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Statement of

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Before the U.S Senate Committee on Banking, Housing and Urban Affairs

"Housing Finance Reform: Fundamentals of Transferring Credit Risk in a Future Housing Finance System"

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Chairman Johnson, Ranking Member Crapo, and members of the committee, thank you for inviting me to appear today. I am Kevin Palmer, Vice President of Strategic Credit Costing and Structuring at Freddie Mac. I head the business unit with primary responsibility for the development and execution of the credit risk sharing transactions that are the subject of today's hearing.

In my statement, I summarize the risk sharing transactions we have undertaken to date, discuss the lessons we have learned from these transactions, and outline our future risk sharing plans.

I would like to highlight three points from my statement that I believe will be useful as you consider these issues:

- First, we have been very encouraged by strong investor interest in our credit risk sharing offerings to date. However, it is important to note that conditions today are highly favorable for investment in mortgage credit risk. We have seen from recent history that investors can and will leave the mortgage market when conditions are less favorable. So I caution that it will take some time to determine the level of long-term sustainable investor interest in mortgage credit risk sharing, particularly during market and economic downturns.

- Second, we have encountered a number of regulatory, tax and accounting issues that have either affected investor interest in participating in our credit risk sharing transactions or influenced our choices of particular structures for those transactions. We believe Congress should consider these and other similar issues as it determines the role that credit risk sharing instruments can play in any future housing finance system.

- Finally, we designed our credit risk sharing transactions to ensure they are cost effective and preserve forward markets.

Freddie Mac's progress under conservatorship

The Freddie Mac of today is not the company that existed prior to conservatorship. We have a new management team, including new chief executive officer, chief financial officer, general counsel, chief risk officer, chief compliance officer, chief administrative officer, head of human resources, and chief information officer. In addition, we have a new head of every business line: single-family, multifamily and investments. Most of these leaders are new to Freddie Mac, while a few are in new roles since conservatorship. At the same time, we have retained many employees with significant experience in and knowledge of the mortgage finance industry.

Freddie Mac is highly mindful and appreciative of the taxpayer support we have received. We are focused on using this support wisely and effectively to provide liquidity to the home mortgage market, help at-risk borrowers avoid foreclosures and fulfill the objectives of the conservatorship. Let me offer a few examples:

We helped more than 11 million families buy, refinance, or rent a home since 2009: Our mortgage purchases enabled 7.5 million families to refinance into lower interest rate home mortgages. For loans we refinanced during 2013, families are saving an average of $3,400 per year. We also funded home purchases for 1.9 million families and rental housing for 1.5 million families.

We helped 913,000 at-risk families avoid foreclosure since 2009: By preventing avoidable foreclosures, we not only help at-risk families but also stabilize and revitalize neighborhoods. More than 475,000 of these families received loan modifications, saving each family an average of $5,220 per year. We also are implementing a Federal Housing Finance Agency (FHFA) directive to substantially improve how servicers work with delinquent borrowers.

We implemented stronger credit standards, resulting in a significantly improved book of business: Our focus is on helping borrowers own homes that they can afford and keep. As of September 30, 2013, mortgages we purchased after 2008 comprise 73 percent of our single-family credit guarantee book of business but only 8.6 percent of our credit losses. Even with our preconservatorship book of business, Freddie Mac's single-family serious delinquency rate – 2.58 percent as of September 30 – is less than half the mortgage industry average of 5.88 percent (as of June 30).

By the end of 2013, we will have paid $71.345 billion in dividends to taxpayers: This slightly exceeds the $71.336 billion in U.S. Treasury funds we have drawn to date. As explained in our November 7, 2013 financial release, Freddie Mac's payment of dividends does not reduce the balance of prior draws of Treasury funds received, and Treasury retains a liquidation preference of $72.3 billion on Freddie Mac's senior preferred stock.

We could not have achieved these results without the support we have received from FHFA, Treasury and the American taxpayer. But these results also attest to the hard work, commitment, and expertise of our employees.

Credit risk sharing initiatives

Freddie Mac began analyzing mortgage credit risk sharing structures in early 2011 as a way of removing some of the risk on our books. This included studying both the economics and the operational issues involved in various risk transfer options and structures. This work helped prepare us for FHFA's directives in its 2012 and 2013 scorecards to begin undertaking credit risk sharing transactions. The 2013 scorecard set a target for us to undertake transactions involving single-family mortgages with at least $30 billion in unpaid principal balances. FHFA specified that we must conduct multiple types of risk sharing transactions to meet this target. Such transactions could include expanded mortgage insurance, credit-linked securities, senior/subordinated securities, and other structures. In addition to reducing our credit risk exposure, the risk sharing goal is also intended to bring more private capital into the market and demonstrate the viability of multiple types of risk transfer transactions involving single-family mortgages.

Freddie Mac has undertaken three such transactions during 2013. Our first transaction, announced in July, was an offering of Structured Agency Credit Risk (STACR) Debt Notes. We just settled a second STACR offering on November 12. Also on November 12, we entered into a reinsurance transaction. The aggregate unpaid principal balances of the mortgages involved in these three transactions will include more than $30 billion that we believe qualifies toward FHFA's scorecard.

Common to these three transactions are several objectives:

- Reduce Freddie Mac's, and therefore taxpayers', exposure to the credit risk of our mortgage purchases by transferring a portion of that risk to private investors.
- Bring new credit investors into the mortgage market.
- Create products that are scalable and sustainable over time.
- Preserve the cost efficiencies of a forward market.

STACR Debt Notes

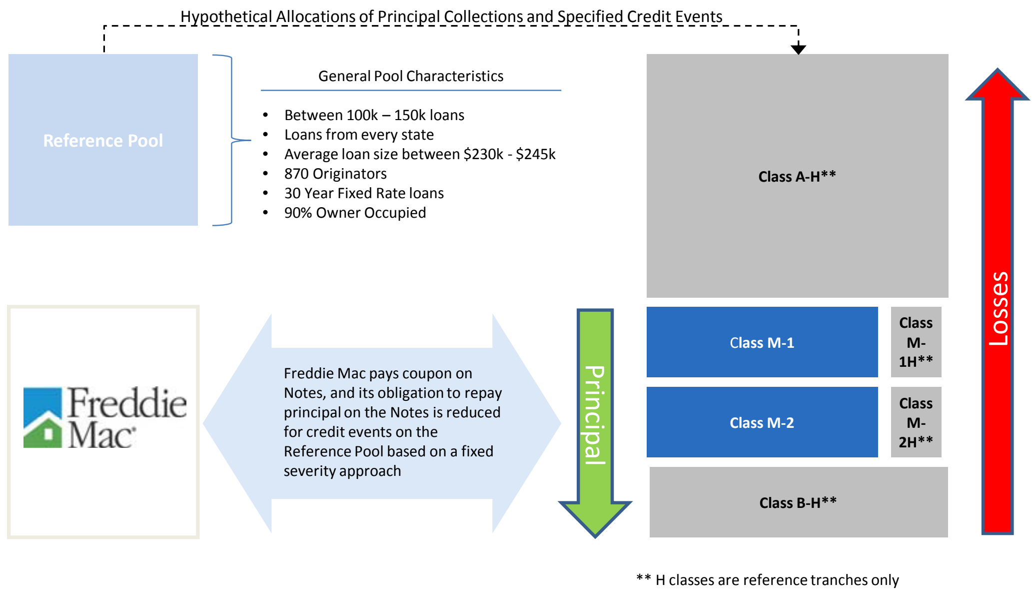
STACR Debt Notes allow Freddie Mac to transfer credit risk from recently acquired single-family mortgages to credit investors who invest in the notes. Interest and principal payments to investors are determined by the delinquency and principal payment experience on that group of newly guaranteed mortgages, known as a reference pool. Although structured as debt notes that are unsecured general obligations issued by Freddie Mac, the transaction is similar to a credit linked note, which allows us to take advantage of the cost efficiencies of the TBA market.

We structured STACR Debt Notes to attract investors by providing a large and highly diversified pool of loans in the reference pool. Diversification is attractive to credit risk investors because it reduces idiosyncratic risk stemming from concentration in specific geographical areas, in originator quality, and servicer practices. The reference pools for the first two offerings together included more than 200,000 high-quality loans, which are diversified based on geographical, originator, servicer and other risk factors, representing more than $50 billion in unpaid principal balance. These pools consist of a subset of 30-year fixed-rate single-family mortgages acquired by Freddie Mac in two recent quarters. Most other securities that transfer mortgage credit risk, by comparison, are based on a smaller pool of mortgages, generally less than 1,000 loans.

Freddie Mac remains the master servicer in the STACR transactions, retaining control of the servicing of the loans in the reference pools. This is beneficial because the loans will be subject to Freddie Mac servicing guidelines, allowing us to maintain our strong loss mitigation support to borrowers. The structure provides for a defined loss transaction – when a borrower is 180 days delinquent (behind by six months) the bond holder takes the defined loss. The structure also allows Freddie Mac to manage the assets of the pool after 180 days. Freddie Mac retains some risk exposure (at least five percent of the losses), assuring investors of our aligned interests. This "skin-in-the-game" is important for servicing and loss mitigation control. To further demonstrate our alignment of interest, Freddie Mac also retained the first loss risk position in the two STACR offerings. Retaining that first loss position helped investors get comfortable with this new type of credit risk sharing instrument, and helped make the structure more economically attractive.

Our first two STACR offerings received positive market responses. About 50 broadly-diversified investors participated in each offering, including mutual funds, hedge funds, REITs, pension funds, banks, insurance companies and credit unions.

STACR General Overview



Additionally, our STACR transactions had little or no impact on the TBA market. The TBA market provides the means for lenders to sell conforming loans into the secondary market before they are originated. This enables lenders to better manage the risks of 30-year, fixed-rate loans and allows borrowers to lock in mortgage rates up to 90 days in advance of closing.

What we have learned from our STACR offerings

Based on our initial STACR offerings, we can identify several issues and challenges:

Limits to investor appetite: While our initial offerings received positive market responses, this does not guarantee that future offerings will receive equal levels of investor interest. Investor appetite for a particular asset class at any given time depends on a variety of factors, including broad economic and market conditions and returns offered by other asset classes. Our first two STACR offerings took place during very favorable conditions for investing in mortgage credit risk. For example, house prices are generally appreciating and credit quality is high by historical standards. As we have seen from recent history, investors will leave the mortgage market when risks and returns are less favorable. While we believe we are well on the road to creating an attractive and scalable investment product, it will take some time to determine the level of long-term sustainable investor interest in STACR Debt Notes as an asset class, particularly during market and economic downturns.

Credit ratings: Our first transaction was not rated by a rating agency. In the course of structuring it, we found investors had differing views over the need for a rating. In the end, we decided against obtaining a rating because doing so would have slowed our ability to complete two transactions this year. This somewhat limited investor participation and impacted the pricing on the first transaction. In the second transaction, one of the two tranches was rated Investment Grade by Moody's and Fitch. The pricing on this transaction was substantially improved. While we attribute most of this improvement to greater market acceptance and familiarity with STACR Debt Notes, obtaining a credit rating also helped.

Tax treatment: Current tax laws affect investor interest in STACR transactions. Real Estate Investment Trusts (REITs), for example, must primarily invest in real estate assets, including interests in mortgages. Because the STACR transactions were general obligation debt issuances and not secured by interests in mortgages or real estate assets, they did not qualify as real estate assets for REIT purposes. While STACR Debt Notes could be held by REITs, there are restrictions on the amounts. Also, Real Estate Mortgage Investment Conduits (REMICs) cannot hold STACR Debt Notes as collateral because the notes are not secured by real property or interests in mortgages and are not interests in mortgages secured by real property.

Accounting treatment: Investors in STACR Debt Notes will mark their investments to market under accounting rules, and this will discourage some investment in them. Some large investors, such as insurance companies, are not interested in assets that are marked-to-market because this would create additional income statement volatility. Freddie Mac also faces increased income statement volatility from mark-to-market treatment of our STACR issuances.

Regulatory hurdles: A Commodity Futures Trading Commission (CFTC) regulation played a role in our decision to structure STACR Debt Notes as an unsecured general obligation instead of a credit linked note. That regulation requires Freddie Mac to register with the CFTC as a Commodity Pool Operator and a Commodity Trading Advisor or to seek a no action letter from CFTC in order for us to issue credit linked notes. Registering with the CFTC likely would have required us to create a subsidiary company – a complicated matter given our being in conservatorship. Further, if we were to seek a no action letter as issuer, our understanding is that some investors would be required to register with the CFTC or require a no action letter in order to purchase credit linked notes we would issue. CFTC's rule did not anticipate this type of offering, and changes to the rule would help. In the meantime, Freddie Mac, in concert with FHFA, continues to work with CFTC to ensure our full compliance.

Our experiences with these tax, accounting and regulatory issues suggest that policymakers, in the course of legislating housing finance reform, should carefully consider how these and other similar issues can affect the ability and willingness of private investors to assume mortgage credit risk.

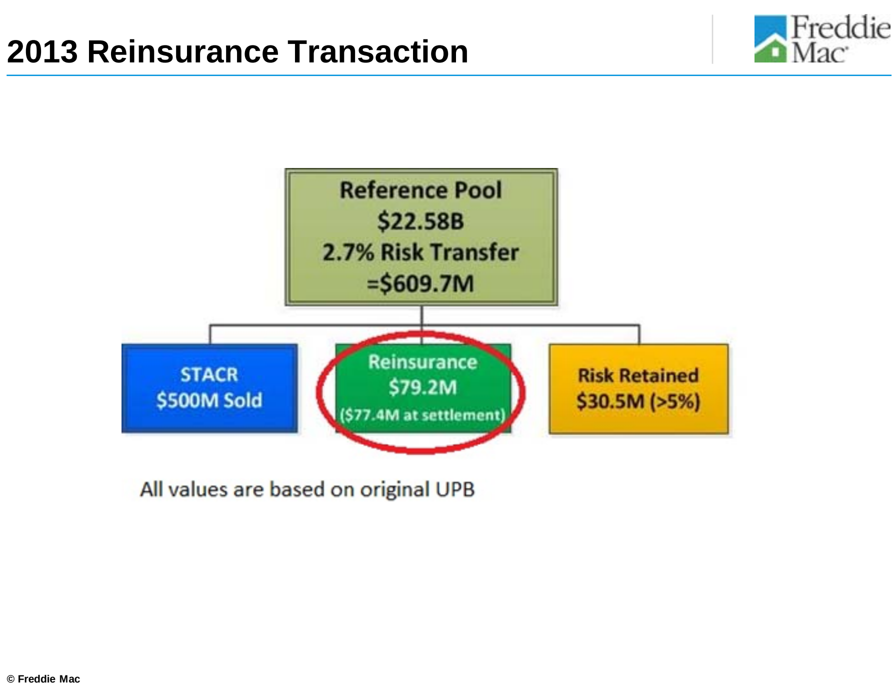
Despite these challenges, we believe Freddie Mac's STACR transactions to date have met our objectives and help us meet FHFA's scorecard objectives for 2013.

Reinsurance transaction

Freddie Mac announced on November 12 that we had entered into a reinsurance-based credit risk sharing transaction. We obtained an insurance policy underwritten by Arch Reinsurance Ltd. to cover up to $77.4 million of credit losses for a portion of the credit risk Freddie Mac retained from the reference pool in the first STACR transaction. The transaction with Arch enabled both parties to leverage this reference pool, and the associated disclosures and due diligence.

This new insurance coverage is intended to attract new sources of private capital from non-mortgage guaranty insurers and reinsurers interested in assuming a portion of the credit risk on specified portions of our single-family mortgage loan portfolio. Reinsurance companies are large diversified companies that specialize in managing a variety of risks. Freddie Mac regards reinsurance companies as a promising new source of capital for mortgage credit risk transfer.

Our experience with conducting this first reinsurance transaction has led us to conclude that there is interest at this time for US mortgage credit exposure among the reinsurance community. Accordingly, we see potential to build a risk sharing product targeted at reinsurance companies that meets our objectives of transferring credit risk, bringing new investors into the market, creating repeatable and scalable products, and preserving the cost efficiencies of the TBA market. Of course, the level of long-term sustainable interest by reinsurance companies in mortgage credit risk sharing transactions, particularly during market and economic downturns, remains to be seen.



Risk sharing plans going forward

In addition to conducting additional STACR and reinsurance transactions, we are looking at two other options for credit risk transfer. The first is risk retention by mortgage originators who sell mortgages to us through recourse agreements. The key challenge to recourse transactions is that sellers retain these obligations on their balance sheets. This has regulatory capital consequences for regulated financial institutions.

A second option we are exploring is a senior-subordinate securitization. While doing this type of securitization would not allow for TBA securitization on these loans under current rules, this structure is common, particularly for jumbo and other nonconforming loans.

Conclusion

As Congress determines the future structure of the housing finance system, Freddie Mac will remain focused on providing liquidity to the home mortgage market, helping at-risk borrowers avoid foreclosures and protecting taxpayers' investment in the company. This includes working with FHFA to develop new and innovative approaches and products to transfer credit risk from taxpayers to private investors.

Thank you again for this opportunity to appear today.