. By the 1980s and 1990s, the need for deposits had eased as mortgage lenders created a new way for funds to flow from savers and investors to prime borrowers through government-sponsored enterprises (GSEs) (*Chart 2, upper panel*).

Fannie Mae and Freddie Mac are the largest GSEs, with Ginnie Mae being smaller. These enterprises guarantee the loans and pool large groups of them into RMBS. They're then sold to investors, who receive a share of the payments on the underlying mortgages. Because the GSEs are federally chartered, investors perceive an

Housing Activity Drops Off



SOURCES: National Association of Realtors; Census Bureau; authors' calculations.

implicit government guarantee of them. Fannie Mae and Freddie Mac, however, haven't packaged many nonprime mortgages into RMBS.

Lacking the same perceived status, nonagency RMBS—those not issued by Fannie Mae, Freddie Mac and Ginnie Mae—faced the hurdle of paying investors extremely large premiums to compensate them for high default risk. These high costs would have pushed nonprime interest rates to levels outside the reach of targeted borrowers.

This is where financial innovations came into play. Some—like collateralized debt obligations (CDOs), a common RMBS derivative—were designed to protect investors in nonagency securities against default losses. Such CDOs divide the streams of income that flow from the underlying mortgages into tranches that absorb default losses according to a preset priority.

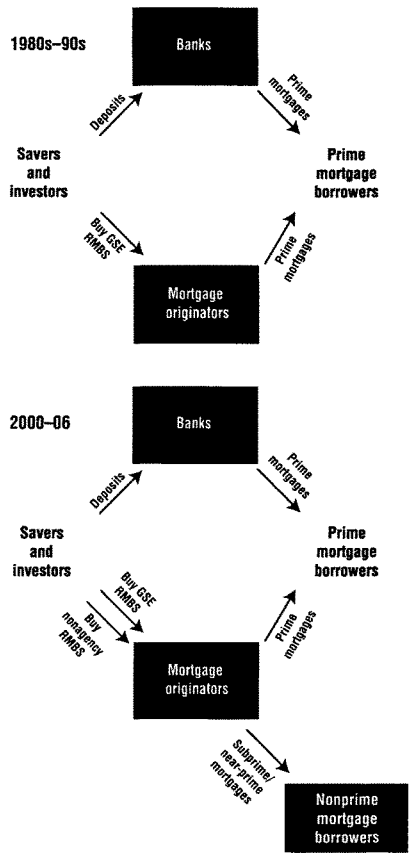
The lowest-rated tranche absorbs the first defaults on the pool of underlying mortgages, with successively higher ranked and rated tranches absorbing any additional defaults. If defaults turn out to be low, there may be no losses for higher-ranked tranches to absorb. But if defaults are much greater than expected, even higher-rated tranches may face losses.

Having confidence in the ability of quantitative models to accurately measure nonprime default risk, a brisk market emerged for securities backed by nonprime loans. The combination of new credit-scoring techniques and new nonagency RMBS products enabled nonprime-rated applicants to qualify for mortgages, opening a new channel for funds to flow from savers to a new class of borrowers in this decade (*Chart 2, lower panel*).

Nonprime Boom Unravels

As problems began to emerge in late 2006, investors realized they had purchased nonprime RMBS with overly optimistic expectations of loan quality.[2] Much of their misjudgment plausibly stemmed from the difficulty of forecast-

Mortgage Financial Flows



Failure to appreciate the risks of nonprime loans prompted lenders to overly ease credit standards. The result was a huge jump in origination shares for subprime and near-prime mortgages.

ing default losses based on the short history of nonprime loans.

Subprime loan problems had surfaced just before and at the start of the 2001 recession but then rapidly retreated from 2002 to 2005 as the economy recovered (*Chart 3*). This pre-2006 pattern suggested that as long as unemployment remained low, so, too, would default and delinquency rates.

This interpretation ignored two other factors that had helped alleviate subprime loan problems earlier in the decade. First, this was a period of rapidly escalating home prices. Subprime borrowers who encountered financial problems could either borrow against their equity to make house payments or sell their homes to settle their debts. Second, interest rates declined significantly in the early 2000s. This helped lower the base rate to which adjustable mortgage rates were indexed, thereby limiting the increase when initial, teaser rates ended.

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 nonprime mortgages. Indeed, swings in home-price appreciation and interest rates may also explain why prime and subprime loan quality have trended together in the 2000s. This can be seen once we account for the fact that past-due rates—the percentage of mortgages delinquent or in some stage of foreclosure—typically run five times higher on subprime loans (*Chart 3*). When the favorable home-price and interest rate factors reversed, the past-due rate rose markedly, despite continued low unemployment.

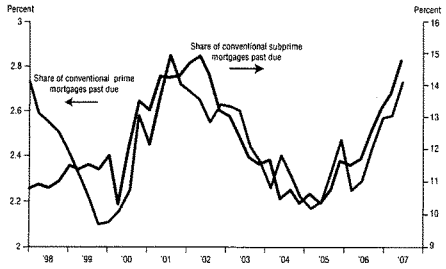
Failure to appreciate the risks of nonprime loans prompted lenders to overly ease credit standards.[5] The result was a huge jump in origination shares for subprime and near-prime mortgages.

Compared with conventional prime loans in 2006, average down payments were lower, at 6 percent for subprime mortgages and 12 percent for near-prime loans.[6] The relatively small down payments often entailed borrowers' taking out piggyback loans to pay the portion of their home prices above the 80 percent covered by first-lien mortgages.

Another form of easing facilitated the rapid rise of mortgages that didn't require borrowers to fully document their incomes. In 2006, these low- or no-doc loans comprised 81 percent of near-prime, 55 percent of jumbo, 50 percent of subprime and 36 percent of prime securitized mortgages.

The easier lending standards coincided with a sizeable rise in adjustable-rate mortgages (ARMs). Of the mortgages originated in 2006 that were later securitized, 92 percent of subprime, 68 percent of near-prime, 43 percent of jumbo and 23 percent of prime mortgages had adjustable rates. Now, with rates on one-year adjustable and 30-year fixed mortgages close, ARMs' market share has dwindled to 15 percent, less than half its recent peak of 35 percent in 2004.

Quality of Prime and Subprime Mortgages Deteriorates



NOTES: Conventional mortgages are those not insured by the Federal Housing Administration or guaranteed by the U.S. Department of Veterans Affairs. Data are seasonally adjusted. Shaded area indicates recession.

SOURCE: Mortgage Bankers Association.

In early 2007, investors and lenders began to realize the ramifications of credit-standard easing. Delinquency rates for 6-month-old subprime and near-prime loans underwritten in 2006 were far higher than those of the same age originated in 2004.

Other signs of deterioration also surfaced. The past-due rate for outstanding subprime mortgages rose sharply and neared the peak reached in 2002, with the deterioration much worse for adjustable- than fixed-rate mortgages. In first quarter 2007, the rate at which residential mortgages entered foreclosure rose to its fastest pace since tracking of these data began in 1970.

Lenders reacted to these signs by initially tightening credit standards more on riskier mortgages. In the Federal Reserve's April 2007 survey of senior loan officers, 15 percent of banks indicated they had raised standards for mortgages to prime borrowers in the prior three months, but a much higher 56 percent had done so for subprime mortgages. Responses to the July 2007 survey were similar.

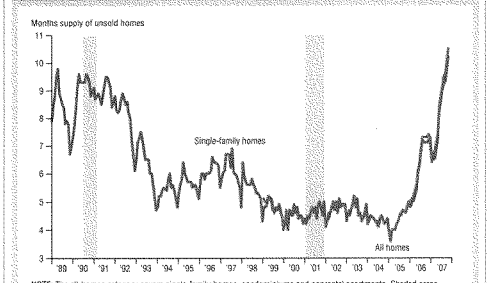
However, in the October 2007 survey the share of banks tightening standards on prime mortgages jumped to 41 percent, while 56 percent did so for subprime loans. Many nonbank lenders have also imposed tougher standards or simply exited the business altogether. This likely reflects lenders' response to the financial disruptions seen since last summer.

The stricter standards meant fewer buyers could bid on homes, affecting prices for prime and subprime borrowers alike. Foreclosures added to downward pressures on home prices by raising the supply of houses on the market. And after peaking in September 2005, single-family home sales fell in September 2007 to their lowest level since January 1998.

The number of unsold homes on the market has risen, sharply pushing up the inventory-to-sales ratio for existing single-family homes from their low in January 2005 to their highest level since the start of this series in 1989 (*Chart 4*). Condominium supply, which is reflected in the all-home numbers, has experienced an even sharper increase since early 2005.

In the absence of home-price appreciation, many households are finding it difficult to refinance their way out of adjustable-rate mortgages.

Chart 4
Existing-Home Inventories Rise from Late-2004 Lows



NOTE: The all-homes category covers single-family homes, condominiums and nonrental apartments. Shaded areas indicate recession.
SOURCE: National Association of Realtors.

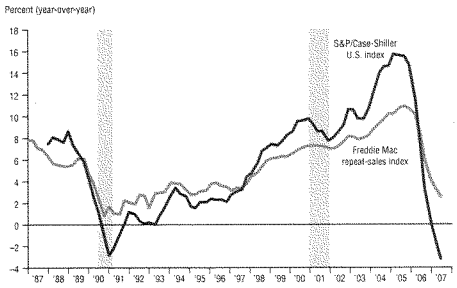
These high inventories will likely weigh on construction and home prices for months to come. After peaking in early 2005, the Standard & Poor's/Case-Shiller index of year-over-year home-price appreciation in 10 large U.S. cities was down 5 percent in August—its biggest drop since 1991. While a Freddie Mac gauge of home prices posted a small year-over-year gain in the second quarter, the pace was dramatically off its highest rate, reported in third quarter 2005 (*Chart 5*).

In the absence of home-price appreciation, many households are finding it difficult to refinance their way out of adjustable-rate mortgages obtained at the height of the housing boom. Larger mortgage payments could exacerbate delinquencies and foreclosures, especially with interest rate resets expected to remain high for the next year (*Chart 6*). This suggests mortgage quality will likely continue to fall off for some time.

Financial Turmoil

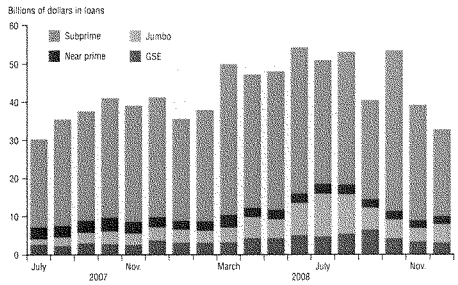
By August 2007, the housing market's weaknesses were apparent: loan-quality problems, uncertainty about inventories, interest rate resets and spillovers from weaker home prices. These, coupled with ratings agencies' downgrading of many subprime RMBS, led to a dramatic thinning in trading for subprime credit instruments, many of which carried synthet-

Chart 5
Home-Price Appreciation Plunges into Negative Territory



NOTE: Shaded areas indicate recession.
SOURCES: Freddie Mac; Standard & Poor's/Case-Shiller.

Chart 6
Scheduled Resets on Adjustable-Rate Mortgages Remain High



SOURCE: Bank of America estimates based on LoanPerformance data.

ic, rather than market, values based on models because of the instruments' illiquidity.

On Aug. 14, the paralysis in the capital markets led three investment funds to halt redemptions because they couldn't reasonably calculate the prices at which their shares could be valued. This event triggered widespread concern about the pricing of many new instruments, calling into question many financial firms' market values and disrupting the normal workings of the financial markets.

Investors sought liquidity, putting upward pressure on overnight interest rates and sparking a sharp upward repricing of risk premiums on assets, particularly those linked to nonprime mortgages. One outcome was an interest rate spike for both mortgage-backed commercial paper and jumbo mortgages, which heightened financial market uncertainty. In this environment, nonagency RMBS were viewed as posing more liquidity and default risk than those packaged by Fannie Mae and Freddie Mac.

Facing greater perceived default risk, investors began demanding much higher risk premiums on jumbo mortgage securities, pushing up the cost of funding such loans via securitization and encouraging lenders to incur the extra cost of holding more of these loans in their portfolios. This contributed to a 1 percentage point jump in jumbo interest rates between June and late August, an especially important increase given that jumbos accounted for about 12 percent of mortgage originations last year.

Although spreads between jumbo and conforming loan rates have fallen off their late-summer highs, they're still elevated. The higher rates have dampened the demand for more expensive homes, just as tighter credit standards reduced the number of buyers for lower-end homes.

Macroeconomic Effects

A housing slowdown mainly affects gross domestic product by curtailing

housing construction and home-related spending. It also reins in spending by consumers who have less housing wealth against which to borrow.[5]

Residential construction likely exerted its largest negative effect in third quarter 2006, when it subtracted 1.3 percentage points from the annual pace of real GDP growth. Last year, many forecasts predicted home construction would stop restraining GDP growth by the end of 2007 and the industry would start recovering in 2008. These predictions were made before the tightening of nonprime credit standards began in late 2006. The change in standards will likely prolong the housing downturn and delay the recovery, although it's hard to tell precisely for how long. Since single-family permits have already fallen 52 percent from their September 2005 peak, however, the worst of the homebuilding drag may be behind us.

The same may not be true for housing's indirect effect on consumption. Since the late 1990s, many homeowners have borrowed against housing wealth, using home equity lines of credit or cash-out refinancing or not fully rolling over capital gains on one house into a down payment or improvements on the next one. These mortgage equity withdrawals gave people access to lower cost, collateralized loans, which bolstered spending on consumer goods. By one measure, these withdrawals were as large as 6 to 7 percent of labor and transfer income in the early to mid-2000s.

The magnitude and timing of these withdrawals may have changed in hard-to-gauge ways. New research suggests housing wealth's impact on consumer spending grew as recent financial innovations expanded the ability to tap housing equity.[6] This is consistent with prior research on housing's connection to U.S. consumer spending.[7] Aside from the interest-rate-related refinancing surge of 2002 and 2003, mortgage equity-withdrawal movements have become increasingly sensitive to swings in home-price appreciation since a 1986 law granted a federal income tax deduction for home equity loans (*Chart 7*).

Compounding the uncertain outlook for consumption is the likely reversal of the early 2000s' mortgage credit liberalization.[8] This will put further downward pressure on home prices and housing wealth and may curtail home equity loans and cash-out refinancings. Finally, the homebuying enabled by the easing of credit standards in recent years may have been at the expense of later sales, further dampening the market going forward.

The timing of housing wealth's impact on consumption may have also changed. For example, before the advent of equity lines and cash-out refinancings, housing wealth increases may have affected U.S. consumption mainly by reducing homeowners' need to save for retirement. Since then, such financial innovations have enabled households to spend their equity gains before retirement. It's unclear how much this may be reversed by the 2007 retrenchment in mortgage availability.

Looking Ahead

The rise and fall of nonprime mortgages has taken us into largely uncharted territory. Past behavior, however, suggests that housing markets' adjustment to more realistic lending standards is likely to be prolonged.[9]

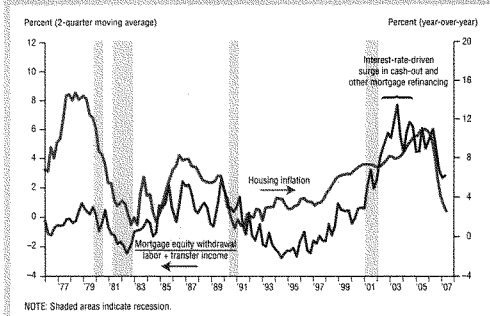
One manifestation of the slow downward adjustment of home prices and construction activity is the mounting level of unsold homes. The muted outlook for home-price appreciation, coupled with the resetting of many nonprime interest rates, suggests foreclosures will increase for some time.

The sharp reversal of trends in home-price appreciation will also dampen consumer spending growth, an effect that may worsen if the pullback in mortgage availability limits people's ability to borrow against their homes.

Although recent financial market turmoil will likely add to the housing slowdown, there are mitigating factors.

Chart 7

Mortgage Equity Withdrawals Increasingly Move with Housing Inflation and Mortgage Refinancings



NOTE: Shaded areas indicate recession.
SOURCES: Freddie Mac; Bureau of Economic Analysis; Federal Reserve, flow of funds data; authors' calculations.

First, the effect of slower home-price gains on consumer spending is likely to be drawn out, giving monetary policy time to adjust if necessary.

Second, the Federal Reserve has been successful in slowing core inflation while maintaining economic growth. This gives policymakers inflation-fighting credibility, which enables them to coax down market interest rates should the economy need stimulus.

Third, even if the tightening of mortgage credit standards undesirably slows aggregate demand, monetary policy could still, if need be, help offset the overall effect by stimulating the economy via lower interest rates. This would bolster net exports and business investment and help cushion the impact of higher risk premiums on the costs of financing for firms and households.[10]

DiMartino is an economics writer and Duca a vice president and senior policy advisor in the Research Department of the Federal Reserve Bank of Dallas.

Notes

The authors thank Jessica Renier for research assistance.

[1] See "The Subprime Slump and the Housing Market," by Andrew Tilton, *US Economics Analyst*, Goldman Sachs, Feb. 23, 2007, pp. 4–6. Securitized mortgages account for roughly 70 to 75 percent of outstanding, first-lien U.S. residential mortgages, according to estimates in "Mortgage Liquidity du Jour: Underestimated No More," Credit Suisse, March 13, 2007, p. 28.

[2] See, for example, Federal Reserve Chairman Ben Bernanke's remarks, "Housing, Housing Finance, and Monetary Policy," at the Federal Reserve Bank of Kansas City's Economic Symposium, Jackson Hole, Wyo., Aug. 31, 2007.

[3] Part of the reason lenders eased credit standards was that they planned to sell, rather thag hold, the mortgages. The earlier easing of standards may have partly owed to the potential moral hazard entailed when nonconforming loans are originated with the intent to fully sell them to investors. Bernanke discusses this in his remarks at the 2007 Jackson Hole symposium (note 2).

[4] The figures are for securitized mortgages. See "Mortgage Liquidity du Jour" (note 1).

[5] "Making Sense of the U.S. Housing Slowdown," by John Duca, Federal Reserve Bank of Dallas *Economic Letter*, November 2006.

[6] See "How Large Is the Housing Wealth Effect? A New Approach," by Christopher D. Carroll, Misuzu Otsuka and Jirka Slacalek, National Bureau of Economic Research Working Paper no. 12746, December 2006; and "Housing, Credit and Consumer Expenditure," by John Muellbauer, paper presented at the Federal Reserve Bank of Kansas City's Economic Symposium, Jackson Hole, Wyo., Aug. 31–Sept. 1, 2007. Also see "Booms and Busts in the UK Housing Market," by John Muellbauer and Anthony Murphy, *Economic Journal*, vol. 107, November 1997, pp. 1701–27; and "House Prices, Consumption, and Monetary Policy: A Financial Accelerator Approach," by Kosuke Aoki, James Proudman and Gertjan Vlieghe, *Journal of Financial Intermediation*, vol. 13, October 2004, pp. 414–35.

[7] "Estimates of Home Mortgage Originations, Repayments, and Debt on One-to-Four-Family Residences," by Alan Greenspan and James Kennedy, Finance and Economics Discussion Series Working Paper no. 2005-41, Board of Governors of the Federal Reserve System, September 2005; and "Mutual Funds and the Evolving Long-Run Effects of Stock Wealth on U.S. Consumption," by John V. Duca, *Journal of Economics and Business*, vol. 58, May/June 2006, pp. 202–21.

[8] This is a possibility to which Muellbauer (2007, note 6) alludes.

[9] See Duca (note 5).

[10] For a discussion of the channels of monetary policy, see "Aggregate Disturbances, Monetary Policy, and the Macroeconomy: The FRB/US Perspective," by David Reifschneider, Robert Tetlow and John Williams, *Federal Reserve Bulletin*, January 1999, pp. 1–19.

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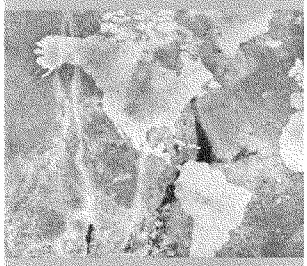

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Mr. ISSA. And, finally, I would like to close—none of you were in Cleveland with me less than a year ago when Mr. Kucinich, the chairman of my subcommittee, worked on this very issue of the availability of home loans to underserved communities and the growing default rate in Cleveland. We drove through and we saw the boarded-up homes, and we saw the fact that this thing was becoming a meltdown in Cleveland.

But I want to note for the record, Mr. Chairman, that, at that hearing, one of the most important things that came up again and again and again was that the people of Cleveland were asking at that time for greater availability of money to finance homes. So just as $70,000 homes were being walked away from because they couldn't make the payments, we were being asked to find ways to finance home affordability.

Mr. Chairman, I would urge us both to work on a bipartisan basis to find solutions going forward for home availability and affordability, since, clearly, the model of simply throwing money at it even if they are risky and, in fact, ultimately not stable if the home values go down hasn't worked, that we work together as Government to try to find a solution that's sustainable.

And, with that, I thank the gentleman and yield back.

Chairman WAXMAN. The gentleman's time has expired.

Mr. Cummings.

Mr. CUMMINGS. Thank you very much, Mr. Chairman.

First of all, I want to thank all of you for being here.

This is a mess. This is a mess.

I have listened here very carefully. I've heard things about curves, business practices, you make profit at one point and then you don't make profit.

The bottom line is that there are people that are being put out of their houses—people in my district. Read the front page of the Baltimore Sun today; there's a front-page story about them. And I hope that the SEC looks at all of this very carefully, because, I got to tell you, something doesn't smell right.

Mr. Mozilo, I wanted to ask you about some of Countrywide's customers who have come to us with their stories. Let's put a human face on all this.

When Shirley Mutterman and her husband were buying their first home in Fauquier County, VA, Countrywide gave them a good-faith estimate for a fixed interest rate of 6.25 percent over 30 years. They were told they would have to put no money down, would have no closing costs and could move in the beginning of the following month. But the closing date was pushed back 2 weeks until just a day or two before they planned to move. And when they arrived at closing, Countrywide presented them with two loans, a 7.25 percent adjustable rate mortgage and an 11.25 percent 15-year fixed rate second mortgage. At closing, their only options were to walk away from the house they found and pay a penalty or sign the loans that Countrywide presented. They chose to sign, and they are now on the verge of losing their home.

And I know that what happens at the chief executive level, we have a tendency to say—some chief executives say, well, that happened down below. Other ones say, it happened under my watch, and so therefore I take responsibility.

But I want to hold that and I want to go to something else, because Mr. Issa makes this sound like it's just some lightweight isolated thing, some business practices just didn't go right, and so therefore some people should not hold some responsibility here.

Some members of this committee have said that you're being used as a scapegoat, and that's the last thing I want, Mr. Mozilo. And I don't really understand why they're saying that. You run the largest originator of home mortgages in the country. If you don't bear personal responsibility, I don't know who does.

And listen to this. In 2003, less than 5 percent of Countrywide's loans were paid to subprime borrowers, those at greater risk of default. But by 2006, this number doubled. Countrywide made more than $120 billion worth of these loans from 2003 to 2006.

Over the same period, you also moved aggressively from fixed rate loans to adjustable or variable rate loans. The percentage of adjustable loans in Countrywide portfolio jumped over 50 percent by 2005. That's a massive increase.

Moreover, your company began offering a new product called pay option ARM. These loans allow homeowners to choose how much they would repay. When they couldn't cover the interest rates, the principal the homeowner owed increased, in effect digging them deeper into a hole, like quicksand.

We also heard from many families about the problems posed by Countrywide's aggressive use of no-doc or liar loans with low teaser rates.

And what is happening is that people are desperate. They are reaching for their dreams, and their dreams are turning into nightmares.

And so we see these compensation rates—I'm sitting here and I'm trying to—I'm just trying to—I'm sitting here and I'm saying to myself, wait a minute. On the one hand, we've got the golden parachutes drifting off onto the golf field, and on the other hand, I've got people that I have to see every day who are losing their homes, trying to figure out how they are going to—where their children are going to come to do their homework the next night. But yet, still, we've got this thing going around, ring around the rosy, as if there should not be a connection between compensation and what happens when we have this kind of conduct.

Now, I don't know all the answers, and I've got a feeling that we're not going to get all the answers in a hearing like this. But I'm hoping that, when all the dust settles, that we are able to protect the American people, that person who is reaching out there just trying to have a little piece of the American dream—and while I worry about the executives and I know that, you know, the $250 million that you might make and whatever is important, I worry about this whole culture where the little guy gets squeezed and, the next thing, he has nothing but a debt—not a house, a debt—and then the parachute just drifts on up the golf course.

So I'm hoping that the SEC will look into this, I hope that all the agencies will look into it very carefully, so that we can make sure that there is true balance, so that person in my district is able to fulfill his or her dream and for future generations.

Chairman WAXMAN. Thank you, Mr. Cummings.

Mr. Towns.

Mr. TOWNS. Thank you very much, Mr. Chairman.

Let me begin by thanking all of you for being here.

You know, I want to start out with some very basic kinds of stuff, because I must admit that I'm having some problems here, because I get the feeling that it's "you scratch my back, I'll scratch your back." I mean, I'm getting that feeling here, and that, to me, is not good.

Let me begin by just asking you, Mr. Parsons, you are the CEO of Time Warner. And, of course, in Citigroup, you actually chaired the compensation board. And those are two very different companies. With Citi, it's the financial service business, and with Time Warner, you are in the media business. Some people might look at that and say, "He doesn't know anything about finance. He's just in there because all the CEOs are taking care of each other. They're scratching each other's backs."

What do you say to somebody like that? Because, after all, I mean, your company is all together different from the company that you were serving on the compensation board for.

Mr. PARSONS. Well, I can think of many different answers, but I'll try to confine myself to the one that's perhaps most relevant.

First of all, although I currently—well, actually, currently I'm the chairman of Time Warner. I was the CEO until the end of last year.

Mr. TOWNS. If you could pull that closer to you. I can't quite hear you.

Mr. PARSONS. I say, while currently the chairman of Time Warner, I was the CEO for many years, until the end of last year. Prior to joining Time Warner, I was the chairman and CEO of Dime Bank Corp, which was the fourth-largest financial services thrift in the United States. And so I had extensive financial services background. So I know something about the business.

But second and perhaps more importantly, the issues that Compensation Committees deal with are issues of talent attraction and talent retention. There's a huge war going on in American business—and, in fact, now it's global business—to seek, find, attract and retain the best talent you can for whatever corporation it is that you happen to be serving, whether on the board or as an executive. And those issues, the issues of sort of enlightened human resource management, of which compensation is one, are more similar across the business spectrum than one might think.

So, in point of fact, I do have a fairly substantial financial services background, but I also have been managing large corporate enterprises that are out competing in the world for talent for many years. And so I hope that those, together with some modicum of common sense, qualify me to serve as an independent director of Citigroup.

Mr. TOWNS. Thank you.

Mr. Finnegan, I want to raise the same question with you.

Thank you very much, Mr. Parsons.

Mr. FINNEGAN. Sir, I ran Chubb Corp., which is an insurance company and financial services business, and prior to that I was CFO and CEO of GMAC, which is a major diversified financial services company.

Mr. TOWNS. Mr. Snyder.

Mr. SNYDER. Yes, Congressman. I want to clarify a point that I made to Congresswoman Norton, just for the record, that I don't want to give any misimpression. The bonus formula was approved by the shareholders, not the contract. So I want to clarify that point.

But in specific answer to your question, Congressman, I prior to my service with Countrywide, I served on two different bank boards, I was chair of a mutual fund board. I have been involved with the financial services community for all of my career, which spans more than 50 years.

Mr. TOWNS. Let me just very quickly—my time is running here.

Mr. Mozilo, your compensation agreement in 2006 entitled you to a $10 million award. Now, I understand—now, the rationale behind that, of course, you received a $10 million stock award, and that was because you indicated that you did not want to retire and you would have gotten $3 million a year if you retired.

Is there anybody else in the company getting that, or have that kind of arrangement?

Mr. MOZILO. Well, yeah, there's a substantial number of executives that have pension plans. So I'm not the only one that gets it. There's a substantial number of employees that get it.

But I wanted to retire. That was my desire, to retire. And, unfortunately, I made the decision to stay on, and that was the basis by which that agreement was made.

Mr. TOWNS. How can you explain that to the shareholders, why you took a $10 million stock award and now you are getting $3 million retirement? I mean, how do you explain that?

Mr. MOZILO. Well the stock award was over a 3-year period from 2006, I believe, to 2009. And it was performance-based, so I had to perform for the shareholders in order to receive the value of that. It was not a gift of $10 million. It had performance-based aspects to it. I had to stay; I had to provide a return on equity to the shareholders. I had a large number of requirements in order for it to be realized. Actually, very little of it will be realized, as a result of what has happened.

Chairman WAXMAN. The gentleman's time has expired. Thank you, Mr. Towns.

Mr. TOWNS. Thank you, Mr. Chairman.

Chairman WAXMAN. Mr. Kanjorski.

Mr. KANJORSKI. Thank you very much, Mr. Chairman.

Let me make a comment. I actually don't know why you're all here today, other than the fact that you had the lack of good fortune to serve in organizations and in positions that haven't done very successfully in the last 18 months. That's hardly why we should hold you up and beat you too badly. So I don't want my remarks to appear to beat you.

However, in listening, I think there are some public policy things this committee and this Congress can learn from you and consider in the future.

Let me ask you an overall question. Do any of you feel that you were undercompensated over this 2, 3-year period? So there's nobody here who says we were underpaid? OK.

I was wondering whether or not you are familiar enough with your tax consequences to tell us whether or not most of the com-

pensation you've received, as I've discerned it from the testimony, is at the minimum capital gains, 15 percent, and not consistent with—or have all of you paid absolute——

Mr. FINNEGAN. Ordinary income.

Mr. MOZILO. Ordinary income, top tax bracket.

Mr. KANJORSKI. On everything?

Mr. MOZILO. Yes. Stock options are ordinary income.

Mr. KANJORSKI. OK. How about anybody else? Did anyone else get the advantage of just capital gains?

Mr. O'NEAL. No.

Mr. KANJORSKI. Now, we are holding you up to an awful lot of criticism. Quite frankly, when I look at what you have made, some people may compare you to other people, like Mr. Paulson with that hedge fund making $3 billion or $4 billion and Mr. Sorenson making $1.4 billion.

The question I have really is, one, do you think as a matter of public policy we ought to see that these people who make these unusual incomes should pay at least the amount of taxes that the average employees pays? So that we ought to do away with 15 percent capital gains, shove them up to what is reasonable income earned rates.

And two, what is enough? I mean, I'm waiting for some executive to come along with the first trillion-dollar income. Would that shock any of you?

It must shock one of you. You think our system should allow absolute unlimited—and if the Congress and the American people are stupid enough to not tax these people or these things, someone should walk away with a trillion-dollar income?

Mr. MOZILO. I think, as a matter of tax policy, that's really the role of Congress and the Government to determine that. And I really have no comment on that.

It is a very difficult issue because we are a capitalistic system, we want people to take risk, we want jobs to be created, we want capital to be created, we want people to have opportunities——

Mr. KANJORSKI. Well, we just heard you criticizing one of our fellow Members, someone selling short in the market and making $3 billion or $4 billion, as if that were a sinful act in a capitalist system. I never learned that in school.

Mr. MOZILO. No, I didn't criticize the amount of money he made. I criticized what he was doing.

Mr. KANJORSKI. You mean selling short is immoral?

Mr. MOZILO. No. In terms of the contribution to an entity that was going to restrict lending in order to increase the amount of foreclosures.

Mr. KANJORSKI. I know, Mr. Mozilo. Then we have to do a subjective judgment.

Let me give you an example. I have just finished with Monoline Insurance Co., and we found that the securitization pools of some of the monoline companies found in trouble is that there was a failure of the first payment on 18 percent of the mortgages in 2006.

Now, with the brilliance that we have at this table and the other hundreds of executives around this country, I can't believe that somebody didn't say, wow, we may have a problem if 18 percent

of the people we're giving mortgages to don't make the first installment payment. Didn't that ever come to your attention?

Mr. Prince, your bank was in trouble. Didn't you get any reports that there were such horrific failures in the system?

Mr. PRINCE. I think, Congressman, that, in all honesty, by the time some of those reports surfaced, in the spring of 2007, most of the damage had already been done. That is the——

Mr. KANJORSKI. When do you think the damage occurred?

Mr. PRINCE. Well, I think, honestly, that the lending patterns began to deteriorate pretty significantly in 2006. And so, by the time——

Mr. KANJORSKI. I just wanted to frame that, because on the floor the other day—I want to make it quite clear for my friends on the other side, this isn't being blamed on the Clinton administration, is it? Does anybody think we could push this back to pre-2000 so we could have another crucifixion?

So it did happen during this administration. Why didn't our Federal Reserve, why didn't our SEC, as Mr. Cummings asked the question, why didn't our Treasury Department see the same statistics that I got on 18 percent failures of mortgages and securitized pools? Why didn't they see this?

Do you have an answer, Mr. Mozilo? You ran the company with the largest number of these. Did you participate in putting pools together?

Mr. MOZILO. Yes, we did, certainly we did. As Mr. Prince points out, these things happen over time, so you are not finding out instantaneously——

Mr. KANJORSKI. No, no, this is for the year 2006.

Mr. MOZILO. Yes, right. And we immediately—first of all, we investigated each of these loans, as to what the cause of it was. And it was a variety of causes. One was——

Mr. KANJORSKI. Mostly people didn't have the income, they didn't have the net worth, and they should have never been in those loans. Isn't that the cause?

Mr. MOZILO. That's not generally the cause. Because people who were sincere about living in a house and want to preserve their house will make the payment or will contact us to see if we can help them work it out.

Generally these are speculators, didn't work out for them, values went down, they abandoned. And a lot of it was fraud.

Mr. KANJORSKI. How long did it take you to come up with the understanding that there was this type of an 18 percent failure rate before you sent the word down the line, "Check all of these loans or future loans for these characteristics so we don't have this horrendous failure?"

Mr. MOZILO. Yes, immediately—within the first—if we don't get payment the first month, we're contacting the borrower. And that's part of what we do. And we are adjusting our——

Mr. KANJORSKI. I understand you do to the mortgage holder. But don't you put all those together in statistics and say, "These packages we are selling now are failing at such a horrific rate that they'll never last and there will be total decimation of our business and of these mortgages?"

Chairman WAXMAN. The gentleman's time has expired, but please answer the question.

Mr. MOZILO. As has been pointed out, these mortgages are put in very complex securities and have a lot of charges to them. So it's very different to see a loan or series of loans, are they in that particular security or another security? The only one who would know that would be the security holder.

Chairman WAXMAN. All Members have had a chance to ask a first round of questions, and some Members have indicated they want to ask a second round of questions. Should we continue on, or should we have a break?

Continue on. OK.

Ms. Norton, I want to recognize you for 5 minutes.

Ms. NORTON. Thank you, Mr. Chairman.

Mr. Parsons, I'm continuing the line of questions that most interest me, and that is the role of the board and the Compensation Committee, because this is all the shareholders have to represent them.

I regard Mr. Prince as an honorable person, because he recognized his own role in contributing to the crisis of his company, and he did the honorable thing in offering his resignation. But of all the CEOs sitting here today, Mr. Prince is the only one who received a bonus in a year when all of these companies were experiencing multibillion-dollar losses.

Now, understand my question. This was not a golden parachute. This was not prearranged compensation. This was not contractual. The board had to meet and affirmatively act after the resignation to give Mr. Prince a bonus, which, by the way, a cash bonus at a time when the company was experiencing these losses of $10.4 million loans.

Now, could I just ask you, Mr. Parsons, in your own opinion, do you believe that a $10 million bonus that was not required of the company, not contractual, came after a resignation, one would say for cause, do you believe that bonus served the fiduciary interests of the shareholders of Citicorp?

Mr. PARSONS. Yes, I do, Madam Congresswoman.

Ms. NORTON. Please explain.

Mr. PARSONS. As simply as I can put it, you're correct, that was a discretionary action taken by the Compensation Committee, recommended to the board and approved by the board. Why? At the time that Mr. Prince, who is an honorable man——

Ms. NORTON. At the time, I'm sorry?

Mr. PARSONS. Mr. Prince, who is—I was agreeing with your assessment that——

Chairman WAXMAN. Mr. Parsons, your voice is too soft. Pull the microphone right up to your lips.

Mr. PARSONS. At the time that Mr. Prince tendered his resignation, he had, in effect, put in a period of time over 2007, I'll call it 10 months, that we had to make a judgment as to how to compensate him for. As you know, compensation and entities——

Ms. NORTON. But he was going to receive his compensation for work done. This is a bonus, isn't it?

Mr. PARSONS. That's part of compensation. Compensation in entities like Citi and the other entities up here consists essentially of

two parts: one, a base salary and, No. 2, a bonus calculation. And as you've heard others testify, the great bulk of compensation for any year is usually conveyed or given in the form of a bonus.

So we will——

Ms. NORTON. What's the compensation then? If the bulk of it was in the form of a bonus, what was the compensation?

Mr. PARSONS. Bonus is a component of compensation.

Ms. NORTON. Well, no, you're saying—can you just aggregate that for me? Because you're making a statement as if that was necessary in order to compensate him for the year 2007. I want you to explain how this was compensation.

Mr. PARSONS. All right. Compensation, broadly defined, is that amount which the bank conveys to its employees for their work during a period of time. In Citigroup, for senior executives, that compensation essentially comes in two different tranches or components: one is base salary——

Ms. NORTON. And what was his salary?

Mr. PARSONS. $1 million a year.

Ms. NORTON. So he got 10 times his salary in a bonus, cash bonus, that the board had to step up and give him after he—I realize his salary——

Mr. PARSONS. That's correct.

Ms. NORTON [continuing]. His salary, it seems to me, was—somebody had been thoughtful about his salary. But now the bonus, after a failure of the company was such that he himself though he should resign, earned him 10 times that amount in bonus.

Mr. PARSONS. So how did that happen? Here are the matters that the committee considered in making a judgment.

Now, you characterize the company as having failed. In point of fact, Citigroup made almost $4 billion in 2007. They did have major write-offs, but the company was profitable. Indeed, many parts of the company had experienced record levels of performance. Only one part of the company really imploded, and that was the part that was focused on these subprime loans.

Other matters that we took into consideration—you heard Mr. Prince testify when he opened this hearing that the two quarters preceding the quarter that led to his resignation were two of the most profitable in 200-year history of Citi. We had improved relations with all of our regulators around the world.

So, in other words, a lot of good things had happened over the course of the year. But some bad things happened also, and those things caused Mr. Prince to resign.

Ms. NORTON. I understand you, Mr. Parsons. You have more? I don't——

Mr. PARSONS. No. I just wanted to complete the story.

Ms. NORTON. I can understand. The size of the bonus is interesting to me. But let me ask you about the board that had to decide this. Because if the board decides we're going to give him 10 times what his salary was this year, even though he resigned essentially for cause, how long did the board meet? What kind of discussion occurred, in order to get to a tenfold increase in that last year?

Chairman WAXMAN. The gentlelady's time has expired, but please answer the question.

Mr. PARSONS. I will do my best to be brief.

Essentially, the determination was made by the Compensation Committee based on the factors I told you. And while it may have been 10 times his salary, it was less than half of the bonus he'd gotten the previous year, because we related his bonus to what happened to shareholders.

I can't give you minutes and hours, in terms of how long the comp committee met. But the comp committee met, considered it thoroughly, and then made a recommendation to the board and the board——

Ms. NORTON. Mr. Chairman, thank you very much.

I do want to indicate that we have information that the board met for 20 minutes to decide on this particular affirmative act of offering a bonus to Mr. Prince when he resigned.

Thank you.

Chairman WAXMAN. Thank you, Ms. Norton.

Mr. Cummings.

Mr. CUMMINGS. Thank you very much, Mr. Chairman.

Mr. Mozilo, I actually have to ask you about a bait-and-switch situation involving Shirley Mutterman and her husband from Fauquier County, VA. And sadly, they suffer today perhaps because they did not look into the detail or maybe they were not given the proper information. But if they had looked into their situation with the detail that you looked into your compensation package, perhaps they would have had certain questions answered.

And I refer, Mr. Mozilo, in 2006, you renegotiated your compensation package with the board at Countrywide. The documents obtained by the committee indicated that you were unhappy with the pay package.

Let me put up an e-mail you wrote to your compensation consultant—and you can put that up—on October 20, 2006. And let me tell you what you said, "At this stage in my life at Countrywide, this process is no longer about money but more about respect, an acknowledgement of my accomplishments. Boards have been placed under enormous pressure by the left-wing, anti-business press and the envious leaders of unions and other so-called CEO comp watchers. I strongly believe that, a decade from now, there will be a recognition that entrepreneurship has been driven out of the public sector, resulting in underperforming companies and a willingness on the part of boards to pay for performance."

What did you mean by that?

Mr. MOZILO. Well, it was an emotional time, Congressman, for me. I had planned to leave the company. They asked me to stay. The chairman at that time had sent me a proposal that was sharply different from what I had expected, and I reacted emotionally.

I apologize for that memo, but it was as the result of a dialog that resulted in the chairman of the committee asking me to get my own consultant. That's how the John England issue came about. But I regret the words I used. I tend to be an emotional individual and was upset at the time.

Mr. CUMMINGS. I understand. And I understand that. But I want you to understand that I've got some constituents that are emotionally upset too, because they're losing their houses. And you were worried about something very important, your wife, and I understand that.

And according to the documents, you were seeking a wide range of perks. So on several occasions, you emphasized that you wanted your contract to provide explicitly for the reimbursement of any taxes owed when your wife traveled with you on Countrywide's jet.

Let me show you another e-mail you wrote to your compensation consultant, this one on November 23, 2006, "In order to avoid extraordinary travel expenses to be incurred by the chief operating officer and me, the spouses would have to travel commercial or not at all, which is not right nor wise."

In fact, you were so concerned about getting taxes paid on your wife's travel that you raised the possibility of retiring if you didn't get this. In the same e-mail to your compensation consultant, you said this, "The board must understand that, if I were to retire today, I would receive approximately $15 million in deferred comp, get directors fees and be able to liquidate my 12 million shares without restriction."

Mr. Mozilo, you made an enormous amount of money. And that's great, that's wonderful, God bless you. According to the documents reviewed by the committee, you've made almost $250 million in compensation and collected $406 million from the sale of Countrywide stock.

Why was it so important to you that Countrywide pay the taxes on your wife's travel on a Countrywide jet?

And I just want you to understand that, again, the reason why this gets to me so badly is because, just a few weeks ago, I held a forum where we were trying to help people in my district renegotiate their Countrywide loans, and they were on the doorstep of foreclosure, some of them with tears in their eyes. And, you know, they're worried about their wives too. They were worried about where their wives were going to cook and where they were going to sleep.

But I'm just curious——

Mr. MOZILO. First of all, I understand exactly what you are saying. Again, I've spent a good part of my life dealing with the issue of homeownership, particularly among lower-income and minority people. I understand more than anyone else the importance of homeownership. My dad didn't buy his first home until he was over 50 years old and died a few years later. I understand the difficulty of making payments, because I interviewed many of these buyers to make these loans at the beginning of Countrywide. I serviced many of these loans. I collected the payments. I understand, as you do, the importance of homeownership and the trials and tribulations people go through. And that's why we've worked so hard. Nobody's doing more than Countrywide, in terms of trying to keep people in their homes and work these things out.

And the thing—before I get into the wife issue—is that I want to say to you that I want to work with your office, and I want to assign people to your staff to work on each of these loans. This burden shouldn't be your burden. It should be our burden and our responsibility to make it right and to find out what really are the facts behind these cases, how did they happen. And particularly the first case you mentioned, about the 11 percent loan, you know, I don't even know how that starts. And I do take full responsibility for anything that happens at Countrywide.

As for the wife issue, you know, in comparison, it sounds out of whack today because it is out of whack today, in today's world. In 2006, things were fantastic. The company had 30 straight years of increased earnings—one of the most successful companies in the history of America, in terms of earnings, stock value, all of that.

The issue was a trivial issue, in retrospect. And what had happened was that, in some cases—and it happened in very few cases, by the way—that the wife is an important part of going to business arrangements, business meetings, to affairs. They're important. And the issue was, how do I get her there? And the way it worked out on the travel was, if she had to come, which was rarely because we had five kids and nine grandkids and she stays home, but if she did, I had to pay an enormous amount of—a substantial amount of money to have her on that plane with me.

And that's how the issue came up. It came up with my colleague who was the second in command of the company, and I wrote the memo. In today's world, I would never write that memo.

Mr. CUMMINGS. I appreciate it. Thank you, Mr. Chairman.

Chairman WAXMAN. The gentleman's time has expired. Mr. Cannon, do you want to——

Mr. CANNON. Thank you, Mr. Chairman. Yes.

Chairman WAXMAN. The gentleman is recognized.

Mr. CANNON. Mr. Mozilo, can I followup on this a little bit now? My understanding is that Countrywide is shrinking in most of its areas. But do you have any areas of the company that are actually growing larger?

Mr. MOZILO. Yes. We have a very large insurance operation, casualty and life insurance company, that is doing extremely well. Balboa Life and Casualty. We bought it back in November 2000—1999. It is doing extremely well.

Mr. CANNON. Do you have any divisions that are growing?

Mr. MOZILO. I'm sorry?

Mr. CANNON. Within Countrywide, the lending area, do you have divisions of Countrywide that are growing? Like your——

Mr. MOZILO. You know, in most areas it is either stable to shrinking.

Mr. CANNON. Are your—you've just been talking——

Mr. MOZILO. Do you mean like homeowners? Those areas? It is all growing. I mean, we have almost 4,000 people today versus in 2004, maybe 200 or 300 who are solely working on the issue that the Congressman raised. These are serious issues, a serious impact on lives. So we—our servicing area—we're servicing $1½ trillion worth of mortgages. 9 million customers, and today many of whom are in problems—so that area is expanding dramatically.

Mr. CANNON. You're adapting—Countrywide is adapting to the problems of America and helping out?

Mr. MOZILO. It is our responsibility to do that.

Mr. CANNON. You talked a little bit about your history and when your dad bought his first home. There is a lot of data out there that indicates that families that own homes do better. Their children do better in school, their children do better in life. I suspect that is part of what motivates you here, is it not?

Mr. MOZILO. You know, I think my background certainly motivates me as it does I'm sure each of the CEOs here at the table.

But I have—since I spent a good part of my life in the field interviewing borrowers for loan applications, I get it. I understand what it means to Hispanic families who can't give you the actual data that you need to approve them, but they have the money. They have the money in the house and they have various jobs, but they can't give you the formal type of verifications that you need in the normal environment. But they are willing to do whatever it takes to stay in that home. I get it when—in fact, there is a loan that—one of the first loans I made was in south central Los Angeles to a family that came to me—that was 30 years ago. They came to me just a few years ago with a book of their life and the life was about their house and what that house did to put their children through school and help him build his business, a car retail business. This is a very important thing to me. This is the mission. And I take it very seriously.

Mr. CANNON. And we are at the highest rate of home ownership in the history of America today, are we not?

Mr. MOZILO. We are now. But that's when—my verbal remarks, I'm concerned we're going to go the other way.

Mr. CANNON. Well, I really hope that you're really successful in renegotiating the loans of many of these people. I spend a lot of time in Judiciary Committees trying to stop an attempt to change the bankruptcy laws that would totally foul up our system. Are you familiar with the "New York Times" piece by Gretchen Morgenson that was entitled "Inside the Countrywide Lending Spree?"

Mr. MOZILO. I'm familiar with it. She has written several articles.

Mr. CANNON. In that article, she said providing the best loan possible to your customers was not always the main goal. Have you had a chance to respond to that article? Would you like to now?

Mr. MOZILO. We'd be happy to provide the committee with—we gave a—if that is the article that I think it is, they sent it to us before they printed it, asked us to respond. We found serious flaws in that article—throughout the article, sent our comments to them and their choice was not to make any changes in the article. But obviously it doesn't make any sense for us to make a loan that is going to fail because we lose. They lose, the borrower loses, the community loses and we lose.

Mr. CANNON. That seems so obvious to me that I'm inclined to ask you to repeat it three times and then go over the red light to explain to people, the fact is you're not in the business of making loans, nobody here is in the business of making loans that will cause people to fail. And, in fact, we had this amazing, remarkable time in American history caused by a confluence of events, including availability of capital, but also the securitization, the very complex securitization of loans that have allowed you to have the capital to allow people to get into home loans. And we also had the creativity to come up with systems that allow people to get in.

Do you have any anything else you would like to comment on that, Mr. Mozilo?

Mr. MOZILO. I think what came to mind when you were going through that, Congressman, is that I don't think anybody ever predicted, certainly not to me, that we would have a complete collapse of the credit markets and the capital markets within a week or two

period. And that was the very foundation of which Countrywide operated under, with access to liquidity. And all of that disappeared and there was no model built by anyone in the world that took into consideration that kind of catastrophe.

Mr. CANNON. Mr. Chairman, I noticed my time has expired. I really hope the people on this panel and others are able to solve the problem of renegotiating loans so that constituents like Mr. Cummings referred to and my constituents can solve their problems and America doesn't crater. Thank you and I yield back.

Chairman WAXMAN. The gentleman's time has expired. Mr. Issa.

Mr. ISSA. I thank the chairman. And as we wind down, I want to just clear up a couple of things. And I know Mr. Cummings did not want to mislead anyone.

Ms. NORTON. Would the gentleman yield me 5 seconds?

Mr. ISSA. Of course, Ms. Gentlelady.

Ms. NORTON. Because Mr. Mozilo was kind enough to offer to assign people to Mr. Cummings in order to help with people who have had serious problems with their subprime mortgages. I have my own constituents here in the District of Columbia. Could I ask for a similar assignment?

Mr. MOZILO. Absolutely. And in fact, Congresswoman, we have placed in each of your offices, both the committee offices and the entire House of Representatives, a card which gives you all the reference numbers to call. And if there are any issues whatsoever, call me directly. That's what I do.

Ms. NORTON. Is your number on there, Mr. Mozilo?

Mr. MOZILO. I'll give it to you. I'll be happy to give it to you.

Ms. NORTON. Thank you.

Mr. ISSA. Thank you. And in reclaiming my time, I trust we'll do that one off the air. Mr. Chairman, I would ask unanimous consent to include in the record a number of charts and information related to performance of various funds that include these types of mortgage backed securities, including Merrill Lynch, BlackRock and others.

Chairman WAXMAN. Without objection, it will be made part of the record.

[The information referred to follows:]

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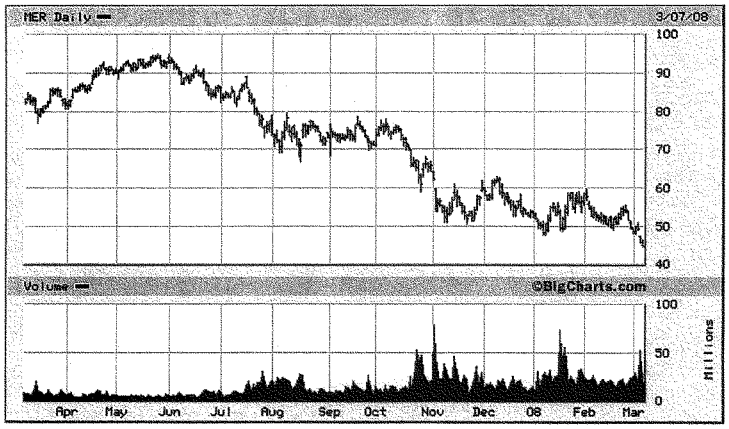
MER Merrill Lynch & Co., Inc 3/7/2008 1:41 PM

Last:	Change:	Open:	High:	Low:	Volume:
44.75	-1.11	45.12	46.47	44.60	18,621,521
	Percent Change:	Yield:	P/E Ratio:	52 Week Range:	
	-2.42%	3.13	n/a	45.70 to 95.00	



Company Data

Company Name:	Merrill Lynch & Co., Inc
Dow Jones Industry:	Investment Services
Exchange:	NYSE
Shares Outstanding:	969,007,000
Market Cap:	43.4 Billion
Short Interest:	31,081,744 (3.21%)
52-Week EPS:	-10.73
52-Week High:	95.00 on Thursday, May 31, 2007
52-Week Low:	45.70 on Thursday, March 06, 2008
P/E Ratio:	n/a
Yield:	3.13%
Average Price:	52.92 (50-day) 67.64 (200-day)

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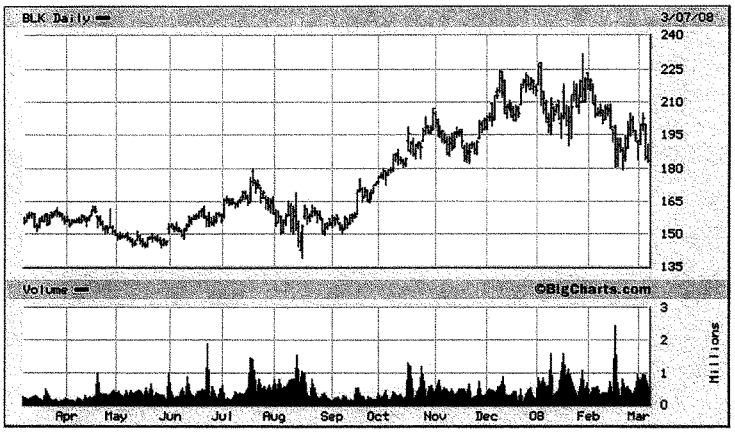
BLK BlackRock Inc 3/7/2008 1:39 PM

Last:	Change:	Open:	High:	Low:	Volume:
183.41	-1.58	184.77	190.65	182.49	530,181
	Percent Change: -0.85%	Yield: 1.70	P/E Ratio: 23.73	52 Week Range: 139.20 to 231.99	



Company Data

Company Name:	BlackRock Inc
Dow Jones Industry:	Asset Managers
Exchange:	NYSE
Shares Outstanding:	117,283,000
Market Cap:	21.5 Billion
Short Interest:	2,513,991 (2.14%)
52-Week EPS:	7.73
52-Week High:	231.99 on Wednesday, January 30, 2008
52-Week Low:	139.20 on Thursday, August 16, 2007
P/E Ratio:	23.73
Yield:	1.70%
Average Price:	205.23 (50-day) 181.98 (200-day)

Mr. ISSA. Thank you, Mr. Chairman. I want to clear up one thing that was said in perhaps a vacuum, sounds terrible to people out in, if you will, the rest of the world that may be watching. Mr. Mozilo, it is kind of interesting that you deal with a tax problem if you take your wife to go meet with institutional lenders or any number of other people with whom you need to develop a relationship or even to a board meeting in which other board members may bring their spouses. I want to note for the record, the chairman, myself, probably everyone that was on the dais here today at some time has put their spouse on a Boeing 737 business jet or a 757 beautifully painted with the United States of America and gone around the world meeting with foreign heads of state, meeting with secretaries, meeting with the people in which our spouses are very helpful in presenting a better view of America. And we do that deliberately. The Speaker of the House included. I've traveled with her and her husband, Paul. So—and we have no tax consequence whatsoever. The only thing we do is we pay for their meals. But on a military jet, it is considered to be at no cost to the government. So I hope we will all put into perspective that those on the dais recognize that often travel with a spouse on official business can in fact be very much good business, good for America and good for the profits of the company, depending upon which side of this dais you're on.

I think it is important again to sort of wrap things up here. And my hope is that we would try to have an understanding. Everything that I've asked to have submitted to the record virtually, including this memorandum or this chart showing the—virtually—and these are median prices. These are not snapshots or current sales. But the median price of a home exceeding inflation at a national level in California, exceeding it by nearly twice what it does on a national basis has gone on almost unrelentlessly on a national basis. A little bit of a dip in the early 1990's. And I know all of you got to see a part of that. Everything that I've asked to have submitted to the record, I think former Fed Chairman Greenspan, Chairman Bernanke, all made the assumption that in fact creditworthiness had to do with wives—you know, marriages, jobs and health. I don't believe that until recently we on the dais and certainly not you there thought that, in fact, underlying value of homes would ultimately be what began a cycle downward. And I would like to put out one question because this is a learned group here today and I'd like to have your input.

Should this committee and the Congress, the government look at—as we do with the Fed chairman who looks at inflation and he looks at the money supply and that money supply related to inflation and jobs, he tries to participate in a regulation so that we not overheat the economy and that we in fact try to not have deep recessions. Should an agency of the government or, if you will, an agency set up by the government like the Fed, look at home pricing, the fact that we put into the market home ownership incentives, sometimes at government expense, and that it fuels the growth in the price of homes or that if we take it out, it can slow it down? Would that type of oversight by the government or an entity that we set up be productive as a result of what we've learned

about overheating the growth in home loans and thus the rise in the value and obviously what we're dealing with today?

Mr. MOZILO. I think that anything—I think we should explore any potential possibility to avoid what we have just—what we're going through. And by the way, I don't think that bullet has fully passed yet, whether it be Goldman or anybody else. I don't think that bullet has completely arrived. But I do believe we should study ways that we can mitigate this kind of disaster. Because the people who really suffer are the people who are in those homes, losing those homes. And as I said, I've never seen anything like this and hopefully we won't see anything like this again.

Mr. ISSA. Is there anyone else before we conclude? Mr. Chairman, I thank you for helping put this in perspective and perhaps lead toward a bipartisan effort to keep these boom-and-bust occurrences from occurring.

Thank you, Mr. Chairman. I yield back.

Chairman WAXMAN. The gentleman's time has expired. The Chair is going to recognize himself for the last round of questions.

Mr. Finnegan, in October 2007, Merrill Lynch's board faced a difficult decision about Mr. O'Neal's ongoing role at the company. Under his leadership as CEO, the company invested heavily in the mortgage market and was suffering record losses as a result of these choices. The board concluded it was time to end Mr. O'Neal's relationship with Merrill Lynch, then had to make a decision about whether to treat his departure as a termination or allow him to retire. Despite the company's financial difficulties, the board did not terminate Mr. O'Neal. Instead they allowed him to resign and then retire from the company. And that decision allowed him to collect a retirement package worth $161 million, including stock and options that had not vested. I can understand the instinct of wanting to allow Mr. O'Neal to retire, but it had real financial repercussions. If the board had fired him for cause, he would have received over $6 million—nothing to sneeze at—in deferred compensation and standard retirement benefits. But he would not have received $131 million in stock and options or an executive annuity worth $24 million because these had not vested. What was the rationale for letting Mr. O'Neal retire with $131 million in unvested stock instead of terminating him and recouping this money for the shareholders?

Mr. FINNEGAN. Sir, the stock awards that Mr. O'Neal had received and which were unvested were governed by certain provisions related to retirement eligibility and cause. Essentially Mr. O'Neal had sufficient points in terms of age and years of service to leave the company and take those stock awards with him unless we could terminate him for cause. The provisions related to cause covered misconduct. They did not cover unsatisfactory financial results.

Chairman WAXMAN. Now, why didn't the contract allow the board to fire him for cause? You were the one who wrote the terms of the contract. So isn't this a boot strap argument you can't fire for cause, it isn't in the contract but you wrote the contract and didn't provide for that?

Mr. FINNEGAN. Well, sir, Mr. O'Neal didn't have a contract individually. The contract I'm referring to is the agreement between

Merrill Lynch and all of its executives, 10,000 executives who are covered by this stock award program. Mr. O'Neal's provisions are not unique. The cause provisions in the stock awards are part of Mr. O'Neal and 10,000 other people and are also generally consistent with the type of cause provisions you see in the industry and American corporations in general.

Chairman WAXMAN. Well, I don't see that in most people's jobs. If there is cause, they get fired. Now you're saying it wasn't just Mr. O'Neal, but many other executives. Your company lost $2.4 billion in the third quarter, $10.3 billion in the fourth quarter, the largest quarterly lost in the company's history. You recorded writedowns of $7.9 billion in the third quarter, $11.5 billion in the fourth quarter. By the end of last year, your stock had plummeted 45 percent from its high in the previous January. If that doesn't qualify as poor performance, it justifies terminating your CEO and maybe others as well for cause, it is hard to understand what does. But to say that you don't have the tools, it means that even if somebody performs badly, there are no consequences to them; isn't that right?

Mr. FINNEGAN. No, sir. I think the consequences were pretty dramatic. Mr. O'Neal lost his job. He got no severance, he got no bonus. And because he was forced to retain stock in the company, he suffered about a $120 million economic penalty.

Chairman WAXMAN. And that was enough of a risk to give him incentive to not do the things that the company did?

Mr. FINNEGAN. Sir, I don't know. I think Mr. O'Neal performed very, very well over a long period of time. In 2007, there was an unprecedented decline in real estate values, a dramatic and precipitous decline in—drying up of liquidity in the mortgage markets. Almost no one——

Chairman WAXMAN. Wait. The mortgage crisis is having enormous repercussions. The families are losing their homes. Our economy is suffering. Thousands are losing their jobs and it seems like everyone is hurting except for the CEOs who had the most responsibility. I have no problem with paying for success, but it looks like when you're a CEO, you get paid for failure. Even if you're the CEO of the largest home loan company, the company perhaps most responsible for the mortgage crisis in the country can make $120 million in stock sales when your shareholders are losing 80 percent of their value.

Now, I thank all of you for being here. And I want to say to Mr. O'Neal and Mr. Prince and Mr. Mozilo what I said in my opening statement. You're all classic American success stories. You have tremendous accomplishments. You've all made enormous contributions to our country. But what is also true is that you're in the middle of an enormous debacle that ended up costing your companies and shareholders billions of dollars. It cost people their homes, it cost other people their jobs. It seems like everyone is hurting except for you. In our first hearing in December on this issue of compensation for executives, we looked at the conflicts of interest among compensation consultants. We shined the light on that problem. As a result, corporate practices are beginning to change. I hope this hearing will also have the same effect. This is the first congressional hearing ever to look at how CEOs are compensated

when their companies are losing billions. And what I think we've learned is that we—if we don't have a system where there are real consequences for failures, that is a real problem. Executives who preside over billions of lost dollars of losses shouldn't be getting millions in bonuses, unvested stock and stock sales, yet this appears to be what is happening. The bottom line is there need to be better mechanisms for accountability. Without this, our economy will remain vulnerable to the kind of economic disruptions we're now experiencing.

I thank you all for being here and I hope you'll all learn from the exchange of information. You've been very generous with your time. That concludes our business, and we stand adjourned.

[Whereupon, at 2:26 p.m., the committee was adjourned.]

[Additional information submitted for the hearing record follows:]

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MEMORANDUM

March 6, 2008

To: Members of the Committee on Oversight and Government Reform

Fr: Majority Staff, Committee on Oversight and Government Reform

Re: Supplemental Information on CEO Pay and the Mortgage Crisis

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On Friday, March 7, 2008, at 10 a.m. in room 2154 of the Rayburn House Office Building, the Oversight Committee will hold a hearing to examine the compensation and retirement packages awarded to the CEOs of three companies implicated in the mortgage crisis: Angelo Mozilo of Countrywide Financial Corporation, E. Stanley O'Neal of Merrill Lynch, and Charles Prince of Citigroup.

In preparation for the Committee's hearing, the Committee has received thousands of pages of documents from the three companies, including board minutes and internal company e-mails. The Committee staff also has reviewed hundreds of public Securities and Exchange Commission (SEC) filings and consulted with leading experts in executive compensation. This memorandum summarizes some of the questions raised by the materials reviewed by the Committee staff.

I. EXECUTIVE SUMMARY

The March 7 hearing provides Committee members the opportunity to examine three case studies in CEO compensation. A common element in the case studies is that each of the CEOs presided over multi-billion dollar losses in the mortgage market. Collectively, the companies run by Mr. Mozilo, Mr. O'Neal, and Mr. Prince lost more than $20 billion in the last two quarters of 2007 alone as a result of investments in subprime and other risky mortgages.

While Countrywide, Merrill Lynch, and Citigroup prospered, Mr. Mozilo, Mr. O'Neal, and Mr. Prince received lucrative pay packages. During the five-year period from January 2002 through December 2006, the stock of Countrywide, Merrill Lynch, and Citigroup appreciated, and the three CEOs collectively received more than $460 million in compensation.

Any alignment between the compensation of the CEOs and their shareholders' interests appears to breakdown in 2007, however. Despite steep declines in the performance and stock price of the three companies resulting from the mortgage crisis, Mr. Mozilo, Mr. O'Neal, and Mr. Prince continued to be well rewarded: Mr. Mozilo received over $120 million in compensation and sales of Countrywide stock; Mr. O'Neal was allowed to leave Merrill Lynch with a $161 million retirement package; and Mr. Prince was awarded a $10 million bonus, $28 million in unvested stock and options, and $1.5 million in annual perquisites upon his departure from Citigroup.

A. Questions about Mr. Mozilo's Compensation

In the case of Mr. Mozilo, the Committee received and analyzed information about both his 2001 and his 2006 employment contracts. Both contracts raise issues about the level of compensation Mr. Mozilo received. In addition, Mr. Mozilo's decision to sell almost $150 million in Countrywide stock from November 2006 through the end of 2007 also raises questions, particularly as many of these sales occurred at the same time the company was borrowing $1.5 billion to repurchase its shares.

Under Mr. Mozilo's 2001 contract, which governed his pay from 2002 through 2006, Mr. Mozilo received total compensation of $185 million in cash, stock, and stock options. In 2004, a compensation consultant hired by the board, Pearl Meyer, raised concerns about the compensation package Mr. Mozilo would receive after his planned retirement as CEO at the end of 2006. The board appears to have accepted some of Pearl Meyer's recommendations and rejected others; it then ended its relationship with the consultant. In 2006, a new compensation consultant, Exequity, raised new questions about Mr. Mozilo's compensation package. According to Exequity, Mr. Mozilo's compensation was based on a flawed "peer group" of companies that inflated his pay and inappropriately placed him at the top of this peer group in terms of salary and bonus.

Countrywide renegotiated and extended Mr. Mozilo's employment contract in the fall of 2006, effective January 2007. The new contract revised Mr. Mozilo's peer group and reduced his compensation. Yet despite these steps, the 2006 contract and the negotiations that defined its terms contain unusual components. Key questions about the 2006 contract include:

- **The Retention of Towers Perrin.** After the board's compensation consultant, Exequity, recommended significant reductions in Mr. Mozilo's compensation, Countrywide management hired a second compensation consultant, Towers Perrin, to review the Exequity proposal. Although the company retained Towers Perrin, internal e-mails show that the consultant appeared to serve as Mr. Mozilo's personal advisor with the goal of achieving "maximum opportunity" for Mr. Mozilo. The final contract was significantly more generous to Mr. Mozilo than Exequity originally recommended.

- **Mr. Mozilo's Separation Package.** Under the "change in control" provisions in Mr. Mozilo's contract, Mr. Mozilo was entitled to a $36 million cash severance. The terms of this agreement appeared to heavily favor Mr. Mozilo. Under the contract, Mr. Mozilo

could terminate his employment and receive severance if the board took an action that "results in the diminution of Executive's status, title, position and responsibilities" or that "results in the Executive not being able to travel by private aircraft at Company expense." In contrast, the board could terminate Mr. Mozilo without paying him cash severance only if Mr. Mozilo is convicted of a felony or acts in "bad faith."

- **The $10 Million Pension Replacement Award.** Under the contract, Mr. Mozilo received $10 million in restricted stock units to compensate him for payments he would have received under his retirement plan if he had retired at the end of 2006. It is unusual to include compensation for not retiring in the pay package of an actively employed CEO.

- **The Calculation of the Cash Bonus.** Under the terms of the 2006 contract, Mr. Mozilo is entitled to a cash bonus (not to exceed $10 million) calculated as a percentage of Countrywide's net income if the company's return on equity (ROE) exceeds 10%. At the time the contract was negotiated, Countrywide was regularly achieving a ROE of over 20%, so the 2006 contract provided Mr. Mozilo with a large bonus even if the company's ROE dropped significantly. One Countrywide official wrote in an internal e-mail: "I can't believe how low the ROE measures are. ... [S]hareholders or newspapers might comment all over this evident fact."

Mr. Mozilo's pattern of stock sales in late 2006 and 2007 raise additional questions. During this period, Mr. Mozilo made three revisions to his stock trading plan, in each case increasing the amount of stock he was authorized to sell. In total, Mr. Mozilo sold 5.8 million shares between November 2006 and December 2007 for almost $150 million. Mr. Mozilo made the first change in his stock trading plan three days after Countrywide announced a $2.5 billion plan to buy back Countrywide stock, which was financed in part by $1.5 billion in new debt. The Countrywide board knew of the changes to Mr. Mozilo's stock trading plan but did not act to prevent Mr. Mozilo's sales. Several board members also made large stock sales during this period.

Particularly in 2007, the discrepancy between Mr. Mozilo's compensation and Countrywide's performance is striking. In 2007, Countrywide announced a $1.2 billion loss in the third quarter and an additional loss of $422 million in the fourth quarter. By December 31, 2007, the company's stock had plummeted 80% from its five-year peak in February. During the same period, Mr. Mozilo was paid $1.9 million in salary, received $20 million in stock awards contingent upon performance, and sold $121 million in stock.

Countrywide's losses have continued in 2008. In SEC filings last week, Countrywide reported a large increase in delinquencies on its pay option adjustable-rate mortgages. Its stock is now trading at $5.70 per share, a drop of more than 87% from its high of $45.03 per share during the stock buyback in early 2007.

B. Questions about Mr. O'Neal's Compensation

The major questions about Mr. O'Neal's compensation surround the terms of his retirement as CEO of Merrill Lynch in October 2007. During 2007, Merrill Lynch reported $18 billion in write-downs related to subprime and other risky mortgages. By the end of 2007, the company's stock had fallen 45% from its five-year peak in January. Yet when Mr. O'Neal departed the company in October, Merrill Lynch awarded him a retirement package worth $161 million.

The largest component of Mr. O'Neal's retirement package was the award of $131 million in unvested stock and options. If the Merrill Lynch board had terminated Mr. O'Neal for cause, he would have forfeited these stock and options because they had not yet vested. Allowing Mr. O'Neal to retire instead of terminating his employment for poor performance significantly inflated the value of Mr. O'Neal's retirement package. It is unclear why this decision was in the interests of Merrill Lynch shareholders.

The Merrill Lynch board also decided to loosen the non-competition restrictions in Mr. O'Neal's retirement contract. An agreement that Mr. O'Neal signed in 2004 prohibited Mr. O'Neal from working for a competitor of Merrill Lynch for approximately three years after his retirement. In October 2007, the Merrill Lynch board approved a new non-competition agreement that cut the duration of the non-competition clause in half and significantly narrowed the companies to which it applied. Only one board member raised an objection to this revision in the agreement.

C. Questions about Mr. Prince's Compensation

After Mr. Prince left Citigroup in November 2007, he received a cash bonus worth $10.4 million. The board also allowed him to retain more than $28 million in unvested restricted stock and stock options. It is unclear how these decisions were related to Mr. Prince's performance or benefited Citigroup shareholders. During 2007, Citigroup announced more than $18 billion in write-downs related to subprime and other risky mortgages, and its stock dropped by 48% from its five-year peak in December 2006. Unlike Mr. Prince, neither Mr. Mozilo nor Mr. O'Neal received a performance bonus in 2007.

The board also awarded Mr. Prince perquisites, worth $1.5 million annually, upon his retirement in November 2007. These perquisites included an office, an administrative assistant, and a car and driver for five years, as well as a commitment to pay taxes associated with the award of these benefits. Mr. Prince had no employment contract entitling him to these benefits upon his retirement from Citigroup.

Earlier this week, Citigroup's stock fell to a nine-year low after foreign investors predicted more losses for the company. Citigroup's stock has now fallen 61% since its high in December 2006.

II. BACKGROUND

By any measure, executive pay is rising rapidly and dramatically. According to *Forbes* magazine, CEOs of the largest 500 U.S. companies received an average of $15.2 million each in 2006, a collective raise of 38% over 2005.[1] Many experts believe there is a growing disconnect between CEO pay and performance, as increases in executive pay cannot be explained by factors such as changes in firm size or performance.[2] In a recent survey of more than 1,000 directors at large U.S. companies, 67% said that they believe boards are having difficulty controlling the size of CEO pay packages.[3]

The large increases in executive compensation also have widened the gulf between CEO pay and that of the average worker. In 1980, CEOs in the United States were paid 40 times the average worker.[4] In 2006, the average Fortune 250 CEO was paid over 600 times the average worker.[5] While CEO pay has soared, employees at the bottom of the pay scale have seen their real wages decline by more than 10% over the past decade.[6]

Last year, the Oversight Committee initiated an investigation into rising executive compensation. In a December hearing, the Committee examined the role played by compensation consultants in setting CEO pay. At the hearing, Chairman Waxman released a report that analyzed conflicts of interest among compensation consultants. This report found that more than 100 large publicly traded companies hired compensation consultants in 2006 with significant conflicts of interest. In many cases, the consultants hired to advise on executive pay were simultaneously receiving millions of dollars from the corporate executives whose compensation they were supposed to assess.[7]

Tomorrow's hearing continues the Committee's inquiry into executive compensation. It will allow the Committee to examine three case studies of executive compensation: the compensation and separation packages awarded to Angelo Mozilo, the Chairman and CEO of Countrywide Financial Corporation; E. Stanley O'Neal, the former Chairman and CEO of Merrill Lynch; and Charles Prince, the former Chairman and CEO of Citigroup.

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[1] *Big Paychecks*, Forbes (May 3, 2007).

[2] Lucian Bebchuk and Yaniv Grinstein, *The Growth of Executive Pay*, Oxford Review of Economic Policy, Vol. 21, 283-303 (2005).

[3] Corporate Board Member and Pricewaterhouse Coopers, *What Directors Think: Annual Board of Directors Survey* (Oct. 2007).

[4] Institute for Policy Studies and United for a Fair Economy, *Executive Excess 2007: The Staggering Social Cost of U.S. Business Leadership* (Aug. 2007).

[5] *Id.*

[6] The current minimum wage is $5.85 — adjusted for inflation, $4.49 in 1997 dollars. The actual minimum wage in 1997 was $5.15.

[7] Majority Staff, House Committee on Oversight and Government Reform, *Executive Pay: Conflicts of Interest Among Compensation Consultants* (Dec. 2007).

The three CEOs are linked by their involvement in the mortgage crisis. Countrywide, Merrill Lynch, and Citigroup all profited enormously in the short term from their investments in subprime and other risky mortgages, and all three companies are suffering now as a result of these investments. Collectively, the three companies recorded losses of more than $20 billion in the last two quarters of 2007: Countrywide lost $1.6 billion;[8] Merrill Lynch lost $10.3 billion;[9] and Citigroup lost $9.8 billion.[10] The hearing provides a lens through which to examine whether the executive compensation and severance arrangements at these companies provided appropriate incentives to protect shareholders from these losses.

In preparation for the hearing, the Committee requested that each company provide internal documents related to the compensation and severance packages of their CEOs. The Committee staff reviewed thousands of pages of company e-mails, board minutes, and other internal documents. The staff also reviewed public SEC filings and interviewed dozens of experts regarding executive pay practices. This memorandum summarizes the compensation and retirement packages awarded to each CEO and identifies questions about whether the terms of the packages advanced the shareholders' interests.

III. MR. MOZILO'S COMPENSATION

Angelo Mozilo co-founded Countrywide in 1969, becoming its CEO in February 1998 and Chairman of the Board in March 1999. Table 1 summarizes the compensation that Mr. Mozilo received while serving as Chairman and CEO.

Mr. Mozilo has been richly compensated by Countrywide, receiving almost $250 million in total compensation since becoming CEO. He also has collected an additional $406 million from the sale of his Countrywide stock. The company prospered during the first ten years Mr. Mozilo served as CEO. Since February 2007, however, Countrywide's stock has fallen by 87% to $5.70 per share.

Three aspects of Mr. Mozilo's compensation raise the most concerns. These are (1) the terms of his 2001 compensation agreement; (2) the terms and negotiation of his 2006 compensation agreement; and (3) his stock sales since October 2006. In each area, there are questions whether the actions of Mr. Mozilo and the board advanced the interests of Countrywide's shareholders.

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[8] Countrywide Financial Corporation, *Countrywide Reports 2007 Fourth Quarter & Year-End Results* (Jan. 29, 2008).

[9] Merrill Lynch, *Merrill Lynch Reports Full Year 2007 Net Loss from Continuing Operations of $8.6 Billion* (Jan. 17, 2008).

[10] Citigroup, *Citi Reports Fourth Quarter Net Loss of $9.83 Billion, Loss Per Share of $1.99* (Jan. 15, 2008).

Table 1. Compensation Awarded to Angelo Mozilo, 1998-2007[11]

Year	Base Salary	Cash Bonus	Other Compensation	Restricted Stock/SARs*	Grant Date Value of Options*	Total Compensation
1998	$1,400,000	$3,935,821	$707,804	$0	$0	$6,043,625
1999	$1,400,000	$4,210,970	$509,031	$0	$0	$6,120,001
2000	$1,650,000	$3,756,377	$570,227	$0	$5,344,850	$11,321,454
2001	$1,458,333	$4,653,601	$570,368	$0	$12,732,305	$19,414,607
2002	$2,041,667	$7,763,976	$733,394 (Includes $133,524 in personal use of company aircraft and related gross-up payments, $37,627 for country club dues, and $26,034 for car use.)	$0	$4,341,295	$14,880,332
2003	$2,266,667	$19,890,455	$641,589 (Includes $78,192 in personal use of company aircraft and related gross-up payments, $95,135 for country club dues, and $27,072 for car use.)	$1,072,827	$9,116,597	$32,988,135
2004	$2,466,667	$17,273,290	$621,241 (Includes $155,542 in personal use of company aircraft and related gross-up payments, $31,249 for country club dues, and $27,150 for car use.)	$2,826,900	$29,806,000	$52,994,098
2005	$2,666,667	$19,557,361	$726,314 (Includes $230,452 in personal use of company aircraft and related gross-up payments, $40,282 for country club dues, and $26,660 for car use.)	$0	$18,360,300	$41,310,642
2006	$2,866,667	$20,461,473	$643,205 (Includes $89,939 for personal use of company aircraft, $15,481 for country club dues, and $27,010 for car use.)	$0	$19,012,000	$42,983,345
2007	$1,900,000	$0	Unknown	$20,000,000	$0	$21,900,000
TOTAL	$20,116,668	$101,503,324	$5,723,173	$23,899,727	$98,713,347	$249,956,239

** The value of stock awards and option awards is based on grant date fair value. Stock awards would be worth less today given decline in stock price. Unexercised options are currently underwater.*

A. The 2001 Compensation Agreement

The terms of Mr. Mozilo's compensation, retirement, and severance are defined in compensation agreements with Countrywide. In March 2001, Mr. Mozilo and Countrywide entered into an agreement that specified the terms of his compensation through February 2006.[12] In 2004, this agreement was extended with modest modifications through December 2006.

In 2004, as Countrywide was considering the extension of Mr. Mozilo's compensation agreement, the board retained the services of Pearl Meyer, a leading compensation consultant. Pearl Meyer raised concerns about the provisions of the contract that governed the pay Mr. Mozilo would receive if he stepped down as CEO at the end of 2006 but retained his position as Chairman of Board, as the company's succession plan anticipated. Pearl Meyer recommended

[11] Salary, bonus, and equity data are extracted from Countrywide proxy statements and confirmed by Countrywide documents provided to the Committee (CFC BATES No. 0001016-0001017). "Other compensation" data are extracted from Countrywide proxy statements.

[12] Countrywide Financial Corporation, 2007 Proxy Statement, Form DEF14A (Apr. 27, 2007), 50-54. (hereinafter "Countrywide 2007 Proxy").

reducing Mr. Mozilo's salary and bonus as a "non-employee" chairman. The consultants wrote that Mr. Mozilo should not receive a $1 million base salary but "should be compensated the same as the Company's other outside Board members, plus an annual retainer as Chairman."[13] Pearl Meyer also argued that Mr. Mozilo should not be eligible for severance as a non-employee chairman: "While severance protection may be appropriate for the period in which Mr. Mozilo serves as Employee Chairman, we do not advise protecting his term as an outside Board member of Countrywide."[14]

In the final 2004 extension agreement, the board aligned Mr. Mozilo's pay as non-employee chairman of the board with the pay of other outside directors but declined to address Mr. Mozilo's potential compensation as an employee chairman.[15] The board subsequently ended its relationship with Pearl Meyer.

In 2006, as the board was renegotiating Mr. Mozilo's compensation, the board hired Ross Zimmerman from the firm Exequity as a compensation consultant. Mr. Zimmerman's analysis raised multiple questions about the terms of the 2001 compensation agreement. He questioned the "peer group" that the board had used in establishing Mr. Mozilo's compensation. He also objected to paying Mr. Mozilo at the 90th percentile of this peer group.[16]

B. The 2006 Compensation Agreement

In 2006, Mr. Zimmerman recommended several specific changes to Mr. Mozilo's pay package to address increasing public scrutiny and shareholder activism concerning executive compensation. First, he proposed revising the peer group of companies used to target Mozilo's compensation by removing investment banks and focusing instead on diversified financial institutions, which represented a more appropriate comparison to Countrywide's business areas. Second, he proposed reducing Mr. Mozilo's compensation from the 90th percentile to between the 50th and 75th percentile of CEO compensation at peer group companies. Third, he proposed tying Mr. Mozilo's cash and equity bonuses to attainment of objective financial metrics and setting maximum awards. In dollar terms, these recommendations would have targeted Mr. Mozilo's annual compensation at $14,250,000 and set a maximum of $27,250,000.[17]

After Mr. Zimmerman and the compensation committee proposed cuts in Mr. Mozilo's compensation, Countrywide management hired a competing compensation consultant, John

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[13] Fax from Claude Johnson and Garry Rogers to Michael Dougherty and Harley Snyder, *Countrywide CEO Employment Agreement* (June 11, 2004) (CFC BATES No. 0000786).

[14] *Id. at 788.*

[15] Countrywide Form 8-K, *Entry into a Material Definitive Agreement* (Oct. 20, 2006).

[16] *Revised Pay Proposal for Angelo Mozilo* (Sept. 19, 2006) (CFC BATES No. 0011023-0001035).

[17] *Revised Pay Proposal for Angelo Mozilo* (Sept. 19, 2006) (CFC BATES No. 0011023-0001035).

England of Towers Perrin, to evaluate the board's proposal. In an e-mail from Mr. England to Mr. Zimmerman, Mr. England asserted:

> Towers Perrin has been retained by Countrywide Financial, not by any individual at Countrywide. ... To Towers Perrin, it is irrelevant who hires us — our role is to provide appropriate counsel for decision-making, independent of influence.[18]

Mr. Mozilo, however, regarded Mr. England as his personal representative, even though he was being paid by Countrywide. In an e-mail to Susan Bow, the Senior Managing Director, General Counsel and Corporate Secretary of Countrywide, Mr. Mozilo wrote: "Approximately two weeks ago, [the head of the compensation committee] and I agreed that it would be best if I obtained a compensation consultant. Since that time I brought in John England (consultant-Towers Perrin) and Jim Barrall (attorney-Latham Watkins)."[19]

Other documents appear to substantiate Mr. England's role as personal advisor to Mr. Mozilo. Mr. England and his colleagues at Towers Perrin appear to have discussed the terms of a possible counter-proposal only with Mr. Mozilo, rather than with other Countrywide management. Mr. England submitted his preliminary proposal to Mr. Mozilo on October 4, 2006, copying only Mr. Mozilo's attorney and other Towers Perrin employees and no members of Countrywide's management.[20] In an October 15, 2006, e-mail, Mr. Mozilo noted that Mr. England transmitted the revised proposal to the Countrywide board only after being "instructed" to do so by Mr. Mozilo.[21]

In the counter-proposal to the board, Mr. England proposed multiple changes to Mr. Zimmerman's original compensation proposal. On the issue of the peer group against which Mr. Mozilo's compensation should be measured, Mr. England suggested dropping Sun Trust, BB&T, and Fifth Third Bancorp, all of which better matched Countrywide's size and had lower paid CEOs, and replacing them with Goldman Sachs, Merrill Lynch, and Bank of America, all of which are large investment banks with higher paid CEOs.[22] He also proposed that Mr. Mozilo receive a $15 million "sign-on equity award."[23]

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[18] E-mail from John England to Ross Zimmerman (Sept. 28, 2006) (CFC BATES No. 0000798).

[19] E-mail from Angelo Mozilo to Susan Bow (Oct. 15, 2006) (CFC BATES No. 0000660).

[20] E-mail from John England to Angelo Mozilo (Oct. 4, 2006) (CFC BATES No. 0000803).

[21] E-mail from Angelo Mozilo to Susan Bow (Oct. 15, 2006) (CFC BATES No. 0000660).

[22] Towers Perrin, *Countrywide Financial: Competitive Compensation Arrangement for the Chairman of the Board and CEO* (Oct. 4, 2007) (CFC BATES No. 0000858).

[23] *Id.* at CFC BATES No. 0000848.

In the end, the board made a number of revisions to accommodate Mr. Mozilo and Mr. England. On the issue of the appropriate peer group, the board dropped BB&T and Fifth Third Bancorp and added Merrill Lynch.[24] Noting its discomfort with giving Mr. Mozilo a $15 million "contract renewal" bonus, as Mr. England advocated, the board instead gave Mr. Mozilo $10 million and positioned it as reimbursement for retirement payments he could have received had he retired.[25]

After receiving the board's final proposal, Mr. England e-mailed Mr. Mozilo:

> My primary unhappiness with what the Board has put forth is that it lowers your maximum opportunity significantly. That's been accomplished by lowering the target bonus and reducing the maximum bonus. ...
>
> That being said, given your desire to sign an agreement today, the Board's proposal is not unreasonable. It's a significant enhancement from what Zimmerman had the first time around.[26]

In response, Mr. Mozilo e-mailed Mr. England:

> I appreciate your input but at this stage in my life at Countrywide this process is no longer about money but more about respect and acknowledgement of my accomplishments. ... Boards have been placed under enormous pressure by the left wing anti business press and the envious leaders of unions and other so called "CEO Comp Watchers" and therefore Boards are being forced to protect themselves irrespective of the potential negative long term impact on public companies. I strongly believe that a decade from now there will be a recognition that entrepreneurship has been driven out of the public sector resulting in underperforming companies and a willingness on the part of Boards to pay for performance.[27]

The final 2006 compensation agreement reflected an effort by the Countrywide board to reduce Mr. Mozilo's compensation. Even so, several components of the final agreement appear to benefit Mr. Mozilo while offering little value to Countrywide and its shareholders. These include the $81 million separation package, the $10 million pension replacement award, the calculation of the cash bonus, and the perquisites.

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[24] *Countrywide Financial Corporation, Overview of Pay Package for Angelo Mozilo, as Approved by Countrywide's Board of Directors* (Oct. 20, 2006)) (CFC BATES No. 0000883-886).

[25] *Id.*

[26] E-mail from John England to Angelo Mozilo (Oct. 20, 2006) (CFC BATES No. 0000888).

[27] E-mail from Angelo Mozilo to John England (Oct. 20, 2006) (CFC BATES No. 0000888).

1. The $81 Million Separation Package

Mr. Mozilo's 2006 employment agreement outlines the terms of his compensation in the event of his resignation, termination, or a "change in control" at the company. The company has estimated the value of his benefits upon separation at $81 million, including $37.5 million in severance and benefits. Table 2 summarizes the components of Mr. Mozilo's separation package.

Table 2. Estimated Value of Angelo Mozilo's Separation Package[28]

Type of benefit	Value
Cash severance	$36,392,209
Pension/retirement benefits (SERP)	$22,340,419
Deferred compensation	$20,604,877
Equity acceleration (at $7 per share)	$1,609,148
Consulting agreement (per year)	$400,000
Perquisites*	$45,651
Estimated Benefits for Separation of Employment	$81,392,304

** The value for perquisites only includes the value of "health and welfare" benefits. Under the contract, Mr. Mozilo is also entitled to other perquisites, including use of the company airplane, payment of country club dues, office space, and other benefits. The monetary value of these perquisites is unknown.*

The separation terms of the employment agreement heavily favor Mr. Mozilo. Under the agreement, Mr. Mozilo can terminate his employment under a wide range of circumstances and receive cash severance. According to the agreement, Mr. Mozilo can terminate his employment and still receive cash severance and other benefits if Countrywide "takes any action ... which results in the diminution of Executive's status, title, position and responsibilities."[29] He can even terminate his employment with severance if the company "takes an action that results in Executive not being able to travel by private aircraft at Company expense."[30]

On the other hand, Countrywide appears to have little, if any, authority to reduce the size of Mr. Mozilo's separation package for poor performance. The compensation agreement does authorize the board to revoke certain components of the separation package "for cause."[31] But "cause" is defined so narrowly that it does not appear to include poor performance. Under the contract, "cause" is defined as a conviction for a felony or a material breach of the employment

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[28] Based on data provided in Countrywide documents provided to the Committee (CFC BATES No. 0000672) and Countrywide's 2007 Proxy.

[29] Countrywide Form 8-K, *Compensatory Arrangements of Certain Officers*, 13 (Dec. 26, 2006).

[30] *Id.*

[31] *Id at 12.*

agreement "committed in bad faith or without a reasonable belief that such breach is in the best interests of the Company."[32]

In his prepared testimony, Harley Snyder, the current chair of Countrywide's compensation committee, asserts that Mr. Mozilo's compensation agreement "aligned Mr. Mozilo's interests with that of the shareholders."[33] But the terms of Mr. Mozilo's compensation agreement appear to sever this purported alignment during periods of declining stock value. Under the agreement, the Countrywide board does not appear to have had the authority to terminate Mr. Mozilo's employment and revoke his cash severance for poor performance.

On January 11, 2008, Bank of America announced plans to acquire Countrywide.[34] Under the terms of Mr. Mozilo's compensation agreement, this change in control entitles Mr. Mozilo to a large cash severance. On January 28, after the Committee informed Mr. Mozilo that he would be called as a witness, Mr. Mozilo announced he would forfeit his cash severance and the consulting agreement and perquisites following the anticipated Bank of America merger. The value of his forfeited severance and benefits is $37.5 million.[35]

2. The $10 Million Pension Replacement Award

Mr. England proposed giving Mr. Mozilo a one-time $15 million grant of restricted stock to provide an incentive for the new three-year term and recognize his "significant concessions" in target compensation.[36] The board agreed to a $10 million annual equity award but resisted giving Mr. Mozilo $15 million and indicated that it was not "comfortable" with the positioning of the award proposed by Mr. Mozilo; instead, it opted to offer Mr. Mozilo a one-time equity award of $10 million to reimburse him for foregone retirement benefits.[37] This payment was to be made in addition to the other components of Mr. Mozilo's compensation, including his salary and any bonus.

After realizing that he was eligible to collect $3 million per year under his Supplemental Executive Retirement Plan (SERP), Mr. Mozilo suggested to Mr. England in an e-mail that

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[32] *Id.*

[33] House Committee on Oversight and Government Reform, Testimony of Harley Snyder, *Executive Compensation II: CEO Pay and the Mortgage Crisis,* 110th Cong. (Mar. 7, 2008).

[34] Bank of America, *Bank of America Agrees to Purchase Countrywide Financial Corp* (Jan. 11, 2008).

[35] Countrywide Financial Corporation, *Countrywide CEO Angelo Mozilo Announces Decision to Voluntarily Relinquish Rights to Approximately $37.5 Million in Cash Severance Payments, Consulting Fees and Perquisites* (Jan. 28, 2008).

[36] Towers Perrin, *Countrywide Financial: Competitive Compensation Arrangement for the Chairman & CEO* (Oct. 24, 2006) (CFC BATES No. 0000861).

[37] Countrywide Financial Corporation, *Overview of Pay Package for Angelo Mozilo, as Approved by Countrywide's Board of Directors* (CFC BATES No. 0000883-0000886).

"[a]lthough it may be unusual," he wanted to collect these retirement payments while continuing his employment with Countrywide.[38] Mr. England did not believe this was a good idea. He wrote: "We can troll through proxy statements but I have never heard of a CEO receiving a pension payment in addition to earning salary, bonus, and long-term incentives."[39] In the end, Mr. Mozilo agreed to accept the $10 million pension replacement award offered by the board.

3. The Calculation of the Cash Bonus

Another noteworthy component of the 2006 compensation agreement is the formula used for calculating Mr. Mozilo's cash bonus. According to the agreement, Mr. Mozilo would receive a cash bonus calculated as a percentage of net income based on the company's return on equity (ROE). If Countrywide's ROE was lower than 10%, he would not receive a cash bonus. If ROE was between 10% and 12%, he would receive a bonus calculated as 0.44% of the company's net income over 10% ROE. If ROE exceeded 12%, he would receive a cash bonus equivalent to 0.44% of Countrywide's net income over 10% ROE, plus 0.64% of Countrywide's net income over 12% ROE, with a maximum value of $10 million.[40]

Through the second quarter of 2007, Countrywide's ROE was 23% over the previous five years, nearly double the threshold set in the agreement.[41] As a result, the new formula had the effect of rewarding Mr. Mozilo even if ROE declined significantly. One member of Countrywide's human resources department wrote in an e-mail: "I can't believe how low the ROE measures are. Over the past three years CFC's ROE has been in excess of 17%. ... [S]hareholders or newspapers might comment all over this evident fact."[42]

4. The Perquisites

One point of contention during the contract negotiations was the level of perquisites Mr. Mozilo would receive. Mr. Mozilo emphasized on several occasions that he expected his new contract to provide explicitly for reimbursement of any taxes owed when his wife traveled with him on the Countrywide jet. In one e-mail to Mr. England, Mr. Mozilo wrote: "in order to avoid extraordinary travel expenses to be incurred by [the President and Chief Operating Officer] and me the spouses would have to travel commercial or not at all, which is not right nor wise."[43]

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[38] E-mail from Angelo Mozilo to John England (Nov. 24, 2006) (CFC BATES No. 0000953).

[39] E-mail from John England to Angelo Mozilo (Nov. 24, 2006) (CFC BATES No. 0000953).

[40] Countrywide Form 8-K, *Compensatory Arrangements of Certain Officers* (Dec. 26, 2006).

[41] *Mozilo Wins Even if Countrywide's Profits Plummet*, Reuters (July 25, 2007).

[42] E-mail from Tara Nadaf to Chuck Quon (Nov. 17, 2006) (CFC BATES No. 0000650).

[43] E-mail from Angelo Mozilo to John England (Nov. 23, 2006) (CFC BATES No. 0000952).

At the end of this e-mail, Mr. Mozilo raised the possibility of retiring if the board did not address this and other concerns:

> The Board must understand that if I were to retire today I would be receiving the SERP, receive approx. $15 million in deferred comp., get Directors fees and be able to liquidate my 12 million shares without restriction. More importantly I wouldn't have to continuously travel all over the world on behalf of the shareholders.[44]

The final compensation agreement obligated Countrywide to pay any taxes due when Mr. Mozilo's wife accompanied him on business trips on the corporate jet.[45]

C. Mr. Mozilo's Stock Sales

In addition to his compensation in the form of salary, bonuses, and other compensation, Mr. Mozilo has made hundreds of millions of dollars by exercising stock options and selling shares. In total, as shown in Table 3, he has made more than $400 million by exercising stock options and selling shares since he became CEO in 1998.

Table 3. Money Earned Upon Exercise of Stock Options, 1998-2007[46]

Year	Value Realized Upon Option Exercise	Year	Value Realized Upon Option Exercise
1998	$0	2004	$48,591,496
1999	$0	2005	$119,024,772
2000	$416,823	2006	$72,214,959
2001	$0	2007	$121,726,054
2002	$10,420,372		
2003	$34,361,357	Total	$406,755,833

Mr. Mozilo's transactions in 2006 and 2007 raise particular questions because during this period, Mr. Mozilo made three changes to his stock trading plan, called a "10b5-1 plan," to increase the volume of shares he could sell. The Securities and Exchange Commission (SEC) authorizes the use of 10b5-1 stock trading plans by corporate executives as an affirmative defense or "safe harbor" against insider trading allegations. Under these plans, executives must

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[44] *Id.*

[45] Countrywide Form 8-K, *Compensatory Arrangements of Certain Officers*, 10 (Dec. 26, 2006).

[46] Data for 1998-2006 extracted from Countrywide proxy statements; data for 2007 calculated based Committee analysis of Countrywide Form 4 filings with the SEC for Jan. 4, 2007 through Oct. 12, 2007, the date of Mr. Mozilo's last sale.

set the dates or prices of their trades in advance and cannot set up a plan when they possess material knowledge not available to the public.[47]

On October 24, 2006, Mr. Mozilo announced that the company would execute a board-approved plan to repurchase up to $2.5 billion in Countrywide stock.[48] The day after, Countrywide's stock price jumped $1.41, almost 4%.[49] Just three days later, on October 27, 2006, Mr. Mozilo adopted a new 10b5-1 plan allowing him to sell 350,000 shares a month.[50] In November, the company repurchased 38.6 million shares of its common stock for $1.5 billion, financed through the issuance of new debt.[51]

On December 12, 2006, Mr. Mozilo filed another stock trading plan to increase his sale of shares.[52] On February 2, 2007, Mr. Mozilo amended this new trading plan to increase once again the number of shares he could sell. He now was allowed to sell 580,000 shares each month.[53] On the same day of this last change, Countrywide shares reached an all-time high of $45.03 per share.

On May 16, 2007, Countrywide announced plans to buy back 23 million more shares for about $1 billion.[54] The company executed this buy back immediately in May.[55] Countrywide's stock prices increased by almost $1 per share the day after the announcement.[56]

In total, Mr. Mozilo sold approximately 5.8 million shares between November 2006 and the end of 2007, realizing almost $150 million.[57]

The Countrywide board was aware of the revisions to Mr. Mozilo's stock trading plan, but took no steps to prevent Mr. Mozilo from selling shares while the company implemented its share buyback plan. In fact, several board members also sold millions of dollars worth of shares

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[47] 17 C.F.R. Section 240.10b5-1(c)(2006); Jesse M. Fried, *Insider Abstention*, 113 YALE L.J. 455, 487 (2003).

[48] Countrywide, *Countrywide Reports 2006 Third Quarter Results* (Oct. 24, 2006).

[49] Committee analysis of Merrill Lynch's stock prices, obtained from www.nasdaq.com.

[50] Committee analysis of Countrywide Form 4 filings with the SEC.

[51] Countrywide Form 10-K, 42 (Mar. 1, 2007).

[52] Committee analysis of Countrywide Form 4 filings with the SEC.

[53] *Id.*

[54] *Countrywide Financial rises on plan to buy back 23 million shares*, Associated Press (May 17, 2007).

[55] Countrywide Form 10-Q, 103 (Aug. 9, 2007).

[56] Committee analysis of Merrill Lynch's stock prices, obtained from www.nasdaq.com.

[57] Committee analysis of Countrywide Form 4 filings with the SEC between Nov. 1, 2006 and Oct. 12, 2007.

during the same period.[58] Harley Snyder, the current chair of the compensation committee, was among the board members making stock sales during this period.[59]

IV. MR. O'NEAL'S COMPENSATION

Stanley O'Neal joined Merrill Lynch in 1986, rising to CEO in December 2002 and Chairman in 2003; he resigned in October 2007. He did not have an employment agreement while serving as CEO and Chairman.

Mr. O'Neal was well compensated by Merrill Lynch. During Mr. O'Neal's six-year tenure as CEO, he received more than $163 million in cash, stock, and stock options. Table 4 summarizes the details of Mr. O'Neal's compensation during this period.

Table 4. Compensation Awarded to Stanley O'Neal, 2002-2007[60]

Year	Base Salary	Cash Bonus	Other Compensation	Restricted Stock*	Stock Options*	Total Compensation
2002	$500,000	$7,150,000	$77,553	$5,355,000	$2,295,000	$15,377,553
2003	$500,000	$13,500,000	$312,299 (Includes $114,158 in personal aircraft use and $167,838 for car use)	$11,200,000	$2,800,000	$28,312,299
2004	$700,000	$0	$334,517 (Includes $119,395 in personal aircraft use and $185,033 for car use)	$31,300,000	0	$32,334,517
2005	$700,000	$14,100,000	$500,294 (Includes $163,685 in personal aircraft use and $198,394 in car use.)	$22,200,000	0	$37,500,294
2006	$700,000	$18,500,000	$375,298 (Includes $149,133 in personal aircraft use and $212,505 in car use.)	$28,800,000	0	$48,375,298
2007	$584,000	$0	$593,691 (Details will be revealed in 2008 proxy.)	$0	0	$1,177,691
Total	$3,684,000	$53,250,000	$2,193,652	$98,855,000	$5,095,000	$163,077,652

** The value of stock awards and option awards is based on the grant date fair value. Stock awards would be worth less today given the decline in stock price. Some unexercised options are currently underwater.*

[58] *Id.*

[59] *Id.*

[60] Salary, bonus, and equity data are extracted from Merrill Lynch proxy statements and confirmed by a Merrill Lynch document provided to the Committee, "E. Stanley O'Neal Six Year Total Compensation History" (No BATES number). "Other compensation" data are extracted from Merrill Lynch proxy statements.

For most of Mr. O'Neal's term as CEO, Merrill Lynch prospered. In the fourth quarter of 2007, however, Merrill Lynch reported a net loss of $10.3 billion, the largest quarterly loss in the company's history.[61] The company also recorded write-downs of $7.9 billion in the third quarter and $11.5 billion in the fourth quarter.[62] These losses were related to sub-prime mortgage exposure accumulated under Mr. O'Neal's leadership. By the end of 2007, the company's stock had fallen 45% to $53.68 per share from its five-year peak of $97.53 per share in January 2007.[63] Merrill Lynch stock closed at $49.32 per share on March 5, 2008.[64]

When Mr. O'Neal departed Merrill Lynch in October 2007, the board faced four key issues: (1) whether to allow Mr. O'Neal to retire; (2) whether to renegotiate his noncompetition agreement; (3) whether to offer him continuing perquisites; and (4) whether to pay him any special severance. The decisions the board made significantly enriched Mr. O'Neal at a time when Merrill Lynch and its shareholders were absorbing large losses. It is questionable whether these decisions served the interests of Merrill Lynch and its shareholders.

A. The Award of $131 Million in Unvested Stock and Stock Options

In dollar terms, the biggest decision the board made upon Mr. O'Neal's departure was its decision to allow him to retire rather than to terminate him for cause.[65] In total, Mr. O'Neal's retirement package was worth $161 million at the time of his departure, which included $24.6 million in pension, retirement, and annuity benefits. This total also included $5.4 million in deferred compensation, which he stood to collect regardless of the circumstances of his termination.[66] By far the largest component of Mr. O'Neal's retirement package was $131 million in unvested stock and options.[67] If the board had terminated Mr. O'Neal for cause, he would have been required to forfeit these unvested stock and options.

The terms of Merrill Lynch's equity grants to employees provide that the board has "sole, absolute, and unreviewable discretion" to cancel unvested grants by terminating employees for cause.[68] During the Committee's investigation, Merrill Lynch's representatives told staff that the company could have been subject to litigation if the board had dismissed Mr. O'Neal for

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[61] Merrill Lynch, *Merrill Lynch Reports Full Year 2007 Net Loss from Continuing Operations of $8.6 Billion* (Jan. 17, 2008).

[62] *Id.*

[63] Committee analysis of Merrill Lynch's stock prices, obtained from www.nasdaq.com.

[64] *Id.*

[65] Document provided to the Committee entitled "ESO Holdings and Valuation" (value as of Oct. 29, 2007) (No BATES number).

[66] *Id.*

[67] Merrill Lynch estimates that Mr. O'Neal's package is now worth about $107.7 million, as of Mar. 3, 2008, as a drop in the company's stock price has lowered the value of his equity holdings. E-mail from Raymond S. Calamaro to Committee staff (Mar. 4, 2008).

[68] Policy language provided to Committee by Merrill Lynch (Feb. 8, 2008).

cause and canceled his unvested stock and options because Mr. O'Neal's actions did not meet the company's definition of "cause." The document authorizing certain equity grants defines termination for cause as follows:

> "Cause" shall mean a determination by a committee ... that in its sole, absolute, and unreviewable discretion: (i) at the time of the termination of your employment, you had committed: a) any violation of Merrill Lynch's rules, regulations, policies, practices, and/or procedures; b) any violation of the laws, rules, or regulations of any governmental entity or regulatory or self-regulatory organization, applicable to Merrill Lynch; or c) criminal, illegal, dishonest, immoral, or unethical conduct reasonably related to your employment; and (ii) as a result of such conduct, it is appropriate to disqualify you from Career Retirement treatment with respect to the Restricted Shares covered by this Grant Document.[69]

It is unclear how this definition would be interpreted in litigation, and it is also unclear what role, if any, legal considerations played in the board's decisions. No documents were provided to the Committee that indicated that the board ever debated terminating Mr. O'Neal for cause or considered withholding all or part of Mr. O'Neal's $131 million in unvested stock and options. From a shareholder perspective, there appears to be no justification for precluding the board from recouping unvested stock and options in cases of poor performance.

B. Reduction in Noncompetition Provisions

Another action taken by the board at Mr. O'Neal's departure was the renegotiation of his noncompetition agreement. A covenant agreement Mr. O'Neal signed in 2004 prohibited him from working for any Merrill Lynch competitor, defined broadly, until all of his stock and options had vested or expired.[70] This is estimated to be three to four years from the time of his retirement.[71]

According to company documents, Mr. O'Neal's attorneys proposed reducing the noncompetition term to one year and limiting the scope to a specific list of companies.[72] Ultimately, the board and Mr. O'Neal agreed to modify his noncompetition agreement to apply

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[69] *Id.*

[70] Merrill Lynch Form 8-K, *Entry into a Material Definitive Agreement*, 4 (Sept. 17, 2004).

[71] According to company documents provided to the Committee entitled "ESO Holdings and Valuation" (value as of Oct. 29, 2007) (No BATES number), the last of Mr. O'Neal's restricted stock vests in Jan. 2011.

[72] Draft separation agreement sent as an attachment via e-mail from Joseph E. Bachelder to Robert D. Joffe at Cravath, Swaine & Moore LLP (Oct. 27, 2007) (Merrill Lynch BATES No. 0001353-0001372).

to only nine specific companies for a period of 18 months. These new terms superseded and replaced all prior noncompetition obligations.[73]

These changes in the noncompetition agreement were approved at a special meeting of the compensation committee on October 29, 2007, and at a meeting of the full board the next day. Only one board member, Aulana Peters, raised any objection to loosening Mr. O'Neal's noncompetition restrictions.[74] The documents the Committee received provide no explanation why the narrowing of Mr. O'Neal's noncompetition agreement was determined to be in the interests of Merrill Lynch and its shareholders.

C. Post-Retirement Perquisites

Because Mr. O'Neal had no employment agreement with Merrill Lynch, Mr. O'Neal was not entitled to continued perquisites after his departure. Nonetheless, the board agreed to provide Mr. O'Neal with office space in New York City for his personal use and the full-time services of an executive assistant for up to three years.[75] The monetary value of this benefit is unknown. The documents do not reflect what shareholder value the board hoped to obtain by providing these perquisites to Mr. O'Neal.

D. Severance Payment

At the time of his retirement, Mr. O'Neal's attorneys proposed that Mr. O'Neal receive a $45 million cash severance payment.[76] The final separation agreement did not include the cash severance payment sought by Mr. O'Neal.

V. MR. PRINCE'S COMPENSATION

Charles Prince worked for Citigroup or its predecessor companies for 29 years, becoming CEO in October 2003 and Chairman in April 2006. He did not have an employment agreement while Chairman and CEO. Table 5 summarizes the details of Mr. Prince's compensation during his time as Chairman and CEO.

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[73] Merrill Lynch Form 8-K, *Compensatory Arrangements of Certain Officer*, 3-4 (Oct. 30, 2007). In notable contrast, Mr. Prince's termination agreement includes a significant non-competition and non-solicitation clause, saying Mr. Prince will not solicit certain Citigroup employees and clients or engage in any competition with the company for a period of five years.

[74] Merrill Lynch document provided to the Committee, *Excerpts from Meeting Minutes from the Merrill Lynch and Management Development and Compensation Committee and the Merrill Lynch Board of Directors* (No BATES number).

[75] Merrill Lynch Form 8-K, *Compensatory Arrangements of Certain Officers*, 3 (Oct. 30, 2007).

[76] Draft separation agreement sent as an attachment via e-mail from Joseph E. Bachelder to Robert D. Joffe at Cravath, Swaine & Moore LLP (Oct. 27, 2007) (Merrill Lynch BATES No. 0001353-0001372).

Table 5. Compensation Awarded to Charles Prince, 2003-2007[77]

Year	Base Salary	Cash Bonus	Other Compensation	Stock Awards*	Option Awards*	Total Compensation
2003	$638,636	$6,965,375	< $50,000	$19,207,706	$2,396,634	$29,208,351
2004	$983,333	$9,690,000	$123,290 (Includes $108,208 in transportation expenses, such as personal use of company aircraft.)	$7,805,833	$1,320,485	$19,922,941
2005	$1,000,000	$12,000,000	$328,062 (Includes $133,114 in transportation expenses, such as personal use of company aircraft.)	$9,666,667	$0	$22,994,729
2006	$1,000,000	$13,200,000	$395,779 (Includes $258,338 for personal use of company aircraft.)	$10,633,333	$746,607	$25,975,719
2007	$1,000,000	$10,400,958	$234,643 (Details to be reported in 2008 proxy).	$0	$337,367	$11,972,968
TOTAL	$4,621,969	$52,256,333	$1,081,774	$47,313,539	$4,801,093	$110,074,708

** The value of stock awards and option awards is based on grant date fair value. Stock awards would be worth less today given decline in stock price. Unexercised options are currently underwater.*

Mr. Prince's compensation history is similar to Mr. Mozilo's and Mr. O'Neal's. Mr. Prince was well paid by Citigroup, receiving more than $110 million in cash, stock, and stock options during his five years as CEO. For most of this period, there is no obvious disconnect between the compensation Mr. Prince received and the performance of the company.

In 2007, however, Mr. Prince's compensation and the performance of Citigroup diverged. Mr. Prince continued to be well compensated in 2007, even receiving a lucrative bonus for that performance year. Yet Citigroup's performance suffered. In 2007, Citigroup's net income dropped by more than $17 billion from 2006.[78] The company was forced to write off more than $18 billion in losses due to its exposure to the subprime mortgage market.[79] By the end of 2007, the company's stock had fallen to $29.44 per share, a 48% decline from its peak of $56.41 per share in December 2006.[80] Citigroup stock closed at $22.15 per share on March 5, 2008.[81]

The Citigroup board made three decisions in November 2007 that significantly enriched Mr. Prince despite the poor performance of the company under his leadership: (1) the board

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[77] Obtained from Citigroup proxy statements and confirmed by a document provided to the Committee by Citigroup, *Chuck Prince: Compensation 2003-2007* (No BATES number).

[78] Citigroup, *Citi Reports Fourth Quarter Net Loss of $9.83 Billion, Loss Per Share of $1.99* (Jan. 15, 2008).

[79] *Id.*

[80] Committee analysis of Citigroup's stock prices, obtained from www.nasdaq.com.

[81] *Id.*

awarded him a pro-rata cash bonus for the 2007 performance year, amounting to $10.4 million; (2) the board allowed him to retain almost $28 million in unvested stock and stock options by letting him retire rather than terminating him for cause; and (3) the board granted him perquisites worth $1.5 million annually. Questions can be raised whether these decisions were in the interests of Citigroup and its shareholders.

A. The $10 Million Bonus

Because Mr. Prince had no employment contract with Citigroup, he had no contractual entitlement to a bonus when he stepped down as CEO in November 2007. The board, however, decided to award Mr. Prince a pro-rata cash bonus for the 2007 performance year. This award, paid in early 2008, amounted to $10.4 million.[82] The amount of the bonus was equal to his 2006 compensation pro-rated for the date of his departure and decreased by the total shareholder return percentage for 2007.[83]

Of the three CEOs who will testify before the Committee, Mr. Prince is the only one to receive a performance bonus for 2007. The documents provided to the Committee do not explain why the board determined that awarding Mr. Prince a $10 million bonus advanced shareholder interests.

B. Award of Unvested Stock and Stock Options

When Mr. Prince became CEO in 2003, he was given a "retention award" of restricted stock valued at $15 million. This "retention award" did not vest until July 2008 and was therefore valueless at the time of Mr. Prince's resignation.[84] According to the company's 2007 proxy statement, if Mr. Prince had voluntarily resigned at the end of the year, he would have forfeited the entire 2003 retention award.[85]

Nevertheless, the board elected to grant Mr. Prince a pro-rata portion of the retention award on his retirement in November 2007. The value of the retention award the Board gave him was $10.7 million.[86]

In addition, Citigroup's board treated Mr. Prince's departure as a retirement as opposed to a termination for cause. This had an effect similar to the decision of the Merrill Lynch board to treat Mr. O'Neal's departure as a retirement rather than a termination: it gave Mr. Prince

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[82] *COP Tally Sheet, Estimate of Termination of Employment Obligations* (calculated as of Nov. 2, 2007) (Citigroup BATES No. 00000001-00000002).

[83] Citigroup Form 8-K (Nov. 4, 2007).

[84] *COP Tally Sheet, Estimate of Termination of Employment Obligations* (calculated as of Nov. 2, 2007) (Citigroup BATES No. 00000001-00000002).

[85] Citigroup *Form Def 14A*, 58 (Mar. 13, 2007).

[86] *COP Tally Sheet, Estimate of Termination of Employment Obligations* (calculated as of Nov. 2, 2007) (Citigroup BATES No. 00000001-00000002).

ownership of about $16 million in previously unvested stock and $1.3 million in unvested options.[87]

If Citigroup had terminated Mr. Prince for cause, he would have lost all unvested equity positions, and he would not have been eligible to receive the additional retirement awards provided by the board. As with Merrill Lynch, however, Citigroup restricted its own ability to revoke Mr. Prince's unvested stock.[88]

C. Post-Retirement Perquisites

In November 2007, the Citigroup board agreed to provide Mr. Prince with an office, an administrative assistant, and a car and driver for five years or until he finds another full-time job. The company also agreed to pay Mr. Prince's taxes associated with these post-termination benefits. The company estimates the value of these perquisites at $1.5 million annually.[89]

Because Mr. Prince had no employment contract with Citigroup at the time of his departure, Mr. Prince was not entitled to these perquisites. None of the documents provided to the Committee by Citigroup explain why providing $1.5 million in annual perquisites to Mr. Prince in retirement benefited Citigroup shareholders.

VI. CONCLUSION

The three case studies reveal important differences in the compensation packages and actions of Mr. Mozilo, Mr. O'Neal, and Mr. Prince. Mr. Mozilo stands out as the only CEO who sold large numbers of shares in his company while the company was engaged in a stock buyback plan. Mr. O'Neal stands out for the size of his retirement package, $161 million. And Mr. Prince stands out for the $10 million performance bonus he received for a performance year in which the company's stock floundered.

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[87] *Id.* The value of the stock and option awards is based on the value as of the retirement date. Under the Citigroup plan, these equity awards vest immediately upon retirement. The stock awards would be worth less today given a decline in the stock price. Unexercised options are currently underwater.

[88] Under the company's Capital Accumulation Program, employees terminated for "gross misconduct" lose any unvested stock and stock options they hold. The Capital Accumulation Program prospectus defines "gross misconduct" as follows:

> The Committee determines what constitutes competition and gross misconduct. Gross misconduct includes, but is not limited to, conduct that is in competition with the Company's business operations, that breaches any obligation to the Company or duty of loyalty, or that is materially injurious to the Company, monetarily or otherwise.

Definition provided by Citigroup via e-mail to Committee staff (Mar. 4, 2008) (citing CAP Prospectus, 32 (Oct.1, 2006)).

[89] *COP Tally Sheet, Estimate of Termination of Employment Obligations* (calculated as of Nov. 2, 2007) (Citigroup BATES No. 00000001-00000002).

At the same time, there are also striking similarities in the three case studies. In 2007, as the mortgage crisis developed, Countrywide, Merrill Lynch, and Citigroup all suffered major losses. Yet Mr. Mozilo, Mr. O'Neal, and Mr. Prince continued to receive lucrative pay and retirement packages. The financial benefits realized by the CEOs as the subprime mortgage crisis unfolded do not appear to have been aligned with the interests of the shareholders.

At the hearing tomorrow, members may want to explore the causes of this disconnect between pay and performance and examine what steps company boards could take to address the issue.

HEARING TITLED "EXECUTIVE COMPENSATION II: CEO PAY AND THE MORTGAGE CRISIS" ON FEBRUARY 28, 2008, BEFORE THE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM, U.S. HOUSE OF REPRESENTATIVES

WRITTEN TESTIMONY OF PATRICIA A. McCOY
George J. and Helen M. England Professor of Law
University of Connecticut School of Law
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Thank you for inviting me to participate in this timely hearing. My testimony today will focus on the incentives of subprime mortgage industry participants to increase their compensation through unnecessarily risky subprime mortgages.

Subprime mortgages are high-cost loans designed for borrowers with impaired credit. These loans pose a heightened risk of default. In the past ten years, press reports of abusive subprime loans have prompted regulators to institute repeated enforcement actions against subprime lenders and servicers for unfair practices and fraud.[1] Despite the seriousness of these

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1. For instance, in 2004, Citigroup Inc. and its subprime mortgage subsidiary, Citifinancial Credit Company, agreed to a cease-and-desist order in which the Board of Governors of the Federal Reserve System imposed a $70 million civil money penalty for alleged predatory lending practices. Timothy L. O'Brien, *Fed Assesses Citigroup Unit $70 Million in Loan Abuse*, N.Y. Times, May 28, 2004, at C1; Press Release, Bd. of Governors of the Fed. Reserve Sys. (May 27, 2004), www.federalreserve.gov/boarddocs/ press/enforcement/2004/20040527/default.htm. The 2004 Citigroup order followed on the heels of an earlier $215 million settlement by Citigroup Inc. in 2002 to resolve FTC charges of predatory lending. Press Release, Federal Trade Comm'n, Citigroup Settles FTC Charges Against the Associates Record-Setting $215 Million for Subprime Lending Victims (Sept. 19, 2002), www.ftc.gov/opa/2002/09/associates.htm. Also in 2004, the Office of Thrift Supervision entered into a supervisory agreement with Ocwen Federal Bank to prohibit alleged predatory loan servicing practices. Supervisory Agreement, Ocwen Fed. Bank FSB and Office of Thrift Supervision, OTS Docket No. 04592 (Apr. 19, 2004), www.ots.treas.gov/docs/9/93606.pdf. The Federal Bureau of Investigation has pursued mortgage fraud aggressively. *See, e.g.*, Fed. Bureau of Investigation, *Statement of Chris Swecker Before the House Finan. Services Subcomm. On Housing and Community Opportunity* (Oct. 7, 2004), www.fbi.gov/congress/congress04/swecker100704.htm; Fed. Bureau of Investigation, Financial Crimes Report to the Public Fiscal Year 2006, www.fbi.gov/publications/financial/fcs_report2006/financial_crime_ 2006.htm#Mortgage (reporting on investigations into equity skimming, property flipping and mortgage-related identity theft).

Between 1998 and 2008, the Federal Trade Commission prosecuted predatory lending cases against home mortgage lenders and brokers including Action Loan Co., Amor Mortgage, Abacus Mortgage, Associates First Capital Corp., Barry Cooper Properties, Capital City Mortgage Corp., Capitol Mortgage Corp., Chase Financial Funding, Inc., CLS Financial Services, Inc., Delta Funding Corp., Fairbanks Capital Corp., First Alliance Mortgage Company, First Plus Financial Group, Inc., Fleet Finance and Home Equity U.S.A., Granite Mortgage, LLC, Interstate Resource Corp., LAP Financial Services, Inc., Mark Diamond, Mercantile Mortgage Co., Mortgages Para Hispanos.Com Corp., Nationwide Mortgage Corp., NuWest, Inc., PWR Processing, Inc., R.A. Walker & Assocs., and Wasatch Credit Corp. *See* Prepared Statement of the Federal Trade Commission on Foreclosure Rescue Fraud before the Senate Special Committee on Aging, Feb. 13, 2008, www.ftc.gov/os/testimony/P064814foreclosure.pdf; Fed. Trade Comm'n, *Prepared Statement of the Federal Trade Commission on Efforts to Combat Unfair and*

charges, the harm from these problems originally appeared to be confined to a relatively obscure corner of the consumer finance market. Until mid-2007, there was little concern that defective subprime loans would spill over into the larger economy.

That changed last July, when subprime losses sank two Bear Stearns hedge funds and pushed a regional German bank named IKB Industriebank to the brink of failure. World markets trembled as stock markets plunged in the United States and Europe, subprime lenders failed in droves, sales of subprime bonds crashed, and the market for interbank credit seized up. As markets deteriorated, write-downs on U.S. subprime bonds triggered such a severe bank run at Northern Rock plc, a British bank, in September 2007 that the Bank of England felt compelled to issue a blanket guarantee for all deposits at British banks and ultimately it had to nationalize Northern Rock. Nor were Northern Rock and IKB Industriebank alone. So many foreign investors bought toxic subprime bonds that even the small Arctic town of Narvik, Norway (pop. 18,000), went insolvent in December 2007 due to investments in bad subprime securities.

Deceptive Subprime Lending Before the Senate Special Committee on Aging, 3-8, Feb. 24, 2004, www.ftc.gov/os/2004/02/02242004subprimelendingtest.pdf; Letter from Donald S. Clark, Sec'y, Fed. Trade Comm'n, to Sandra F. Braunstein, Dir., Fed. Reserve Sys. Div. of Consumer and Cmty. Affairs (Feb. 23, 2005), www.ftc.gov/os/2005/03/050301enforcemntrpt.pdf; Press Release, Fed. Trade Comm'n, Capital City Mortgage Corp. Defendant Settles with FTC (May 14, 2004), www.ftc.gov/opa/2004/05/sanne.htm; Press Release, Fed. Trade Comm'n, Capital City Mortgage Settles FTC Charges (Feb. 24, 2005), www.ftc.gov/opa/2005/02/capitalcity.htm; Press Release, Fed. Trade Comm'n, FTC Challenges Bogus Mortgage Loan Brokers (June 1, 2004), www.ftc.gov/opa/2004/06/pwrprocessing.htm; Press Release, Fed. Trade Comm'n, FTC, DOJ and HUD Announce Action to Combat Abusive Lending Practices, (Mar. 30, 2000), www.ftc.gov/opa/2000/03/deltafunding.htm; Press Release, Fed. Trade Comm'n, FTC: Mortgage Broker's Deceptive Claims Tricked Consumers Looking for a Good Rate (June 2, 2004), www.ftc.gov/opa/2004/06/ chasefinancial.htm; Press Release, Fed. Trade Comm'n, Home Equity Lenders Settle Charges that They Engaged in Abusive Lending Practices; Over Half Million Dollars To Be Returned to Consumers (July 29, 1999), www.ftc.gov/opa/1999/07/hoepa.htm; Press Release, Fed. Trade Comm'n, Home Mortgage Lender Settles "Predatory Lending" Charges (Mar. 21, 2002), www.ftc.gov/opa/2002/03/famco.htm; Press Release, Fed. Trade Comm'n, Midwest Mortgage Lender Agrees to Settle Illegal Lending Charges Brought by FTC, HUD, and State of Illinois, (July 18, 2002), www.ftc.gov/opa/2002/07/ mercantilediamond.htm; Fed. Trade Comm'n, FTC Subprime Lending Cases (since 1998), www.ftc.gov/opa/2002/07/subprimelendingcases.htm (last visited Feb. 28, 2007).

State attorneys general and state banking regulators have also instituted aggressive enforcement actions for subprime abuses. While the individual state proceedings are too numerous to all name, two nationwide settlements stand out. In 2006, forty-nine states and the District of Columbia reached a $325 million settlement with Ameriquest Mortgage Company over alleged predatory lending practices. *See, e.g.*, Press Release, Iowa Dep't of Justice, Miller: Ameriquest Will Pay $325 Million and Reform its Lending Practices (Jan. 23, 2006). In 2002, state attorneys general from forty-four states and the District of Columbia secured a $484 million settlement from Household Finance Corporation to dismiss charges of deceptive subprime loans. *See* Press Release, Iowa Attorney General, States Settle With Household Finance: Up to $484 Million for Consumers (October 11, 2002).

Back at home, skyrocketing subprime foreclosures pushed the United States to the edge of a recession. By February 2008, panic over credit quality had paralyzed the markets for term auction securities, leveraged financing, and asset-backed bonds securitizing commercial real estate loans, jumbo mortgages, and even student loans. Private-label mortgage-backed securitizations and subprime lending dwindled and no one knows what future form these markets will take. Financial services companies have taken approximately $150 billion in subprime write-downs to date since the beginning of 2007. In February 2008, the Group of Seven estimated that financial institutions worldwide face up to $400 billion in write-downs resulting from subprime losses.[2]

Market failures in the U.S. subprime mortgage industry lie at the root of these problems. My testimony begins by describing the regulatory changes and technological advances that paved the way for the subprime market and the securitization of subprime loans. Next, I describe how the compensation systems for subprime mortgage professionals and investment banks created perverse incentives to artificially increase the risk of subprime loans. Finally, I chronicle how these incentives caused the subprime industry to spiral downward due to lax underwriting and outright loan fraud.[3]

Mortgage Lending in the Old Days

Back in the late 1970s, the home mortgage world was a different and rather sleepy place. Most mortgage lenders were banks and thrifts, not consumer finance companies, because only banks and thrifts had access to cheap and ready funds in the form of deposits. Bank underwriters evaluated loan applications wearing eyeshades and using pencils, not computers, plus their seat-

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[2] *G-7: $400 billion newest subprime tab*, INVESTMENT NEWS, Feb. 11, 2008, www.investmentnews.com/apps/pbcs.dll/article?AID=/20080211/REG/772519581.

[3] For a fuller treatment of the topics discussed in this testimony, see Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance Of Predatory Lending*, 75 FORDHAM L. REV. 2039 (2007); Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255 (2002).

of-the pants judgment. Once a bank made a loan, it serviced that loan and kept the loan on its books, instead of selling it to investors. Banks retained the risk that a loan might go bad and that made their lending decisions conservative. People with bad credit did not get conventional mortgages, nor did many minorities. Instead, home mortgages were reserved for the best credit risks, whom banks often deemed to be white.[4]

Similarly, unlike today, and throughout most of the 1970s, home mortgages were heavily regulated for the protection of consumers. Back then, state and federal governments capped interest rates on mortgages. In addition, many states banned adjustable-rate mortgages and balloon loans; others banned prepayment clauses. Congress augmented these laws by mandating federal disclosures about the loan terms and closing costs of home mortgages in the Truth in Lending Act of 1968 and the Real Estate Settlement Procedures Act of 1974.

In retrospect, the 1970s marked the high point in regulation of residential mortgages. Rampant inflation was waiting in the wings and would soon usher in a prolonged period of deregulation that would remove legal barriers to the emergence of the subprime market a decade later.

Deregulation of Residential Mortgages

In the late 1970s, when inflation roared out of control, the old system of interest rate caps on loans became unworkable. From 1972 to 1980, conventional mortgage rates rose from 7.38% to 13.77% a year. In states where mortgage rates rose above the state's usury cap, mortgage lending and real estate sales went into a stall. Soaring interest rates also jeopardized the deposit bases of banks and thrifts, as depositors fled in droves to put their money into new-fangled money market funds at securities firms paying market rates of interest. As the banking industry faltered and real estate sales dried up, Congress took action by abolishing interest rate caps on

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[4] Alicia H. Munnell, Lynn E. Browne, James McEneaney, & Geoffrey M.B. Tootell, *Mortgage Lending in Boston: Interpreting the HMDA Data*, 86 AMERICAN ECONOMIC REVIEW 25-53 (1996).

first-lien residential mortgages in the Depository Institutions Deregulation and Monetary Control Act (also known as the DIDMCA) in 1980. Two years later, Congress deregulated mortgages further in the Alternative Mortgage Transactions Parity Act of 1982, known for short as AMTPA. Specifically, in the 1982 follow-on law, Congress gave the go-ahead to home mortgages with adjustable-rate terms, balloon clauses, interest-only terms, and negative amortization. Both of these federal laws, moreover, overrode state and local laws that were inconsistent with deregulation.

The 1980 and 1982 laws had good intentions, i.e., to free up the supply of mortgages and allow banks and thrifts to charge market rates of interest and thereby shore up their balance sheets. At the same time, there were profound and troubling consequences from permitting lenders to shift interest rate risk onto borrowers. Removing interest rate caps made it easier for lenders to charge higher risk borrowers higher rates. Lenders were also granted the freedom to dream up an endless array of exotic mortgages with complex features. Liberated by the 1982 law, lenders could now offer adjustable-rate mortgages with exorbitant lifetime caps and balloon loans that could blow up in borrowers' faces. Furthermore, lenders could now peddle interest-only mortgages where the payments did not reduce principal and, worse yet, negative amortization loans where the principal could actually *increase*. Deregulation left it to the market to maintain proper underwriting and curb consumer abuses.

Deregulation was not enough alone to bring the subprime home loan market to life. But deregulation paved the way for subprime loans by dismantling the legal barriers to risk-based pricing and foolhardy mortgages.[5] In a few more years, major technological advances in mortgage lending would make subprime loans a reality.

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[5] In 1994, Congress passed a federal anti-predatory lending law titled the Home Ownership and Equity Protection Act (HOEPA) that addressed abuses in the subprime market. HOEPA, though, only applies to the most expensive 1% of subprime loans. Since 1999, a majority of states have passed laws of various strength that are

The Rise of Subprime Lending

As recent experience has shown, subprime mortgages pose higher risk. Many subprime borrowers – but by no means all -- have low incomes or weak credit profiles.[6] In addition, people with subprime loans pay higher interest rates and fees, which make it harder for them to make their monthly mortgage payments.

Because many subprime loans are higher risk, the lending industry had to solve two problems in order to create the subprime market. First, lenders needed a way to *price* the added risk that subprime loans entail. Second, lenders needed a way to *spread* that risk among a wider group of investors.

Technological innovation seemed to provide a solution to both of these problems. With computerization, the mortgage lending industry acquired a powerful tool to help price different borrowers' risk. For the first time, the brainpower of the mainframe and later the micro-chip made it possible to analyze vast stores of loan performance data in order to predict default risk and price it. Using computerized statistical analysis, statisticians could spot the factors that best predicted prompt payment and measure their effect. Then, the statisticians took that information and used it to design *automated underwriting models*, which allowed loan officers and brokers to run people's loan applications through a computer, judge their credit risk, and price it.

In the process, automated underwriting (or "AU," as it was dubbed) dashed a number of hoary maxims about traditional loan underwriting. Out went the requirement of a twenty percent down payment and three months' expenses in savings. Out, too, went an insistence on pristine credit records, low debt ratios, and full income documentation. Automated underwriting gave

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patterned after HOEPA and regulate high-cost loans. *See* Raphael Bostic, Kathleen C. Engel, Patricia A. McCoy, Anthony Pennington-Cross & Susan Wachter, *State and Local Anti-Predatory Lending Laws: The Effect of Legal Enforcement Mechanisms*, 60 J. ECON. & BUS. 47-66 (2008). Due to preemption orders by the U.S. Comptroller of the Currency and the U.S. Office of Thrift Supervision, however, these state laws have limited effect because they do not apply to federally chartered banks and thrifts and their mortgage lending subsidiaries.

[6] *See, e.g.*, Howard Lax, Michael Manti, Paul Raca & Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency*, 15 HOUS. POL'Y DEBATE 533 (2004).

lenders the confidence to lend to hitherto unserved borrowers with damaged credit or no credit at all.

That said, there was no assurance that computerized analysis actually yielded the right price. The United States was in an unprecedented period of housing price appreciation and the historical data that the models analyzed was largely devoid of subprime loans. Nevertheless, AU and other proprietary pricing models gave the appearance of accurate pricing, which was enough to embolden the market. Indeed, some lenders became so sanguine about risk-based loans that they dispensed with AU altogether.

With the task of pricing risk seemingly solved, the task remained of how to spread the risk of subprime loans throughout the wider market. In the old days, banks and thrifts kept home mortgages on their books until those loans were pre-paid or reached maturity. This destabilized their balance sheets, because they had to "borrow short and lend long." In other words, depository institutions had to fund their long-term mortgages with short-term deposits. If interest rates went up on deposits and the mortgages didn't earn enough to pay market returns on deposits, a bank or thrift could find itself in a financial jam. It could try to meet market rates on deposits by going into the red or by hiking loan rates by making riskier and riskier loans. Or it could pay below-market rates on savings accounts and drive away its depositors. This Hobson's choice – known as the "term mismatch" problem – was a direct cause of the 1980s savings and loan crisis.

Starting in the late 1970s, an innovation called "securitization" burst on the scene and eliminated the need for lenders to hold their mortgages in portfolios. The idea behind securitization is ingenious: bundle a lender's loans, sell them to a far-off trust, repackage the monthly loan payments into bonds rated by rating agencies, back the bonds using the underlying mortgages as collateral, and sell those bonds to investors.

This ability to finance home mortgages through the capital markets accomplished four things. First, lenders were able to get their mortgages off their books and sell their loans to investors for cash. Second, securitization appeared to manage the risks of subprime mortgages by slicing and dicing those risks and spreading them among millions of investors. Third, securitization opened up far larger pools of capital across the nation and abroad to finance home mortgages. Finally, securitization freed lenders from relying on deposits and capital reserves in order to make loans. Instead, in a continuous cycle, lenders could make loans, immediately sell those loans through securitization, and then use the cash to make a new batch of loans, which again would be securitized. This paved the way for a new breed of nonbank subprime lender, who had little in the way of capital reserves, was free from federal banking regulation, and was inured to the reputational constraints faced by banks and thrifts.

Securitization got its start in the late 1970s. At first, it was limited to prime loans, most of which were securitized through two government-sponsored entities (GSEs), Fannie Mae and Freddie Mac. Once the market gained confidence about its ability to price subprime mortgages, securitization expanded to the subprime market in the early 1990s. Because the GSEs only made limited forays into the subprime market, most subprime securitizations did not take place through the GSEs, but rather through the "private-label" securitization market. The private-label market lacked the high degree of public accountability that is required of Fannie Mae and Freddie Mac as GSEs.[7] By 2006, two-thirds or more of subprime mortgages were being securitized through the private-label market.

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[7] *See, e.g.*, Office of Federal Housing Enterprise Oversight, *About OFHEO: OFHEO's Mission*, www.ofheo.gov/about.aspx?Nav=55; Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance Of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2095 (2007).

Perverse Incentives Toward Heightened Risk

In the past twenty years, the home mortgage industry underwent fundamental changes that increased its incentives to take reckless risks with subprime loans. Specifically, the mortgage lending industry evolved from one in which the lender retained the full risk that a loan would default to one in which lenders, mortgage brokers, and investment banks were paid upfront while passing off the risks onto borrowers and investors.

Securitization altered the structure of mortgage lending and the financial incentives of its players in ways that were underappreciated at the time. Before securitization, lenders usually did it all: they solicited loan applicants, underwrote the loans, funded those loans, serviced the loans, and held the loans in portfolio. Lenders earned profits on loans mostly in the form of interest payments, not upfront fees. If the loans went into default, the lenders bore the losses. Default was such a serious financial event that lenders took care when underwriting loans.

All that changed with securitization. Securitization allowed lenders to outsource parts of the lending process. That reduced their incentives to exercise care when making loans. With securitization, a lender could make a loan and sell it to investors, who would bear the financial brunt if the loan went belly-up. Unlike in the past, lenders mostly made their money on upfront fees collected from the borrowers and the cash proceeds from securitization offerings, not on the interest payments on loans. Lenders liked the security of being paid in advance, instead of having to wait for uncertain monthly payments over the life of the loan.

Lenders also knew that their risk from securitization was only a fraction of the risk they otherwise would assume from holding whole loans on their books. Besides, lenders rationalized, securitization sliced the risks that they passed on into finer and finer pieces that were diversified among investors. Because they knew they could pass the lion's share of subprime risks onto faceless investors, lenders had less reason to care about how well a loan performed. Some

lenders even had two sets of underwriting standards: high underwriting standards for the loans they kept on their books and lax underwriting standards for the loans that they securitized. All the while, investors were clamoring for higher-yield bonds, which required backing those bonds with higher-risk home loans. Together, these dynamics encouraged lenders to make ever riskier loans and to pass off the worst loans onto investors.

Investors tried to protect themselves by requiring lenders to retain the riskiest parts of subprime securitizations. Lenders became able to dispose of that retained risk, however, by repackaging those interests and securitizing them all over again, this time as bonds known as collateralized debt obligations (CDOs).

Most lenders used investment banks to underwrite their subprime securitizations. Of the major Wall Street firms, Lehman Brothers, Bear Stearns, Merrill Lynch, J.P. Morgan, Morgan Stanley, Citigroup, and Goldman Sachs underwrote most private-label subprime securitizations.[8] After IPO offerings dried up during the three-year bear market from 2000 through 2002, mortgage-backed securities deals and CDOs stepped into the breach and became one of the hottest profit centers for investment banks.[9] By 2006, Wall Street had cornered the subprime business, securitizing over two-thirds of subprime loans.[10]

Investment banks profited from subprime underwriting by collecting a percentage of the sales proceeds, either in the form of discounts, concessions, or commissions. Once an offering was fully distributed, the underwriter collected its fee in full. This compensation system for the underwriters of subprime securitizations caused Donna Tanoue, the former Chairman of the Federal Deposit Insurance Corporation, to warn: "[T]he underwriter's motivation appears to be

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[8] Gretchen Morgenson, *Crisis Looms in Market for Mortgages,* NEW YORK TIMES, March 11, 2007; *Scorecard – Everyone Out of the Pool*, INSTITUTIONAL INVESTOR, Sept. 17, 2007.

[9] Laura Mandaro, *Investment Banks Stay Busy*, INVESTOR'S BUSINESS DAILY, Feb. 21, 2006, at A14.

[10] Gretchen Morgenson, *Crisis Looms in Market for Mortgages,* NEW YORK TIMES, March 11, 2007.

to receive the highest price and best execution possible on behalf of the issuer - not to help curb predatory loans."[11]

Tanoue's warning proved prophetic. Earlier this month, Fitch Ratings projected that fully *forty-eight* percent of the subprime loans securitized by Wall Street in 2006 would go into default.[12] Despite that dismal performance, 2006 produced record net earnings for Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns.[13] That year, manager pay reflected the bottom-line importance that investment banks placed on private-label mortgage-backed securities, with managing directors in the mortgage divisions of investment banks earning more on average in 2006 than their counterparts in other divisions.[14]

As part of their duties, underwriters for subprime bond offerings drafted prospectuses and offering memoranda that were supposed to inform investors about the underwriting criteria and risks of the subprime loans in the loan pool. These documents usually stated that the lenders reserved the right to make exceptions to their underwriting standards in individual cases. But in 2006 and 2007, some offering documents failed to say that the exceptions – in other words, loans that flunked the lender's underwriting standards – far outweighed the number of loans that met those standards.[15] Ratings agencies have asserted that investment banks withheld due diligence reports from them that quantified the size of these exceptions. One due diligence firm has further alleged that some investment banks ordered it to cut its random samples of subprime loan

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[11] Remarks by Donna Tanoue, Chairman, Federal Deposit Insurance Corporation, Before the Annual Conference, National Congress for Community Economic Development, New Orleans, LA, October 13, 2000, www.fdic.gov/news/news/speeches/archives/2000/sp13Oct00.html.

[12] For loans in the 2007 subprime vintage, Fitch estimates that forty-three percent will go into default. *Fitch Places $139B U.S. Subprime RMBS On Watch Negative on Worsening Mortgage Performance*, REUTERS, Feb. 1, 2008, www.reuters.com/article/pressRelease/idUS203638+01-Feb-2008+BW20080201.

[13] 2006 Annual Reports for Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns.

[14] Jenny Anderson & Vikas Bajaj, *Wary of Risk, Bankers Sold Shaky Mortgage Debt*, NEW YORK TIMES, Dec. 6, 2007.

[15] Vikas Bajaj & Jenny Anderson, *Inquiry Focuses on Withholding of Data on Loans*, NEW YORK TIMES, Jan. 12, 2008.

pools by half when checking for compliance with loan underwriting guidelines in order to permit those banks to turn a blind eye to the wide prevalence of exceptions.[16]

The major rating agencies also had financial incentives to understate the risks of subprime mortgage-backed securities and CDOs. The investment banks that underwrote subprime securitizations paid the rating agencies that provided them with investment-grade ratings. After an investment bank divided a subprime bond offering into different buckets (called tranches) according to default risk, the rating agencies rated each tranche. The rating agencies touted their top-rated subprime bonds – ranging from AAA down to A -- as hardly ever defaulting. These ratings lured droves of investors in the United States and abroad who were in search of higher yields to buy the top-rated subprime bonds and CDOs. The more good ratings that the agencies issued, the more deals that were sold, reaping profits for the rating agencies and the investment banks who hired them.

Securitization was not the only form of outsourcing in the subprime industry. Increasingly, subprime lenders, through their wholesale loan divisions, used independent mortgage brokers to solicit potential customers and process loan applications. Lenders even outsourced loan underwriting to contract underwriters for as little as $10 per loan application. Both sets of players had incentives to close loans at any cost and to deceive participants down the line about the risks of those loans.

Contract underwriters, for instance, were only paid a small flat fee per loan. Often that fee was too low to verify incomes and carefully evaluate credit risk. Contract underwriters, as a result, had economic incentives to dispense with verification and instead underwrite mortgages as stated-income or no-documentation loans.

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[16] Jenny Anderson & Vikas Bajaj, *Loan Reviewer Aiding Inquiry Into Big Banks*, NEW YORK TIMES, Jan. 27, 2008.

The perverse incentives were even worse for brokers. Mortgage brokers only got paid if they closed a loan. Furthermore, subprime brokers were paid solely through upfront fees at closing, meaning that if a loan went bad, the losses would fall on the lender or investors, not the broker. In the most pernicious practice of all, lenders paid brokers thousands of dollars per loan in fees known as yield spread premiums (or YSPs) in exchange for loans saddling borrowers with steep prepayment penalties and higher interest rates than the borrowers deserved, based on their incomes and credit scores.

YSPs, by driving up interest rates, substantially increase the likelihood that subprime loans will default and go into foreclosure. Economists have estimated the size of this risk. For every one percent that the initial interest rate on a home mortgage goes up, the likelihood that a household will lose its home rises by sixteen percent a year. For adjustable-rate mortgages (ARMs), these statistics are even worse. When the interest rate on an ARM resets, every one percent increase in the reset rate makes it thirty percent more likely that a household will lose its home.[17] Many recent subprime hybrid ARMs have initial resets of three percentage points,[18] which drives home how much overpriced subprime loans put homeowners and investors at risk.

The compensation structure for mortgage brokers encouraged numerous subprime brokers to do whatever it took to close a loan. Sometimes this involved padding a borrower's income or assets. Sometimes this was with the borrower's involvement, but more often it was not. Sometimes doing whatever it took meant commissioning an inflated appraisal; other times it meant duping borrowers with overpriced loans. Many of these borrowers had credit scores that

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[17] Donald R. Haurin & Stuart S. Rosenthal, The Growth Earnings of Low Income Households and the Sensitivity of Their Homeownership Choices to Economic and Socio-Demographic Shocks (U.S. Department of Housing and Urban Development April 2005): vii, 18, www.huduser.org/Publications/pdf/EarningsOfLow-IncomeHouseholds.pdf

[18] Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, on Strengthening the Economy: Foreclosure Prevention and Neighborhood Preservation; before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 538 Dirksen Senate Office Building, January 31, 2008, www.fdic.gov/news/news/speeches/chairman/spjan3108.html.

were high enough to qualify them for cheaper prime loans.[19] Moreover, if a broker put a borrower into a loan that the homeowner could not afford, the broker could always offer to refinance that loan and pocket another round of fees. In all of these ways, brokers had financial incentives to boost the risk of subprime loans and to foist that risk onto borrowers, lenders, and investors. In theory, these injured parties could sue careless or fraudulent brokers, but in reality, most of those brokers had meager capital, leaving them judgment-proof.

Lenders looked the other way because they profited from higher loan volumes and planned to securitize the loans anyway and shift the risk to investors. To maximize their loan volume from brokers, many lenders relaxed their quality controls on brokered loans. In fact, one subprime lender, Novastar Financial, made no bones about that fact when it reportedly sent a brochure to its brokers trumpeting, "Did You Know NovaStar Offers to Completely Ignore Consumer Credit!"[20]

At the end of the day, securitization and its sister forms of outsourcing gave financial incentives to actors in the mortgage industry to originate unduly risky subprime loans. Mortgage brokers originated faulty loans because they knew they could shift the credit risk onto lenders while collecting their pay at closing. Lenders agreed to make defective loans because they got paid upfront while dumping those loans onto investors. Investment banks and rating agencies glossed over the risks of subprime loans because they knew they would get paid from the securitization proceeds. Investors took the ratings on blind faith because they were greedy for high returns and did not insist on closer scrutiny of loan pools. To the contrary, relentless demand by investors at home and abroad for high-yield subprime bonds required shunting a continuous stream of borrowers into subprime loans.

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[19] Rick Brooks & Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy*, WALL STREET JOURNAL, Dec. 3, 2007.

[20] Gretchen Morgenson, *Creative Loans, Creative Compensation*, NEW YORK TIMES, Nov. 18, 2007.

The Subprime Surge and Bust

From 1994 to 2005, subprime loans rocketed in growth at twenty-six percent a year. In order to maintain this meteoric rate of growth, the subprime sector needed to deliver a steady stream of customers for high-cost loans. To ensure that stream of customers, the subprime industry came to rely on – and fueled – looser and looser underwriting standards.

In the early years, it was easy for the subprime market to grow fast because it started out so small. Back in 1994, subprime mortgages accounted for less than five percent of home loans. Even by 2001, subprime mortgages only made up nine percent of total home loans. During those early years, from the viewpoint of macroeconomists, subprime mortgages were just a drop in the bucket compared to home mortgages overall in most parts of the country.

But with the traumatic events of 2001, everything changed. The previous year, the dot-com bubble had burst, plunging the U.S. economy into recession. By August 2001, the S&P 500 Index was off twenty-six percent from its previous high. Then tragedy struck. On September 11, al-Qaeda attacked the World Trade Towers and the Pentagon, striking at the very heart of Wall Street. As the country grieved, the faltering economy attempted to revive, only to sustain another blow in December 2001, when Enron filed for bankruptcy. As one corporate scandal after another came to light, public confidence in the stock markets crumbled. The S&P 500 slid another fifteen percent and did not begin to bounce back until the fall of 2002, after Congress passed the Sarbanes-Oxley Act.

Throughout it all, the housing market was the one bright spot in the economy. In mid-2000, with the dot.com bubble about to burst, the Federal Reserve Board exercised its "Greenspan put" and slashed interest rates, causing housing prices to grow at a steady clip of ten percent a year nationally. After the 9/11 attacks, with the recession in full swing, the Federal Reserve Board ordered further rate cuts in order to jump-start the economy.

Between August 2001 and January 2003, the Fed lowered the discount rate from 3 to 0.75 percent. Mortgage rates followed suit and sank to new lows. By May 2003, rates on thirty-year fixed mortgages had fallen to their lowest point in decades. Mortgage lenders did land office business and were flooded by consumers who wanted loans to buy or refinance homes. On the sidelines, Fed Chairman Alan Greenspan heaped praise on consumers for fueling consumer spending by taking out adjustable-rate loans in order to extract equity from their homes.

The mortgage boom was good for prime loans, but it was even better for subprime loans. Between 2001 and 2005, subprime lending's market share doubled in size, to twenty percent of consumer originations, and it stayed at twenty percent through 2006. Nationally, home prices grew at double-digit rates in 2004 and 2005. As housing prices rose, consumer confidence soared and lenders plied homeowners with offers of easy credit.[21]

Rising home prices created problems of their own. On the coasts, spiraling home prices outpaced family incomes, threatening to put home-buying out of reach for many aspiring homeowners. Meanwhile, interest rates began to go up. Between July 2004 and July 2006, the Federal Reserve Board raised the federal funds target rate by four percent and did not start lowering it until July 2007, which made mortgages more expensive and pushed up the index rates on adjustable-rate mortgages. Lenders found it harder and harder to qualify borrowers using standard underwriting criteria for safe fixed-rate mortgages.

As consumers became financially stretched, housing starts started to decline.[22] In the industrial Midwest, plant closings and job losses pushed many middle-income homeowners into

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[21] Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, on Strengthening the Economy: Foreclosure Prevention and Neighborhood Preservation; before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 538 Dirksen Senate Office Building, January 31, 2008, www.fdic.gov/news/news/speeches/chairman/spjan3108.html; Federal Reserve System, Truth in Lending, 73 Fed. Reg. 1672, preamble (Jan. 9, 2008).

[22] Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, on Strengthening the Economy: Foreclosure Prevention and Neighborhood Preservation; before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 538 Dirksen Senate Office Building, January 31, 2008, www.fdic.gov/news/news/speeches/chairman/spjan3108.html.

default. Lenders and brokers, seeing the handwriting on the wall, changed their mix of loan products to keep loan originations – and their fee income – from falling off the cliff. To keep initial monthly payments within affordable reach, lenders began making more adjustable-rate mortgages (ARMs) and qualifying the borrowers only at the lower introductory rates. These subprime ARMs were not your parents' ARMs of yore, with low reset rates and manageable lifetime caps. Instead, the introductory rates on these subprime adjustable-rate loans started at seven to nine percent. Indeed, for mortgages originated in 2006, the average starting rate for subprime adjustable-rate mortgages – 8.29% -- was *higher* than the average 8.06% rate on subprime fixed-rate loans.[23] After the introductory period – normally, two or three years – when rate reset, high margins on these loans caused borrowers' monthly payments to go up overnight by fifty to one hundred percent or more. Far from the exception, these subprime "hybrid" ARMs accounted for three-fourths of subprime loans securitized in 2004 through 2006.[24]

Other ARMs had even more exotic features. Interest-only ARMs allowed borrowers to pay only interest, not principal, for an initial period. Even worse were option payment ARMs with negative amortization, which were peddled to prime borrowers and designed to make the borrowers' principal *grow* over time. Over three-fourths of borrowers with option payment ARMs only made the minimum payments, which increased the principal they owed on their loans.[25]

Lenders also dealt with rising home price appreciation by approving loans without verifying the borrowers' incomes or assets. If the borrower's income was too low to qualify, no problem. The lender could simply reach into its bag of tricks and pull out a stated-income loan, a

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[23] Remarks by FDIC Chairman Sheila Bair, University of Connecticut School of Law, Hartford, Conn., Feb. 14, 2008.

[24] Federal Reserve System, Truth in Lending, 73 Fed. Reg. 1672, preamble (Jan. 9, 2008).

[25] Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, on Strengthening the Economy: Foreclosure Prevention and Neighborhood Preservation; before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 538 Dirksen Senate Office Building, January 31, 2008, www.fdic.gov/news/news/speeches/chairman/spjan3108.html.

NINA loan – no income, no assets – or even a NINJA loan – no income, no job, no assets -- based on the house value alone. Lenders even made these loans when borrowers gave them full documentation of their assets and income because lenders earned higher interest rates on low- and no-documentation loans. By 2006, more than forty percent of subprime loans and eighty percent of "Alt-A" loans that were securitized consisted of these sorts of "liar loans."[26]

As competition intensified, lenders and brokers scrambled for loan customers by reaching down the credit scale while loosening their underwriting standards. For borrowers with no down payment, 100 percent financing was easily had, generally by using piggyback second mortgages. Loans for the full property value or more went to people with tight incomes and spotty payment records. Loan terms were stretched out to forty or even fifty years. Desperate to keep origination volumes up, lenders layered risk upon risk, making no-documentation ARMs with high payment shock and no down payments to cash-strapped borrowers with low credit scores. The low initial payments on these loans lured numerous unsuspecting borrowers into larger loans than they could afford.[27]

There were warning signs in late 2006 that the subprime market was on the verge of collapse. Delinquencies were rising and so were foreclosures. That fall, Goldman Sachs and Balestra Capital placed lucrative bets that subprime investment vehicles would fall in value.[28] Investors began to insist that lenders buy back failed subprime loans. Funding sources began to

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[26] Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, on Strengthening the Economy: Foreclosure Prevention and Neighborhood Preservation; before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 538 Dirksen Senate Office Building, January 31, 2008, www.fdic.gov/news/news/speeches/chairman/spjan3108.html; Gretchen Morgenson, *Crisis Looms in Market for Mortgages,* NEW YORK TIMES, March 11, 2007.

[27] Gretchen Morgenson, *Crisis Looms in Market for Mortgages,* NEW YORK TIMES, March 11, 2007.

[28] Jenny Anderson & Vikas Bajaj, *Wary of Risk, Bankers Sold Shaky Mortgage Debt,* NEW YORK TIMES, Dec. 6, 2007; Nelson D. Schwartz & Vikas Bajaj, *How Missed Signs Contributed to a Mortgage Meltdown,* NEW YORK TIMES, Aug. 19, 2007.

dry up and in December 2006, Ownit Mortgage Solutions and Sebring Capital Partners became the first in a long line of subprime lenders to fail.[29]

In 2007, the house of cards came tumbling down. For the first time since the Great Depression, housing prices declined nationwide, sharply in some markets, and distressed borrowers found that they had limited options.[30] Rising interest rates, stricter underwriting, falling home prices, and harsh prepayment penalties made it difficult for borrowers to refinance. Falling real estate values prevented delinquent borrowers from paying off their loans in full by selling their homes.

Defaults soared and so did foreclosures. By November 30, 2007, one-fifth of subprime ARMs were ninety days or more delinquent or in foreclosure, many due to early payment defaults. Foreclosures are expected to rise as more loans come due to reset.[31] The subprime bond market skidded to a halt. Investors fled anything remotely tainted with subprime and panic infected credit markets in the United States and abroad, spreading to the markets for interbank loans, asset-backed commercial paper, mortgage insurance, term auction securities, and student loans.

Conclusion

Market failures in the subprime home mortgage industry are responsible for the economic crisis that the United States faces today. In the 1980s, deregulation assumed that lenders would maintain sound underwriting standards and only make loans that borrowers could afford. Since then, however, lenders have outsourced major parts of the lending process to brokers, contract underwriters, investment banks, rating agencies, and servicers. This outsourcing created

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[29] Vika Bajaj & Christine Haughney, *Tremors at the Door*, NEW YORK TIMES, Jan. 26, 2007; see also The Mortgage Lender Implode-O-Meter, http://ml-implode.com/.

[30] Anna Bernasek, *When Does a Housing Slump Become a Bust?*, NEW YORK TIMES, June 17, 2007; David Leonhardt & Vikas Bajaj, *Drop Foreseen in Median Price of U.S. Homes*, NEW YORK TIMES, Aug. 26, 2007.

[31] Speech by Federal Reserve Board Randall S. Kroszner at the American Securitization Forum 2008 Conference, Las Vegas, Nevada, Feb. 4, 2008, www.federalreserve.gov/newsevents/speech/kroszner20080204a.htm.

perverse incentives for brokers, lenders, rating agencies, and underwriters to pocket upfront profits while off-loading unnecessary risks onto unsuspecting borrowers and investors. The lax underwriting that fueled the subprime crisis was a direct result of the perverse compensation structure that the outsourcing of the mortgage process created.

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