Testimony of Richard F. Syron
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COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES
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Chairman Frank, Ranking Member Bachus 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 just about three years ago. I greatly appreciate the opportunity to appear before the Committee today to report on our accomplishments and challenges, and to discuss key aspects of H.R. 1427, the proposed legislation on regulatory reform of the oversight of Freddie Mac and Fannie Mae (GSEs), and the Federal Home Loan Banks (FHLBs).

The issue of GSE regulatory oversight is vitally important to our nation's economy and to homeowners. My views on this important topic have been profoundly shaped by my 25 years spent regulating financial institutions. Before heading the Federal Reserve Bank of Boston, I was 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 Department. Perhaps the most salient thing I learned in these capacities was the critical need for maintaining safety and soundness while, at the same time, assuring adequate credit flows, particularly in times of economic transition.

I would also like to thank the Chairman, the ranking member, members of the Committee, the Administration and both our safety and soundness and mission regulators for their hard work in forging the proposed GSE regulatory oversight legislation under consideration today.

Before I comment on specific aspects of H.R. 1427, I would like to report on Freddie Mac's progress on two important fronts: our financial remediation and reporting timeline, and mission fulfillment. I would also like to frame the current discussion about the GSEs in the context of our legislative history, and suggest that any substantial modifications to the GSE business model be undertaken with great care and with legislative objectives carefully balanced, lest we unnecessarily weaken or impair the GSEs' ability to continue fulfilling their mission.

Financial Remediation and Reporting

In early 2005, in testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, I called 2005 a "bridge" year in terms of getting our financial house in order. Today I confess I had in mind what Eastern Shore Marylanders know as the Kent Narrows Bridge, but the reality of the task bears greater resemblance to the four-mile Chesapeake Bay Bridge. This is because the nature of the financial remediation required to return Freddie Mac to timely financial reporting turned out to be far more complicated than anticipated. Rather, what we've been engaged in is nothing short of a top-to-bottom transformation of the entire company.

To begin, we needed to attract and hire top-notch leaders to get the job done. In the past three years we completely rebuilt Freddie Mac's senior management team. We've also progressed in redesigning, updating and overhauling nearly every financial and management system at Freddie Mac. We've instituted new governance structures, new compliance and ethics requirements, and new employee engagement programs designed to retain a strong workforce and effect cultural change. In short, restating earnings was the tip of the iceberg.

While much of our financial remediation work has not been visible to the public, we have made significant progress on a number of important initiatives designed to improve Freddie Mac's financial reporting infrastructure and remediate our control environment. These activities are part of Freddie Mac's comprehensive plan for returning to quarterly financial reporting. The plan includes mitigation and remediation of identified control issues; strengthening of the financial close process; implementing critical systems initiatives; and completion of a review of the company's system of internal controls related to the processing and recording of all financial transactions.

Our risk management has always been strong, but strengthening our risk management capabilities even further remains a key focus. During 2006 we rebuilt our enterprise risk management infrastructure, including a governance structure that links the Board of Directors, executive management and line management and staff. We also augmented our credit and interest rate risk management capabilities by increasing our focus on the identification, assessment and remediation of operational risks.

While upgrading our systems and internal controls, we released audited financial results for 2003, 2004 and 2005. Further, we expect to release our 2006 audited financial results on March 23, 2007, bringing us up to date on our annual reporting. We expect to resume quarterly financial reporting during the second half of 2007. Once we have returned to regular quarterly reporting we look forward to beginning the process to register our common stock with the SEC.

Sound accounting systems, timely financial reporting, strong internal controls, and state-of-the-art operational risk management are critical to our future financial success and our credibility with policymakers and the financial markets. While we wish this process had been simpler and faster, we are making steady progress.

Mission Fulfillment

By law, the housing GSEs have a broad and important public mission to provide liquidity, stability and affordability to the nation's residential mortgage markets. While affordability is a keystone of our public mission, it is not our sole reason for existence. Affordability is an extremely important mission responsibility, but, as I will discuss shortly, both liquidity and stability are vitally important. Far from being relics of a quainter era in U.S. mortgage markets, the stability and liquidity provided by the GSEs is key to the continued vibrancy of the nation's housing markets and broader economy. Further, we consider the affordability component of our mission as broader than achieving annual HUD housing goals.

Mortgage Liquidity: Financing for 50 Million Homes

In chartering Freddie Mac and Fannie Mae, Congress gave us the responsibility of being a continual presence in the mortgage marketplace. Freddie Mac does that by providing a stable supply of low-cost mortgage funds whenever and wherever qualifying families need them – and we've been doing it for 37 years. In recent months, Freddie Mac reached an important milestone: the financing of our 50 millionth home. These mortgage investments have supported homeownership in communities around the country, as well as financed apartment units affordable to millions of low- and moderate-income families.

Our continuous presence in the market also promotes affordability. As can be seen from a quick scan of the Internet or newspapers, conventional fixed-rate mortgages eligible for sale to the GSEs typically bear lower interest rates than mortgages above the conventional conforming loan limit.[1] A study co-authored for us by former OMB Director James Miller estimates that these lower rates save American homeowners between $16 and $21 billion in housing costs every year.[2] Low-cost mortgages funded by Freddie Mac have also enabled families to refinance their mortgages into lower-cost instruments, saving consumers billions of dollars in mortgage interest and prepayment penalties over the years.

Notwithstanding novel developments in mortgage finance, the classic fixed-rate mortgage remains the product of choice for many borrowers because it protects them from upward swings in mortgage interest rates – and allows them to refinance whenever they want without penalty. At the end of 2005, the fixed-rate mortgage market most heavily supported by the GSEs comprised more than 80 percent of prime conventional conforming mortgages outstanding. In

[1] The real estate section of the *Washington Post* on March 10, 2007 (Section G, page 2) showed that, among the lenders listed, quoted rates for 30-year, fixed-rate mortgages up to $417,000 (the current conforming loan limit) were on average 26 basis points lower than rates on 30-year, fixed rate mortgages above $417,000.

[2] James C. Miller III and James E. Pearce, "Revisiting the Net Benefits of Freddie Mac and Fannie Mae," at 24-25 (November 2006).

contrast, fixed-rate mortgages comprised less than 40 percent of higher-balance jumbo mortgage debt, and only one-fourth of subprime debt.[3]

The widespread availability of low-cost fixed-rate mortgage financing is largely the result of a well-functioning GSE system of housing finance. As secondary market entities, the GSEs purchase conforming mortgages that banks and other primary market originators do not wish to hold on their own balance sheets. We provide this outlet by offering an attractive "take out" bid for the conforming mortgages originated by banks. In this way, GSEs are constantly replenishing the funds available for home purchase and refinancing.

Banks typically hold adjustable-rate mortgages (ARMs) in their own portfolios and sell "long tail-risk" mortgages, such as the prepayable 30-year fixed-rate product, to the GSEs. In this way, banks can reduce the amount of interest-rate risk they must hedge. GSEs take on this interest-rate risk and diffuse it through domestic and international capital markets by securitization, the issuance of long-term callable debt or the use of hedging instruments.

The transfer of interest-rate risk from mortgage originators to the GSEs is vital to the long-term viability of the housing finance system – and to the prospects of sustainable homeownership. ARMs typically pose much less interest-rate risk for portfolio investors; instead, the challenge of dealing with changes in interest rates is borne by ARM borrowers. In flat or declining rate environments, the risk to the homeowner is usually manageable. However, as mortgage rates rise, these risks can be extremely difficult for families to manage, as demonstrated by the subprime market today.

The subprime market has grown markedly in recent years, and while there are many drivers of this growth, let me turn to economics and mention the important role of supply and demand. On the demand side, many subprime borrowers sought mortgage products with low monthly

[3] LoanPerformance, a subsidiary of First American Real Estate Solutions, gives the fixed-rate share of prime conventional conforming debt as 83 percent as of December 31, 2005, of prime jumbo debt as 39 percent from its servicing database, and of subprime debt at 26 percent from its securities database. OFHEO has estimated that 85

payments, largely in response to the run-up in house-price inflation. As long as house prices continued to rise, home equity was building up and the transactions costs associated with refinancing could be absorbed. On the supply side, subprime investors were driven by a nearly insatiable demand for yield, which is a function of the higher risks associated with subprime mortgages. To manage these risks, highly structured and complex subprime securities were developed that diffuse these risks to an increasingly large and global investor base.

The confluence of strong borrower demand for low-payment mortgages and strong investor appetite for high-yielding securities fueled the origination of 2/28 and 3/27 hybrid ARMs. Because of their short reset periods, floating rates, prepayment penalties and high margins, these mortgages were well suited to investor securitization needs. In times of low mortgage interest rates and rising home prices, many homeowners fared well in this market. However, as we are seeing now, the combination of rising short-term interest rates and softening house prices has made these mortgages much more onerous for many credit-impaired borrowers.

The point here is not to make adverse comparisons to adjustable-rate products or the subprime market. Both serve important housing finance needs. Rather, I am trying to draw a distinction between the segment of the mortgage market most heavily supported by the GSEs and alternative market solutions to the challenge of providing long-term mortgage financing. Over time the GSE market has evolved to serve household needs, and there is no better example than the high share of low-cost fixed-rate mortgages made possible by GSE mortgage purchases and investments. In contrast, the subprime market, as we know it today, is largely investor-centric. Investor preferences tend to drive what gets originated. Further, when yields dry up, investors will look for better opportunities elsewhere. This is not the case in the GSE market, where we ensure a continuous presence. This responsibility to serve markets in good times and bad is a responsibility not shared by private equity funds, hedge funds, non-bank financial institutions or even depositories. These institutions have the freedom, and indeed an obligation to their owners, to deploy their assets as they wish.

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percent of conventional conforming debt was fixed-rate as of the end of 2005, and that 15 percent of jumbo debt was fixed-rate (http://www.ofheo.gov/Research.asp).

In summary, the GSEs statutory requirement to provide liquidity to the nation's mortgage markets remains a highly important aspect of their congressional charter. Mortgages financed by the GSEs are lower cost, highly available, and permit households to shift interest rate risk – at will – to financial institutions that are highly qualified to manage it.

Mortgage Market Stability: Our Hurricane Response

Freddie Mac's second statutory purpose is to provide stability to the nation's housing markets. Like liquidity, stability is another under-appreciated aspect of our statutory purposes, that is, until things become unstable. Whether it was our mortgage purchases following the meltdown of the Long Term Capital Management hedge fund in 1998, or our confidence-building debt issuances in the extremely chaotic financial aftermath of 9/11, the combination of Freddie Mac's financial strength and mission focus has brought needed stability to financial markets. Our response to the 2005 hurricanes was no exception.

After Hurricanes Katrina, Rita and Wilma battered the Gulf Coast in the fall of 2005, Freddie Mac's actions helped cushion the impact of the hurricanes on struggling families, our lending partners and the region's housing sector as a whole. In the immediate aftermath of the storms, Freddie Mac and the Freddie Mac Foundation donated $10 million in humanitarian assistance, with special emphasis on finding temporary or permanent housing and providing supportive services for displaced families. Working with our nonprofit and business partners, Freddie Mac placed more than 2,100 families into housing, including single-family homes and apartments donated from our real estate-owned (REO) portfolio.

To help affected families keep their homes, we implemented a series of temporary policies. Through our lender customers and mortgage servicers (many of whom were themselves facing extraordinary hardships), we provided mortgage payment relief to any homeowner who needed it for up to as many as 21 months. By the end of last year, Freddie Mac had provided forbearance to more than 34,000 families, with the option for our servicers to continue to extend forbearance until June. Moreover, Freddie Mac implemented policies to avoid penalizing those who were attempting to rebuild their homes and lives. We instructed our servicers to suspend credit reporting, stop charging late fees, and stop pursuing collections on affected families who fell short on their mortgage payments.

In addition to providing mortgage payment relief, Freddie Mac streamlined our loan modification requirements so that servicers could easily assist homeowners seeking to hold on to their homes. In some cases, servicers restructured mortgages so borrowers would have lower and more manageable monthly payments. In other cases, servicers established repayment plans. By the end of 2006, Freddie Mac had provided workouts on more than 4,000 loans for Gulf homeowners. More loan workouts are underway.

Finally, to help begin the process of rebuilding in the Gulf region, Freddie Mac pledged to purchase $1 billion of mortgage revenue bonds (MRBs) from state and local housing finance agencies. Within one year, Freddie Mac had fulfilled the $1 billion commitment. The bonds are helping as many as 10,000 low-and moderate-income families obtain low-cost mortgages and home repair loans from participating lenders. The MRB initiative, as well as several other steps we took to assist lenders, servicers and their borrowers, depended heavily on our retained portfolio and its ability to allow us to spring into action quickly. Later in the testimony, we discuss in more detail how we use the portfolio to fulfill our mission.

Mortgage Affordability: Affordable Housing Goals

Promoting mortgage affordability is the third “leg” of the GSE statutory responsibilities. In this era of declining housing affordability and a critical shortage in the supply of affordable housing any and every effort to lower the cost of buying or renting a home is sorely needed. Over the years, Freddie Mac has made important contributions to affordability, including driving down the cost of origination through automated underwriting; developing new products, with very low down payments and other underwriting flexibilities, like Home Possible®; and making sizeable investments in housing related tax credits and MRBs.

For example, for the past three years, Freddie Mac has set records in new multifamily business transactions, totaling $78.8 billion in financing for approximately 1.5 million apartment homes. This figure includes $4.9 billion in targeted affordable housing products which finance apartments that receive some form of government subsidy; $3.1 billion in low-income housing tax credits (LIHTCs) which provides important support for the creation or rehabilitation of rental housing for America's lowest-income families; and over $2.7 billion in rental housing for senior citizens. Freddie Mac has a long history of increasing the availability of affordable rental housing in the United States. More than 90 percent of the rental units we have financed are affordable to people whose incomes are at or below area median income.

The affordable housing goals, administered by the Department of Housing and Urban Development (HUD), are perhaps the most well-known measure of our success in meeting the affordability aspect of our mission. Established by Congress, the three statutory housing goals direct that specific percentages of our mortgage purchases and investments be targeted to borrowers at the lower end of the income scale, or living in particular communities that may be underserved by mortgage markets.

We make strong efforts to make all the goals and subgoals each year, but the challenge of meeting housing goals that have been increasing significantly in recent years begs the question of whether we are over-relying on housing finance to solve the nation's housing affordability problem. In the current environment, we are being reminded that housing finance that is not sustainable is *not* affordable housing. Instead, we need solutions that embrace the totality of the housing equation. A growing body of research suggests that some of the greatest opportunities for progress may be found on the supply side of the equation – including such things as zoning, permit requirements, and other man-made restrictions on supply that raise the cost of housing.[4]

[4] See, for example "Regulation and the Rise of Housing Prices in Greater Boston" by Edward L. Glaeser, Jenny Schuetz, and Bryce Ward, Cambridge: Rappaport Institute for Greater Boston; "Zoning's Steep Price" by Edward L. Glaeser and Joseph Gyourko, *Regulation*, Fall 2002, pp. 24-30; "Why Have Housing Prices Gone Up?" by Edward L. Glaeser, Joseph Gyourko and Raven E. Saks, Harvard Institute of Economic Research Discussion Paper Number

Genius of the GSE Model: Attracting Private Capital for Public Purposes

One of the principal reasons for the success of the GSE model is that it attracts private capital to achieve a public purpose. Throughout our history, the government has sought to harness private enterprise and individual initiative to develop our nation, strengthen our economy and improve the lives of our people. [5] The housing GSEs fit solidly within this tradition.

Freddie Mac and Fannie Mae are federally-chartered corporations financed by the capital of private shareholders. Fannie Mae was created in 1938 to provide a secondary market for mortgages insured by the Federal Housing Administration (FHA). Originally chartered by the Depression-era Reconstruction Finance Corporation, Congress rechartered Fannie Mae in 1954 as an agency within the Housing and Home Finance Agency (the predecessor to today's Department of Housing and Urban Development). The 1954 Act contemplated that Fannie Mae would eventually become a privately-owned corporation, and accordingly, Congress required that Fannie Mae's operations were to be self-supporting and financed by private capital to the maximum extent possible.[6] Congress's vision of Fannie Mae becoming a privately-owned and financed company became reality in the 1968 Act that privatized Fannie Mae and created Ginnie Mae.[7]

2061, February 2005. See also "An Economic History of Zoning and a Cure for its Exclusionary Effects" by William A. Fischel, *Urban Studies*, Vol. 41, No. 2, pp.317–340, February 2004.

[5] Among the best known examples of this approach are the Erie Canal to spur development of the Midwest, railroad land grants to encourage creation of an advanced transportation system, the Homestead Act, which gave land to those willing to develop it, and the creation of what were essentially public-private partnerships to bring rural electric and telephone service throughout our nation.

[6] The act mandated two types of capital: preferred stock held by the Secretary of the Treasury and common stock issued to sellers of mortgages to Fannie Mae.

[7] The 1968 Act provided for the retirement of the preferred stock held by Treasury and transfer of control of Fannie Mae's board of directors to its common stockholders. By 1970 both objectives were achieved, and Fannie Mae has since operated as a business corporation financed exclusively by private capital.

Freddie Mac was created in 1970 to create a secondary market for mortgages originated by thrift institutions. Its board consisted of the members of the Federal Home Loan Bank Board (the predecessor to the Office of Thrift Supervision) and its initial capital consisted of contributions from the Federal Home Loan Banks, which became the shareholders. From its inception, Freddie Mac was designed to operate in a self-supporting manner. As part of its resolution of the thrift crisis in 1989, Congress created a corporate governance structure for Freddie Mac virtually identical to that of Fannie Mae. The preferred stock was converted into common stock, and Freddie Mac has since then been a shareholder-owned, publicly-traded corporation.

The shareholder-owned nature of the GSEs is reflected in our governance structures set forth in our charters. We each have a federal charter that provides that our Board of Directors is responsible for the operation of the company. Our directors have the same common law and statutory duties of care, good faith and loyalty to the corporation and to its shareholders as the directors of any other private corporation. This is equally true of shareholder-elected and Presidentially-appointed directors. The late Chief Justice Rehnquist, writing in his prior capacity as head of the Justice Department's Office of Legal Counsel, opined that "the directors of [the then newly privatized Fannie Mae] are undoubtedly subject to" the standard common law and statutory fiduciary duties applicable to all corporate directors.

I bring up this history for a reason. The genius of the GSE model as it has evolved since the Great Depression is the ability to harness private capital as much as possible to promote the public purpose of a liquid secondary market for housing finance. To that end, Congress has given the GSEs the freedom they needed, within the context and confines of their charters, to successfully compete for private capital and achieve attractive returns on that capital. Imposing too many conflicting demands on the GSEs risks crippling this highly successful model.

GSE Regulatory Reform: A Balancing Act of Competing Policy Objectives

Freddie Mac has testified on numerous occasions on the issue of GSE regulatory oversight and our basic position has not changed. We continue to support legislation that enhances the GSE current regulatory structure in a way that ensures continued public confidence in the financial viability of the housing GSEs, which remain two key pillars of our nation's housing industry and broader economy. That said, we have a responsibility to take into account the full impact of any proposed legislation on our continuing ability to fulfill our statutory mission of providing liquidity, stability and affordability to the nation's housing markets.

As I will describe below, GSEs are highly adaptable institutions, having demonstrated considerable willingness and ability to adjust to changing policy emphases within the context of our statutory mission. Created in 1970, Freddie Mac spent a good part of our first 15 years focused on creating a vibrant secondary market for conventional conforming loans. We did this by introducing standardization and securitization to the mortgage market. In the late 1990s, we turned to the mortgage purchase side of the business and were the first to develop new automated tools to help lenders originate and sell mortgages into the secondary market with greater efficiency and lower costs. Homeowners were the chief beneficiaries of these innovative efforts, enjoying a fairer, faster and cheaper origination process. In 2001, the focus was on protecting subprime borrowers from certain predatory lending practices, and Freddie Mac took the lead by establishing a number of consumer protections that have largely become industry norms. We are subject to increasingly stringent HUD affordable housing goals; on average, the 2008 goals are about two-thirds higher than the first permanent goals in 1996. Today, over fifty percent of our mortgage purchases and investments support mortgage financing for families with incomes below the area median or who live in underserved communities.

That brings us to the present. Witnesses testifying at a recent Senate Banking Committee hearing urged the GSEs to voluntarily restrict investments in short-term hybrid ARMs. As announced a few weeks ago, Freddie Mac once again took the lead and did just that. Beginning in September 2007, we will restrict our subprime purchases to those mortgages that have been underwritten to a fully-indexed level, with concomitant restrictions on the use of stated income and excessive debt-to-income ratios. We also are working to develop model subprime products, consistent with safety and soundness, which will provide safer financing alternatives for families with blemished credit.

Freddie Mac is pleased to be able to promote greater borrower protections in the subprime market. Unfortunately, at some point, such leadership actions may conflict with other policy and regulatory expectations of the company.

Perhaps the broader point – particularly in the context of new legislative and regulatory requirements that may be placed on the GSEs – is that while the GSEs have proven to be highly adaptive, even elastic, over the years, they are not infinitely so. This is because the GSEs, by design, were structured along three key dimensions that must be held in some sort of balance for the whole franchise to work. These three dimensions are mission, capital and shareholder return. While I will admit that, at certain times in our past, these objectives may not have been properly balanced, I am pleased to say that we've worked hard in the past three years to bring things back into a proper balance.

In the same way, the legislation before us also needs to achieve this same type of balance. While there is a fair degree of "elasticity" in this balance, it is critical to note that there is a tipping point: GSEs are not infinitely elastic. We cannot be all things to all people at the same time.

While I am not sufficiently prescient to say that point has arrived, I believe we are approaching a time of difficult tradeoffs. These tradeoffs are what we are talking about today. Without a doubt, the GSE charters are valuable assets resulting in lower GSE borrowing costs. These savings are largely passed through to borrowers in the form of lower interest rates than can be obtained through the higher-cost jumbo market. Lower borrowing costs also provide the GSEs the ability to subsidize certain less profitable mortgage investments, as envisioned by our charters.

On the other hand, the GSE charters also come with a number of business restrictions and mission responsibilities. Unlike banks, to which the GSEs are so often compared, Freddie Mac's business is confined to the residential mortgage market – in good times and bad. We can't diminish our support for this market when there are more profitable investments to be had elsewhere.

Unfortunately, in the past few years, GSE reform legislation has become a tug of war over these two aspects of the GSE charters. One side of the debate appears to support provisions that would minimize the value of GSE charters in the name of reducing potential systemic risk and increasing competition for mortgage assets. The view is that the GSEs are too big, too risky and should be constrained in their ability to develop new products or innovate in ways that might affect the competitive landscape of the primary mortgage market. Proponents of this view support legislative provisions that would raise capital requirements, shrink the size and growth of our mortgage portfolio, and limit innovation through excessive regulation of virtually every aspect of our business.

At the same time, others want to take advantage of the value of the GSE charters by increasing the scope of GSE mission responsibilities and making them legally enforceable. These mission expansions would include the establishment of new financial obligations tied to our total mortgage portfolios; additional and greater targeting of the annual housing goals toward higher-risk borrowers, and the addition of explicit legal duties to serve underserved markets.

These two policy objectives – minimizing the value of the GSE charters while expanding GSE responsibilities – cannot be achieved simultaneously. A few examples:

- Requiring capital above the actual risks of our business will slow growth and reduce dollars going to the new affordable housing fund.

- A greatly constrained retained portfolio will mean little or no ability to provide market support for mortgages when other investors leave the market. Conventional conforming mortgage rates likely will rise for consumers.

- Extremely aggressive housing goals that are targeted in very-low-income areas may result in unintended negative consequences. Excessive demand-side mandates can result in an over-extension of credit to some borrowers, with consequences like those we are seeing in the subprime market today.

- Restraints on growth and increased mission responsibilities combined with sustained excess capital will greatly reduce franchise value and diminish investment in GSEs.

Thus, the "awkward reality" – GSE regulatory reform is a delicate balancing act. Policymakers and regulators must solve a complex equation that strikes appropriate balances and tradeoffs.

Balance of Congressional Policy and Regulatory Discretion

A second balancing act that must be achieved in GSE reform legislation is the need to balance Congressional policy direction and regulatory discretion. I am exceptionally passionate on this point due to my experiences as former head of the Boston Fed during the New England credit crunch of the early 1990s. As I describe later in this testimony, unintended regulatory action turned what should have been a modest downturn into a regional recession.

Freddie Mac supports the intent and direction of H.R. 1427. However, we have concerns about how certain provisions in H.R. 1427 will be understood, interpreted and ultimately implemented. I am not talking about short-term concerns. GSE legislation has been many years in the making, and, if enacted, is unlikely to be revisited for years to come.

As currently drafted, the provisions dealing with issues such as capital, mortgage portfolios and business activity oversight are very broad. As an example, consider the proposed language on regulatory oversight of our mortgage portfolio. In contrast to portfolio provisions contained in last year's Senate GSE bill (S. 190), H.R. 1427 does not specifically require or direct the regulator to reduce our mortgage portfolio. This has been widely interpreted as meaning that the regulator would not impose the drastic reductions in our portfolio called for by our critics.

However, the language does provide the regulator with very broad authority to limit or substantially reduce the size of GSE portfolios, if they choose to do so – making it possible to achieve the policy objectives of S. 190 through the provisions of H.R. 1427.[8]

The high degree of discretion has cheered some GSE critics – and that worries us. A Fellow with the American Enterprise Institute and long-time GSE critic recently noted that these requirements give the regulator the authority to substantially and permanently reduce the size of GSE portfolios. In a recent article, he wrote that "the language gives the director the necessary authority, if he chooses to use it" to force reductions in GSE portfolios, and thus H.R. 1427 "deserves the support of those who have sought this goal." [9]

In my view, similar issues exist with regard to how a regulator might interpret other key provisions in the legislation. For this reason, we believe it is essential that Congress provide greater clarity and direction regarding the continued role of the GSEs. Will the GSEs remain a vital force in the provision of low-cost mortgage money to America's homebuyers and renters? Or will the GSEs be pared back to serve an FHA-sized market? We think it is for Congress to decide.

Balance Among Other Regulated Entities

A final balancing act is the need to ensure that GSE regulatory reform is consistent with regulatory trends in financial services. While the regulatory pendulum during the past several years has swung toward increased regulation generally, in recent months there has been growing concern that it may have swung too far in financial services. From Treasury Secretary Paulson and a number of other key financial leaders, we have heard wise calls for "striking the right

[8] The bill would direct the regulator to "establish standards by which the portfolio holdings, or rate of growth of the portfolio holdings, of the enterprises will be deemed to be consistent with the mission and the safe and sound operations of the enterprises." The regulator would be required to consider six specific criteria in establishing these standards, including "the potential risks posed by the nature of the portfolio holdings," as well as seventh which covers "any additional factors the Director determines to be appropriate…."

[9] Peter Wallison, "Viewpoint: House Bill To Authorize GSE Portfolio Lid," American Banker, January 12, 2007.

balance" in regulation – warning that "[e]xcessive regulation slows innovation, imposes needless costs on investors, and stifles competitiveness."[10] A report jointly commissioned and issued by U.S. Senator Charles Schumer and New York Mayor Michael Bloomberg warns that overregulation is one of the principal factors endangering New York's position as the global financial center.[11]

Likewise, there is reluctance for the most part to substantially increase regulation in the financial services industry, even of lightly regulated sectors. For example, some policymakers and industry observers have called for greater regulation of hedge funds. The 1998 failure of a then little-known hedge fund, Long Term Capital Management, sparked a broader crisis in the financial markets that required the active intervention of the Federal Reserve System to address. However, just last month, financial regulators such as the President's Working Group on Financial Markets (which is comprised of the Secretary of the Treasury and the Chairmen of the Federal Reserve Board, the Securities and Exchange Commission and the Commodity Futures Trading Commission) indicated that instead of increasing direct regulation of hedge funds, their preferred approach is to focus on using existing regulatory structures to encourage improved transparency and market discipline among hedge funds and stronger risk management by counterparties and creditors.[12]

What is perhaps most striking about the public discussion over GSE regulatory oversight is how disconnected it is from this broader discussion of financial services regulation. None of the concerns being expressed about the dangers of overregulation are being applied to the GSEs – indeed, they are completely absent from the policy discussion. An outside observer might thus surmise that when it comes to regulation, the GSEs are infinitely elastic – no amount of regulation will materially impact their ability to function. This is just not the case. While

[10] Remarks by Treasury Secretary Henry M. Paulson on the Competitiveness of U.S. Capital Markets, Economic Club of New York (November 20, 2006).

[11] *Sustaining New York and the US' Global Financial Services Leadership*, January 22, 2007.

[12] See President's Working Group on Financial Markets, *Principles and Guidelines on Private Pools of Capital*, February 22, 2007.

Congress can impose any mandates or requirements it deems fit on us, it cannot compel anyone to invest in the GSEs, nor can it require anyone to do business with them. Like other companies, the GSEs must attract shareholder capital, and they must compete for the business of lenders. If we operate under legislative and regulatory restrictions that prevent us from providing shareholders a competitive return, we will not attract their capital. If we operate under restrictions that make it unattractive for lenders to do business with us, then they won't – they will go elsewhere. And then we will be unable to fulfill the purposes for which we were created – an outcome we believe no one in Congress wants.

Of course, some might respond that the GSEs brought this on themselves – and in many ways, they are right. I am acutely mindful of the mistakes we made in the past and how they sparked the debate we are having today. But the company I am privileged to lead today is vastly different from the company I joined a little over three years ago. While our work is not yet complete, Freddie Mac has rectified many of the mistakes of the past and continues to focus its efforts on regaining the public trust. We are more committed than ever to fulfilling our mission and serving the needs of our nation's homebuyers and renters. It is our obligation, and the times demand it.

But regulation must be rooted in the recognition that the GSEs are businesses that have to compete with other businesses in the marketplace. Capital is one key issue about which we ought to be particularly aware of competitive impacts. It is especially puzzling to contemplate a dramatic increase in required capital for the GSEs, at the same time as our main competitors are arguing that their capital requirements should be substantially *eased* under the implementation of Basel II. In a recent study for the Mortgage Bankers Association, Professor Mark Flannery of the University of Florida found that even at current GSE capital levels, large banks under Basel II may be allowed to hold lower levels of equity capital against prime mortgage credit risk than the GSEs.[13] If Professor Flannery is right, that will put a big squeeze on the GSEs' securitization

[13] Mark J. Flannery, "Likely Effects of Basel II Capital Standards on Competition within the 1-4 Family Residential Mortgage Industry," manuscript, University of Florida, October, 2006.

business – the one area where there is the least controversy over the GSE role. Furthermore, many of our competitors enjoy both explicit and implicit government guarantees. For example, banks' insured deposits fund more than three-quarters of their loan portfolios, providing a low-cost and stable funding base because of government backing. In addition, beyond insured deposits, many large banks also benefit from the market's perception of implicit government guarantees. A recent Moody's report estimated there is a 98 percent probability that the government would bail out some of the nation's largest banks in the event of a crisis.[14]

We support strengthening GSE oversight, but not at the cost of crippling our ability to compete in the marketplace. On capital, for example, we urge that any new capital requirements avoid placing us at a disadvantage in relation to our competitors. Modern financial service regulators acknowledge the competitive impact of disparate capital requirements: one reason the bank and thrift regulators proposed Basel IA was to level the playing field for depositories not subject to Basel II's substantial reductions in capital requirements for residential mortgages. Striking the right balance in regulation is just as important for us as it is for banks, insurance companies, broker/dealers, and hedge funds.

Systemic Risk

In response to these statements, our critics likely would assert that the GSEs require much stronger regulation than other financial institutions because their investments in mortgages pose unique risks to the financial system as a whole. This is an issue on which there has been a great deal of heated debate (and I will admit at times there has been more heat than light on both sides). I would like to offer several facts and observations for the Committee's consideration that hopefully will help clarify this issue.

Systemic risk is an issue to which the Administration has devoted considerable attention. Thus, it may be useful to look at the very recent work of the President's Working Group on Financial

[14] "Moody's Announces Bank Rating Actions Resulting From Implementation of JDA Methodology – United States," March 2, 2007.

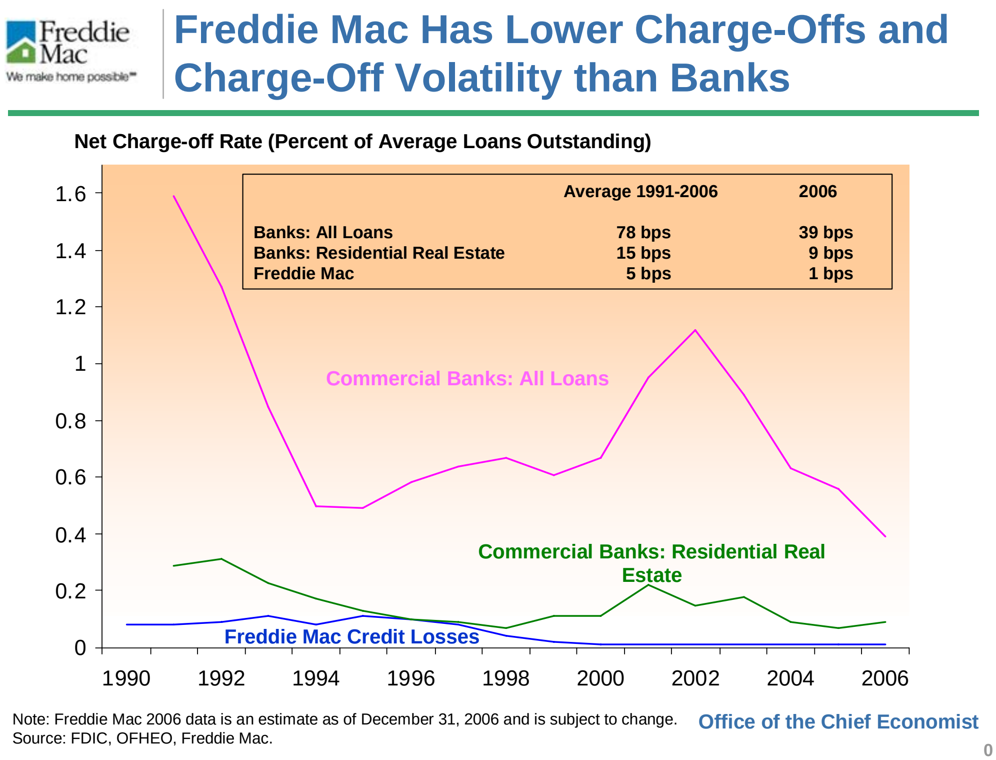
Markets cited above that set forth broad principles for use by the financial regulators in mitigating potential systemic risks posed by "private pools of capital" (*e.g.*, hedge funds). Hedge funds differ from GSEs in critical ways. Unlike the GSEs, hedge funds are unregulated, loosely capitalized and opaque; they are not required to publicly disclose their portfolio holdings, trading strategies or even their financial performance. They also invest in a wide range of asset classes while we are generally restricted to investing in high-quality mortgage related assets.

That said, and even though we present much less risk to counterparties than a typical hedge fund, many of the Working Group's findings are applicable. For example, in its two "overarching principles," the Working Group argues, first that "public policies that support market discipline, participant awareness of risk, and prudent risk management are the best means of protecting investors and limiting systemic risk" and second, that "supervisors should use their existing authorities…to foster market discipline." I agree wholeheartedly with these two principles and believe that market discipline and strong supervision are the most effective way to manage the systemic risks posed by large financial institutions. As for GSE supervision, over the past three years I have seen just how tough a safety and soundness regulator OFHEO can be. H.R. 1427 would make that oversight even stronger. As a former bank regulator, I am also very confident in the federal banking agencies' abilities to monitor their institutions' counterparty risks. With regard to market discipline, we have made important efforts, such as our issuance of subordinated debt, to enhance the degree of market discipline.

Moreover, in the context of the debate regarding the GSEs, systemic risk is routinely used as shorthand for the view that these institutions somehow present a special degree of risk to the U.S. financial system (or even the world's financial markets). The simple fact is that while the GSEs are large financial institutions, they are only two of a group of large financial institutions within the U.S. Our financial system is quite resilient and innovative – the subject of constant changes and improvements. Further, the nation's system for financing residential real estate mortgages is the envy of the world – as is shown by the investments in it from various sources around the globe. While we agree that the system could be stronger, we strongly disagree that the GSEs represent a unique, large looming problem waiting to happen, particularly given the intense scrutiny we have received.

The assets the GSEs own are considered to be among the safest financial products, evidenced by the reduced level of capital called for by the Basel II accord for high quality residential mortgages. A mortgage in our portfolio is no riskier than a mortgage held in the portfolio of a bank, insurance company, hedge fund, or central bank – the risks are exactly the same. As a means of allocating capital, regulatory capital requirements for a particular asset should be comparable regardless of whether the asset is held by a bank, an insurance company, a central bank or a GSE, taking into account the risk management capabilities of the institution holding the asset.

Freddie Mac has a demonstrated track record of managing the risks of mortgages very effectively over many years. As shown in the table below, Freddie Mac's credit-related losses have averaged only one basis point annually throughout this decade. Compare this to the credit losses of the commercial banking sector, which from 2001-2005 averaged 83 basis points for all loans and 14 basis points for residential mortgages.



Our management of interest-rate risk has been equally effective. We do not retain all of the interest-rate risk in our portfolio – we disperse most of it into the capital markets through the use of callable debt and derivatives. The record refinancing boom of 2003 provides a prime example of how we do this. During 2003, we financed nearly $835 billion in new mortgages, as borrowers refinanced to take advantage of historically low mortgage rates. During this time, more than half of our total mortgage portfolio prepaid. To manage the effect of this boom on our retained portfolio, we also called and refinanced much of our debt. This is the type of shift in the market to which our critics assert that we are uniquely vulnerable. In fact, our reported risk measures were consistently low, and our fair value of net assets increased by 19 percent. These same disclosures show that our duration gap – which contrasts the expected life of our assets and liabilities – has been at zero months in every month but one since January 2004. A duration gap of zero months indicates that assets and liabilities are expected to mature at the same time, demonstrating they are properly matched. All of this can be verified by reviewing our monthly disclosures.

None of this is meant to suggest that there are no risks involved in GSE mortgage investment. Ensuring that we manage these risks well should be key to the new regulatory regime. But the risks of the GSEs investing in mortgages, as opposed to other investors, are not unique, nor are they uniquely difficult to manage.

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

Legislative Proposals

It is my hope that each aspect of H.R. 1427 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.

While fulfilling our mission and remaining safe and sound are each necessary, 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 without upsetting that balance. But there are other combinations of provisions that could 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 our actual risks
- Potentially onerous new product or activity constraints that inhibit innovation and and our ability to offer competitive products to our customers

- Provisions that could lead to unwarranted restrictions on our investment portfolios

- Provisions that create a proliferation of affordable housing obligations rather than consolidating existing and new ideas into the most effective package

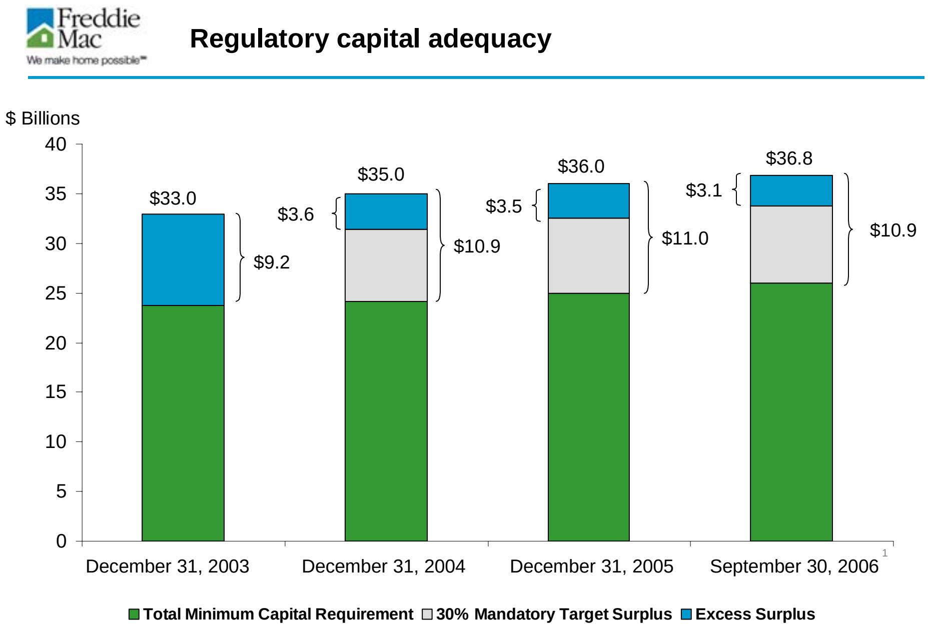
These are challenging issues, but I have faith that Congress will strike the right balance.

Capital Requirements

H.R. 1427 gives the regulator new authority to adjust the existing minimum capital ratios and risk-based capital standards for both the GSEs and the FHLBs.

As an initial matter, Freddie Mac has always been more than adequately capitalized under both the risk-based and minimum capital ratios – for us, the more stringent of the two – established under current law. As the graph below clearly illustrates, before OFHEO's imposition of the current 30 percent add-on for operational risk, we held a surplus over regulatory minimums, and even now hold a $3 billion cushion over the OFHEO mandatory target surplus.

This is real, permanent, at-risk capital that provides the first line of defense in the unlikely event of a financial catastrophe at Freddie Mac. Since shareholders are the ones providing the capital, they – and not the taxpayers – will be the ones to bear the losses. Shareholders expect an adequate return on their investments in exchange for putting their money on the line, but like any other investor, they buy our stock at their own risk.



[1] OFHEO will determine if minimum capital resubmissions are required.
Source: Freddie Mac and OFHEO.

As a mortgage guarantor, it goes without saying that being adequately capitalized is a *sine qua non* of our business. But we fundamentally believe that our mission as a GSE depends on capital requirements that are tied to the *actual risks of our business.* Under our charter, we can deal solely in mortgages. This business gives rise to three basic risks: mortgage credit risk, interest-rate and other market risks, and operational risks. We should be required to hold sufficient capital against each of those risks to ensure that we can weather unexpected losses, without requiring so much capital that we become inefficient and uncompetitive.

Some critics nevertheless would like us to have much higher capital. For example, some argue our capital should mirror bank capital. As a general matter, all financial institutions should hold comparable capital against comparable assets, but as institutions, banks hold a wider array of assets and have very different risk profiles than the GSEs. Others want us to hold capital against a doomsday scenario, based on the view that we present a unique systemic risk to the global financial system. Either would create a capital regime divorced from risks we actually present, and are thus inherently arbitrary and speculative. Most importantly, raising GSE capital apart from their actual risks would make it much harder for us to meet our mission of ensuring liquidity, stability and affordability, without adding meaningfully to our financial safety and soundness.

Requiring capital above and beyond actual risks also can have very real and very serious market effects. From my days as President of the Federal Reserve Bank of Boston, I know firsthand the painful effects that can ensue in a market in transition from my analysis of the early 1990s credit crunch that particularly affected New England. As I noted in my testimony before a House Subcommittee at the time, the drop in real estate prices triggered a substantial rise in nonperforming assets among lenders, which ate away at the capital base of banks and other lenders.[15]

Ultimately, this led to a "capital crunch" that curtailed credit availability for all types of real estate lending save one: conforming residential loans. In contrast to the rising costs and declining availability of construction and development loans, commercial-property loans, jumbo mortgages, and small business loans, the conforming home-mortgage market remained robust with conforming mortgage rates remaining on par with those in other markets.[16] The reason is because Freddie Mac and Fannie Mae were doing the job that Congress had set out for them: providing liquidity and responding appropriately to capital market trauma so as to mitigate economic shocks and hence support a recovery.

As in the early 1990s, we are at one of these transition times right now. The recent downturn in the housing market has led to a drop in home values in many markets across the U.S., has sliced a percentage point from annualized GDP growth over the last three quarters, and will slow

[15] 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.

[16] Mortgage rate data compiled by HSH Associates show that mortgage rates on jumbo fixed-rate loans in the Boston metropolitan area averaged 0.2 percentage points *above* the national average jumbo rate during the fourth quarter of 1990, after a full year of falling real-estate values. In contrast, conforming rates in Boston averaged up to 0.1 percentage points *below* the national average each quarter of the recession.

expansion during the first part of this year as well.[17] Mortgage delinquency rates are up at banks and savings institutions, and subprime servicers have experienced a sharp deterioration in loan performance over the past year.[18] Furthermore, the latest Federal Reserve survey of senior loan officers at major banks found that, on net, home mortgage credit underwriting had tightened over the last quarter of 2006.[19]

One reason Freddie Mac and Fannie Mae were created was to mitigate the impacts on the housing finance system of a transition like the one we are experiencing right now. Freddie Mac and Fannie Mae perform this role through every recession and each downturn in the residential housing market. We provide stability to the housing sector by providing funds *counter-cyclically* to lenders. That means that at the point in the business cycle when economic activity is contracting, Freddie Mac and Fannie Mae *increase* their relative provision of funds to the mortgage market, and vice versa. In contrast, other mortgage investors make credit available pro-cyclically, such that fewer funds are available during a housing downturn. By acting *counter* to the business cycle, Freddie Mac and Fannie Mae help reduce the depth of a housing recession and support credit flows during an expansion in an “as needed” basis.[20]

We can only serve this function if we have the capital (and operational flexibility) to respond quickly to market transitions. For example, if regulators require us to hold capital in excess of

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[17] Bureau of Economic Analysis News Release BEA 07-06, February 28, 2007, “Gross Domestic Product: Fourth Quarter 2006 (Preliminary),” Table 2, shows that the fall in residential fixed investment subtracted an average of 1 percentage point from real GDP growth over the second to fourth quarters of 2006.

[18] The Federal Reserve Board’s *Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks* shows that the 30-day delinquency rate on residential loans had risen to its highest level in nearly four years as of December 31, 2006, and charge-off rates to the highest level in nearly three years. *Moody’s Special Report*, “Early Defaults Rise in Mortgage Securitizations,” reports a large increase in subprime and alt-A early-payment default rates during 2006 (January 18, 2007).

[19] Federal Reserve Board, *The January 2007 Senior Loan Officer Opinion Survey on Bank Lending Practices*, reported that “On balance, about 15 percent of domestic banks reported that they had tightened credit standards on residential mortgage loans over the past three months, the highest net fraction posted since the early 1990s.”

[20] See two papers by Joe Peek and James A. Wilcox: “Secondary Mortgage Markets, GSEs, and the Changing Cyclicality of Mortgage Flows,” ed. Andrew H. Chen, *Research in Finance* Volume 20, pp. 61-80, 2003; and “Housing, Credit Constraints, and Macro Stability: The Seconday Mortgage Market and Reduced Cyclicality of Residential Investment,” *American Economic Review*, May 2006, pp. 135-140.

our actual risks, we may not have the financial base that allows us to inject liquidity into the marketplace by buying and holding mortgages. We should be careful not to damage the successful GSE business model, especially at a time when GSEs may be needed to sustain the world's most liquid and successful housing finance system.

GSE Mortgage Portfolios

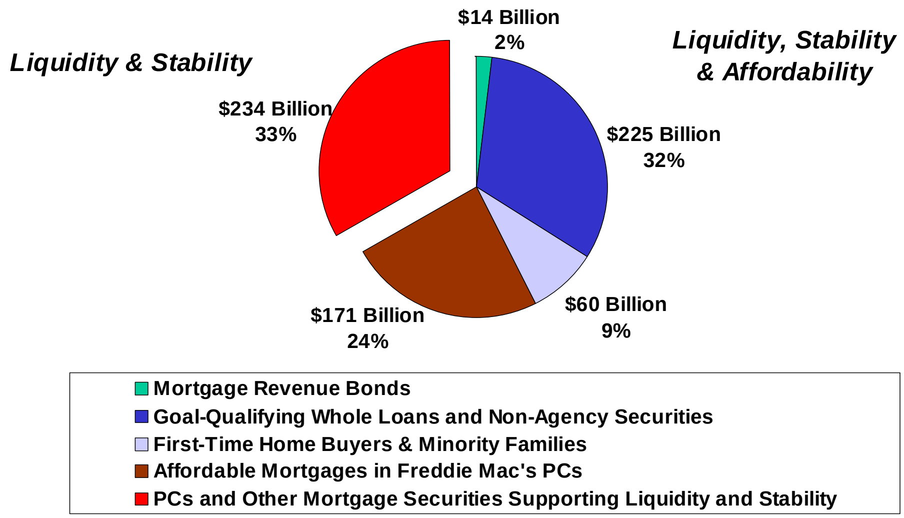
Let me now turn to our mortgage investment portfolios. We are gratified that H.R. 1427 does not mandate the draconian cutbacks mandated by last year's Senate bill. But, as the head of National Association of Home Builders pointed out a few weeks ago, the bill would allow the regulator to compel the same massive portfolio cuts as the Senate bill. Because our ability to invest in mortgages is a critical tool for achievement of our mission, we, like the Home Builders, would like to see revision of the bill to prevent such an outcome.

Why do we say that the portfolios are critical to our mission? Our charter gives us the obligation to ensure the liquidity, stability, and affordability of mortgage credit across the country, in good times and bad. We fulfill these obligations through intermediating mortgage assets, largely through securitization, but also – because the demand for mortgage assets is volatile and unpredictable – through supporting demand through purchases of mortgages for our portfolio. The portfolios contribute to our mission even when we are not buying, because investors know we will provide a "backstop bid" and buy their mortgages if they later need to sell. This helps keep markets liquid and mortgage rates low across economic environments.

Recently, we have heard that only 30 percent of our portfolios fulfills our affordable housing mission. We respectfully disagree with this characterization as too narrow a view of our mission, as well as the contributions we make to affordable housing. First, since we can only invest in mortgages permitted by our charter, by definition every mortgage asset we invest in is mission-related. Every mortgage asset, whether a whole loan, multifamily security, or mortgage revenue bond, fulfills at least one of our mission purposes of providing liquidity, stability and affordability. The same can be said of investments in Freddie Mac's own mortgage-backed securities. I do concede the difficulty of quantifying the additional mission benefit of investing in securities we have already guaranteed, but our constant presence and scale provides ongoing liquidity in our securities, helps keep rates low, and ensures a back-stop bid for mortgages in times of market volatility.

As the chart below shows, we estimate that about two-thirds of our retained mortgage portfolio either directly or indirectly supports the affordable component of our mission. This "affordable" share is comprised of a number of different investments: bonds financing low-cost housing (including the $1 billion in MRBs we bought to help rebuild the Gulf Coast); goal-qualifying whole loans and non-agency securities; non-goal-qualifying mortgages and securities supporting first-time homebuyers and/or minority families; and affordable mortgages contained in Freddie Mac securities.

Freddie Mac's Retained Portfolio Supports Our Statutory Mission



Freddie Mac's Retained Portfolio as of December 31, 2006: $704 Billion

-- Mortgages $66 billion (including $6 billion restructured and non-performing mortgages)
-- Freddie Mac securities: $354 billion
-- Other mortgage securities: $284 billion

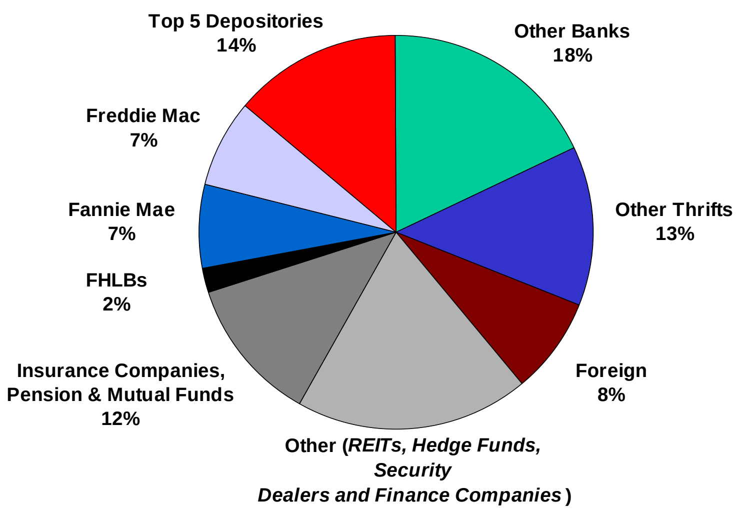
Source: Freddie Mac

Another argument is that the GSE portfolios are too big. While the GSEs, have in the past, comprised a relatively larger share of the overall market, this is not true today. Numerous investors compete vigorously for mortgage assets, and as a result both companies' share of U.S. residential mortgage debt outstanding (MDO) has dropped significantly, while the MDO share for competing investors has grown dramatically.

At the end of 2003, Freddie Mac held about 8.5 percent of MDO, and Fannie Mae just under 12 percent. Data released by Federal Reserve Board last week showed that MDO was nearly $11 trillion as of the end of 2006. Of that amount, the shares of MDO held by Freddie Mac and Fannie Mae were less than 7 percent for each – down approximately 40 percent from three years ago. In contrast, the mortgage portfolios of the five largest depositories grew by 29 percent in the last year alone. The largest of these portfolios is now approaching half a trillion dollars and in total these depositories hold more than $1.6 trillion in mortgages. This is more than 14 percent of MDO, a larger share than the GSEs combined.[21]

Mortgage Risk Is Widely Dispersed Among Many Investors

June 30, 2006: $10.5 Trillion



Sources: Freddie Mac and Fannie Mae January 2007 Monthly Volume Summaries, Inside MBS & ABS (October 20, 2006), FDIC and the Federal Reserve Board

Several observations can be made from these data. First, the large banks also hold large mortgage portfolios, collectively larger than the GSEs. Second, the data show that mortgage risk is already widely dispersed throughout the global economy, with the seven largest mortgage investors together owning less than 28 percent of MDO.

This is not a criticism of the banks. In our view, the key question is not size *per se*, for us or for the banks. It is whether we are able to manage the risks of our businesses without jeopardizing our financial safety and soundness. With respect to mortgage risk, our track record is second to none. Even in the darkest days of our accounting problems, the low volatility of our risk measures evidenced that we manage mortgage risk conservatively and successfully.

A final source of opposition to the GSEs' retained portfolios is that they are profitable, and that is true. However, profits are indispensable to the GSE model. Profits are what allow us to be private sector institutions, using private-sector methods and private capital, to respond to market realities. It is my sincere hope that this candid explanation helps the Committee understand why we are extremely apprehensive about how the regulator might exercise his authority over the retained portfolios. OFHEO's Director has been very open about his view that the portfolios are too big and uniquely risky. We respectfully but strongly disagree with him on this question, but do agree that the regulator should have clear authority to ensure that our investment portfolios (and those of the FHLBs for that matter) be operated safely and soundly and in compliance with our charters.

Prior Approval

As noted earlier in my remarks, the GSEs have a long and distinguished record of innovation. Whether we're talking about the creation of new securities, new mortgage products, or new technologies, GSE innovations have brought incalculable benefits to the mortgage market and homebuyers. Superimposing thickets of regulation on this process is a sure way to slow things down – if not shut them down altogether. For example, many have called for the GSEs to develop so-called subprime "rescue" products, and we are interested in doing just that.

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[21] Sources: Federal Reserve Board; Freddie and Fannie year-end MVS; Bloomberg; FDIC.

However, overburdening GSE product development with excessive comment and approval requirements could greatly slow our ability to bring this needed product to market.

In our view, the Director's prior approval authority should only apply to major changes in GSE offerings to ensure compliance with our charter and safety and soundness. Although a bureaucratic prior approval process may offer a competitive benefit to individual market participants, there is no discernible public benefit to crippling our ability to innovate, compete, and respond to our customers' needs as we do routinely in our everyday business.

Conforming Loan Limit Increases

This Committee is considering including in GSE legislation a provision that would increase the maximum conforming loan limit in areas with high housing costs. Depending on how a high cost area loan limit is defined and implemented, this change would provide needed relief to families squeezed by high housing costs by extending the benefits of the conforming market to them.

Affordable Housing

Congress is considering making fundamental changes to the affordable housing obligations of the GSEs. Possible changes being discussed are creating an affordable housing fund that would be financed through contributions made by Freddie Mac and Fannie Mae, redefining the housing goals, and creating a statutory "duty to serve" underserved markets. With regard to the proposed fund, I do not believe the CEO of any shareholder owned company would enthusiastically support an additional cost imposed on his or her business, and I'm no exception. At the same time, I understand the interest in Congress in creating such a fund.

Each of these changes to our affordable housing obligations would have a significant impact on the GSEs. All three simultaneously – especially in combination with the capital, portfolio and prior approval provisions discussed above – could push us past the tipping point I warned about earlier. Our ability to perform our mission depends upon our ability to attract shareholder capital and compete in the marketplace. And this ability is affected by the cumulative amount of regulation and obligations we operate under – this is the focus of our concern.

Accordingly, we would urge Congress to consider the following principles in the context of reform of GSE mission responsibilities:

- Legislative reform that addresses the GSEs' affordable housing mission must be holistic in approach. In the context of current legislative proposals, efforts to amend the goals regime, create an affordable housing fund, and establish a duty to serve underserved markets, must consider the interplay among, and cumulative impact of, these proposals.

- Efforts to amend the goals regime (and related proposals) should foster innovation, leveraging market developments and strategies, in expanding homeownership and rental opportunities for low-income families and underserved communities.

- The goals regime should refrain from imposing numerous, difficult-to-administer goals with potentially overlapping objectives. Rather, the goals should promote efficiency in directing benefits through the secondary market to targeted groups, align with the GSEs' other mission objectives – liquidity and stability, and encourage the development of affordability initiatives through incentives (rather than simply through rigid mandates).

- The goals regime, and any targets thereunder, must be reflective of market conditions, recognizing the GSEs' role as secondary market participants.

In short, expansion of the GSE mission responsibilities is a very important component of this legislation. Expanded affordable housing mission requirements should be designed to work synergistically with each other, and more broadly with the other GSE statutory purposes of providing liquidity and stability. Further, they should not create unintended negative consequences for the long-term viability of the franchise, the markets we support and the homeowners and renters we serve. In this vein, we acknowledge the efforts of HUD Secretary Jackson in his administration of the GSE housing goals.

Conclusion

Freddie Mac supports legislation that enhances the GSE regulatory structure in a way that ensures continued public confidence in the financial viability of the housing GSEs, which remain two key pillars of our nation's housing industry and broader economy.

As stated earlier in this testimony, we urge policymakers to take into account the full impact of proposed legislation on our continuing ability to serve the full breadth of our statutory mission of providing liquidity, stability and affordability to the nation's housing markets. We believe the successful implementation of this legislation will require striking a delicate balance on three important dimensions. Without a proper balance between the desire to both minimize and take advantage of the charter; regulatory balance among other regulated entities; and a careful balance between statutory direction and regulatory discretion, we remain highly concerned that this legislation will not only shrink the size of the GSEs – but also the very strong, safe, consumer-focused mortgage market we serve. We respectfully submit that in this time of relative weakness in the U.S. housing market, over-engineering the GSE-model of housing finance, including requiring capital in excess of actual risks, may lead to further market weakness, higher mortgage rates for borrowers and a diminished supply of long-term fixed-rate financing, which is critical to ensuring sustainable homeownership for America's families.

* * * * *

Thank you for the opportunity to appear before the Committee today. I know the views contained in this testimony are potentially controversial. My purpose in raising them is not to be quarrelsome. Rather, the issues before this Committee are so important that it would be irresponsible of me to shy from candor. Nevertheless, let me affirm that Freddie Mac is a creation of the Congress, and we are committed to doing what you want us to do.

I look forward to working with Chairman Frank, Ranking Member Bachus and the members of this Committee. I look forward to your questions.