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COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
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Chairman Dodd, Ranking Member Shelby and members of the Committee:

I greatly appreciate the opportunity to appear before the Committee today to discuss key aspects of proposed legislation on regulatory reform of the oversight of Freddie Mac and Fannie Mae (GSEs), and the Federal Home Loan Banks.

The last time I testified before this Committee was in 2005. Things were very different then. In 2005, single-family housing starts set a record; at the end of 2007, they had fallen 50 percent from their peak. House prices adjusted for inflation were growing at the fastest pace recorded in the past century. Today nearly every measure shows significant declines in both real and nominal values. Back then, the spread between jumbo and fixed-rate, conforming mortgages was 20 basis points. Today that spread is in the neighborhood of 100 basis points, a record high. Back then, the global capital markets were flush with liquidity and investment banks were reporting large profits. Now, a number of lenders have gone out of business, others have had serious problems, and we are in a global credit contraction. Since 2005, foreclosures have doubled – a tragedy not only for the families involved but also for the communities in which they live.

This dramatic shift in housing's fortunes has major implications for the broader economy. Instead of a strong housing market moving in tandem with a robust overall economy, as was the case in 2005, many fear that the downturn in housing may drag the broader economy into recession. That is something no one wants to see. Hence, it is a delicate moment for policymakers and market participants alike.

It is against the backdrop of a market in turmoil that we again consider the issue of GSE regulatory reform. As I have testified in the past, my views have been profoundly shaped by my 25 years spent regulating financial institutions. Perhaps the most salient thing I learned was the critical need for maintaining safety and soundness while, at the same time, assuring adequate credit flows, particularly in times of economic distress. Although we are in uncharted waters in terms of the forces driving today's housing finance crisis, these lessons from the past still hold true.

History as Guide

In the early 1990s a credit crunch in New England turned into a severe regional slump that lasted for more than half a decade.[1] I observed this crisis first-hand during my tenure as President of

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

the Federal Reserve Bank of Boston. As I testified in 1991 before the Subcommittee on Domestic Monetary Policy for the Committee on Banking, Finance and Urban Affairs (attached), while many banks were adequately capitalized on a risk-adjusted basis, procyclically-required increases in capital exacerbated the downturn.[2] Ultimately, this led to a "capital crunch" that further curtailed credit availability for all types of real estate lending save one: conforming residential loans.

The conforming mortgage market was protected from the downturn because Freddie Mac and Fannie Mae were doing the job that Congress had assigned them: restoring stability by providing liquidity and responding appropriately to capital markets' trauma, thereby mitigating economic shocks and supporting a recovery.

I did not always have such a sanguine view of Freddie Mac and Fannie Mae. As an economist, I viewed GSE intervention in the housing market as inefficient. One or two credit crises have a way of changing one's thinking, however. In times of financial stress, markets can go to extremes, and the resulting disappearance of liquidity can impose severe costs throughout the economy. The GSEs, it must be acknowledged, do lend support to one of the most vital segments of our economy. Moreover, homeownership has been and will continue to be central to the American dream of homeownership, and strong, vibrant GSEs are a key to making that dream a reality.

Today, the conforming market supported by Freddie Mac and Fannie Mae is the only well-functioning segment of the mortgage market. To be sure, we're experiencing greater losses as house prices decline, but that is not surprising since this is the market we were created to support. That said, long-term fixed-rate conforming mortgages are still widely available and rates are low. Since the market downturn in August, the two GSEs have supplied $466 billion in prime market liquidity, saving conforming market borrowers almost a full percentage point on their mortgages.

In addition to providing needed liquidity, Freddie Mac has taken a leadership role in addressing some of the excesses of subprime lending. Last winter, we were the first to announce that we would restrict our subprime investments in securities backed by short-term adjustable-rate mortgages (ARMs) to those that have been underwritten to a fully-indexed, fully-amortizing level. We also restricted the use of stated income in lieu of more traditional documentation standards and encouraged subprime lenders to escrow borrower funds for taxes and insurance.

Senator Dodd provided early leadership on this issue when he convened the Homeownership Preservation Summit, in which we were pleased to participate. Freddie Mac made a commitment at that time to buy $20 billion in consumer-friendly mortgages that provide better choices for subprime borrowers. Since May 1, 2007, we have bought about $42.5 billion of prime

[2] Richard F. Syron, "Are We Experiencing A Credit Crunch?" *New England Economic Review*, July/August 1991, pp. 3-10.

mortgages that financed borrowers whose credit profiles might have otherwise relegated them to the subprime market. Finally, we have consistently been at the forefront of efforts to help borrowers avoid foreclosure. Freddie Mac and its servicers helped nearly 47,000 borrowers avoid foreclosure and keep their homes in 2007.

These efforts follow a long leadership tradition. Since 2000, Freddie Mac has taken unilateral, voluntary leadership positions to combat predatory lending. These include our bans on single-premium credit life insurance, prepayment penalties greater than three years on subprime loans, and mortgages with mandatory arbitration contracts, and our insistence on regular credit reporting.

I applaud Senator Dodd and the members of this Committee for the careful attention they are giving to the mortgage market crisis. Last week, the Committee heard a variety of ideas about how to cut the number of subprime foreclosures, moderate the decline of house prices, and try to stabilize neighborhoods. The fact that we need to consider these ideas demonstrates the gravity of the present situation.

Finding the Right Balance

As with the New England credit crunch, finding the right balance between capital and liquidity goes to the heart of today's GSE debate. This debate is about how much capital is needed to ensure the continued safety and soundness of the GSEs versus how much should be deployed to protect homeownership gains, stabilize neighborhoods and support our nation's housing industry, a key sector of the economy.

It is not an easy balance to strike, and there are legitimate differences of opinion. GSE oversight must satisfy two potentially opposing objectives, safety and soundness and mission, and difficult tradeoffs sometimes must be made. For example, some want the GSEs to hold more capital – along the lines of the capital ratios that banks are required to meet. At the same time, others want the GSEs to deploy their capital more freely in order to extend the availability of mortgage credit to higher risk borrowers and product segments. But there is another consideration as well: the people that provide the capital in the first place justifiably expect to receive a reasonable return on their investment. Otherwise, the GSEs would lose access to the capital markets and taxpayers would lose an important first line of defense.

As to the question of whether Freddie Mac supports regulatory reform, the answer is "Yes." We have long said that regulatory reform is needed to ensure continued public – and investor – confidence in the GSEs. We just need to ensure that reform strengthens the GSEs and their ability to meet their important housing mission – while keeping investors in the game.

Capital

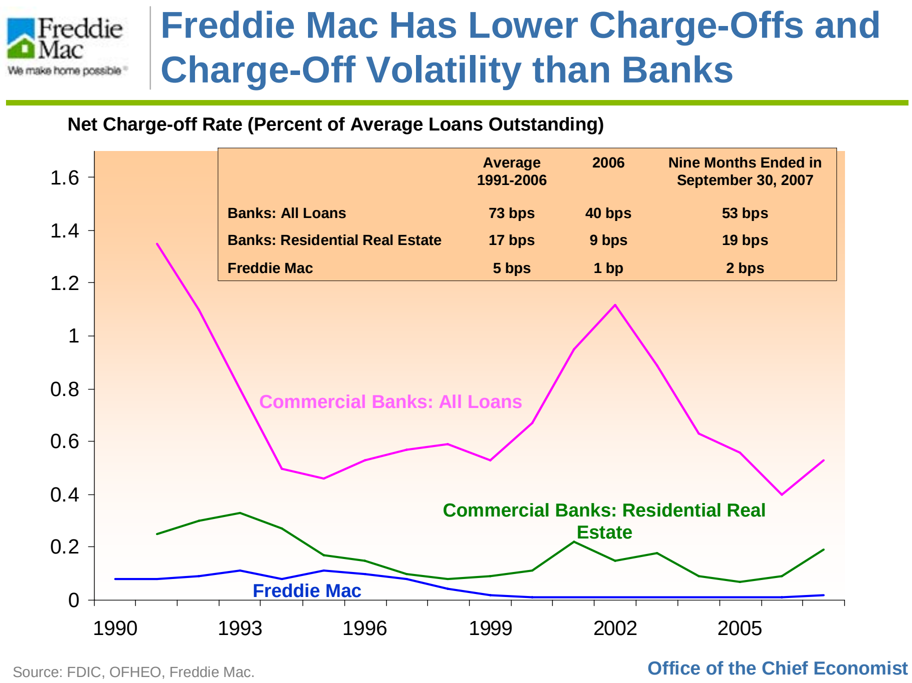
Without a doubt, appropriate capital is critical to the long-term safety and soundness of any financial institution – the GSEs included. Appropriately capitalized institutions are also critical to the viability of markets, as we are seeing today.

The subprime mortgage crisis has set into motion a destructive cycle in which falling house prices exacerbate credit problems and generate losses for lenders and investors. These losses, in turn, erode the capital at financial institutions. In response, lenders and investors have been forced to shrink their balance sheets and pare back lending, further restricting market liquidity and credit availability. These tighter credit conditions complete the circle, as weakening demand feeds through into lower house prices.

One repercussion of this dangerous spiral has been that many large commercial and investment banks have sought capital infusions to bolster their balance sheets. Freddie Mac has added substantially to our capital position as well. As it stands now, the GSEs are one of the few sources of patient capital to invest in the mortgage market, which is exactly what is needed to see us through this crisis.

In light of these very real challenges, it is imperative that the GSE regulatory framework set the level of capital consistent with the inherent risks of the assets while considering the important mission the GSEs must play, particularly in turbulent times. Freddie Mac currently manages to a 30 percent capital surplus above our minimum requirements. This surplus was established by our regulator four years ago to address heightened operational risk, and I believe it was the right thing to do at the time. Since mortgage credit was abundant (some might say too abundant), the market was not overly affected by the higher levels of GSE capital.

However, permanently higher capital without regard to risk could have a significant market impact, particularly in times of economic strain. This could occur, for example, if the GSEs were required to hold the same level of capital as banks – even though GSE losses are significantly lower. As shown in the chart below, for the first three quarters of 2007, Freddie Mac charge-offs rose to 2 basis points. In contrast, bank residential mortgage charge-offs rose to 19 basis points, and total bank charge-offs rose to 53 basis points. Not only are bank losses higher, but they have risen more over the past year relative to Freddie Mac's. Given the state of the mortgage market, our losses will rise but will likely continue to remain a fraction of banks' losses on residential mortgages.



Requiring the GSEs to have the same leverage ratio as banks would make the GSE business model unviable without enormous price increases, which would be problematic on a number of fronts. If required capital levels are raised too high, the return to shareholders could be so diluted that we would not be able to attract the capital needed to provide liquidity to the market.

Risk-based standards should be designed to ensure sufficient capital to support the risks that arise from our business. We would also support a framework that provides the GSE regulator discretion to raise minimum capital standards temporarily based on a finding of increased risk, where the levels return to the earlier level once the circumstances giving rise to the increase have subsided.

These clarifications are needed to ensure that the GSEs remain safe and sound and that we can fulfill the critical market-stabilizing role we were created to play. Finding the right balance on capital is so important to the economic viability of the enterprises, as well as to their ability to meet our mission, that some guidance should be written into the statute to ensure that Congress' intent is clear.

Mission

Under our charters, the GSEs have a three-fold mission to maintain the liquidity, stability and affordability of the conventional conforming market. That last component is very important to us. Despite the present challenges in mortgage markets, families' needs for affordable housing are not going away.

The housing market has just concluded a long period of strong house price growth, which facilitated the extension of mortgage credit to borrowers with weaker credit profiles and limited capacity to repay the loans. In retrospect, there was an unrealistic expectation that unending house price appreciation would compensate for these risks. The entire country is now paying dearly for this shortsightedness – not the least of whom are the families who are at risk of losing their homes and the communities devastated by foreclosures and falling property values**.**

For this reason, we are very concerned about the efficacy of legislation that imposes more and deeper-targeted housing goals on the GSEs, as well as additional duties and penalties. Excessive mandates can result in an over-extension of mortgage credit to some borrowers with consequences like those we are seeing in the subprime market today. In fact, a disproportionate share of the credit losses come from the loans that qualify for our affordable housing goals; these loans incur losses approximately two times the rate of non-goal qualifying loans. Because there are ebbs and flows in the economy, the goals need to be flexible enough to adapt to changing circumstances.

To address these concerns, key modifications are needed to allow the enterprises the capacity to meet the affordable housing components of our mission in all economic environments. These components cannot be achieved in the abstract – they must be aligned with market and business realities. For example, we would urge that goal levels be closely *tied* to actual market conditions and that the affordable housing fund be *tied* to the profitability of the enterprises. Legislation also should guard against a proliferation of goals, subgoals and overlapping requirements, and provide an enforcement regime that is remedial rather than punitive. Bonus points worked well in the past to encourage the GSEs to enter more challenging markets when it made business and market sense to do so.

Greater flexibility would ensure that the GSEs pass along important charter benefits to targeted families without distorting markets or fueling the origination of mortgages unsustainable in times of economic strain. We look forward to working with this Committee and others in Congress to ensure that the GSEs meet the affordable housing component of our mission in the most efficacious way possible.

Portfolio

Freddie Mac's ability to buy mortgages and hold them in our retained portfolio is an important tool in fulfilling our obligation to help maintain the liquidity, stability and affordability of the mortgage market. Portfolio purchases are especially important when other investors leave the market; our purchases add liquidity to the mortgage market, which helps keep rates low for borrowers. Portfolio purchases also provide the company a diversified source of income relative to securitization alone. This is an important way we build capital needed to withstand inevitable downturns in the housing market like the extraordinary one we are experiencing today.

In our view, an appropriate capital and supervisory regime remains the best way for the regulator to ensure that the risks of our portfolio do not threaten our safety and soundness. If, however, the Committee believes that it is prudent to give the regulator explicit authority to oversee the portfolios, the focus should be on managing the risks the portfolios pose to our financial safety and soundness, and require the regulator to balance that with our broad mission to provide liquidity, stability and affordability in all market environments. As I mentioned before, the portfolio should allow us to offer a reasonable return to shareholders, who are the source of the capital that underlies our stability and protects taxpayers.

Activities

A final area the Committee may want to consider is the need to ensure that any GSE reform legislation preserves our ability to bring innovative initiatives to the marketplace.

Under our charter, Freddie Mac cannot originate mortgages, and, let me assure you that we have no desire to exceed our charter authorities. Under current law, HUD must approve any GSE "new programs." This process is working: we keep HUD apprised of any initiatives that may require approval, and HUD has been vigilant in its review of our initiatives and activities.

If we are to fulfill our charter, however, we must be able to innovate and act nimbly to meet the needs of our customers and the market – as we did last summer when we quickly brought to market our new SafeStep^{SM} subprime alternative product. To ensure our continued ability to innovate to meet market needs, we would be concerned about a regulatory regime that is overly rigid and that seems more designed to protect our competitors than to ensure that we can continue to fulfill our mission.

In summary, Freddie Mac supports GSE reform legislation that strikes the appropriate balance between mission and safety and soundness. The present downturn in the housing markets reminds us again of the importance of the GSEs and the need to keep them strong and vibrant. The way to do that is to ensure that capital is tied to risk and that the affordable housing obligations make sense in all economic environments. Providing liquidity, affordability and stability is the mission Congress gave Freddie Mac 38 years ago, and we remain committed to doing our best to fulfill it.

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