STATEMENT OF GEORGE D. GOULD

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FREDDIE MAC

BEFORE THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

HEARING ON PROPOSALS FOR IMPROVING THE REGULATION OF THE HOUSING GOVERNMENT-SPONSORED ENTERPRISES

OCTOBER 16, 2003

Thank you, Chairman Shelby, Ranking Member Sarbanes and members of the Committee. Good morning. It is a pleasure to be here today. My name is George Gould.

I have served on Freddie Mac's board since 1990 and am currently the Presiding Director and Chairman of the Governance and Finance Committees. I am also vice chairman of Klingenstein, Fields & Company, a firm that manages individual assets and estates. Prior to joining this firm, I served as Undersecretary for Finance at the Department of Treasury from 1985 to 1988. At the request of President Reagan, I chaired the Working Group on Financial Markets to examine the effect of the October 19, 1987 stock market crash.

I welcome the opportunity to be here today to discuss key aspects of a strengthened regulatory structure for Freddie Mac and Fannie Mae. Freddie Mac plays a central role in financing homeownership and rental housing for the nation's families. Our job is to attract global capital to finance America's housing. Given the importance of housing to our economy, and the importance of housing finance to global capital markets, it is critically important that our regulatory structure provide world-class supervision. Hence, I would like to recognize Senators Hagel, Corzine, Sununu and Dole for their legislative efforts in this regard. We commend them for helping to get these important discussions off the ground.

Before expressing our views on specific proposals, I would like to say a few words about the resolution of Freddie Mac's accounting issues and steps we are taking to ensure these problems never occur again. I would also like to recount Freddie Mac's long track record supporting strong, credible regulatory oversight.

Resolution of Accounting Issues

On January 22, 2003, Freddie Mac announced, in conjunction with our new independent auditor, PricewaterhouseCoopers, the need to restate earnings for 2000, 2001 and 2002. In our June 25, 2003 press release we described the major factors leading to the need to restate earnings, a copy of which is provided for the record. In stark contrast to other recent corporate restatements, we expect Freddie Mac's restatement to show a large cumulative *increase* in earnings for the prior years. As we announced last month, we expect to release restated earnings for prior years in November. We deeply regret this delay, which was largely due to a systems error uncovered during the final validation of results.

While the restatement will represent an important milestone, we remain determined to bring our financials completely up to date as quickly as possible. Once we resume timely reporting of our financials next year, we will proceed with our commitment to complete the process of voluntarily registering our common stock with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 so that we become a reporting company under that Act. We are irrevocably committed to the voluntary agreement we announced last summer to submit to the periodic financial disclosure

reporting requirements that apply to registrants. Freddie Mac reaffirmed this commitment in a letter to Treasury Secretary John Snow on July 14, 2003.

I would like to briefly mention steps we are taking to ensure problems like these never happen again. While the Board has taken many important steps to date, I will be the first to acknowledge that more can be done –and *will* be done.

First, the Board is extremely "hands on" with regard to getting the restatement done – and getting it done right. The committee responsible for overseeing the restatement has met weekly since March, and the Board is in constant communication with management. We are also overseeing the implementation of a comprehensive remediation plan.

Second, we are moving aggressively to address weaknesses in our disclosures and related processes. We've added highly qualified accounting personnel and we're working to strengthen our control infrastructure. In addition, we've brought in independent experts to review best practices and propose remediation. For example, we've engaged former SEC Division of Corporation Finance chief David Martin to help us with disclosure. The Board is fully committed to implementing his recommendations, as well as those of other independent experts.

Regulatory Oversight Structure

Freddie Mac has long supported strong regulatory oversight. In October 2000, Freddie Mac and Fannie Mae announced a set of public commitments to ensure that the two GSEs remain at the leading edge of financial risk management and risk disclosure. These commitments, which I will describe in greater detail below, continue to represent a high standard that few other financial institutions can meet.

In May 2001, we appeared before a Senate subcommittee and announced we had implemented five of the six commitments, with the sixth being implemented the following month. In June 2001, we testified before a House subcommittee that a strong regulator is essential to maintaining the confidence of the Congress and the public that we can meet our mission. We outlined key principles for effective regulatory oversight and pledged to work with the Congress in that regard. Those principles are as follows:

- First, the regulator must be highly credible. We continue to firmly believe that the GSE regulator must have supervisory expertise, be adequately funded and be independent in its judgments. Credibility is absolutely fundamental to the continued confidence of the Congress, the public and the markets.

- Second, the regulator must support housing. Not only is housing an important public policy objective, it has been an economic powerhouse for the past several years. The necessity of expanding affordable housing opportunities is more urgent than ever. Over the next 10 years, America's families will need an additional $8 trillion to fund their mortgages. By innovating new mortgage

products and new mortgage investment vehicles, Freddie Mac will open doors for the homebuyer of the future, who is more likely to be a low-income, minority or immigrant family, eager to realize the American dream. We continue to work diligently to fulfill our commitment to President Bush to significantly expand the number of minority homeowners by the end of the decade.

- Third, and very importantly, the regulator must enjoy strong bi-partisan support. In this regard, I would like to commend Chairmen Shelby and Oxley for the joint statement they recently issued. In the statement, they pledged to seek a timely bi-partisan resolution of questions relating to regulatory restructuring.

With these principles in mind, today I will comment briefly on key aspects of the regulatory structure under consideration in this Committee. The Committee has requested our views on a number of issues, starting with regulatory structure and independence.

Structure and Independence

Freddie Mac would strongly support the creation of a new regulatory office within the Department of the Treasury, if Congress were to determine that this would enhance our safety and soundness oversight. We recommend that the new regulator have a Director appointed by the President, with the advice and consent of the Senate, for a five-year term of office.

To ensure that the new regulator is able to exercise independent judgment, we would support applying the same operational controls as apply to the relationships between the Secretary of the Treasury and the Office of the Comptroller of the Currency and the Office of Thrift Supervision.[1] It is difficult to justify why the GSE regulatory structure should differ so strikingly from other regulators – at the risk of politicizing our mission and the critical role we play in global financial markets.

Funding of New Oversight Offices

We also are prepared to support providing both the new regulator and the Secretary of HUD authority to assess Freddie Mac outside the annual appropriations process to pay for the costs and expenses of carrying out their respective responsibilities vis-à-vis the GSEs. Additionally, we recommend that the General Accounting Office regularly report to the Congress on the efficacy of the new regulatory structure and the reasonableness of the costs relative to other world-class financial regulators so that neither unnecessarily raise the cost of homeownership.

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

Capital Adequacy

Adequate capital is the touchstone of investor confidence and is key to our ability to attract low-cost funds to finance homeownership in America. Freddie Mac's regulatory capital requirements incorporate two different measures: a traditional (leverage) capital requirement and a risk-based capital stress test that requires Freddie Mac to hold capital sufficient to survive 10 years of severe economic conditions. Freddie Mac consistently has exceeded both stringent capital standards.

Freddie Mac's capital requirements were developed in keeping with our charter, which restricts us to lower-risk assets than banks. Since 1994, charge-off losses at the five largest banks have been, on average, 17 times larger each year than charge-offs at Freddie Mac. Even in these banks' *best* year, charge-offs were more than five times higher than Freddie Mac's *worst* year.[2] Limiting the comparison to mortgage assets, the residential mortgages found in bank portfolios typically entail greater risk than those in Freddie Mac's portfolio. Banks tend to hold a higher proportion of second mortgages, adjustable rate mortgages, subprime mortgages, and uninsured mortgages with high loan-to-value ratios. These historically present greater risk than the fixed-rate conforming loans that are the core of Freddie Mac's business. In 2002, FDIC-insured institutions had an average charge-off rate of 11 basis points on their mortgage portfolios, compared to 1 basis point for Freddie Mac.[3]

In addition to our low exposure to mortgage credit risk, Freddie Mac maintains an extremely low interest-rate risk profile. Our risk management framework has performed exceptionally well through a number of challenging interest-rate cycles – and recent months are no exception. Despite the most turbulent market environment in eight years, our average monthly duration gap was just one month in July. Maintaining a low-risk profile that is durable through time is the hallmark of Freddie Mac's disciplined approach to managing interest-rate risk.

Given this lower risk exposure relative to banks, we agree with Secretary Snow's testimony before the House last month that the GSE minimum capital requirement is adequate and need not be changed. The GSEs' minimum capital requirements are commensurate with our lower risk profile and the limitations of our charter. In addition, our rigorous risk-based capital stress test ensures that our risks remain low throughout a sustained period of severe economic conditions. According to an analysis prepared by L. William Seidman, former chairman of the FDIC, the stringent risk-based capital standard applicable to Freddie Mac could be extremely challenging if applied to most other

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

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

financial institutions.[4] More recently, the CapAnalysis Group, LLC, concluded that the risk-based capital stress test is "a much more stringent test for judging the safety and soundness of a financial institution than is a traditional capital-requirements test."[5]

Regulator Discretion on Risk-Based Capital

Conclusions about appropriate capital determinations will continue to evolve in the years ahead. Accordingly, our regulator must have adequate discretion to ensure that Freddie Mac's capital standard keeps pace with these developments. Although the basic parameters of the risk-based capital stress test are set in law, our present regulator has significant discretion in adjusting the risk-based capital requirements. Additional discretion, such as provided to federal banking agencies, could help ensure the GSE risk-based capital standard remains at the forefront of financial sophistication, while continuing to tie capital to risk.

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

We also believe the new regulator should be encouraged to gather information over the entire business cycle before making changes. This could be accomplished by requiring that the current rule remain in place for a period of time and expressing congressional intent to this effect. When a new rule appears warranted, policymakers should ensure that certain fundamental principles remain firmly intact. Any future capital standard must continue to:

- Tie capital levels to risk
- Be based on an analysis of historical mortgage market data
- Remain operationally workable and as transparent as possible; and
- Accommodate innovation so the GSEs can carry out their missions.

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

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[4] L. William Seidman, et al., Memorandum to Freddie Mac, March 29, 2000.
[5] The CapAnalysis Group, LLC, OFHEO Risk-Based Capital Stress Test Applied to U.S. Thrift Industry (March 17, 2003), p. 1.

In summary, Freddie Mac supports granting the regulator greater discretion to set risk-based capital levels that accurately reflect the risks we undertake. However, changing risk-based capital standards unnecessarily, capriciously or frequently will reduce the amount of mortgage business the GSEs can do, resulting in higher costs for homeowners and renters.

Mission Oversight and New Program Approval

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

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

Supervisory and Enforcement Parity

The current legislative structure provides our safety and soundness regulator an array of supervisory and enforcement authorities to ensure that Freddie Mac is adequately capitalized and operating safely.[6] If Congress were to deem it appropriate, we would support providing the GSE safety and soundness regulator authorities similar to those accorded to the federal banking agencies. These enhanced powers would include broadening the individuals against whom the regulator could initiate cease-and-desist proceedings; new authority to initiate administrative enforcement proceedings for engaging in unsafe and unsound practices; new removal and suspension authority and authority to impose industry-wide prohibitions; and new authority to assess civil money and criminal penalties.

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

Conservatorship

In the unlikely event of extreme financial distress, we believe conservatorship is the right approach. Although we believe that current law provides ample convervatorship powers, we would be willing to consider whether additional authorities could enhance Congress' and the public's confidence in our safe and sound operation. We agree with Secretary Snow's testimony before the House that steps beyond potential enhancements to conservatorship would appropriately be left to the Congress and not to the GSE regulator.

Market Discipline Commitments

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

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

- Maintenance of at least 5 percent of on-balance sheet assets in liquid, marketable, non-mortgage securities and compliance with the Basel Committee on Banking Supervision Principles of Sound Liquidity Management, which requires at least three months' worth of liquidity, assuming no access to new issue public debt markets. Because of the critical importance of liquidity to the achievement of our mission – and the importance of non-mortgage assets to this liquidity – the GSEs' non-mortgage assets should not be singled out for onerous regulatory treatment.

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

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

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

In July 2002, the GSEs made an additional commitment to voluntarily register their common stock with the Securities and Exchange Commission under the Securities Exchange Act of 1934 so that both companies will become reporting companies under that law. Freddie Mac is fully committed to completing this process as soon as our financial statements are brought up to date.

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

Affordable Housing Goals

I would now like to say a few words about mission oversight. Freddie Mac's mission is to ensure a stable supply of low cost mortgages for America's families – whenever and wherever they need them. This mission defines Freddie Mac and what we are trying to accomplish. Our business model flows directly from our congressional charter, which requires us to focus exclusively on financing residential mortgages.

Meeting the annual affordable housing goals is a key aspect of our meeting our mission. Established in 1993 and increased in 1995 and 2000, the three affordable housing goals specify that significant shares of Freddie Mac's business finance homes for low- and moderate-income families and families living in underserved areas. In 2000, HUD specified that 50 percent of Freddie Mac's mortgage purchases must qualify for the low- and moderate-income goal,[7] 31 percent must be of mortgages to borrowers in under-served areas,[8] and 20 percent must be of mortgages to low- or very-low income borrowers or those living in low-income areas.[9] Freddie Mac has successfully met all the permanent housing goals, which are the highest and toughest of any financial institution.

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

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

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

Conclusion

Freddie Mac has long supported strong regulatory oversight. It is critical to the achievement of our mission. As we have stated on previous occasions before the Congress, our core principles for the creation of a new regulatory structure are credibility, commitment to the GSE housing mission and a high degree of bi-partisan support.

As I have outlined today, Freddie Mac is prepared to embrace significant enhancements that will make our regulatory structure stronger, in many cases, than the bank regulatory model. Building these new enhancements into existing law would give the new GSE regulator comparable supervisory and enforcement powers as bank regulators. In addition, it would impose tougher regulatory requirements in many areas, including program approval standards and a risk-based capital stress test. Our mission regulator would continue to oversee the most challenging, quantitative affordable housing goals in the industry – with tremendous powers to enforce them. Taken together, this enhanced GSE regulatory structure is strong, solid and credible. It is key to maintaining the confidence of the Congress and the public that we can meet our vital mission while remaining at the forefront of capital and risk management.

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