**Testimony of Richard F. Syron**
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**Committee on Banking, Housing and Urban Affairs**
**United States Senate**
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Thank you, Chairman Shelby, Ranking Member Sarbanes and members of the Committee. Good afternoon. I appreciate the opportunity to appear before you today. My name is Richard F. Syron. I am the Chairman and Chief Executive Officer of Freddie Mac, a position I took at the end of December 2003.

Prior to joining Freddie Mac, I was executive chairman of Thermo Electron Corporation, an S&P 500 firm with 11,000 employees. Prior to that, I held a number of positions, including the Chairman and Executive Officer of the American Stock Exchange, president and Chief Executive Officer of the Federal Reserve Bank of Boston, and president and Chief Executive Officer of the Federal Home Loan Bank of Boston. I also served as assistant to then-Federal Reserve Chairman Paul Volcker, and earlier as Deputy Assistant Secretary for Economic Policy of the U.S. Department of Treasury.

It is a great privilege to lead Freddie Mac, which plays such a critical role in financing homes for America's families – and providing strength and resiliency to America's economy. I could aspire to no greater legacy than to restore public trust in an institution chartered by Congress to ensure the stability and liquidity and accessibility of the nation's mortgage markets.

The issue of regulatory oversight reform of the housing government sponsored enterprises (GSEs) is vitally important to our nation's economy and to homeowners. My views on this important topic have been profoundly shaped by my experiences as a former regulator. My firm belief that capital should be tied to risk stems directly from my tenure at the Boston Federal Reserve, where I was deeply involved in restructuring New England's banking system following the credit strains of the late 1980s and early 1990s. My views on homeownership, however, have more personal roots. I grew up in Boston in a two-family home financed by a VA loan that my father was able to obtain when he returned from World War II.

Today, in my comments to this Committee, I will focus on three areas:

- Why GSEs exist – and what they've accomplished;
- The imperative of regulatory oversight reform; and
- My top priorities for Freddie Mac, particularly how we are remedying our past accounting errors

## Why GSEs Exist and What They Have Accomplished

One advantage of being a newcomer is the ability to ask provocative questions – and there is no more provocative issue in the housing world than the role of the GSEs and the benefits they bring. Since arriving at Freddie Mac just eight weeks ago, this question has been vigorously discussed in the halls of government, by national think tanks, in newspapers – and just yesterday in this chamber by Alan Greenspan.

I approach this question from the perspective from what we know – that is, the current system of housing finance and its known benefits – and weigh it against what we don't know, that is, what housing finance would look like without the GSEs.

What we know is based on 70 years of mortgage history. In the aftermath of the Great Depression, Congress chose to provide explicit government insurance to both the housing and banking industries to entice investors back to housing. While the plan worked, it also put the government directly on the hook for the risks associated with loaning individual homebuyers large sums of money for long periods of time. Mortgages carried significant credit risk because of the differences in the ability of borrowers to repay their loans. However, interest-rate risk was more vexing. Even if a borrower did not default over the course of 30 years, money would be tied up in a fixed-rate asset whose value was subject to the vagaries of interest-rate movements over prolonged periods.[1]

To address this issue, Congress found an ingenious way to stimulate long-term investment in housing without exposing the public fisc to the risk of substantial loss: create financial institutions with a limited nexus to the government and give them the singular job of making markets stable and liquid, at all points along the business cycle.

The GSE model of housing finance has been a Congressional success story. By providing attractive returns on capital, the GSEs have proven to be effective managers of the credit risk of the mortgages they buy. Further, by maintaining exclusive focus on the residential mortgage markets, as required by law, the GSEs have developed extraordinary expertise in understanding the credit characteristics of borrowers. This has resulted in a steady lowering of down payment requirements within the conventional market to the point at which the GSEs, with no explicit subsidy, are able to provide nearly the same benefit to borrowers as the government provides through its on-budget FHA and VA mortgage programs.

Management of interest-rate risk also has been a notable success. Through the creation of mortgage-backed securities, the issuance of callable debt and the use of derivatives, the GSEs routinely and efficiently transfer interest-rate risk from individual households to global capital markets. Not only do the GSEs make it possible for originators to lend

[1] These risks are real: recall the huge credit losses that resulted from the "oil-bust" in the early 1980s, and the taxpayer bailout of the S&Ls, which were in the untenable position of holding 6 percent mortgages in an 18 percent interest-rate environment.

money to individual homeowners for long periods of time at better rates than many corporations can borrow, but they permit borrowers to "put" the mortgages back whenever they desire to do so and at no penalty. This extremely valuable option makes the 30-year fixed-rate mortgage the product of choice among U.S. homeowners; in 2003, 82 percent of all conforming purchase-money originations were fixed-rate mortgages. Homeowners were able to profit from falling interest rates by refinancing into lower-cost loans, adding billions of dollars to our economy. Prepayable mortgages also help diminish friction in our economy by facilitating the mobility of the nation's labor markets.

These innovations in mortgage financing made possible by the GSEs produce valuable benefits. Low-cost mortgage money is readily available. Families can get their loans approved in minutes. (In fact, during this hearing, Freddie Mac likely will have financed mortgages for about 2,000 families.) Today more people own homes – and higher quality homes – than at any time in our nation's history and than in virtually any other part of the world.[2] And wealth created through homeownership will help bear us into old age, taking some of the burden off Social Security and allowing us to pass something along to the next generation. Not a bad track record for Congressional inspired institutions that need no budget authority, pay significant federal taxes and employ thousands of people.

In U.S., we tend to take these benefits for granted. However, very few countries can boast of such an efficient and effective mortgage delivery system.[3] Despite the integration of world capital markets, the U.S. is still the only place where a long-term callable mortgage product is broadly available. Countries that want to provide long-term prepayable mortgages to their own citizens are considering creating GSEs. The European Union is currently considering the creation of a GSE-type agency to "enable lenders to provide their existing mortgage products at better prices and introduce long-term, fixed-rate mortgages without redemption penalties."[4]

Let's now consider U.S. housing finance without the GSEs. There are three key arguments I would like to address.

First is the view that government sponsorship is no longer needed to attract capital to housing or to provide an abundant supply of 30-year fixed-rate mortgages. This optimistic view contradicts the experience in other developed countries. That is, if homeowners in Northern New York or Washington State lived a few miles to the north in Canada, they would typically be restricted to a seven-year fixed-rate mortgages, they would be locked into higher interest rates or have to pay heavy penalties if they wanted to prepay, and they would have to put 25 percent down.

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[2] "As a result of the very favorable conditions in the housing sector, the U.S. homeownership rate climbed to 68.2 percent in the third quarter of 2003 -- equal to its highest level on record," 2004 Economic Report of the President, p. 89.[2]

[3] Marsha J. Courchane and Judith A. Giles, "A Comparison of U.S. and Canadian Residential Mortgage Markets," March 2002.

[4] Richard Adams, "Banks Back Cheaper Mortgage Plan," The Guardian, November 17, 2003.

This sanguine view of markets also reflects our collective amnesia about where we are in the credit cycle. History reveals that certain industries will slump, that certain regions will experience economic downturn, which, in turn, causes house values to fall and defaults to rise. We also know that with interest-rates at historic lows, the mortgages put on the books today, in all likelihood, will require financing for decades to come. In short, it is easy to dismiss the risks of mortgage lending when times are good.

GSEs were created precisely for those times when things are not going so well, however. GSEs absorbed significant losses during the oil bust in the 1980s and during the weakening of the economy in Northeast in the early 1990s. They also stabilized residential mortgage rates during the international financial crisis of 1998 – and again after 9/11 – by continuing to provide liquidity to the secondary market for conforming home loans. Their actions ensured that mortgage credit remained available *and* affordable.

A second argument concerns the allocation of capital to housing. The housing market has an enormous impact on the economy, directly accounting for more than one-third of the nominal growth in GDP over the past three years.[5] And this does not begin to account for all the indirect support for consumption generated by record levels of refinancing in the past few years. Housing played an important countercyclical role in supporting the recent weak economy, as noted in the President's 2004 Economic Report:

> *Despite the similarities between the recent business cycle and previous ones, this most recent cycle was distinctive in important and instructive ways. One noteworthy difference is that real GDP fell much less in this recession than has been typical. . . This relatively mild decline in output can be attributed to unusually resilient household spending. Consumer spending on goods and services held up well throughout the slowdown, and investment in housing increased at a fairly steady pace rather than declining as has been typical in past recessions.*[6]

Finally, there are arguments about size and systemic risk. Residential mortgage debt outstanding grew at an annualized rate of 8.6 percent over the past decade. Not surprisingly, the GSEs also have experienced significant growth. But GSE size is not an accurate proxy for risk. On average, there is approximately 40 percent collateral in homeowner equity behind the loans Freddie Mac has guaranteed. Interest-rate risk also is well managed. Freddie Mac strives to maintain an extremely closely match between the duration of our assets and liabilities. Throughout 2003, for example, a period of extreme turbulence in financial markets, Freddie Mac's duration gap never exceeded one month.

[5] These percentages are based on data published by the Bureau of Economic Analysis, U.S. Department of Commerce for 1996 through 2003 and data for the same years available upon request from Freddie Mac.
[6] 2004 Economic Report of the President, pages 30, 32.

Finally, there is no way that mortgage debt and the risks of investing in it would disappear by downsizing the GSEs or making other changes to the GSE charter. Rather, the burden of managing mortgage credit risk would shift from these institutions to those with explicit government support, while interest-rate risk would shift onto individual households. Another likely outcome is that higher costs of conventional mortgage financing could cause borrowers to shift into the FHA market, thereby actually increasing government subsidization of housing. For homeowners, restrictions on GSE growth likely would result in reduced availability of 30-year fixed-year prepayable mortgages and higher costs.

These uncertain benefits must be coupled with the potential risks of dismantling a highly efficient and successful housing finance system. We can get a glimpse of a world without GSEs by looking at the jumbo market. On any given day, it is possible to look in a newspaper and find that mortgage rates on conforming loans are regularly one-quarter of a percentage point lower than those in the higher-balance jumbo market. Borrowers in the jumbo market not only pay higher rates, but they are more likely to have to settle for an adjustable-rate mortgage (ARMs).

ARMs have the obvious advantage of lowering monthly mortgage payments in the first few years of homeowning, but they require borrowers to bear the interest-rate risk on the loan – rather than the capital markets bearing this risk. This results in higher borrower defaults over the long term. Jumbo borrowers also typically make larger average down payments than conforming borrowers. Higher mortgage-interest rates and larger down payments make it significantly harder for low- and moderate-income families to become homeowners.[7]

In summary, we are a nation of homeowners – and from all I can tell, we want to keep it that way. While discussions of the optimal allocation of the nation's capital have their place, I believe this nation made the right decision 70 years ago to lend housing a helping hand. (You'll have to excuse my passion on this subject, but homeownership was part of my Ph.D. dissertation 30 years ago.) Bi-partisan support for federal housing policy has paid enormous dividends. Families build wealth. Kids do better in school. Neighborhoods are safer. And, in recent years, housing has been the backbone of our nation's economy. Support for homeownership – whether explicit or implicit – clearly has been good for this country.

But the task is not finished. There are millions of families still waiting to participate in the American Dream, and the homeownership gap between white families and families of color is unacceptable. This is not the time to begin dismantling the world's finest housing finance system, or placing artificial limits on the GSE growth. The potential benefits of doing so are uncertain, and the risks are great.

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[7] Roberto Quercia,, George McCarthy, and Susan Wachter, "The Impacts of Affordable Lending Efforts on Homeownership Rates," *Journal of Housing Economics* (Vol. 12, 2003), pp. 29-59.

## Imperative for Regulatory Reform

Continued support for the GSE model of housing finance does not imply that improvements to the GSE regulatory oversight structure are not needed. They are. As a former regulator, I will be the first to say that world-class regulatory oversight is absolutely critical to the achievement of Freddie Mac's mission and to maintaining the confidence of the Congress, the public and financial markets. Freddie Mac strongly supports the enactment of legislation that provides strong, credible regulatory oversight. These enhancements are needed – even overdue.

I am sadly aware that Freddie Mac's accounting issues are the source of much of the current controversy regarding the role of the GSEs. However, as with any episode such as this, it is critical to get the ship back on course without overreacting at the wheel. Given the enormous benefits of the conforming mortgage market, which has proven its resiliency in all interest-rate and credit environments, zeal to improve this system must be tempered with an abundance of care. Borrowing a phrase from our friends at the Homebuilders, I urge the Committee to "measure twice and cut once."

To guard against potential negative unintended consequences, I would like to offer a set of principles, based on my experience as a former regulator. The new GSE regulatory structure must:

- Engender public confidence through world-class supervision and independence
- Ensure continued safety and soundness of the GSEs
- Respond flexibly to mortgage market innovation
- Strengthen GSE market discipline through robust and timely disclosure

With these principles in mind, today I will comment briefly on key aspects of the regulatory structure under consideration in this Committee.

## Structure and Independence

Freddie Mac would strongly support an independent board regulatory structure modeled on independent federal agencies such as the Securities and Exchange Commission. Our preference would be for a three-member board, comprised of a Chair and two additional members. The President would appoint Board members, by and with the advice and consent of the Senate, subject to statutory criteria relating to qualifications of the nominees. For instance, we believe that at least one member of the Board should have significant housing industry experience. It would also be important to ensure that members have significant experience with complex financial transactions. As is typical

with independent boards, we would suggest that not more than two of the Board members be members of the same political party.

Notwithstanding the importance of housing and financial expertise, we would have some concern if the Board were to include representatives of cabinet departments such as the Department of Housing and Urban Development, the Department of the Treasury or other Executive branch departments. The purpose of establishing an independent board is just that, independence. Inclusion of Executive branch representatives on the GSE regulatory board could compromise this important component of world-class regulation.

Freddie Mac would have similar concerns should the Congress decide to locate the new regulatory office within the Department of the Treasury. To ensure independence, we would support applying the same operational controls as apply to the relationships between the Secretary of the Treasury and the Office of the Comptroller of the Currency and the Office of Thrift Supervision.[8] Adequate firewalls are needed to avoid the politicization of the GSE mission and the critical role we play in the nation's economy and global financial markets.

**Funding of New Oversight Offices**

Freddie Mac supports providing both the new regulator and the Secretary of HUD authority to assess Freddie Mac outside the annual appropriations process to pay for the costs and expenses of carrying out their respective responsibilities vis-à-vis the GSEs. However, we would suggest that the General Accounting Office regularly report to the Congress on the efficacy of the new regulatory structure and the reasonableness of the costs relative to other world-class financial regulators so that neither unnecessarily raise the cost of meeting our mission.

**GSE Capital Requirements**

Second to questions of GSE role and benefits, I have quickly learned that questions about GSE capital adequacy are highly contentious and can serve as "stalking horses" for other issues. There is no question these issues are of paramount importance. Capital adequacy is the touchstone of investor confidence and is key to our ability to attract low-cost mortgage funds. On that score, Freddie Mac consistently has exceeded both its minimum capital and risk-based capital standards.

However, from the perspective of a former regulator, I believe there are many difficult and sometimes confusing aspects about the direction of the debate on GSE regulatory oversight. The first is the view that the GSEs should be held to the same capital standard as for banks. Let me begin by stating the obvious: GSEs are not banks.

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[8] *See* 12 U.S.C. §§ 1, 250, 1462a(b)(2), (3) and (4) and 1464(d)(1)(A).

- There are nearly 10,000 banks and savings institutions in this country. There are two GSEs focused exclusively on housing.
- Banks are largely funded by deposits. GSEs must rely exclusively on the capital markets for their funding.
- Banks can (and do) invest in a wide range of higher-risk assets, ranging from unsecured loans, to commercial loans and loans to foreign countries. In contrast, GSEs are restricted to one line of business: residential mortgages finance. We invest almost exclusively in conventional conforming mortgages, among the safest investment vehicles around.

Given these important distinctions, it is entirely appropriate that the GSE capital regime be distinct from the bank capital model. GSE capital requirements reflect the confinements of its GSE charter, such as the conforming loan limit and credit enhancement requirements for high loan-to-value mortgages. These charter limitations necessarily result in a lower GSE risk profile.

Since 1994, charge-off losses at the five largest banks have been, on average, 17 times larger each year than charge-offs at Freddie Mac. Even in these banks' *best* year, charge-offs were more than five times higher than Freddie Mac's *worst* year.[9] Limiting the comparison to mortgage assets, the residential mortgages found in bank portfolios typically entail greater risk than those in Freddie Mac's portfolio. In 2002, FDIC-insured institutions had an average charge-off rate of 11 basis points on their mortgage portfolios, compared to 1 basis point for Freddie Mac.[10] Given this lower risk exposure relative to banks, we believe that the GSE minimum capital requirement is adequate and need not be changed.

The second troubling aspect of the current debate is the fixation on the GSE minimum capital ratio, when the risk-based capital standard is a far more effective regulatory tool. Leverage ratios are last year's capital "model." They have significant limitations – and, depending on how they are enforced, can do more harm than good.

I observed first-hand the problems with overzealous enforcement of simple leverage ratios during my tenure at the Federal Reserve Bank of Boston in the early 1990s. While many financial institutions in the Northeast were adequately capitalized on a risk-adjusted basis, the strict enforcement of simple leverage ratios required them to liquidate a substantial portion of their assets. This resulted in a drying up of commercial credit that greatly exacerbated the economic downturn. The infamous "credit crunch" had profound effects on small and mid-size businesses and employment in the Northeast. It turned a

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[9] Federal Financial Institutions Examination Council, *Consolidated Reports of Condition and Income* and Freddie Mac annual reports for 1994 to 2001. For 2002 Freddie Mac credit information, see http://www.freddiemac.com/news/archives/investors/2003/4qer02.html.

[10] Federal Financial Institutions Examination Council, *Consolidated Reports of Condition and Income* and Freddie Mac. See http://www.freddiemac.com/news/archives/investors/2003/4qer02.html.

two-year recession into a five- to six-year slump.[11] I discuss these issues in two articles I wrote on this subject.[12]

My experiences are consistent with leading international trends in capital management. Drawing from recent 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 Basel Consultative Paper and the 2001 New Basel Capital 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 under consideration in this country, more accurately aligns capital requirements to the actual risks incurred by regulated institutions.[13]

Notwithstanding my philosophic differences regarding the efficacy of leverage ratios, I can understand the need for regulator discretion to increase the leverage ratio in the event of a finding of an unsafe and unsound practice. We believe parameters should be put in place in statute that define the circumstances under which such an increase could be undertaken, as well as parameters for resetting the ratio to the statutory minimum once the unsafe and unsound practice has been satisfactorily addressed.

## Discretion on Risk-Based Capital

In my view, greater discretion with regard to the GSE risk-based capital rule is the best way to avoid potential negative unintended consequences associated with strict enforcement of leverage ratios. Ten years in the making, the GSE risk-based standard is unique among financial services regulation. It requires Freddie Mac to hold capital sufficient to survive 10 years of *severe* economic conditions; under the risk-based test, both the credit and interest-rate risk of the GSE's mortgage holdings are stressed to historic proportions. Without a doubt, this rule is at the cutting edge of financial services regulation.[14] It ties capital to the specific risks of an institution – ensuring safety and

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

[12] See Richard F. Syron, statement before the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, May 8, 1991, reprinted in "Are We Experiencing a Credit Crunch?", *New England Economic Review* ((July/August 1991), pp. 3-10; and Richard F. Syron, "The New England Credit Crunch," *Credit Markets in Transition: Proceedings of the 28th Annual Conference on Bank Structure and Competition*, Federal Reserve Bank of Chicago (1992), pp.483-9.

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

[14] 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 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

soundness without raising costs unnecessarily or crippling the smooth flow of mortgage capital. It is the standard-bearer in capital regulation.

To ensure that the GSE capital standard remains at the forefront of capital regulation, the new regulator must have adequate discretion to keep pace with developments. Although the basic parameters of the risk-based capital stress test are set in law, our present regulator has significant discretion in adjusting the risk-based capital requirements. Additional discretion, such as provided to federal banking agencies, could help ensure the GSE risk-based capital standard remains at the forefront of financial sophistication, while continuing to tie capital to risk.

Discretion must be balanced with continuity, however. Unnecessarily changing the risk-based capital standard harms those who made investment decisions based on a particular set of rules, only to find later that the rules were changed. This sort of "regulatory risk" increases costs that are ultimately borne by mortgage borrowers. Therefore, until such time as an overhaul of the risk-based capital stress test appears warranted, the regulator should be encouraged to continue to apply the existing risk-based capital rule. The rule has been in effect for only one year and has yet to show signs of need for reform.

We also believe 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 appears warranted, policymakers should ensure that certain fundamental principles remain firmly intact. It would be our strong suggestion that any future capital standard must 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; and accommodate innovation so the GSEs can carry out their missions.

Further, we would expect that any changes to the rule be accomplished through notice-and-comment rulemaking, with 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 regulator greater discretion to set risk-based capital levels that accurately reflect the risks we undertake. Discretion on risk-based capital greatly mitigates the need to provide unfettered regulator discretion on minimum capital. Changing capital standards unnecessarily, capriciously or frequently will reduce the amount of mortgage business the GSEs can do, resulting in higher costs for homeowners and renters.

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

**Supervisory and Enforcement Parity**

The current legislative structure provides our safety and soundness regulator an array of supervisory and enforcement authorities to ensure that Freddie Mac is adequately capitalized and operating safely.[15] If Congress were to deem it appropriate, we would support providing the GSE safety and soundness regulator authorities similar to those accorded to the federal banking agencies. These enhanced powers would include broadening the individuals against whom the regulator could initiate cease-and-desist proceedings, new authority to initiate administrative enforcement proceedings for engaging in unsafe and unsound practices, new removal and suspension authority and authority to impose industry-wide prohibitions, and new authority to assess civil money and criminal penalties.

**Conservatorship v. Receivership**

While it may be appropriate to draw on certain banking provisions to improve the GSE regulatory oversight structure, we strongly believe the mechanism for dealing with extreme financial distress is not one of them. Receivership is an efficient disposition mechanism for thousands of federally insured depository institutions, whose failure would not threaten the stability of and public confidence in the financial system, particularly in the federal deposit insurance system. However, it is not a credible option for dealing with two GSEs. In contrast to the situation for most insured institutions, the decision to liquidate a GSE would have substantial economic, market and public policy consequences. It would threaten the public policy mission of the GSEs and could potentially disrupt the legal obligations and expectations of market participants.

Recognizing the unique role of the GSEs, and our mission to expand homeownership, Congress chose a different disposition mechanism when it established the current GSE regulatory oversight structure. To address the unlikely event of extreme financial distress, Congress gave the safety and soundness regulator the right to appoint a conservator, which would rehabilitate an ailing GSE. However, Congress reserved to itself the right to appoint a receiver.

Although Freddie Mac believes that current law provides ample convervatorship powers, we would be willing to consider whether additional authorities could enhance Congress' and the public's confidence in our safe and sound operation. Such enhancements to existing GSE conservatorship powers would achieve the important policy objective of strengthening the GSE regulatory oversight structure without the potential unintended consequences that could result from receivership. Many market participants might view a change to receivership as a first step to privatization of the GSEs. This could have

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[15] "Comparison of Financial Institution Regulators' Enforcement and Prompt Corrective Action Authorities," GAO-01-322R, January 31, 2001.

significant implications on our ability to support the market for 30-year fixed-rate mortgages.

## Mission Oversight and New Program Approval

We believe that the HUD Secretary should retain all existing GSE mission-related authority consistent with HUD's mission to expand homeownership and increase access to affordable housing. Specifically, HUD should retain authority to ensure that the purposes of the GSEs' charters are accomplished and continue to have regulatory, reporting and enforcement responsibility for the affordable housing goals, just as under current law. Additionally, HUD should retain existing fair housing authority.

We also believe that, in keeping with its housing mission, HUD should retain its authority to approve any new programs of Freddie Mac and Fannie Mac. HUD alone has the expertise to determine whether new mortgage programs are in keeping with our charter and statutory purposes. In this vein, we also urge the Committee to maintain a new *program* standard – not a new *activity* standard. Requiring the regulator to provide advance approval of each and every new activity significantly exceeds the standard required of banks and would chill innovation in mortgage lending. Our ability to lower housing costs for homeowners and renters is directly linked to our expertise in managing mortgage credit risk and our distinguished record of bringing innovative products and services to market.

## Affordable Housing Goals

Meeting the annual affordable housing goals is a key aspect of our meeting our mission. Established in 1993 and increased in 1995 and 2000, the affordable housing goals specify that significant shares of Freddie Mac's business finance homes for low- and moderate-income families and families living in underserved areas. In 2000, HUD specified that 50 percent of Freddie Mac's mortgage purchases must qualify for the low- and moderate-income goal,[16] 31 percent must be of mortgages to borrowers in under-served areas,[17] and 20 percent must be of mortgages to very-low income borrowers or low-income borrowers living in low-income areas.[18] Freddie Mac has successfully met all the permanent housing goals, which are the highest and toughest of any financial institution.

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[16] Low- and moderate-income families have incomes at or below 100 percent of the area median income.
[17] Underserved areas are defined as (1) for OMB-defined metropolitan areas, census tracts having a median income at or below 120 percent of the median income of the metropolitan areas and a minority population of 30 percent or greater; or a median income at or below 90 percent of median income of the metropolitan area; and (2) for nonmetropolitan areas, counties having a median income at or below 120 percent of the state nonmetropolitan median income and minority population of 30 percent or greater; or a median income at or below 95 percent of the greater of the state nonmetropolitan median income or the nationwide nonmetropolitan median income.
[18] Low-income areas refer to census tracts in which the median income is at or below 80 percent of the area median income. Low-income families have incomes at or below 80 percent of area median income, while very-low-income families have incomes at or below 60 percent of the area median income.

The existing statutory and regulatory structure provides great discretion to our mission regulator to determine the goals – and creates strong incentives for us to achieve them. The HUD Secretary currently has the regulatory authority to establish and adjust the housing goals. In the event a GSE fails to meet one or more of the goals – or there is a substantial probability that a GSE will fail one or more of the goals – the Secretary is authorized to require the submission of a housing plan. Further, the Secretary may initiate a cease-and-desist proceeding and impose civil money penalties for failing to fulfill the housing plan. By contrast, bank regulators do not have authority to bring enforcement proceedings against an institution that is not meeting its CRA obligations. These are strong incentives for the GSEs to strive to meet the goals year after year – to say nothing of the reputational "penalty" for failing to meet a goal.

Considering that we have consistently met the permanent affordable housing goals, and that existing powers already are the industry's toughest, additional enforcement authority seems completely unnecessary. Additional enforcement authority would add little to the legislative and regulatory incentives that Congress and HUD have put in place. Therefore, we respectfully suggest that no additional authority is needed.

**Market Discipline Commitments**

In October 2000, Freddie Mac and Fannie Mae announced a set of six public commitments to ensure the GSEs adhere to a high standard of financial risk management. These commitments continue to represent a very high "bar" among financial institutions. Excluding the commitment to adhere to an interim risk-based capital standard (which was rendered obsolete with the completion of the current risk-based capital stress test) the commitments are as follows:

- Periodic issuance of publicly traded and externally rated subordinated debt on a semiannual basis and in an amount such that the sum of core capital and outstanding subordinated debt will equal or exceed approximately 4 percent of on-balance-sheet assets. Because subordinated debt is unsecured and paid to the holders only after all other debt instruments are paid, the yield at which our subordinated debt trades provides a direct and quantitative market-based indication of our financial strength.

- Maintenance of at least 5 percent of on-balance sheet assets in liquid, marketable, non-mortgage securities and compliance with the Basel Committee on Banking Supervision Principles of Sound Liquidity Management, which requires at least three months' worth of liquidity, assuming no access to new issue public debt markets.

- Public disclosure of interest-rate risk sensitivity results on a monthly basis. The test assumes both a 50 basis-point shift in interest rates and a 25 basis-point shift in the slope of the yield curve – representing an abrupt change in our exposure to

interest-rate risk.

- Public disclosure of credit risk sensitivity results on a quarterly basis. The disclosure shows the expected loss in the net fair value of Freddie Mac's assets and liabilities from an immediate nationwide decline in property values of 5 percent.

- Public disclosure of an annual independent rating from a nationally recognized statistical rating organization.

In July 2002, the GSEs made an additional commitment to voluntarily register their common stock with the Securities and Exchange Commission under the Securities Exchange Act of 1934 so that both companies will become reporting companies under that law. Freddie Mac remains irrevocably committed to completing this process as soon as possible after the company's return to timely reporting.

Freddie Mac would support giving the regulator authority to ensure we carry out these important public commitments. Taken together, they significantly enhance the degree of market discipline under which the GSEs operate. Robust and frequent credit and interest-rate risk disclosures, combined with the release of annual independent ratings and the issuance of subordinated debt, constitute an important "early warning system" for investors.

**Top Priorities for Freddie Mac**

Finally, I would like to say a few words about Freddie Mac – and my top priorities for strengthening this vital company and restoring the trust of the Congress, the public and investors.

Commitment to Exemplary Accounting. Clearly, my most pressing priority is to get Freddie Mac's financials done – and done right. On November 21, 2003, the Freddie Mac Board of Directors and our management team announced the release of the company's restated and revised financial results for the years 2000 through 2002. The restatement was a significant step in Freddie Mac's progress toward achieving accurate and timely financial reporting. The company will issue its annual report for 2002 on Friday, February 27, 2004 and hold the related annual stockholders' meeting on March 31, 2004.

As for 2003 and beyond, we are currently working around the clock with the objective of releasing quarterly and full-year 2003 results by June 30, 2004 and to provide the 2003 annual report and hold the related stockholders' meeting as soon as possible thereafter.

I am also focused on ensuring that these problems do not happen again. I am pleased to report that, under the guidance of our Board of Directors, Freddie Mac is building an environment that will allow us to provide comprehensive and understandable information

about our company, incorporating the highest level of financial transparency, accounting controls, compliance, and professional standards. Our aim is not simply to meet what is required but to become a model of financial excellence.

We've added over 100 professionals in the accounting, reporting and control areas, including a significant number of new officers and senior managers. We have also retained leading experts in the areas of public disclosures and corporate governance to assist the company in designing and implementing processes and practices in these areas. In October 2003, we hired a Senior Vice President – Chief Compliance Officer who is responsible for overseeing Freddie Mac's compliance with policies, procedures and practices, including compliance with laws and regulations. Additionally, in October 2003, we created the position of Chief Enterprise Risk Officer. Both of these positions currently report directly to me.

We are also working to create and implement new infrastructure and systems to ensure the quality, integrity, transparency, and timeliness of our financial reporting.

Finally, we have taken steps to ensure that Freddie Mac's corporate culture promotes integrity, high ethical standards, and the importance of compliance. Virtually all of our employees have completed a corporate-wide training program on the company's Code of Conduct and the provisions of the Act sponsored by Senator Sarbanes and Chairman Oxley.

The scope of these activities is wide and deep. I was deeply involved in the transformation of a Fortune 500 company before, and I am committed to doing it again. Freddie Mac is on the path to becoming a new and better company.

Enhanced Commitment to Mission. My second priority is to renew and expand the company's commitment to mission. It is a great honor to be the leader of a company that has an explicit mission to do good things for society. There are very few publicly owned companies that have such a "higher calling" – and, as a nation, we should work to make them better, as is the Committee's intent.

The special privileges that flow from the GSE charter entail special responsibility. While the annual affordable housing goals are an important component of our mission to expand mortgage market accessibility, I view the goals more as a threshold than a ceiling. I am particularly focused on the housing finance needs of minority consumers. The homeownership rate for African Americans is 48 percent and 47 percent for Hispanics. We must do better – and we will.

When I was at the Federal Reserve Bank of Boston, I oversaw one of the first major research projects looking at discrimination in mortgage lending. That research led to calls for greater objectivity in mortgage underwriting – and eventually to the birth of automated underwriting. Automated underwriting systems, such as Freddie Mac's Loan Prospector®, have played a critical role in expanding minority borrower access to

mortgage markets. Now Freddie Mac is looking at ways to integrate nontraditional credit variables into automated underwriting. It won't be easy – but neither was creating the first mortgage-backed security, which is now widely traded around the world.

We're also studying the best way to extend the efficiencies of the conforming mortgage market to the subprime market. This market serves a needed function, but many borrowers – particularly minority borrowers – could qualify for lower-cost conforming mortgages if they had the chance. Further, abusive lending practices make this market ripe for the standardization and accountability that the GSEs provide. It's time to transform that market so that is serves borrowers better.

These and other initiatives to enhance Freddie Mac's commitment to mission are currently under active consideration. I would be happy to return to the Committee at some future point to describe specific new commitments Freddie Mac will make to further expand access to low-cost mortgage money for more families.

<u>Maintaining Safety and Soundness</u>. A final priority is to maintain Freddie Mac's rock-solid commitment to safety and soundness. Despite last year's accounting travails, Freddie Mac's franchise was safe and strong. Our safety and soundness regulator, the Office of Housing Enterprises Oversight (OFHEO), continually assessed us as "adequately capitalized," the highest rating. And we are in full agreement with OFHEO's directive of [date] to hold excess capital until our financials are complete.

I have been particularly impressed by the company's assiduous management of interest-rate risk. Each day at 5 pm, I receive a set of measures of Freddie Mac's exposure to interest-rate risk *for that day*. And each month, investors around the world see what I see when the company discloses our average monthly duration gap and other statistics. Only the housing GSEs provide such frequent and transparent measures of risk exposure. Freddie Mac is clearly a company that is serious about managing risk – and good at it, too. This will not change. If anything, I will see that our risk management practices and disclosures are strengthened.

## Conclusion

Freddie Mac strongly supports the enactment of legislation that provides strong, credible regulatory oversight. These enhancements are needed – even overdue. They are critical to the achievement of our mission and to maintaining the confidence of the Congress and the public.

As a former regulator, I strongly support significant enhancements that will make our regulatory structure stronger, in many cases, than the bank regulatory model. Building these new enhancements into existing law would give the new GSE regulator comparable supervisory and enforcement powers as bank regulators. In addition, these enhancements would impose tougher regulatory requirements in many areas. Our mission regulator

would continue to oversee the most challenging, quantitative affordable housing goals in the industry – with tremendous powers to enforce them.

These enhancements will ensure that we improve on the greatest housing finance system in the world – without damaging it. A measured approach to reform is critical to keeping the door of homeownership to a new generation of homebuyers.

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Thank you for the opportunity to appear today. I look forward to working with Chairman Shelby, Ranking Member Sarbanes and the members of this Committee to secure the future of our housing finance system and, with it, the dreams of millions of families.