Testimony of Richard F. Syron
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COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
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Chairman Shelby, Ranking Member Sarbanes and members of the Committee:

My name is Dick Syron. I am the Chairman and Chief Executive Officer of Freddie Mac, a position I took 16 months ago. I last appeared before this Committee after only two months on the job – and you were exceedingly gracious, considering my limited knowledge of the task before me. Together with the Freddie Mac employees I am privileged to lead, I have learned a great deal since I last testified. We have worked extremely hard and made tremendous progress. I greatly appreciate the opportunity to appear before the Committee again today to report on our accomplishments and discuss where we all go from here.

When I last spoke with you, I told you then that I approached the issues of regulatory reform largely from the perspective of a regulator, having been President and CEO of the Federal Reserve Bank of Boston. In fact, I have spent 25 years in public service, a good part of that regulating financial institutions. Before heading the Boston Fed, I was President and CEO of the Federal Home Loan Bank of Boston. Prior to that, I was privileged to serve as assistant to then-Federal Reserve Chairman Paul Volcker. Earlier, I was Deputy Assistant Secretary for Economic Policy of the United States Treasury.

I will say that my experiences as a regulator have caused me to listen with particular attention and care to the testimonies of Chairman Greenspan and Secretaries Snow and Jackson during the week of April 4th. Though I do not agree with everything these distinguished gentlemen said, I have listened carefully, I have heard their concerns and I deeply appreciate them. I know that we can and will work together to accomplish the regulatory reforms we all agree are necessary.

I would also like to say a few words about Armando Falcon, the departing head of OFHEO, our safety and soundness regulator. Director Falcon leaves behind an impressive list of accomplishments, particularly in bringing to fruition a risk-based capital stress test that is truly state of the art. Freddie Mac anticipates that if Congress passes GSE reform legislation this year, it will complete the collection of regulatory tools necessary to ensure that our safety and soundness regulator has everything it needs to take its place among the elite of financial institution regulators worldwide.

Progress to Date

Since coming on board, I have issued a message to each and every Freddie Mac employee that our principal duty is to meet the very highest standards. This includes *all* of our work, but specifically it applies to accounting and operational controls, disclosure and dedication to our mission – as well as the indispensable values of business ethics and integrity. I am pleased to

report that Freddie Mac's people have answered that call with a commitment and a dedication that would make any CEO proud.

While we have much more to do, Freddie Mac made significant strides in getting our house in order last year. We continued to address the remediation of our internal controls, and we built a robust internal compliance and ethics program. I am particularly pleased to report that on March 31, 2005, we met our commitment to publish quarterly and full-year financial results for 2004 on our announced timeline. We are on track to meet all of our objectives of becoming current in our financial reporting. Based on this schedule, we expect to file Form 10 registration statement to register our common stock with the Securities and Exchange Commission in the second quarter of 2006. For all of us at Freddie Mac, particularly our accountants and others who labor diligently over our books, that will be a proud day indeed.

In 2004, Freddie Mac also made significant progress in recommitting ourselves to our affordable housing mission. We financed homes for more than 3.7 million families, and reported that we met all of our affordable housing goals, which direct mortgages to low-income and very-low-income families. This alone is notable, since changes in certain regulatory counting mechanisms made the goals effectively 14 percent higher on average.

We forged new relationships with our lender partners and, with their help, launched a new suite of affordable housing products called Home Possible. This initiative is expected to help nearly half a million people, including first-time homebuyers and immigrant families, buy a home over the next three years. We also maintained our leadership role in combating predatory lending by implementing our ban on mortgages containing mandatory arbitration clauses. As important as it is for the GSEs to say "yes" to mortgage purchases, there are times when saying "no" is clearly the better choice. Our efforts to combat predatory lending may not always be popular with everyone, but we will continue to hold ourselves to high standards to ensure that borrowers have every chance to build equity through homeownership.

Now we are well into 2005 – what I call a "bridge year." It's a time for us to complete the process of rebuilding our financial and business infrastructure and, most importantly, rebuilding public trust through accountability. Congress created us, and Congress needs to know that we are 100 percent wholly committed to doing our job and meeting our responsibilities to the public. I am here today to assure you that Freddie Mac is doing just that: we are addressing the problems of the past and have become a better company for it. Working with you, we look forward to a bright future serving our vital mission.

It is my sincere hope that this bridge year also brings passage of GSE regulatory reform legislation. Strengthened regulatory oversight is needed, and on numerous occasions I have stated my commitment to help facilitate it. We review each legislative proposal against the yardstick of whether it allows us to fulfill our housing mission while being responsible to those investors who provide us with the means to do so.

Unfortunately, in the past year, regulatory reform has ballooned into a referendum on the entire GSE system of housing finance. The list of perceived issues has grown exponentially – and noble statements about the need for strengthened regulation can belie more competitive interests.

While a number of the provisions may be reasonable, taken together they may result in unintended negative consequences for the nation's housing finance system. It may be true that the GSEs have "cried wolf" on previous occasions, but this is not one of those times and I'll explain why.

Regulatory Reform that Preserves a Vibrant System

Freddie Mac and Fannie Mae are unique corporate entities created by Congress to serve specific policy objectives: to ensure that low-cost mortgage money is plentiful, accessible and broadly distributed across the country. By nearly every account, the system has been hugely successful. Long-term, fully prepayable mortgages are widely available. Terms are standardized. Borrowers' rights are protected. Applications are automated. Refinancing is often a breeze. With a such system in place, it is no surprise that U.S. homeownership has been on a steady upward march and that families have more of their wealth invested in their homes than in the stock market.

The GSEs also provide numerous benefits to the U.S. economy, as confirmed by several recent studies. Research commissioned by the Treasury of the United Kingdom affirmed the beneficial role of fixed-rate mortgages, which are standard fare in the U.S. because of the GSEs. Compared with adjustable-rate mortgages, fixed-rate financing was found to reduce volatility in house prices, thereby providing a stabilizing effect to the broader economy.[1] Similarly, a study by the International Monetary Fund compared house-price volatility with the proportion of fixed-rate lending in 18 developed countries between 1971 and 2003 and found that those with the greatest levels of fixed-rate lending also had the lowest house-price volatility.

A third study found that the GSEs support the U.S. economy by acting *counter-cyclically*. At the point in the business cycle when economic activity is contracting, Freddie Mac and Fannie Mae *increase* their provision of funds to the mortgage market. In contrast, other mortgage investors (mostly commercial banks and savings institutions) make credit available *pro-cyclically*: that is, they reduce mortgage lending during recessions. By acting *counter* to the business cycle, Freddie Mac and Fannie Mae reduce the depth of a housing recession and support credit flows

[1] "The UK Mortgage Market: Taking a Longer Term View," Report by David Miles for H.M. Treasury, March 2004. The U.K. mortgage market consists of adjustable-rate mortgages (or very short-term balloons), and the government wanted to know whether there was a benefit to greater promotion of long-term fixed-rate lending. Miles compared empirical studies of house price volatility across the U.S., U.K., and the Netherlands (which also has medium- to long-term fixed-rate loans) and found that U.K. house prices were more sensitive to interest rate movements than in the other two nations. Further, he compared simulations of the effect of different levels of house price volatility on personal consumption and economic growth within the U.K., and concluded that "...the results suggest that had house prices followed a less volatile path....then the path of consumption would have been less variable and as a result macroeconomic volatility would have been lower." (Miles, p. 94) Thus, Miles was able to establish a link between fixed-rate mortgage lending, lower house-price volatility, lower consumption variability and greater macroeconomic stability over time.

The second analysis from the International Monetary Fund (IMF) compared house-price volatility over 1971-2003 with the proportion of fixed-rate lending in 18 developed countries and found that those with more fixed-rate lending also had lower house-price volatility. The IMF also commented on the linkage running from house prices through consumption spending: "House prices and economic activity are tightly linked. Changes in house prices influence demand and output by affecting households' wealth and capacity to borrow." (pp. 77-78).

during an expansion.[2] So during good times, the GSEs support the mortgage market on an "as needed" basis; but during economic recessions – when the need is the greatest – Freddie Mac and Fannie Mae provide for those needs.

Dr. Susan Wachter, the Richard B. Worley Professor of Financial Management at the Wharton school at the University of Pennsylvania, who appeared before this Committee in February, has reached similar conclusions. According to Dr. Wachter, the American mortgage instrument – the long-term, fixed-rate, freely prepayable conventional mortgage – "helps to stabilize macroeconomic growth.... The role of mortgage market access to global capital markets as an automatic stabilizer for the U.S. economy is demonstrated by the strength of the housing sector and its impact in moving the economy out of the 2001 recession."[3] The unique structure of the GSE system – transferring the risk of interest-rate fluctuations to investors in pass-through securities from borrowers and financial institutions – is what allows for the size and stability of the American mortgage market.

The benefits of the GSE system of housing finance are broadly recognized and well documented. But they do not negate the fact that the GSEs have made serious mistakes in recent years. We all can agree that these are imperfect institutions in need of regulatory reform. However, we have to look at the cumulative effect of all the changes that we are talking about today – otherwise we run the risk of unraveling this remarkable system and the many benefits it provides.

There are a lot of stakeholders in the current debate. If we get it wrong, consumers will pay higher mortgage rates, and lenders may have trouble finding buyers for their mortgages in lean times. But there are other key players we cannot ignore: the people who invest in U.S. housing via the GSEs in hopes of earning a return. The capital provided by these private equity and debt investors serves as a critical first line of defense for the GSEs and the government. Without them, the whole system breaks down.

Let's first talk about our shareholders. In creating the GSEs, Congress decided it did not want the government to be the first line of defense for the risks of the secondary mortgage market – so it created private-sector corporations that would be owned by independent shareholders. We shouldn't forget that it's their money – in the case of Freddie Mac, $31 billion of shareholder wealth – that is first on the hook should we fail to manage our risks properly. Their investment also enables us to play a stabilizing force in the economy. In the wake of the Asian debt crisis in 1998, Freddie Mac was able to raise over $2 billion in equity capital to support the U.S. housing market.[4]

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[2] Two scholars, Joe Peek and James Wilcox, examined residential credit flows relative to potential GDP (an estimate of the economy's output at full employment) over recessions and credit crunches and found that Freddie Mac and Fannie Mae provided funds to residential lenders *counter* to these credit cycles, and in stark contrast to the *pro-cyclic* pattern of bank and savings institutions.

[3] Statement of Prof. Susan Wachter before the Senate Committee on Banking, Housing, and Urban Affairs, February 10, 2005.

[4] See Freddie Mac 1998 Annual Report, pages 33 and 46. It includes $1 billion in newly issued common stock, $1.2 billion in newly issued preferred stock.

As with any corporation, our shareholders expect – and deserve – to be paid for the use of their capital. Many of our shareholders are average Americans. Roughly 43 percent of our stock is held in pension funds and mutual funds, whose primary investors include individuals, retirement funds and college tuition savings plans. That's a lot of nest eggs.

Our debt investors play a similarly critical role in making the system work. By investing in GSE debt, they enable us to purchase more mortgages from lenders, which replenishes funds available for housing. Our debt investors are the second line of defense for the U.S. housing finance system. At the end of 2004, they were providing over $733 billion to Freddie Mac.

At this juncture, regulatory reform is needed to maintain public trust, but overregulation could do more harm than good. Every day, the GSEs make possible an interdependent web of transactions among investors, lenders and consumers. Pulling hard on the threads of this finely woven system is possible to a point. However, the system is not infinitely elastic. No one knows for sure how far we can push the GSE model of housing finance before the providers of our debt and equity capital decide to take their money elsewhere. Thus, we want to work with you to ensure that whatever bill results from this Committee's efforts collectively retains the key elements of the model that has been so beneficial to America's families.

To preserve our ability to execute our congressional mandate, Freddie Mac supports sound legislation that is effective in sustaining the vibrancy of our current system of housing finance.

Now let me turn to specific proposals under consideration in this Committee.

Legislative Proposals

There are many proposals under consideration before this Committee, and it is my hope that each one will be measured against the twin criteria of safety and soundness and mission. Each should advance, or at least do no harm, to the safety and soundness of the GSEs. And each should advance, or at least do no harm, to the GSEs' ability to fulfill their mission.

The term "safety and soundness" is widely understood. There has been some confusion, however, about what the GSE mission entails. In order to assess the legislative proposals, we need a shared understanding of the term mission.

By charter, the GSE mission is to provide liquidity, stability and affordability to the nation's mortgage markets. Very often, the term "mission" is thought to refer only to affordable housing. Make no mistake, affordable housing is a vital component of our mission, and we are paying increasing attention to this critical objective. Nonetheless, we were created to fulfill – and we do fulfill – an even broader mission.

While both fulfilling our mission and enhanced safety and soundness are each desirable ends, in practice, achieving both requires a delicate balance. We believe there are a number of legislative proposals that can be combined into a bill that strengthens regulatory oversight while maintaining that balance, such as widening our regulator's discretion to modify our capital requirements and providing appropriate receivership authority. But there are combinations that

would create significant tension between fulfilling our mission and ensuring safety and soundness, such as:

- Proposals that lead to higher borrowing costs or that significantly harm our ability to attract debt and equity investors
- Requirements to hold capital beyond levels indicated by risk
- Potentially onerous new program or activity constraints that inhibit innovation

These are challenging issues, but I have faith that Congress will strike the right balance.

Capital Requirements

Capital adequacy is the touchstone of investor confidence and is critical to our ability to fulfill our mission and attract low-cost funds to the mortgage market. Freddie Mac's capital position is and has been very strong. We have consistently exceeded our minimum leverage and risk-based capital standards and, as required by our regulator, have maintained a 30 percent surplus over our minimum ratio for the past 14 months. Despite our accounting issues, we have consistently received the highest GSE capital rating by OFHEO.

Our strong capital position notwithstanding, Freddie Mac supports providing greater discretion to the GSE regulator to ensure public trust. Three considerations should guide this important discussion: First, the recognition that capital is vitally important to safety and soundness, investor confidence and the GSEs' ability to attract low-cost funds to the mortgage market. Second, capital must be tied to risk, recognizing the unique GSE risk profile. Ironically, requiring capital levels beyond what's appropriate can force any institution to become more risky. A financial institution with excessive capital requirements must take on riskier assets in order to earn sufficient profits to provide attractive returns to its investors.[5] Third, requiring capital beyond levels commensurate with risk limits our ability to fulfill our mission of providing affordable housing and stability to the mortgage market.

Based on these considerations, Freddie Mac supports:

- Maintaining the current statutory minimum capital ratios
- Providing the regulator with additional flexibility on risk-based capital

[5] One example of how this could happen is by reducing capital standards for banks, while at the same time increasing them for the GSEs. According to W. Scott Frame and Lawrence White, in Emerging Competition and Risk-Taking Incentives at Fannie Mae and Freddie Mac , p. 18, Federal Reserve Bank of Atlanta Working Paper 2004-4, February 2004. Capital Standards like Basel II and the FHLB mortgage programs represent "competitive threats to the growth of both Fannie Mae's and Freddie Mac's credit guarantee business, as well as their retained mortgage portfolios. Such developments could, in turn, lead to more risky behaviors by these two GSEs. It is this last consequence that warrants greater regulatory awareness."

- Providing the regulator discretion, based on a set of statutory criteria, to increase minimum capital levels to capture elevated risks that are not captured by the risk-based capital standard. The regulator must consider the effects of higher capital levels on both mission and safety and soundness

- Requiring appropriate procedural safeguards for any adjustments to minimum capital

Minimum Capital Requirements: The purpose of leverage ratios is to provide a backstop so that no matter how low quantifiable risk falls over the course of the business cycle, sufficient capital remains within the institution. These ratios must be carefully set recognizing the business model and mission of the regulated entity. The GSEs are required in statute to hold 2.5 percent capital for on-balance sheet assets, and 0.45 percent for off-balance sheet assets. This is effectively a total of approximately 3 percent against on-balance sheet assets. In addition, we are required to hold an additional 30 percent to cover management and operations risk.[6]

Some have suggested that the GSEs' capital requirements should be more closely aligned with those of banks. I agree with this for *risk-based capital requirements* where regulators are aligning capital with risk. Financial institutions should face equal capital for equal risk. However, that is very different from saying we need the same *leverage ratios* as banks.

GSEs differ from banks in terms of role, charters, business models and the composition and nature of our portfolios. Banks invest in a wide range of assets, including those with relatively high risks, ranging from unsecured loans to commercial borrowers and to relatively high-risk loans to foreign countries. In contrast, GSEs invest in conventional conforming mortgages on properties in the United States, historically the safest investment vehicles available. Another distinction stems from GSE charter restrictions that further reduce our risk profile. These restrictions include the conforming loan limit and insurance requirements for mortgages with loan-to-value ratios higher than 80 percent. These differences produce different results, even controlling for asset type. For example, since 1994, charge-off losses for mortgages at the five largest banks have been, on average, 4 times higher than mortgage charge-offs at Freddie Mac.

Recent experience further cautions against over-reliance on minimum capital ratios. Not many years ago, overzealous capital regulation led to disastrous consequences in the Northeast – drying up credit and exacerbating an economic downturn. I observed this crisis first-hand during my tenure as President of the Federal Reserve Bank of Boston. While many banks were adequately capitalized on a risk-adjusted basis, the strict enforcement of minimum capital, or simple leverage ratios, required them to liquidate a substantial portion of their assets. This resulted in the now infamous "credit crunch," which had profound effects in the Northeast on not

[6] In contrast, current risk-based capital requirements for banks do not include a specific charge for either interest rate risk or management and operations risk. Basel II will remedy only the latter, but still will not require a set amount of capital for interest rate risk.

only small and mid-sized business, but employment as well. This credit crunch turned a two-year national recession into a severe regional slump that lasted for more than half a decade.[7]

Some are beginning to understand the limits of using simple leverage ratios and are suggesting eventually eliminating them for large banks.[8] It is our view that the two trends – one to decrease and bank leverage requirements and the other to increase the GSE statutory leverage requirement – are inconsistent.

My experiences are consistent with leading international trends in capital management. Drawing from statements by the Basel Committee on Banking Supervision, risk-based capital regimes are preferable to the use of simple ratios to set capital standards. In its 1999 Consultative Paper and the 2001 New Basel Accord, the Committee proposed a capital adequacy framework to replace the 1988 Capital Accord for U.S. Bank capital standards, which relied heavily on simple ratios to set capital standards. The new framework, which is currently in the process of being adopted in this country, more accurately aligns capital requirements to the actual risks incurred by regulated institutions.[9]

Notwithstanding these concerns, I understand the need for regulatory discretion to increase those ratios during certain situations. Again, we believe that statutory criteria should be in place to define the circumstances that warrant an increase and its duration. The leverage ratio should only be increased when the elevated risk is not captured in the risk-based capital standards. Any adjustment to minimum capital levels should be adopted and carried out with appropriate procedural safeguards.

Risk-Based Capital Requirements: Greater regulatory discretion regarding the GSE risk-based capital rule is the best way to tie capital to risk. Ten years in the making, the GSE risk-based standard is unique among financial services regulation. Freddie Mac is required to hold capital sufficient to survive 10 years of severe economic conditions and major interest-rate swings.

In our view, the GSE risk-based capital rule is at the cutting edge of financial services regulation.[10] The rule ties capital requirements to the specific risks of an institution – ensuring

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[7] History of the Eighties, Lessons for the Future: An Examination of the Banking Crisis of the 1980s and Early 1990s, vol.1, part 2, Sectors and Regional Crisis, Ch. 10, Banking Problems in the Northeast, Federal Deposit Insurance Corporation, 1997.

[8] Recent comments by Federal Reserve Governor Susan Bies suggest that bank capital leverage ratios may be eliminated altogether once the new agreement is in place. "The leverage ratio down the road has got to disappear," Ms. Bies said. "I would say to the industry: If you work with us and be patient, we understand the concerns about leverage ratios and as we get more confidence in the new risk-based approach, it will be easier for us to move away from the leverage ratio." "Congressional Pressure for Consensus on Basel II," *American Banker*, March 15, 2005.

[9] *The New Basel Capital Accord,* Consultative Document, Basel Committee on Banking Supervision (January 2001).

[10] According to an analysis prepared by L. William Seidman, former chairman of the FDIC, the stringent risk-based capital standard applicable to Freddie Mac could be extremely challenging if they were to be applied to most other financial institutions. L. William Seidman, et al., Memorandum to Freddie Mac, March 29, 2000. More recently, the CapAnalysis Group, LLC, concluded that the risk-based capital stress test is "a much more stringent test for judging the safety and soundness of a financial institution than is a traditional capital-requirements test." The

safety and soundness without raising costs unnecessarily or crippling the smooth flow of mortgage capital. To ensure the rule remains the best practice in capital regulation, we support providing additional regulatory discretion to improve it, as long as appropriate safeguards are in place.

Here are some guiding principles for modifying risk-based capital standards:

- The new regulator should be encouraged to gather information over the entire business cycle before making changes. This could be accomplished by requiring that the current rule remain in place for a period of time and expressing congressional intent to this effect.

- When a new rule seems to be warranted, policymakers should ensure that any future capital standard continue to tie capital levels to risk; be based on an analysis of historical mortgage market data; remain operationally workable and as transparent as possible; accommodate innovation so the GSEs can carry out their missions.

- Changes to the rule should be accomplished through notice-and-comment rulemaking. There should be an adequate comment period for all interested parties to express their views, followed by an adequate transition period for the GSEs to make any necessary adjustments to comply with new requirements.

In summary, Freddie Mac supports improvements to the GSE capital regime that reflect the unique role of the GSEs, while ensuring public trust in our financial strength. Based on my experience as a regulator, I fully support granting the GSE regulator greater discretion to set risk-based capital levels that accurately reflect the risks we undertake. Discretion on risk-based capital greatly mitigates the regulator's need to rely on simple leverage ratios. Changing capital standards unnecessarily, capriciously or frequently will reduce the amount of mortgages the GSEs can help provide, resulting in higher costs for homeowners and renters.

New Program Approval and Activities

The GSE charter conveys certain special abilities that enable us to effectively pursue our mission. At the same time, the charter places a number of limitations on our business, such as prohibitions on originating mortgages, engaging in activities outside residential housing finance, and purchasing mortgages above the conforming loan limit.

Furthermore, under current law, the GSE regulator has strong authority to monitor, and under appropriate circumstances, halt a GSE's business activities and initiatives. The GSE regulator can determine that a GSE is acting outside the scope of its charter and may order that GSE to cease and desist engaging in the activity or initiative. In addition, before a GSE can commence a new program, it is required to submit a new program approval request to the regulator. After review of the request, the GSE regulator can deny a GSE's request for new program approval.

CapAnalysis Group, LLC, OFHEO Risk-Based Capital Stress Test Applied to U.S. Thrift Industry (March 17, 2003), p. 1.

We believe that this is a balanced approach, and proposal that would maintain this regulatory structure would be acceptable to us.

Despite these time-proven safeguards, some contend that these limitations are inadequate and that a so-called "bright line" is needed to further limit the scope of GSE business activities by drawing a new, more restrictive line between the activities of the GSEs and those of primary market participants. While seemingly innocuous, the so-called "bright line" proposal would seriously harm the GSEs' abilities to respond appropriately and quickly to the needs of this market – a market that is innovative, creative and fast-paced.

Also, it would discourage innovations by both the GSEs and the participants in the primary mortgage market. Precluded activities could range from the use of automated underwriting systems, by which we assess mortgage credit risk, to our award-winning financial literacy programs, to our ability to establish anti-predatory lending standards designed to protect unsuspecting consumers. More broadly, the "bright line" proposal would erect a "concrete barrier" between two markets that currently require – and benefit from – a substantial degree of integration, innovation and dynamism. Integration and innovation will be critical to America's ability to provide housing to minority and immigrant families, who will constitute the lion's share of the growth in new households in the coming decades.

We believe that the GSE regulator can be informed of new business activities in a manner that does not stifle innovation and dynamism, but rather, compliments the integrative strength unique to the U.S. mortgage market. One proposal of which we are aware ensures that the GSE regulator would be notified of any business product or activity undertaken by a GSE, and the proposal accomplishes this without unnecessarily inhibiting the ability of the GSE to respond to the emerging needs of the dynamic mortgage and capital markets. We find that this proposal strikes the right balance and is therefore acceptable to us. The one caveat we would add, however, is that the term "activity" or "activities" should be appropriately defined so that the GSEs can continue to serve the fast-changing needs of emerging and underserved markets.

Receivership

We view strong regulatory oversight as essential to preventing serious financial difficulties. In the remote event of a financial crisis, the issue is whether the regulator has the tools necessary to address the situation adequately.[11]

Our safety and soundness regulator has the authority to appoint a conservator to rehabilitate a financially troubled GSE. Congress reserved for itself the authority to appoint a receiver.

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[11] "On a stand-alone basis, Fannie Mae's probability of default over a one-year horizon at the end of 2003 was in the range of one in ten thousand, or 0.0001, based on the Fannie Mae default risk simulations model developed for this paper. In contrast, the lowest "stand-alone" default probability calculated for any commercial bank in my sample was 0.00027 based on the proportional hazard model and 0.0008 based on the Moody's-KMV RiskCalc model," page 3, "The Relative Risk of Fannie Mae," by R. Glenn Hubbard, Volume III, Issue 3, September 2004.

Freddie Mac understands the desire to provide the regulator with authority to appoint a receiver to provide greater certainty to the resolution process. In providing this authority, Congress should ensure that the GSEs maintain appropriate access to the capital markets in order to fulfill our mission.

Supervisory and Enforcement Powers

We believe that legislation should provide the regulator with the tools it needs to effectively oversee the GSEs. To that end, if Congress were to deem it appropriate, we would support providing the new GSE safety and soundness regulator authorities comparable to those of the federal banking agencies. These enhanced powers would include:

- Broadening the categories of individuals against whom the regulator could initiate cease-and-desist and other enforcement proceedings
- New authority to restrict unsafe and unsound practices
- New authority to remove and suspend executive officers and directors and to impose industry-wide prohibitions

Structure and Independence

Freddie Mac has long supported the creation of a strong, credible regulator, one that enjoys the confidence of Congress, investors and the public. Several structures could achieve these ends, as long as they ensure that the new regulator has

- Significant experience in housing
- Substantial expertise with complex financial transactions
- An appropriate degree of independence

If the regulator were to be a division of the Treasury Department, ensuring the appropriate degree of independence would require providing the same operational controls as those that apply to the Office of the Comptroller of the Currency and the Office of Thrift Supervision.[12] For example, the regulator would need to have authority to testify and submit reports to Congress and to promulgate regulations without prior review or approval authority by the Secretary of the Treasury.

Affordable Housing Mission

Freddie Mac's mission is to provide liquidity, stability and affordability to the nation's mortgage markets. Not long after I arrived at Freddie Mac, it became clear to me that, while we have done

[12] *See* 12 U.S.C. §§ 250, 1462a(b)(2) - (4); 1464(d)(1)(A).

a very good job with liquidity and stability, we have not always given enough attention to affordability. One of my top priorities has been to put our affordable-housing mission at the forefront of our activities. As discussed earlier, we're devoting far more resources to our affordable housing mission, and we're making good progress. Meeting the affordable-housing goals is, of course, a key element of serving our affordable housing mission.

Any discussion of affordable-housing goal legislation should recognize the recent dramatic expansion of our affordable-housing obligations. During my first year at Freddie Mac, we saw an effective increase in the level of the existing housing goals because of the expiration of bonus points for small multifamily properties and other counting mechanisms. These changes boosted our goals by 14 percent on average – and we worked strenuously to meet the higher effective levels.

Now a new regime has been put in place that raises the bar still higher. In 2004, HUD promulgated new goals and new purchase-money subgoals for 2005 to 2008. In all, the GSEs now have seven goals, subgoals and dollar targets. The goals are much higher than in previous years, and they ascend over the four-year period. By 2008, at least 56 percent of the mortgages we purchase will be affordable to low- and moderate-income families, 39 percent of our purchases will be in underserved areas and 27 percent will be affordable to very-low-income families. Additionally, HUD has created new purchase-money subgoals for metropolitan areas, many of which are set above the levels of subgoal-qualifying loans that the primary market is expected to produce.

As in 2004, we are doing our best to meet this new and expanded challenge. For example, we are adjusting our mortgage sourcing and purchasing strategies. That said, we may be at a point where achieving additional goals and subgoals paradoxically come into conflict with achieving our broader public mission of providing affordable housing. Since the goals are set as a percentage of our total business, we may have to reduce liquidity to non-goal-qualifying segments of the market in order to meet our regulatory requirements. Forcing the GSEs to engage in this kind of "denominator management" pits the liquidity and stability work we do for all borrowers with the affordability work we do for those at the lower end of the income scale.

In our view, there are better ways to direct the GSEs toward underserved areas than by setting an excessive number of goals and subgoals, which sacrifice innovation and flexibility for micromanagement of our business activities. We believe that the market, as well as consumers, would be better served through a set of fewer, but more targeted goals that are better aligned with bank affordable housing requirements. We also believe it would be preferable to designate underserved markets and set aside funds exclusively for the development and investment in those markets in order to help families afford and keep their homes. The dollar value of the fund would be tied to our earnings, ensuring that the incentive to do well is aligned with the imperative to do good.

Guarantee Business

Another issue under consideration relates to Freddie Mac's guarantee business. Under this business, a lender sells mortgages to Freddie Mac and receives securities backed by those

mortgages in return. Freddie Mac guarantees to the holders of its securities the payment of principal and interest on the underlying mortgages – even in the event that the borrower defaults on the mortgage.

To cover these costs, Freddie Mac charges lenders a management and guarantee fee for issuing, managing, and guaranteeing payments on its mortgage-backed securities. The fee covers projected credit-related losses from borrower defaults over the life of the mortgages, based on historical experience, the costs of administering the guarantee business, and the return on capital held against the guarantee business. The GSE guarantee acts like a "good housekeeping seal of approval," increasing the value and liquidity of the underlying mortgages. This enables both Freddie Mac and mortgage lenders to attract more capital to fund America's housing needs.

Many of the questions recently raised about Freddie Mac's guarantee business revolve around the level of competition we face. Some suggest that we face little competition and thus can charge lenders whatever we wish. In reality, Freddie Mac faces a high level of competition from Fannie Mae, the Federal Home Loan Banks, FHA/VA, large lenders that purchase mortgages from other lenders, private-label mortgage-backed securities issuers, and other investors. Lenders thus have many alternatives to Freddie Mac, and we must earn their business through competitive pricing.

Some have proposed regulating the pricing of guarantee fees and disclosure of the fees paid by lenders to Freddie Mac. We believe it would be inappropriate for Congress or a regulator to mandate pricing in the mortgage market, and would suppress competition over time. Pricing should continue to be set by the competitive market forces that exist today. If Freddie Mac were required to publicly disclose the pricing of our guarantee business, this would place us at a substantial disadvantage to competitors who are exempt from such requirements. Based on the specific level of disclosure required, we also could be placed at risk of being adversely selected by mortgage sellers.

Executive Compensation

Congress rightly wants the new GSE regulator to have the tools necessary to place it among the elite of financial institutions regulators, because the regulator will oversee two of the most important financial institutions in America. Those tools must include oversight of executive compensation, and we support reasonable oversight of our executive compensation practices.

It is important to realize that the continued safe and sound operation of the GSEs depends on our ability to attract and retain highly-qualified individuals to run them. For better or worse, if it is important that the GSEs be run like world-class financial institutions, we will need to be able to attract and retain world-class financial executives. The GSEs have to compete for executive talent with other major national and regional financial institutions. If we are not able to pay our executives comparably to their peers, we won't be able to hire and keep the individuals we need to ensure that we stay safe and sound over the long run.

GSE Mortgage Portfolios

Two weeks ago, this Committee heard from Federal Reserve Chairman Alan Greenspan, Treasury Secretary John Snow and Secretary of Housing and Urban Development Alphonso Jackson. While many aspects of GSE regulatory reform enjoyed lively debate, one recurring concern was over the size of the GSE retained portfolios. I want to address this issue squarely and directly.

First, the long-term prepayable fixed-rate mortgage is the product of choice among America's families. In virtually every other country, however, borrowers are more likely to get adjustable-rate mortgages, which require them to bear the risk of rising interest rates. In our country, and more specifically in the segment of the market supported by the GSEs, we made the policy choice long ago that individual borrowers should have the option, through a long-term fixed rate mortgage, to shift that interest rate risk to an institution that is better equipped to manage it. From that choice follows an inevitable fact: someone, somewhere, must hold each of those loans in a portfolio. And each portfolio owner bears and manages the interest rate risk that has been shifted from the borrower to an institution.

In discussions over the GSE portfolios, no one questions the fundamental choice to move the interest rate risk from individual borrowers to institutions. Rather, as I understand it, the debate focuses on the size of the portfolios currently held by the GSEs and whether the portfolios contribute to our mission. Let me address these concerns in some detail.

First, Freddie Mac's portfolio is integral to our mission. Freddie Mac's charter provides two ways to attract capital to the U.S. housing market: we can either securitize mortgages or hold them in our portfolio. Securitization refers to the packaging of loans into mortgage-backed securities; in this instance, Freddie Mac manages the risk that borrowers will default on their mortgages but passes along to an investor the risk that homeowners may prepay their loans. Alternatively, we can purchase loans for our portfolio and finance them by issuing debt. In this case, Freddie Mac retains both the credit and interest-rate risk of the mortgages.

A number of investors, particularly some overseas, prefer to invest in the U.S. housing market by purchasing GSE debt, which features regular payment streams. The benefit of GSE debt is that it features regular than trying to predict the uncertain prepayments associated with mortgage pass-throughs. In 2004, foreign central banks accounted for 19 percent of Freddie Mac's outstanding debt securities, and overseas investors bought 48 percent of our debt in syndicated bond deals. By offering investors two ways of making their capital available to serve U.S. families, we diversify and expand the pool of available capital. Investment preferences to date suggest that many foreign investors would not shift their investments in U.S. housing from debt to mortgage backed securities, but instead would take their capital elsewhere. Our mortgage portfolio enables us to *insource* a significant share of the financing of American homeownership.

Second, our portfolio helps support and cross-subsidize our affordable housing activities. Freddie Mac runs an integrated business model; our securitization program and retained portfolio are inextricably linked. Many of the loans we purchase to help us meet our affordable housing goals have lesser returns than other mortgages, as envisioned by our charter. Returns earned on

other assets in the retained portfolio help support the benefits we provide through our affordable programs, and also provide returns to keep private capital financing the system.

In addition, Freddie Mac's portfolio holdings contribute directly to the liquidity and stability of financing in the affordable housing sector. We currently hold in portfolio more than $60 billion in multifamily mortgage assets. Both these programs are critical to our ability to meet our affordable mission. Equally important, by owning subprime securities, we have positively influenced the practices of subprime lenders. Approximately $300 billion of the mortgages in our retained portfolio qualify under our affordable housing goals.

Third, our portfolio is very conservatively managed and tightly regulated. GSEs bear the interest-rate risk on loans held in portfolio – and our investors demand that we manage it very prudently. Thanks to the advent of the callable debt market, which Freddie Mac helped pioneer, and the vast liquidity of interest-rate derivatives, we are able to manage this risk so there is very little difference between the duration of our mortgage assets and the debt we issue to finance them. Even in 2003 – a tumultuous year at Freddie Mac and the biggest refinancing year in history – our duration gap never deviated from a very narrow range, and averaged zero months for the year. That has remained the case for 2004 and 2005 as well. Very few institutions in the world manage such a tight book – or provide the monthly disclosures to prove it. Further, the amount of interest-rate derivatives we use pales in comparison to the derivatives positions held by the largest banks in the U.S. For example, at the end of 2003, the notional value of the derivatives used by the GSEs was just 3 percent of the combined amount used by the top five U.S. banks.

Of course, the Congress and the public should not rely on our risk-management capabilities alone. That is why the stringent capital provisions of our current regulatory system provide rigorous oversight of our risk management. And, as discussed in greater detail above, we support the strengthening of this oversight, as reflected in the capital-related proposals and bank-like enforcement provisions that the Committee considered last year.

Under the regulatory risk-based capital stress test administered by OFHEO each quarter, GSE capital is subjected to severe interest-rate and credit risk shocks. It requires the GSEs to hold enough capital to survive 10 years in which mortgage defaults are assumed to rise to Great Depression proportions. Simultaneously, interest rates move by as much as 6 percentage points in either direction. Thus, to the extent that our interest-rate risk increases, so would the amount of risk-based capital we would need to hold. Freddie Mac consistently passes this test with more than adequate capital, a testament to our strong capital and risk management techniques. Very few other financial institutions could pass this stringent test.

Fourth, portfolio growth is increasingly subject to market discipline. It has been suggested that because the GSEs have lower borrowing costs, they can grow the portfolios indefinitely and indiscriminately. That simply is not arithmetically possible. We enter the market to buy mortgages to provide liquidity and stability to the market, as our charter demands and when it is profitable to do so. We increase our purchases as other investors, such as banks, exit the mortgage market in search of higher returns elsewhere. The portfolios align the profit incentives

of the GSEs with our statutory imperative of ensuring a stable supply of low-cost mortgage funds for consumers.

Here is an important fact: Unlike other institutions, GSEs are limited purpose corporations. We serve the residential mortgage market – in good times and bad.

Right now, times are good. Aside from the recession in 2001, which the housing sector helped keep short and mild, we've had over a decade of great prosperity. Unemployment is down and homeownership is up. Mortgage defaults – and thus credit losses – are near record lows. Depository institutions are flush with low-cost deposits and have been investing heavily in mortgages, so the "carry trade," as it's called, has been strong for more than a year now. As a result, growth in Freddie Mac's portfolio has greatly receded from prior years. (In fact, it grew by only about one percent last year.)

However, it wasn't too long ago when market volatility produced by the debt crisis in 1998 and the economic downturn in 2001 caused other participants to exit the market. Lower demand caused prices to fall, which, in turn, raised mortgage rates for borrowers. In these instances, the GSEs acted as the buyers of last resort by providing needed liquidity to the market. Because we can retain mortgages in our portfolios, we were able to purchase loans at lower prices, which caused "spreads" to tighten, thereby keeping interest rates low for borrowers.

Fifth, capping the GSE mortgage portfolios would harm mission achievement and would not reduce systemic risk. Artificial caps would not reduce the risks associated with long-term prepayable fixed-rate mortgages. Instead, other institutions, primarily federally insured depositories, would assume the burden of managing the interest risk. As several witnesses testified before this Committee, the GSEs likely have a comparative advantage in managing interest-rate risk. Thus, as Professor Sanders testified before this Committee in February, "...if we very simply took it away from Fannie and Freddie we're just sticking it somewhere else, and we've got to be sure they're capable." [13] Thus, before shifting those risks from the GSEs to the depositories, Congress must be certain that those institutions would be better suited than the GSEs to manage that risk.

Artificial caps would, however, have a significant impact on GSE ability to achieve their mission. First, the investor base for mortgages would contract. Many current investors would shift out of housing into other financial sectors because they lack the expertise to evaluate mortgage prepayment risk. A smaller supply of mortgage funds would cause interest rates to rise. Capping the portfolios also could mean that, under certain circumstances, the housing finance system no longer has a buyer of last resort.

In summary, the GSE portfolios serve important policy objectives and are integral to the overall efficiency and stability of the mortgage market. Our portfolio programs represent an important corollary to the securitization process – and therefore cannot be eliminated without the potential of significant harm to the system. To be sure, it is critical that the portfolios be tightly managed and adequately capitalized for the risks they represent. But unless we want to cap the

[13] Testimony of Prof. Richard Green and Anthony B. Sanders before the Senate Committee on Banking, Housing and Urban Affairs, February 10, 2005.

homeownership rate or eliminate the backstop provided by a GSE buyer of last resort, the portfolios should not be limited.

It is our view that the risk-based capital provisions, backstopped by the minimum capital provision, provide an appropriate and risk-related means for the regulator to constrain aspects of a GSE's business activities, including the size of an investment portfolio when that is warranted.

Non-Mortgage Investments

We have a "cash and investments portfolio" that consists of liquidity investments, so-called "non-mortgage investments," that help us fulfill our statutory purposes of providing a stable and reliable supply of low-cost residential mortgage credit nationwide, in all markets and in all market conditions. We invest in non-mortgage related assets, such as asset-backed securities and obligations of states and municipalities, to

- Manage recurring cash flows and cash management needs
- Maintain capital reserves to meet mortgage funding needs
- Provide diverse sources of liquidity needed to provide stability under a broad range of market conditions and
- Aid in managing interest rate risk associated with mortgage-related investments. [14]

These investments are subject to supervisory oversight by OFHEO for safety and soundness purposes and by HUD for mission-related purposes. Our regulators regularly review our non-mortgage liquidity investments.

Like our retained mortgages, our non-mortgage investments are an integral part of our ability to fulfill our statutory purposes; they can be quickly liquidated to support mortgage purchases under a broad range of market conditions. Restrictions on these investments would diminish our ability to fulfill our mission effectively.

Conclusion

Thirty-five years ago, around the time Freddie Mac was created, I was beginning my career as a young economist. I remember what it was like to get my first home mortgage. You went to the bank, hat in hand. There was very little automation, competition, innovation, convenience or negotiation. If they found you worthy, it was pretty much take it or leave it.

Looking back, the process reminds me a bit of what Henry Ford said about buying a Model T: you could get one in any color you wanted – so long as it was black. Getting a home mortgage involved very little customer choice. And the bank – not the consumer – was in the driver's seat.

[14] Freddie Mac adjusted our investment strategy last year. As a result of that adjustment, we did not hold corporate debt securities or preferred stock as of December 31, 2004.

Worse yet, housing finance was a captive of the business cycle. As soon as the economy picked up, interest rate increased, credit dried up and housing *starts* ground to a *stop*.

So in 1970 – the year of Freddie Mac's birth – our nation considered creating a secondary market for conventional mortgages. As the then-President of the National Association of Homebuilders told Congress: "The lack of a stable supply of residential mortgage funds … has brought this industry to the brink of disaster and is steadily worsening an already serious housing shortage."

Congress and the President got it right. Over the years, the housing GSEs have attracted global capital, created new mortgage tools, and served as a shock absorber when the broader financial markets locked up. As a result, housing today is less vulnerable to the business cycle than ever before.

The GSEs serve a critical purpose for the American people. Any economist will tell you that, while not perfect, the system works. Let's make the GSEs better, rather than jeopardize their support of markets and the broader economy. Let's keep putting private money to work to serve an important public mission.

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Thank you for affording me the opportunity to appear before you today. I look forward to working with Chairman Shelby, Ranking Member Sarbanes and the members of this Committee.