REVIEW OF THE VOLUNTARY AGREEMENT BY FANNIE MAE AND FREDDIE MAC

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON
FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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REVIEW OF THE VOLUNTARY AGREEMENT BY FANNIE MAE AND FREDDIE MAC

TUESDAY, MARCH 27, 2001

U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES
Washington, DC.

The subcommittee met, pursuant to call, at 2:05 p.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker, [chairman of the subcommittee], presiding.

Present: Chairman Baker; Representatives Oxley, Ney, Shays, Bachus, Jones, Weldon, Biggert, Ose, Hart, Kanjorski, S. Jones, Sherman, Meeks, Ford, Hinojosa, Lucas, Shows, Crowley, Israel and Ross.

Chairman BAKER. I'd like to call this hearing of the Capital Markets Subcommittee to order and welcome our witnesses to the table. And I would like to note that there were Members present before the Chairman, who was 5 minutes late because an unnamed airline was 3 hours late leaving my fine city this morning. But I did make it. We can take a look at that maybe later.

I do welcome my participants to the hearing this morning. This hearing is pursuant to an agreement reached last October with the Government sponsored enterprises of Fannie Mae and Freddie Mac, both of whom had been the subject of study over the course of the last year with a series of hearings and meetings with Members concerning the accuracy of current regulatory oversight and appropriate overview of their business operations, given the relationship between their business success and the United States taxpayers.

Last fall, there was an important six-point plan publicly agreed to in which the CEOs of both Fannie Mae and Freddie Mac appeared and expressed support for this initiative, and second, a willingness to work with the committee this session on the construction of a new regulatory oversight body.

The purpose of the hearing today is to receive testimony from representatives of both enterprises regarding the compliance success with the terms of that agreement since last October.

I certainly am pleased to have read their published reports of the success of implementation to date. I'm looking forward to a more detailed discussion and feel that this is an extraordinarily important first step that we have taken to ensure the safety and soundness of these two very important business enterprises.

For Members of the subcommittee who have not been engaged in this topic previously, these institutions are the third and the seventh largest corporations in America by SSIs, are extremely important in providing liquidity in the home ownership market, and have for many decades been the reason for facilitating access to home ownership to many individuals otherwise without such opportunity.

So they perform excellent work. They are today, as I said in all prior meetings on this subject, well managed, highly profitable, successful enterprises. But our mission on this subcommittee must be to have the long-term view and to ensure that appropriate oversight is in place and remains in place in the unfortunate circumstance of a downturn in our economy and spiraling interest rates and a softening of loan demand, we want to ensure that the adequacy of these financial enterprises is sufficient to withstand such troubling times.

Hence, the reason for the agreement of last fall, the hearing today, and the work ahead of the subcommittee for the next several months with regard to the regulatory structure.

At this time I would like to recognize Mr. Kanjorski for an opening statement.

[The prepared statement of Hon. Richard H. Baker can be found on page 44 in the appendix.]

Mr. KANJORSKI. Mr. Chairman, before commenting further on today's proceedings, I must commend you for your continuing leadership on Government sponsored enterprise issues. In the 106th Congress, in addition to passing legislation to modernize the Federal Home Loan Bank system, we held hearings over 5 days and roundtable discussions on legislation designed to reform the regulation of housing GSEs and eliminate some of their statutory benefits. Although that bill did not become law, it did help lead to the development of six voluntary commitments by Fannie Mae and Freddie Mac, the subject of today's hearing. You deserve congratulations for playing an important role in raising public awareness about these issues.

During our lengthy hearings last year on GSE regulation, I believe we reached consensus on several points.

First, we agreed that we have the world's most successful housing finance system and we gained an appreciation of the important role that GSEs play in that system.

Second, we agreed that Fannie Mae and Freddie Mac have grown significantly in recent years.

Finally, we agreed that we must have strong, independent regulators for the housing GSEs. These regulators must also have the resources they need to get the job done.

As one of the few remaining committee Members who participated in the entire Congressional dialogue to resolve the savings and loan crisis, I am acutely aware of the need to protect taxpayers from risk.

It is in the public's interest to ensure that Fannie Mae and Freddie Mac continue to operate safely and soundly. We can best achieve this goal by pursuing a three-pronged supervisory approach that includes regular Congressional oversight, continued effective

Government regulation, and increased market discipline for the two GSEs.

Through our extensive studies last year and our hearings today, we are fulfilling our obligations in Congress to conduct regular oversight of the GSEs.

In addition, from my perspective, OFHEO operates with increasing effectivness as the safety and soundness regulator for Fannie Mae and Freddie Mac.

The agency has, for example, developed and implemented a robust, comprehensive and continuous examination program that works. And it will soon publish its long-awaited risk-based capital standard rounding out the existing capital standards.

The voluntary commitments recently developed by Fannie Mae and Freddie Mac promoting market discipline completes the third leg of my supervisory tripod.

By strengthening capital adequacy and increasing transparency, the overall package, in my view, constitutes a sound set of measures to supplement OFHEO's formal regulatory regime and augment Congressional oversight.

The voluntary commitments are also consistent with the prevailing thinking of leading risk management specialists.

At our October press conference on the voluntary commitments, I noted that the initiatives, when implemented, would hopefully become a complement to and not a substitute for OFHEO's already strong safety and soundness examination program and capital requirements.

In that vein, I asked OFHEO to review the regulatory environment surrounding the voluntary measures in advance of today's hearing. In response, Director Falcon notes that these enhanced disclosures improve the public's awareness of Fannie Mae and Freddie Mac's financial condition and risk management practices.

I agree and would ask, Mr. Chairman, unanimous consent to submit this letter for the record.

Chairman BAKER. Without objection.

[The material referred to can be found on page 54 in the appendix.]

Mr. KANJORSKI. If we once again decide to pursue legislative action affecting the GSEs in the 107th Congress, we must be sure not to diminish their ability to work efficiently.

In my view, we should also explore modernizing their mission. For example, the GSEs could work to improve economic development in our Nation's distressed areas or to create a secondary market for investments made pursuant to the Community Reinvestment Act. These worthy ideas merit our prudent consideration.

Finally, throughout last year's deliberations on GSEs, I consistently noted that we must move forward cautiously in this area so as to ensure we maintain the delicate balance that has lead to more than 67 percent of all American families owning their homes.

On at least one occasion last year, however, our committee's actions discouraged investors and raised home ownership costs. As we proceed today, we must renew our efforts to ensure that we do not repeat that mistake.

Mr. Chairman, I therefore look forward once again to carefully, deliberately and objectively examining the many issues relating to housing GSEs in the 107th Congress.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 52 in the appendix.]

Chairman BAKER. Chairman Oxley.

Mr. OXLEY. Thank you, Mr. Chairman. Many Members of our subcommittee are taking on an important issue for the first time. Government sponsored enterprises, better known as GSEs, is one of those issues, and I'm pleased that we are having this hearing today so that Members have an opportunity to learn about the vital role the GSEs play in our housing finance system and overall economy.

Expanded home ownership is a top priority for all of us. Congress created Fannie Mae and Freddie Mac to broaden consumer access to mortgage credit. Fannie and Freddie developed a secondary market for conventional mortgages, and then a wider market for mortgage securities.

Fannie and Freddie have greatly advanced their housing mission and are a real success story. In order to continue benefiting America's families, Fannie Mae and Freddie Mac must operate according to the highest standards. They are two of the leading financial institutions in this country, and they occupy a central role in the mortgage and capital markets.

Fannie and Freddie are well managed, highly sophisticated businesses. However, in light of their size and growth, a number of concerns have been raised. These include the adequacy of their supervision, the nature of their mission, and the risk they could pose to the financial system in the event of a downturn.

The voluntary agreement reached last October addresses many of these concerns. And I congratulate you, Mr. Chairman, for your leadership, as well as Ranking Member Kanjorski, on this meaningful and timely agreement.

The commitments to meet higher capital, risk management, and disclosure standards are impressive and commendable, and I look forward to hearing from the witnesses about the specifics of those commitments, the progress they have made in implementing them, and their future plans.

In addition, we should take a look at the existing framework for regulating Fannie Mae and Freddie Mac. We should consider whether the current division of regulation between OFHEO and HUD ought to be streamlined, and whether the regulators have the powers they need to be effective.

More effective regulation, along with improved market discipline resulting from the voluntary agreement, could give Congress and the markets even greater confidence in Fannie and Freddie.

Mr. Chairman, I look forward to this subcommittee's responsible oversight of the GSEs, and I yield back.

[The prepared statement of Hon. Michael G. Oxley can be found on page 60 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Chairman, for your interest and participation today. Are there other Members with opening statements?

Mr. Ney.

Mr. NEY. Thank you, Mr. Chairman.

Chairman BAKER. I'm sorry. I should go to the other side.

Ms. Jones, did you care to make an opening statement?

Ms. JONES. Thank you, Mr. Chairman. Good afternoon, Mr. Chairman and Ranking Member Kanjorski and Members of this subcommittee. I ask unanimous consent that my full statement be included in the record.

Chairman BAKER. Without objection, as will all Members' statements be included in the record.

Ms. JONES. We are here again this afternoon to review voluntary agreements that were established to improve capitalization information disclosure and market discipline.

Many of us on this subcommittee remember and sat through six GSE hearings and then to examine in great detail Fannie Mae and Freddie Mac.

From those hearings, we examined their safety and soundness to an exhaustive length, and I must note, at no time did we find there to be any safety and soundness issues.

Both Fannie Mae and Freddie Mac pledged themselves to six voluntary commitments, which we will review today and I won't go through them. I'm proud to hear of their progress made by both, and in stepping up to the challenge and demonstrating that they're both solid and sound institutions. Their success is America's success.

I hope our review this afternoon will allow Fannie Mae and Freddie Mac to continue to fulfill their housing mission and do what they do best. Their mission is an important mission, and I am not as concerned about market share, but I am concerned about affordable housing in the 11th Congressional District, home ownership for those still seeking a piece of the American Dream, and also special housing needs of the elderly.

Housing is still a key public policy concern for all of us.

GSEs were established to address many of these problems, and all I say is, let them do their job. Again, if it ain't broke, why fix it? Let Fannie Mae and Freddie Mac continue to lead the mortgage finance industry in making credit available for low- and moderate-income families.

I want to skip on just to the closing of my opening statement, Mr. Chairman, to say that I hope that our review this afternoon serves to clear the record about GSEs' safety and soundness. I realize that there is much more to be done by these organizations.

While home ownership rate sits at around 67 percent, and some say is close to being saturated, there is still room for improvement for those who are left out of this Nation's prosperity.

For example, African Americans are still under 50 percent—47.8 percent in home ownership. And the Hispanic community is also under 50 percent—some 47.5 percent. That's not saturation, Mr. Chairman.

I thank you for the opportunity to present my remarks, and I look forward to an opportunity to be heard in this hearing.

Thank you.

[The prepared statement of Hon. Stephanie T. Jones can be found on page 49 in the appendix.]

Chairman BAKER. Thank you.

Mr. Ney.

Mr. NEY. Thank you, Mr. Chairman and Ranking Member Kanjorski for calling this hearing this afternoon. I didn't serve on the Capital Markets Subcommittee during the 106th, but I did take note of the good work that you did.

You are being commended for your thorough oversight of Fannie Mae and Freddie Mac. There can be no doubt of the important role that these two companies play in helping to provide affordable housing for all Americans.

In the 18th District that I represent, Freddie Mac has provided hundreds of millions of dollars of loans averaging $78,200 as the average loan. Fannie Mae has invested a total of $759 million over its lifespan. This has made home ownership dream a reality for many of my constituents in Appalachia.

In light of these questions, however, that were raised in the 1992 GSE reforms that were passed following the savings and loan disaster, Fannie and Freddie made six voluntary agreements with Congressman Baker, our Chairman, last year designed to strengthen safety and soundness of GSEs by increasing the market transparency.

These agreements brought new levels of transparency to the operations of these companies and exceed standards to which almost all the private companies are held.

This hearing, of course, is designed to follow up on these agreements and see if they have served the purpose of showing that market disclosure can give us the assurances we need to trust that Fannie Mae and Freddie Mac continue to fulfill their role of providing affordable housing to all Americans while remaining the Nation's stable institutions in which we place our trust and faith.

So far, both Fannie and Freddie have been diligent in following both the spirit and tenor of the voluntary agreements. The lengths to which they have gone to meet these six voluntary agreements is commendable, and I look forward to hearing the details of the implementation of the six voluntary agreements.

I also look forward to the discussion on the impact of market discipline on safety and soundness.

Again, thank you, Mr. Chairman and Ranking Member for this hearing.

Chairman BAKER. Thank you very much, Mr. Ney. Are there are other opening statements?

Mr. Meeks.

Mr. MEEKS. Thank you, Mr. Chairman and Ranking Member Kanjorski.

Home ownership is a key factor in asset and wealth creation for individuals all over the world. For many Americans, a home is the most significant purchase and/or investment they will ever make. Increasing home ownership opportunities for my constituents is a major component to my economic development initiatives.

In fact, we go around the district urging the constituency to rent the car, but own the house, and we teach them that owning the house is an appreciating asset, while owning the car is just a depreciating asset.

This is one of the reasons why I'm organizing a Congressional Black Caucus housing summit in my district in May.

Of all the bills and all of the questionable legislation that Congress has passed, the creation of GSEs—Fannie Mae, Freddie Mac and the Federal Home Loan Bank—was one of its wisest and most effective laws. By creating a secondary market for the mortgage industry, they have increased the supply of cash available to their banking partners while at the same time decreasing the credit risk to banks, making them more willing to extend credit to many individuals and families seeking inclusion in the American Dream.

The creation and work of the GSEs are critical factors in American's nearly reaching a 70 percent rate of home ownership. Fannie Mae and Freddie Mac have also had a significant impact on ownership in minority communities.

In the year 2000, Fannie Mae and Freddie Mac assisted over 500,000 minority families with nearly $60 billion in financing. Yet for all the good that has been done, including a nearly 5 percent increase in minority home ownership since 1994, minority home ownership is still lagging the national rate by some 20 percent.

I expect the GSEs, their lending partners and the Members of this subcommittee to work together on rectifying this inequity.

I have reviewed the voluntary initiatives that Freddie and Fannie Mae agreed to last year as well as the progress they have made toward implementing them. By meeting each of the six initiatives, Fannie and Freddie will provide increased public confidence in their already well managed and financially profitable companies and hopefully allay most of the concerns some of my colleagues have about their role in the home mortgage industry.

Many of these initiatives exceed the best practices of any of the Nation's most successful financial institutions. Perhaps these initiatives will set a new national and international standard for risk management and disclosure to help us to avoid any future S&L-type debacles.

I look forward to learning more about Fannie Mae and Freddie Mac's progress in achieving the initiatives and working with them to maximize the success of their mission.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Meeks.

Mr. Bachus.

Mr. BACHUS. Thank you, Mr. Chairman. First of all, I want to commend you, not so much for having this hearing, but for fashioning the voluntary agreement last year, which—we're here to look at the progress of that agreement.

So had it not been for your leadership, we wouldn't be here today talking about the progress that's been made.

Chairman BAKER. You're kind in describing it in those terms. Others have different opinions.

Mr. BACHUS. And I think all our goal, oversight goal, is to see that Fannie and Freddie and the other GSEs are properly, adequately capitalized; that there is market discipline and there is transparency in disclosure. That helps the consumer. It helps the taxpayer. It helps the GSE, and it is good for the country.

I would add that over the last several decades, Fannie Mae and Freddie Mac have really shaped the secondary mortgage market by providing adequate liquidity. They have done a great job in improving the distribution of investment capital for residential mortgage financing, and we really have the best financing system in the world for residential mortgages.

If you went to Europe, you couldn't even get a 30-year mortgage. They are not available. So they have done a commendable job.

We've got the highest rate of home ownership in the world, the highest rate ever in this country. And individual consumers I believe saved several thousand dollars a year because of what was initially a Congressionally chartered effort.

I do know that there has been some criticism of the GSEs because of their Government sponsorship. But I would think to a great extent, these advantages are offset with serious regulatory restrictions and affordable housing mandates that we have put on these GSEs that other "private sector" entities don't have. And I think we ought to keep that in mind.

Although Freddie and Fannie did have a 30-year record of managing the secondary mortgage activity successfully, as I said, we all welcome any additional efforts by the two GSEs working with Congress and the oversight agencies to ensure that the safety and soundness of their institutions are maintained and improved.

And I think the voluntary initiatives announced last year were a good approach to take. I look forward to hearing the testimony of our two witnesses.

I once again commend the Chairman and would note that both the GSEs represented today have taken the initial steps in complying with certain of the agreements made last year, so I commend you for that.

Chairman BAKER. Thank you, Mr. Bachus. Your time has expired.

Mr. Hinojosa.

Mr. HINOJOSA. Thank you, Mr. Chairman and Ranking Member Kanjorski.

As a new Member of this committee and subcommittee, I am looking forward to learning more about the issues related to Government sponsored enterprises and their work in providing affordable housing in the United States.

I hope to hear from Fannie Mae and Freddie Mac on their implementation of the voluntary initiatives announced last October on which this hearing is focused.

I'll just tell you at the start that these companies are doing an admirable job providing affordable housing in South Texas, and particularly in the Texas border region I represent from McAllen, Texas to San Antonio.

The need for affordable housing along the border is great, and the barriers of home ownership are unique. Fannie Mae has shown flexibility and creativity in addressing the needs of our immigrant population and low-income families who may not have the long employment history nor the credit credentials often required to get competitive mortgage rates.

Without these secondary lenders in the marketplace and the specific HUD mandates to house minorities and the historically underserved populations, I am fearful of the rates and requirements that would be imposed upon the most economically vulnerable members of our society.

Mr. Chairman, I think that we all should have an equal chance at the American Dream. By partnering with commercial banks, Fannie Mae and Freddie Mac, bringing consumers affordable rates and flexible downpayment amounts, the system appears to be working the way Congress intended in chartering these GSEs. They bring competitive rates, creative programs and opportunities for increased home ownership to our communities, especially the minority communities I represent.

Some believe that home ownership in the United States has reached its saturation point and that Fannie and Freddie may no longer be needed. Mr. Chairman, as I look around my district and talk to my constituents, I cannot agree with that assessment.

The rate of home ownership for Hispanic Americans in the United States lags an estimated 26.4 percent behind the larger Anglo home ownership rate. We need to close that gap. If these companies can help, then their job and usefulness is far from complete.

In closing, I'll just say I congratulate this subcommittee for its vigilance in overseeing the GSEs. I think this hearing will be useful in reviewing the steps taken by the GSEs to guarantee their financial soundness.

At the same time, I trust we will be careful not to cause unintended adverse consequences in addressing GSEs that would have a negative effect on our Nation's housing nor on the interest rates paid by consumers.

I look forward to hearing the testimony of the witnesses, Mr. Brendsel from Freddie and Mr. Howard from Fannie Mae.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you very much.

Mr. Israel.

Mr. ISRAEL. Thank you, Mr. Chairman and Ranking Member Kanjorski.

I am also a brand new Member of this subcommittee and learned early of the Chairman's concern for enhancing the safety and soundness of the GSEs. And I am sure that, principally as a result of that concern, both Fannie and Freddie embarked on its voluntary commitments that today make them better and stronger companies.

I think we can all agree that the creation of Fannie Mae and Freddie Mac is one of those instances where Congress really got it right. They are an enormous public policy success. Their creation has ensured that our housing system is better than any other in the world, but it can be even better.

Their existence ensures that Americans have ready access to mortgage funds at the same rate, no matter where they live in the country, no matter what the financial state of the Nation or the world.

The voluntary commitments that Fannie and Freddie agreed to last fall are added measures to ensure that they will always conduct their business safely and soundly. These commitments not only demonstrate their financial strength, but they provide not available previously windows to that safety and soundness.

This Nation is fortunate since no other country has a secondary mortgage market created by Fannie Mae and Freddie Mac that ensures we have mortgage credit available all the time, no matter what happens in other credit sectors.

These are well run, safe companies that bring down the cost of mortgage credit. Our work should strengthen this model, and I thank the Chair.

Chairman BAKER. Thank you very much, Mr. Israel.

There being no further Democrats, I'll go back to Mr. Sherman.

Mr. SHERMAN. Well, Mr. Chairman, I was going to deliver this really eloquent opening statement, but the gentleman from New York just delivered it. So I thank him for his remarks and the other remarks that preceded his.

I think that this voluntary agreement does a lot to strengthen these two entities and that they do a lot to provide for home ownership.

We obviously have not achieved the home ownership percentages that I'd like to see, but we are certainly doing better in every sector and with every community than we had even 10 years ago. Thank you.

Chairman BAKER. Thank you, Mr. Sherman. If there are no further opening statements, at this time I would like to introduce our two witnesses for the hearing today. I certainly think they are no stranger to the subcommittee.

I wish to welcome the CEO of Freddie Mac, Mr. Leland Brendsel, as well as the Vice President and Chief Financial Officer, Mr. Timothy Howard.

Gentlemen, we will certainly make your complete testimony as part of the record. Please feel free to proceed as your pleasure. Mr. Brendsel, if you would please, sir. Welcome.

STATEMENT OF LELAND C. BRENDSEL, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FREDDIE MAC

Mr. BRENDSEL. Thank you, Chairman Baker. And good afternoon. Indeed, I'm pleased to be here and to appear before this subcommittee.

I am the Chairman and Chief Executive Officer of Freddie Mac. And I'm certainly pleased that Chairman Oxley could be here earlier and look forward to working with him as well as Members of this subcommittee as we move forward.

As you have already said, Chairman Baker, last October Congressman Kanjorski, you, Members of the subcommittee, Freddie Mac and Fannie Mae joined together in a landmark announcement, one that provides, I believe, a model of financial management for the new century.

Freddie Mac committed to a six-point plan that keeps us at the vanguard of world financial practices. We did this to put to rest any concerns about any future safety or soundness of Freddie Mac, since indeed, as has already been said here today, there are no concerns currently. Indeed, we are rock solid.

Freddie Mac plays a vital role in financing home ownership and rental housing. It is something we are strongly committed to. And we are determined to maintain the confidence of Congress, of investors and of the public in our ability to keep meeting our mission.

The commitments that we made last fall and announced with you are real, they are significant, and I believe they completely out-pace the practices of other financial institutions, with the single exception of Fannie Mae.

Even before we made these commitments, Freddie Mac already had outstanding risk management and information disclosures for investors and the public. But we are now providing more relevant information about our condition than any other financial company, I believe, in the world.

Our commitments meet or exceed recommendations of international experts in financial regulation. The national rating agency, Moody's, said last fall that they set new standards not only for us, but also for the global financial market.

We also asked former FDIC Chairman William Seidman for his assessment of these commitments. And he concluded, and I quote, "This package of disclosures and standards puts you in a position of providing more and better public information than any other financial institution, both regulated and non-regulated."

Now with your permission, Mr. Chairman, I would like to enter his full comments for the record.

Chairman BAKER. Absolutely. Without objection.

[The prepared statement of William Seidman can be found on page 145 in the appendix.]

Mr. BRENDSEL. Thank you. Now let me walk through each commitment and report on their status of implementation at Freddie Mac.

I'm pleased to report that Freddie Mac's implementation is nearly complete.

Briefly, the first commitment is public disclosure of our independent rating. We announced our AA-minus risk-to-the-Government rating from Standard & Poor's on February 27th.

To put this in perspective, of the ten largest bank holding companies, only two have a rating this high on their senior debt.

Originally we planned to obtain a rating once a year, but now Freddie Mac has gone beyond that. We asked Standard & Poor's for a continuous surveillance rating, which means that S&P will notify the public if there is ever a change in our financial position that affects our rating.

Our second commitment ensures that we maintain a high level of liquidity. We announced that we met that commitment on March 8th. Freddie Mac has enough liquid high quality assets so that we can meet all our financial obligations even if we are unable to issue debt for 3 months. That's a high standard.

The Basel Committee on Banking Supervision suggested that institutions maintain a liquidity reserve of between 1 and 3 months. We chose the more stringent 3 months. This sets a new best practice for industry.

Our third commitment is semi-annual issuance of subordinated debt. We completed our first $2 billion issue on March 21st. It will be the first of many issues, of course.

The benefit of this commitment is twofold. The issuance of subordinated debt enhances our already strong financial base. In addition, it provides real-time information to the market about our financial condition.

After 3 years, the sum of our core capital and subordinated debt will equal at least 4 percent of our assets.

We expect that there will be an additional $8 to $10 billion of investor funds standing in front of our senior debt holders.

A recent report by the Federal Reserve and the Treasury views subordinated debt as a tool to enhance market discipline. No bank has committed to a regular program of subordinated debt, however. But Freddie Mac, along with Fannie Mae, stepped up to the challenge.

Our fourth commitment is to implement a risk-based capital stress test on an interim basis until our regulator, OFHEO, completes the final rule. Yesterday, we announced that we passed this test. Freddie Mac holds enough capital to survive a 10-year downturn much like the Great Depression. This is the most rigorous test in the financial services industry.

And again, to put this in perspective, for the thrift industry to pass this test, it would have to triple its capital today.

Our fifth commitment is new quarterly disclosure about credit risk. Going beyond our already extensive credit risk disclosures that we currently provide to investors, Freddie Mac has added a new forward-looking disclosure.

Most credit disclosure, in fact, is backward-looking, focusing on charge-offs, loans that were already delinquent. Our new measure predicts the impact of a 5 percent decline in housing prices nationwide and the impact that would have on losses of Freddie Mac.

We made this disclosure for the first time yesterday and will include it for the record. It demonstrates Freddie Mac's financial strength and the many layers of protection that we have for our mortgage purchases.

Finally, our sixth commitment is new monthly disclosure of interest-rate risk. We will meet this sixth and final commitment with our regular monthly disclosure to investors in the middle of April.

This commitment exceeds supervisory guidance made just last week by the Federal Reserve and the OCC, I would point out. These agencies encouraged large financial institutions to adopt the recommendations of the commission headed by former Chase Chairman Walter Shipley. They called on banks to move from annual to quarterly disclosure of interest risk. Our move is to monthly disclosure, which keeps us, I think, a step ahead.

Taken together, our six commitments represent a watershed in financial practices. I think this is important. Because over the next 10 years, America's families will need an additional $6 trillion to fund their mortgage loans, a net increase, reflecting anticipated growth in home ownership as well as the growth in this Nation and the strength of its economy.

Freddie Mac will open doors of opportunity for the home buyer of the future who is more likely to be a low-income, minority or immigrant family eager to realize the American Dream.

To meet our mission, Freddie Mac is wringing out every unnecessary cost and barrier to home ownership. We're pushing the limits of technology. We're searching the globe to find the lowest cost funds for housing. Indeed, housing is one of the few bright spots on today's economic horizon. More than ever, the country needs Freddie Mac's strength and vitality, and the six commitments demonstrate our determination to remain safe and sound and to finance housing for generations to come.

So, Mr. Chairman and Members of the subcommittee, I appreciate your support when we announced these commitments, and I look forward to working with you in the future to secure the future of America's housing finance system and with it the dreams of millions of families.

Thank you very much.

[The prepared statement of Leland C. Brendsel can be found on page 61 in the appendix.]

Chairman BAKER. Thank you, Mr. Brendsel.

Mr. Tim Howard.

STATEMENT OF J. TIMOTHY HOWARD, EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, FANNIE MAE

Mr. HOWARD. Mr. Chairman, Congressman Kanjorski, Members of the subcommittee, I'd like to thank you for the opportunity to come before you today.

My name is Timothy Howard and I am Chief Financial Officer and a member of the Office of the Chairman of Fannie Mae.

Mr. Chairman, last October Fannie Mae's Chairman and Chief Executive Officer, Frank Raines, was pleased to join you, Congressman Kanjorski and others in Congress to announce that Fannie Mae would adopt a series of six voluntary initiatives to further strengthen our liquidity, transparency, market discipline and capital.

Under your leadership, this was a signal achievement for the safety and soundness of the financial system.

Consolidation and globalization in the financial services industry is a reality today. In the last decade, the total number of banks in America has fallen by 40 percent, and the share of assets in the eight largest banks has almost doubled, from 21 percent to 41 percent.

America's two largest banks now hold 19 percent of all bank assets, nearly double the concentration of 8 years ago.

As financial institutions become larger, more global, more complex and more interconnected, financial supervisors and policymakers worldwide are proposing new strategies to strengthen their safety and soundness and reduce the potential for systemic risk.

Every large financial institution has the potential to affect the fundamental safety and soundness of the financial system. Fannie Mae is no exception.

With that in mind, over the last year, we engaged in a series of discussions with key policymakers, including people at Treasury, the Federal Reserve, and our own regulator, the Office of Federal Housing Enterprises Oversight, to determine how best to ensure that Fannie Mae's safety and soundness protections are at the vanguard of evolving world practices.

And I would add, Mr. Chairman, that the hearings and oversight by this subcommittee under your leadership has played a critical role in our review.

We learned much that was useful. For example, the Basel Committee on Banking Supervision supports the use of risk-based capital standards with an economic stress test. The Working Group on Public Disclosure chaired by Walter Shipley recommends increased transparency as a means to enhance market discipline. And a recent study by the U.S. Treasury and the Federal Reserve suggests that issuing subordinated debt can strengthen market discipline in a powerful way.

In the end, I believe the discussions we engaged in greatly raise the level of understanding of Fannie Mae's role in the housing finance system and our risk management strategies. They also reaffirmed the fundamental wisdom of the changes to our charter made by Congress in 1992.

Through these charter revisions, Congress provided for a dedicated financial regulator, continuous on-site examination with results disclosed to the public, and most far-reaching of all, a risk-based capital standard with a severe economic stress test long before the Basel Committee proposed this model for others.

These measures in 1992 put Fannie Mae at the cutting edge of regulatory discipline. But our discussions last year with policymakers made it clear that Fannie Mae had the opportunity to build on this cutting edge regulatory discipline by adopting measures to enhance our market discipline.

That led to the joint announcement by Fannie Mae and Freddie Mac last October 19th committing to the six voluntary initiatives.

Mr. Chairman, Congressman Kanjorski, I am pleased to report to you today that Fannie Mae now has implemented all six of these voluntary initiatives during the first quarter of this year, and in some cases, we have gone beyond our commitment.

In January we did our first issuance of subordinated debt. This $1.5 billion, 10-year issue was rated AA–2 by Moody's and AA-minus by Standard & Poor's. We priced it at a spread of 22 basis points over our senior debt. And since that time, it has traded in a range of 18 to 28 basis points over our senior debt.

That is a higher spread to senior debt than the subordinated debt of many high quality commercial banks, and it shows that investors do believe that our subordinated debt is in a different risk category from our senior debt.

In late January we obtained and disclosed "a risk to the Government" rating of AA-minus from Standard & Poor's. This rating measures our inherent credit quality without assuming Government support. No U.S. commercial bank holding company or thrift institution has an S&P rating higher than AA-minus.

And we went beyond the October 19th commitment by seeking this rating on a surveillance basis, which means that S&P will change its rating during the year if our financial condition changes.

We announced earlier this month that we have built enough liquidity into our portfolio to allow us to continue to operate smoothly and meet our obligations even if we had no access to the agency bond market for 3 months. This is a statement very few financial institutions could make.

We also said that we would disclose each quarter the percentage of our on-balance sheet assets we hold as liquid assets, again, going beyond the terms of the voluntary initiatives.

And yesterday we announced that we had made the initial disclosures of our interest rate risk and credit risk sensitivities, as well as disclosures from our interim risk-based capital stress test.

For our interest rate disclosure, we followed the directives of the new Basel Accord and released the two measures of interest rate risk we used to manage our business internally: net interest income at risk, and our effective duration gap. We are going beyond our commitment by releasing our duration gap on a monthly basis.

We also made our first quarterly disclosure of the impact on our credit losses of an immediate 5 percent drop in home values. We are showing our credit loss sensitivities both with and without the effect of credit enhancements to highlight the role that loss-sharing arrangements play in our credit risk management.

And finally, we carried out our first interim risk-based capital stress test. We passed this test with a capital cushion of between 10 and 30 percent of our total capital as of December 31st, 2000.

Combined with our charter revisions in 1992, the six voluntary measures we have just implemented place Fannie Mae at the vanguard of risk management and disclosure practices worldwide with cutting edge regulatory discipline bolstered by cutting edge market discipline.

If there is any question or concern about how Fannie Mae is doing, there are now several ways to find out. You can look at the results of our supervision exams. You can look at our capital levels, our regular stress test results, our external rating reports, our monthly and quarterly reports on how the economy is affecting our business, or changes in the value of our subordinated debt.

No financial company in the world will tell you more about its financial condition than Fannie Mae does.

Our new disclosures reinforce the fact that Fannie Mae is one of the safest, soundest financial institutions in the world. Our subordinated debt and risk-to-the-Government ratings are among the strongest in the industry.

We have more than adequate liquidity to survive for 3 months without access to the credit markets, and we could endure the worst economic shocks in history, shocks few other financial institutions could survive, with significant capital left over.

Mr. Chairman, Congressman Kanjorski, thanks to your leadership and partnership, our safety and soundness regime is now consistent with the best thinking in the world, and it goes well beyond any federally-chartered bank or financial institution today.

Together, we have produced an even safer, sounder Fannie Mae, a stronger U.S. housing finance system, and a better chance for more Americans to own a home. And we have done more than that. Together, we have created in Fannie Mae nothing less than a model for financial institutions in America and around the world.

Mr. Chairman, we applaud you for your leadership and look forward to continuing to work with you.

[The prepared statement of J. Timothy Howard can be found on page 151 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Howard. Thank both of you gentlemen.

My first question relates to the comment about the stand-alone measure of the S&P rating, Mr. Howard. In your testimony, the rating agencies rated your subordinated debt separate and apart from Fannie's relationship with the Federal Government.

I visited with a representative of S&P not long ago trying to understand the mechanisms by which ratings were established. And there's a fine line that I think has been drawn, but that I need to clarify from your perspective.

As I understand it, they set aside the value of a governmental intervention by exercising the line at the Treasury. But at the same time, they did calculate the value of the ratings.

The fact that the market perceives that you have an implicit guarantee, therefore, even in illiquid markets, you have the ability to market your securities and debt instruments in a manner which others may not, so that there is a buy-side bias, as I would describe it, in the market toward the rate, although it does take into consideration prohibiting the exercise of a line of credit. Do you see that differently? That's the way it was explained to me.

Mr. HOWARD. Let me go into my understanding of both the rating Standard & Poor's did of our subordinated debt as well as the risk-to-the-Government rating, because they are rating somewhat different things, but from a common perspective.

In each case, Standard & Poor's assumes that our fundamental operating practices, whatever causes them to be what they are, whether it's a view by investors that the Government would in some form support our senior debt or not, they take no position on that. They simply say that whatever your current operating practices are—"your" being Fannie Mae's—we assume those will continue in times of duress.

For our subordinated debt——

Chairman BAKER. Excuse me. I'm sorry. But on that point, whatever your existing business practices are will continue during times of duress?

Mr. HOWARD. Yes.

Chairman BAKER. That is, despite the fact that the securities may say not guaranteed by the full faith and credit of the United States, you could buy it with that assumption anyway? That that's sort of the market practice today.

Mr. HOWARD. The investors with whom I speak, and Mr. Baker, Chairman Frank Raines and I returned from Europe a month ago, doing our annual visit with European investors. For 17 years, Fannie Mae has been doing a visit with European investors in the spring and a visit with Asian investors in the fall.

We talk to investors continually. The investors, including the most sophisticated, fully understand that our debt is not guaranteed by the U.S. Government. There is no ambiguity in their minds on that point.

What Standard & Poor's does in rating our subordinated debt, they have said explicitly they do not assume that in the unlikely event that Fannie Mae were to encounter financial difficulty, that the U.S. Government would guarantee or support that debt. That's an explicit statement they make.

So the subordinated debt rating is a very pure credit quality rating of our obligations, assuming no Federal support. And that distinguishes it from the senior debt.

The risk-to-the-Government rating, in my understanding from talking to Standard & Poor's, attempts to view the U.S. Government as a potential creditor of Fannie Mae, and in effect ranks the probability of the Federal Government ever being put in a position where it has to make a decision whether to support or not support the senior debt.

And in both cases, whether it's viewing the exposure that a subordinated debtholder has to Fannie Mae's credit condition, or viewing the Government's role as an entity that has chartered Fannie Mae and may at some point face a decision about whether or not to support senior debtholders, in each case we have been accorded a AA-minus rating, which is extraordinarily high. And that represents, in my view, the fundamentally sound risk management practices that we have put in place.

Chairman BAKER. Let me follow up with the second part, Mr. Brendsel, of the stated agreement of October. And first let me congratulate both Fannie and Freddie for your success in the implementation of the proposal to date. I want to acknowledge that and that you have in my judgment made a good faith effort to comply with the tenor and tone of the agreement.

However, that meeting of that morning, I announced the intent to introduce legislation this year with regard to a regulatory structure. I don't want to open a discussion as to the details of the regulatory structure.

All I want is to confirm, since this is the first opportunity you've had to visit in this forum since last October, that you, both from a corporate perspective, view the creation of a strong regulatory structure not only as protection for the taxpayer, but an asset in the markets, because it gives them confidence and you do have oversight that is appropriate and sufficient.

Mr. Brendsel.

Mr. BRENDSEL. Absolutely.

Chairman BAKER. Mr. Howard.

Mr. HOWARD. Yes. We believe that the existence of a strong regulatory structure is very much in our interests, the interests of our investors, policymakers, and anyone who has a strong interest in the continued smooth workings of the U.S. housing finance system.

Chairman BAKER. Let me do this quickly. I really wish I had a whole lot more time. But since we have a fair number of Members, I'll try to stick to 5 minutes. I would just like to have a little more in-depth analysis if I might, Mr. Howard, or from both operations with regard to the spreads on the sale of subordinated debt. It appears that the spreads have widened instead of narrowed from the first offering at 22 basis points. I've seen different reports where it's vacillated. But it seems of late to have been significantly higher than it was at the outset, and I wish to understand better whether that's a liquidity issue in the market or other reasons. And I'll just get that in writing at a later time.

Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman.

As I understand it, in developing the voluntary commitments, you studied worldwide the best practices of regulators for safety and soundness of financial institutions, particularly those of your own regulator, OFHEO. How do your commitments stand up in comparison with other financial regulators, both inside and outside of the country?

Mr. BRENDSEL. Well, Mr. Kanjorski, as I commented in my oral statement, our disclosures really stand up extremely well. In fact

I would call them world class in terms of the kind of information they provide to investors.

Justice Brandeis once said "sunshine is the best disinfectant." And that's really what has occurred here. We are providing the kind of information to the marketplace, to investors that really exposes us to the sunshine, to the scrutiny of our investors, and whether it is our practice to issue additional subordinated debt, disclosure of our independent rating, disclosure of our interest rate risk or credit risk, they put us at the head of the pack.

And it really is reflecting the recommendations made by the Basel Committee on Banking Supervision as well as the Shipley Commission as well as recommendations by the Fed and Treasury for commercial banks in this country.

Mr. HOWARD. The recommendations of both the Basel Committee as well as the Shipley Commission were targeted primarily on disclosure practices of institutions as a supplement to regulation.

Although in the case of Basel, Basel did support quite strongly the use of specific stress tests and internal models in gauging the true risk of complex financial institutions. And in that regard, the legislation in 1992 was quite far-sighted in enshrining in statute the need to do just such a test, using the actual data from businesses practices in determining the amount of capital that the entity should hold in light of the specific risks that it takes and the way in which it manages them.

So in that regard, I believe OFHEO's regulatory structure is indeed at the cutting edge of regulatory practice.

Mr. KANJORSKI. Some have suggested that the recent GAO report on OFHEO regulatory authority concludes the agency lacks sufficient enforcement power to ensure that Fannie Mae and Freddie Mac do not pose a threat to the economic stability of our country.

The report, however, also notes that it appears each regulator has the statutory tools available to address significant safety and soundness concerns. These views seem to be in conflict. I was just wondering if you would give us your perspective on these two conflicting views.

Mr. BRENDSEL. My reading of the GAO report—and indeed, it's my reading—is that it concludes that OFHEO does have adequate regulatory authority that they need for regulating the two institutions, albeit in some cases it is slightly different than the authorities that banking regulators have.

But that is also appropriate, given that we are different kinds of institutions. We're only two. We're only focused on one line of business—residential mortgage loans. We're not engaged in a myriad of activities like banks are. And indeed, our regulator only has two institutions to focus on rather than the thousands of banking institutions.

So overall, my conclusion on reading the report is although different in some cases, they conclude that the authorities are adequate and appropriate.

Mr. HOWARD. Congressman Kanjorski, I would echo that. I would also add that the principal conclusion of the GAO report, and I'll quote this, is that "based on each regulator's powers and authorities, it appears that each regulator has statutory tools available to address significant safety and soundness concerns."

The GAO report did highlight areas where the powers were different. But as Mr. Brendsel said, that seems to reflect largely the different circumstances of banks and other financial institutions versus Fannie Mae and Freddie Mac.

Mr. KANJORSKI. I guess it is not proper to ask the hen whether we should empower the fox, but do you feel that Congress should give greater powers to your regulators? Is this something we should presently investigate or potentially legislate?

Mr. BRENDSEL. I think that overall, I would say first and foremost, we support a strong and credible effective regulator. Whatever the structure, whatever the particular authorities that are necessary to carry out that objective that you give to the regulator, we certainly want the regulator to be professional, knowledgeable, have the appropriate authorities. And ultimately, it's a decision for Congress to make.

And from my standpoint today, at least from what I understand their authorities to be in my reading of the GAO report, I would not recommend to Members of Congress that any changes be made.

But first and foremost, we want a regulator that has credibility and the confidence of you and of investors worldwide.

Mr. HOWARD. Our view is quite similar.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Kanjorski.

Mr. Ney.

Mr. NEY. Thank you, Mr. Chairman. I have a question for both witnesses.

Freddie Mac and Fannie Mae operate with less equity capital per dollar of debt than banks risk. Given your size, what would you want to comment on the suggestions made that there's undercapitalization and perhaps the capital adequacy needs to be increased? Do you want to comment on that?

Mr. HOWARD. I'd be happy to. One of the principles of the Basel Commission is that capital needs to be appropriate for the risk undertaken. In Fannie Mae's case, and also in Freddie Mac's case, we are doing business in a single asset class. U.S. residential mortgages.

We do two things with that asset class. We guarantee the credit and we take the interest rate risk for the mortgages that we hold in portfolio. On the credit risk side, the fundamental credit quality of residential mortgages is extremely high compared with other asset classes—consumer loans, loans to small businesses, loans to international borrowers.

There's a wealth of data on that. And under the principle that capital needs to relate to risk, if an entity is limited to a single business which has a low embedded default rate, less capital on an absolute basis can still mean a much stronger institution if the entity holding that small amount of capital is limited to mortgages.

Fannie Mae's risk-based capital test is designed to measure exactly that, and it goes beyond that. Because by explicitly relating capital to risk, it gives us the financial incentive to hedge our risks and limit our risks in a fashion that we can keep our required risk-based capital under our statutory minimums.

One of the fundamental flaws recognized by international regulators of the current ratio-based system that covers most institutions including commercial banks is it requires a large amount of capital as a buffer against what could go wrong, equivalent to what you could as capital against the 100-year flood. The only problem with that is entities that have to hold that capital then have to go out and attempt to earn a return on that excess capital, which gives them the incentive to take more risk.

So the incentives under the additional capital system are in my view precisely the wrong ones. A company that takes modest risk and hedges it well can actually be considerably safer, sounder and stronger than the one that has a higher nominal amount of capital, but is taking more risks, because it has a broader range of businesses and doesn't hedge as well.

Mr. NEY. Mr. Brendsel.

Mr. BRENDSEL. I'm not certain I can add to Mr. Howard's dissertation, an excellent dissertation on risk-based capital, other than to say ditto.

If we can survive, which is basically what is contemplated in the 1992 legislation and essentially how Freddie Mac operates today, if we can survive an economic calamity that is basically equivalent to the Great Depression, that clearly indicates we are extraordinarily strong and well capitalized, even though you can't measure it by the typical kinds of accounting ratios that many use. But that's not the appropriate measure of capital adequacy and capital strength, as Mr. Howard has pointed out.

Mr. NEY. Everybody talks about the crisis in affordable housing. How do you feel that the six voluntary commitments that have been made and are being undertaken in fact would help with the mission of home ownership?

Mr. BRENDSEL. I think they're extremely positive, because they will serve to maintain the confidence of investors in the world's capital markets, the confidence of the public policymakers, and indeed, the confidence of our customers, the Nation's mortgage lenders, that we are there and will be able to meet our obligations as well as provide the kind of liquidity and stability to the mortgage market.

Ultimately that means there will be more mortgage money available at lower rates, which is in essence the core of what we're doing in terms of providing money to finance affordable housing as well as housing for middle income Americans.

Mr. HOWARD. There is a very fundamental connection between our safety and soundness and our ability to carry out our mission.

As Fannie Mae continues to do its part to meet the large number of unmet housing needs that still exist, we will by definition get a larger profile. Our mortgage portfolio will continue to grow. We will issue more debt. Our credit needs will continue to grow.

A growing Fannie Mae is evidence that we are being more effective carrying out our mission of making housing credit more available and more affordable.

As we grow, this concern that exists legitimately among policymakers over whether or not size equates to risk goes fundamentally to the heart of these voluntary disclosures and a strong regulatory system.

We feel that if we can be as transparent as any financial entity in the world, we can continue to be innovative, be aggressive in achieving our mission and reaching the pockets of unserved areas and not have concerns be raised about whether or not this should cause Congress to worry about our fundamental safety and soundness and risk to the taxpayer.

Chairman BAKER. Thank you, Mr. Ney.

Mr. Meeks.

Mr. MEEKS. Thank you, Mr. Chairman.

Mr. Howard, can you—as you know, predatory lending is a scourge in the minority community. Can you tell us about the specific steps your company is taking to combat predatory lending?

Mr. HOWARD. Yes. I would be happy to do that. Several months ago we announced a series of guidelines to which we requested that our lenders adhere in showing us credit-impaired loans that might conceivably be eligible for purchase by us.

The areas that we specifically looked at included a number of—the interest rate that could be charged on those loans, whether or not there were prepayment penalties that were unreasonably imposed on the loan, and the existence of prepaid credit life policies that might result in an erosion of equity in the property, making it harder for the borrower to stay in the home.

We came out with a series of guidelines that were quite explicit. We shared those with our lending partners, came to an agreement that these were the right set to use, and have implemented them. And we found that many originators have in fact confirmed their origination practices to those standards.

So we think that even though our presence in the market as far as guaranteeing or purchasing of those loans has not increased as much as ultimately we believe it could, we think we've already had an impact on lending practices which is highly positive.

Mr. MEEKS. Mr. Brendsel, Freddie Mac has bought billions of dollars of subprime mortgages. In the same vein, how can you ensure that these mortgages are not predatory?

Mr. BRENDSEL. First of all, we only deal with the good guys. And there are some, as you've already pointed out, Congressman, that are not the good guys. They're engaged in abusive practice and so forth.

So what do we do? We have a combination of certainly guidelines and requirements for any mortgage loan that we will purchase that includes no high cost loans, no single-premium credit life, no prepayment penalty in excess of 5 years, required monthly reporting by all of our services, prompt reporting of prompt payments. And so we begin with that.

Second, we have an audit program that on a regular basis audits the customers that we do business with around adherence to our policies and guidelines.

And finally, we engage in a fairly significant education campaign overall, not only with lenders, but also increasingly with consumers in communities.

We've been involved in something called the "Don't Borrow Trouble" education campaign that we've now taken to 12 cities that really is a public education campaign around, again, alerting consumers to what to look out for when they go to get a mortgage loan or any loan.

Mr. MEEKS. And finally, let me just ask both of you I guess, there's a new problem, or maybe it's an old problem, that I have found in my district. While understanding that we need the subprime market, I'm becoming concerned that we've been finding individuals who had Class A credit, but they are led into the subprime market.

And as a result of being classified improperly, they are being robbed in essence of their individual buying power, buying power that they would have, if not the money for the mortgage, because of the incorrect classification.

And then I've heard this phrase, "mission creep," that is leading you into the subprime market. Can you tell me how do you respond to that? Mission creep and the misclassification of borrowers.

Mr. BRENDSEL. If "mission creep" means trying to clean up practices in the subprime market, trying to find ways to qualify more borrowers for low cost loans that can be purchased by Freddie Mac, we plead guilty, absolutely. But in fact, we're not going beyond our charter there. That's foursquare in keeping with the purpose and mission for which Freddie Mac is chartered.

Indeed, yesterday there was an article in *The American Banker* that talked about some subprime lenders who were complaining that we were engaging in some business, trying to buy some business and purchase subprime loans, and it's going to drive down their profit margins, drive down what I would say is their excessive fees and returns that they are getting today.

So, great article, great compliment, I think, to what Freddie Mac is doing. I submitted it for the record actually. Beyond that, though, I think what we've also discovered is that there frankly are just many families that are in the subprime market that really can qualify for a prime loan if only they are reached by the right lender.

That's why we want to partner and team up with the right lender with our tools, many of our automated underwriting tools, so that they can qualify those families for a prime loan at the lowest possible rate.

[The article referred to can be found on page 144 in the appendix.]

Chairman BAKER. Your time has expired, Mr. Meeks.

Mr. Shays.

Mr. SHAYS. Thank you, Mr. Chairman. I want to compliment both gentlemen for their efforts to comply or conform to the voluntary agreement. You're satisfied, so I'm satisfied.

I also say if you told me a year ago that I'd be reading *The American Banker*, I'd say "fat chance."

[Laughter.]

Mr. SHAYS. But I want to continue what Mr. Meeks went on, and I want to know, what is the lowest acceptable score that you would have?

Mr. HOWARD. We have no automatic cutoff. We have programs that will evaluate all borrower characteristics, credit score, the property the person is borrowing.

Mr. SHAYS. So you have no score?

Mr. HOWARD. We have no bright line below which one cannot get a loan.

Mr. BRENDSEL. We do not either.

Mr. SHAYS. And how are you pricing these borrowers' risks? How do you determine that?

Mr. HOWARD. We look at the characteristics, and based on a review of the characteristics compared with how loans with similar characteristics have behaved in the past, we pick prices that we believe adequately compensate us for bearing that risk.

Remember, we have two objectives whenever we're underwriting a loan. We want to make sure that the consumer gets the lowest rate possible, but we also have to grade it and price it so that we meet our safety and soundness objectives on the other side. It's a constant balancing act.

Mr. SHAYS. Mr. Brendsel.

Mr. BRENDSEL. Same answer.

Mr. SHAYS. Same answer as his? Thank you. How are you disclosing your activities to your shareholders? Should we have been surprised this was happening?

Mr. HOWARD. What's the "this"? I'm sorry.

Mr. SHAYS. How would you disclose your activities to your shareholders? You know, you're getting into a new market it seems to me.

Mr. HOWARD. We have been very open with our investors as well as the Congress about our intent to be active in this market.

I'll echo what Mr. Brendsel said in that this is in no way mission creep. Mission creep has a connotation of doing something you shouldn't be doing. And making loans to people with less-than-perfect credit is not only totally within our charter, it's something that we should do and it's something that's right to do.

And as we can take more advantage of the benefits of automated underwriting that allow us to more effectively grade credit risk, we can and will be moving further into this area.

I will say that last year we have done an amount of this business that's significant to the market.

Mr. SHAYS. I don't mean to be rude and interrupt, but I only have 5 minutes.

How do you respond to the allegations that the GSEs are using their ability to allocate business to the detriment of the institutions that are outspoken critics of them, such as moving up to the list of approved bidders for Fannie?

I'm going to give you a chance to—this is today's edition of *The American Banker*. So don't give me as long an answer as they have here.

Mr. HOWARD. It actually deserves a longer answer. I will give you a short answer. The allegations are completely baseless.

Mr. SHAYS. Let me just ask you, though. They're baseless that you haven't done it, but how can you be assured that others in your organization haven't made that—if someone said my staff did something, I could say "they're baseless," but I would check it out. I would know they were baseless. You don't——

Mr. HOWARD. Congressman, I have checked it out. The only specific cite made in the article alleging threats was that we removed Wells Fargo Bank from a list of approved or eligible bidders for our debt. We did not do that. We have no such list.

Wells Fargo, as any other bank, can bring us debt transactions anytime it wants to.

Mr. SHAYS. Fair enough.

Mr. Brendsel.

Mr. BRENDSEL. As I was reported in *The American Banker*, I made a statement, wrote a letter indicating that Freddie Mac has not, does not, will not engage in bullying or abusive tactics. We have a clear corporate ethic against that kind of thing. Second——

Mr. SHAYS. If any of your employees were implying that might be the case, what would be your response to those employees?

Mr. BRENDSEL. Depending upon the seriousness, clearly I would do a review of that particular statement and obviously it could result in an employee being fired.

Mr. SHAYS. You would consider that a very inappropriate action?

Mr. BRENDSEL. Absolutely.

Mr. HOWARD. As would I.

Mr. SHAYS. Thank you very much.

Chairman BAKER. Thank you, Mr. Shays.

Ms. Jones.

Ms. JONES. I'll pass. I'll pick up later on.

Chairman BAKER. Mr. Ford.

Mr. FORD. Thank you, Mr. Chairman. Thank you both Fannie Mae and Freddie Mac for being here. I want to follow up my colleague, Mr. Shays, with a line of questioning he was sort of following through.

I guess in the article from yesterday's *American Banker* reads that "The idea that Fannie and Freddie would dip their toes"—it's sounding something like "The Sopranos", I might add—but, "would dip their toes further into subprime lending has lenders concerned that their margins will shrink and their profits erode. They also figure they will lose business as prime lenders snap up their loans by offering better rates."

I applaud you, both of you, for working to make housing more affordable. It would seem to me, Mr. Chairman, that on this subcommittee we would be applauding that and encouraging that as well.

Would you mind—I know that you've had questions asked by my colleague, Mr. Meeks and certainly by others on the subcommittee—would you mind elaborating just briefly if you could on some of your other efforts in the subprime market? I know you started, Mr. Brendsel of Freddie Mac. I can't pronounce your last name correctly.

Mr. BRENDSEL. Brendsel.

Mr. FORD. Mr. Brendsel. I'm sorry. Mr. Brendsel, if you could elaborate for 30 seconds and perhaps, Mr. Howard, you could as well, just summarize very quickly some of your activities in the subprime market.

And why have you made these people so mad at you is what I want to know. Is it you're providing more housing for people? Is that essentially what it is?

Mr. BRENDSEL. Yes. Basically, it's all about competition if you want to look at it that way. It is providing additional consumer choice through other lenders.

After all, one of the reasons why someone finds themself in a situation of having to take out a subprime loan is that that's the only source of credit that they may be aware of.

And indeed, by working with a number of lenders, small as well as large, providing them with the kinds of tools so that they can originate those loans, it means that, you know, that family can get a better mortgage loan.

Well, the subprime lender that was charging very high fees and very high costs is going to be unhappy, and that's what you see reflected in the article of yesterday.

Mr. FORD. Mr. Howard.

Mr. HOWARD. We are very much aware that there are many, many borrowers who are not getting the best mortgage for which they are qualified.

We have developed products, including our expanded approval and timely payment reward mortgages that are designed to address that. But we're also working very intensely with our lender partners on figuring out how to get those products in front of you.

We are surprised, frankly, that even with the products, we're not getting the demand that we would hope we could. So we think we have to come up with new ways for making those products available and accessible to people who could benefit from them.

And we are going to work very hard and very diligently until we figure out how to do that. We think we have a service to offer this underserved area, and we intend to do that.

And I think that's one reason why subprime lenders are currently kicking up some dust around this.

Mr. FORD. Is it true that over the life of an average subprime loan that a consumer will pay nearly $209,000 more than a conventional loan?

Mr. HOWARD. It's certainly possible given the rates that I've heard are being charged in that market.

Mr. FORD. I know we are discussing a potential tax cut here, which I support, I might add, here in Congress, but I cannot think of a better tax cut for working people than helping them to save that amount of money over the life of a loan.

To put some of these voluntary initiatives in perspective, both of you, could you please comment as briefly—my time is running out—on how safeguards like these compare to the norms of industry? Have other companies, particularly those that are part of FM Watch, taken similar steps or they simply mirror what you all are doing?

Mr. BRENDSEL. I can't say how particular companies that are members of FM Watch match up against these particular disclosure commitments.

However, in general, I can say that based on my knowledge of what financial institutions disclose, our commitments, our disclosures put us clearly up ahead of the pack.

Indeed, last year, we retained PriceWaterhouseCoopers to review our disclosure practices before we made these additional commitments. At that time, they said our disclosures to investors placed us among the best of the best in terms of banking and financial institutions.

These additional commitments take us beyond the best.

Mr. FORD. Mr. Howard.

Mr. HOWARD. Our commitment is to remain at the forefront of disclosure practices. We think we have now moved beyond that to being best practice. If and as disclosure practices improve, we will revisit what we're doing, and our commitment is to stay ahead.

Mr. FORD. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Ford.

Mr. Bachus.

Mr. BACHUS. Thank you, Mr. Chairman. I'd like to yield 15 seconds.

Mr. SHAYS. Just very quickly. My concern and my questions are, it's not a level playing field. We give you a charter because of that. We cannot go into our business if we put everyone out of business. And the question is, what's appropriate for you to be in? And I'm not asking for a response now, but I'm eager to have a second round of questions just to pursue what is your legitimate business.

Thank you.

Mr. BACHUS. Thank you. Gentlemen, you all make projections on your debt in future years, and I've noticed that Treasury, they make projections on what their debt is. And I'm told that the debt of Fannie Mae and Freddie Mac will exceed that of the U.S. Treasury by 2005.

Is that accurate? Are you aware of that?

Mr. BRENDSEL. I can't say whether or not those particular projections are accurate. I can say that those types of comparisons that you read are kind of comparing apples to oranges, or I'd put it this way.

Declining U.S. Treasury securities outstanding is clearly good news for the U.S. taxpayer.

Increasing Freddie Mac securities outstanding really reflects good news for America's home buyers. And after all, it is securities that are backed by mortgages on people's homes.

So our growth is in line with the growth of the U.S. mortgage market. Indeed, for example, over the last 5 years, residential mortgage debt outstanding has grown roughly 8 percent a year. We've grown roughly 9 percent a year. But that reflects the strength of the economy, increasing home ownership rates, the exploding home ownership rates that have occurred over the last several years.

And so, clearly, that is good news for America's home buyers as reflected in the strength of Freddie Mac, not any risk to the U.S. Treasury or taxpayer.

Mr. HOWARD. I'd make a couple of points to that. First of all, this is what we would call a high quality problem, having Treasury debt disappear by the year 2010. When Treasury debt totally disappears, my teenaged daughter will have more debt outstanding than the U.S. Treasury.

Fannie Mae currently has about $640 billion in debt outstanding, all of which is funneling capital into housing. A very important point in comparing Fannie Mae debt with Treasury debt is the fact that, because we deal exclusively in the secondary market, we do not create debt except insofar as we cause more mortgages to be made.

Whenever Fannie Mae buys a mortgage in the secondary market by issuing debt, the proceeds of that debt are given to the seller who then pays off their debt. So what's happening in the aggregate is debt is shifting from that of the seller of the mortgage to Fannie Mae.

We talked earlier that Fannie Mae debt has a stand-alone rating of AA-minus. It's very high quality debt. So this is a good problem to have in my view.

Mr. BACHUS. Thank you. Mr. Howard, Moody's, in rating your subdebt, stated "It is Fannie Mae's intent to create a class of securities that would reflect the market's views on the firm's credit profile via the price at which it trades." Would you explain?

Mr. HOWARD. Yes. What we're hoping to do is create a class of security where investors know they have an economic interest in the risk management practices of Fannie Mae.

And that's because we built into the subordinated debt a feature that would cause the holders of that subordinated debt to have their interest payments deferred for up to 5 years if our capital falls below a threshold amount. And that threshold amount is 125 percent of our so-called critical capital level.

With that financial incentive, we believe subordinated debtholders will pay attention to our disclosures, monitor our credit quality, and the reflection of their view will be in the price at which that subordinated debt trades relative to our senior debt.

Mr. BACHUS. You just mentioned that you would defer interest payments. A lot of times on subordinated debt, that debt converts to equity. Is that right?

Mr. HOWARD. Subordinated debt can be structured that way. We have deliberately chosen not to do that, because we want to ensure that a holder of subordinated debt has the same interest as the U.S. taxpayer.

The subordinated debt that converts to equity gives the holder an interest in the company doing whatever it can to make that subordinated debt principal pay off, even if the risk the company takes are very high, the equity holders, if a company is in trouble, basically want the company to go for broke, shoot for the moon, on the hope they'll get paid off. Debtholders want exactly the opposite.

So subordinated debtholders in that circumstance, if the debt is not converted to equity, have exactly the same interest as the Congress and the U.S. taxpayer, and that's what we wanted to create.

Mr. BACHUS. But of course, it might not bring you up to the minimum capital standards, which you are intending to do by deferring those interest payments.

Mr. HOWARD. No. But remember, the suspension of interest is only triggered if we fall below those critical capital thresholds which, given our risk management incentives and practices, is a highly unlikely event. And again, that's reflected in our stand-alone credit rating.

Mr. BACHUS. Who is going to verify the commitments you've make whether they're being acted upon?

Mr. BRENDSEL. Certainly it starts internally with our own board of directors and our internal audit function. Externally, of course, it will be verified by our regulators through their examination function at OFHEO.

Mr. BACHUS. So you do see part of their role is to verify that the commitments you made to this subcommittee are realized?

Mr. BRENDSEL. Yes.

Chairman BAKER. You've expired your time, Mr. Bachus. We'll come back to you.

Ms. Jones.

Ms. JONES. Thank you, Mr. Chairman. I want to commend you for holding these hearings once again. It's kind of like deja vu, though. Remember last year when you were holding these hearings, Mr. Brendsel, Mr. Howard, and all the articles that came out about Fannie Mae and Freddie Mac on the issues of mission creep?

I want to quote specifically from an article in *The Washington Post* that said, "Today a hearing before Representative Richard Baker, Chairman of the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, was not scheduled to question the company's lending guidelines, rather aimed at assessing their progress toward a number of goals laid out last year." And on and on and on.

That was the intent of this hearing, was it not, gentlemen? Is that why you came prepared to testify today, Mr. Brendsel?

Mr. BRENDSEL. Yes.

Ms. JONES. Mr. Howard?

Mr. HOWARD. Yes it is.

Ms. JONES. And I really didn't intend to question the issue of mission creep, but seeing how everybody else decided they'd go down the line on mission creep, I thought I'd go that route myself.

It's true that the mission of both of your Government sponsored enterprises allows you to go into the secondary market? I'm kind of cross-examining like a prosecutor. Forgive me. Give me short answers. Correct?

Mr. HOWARD. Yes.

Ms. JONES. And in that effort, Mr. Howard, you've been with Fannie Mae maybe—in this position for the past 10 years. Is that correct?

Mr. HOWARD. Eleven, yes.

Ms. JONES. Eleven. Excuse me. And in those 11 years as the CFO of Fannie Mae, can you talk about why you chose to go down the route that you've gone to look at your charter and make some specific changes and what you thought you were permitted to do under the law?

Mr. HOWARD. We last took a look at our charter in 1992 in conjunction with Congress. At that time, Congress made some changes, including giving us specific housing goals that we have met every year since they've been in effect. It created a new regulatory capital standard, which we're now discussing.

Subsequent to the 1992 law, we have made no request for further charter expansion. We believe our charter as adopted by Congress in 1992 is exactly the right charter for us to have to carry out the mission that Congress has given us.

We have been operating within that charter, which is why on the topic of mission creep, I have yet to hear a credible description of what it is we are doing that exceeds the charter that this Congress passed in 1992.

Ms. JONES. Mr. Brendsel, would you like to answer that question as well?

Mr. BRENDSEL. Having been in Freddie Mac since 1982, now 18 years, I have a long history in the evolution of Freddie Mac.

First I'd say our charter is very clear as to our purpose, our authorities, what we can do and what we cannot do. And over time, while the regulatory structure has been changed and enhanced certainly for Freddie Mac, we have not sought really to change our charter in terms of our authorities with one exception that I can remember, and that is in fact we proposed, attempted to get a change to the charter requirement that we have private mortgage insurance on every low downpayment mortgage that we purchase.

We proposed making it more flexible so there would be alternative forms of credit enhancement that we could use on low downpayment mortgages. We saw that the evolution of the capital markets meant that there were many other alternatives other than private mortgage insurance to give us that protection.

That particular proposal failed, but I still think it's a good idea.

Ms. JONES. Do you know who Beneva Scholte is?

Mr. HOWARD. I've heard the name.

Ms. JONES. She's the contact person for the FM Watch report that outlines how GSE mission creep threatens American consumers, the report that came out about a week ago, just in time for our wonderful hearing. Have you ever been in contact with her?

Mr. HOWARD. I have not been personally.

Ms. JONES. Let me finally say that you've had an opportunity since last year to comply with these six voluntary agreements to put your ships in better shape than they already were in, correct?

Mr. BRENDSEL. Correct.

Ms. JONES. You don't have any issue about entering into voluntary compliance, do you?

Mr. BRENDSEL. No.

Ms. JONES. Did you welcome the opportunity to continue to make these two companies the leading companies here in the United States in pushing or providing for affordable housing in the United States?

Mr. BRENDSEL. Absolutely. I couldn't have said it better myself.

Ms. JONES. Thank you very much, Mr. Chairman. I yield the balance of my time.

Chairman BAKER. Thank you.

Mr. Weldon.

Mr. WELDON. Thank you, Mr. Chairman.

Mr. Brendsel, you stated regardless of disruptions in the capital markets that that may make it impossible to borrow, Freddie Mac has the means to meet our financial obligations for at least 3 months.

Mr. BRENDSEL. That's true.

Mr. WELDON. I think, Mr. Howard, you said the same thing?

Mr. HOWARD. Yes.

Mr. WELDON. Could you give me a little more detail on how you'd go about doing that?

Mr. HOWARD. I think we would both do it in a similar way. First of all, we maintain a fairly sizable liquidity portfolio. As of the end of last year, it was 8 percent of total assets.

That liquidity can be run off. They're high quality securities that can be sold to allow us to pay down debt if we don't have access to capital markets.

Mr. WELDON. What kind of securities are they?

Mr. HOWARD. Many of them, we made short-term loans to banks, in the Fed funds market. We have AAA-rated securities that can be sold readily for prices very close to what we paid for them.

We also have over $300 billion in high quality Fannie Mae mortgage-backed securities that can be pledged as security for repurchase agreements that can then be used for borrowing. This is very standard practice in the financial services industry. And the use of those securities as collateral for repurchase agreements would give us many months of access to borrowing without having to issue debt.

Mr. WELDON. Mr. Brendsel.

Mr. BRENDSEL. My answer would be very similar. Clearly, we start out with a schedule of what are all the outstanding commitments and obligations that the company will have coming due over the next 3 months, so we can have a clear idea on that.

And then second, we make certain we have the kind of liquidity that Mr. Howard was referring to, whether it was in the form of very high grade, high quality corporate securities and banking securities or our own mortgage-backed securities.

Mr. WELDON. Correct me if I'm wrong. It's very easy for you to raise capital by just issuing debt, and that in itself gives you a lot of liquidity in terms of giving you the ability to expand your business. Would you say that that enhances safety and soundness for your institutions?

Mr. HOWARD. Not just for our institution, but for the financial system as a whole. So in times such as the fall of 1998 when credit was not readily available, we were able to issue Fannie Mae debt that investors valued and would invest in, take those proceeds and channel them into the housing market.

So we can serve as a stabilizing force for the entire system.

Mr. WELDON. Do you want to add to that at all?

Mr. BRENDSEL. This may be just a point of clarification. This liquidity and contingency commitment would assume that we would not be able to issue any debt at all for that 3-month period.

Mr. WELDON. Right. I realize that. You have been conducting the internal risk-based capital test, the so-called "stress test." In the agreement you committed to disclosing the parameters of your testing models and the outcomes of the testing. What level of detail are you going to be providing on that? Or have you made that decision yet or not?

Mr. HOWARD. Yes. In implementing the interim risk-based capital test associated with the voluntary agreements, we have moved from using a model based on Fannie Mae's own specification that we have been running since 1993 to one that uses as its basis the notice of proposed rulemaking that OFHEO put out in 1999.

So we use that as the basis plus amendments OFHEO has made subsequent to that.

In addition, we added elements in our comment letter of March 10th of 2000, which is publicly available, and made some additional adjustments to approximate as closely as we could what we think a final official standard might look like. And those changes are available on our website as part of our disclosure package.

So by going to OFHEO's website, looking at our comment letter on our website, an observer can look at all of the elements that we used in running our risk-based capital test on an interim basis that we just announced.

Mr. WELDON. The same for you as well?

Mr. BRENDSEL. Similar. We've attempted to coordinate wherever possible types of disclosures with Fannie Mae to assure that investors wouldn't be confused.

Mr. WELDON. Have two standards.

Mr. BRENDSEL. Yes, two standards and so forth. And I wouldn't say that in all cases we have adopted the identical approach.

But I'd like to add one additional point about Freddie Mac. We really began managing the company under a kind of a stress test approach to assess capital adequacy and to maintain assurances that we were appropriately capitalized beginning in the late 1980s.

Indeed, we were an advocate of the legislation that was crafted in 1992 establishing this very dynamic and forward-looking, at the time an avant garde risk-based capital approach, and we've been managing according to that at Freddie Mac ever since.

Indeed, we were disclosing a lot about how we assessed capital even before we made this final commitment. And now of course, we're going to provide additional information including general information around the kind of parameters in this stress test that we use for this disclosure.

Mr. WELDON. Thank you, Mr. Chairman. I think my time has expired.

Chairman BAKER. Thank you very much, Mr. Weldon.

Mr. Hinojosa.

Mr. HINOJOSA. Thank you, Mr. Chairman. I want to yield my first 2 minutes to my good friend and colleague, Congressman Israel.

Mr. ISRAEL. Thank you. I thank the gentleman for yielding.

There seems to be near-unanimous praise on both sides of the aisle for the voluntary initiatives that you are conforming to, and you've already stated that those voluntary initiatives help you meet your core competency, which is to provide affordable housing.

I'm just wondering whether you can estimate the approximate cost of conformance with the voluntary issues in terms of personnel or hard dollars. Mr. Howard?

Mr. HOWARD. Most of the voluntary commitments codify or make public practices that we have already undertaken. Those practices do have costs, because we need to have high quality staff to do risk assessment. We need to do lots of modeling to help us get a sense for how best to measure and manage our risk.

The one specific cost that's easy to track is the additional cost we pay to issue subordinated debt. Because if we didn't have a subordinated debt, we would issue senior debt at a lower cost.

So for the first issue we did, $1.5 billion, we paid 22 basis points more. That's a pure additional cost.

We have committed to build our subordinated debt up to roughly 1.5 percent of total assets, which over the next 3 years will be between $12 and $15 billion of subordinated debt. And if we pay 22 basis points on all of that, that will be a real incremental cost over and above the others that I've mentioned.

Mr. ISRAEL. Mr. Brendsel, if you answer briefly please.

Mr. BRENDSEL. Yes. The additional incremental cost on subordinated debt would be similar. I think our first issue, we had 22 basis points, which would amount to, on a $2 billion issue, that we did about $4.4 million annually in additional cost.

If, however, these commitments, including the subordinated debt, provide greater assurance and confidence to the investors in the stability of the company, really the confidence of Congress and the public, that will be more than offset in terms of overall cost on our senior debt.

Mr. ISRAEL. I thank the gentleman for yielding.

Mr. HINOJOSA. Thank you. I was looking at the closing statement that Mr. Brendsel used, and he said that he looks forward to working together with us to secure the future of our housing finance system and with it the dreams of millions of families.

So that brings me to one of the points that I made earlier in my opening remarks, and that was my concern about the wide gap that exists between the standard families owning a home, Anglo-Saxon families, I think that there's a lag of 26 percent behind Anglo-Saxon home ownership.

So can you tell me what your company is doing to close this wide gap?

Mr. BRENDSEL. Yes. I can tell you what our company is trying to do with all its energy and all the commitment of the 4,000 employees at Freddie Mac and their creativity.

First of all, I'd emphasize that we are committed to closing that gap, finding every avenue that we can within our charter.

Certainly, it includes developing new flexible mortgage products that make it easier for a low-income or minority family to afford their first home. It includes partnering with organizations that know the Hispanic community well, like the National Council of La Raza and the National Association of Hispanic Real Estate Professionals.

Indeed, we recently entered into an agreement, a partnership really, with those two organizations, $2 million to develop web-based technology to increase home ownership counseling for Hispanic families.

In addition, we're constantly trying to improve our underwriting systems, use technology to drive down origination costs, increasing the ability of a low-income family or a minority family to get a mortgage loan. And, of course, we are constantly exploring new ways to attract capital from throughout the world at a lower cost, making it again more possible to afford a home.

I think it's a journey. It's a journey that we've been on for decades now. Clearly, there's a long way to go. Yes, the average home ownership rate nationally approaches 70 percent, 67 percent. But as you have clearly indicated, the home ownership rate for Hispanics as well as African American families in this Nation falls well below and indicates that there is still a lot more work to be done.

Mr. HINOJOSA. Mr. Howard, your group has done a great deal of effort in San Antonio to Brownsville, to McAllen, to Laredo and that area, because I've seen some of the programs that were introduced in these last 4 years as we were moving many families from welfare to jobs, and in some cases not letting them stay more than 2 years in Section 8 housing.

Do you have a way of monitoring and assessing the success or failure of your new programs as they relate to get Hispanics to own their own homes?

Mr. HOWARD. Yes we do. Last year, Fannie Mae announced our $2 trillion American Dream commitment. That was the successor to our $1 trillion initiative that we announced back in 1994.

In both cases, we established a very rigorous pattern of announcing specific goals and then tracking and reporting on how we were doing against those goals.

One of the subgoals of the American Dream commitment is a specific minority lending initiative where we are setting targets to help close the home ownership gap between minorities, including Hispanics, and majority Americans.

But I've noticed in recent publications by FM Watch and others, they're claiming that we have solved the home ownership problem and that we should stop. That totally ignores the very wide gap between minority home ownership and majority home ownership that we are committed to working on to close.

And through the American Dream commitment and specific target initiatives that we are working on with interest groups as well as lenders and others, we will follow up on those initiatives, track and report on them, and hopefully be a positive force in achieving a good outcome.

Mr. HINOJOSA. Would you repeat the name of the organization that felt that you should stop?

Mr. HOWARD. FM Watch.

Chairman BAKER. You'll be hearing more from those folks, Mr. Hinojosa, I'm sure.

[Laughter.]

Chairman BAKER. The gentleman's time has expired. I'll start back on a second round. There being no further Republican Members.

Just one comment again on the specifics of the arrangement of last fall. The requirement to issue subordinated debt equal to 4 percent as subtracted from the core capital, whatever that difference turns out to be, an annual rating which now has turned into a surveillance rating, new liquidity standard for a 3-month operating window, an interest rate risk disclosure and credit risk disclosure that is new and heretofore not engaged in, and each of you commented that you feel that that package represents a substantive structural change in the level of transparency and disclosure to the markets. Is that correct?

Mr. HOWARD. Yes it is, sir.

Chairman BAKER. And to your knowledge, has it had an adverse impact on your operations since you complied with these activities?

Mr. HOWARD. None whatsoever.

Mr. BRENDSEL. No.

Chairman BAKER. Well, I just want to make the point, and this is coming from a little different perspective, that it is possible to manage the affairs of Government sponsored enterprises without necessarily legislation, but with regulatory changes that do not result in adverse circumstances, like throwing hundreds of thousands of people out of home ownership. I feel that's a pretty substantive point to make.

Second, that with regard to the discussion of the regulator piece that is yet to come, these are elements that a—I don't want to say a well-run shop, because you all are extraordinarily well run—would want to have in the marketplace, coupled with a competent regulator so there's no question about the stability of your debt issuances.

And the reason for bringing that up is I am concerned about the consolidation of the counterparties because of mergers and acquisitions internationally and domestically and your ability to hedge risk appropriately.

I am concerned about the difficulty we may engage in if we have a short-term 1998 liquidity problems and whether or not—I'm not suggesting we haven't gone far enough, but what I'm asking you is, what is your level of confidence, knowing now that these new standards are operative, that the markets are now expecting this, and you can't back off of it. It's a requirement that you must go forward with. Am I reading anything into the spreads on the subdebt as being any indicator of any concern, particularly with the consolidation of counterparties' potential liquidity problems in the broader market, not within your shop?

How good do you feel about the deal we put together here and its effect on being able to insulate taxpayers from any adverse circumstances that could develop? Keep in mind we're talking the 1980s and Louisiana/Texas oil and gas patch circumstances that are in pretty dire consequences.

Mr. BRENDSEL. Mr. Chairman, I think I would answer the question this way. We started from a point at the time that we announced the commitments that we were already extraordinarily well capitalized for the risks we take and face, because we're only in the home ownership business and rental housing.

And we only added to that by the additional commitments. Obviously, spreads on securities fluctuate from day to day for a variety of reasons, many of which have nothing to do with any one institution. So I don't know what you're reading into a spread moving from 22 basis points to 28 basis points, but in the scheme of things, that is just a random fluctuation.

I used to be the chief financial officer at Freddie Mac years ago and I've lost my edge a little bit, so I'll let Mr. Howard comment as well.

Mr. HOWARD. I put the movement in our subordinated debt in this perspective. As Mr. Brendsel mentioned, each of us priced subordinated debt around 22 basis points off our senior debt.

In our case, we traded as tight as about 18 and as wide as 28. That's a minus 4 plus 6 move. That is a range that is well within what other issuers of subordinated debt have experienced over the same time period. These are the high quality commercial banks that have subordinated debt outstanding that is quoted publicly in the market.

I would also say that over the last year, our 10-year senior debt spreads to Treasuries have moved within a swing of about 45 basis points, reflecting a host of factors, none of them specifically being credit quality-related.

Chairman BAKER. Well, the overall interest market since the date of introduction of the legislation year til now has been nothing but a continuous, steady downhill trend, and we're enjoying a very low interest market at the moment, which certainly has to have a much larger effect on the cost of selling than anything else I can imagine. I'm again exceeding my time.

Mr. Kanjorski.

Mr. KANJORSKI. Mr. Chairman, I think I have asked all my questions and heard all the answers. I suggest this has been a very successful hearing.

Chairman BAKER. Does any other Member wish to be heard?

Ms. JONES. Just very briefly. Some would say that the current interest market has been influenced by conversations by our chief officer of Government and other elected officials or appointed officials in his Administration. Some would say that, wouldn't they, Mr. Brendsel, Mr. Howard?

I'm not asking you to say it, because you can't say it, but I can say it. That some of the articles would say that the interest or the economy is in the position that it was—I think it was the *New York Times* in fact that said that some in our Administration have talked the economy down. You read that, didn't you, Mr. Brendsel? You don't have to admit to it. But I know you read it. Well, let me go on.

[Laughter.]

Ms. JONES. Standard & Poor's and Moody's, those are the organizations that evaluated your economic status and debt ratio, right? Correct?

Mr. HOWARD. Yes, that's correct.

Mr. BRENDSEL. That is correct.

Ms. JONES. And in fact, they're kind of like Alan Greenspan. When he speaks, people listen. When Standard & Poor's and Moody's give you a rating, people listen to that, right?

Mr. HOWARD. Yes they do.

Ms. JONES. And in fact, in order to judge your soundness, and what's the other word I want?

Mr. HOWARD. Safety.

Ms. JONES. And safety. Thank you very much. You went to these institutions to have them evaluate you and even passed what was part of the voluntary agreement.

Mr. HOWARD. Correct.

Ms. JONES. And so if I were sitting in your shoes, I would feel pretty darn good about the—I wish my son would get A and double AA and what are those other ratings?

[Laughter.]

Ms. JONES. But he says, Mom, give him time. But you're at that status right now. Is that correct?

Mr. HOWARD. Yes we are.

Ms. JONES. I wondered if you might briefly elaborate for me. One of my colleagues said something about when you can raise capital by issuing debt. I can't think of his name. He's seated four down on the side. He said that the way you can raise capital for your company is by issuing debt. Is that correct?

Mr. HOWARD. He may have said that.

Ms. JONES. Anyway, he raised the question. My question is—and I'm not a business expert or anything—but most corporations raise capital by issuing debt. You're not doing anything unlike other corporations. Is that a fair statement?

Mr. HOWARD. I don't believe we are.

Ms. JONES. OK. And wouldn't it be fair to say that because of the lack of affordable housing in the United States and because there are so many people in need of housing, there's room at the table for many, many financial institutions who want to engage in mortgage lending in communities, regardless of their color, economic interest, to get involved?

Mr. HOWARD. Very much so.

Ms. JONES. And that even though this is a competitive market, Fannie Mae does not have to engage in threatening tactics in order to be successful?

Mr. HOWARD. We do not and have not.

Ms. JONES. What about you, Freddie Mac? Do you have to engage in threatening tactics in order to be successful?

Mr. BRENDSEL. No. We never have and we never will.

Ms. JONES. I'll yield, Mr. Chairman.

Chairman BAKER. Thank you.

Mr. Shays.

Mr. SHAYS. Thank you, Mr. Chairman. I just want to say that both your organizations have been very helpful to me. Both organizations are very responsive.

But I found the hair on my back rising when you talked about going to any market where you see an opportunity, where there's an overpricing and so on. It almost sounded a little sanctimonious to me, with all due respect.

You all are given opportunities to compete that your competition in a sense doesn't have. Is that correct?

Mr. HOWARD. This is a longer discussion, but I think that's a complicated subject.

Mr. SHAYS. It is a complicated subject. And that's almost an arrogant answer. I realize it's a complicated subject. But the bottom line is, you are given certain opportunities that your competition doesn't have.

Mr. HOWARD. We are given different opportunities from those which our competition's been given.

Mr. SHAYS. Your cost of capital is less, correct?

Mr. HOWARD. In the long-term end of the market, yes. In the short term, it is higher than our competition.

Mr. SHAYS. You don't have to file certain reports, correct?

Mr. HOWARD. That's correct.

Mr. SHAYS. You don't have to pay State and local taxes?

Mr. HOWARD. Through Congressional design.

Mr. SHAYS. I know that. I'm not saying that you have these powers illegally. You have them. We've given them to you. And doesn't that apply to you as well? It applies to both organizations.

Mr. BRENDSEL. That's correct.

Mr. SHAYS. So you don't have to pay State and local taxes. You can get capital, at least in the long-term, cheaper. There are certain advantages you have.

And so what obligations do I have up here to make sure that you don't use those advantages to basically put everyone out of business?

Mr. HOWARD. We have a charter that precisely limits us to channeling whatever those advantages may be into housing.

Mr. SHAYS. So the charter basically sometimes is going to tell you that you can't go into a marketplace even if you happen to think that the market is overpriced and you have opportunities?

Mr. HOWARD. Yes, that's correct.

Mr. BRENDSEL. I think I would agree with many of the points that you were making, Congressman. We compete with certain tools, advantages, that come as a result of our charter. And indeed, with those tools come special or different responsibilities. We're limited obviously to only the residential mortgage market.

Indeed, we're also limited. We can't originate a mortgage loan. In addition, of course, we can't buy mortgage loans on expensive housing, so-called jumbo loans.

Our charter is very clear. We can't go off into doing credit cards. We can't go off into any number of different other things.

Mr. SHAYS. The bottom line, the purpose for which you exist is to enable Americans to buy more homes. That's the basic purpose for why you exist. And you've done a pretty good job of that. Am I wrong? Isn't that the basic purpose? If we want more residential housing, we want more homeowner properties.

Mr. HOWARD. But beyond that, it's targeted residential investment. That's why we have housing goals that guide us as to where we should focus whatever benefits Congress gave us. There are limits that come with the benefits.

Mr. SHAYS. So you could make a determination in your charter allowed it that there's great opportunities in the jumbo loan market?

Mr. HOWARD. No. That's expressly——

Mr. SHAYS. Maybe you didn't hear my question. If your charter allowed it?

Mr. HOWARD. Yes.

Mr. SHAYS. And we tell you you can't go into that marketplace. Why do you think we do that?

Mr. HOWARD. To focus our efforts where Congress deemed they were most necessary.

Mr. SHAYS. So you have a problem with this subcommittee overseeing your activities?

Mr. HOWARD. No.

Mr. SHAYS. Do you have a problem with our investigating the possibility of providing more regulations?

Mr. HOWARD. No.

Mr. SHAYS. That's good.

Mr. HOWARD. Terrific.

Mr. SHAYS. We'll be watching.

Mr. HOWARD. We look forward to it.

Mr. BRENDSEL. Congressman, could I make an additional comment? And indeed, with regard to the last point, we in fact welcome the oversight.

Actually I think it makes us a better organization, a better company, and it's really better for the Nation as a result.

Finally, the other point I wanted to make is the issue of benefits or advantages relative to others. Mr. Howard said it's a complex issue. It's more complicated than simple, I think, as has been reflected here today in our conversation.

Freddie Mac recently requested that James Miller, former Director of OMB in the Reagan Administration, and James Pearce with Welch Consulting, do a study to look at our companies' advantages, the benefits we receive, and then the benefits to consumers. That was a report they issued on January 9th.

Two points I would leave you with. One is it clearly shows that the benefits realized by the Nation, consumers and homebuyers, the value of those greatly exceeds the advantages realized by Freddie Mac and Fannie Mae.

The second point they make is, in fact, there are many other institutions in the marketplace in residential mortgage markets elsewhere that possess their own set of federally bestowed advantages, specifically banking institutions that have federally-insured deposits and that are members or are able to borrow from the Federal Home Loan Bank system, which are themselves Government-chartered corporations.

And so, their final conclusion was, in fact, that we were a more efficient way for the Government to support and encourage the flow of mortgage credit to this Nation's mortgage markets.

Mr. Chairman, I'd like to submit that report for the record.

[The report referred to can be found on page 103 in the appendix.]

Chairman BAKER. Without objection.

Mr. Hinojosa.

Mr. HINOJOSA. Thank you, Chairman Baker.

I would ask Mr. Howard a question. Can you please tell me what the predatory lending is and how it differs from subprime lending?

Mr. HOWARD. Predatory lending in my view—and I'm not the world class expert on this—does not have a precise definition. In general, they are lending practices that are not in the best interests of the consumers, and typically the consumer is not made fully aware of prior to committing to a loan.

We have categorized predatory lending practices into certain groups. And at that point, the basis for the guidelines that we put out to our lenders.

But precisely because there is not a specific definition of predatory lending, we entered into discussions with numerous parties to try and come up with a right balance, because the flip side of too restrictive guidelines is that people who have only one place to get credit find they can't get credit anywhere, which is an outcome we don't want. So we're attempting to find that fine line between making sure that people have loans they can afford, even if they have to pay a higher rate because of their past credit, and abusive practices that end up causing them to lose their home.

Mr. HINOJOSA. I think Freddie Mac—I'd like to ask you what is your company doing to respond to the problems that Mr. Howard just outlined?

Mr. BRENDSEL. In predatory lending?

Mr. HINOJOSA. Predatory lending, yes.

Mr. BRENDSEL. We refuse to purchase certain kinds of loans that are generally regarded as being associated with predatory lending practices, excessive interest rates on those loans, single-premium credit life insurance, prepayment penalties that extend for an excessive period of time.

We also refuse to deal with certain lenders that we have determined are associated with predatory practices. So it's a combination of having policies against purchasing certain kinds of loans and also policies against dealing with lenders that are associated with abusive practices.

Mr. HINOJOSA. Thank you for that explanation. I wish to yield the balance of my time to Congresswoman Jones.

Ms. JONES. Thank you, my colleague. Let me begin with the question on restrictions and go through maybe a few restrictions that Fannie Mae has as a result of being a Government sponsored enterprise.

You're restricted to a single line of business, residential mortgages. Is that correct, Mr. Howard?

Mr. HOWARD. Yes it is.

Ms. JONES. You are confined to mortgages under the loan limit, currently $275,000 for a single family loan. Is that correct?

Mr. HOWARD. Yes it is.

Ms. JONES. You're required to operate in all markets at all times. Is that correct?

Mr. HOWARD: Yes.

Ms. JONES. Must meet percent of business goals for affordable housing, correct?

Mr. HOWARD. Correct.

Ms. JONES. And meet a rigorous risk-based capital test in addition to six voluntary agreements or policies you just recently accorded yourself to. Is that correct?

Mr. HOWARD. Yes. Although currently we're meeting the interim test because the regulatory test has not been officially promulgated.

Ms. JONES. Now let me go to the charter purposes. One, to provide stability in the secondary market for residential mortgages. Is that correct?

Mr. HOWARD. It is.

Ms. JONES. To respond appropriate to the private capital market, correct?

Mr. HOWARD. Yes.

Ms. JONES. To provide ongoing assistance to the secondary market for residential mortgages, including activities relating to mortgages on housing for low- and moderate-income families, and following a reasonable economic return that may be less than the return on other activities by increasing the liquidity of the mortgage investments and improving the distribution of investment capital available for residential mortgage financing, correct?

Mr. HOWARD. That sounds right.

Ms. JONES. And finally, to promote access to mortgage credit throughout the Nation, including central cities, rural areas, and underserved areas by increasing, quote, "the liquidity", unquote, of mortgage investments and improving the distribution of investment capital available for residential mortgage financing charter purposes, correct?

Mr. HOWARD. Yes.

Ms. JONES. And it is not your intention in any of the activities that you engage in, Mr. Howard, Mr. Brendsel, to act outside of those chartered purposes.

Mr. HOWARD. It is not.

Ms. JONES. Is that a fair statement?

Mr. BRENDSEL. That's correct.

Ms. JONES. Thank you. I yield the balance of my time, Mr. Chairman.

Chairman BAKER. Thank you, Ms. Jones.

Ms. JONES. Mr. Hinojosa's time actually.

Chairman BAKER. Thank you, Mr. Hinojosa-Jones.

[Laughter.]

Chairman BAKER. Mr. Shays.

Mr. SHAYS. Mr. Chairman, I didn't really need a full 5 minutes just to say that I really appreciate both witnesses appearing before us.

You know, I'm new to this subcommittee. I find this a very interesting subcommittee to serve on. I appreciate your chairmanship of this subcommittee.

But I have a lot of constituents who both work with you and appreciate your partnership and also compete with you. I have a lot of consumers who have benefited deeply by what your organizations do, but I'm absolutely convinced that the playing field isn't level. And because it's not level, we have that oversight responsibility.

I look forward to learning more about what you all do and how you try to conform to your charter and so on. Thank you. I thank you, Mr. Chairman.

Mr. HOWARD. We look forward to working with you on that.

Chairman BAKER. Thank you, Mr. Shays.

There being no further comment from Members, I just wish to wrap our hearing up today.

Someone asked earlier in the course of the hearing who would be the overseer to assure third parties that the terms of the voluntary agreement are successfully implemented over time.

Since we joined hands at the start, I guess it would be appropriate for us not to release hands until we get a regulatory structure that we can pass this responsibility off to.

So I will announce, with the agreement of Mr. Kanjorski, who had to leave a little bit earlier, that we will continue in this fashion on some semi-annual or annual basis to receive reports from the enterprises using today's report as the benchmark against which future measurements can be made.

Second, and it's has been referred to widely, but we will have legislation to introduce in the near term on the suggested regulatory structure, which I have not yet, but do intend to visit with both of the GSE management teams before the bill is finally brought.

I also shared that with Mr. Kanjorski and assured him that we would get him a copy of the bill before it would be finally introduced.

We will also soon receive the report from the CBO relative to the now long-awaited subsidy evaluation which could be the subject of an additional topic.

Suffice it to say we are going to move very slowly, but I want the Members of the subcommittee and the representatives of the GSEs to understand that we're going to have a very thoughtful through-the-summer type of discussion, no rush to judgment. But I do believe that the steps we take in here build a platform of a cooperative agreement that can be carried forward, and that we won't find it necessary to result in some of the exchanges which occurred in last year's debate and that we can jointly perform the service of making good public policy while not adversely affecting home ownership, and I think at the same time enhance the marketability of the two enterprises' products by creating a regulator that does have credibility.

To that end, gentlemen, I look forward to working with you and Members of this subcommittee.

Mr. BRENDSEL. And we welcome the opportunity to work with you, Mr. Chairman.

Mr. HOWARD. As do we.

Chairman BAKER. Thank you very much. The hearing is ended.

[Whereupon, at 4:20 p.m., the hearing was adjourned.]

A P P E N D I X

March 27, 2001

EXCHANGE

Subcommittee on Capital Markets

Richard H. Baker, Chairman

Securities, Insurance, Government-Sponsored Enterprises

The News from U.S. Rep. Richard H. Baker
Sixth District, Louisiana
FOR IMMEDIATE RELEASE: March 27, 2001
CONTACT: Michael DiResto, 225-929-7711

Opening Statement
The Honorable Richard H. Baker
Chairman, House Financial Services Subcommittee on
Capital Markets, Insurance and Government Sponsored Enterprises
March 27, 2001
Capital Markets Subcommittee Hearing
"Reviewing Fannie Mae's and Freddie Mac's Initiatives for
Enhanced Risk Management and Market Transparency"

I have read news reports today announcing that Fannie Mae and Freddie Mac have already met and exceeded the six commitments they made to myself, Rep. Kanjorski and other Capital Markets subcommittee members last October. Nevertheless, we will go ahead with today's hearing as planned. And I want to thank Mr. Brendsel and Mr. Howard for appearing before us today to share their news with Congress as well.

I have also read with interest a series of news reports chronicling the spirited exchange of words between Fannie and Freddie and several of their business partners and competitors with regard to various criticisms and defenses of the two companies' activities. Today and throughout this month Fannie and Freddie have faced and responded to serious charges concerning financing access for low-income homebuyers, mission creep, and anti-competitive business practices.

I am confident Ranking Member Kanjorski joins me in hoping that both sides of these disputes will promptly cool their rhetoric. While these charges may deserve consideration by the subcommittee, they are not the subjects of today's proceedings. I do not think the subcommittee should jump recklessly into these disputes. Nor do I think it's likely that heated exchanges will help bring about our common desire for a reasonable resolution of these matters being sought by regulators or others.

Today we have hopes of starting anew on the right foot. In October we took a "meaningful first step" toward greater market transparency and enhanced risk management. The subcommittee will now begin to examine the details of these measures previously proposed in broad strokes. I hope we will be able to assess not only Fannie's and Freddie's progress in implementing these commitments, but also if, when implemented, these measures in fact meet our goals of real transparency and market discipline and how we might best monitor Fannie's and Freddie's performance in this regard.

To that end I would remind subcommittee members of two facts underlying the importance of our oversight responsibilities. First, according to most recent estimate projections, Fannie Mae's and Freddie Mac's outstanding debt will surpass the level of outstanding publicly held Treasury debt by year 2005. Moreover, total outstanding housing GSE debt will surpass Treasury debt by 2003 and exceed the $4 trillion mark in 2005 (see chart below).

Second, the Treasury testified last year that "GSEs operate with less equity capital per dollar of debt than other financial institutions. Fannie Mae and Freddie Mac have roughly $32 of debt for each dollar of capital.... In contrast, per dollar of capital, large banks have about $11.50 of debt [and] thrifts have $12.50 in debt." Also, though without making comparisons to the companies' respective management and areas of business, we know from the President's Working Group on Financial Markets that less than one month before it's collapse the hedge fund Long-Term Capital Management had "a balance-sheet leverage ratio of more than 25-to-1."

When financial markets are beginning to contemplate a world of scarcer Treasury bonds and replacement benchmark debt, common sense dictates that these two facts inform how Congress adequately addresses the future stability of financial markets and any repercussions for American taxpayers.

We have made extraordinary progress from when we first raised systemic-risk questions a year ago. I commend Fannie and Freddie for the speedy implementation of their enhanced disclosure and risk-management commitments, but more so for the courage it took to admit their necessity. With systemic risk, as with all problems, acknowledging a problem's existence and agreeing to work together to solve it are the first and most important steps.

I appreciate Chairman Oxley's interest in considering the need for positive regulatory change. I look forward to working closely in the coming weeks with the chairman, with Fannie Mae and Freddie Mac, and with subcommittee members in crafting common sense regulatory reform that clears away all existing market uncertainty and toward the final goal of sound public policy. For the good of homebuyers, investors, taxpayers, and the GSEs themselves.

(Chart attached)

Treasury, Fannie & Freddie, Housing GSE Debt Outstanding

Dollars, in billions

Fiscal Year	Publicly Held Treasury Debt *	Fannie Mae & Freddie Mac Debt **	Housing GSE Debt***
1995	3,603.34	419.11	656.01
1996	3,733.01	488.25	743.15
1997	3,771.13	542.62	837.82
1998	3,720.09	747.69	1,090.89
1999	3,633.00	908.33	1,389.93
2000	3,410.00	1,069.58	1,650.18
2001	3,174.00	1,293.12	1,983.33
2002	2,947.00	1,563.38	2,383.74
2003	2,715.00	1,890.13	2,864.98
2004	2,463.00	2,285.17	3,443.38
2005	2,206.00	2,762.77	4,138.54

* Source: Office of Market Finance, U.S. Treasury Department, and President's budget, "A Blueprint for New Beginnings," page 201. FYs 2001-2005 are estimates.

** Source: FYs 1995-2000: Office of Federal Housing Enterprise Oversight.
FYs 2001-2005 are projections based on average growth rate for FYs 1995-2000.

*** Source: FYs 1995-2000: Office of Federal Housing Enterprise Oversight and Federal Housing Finance Board. FYs 2001-2005 are projections based on average growth rate for FYs 1995-2000. Figures represent combined debt levels of the Housing GSEs: Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

Compiled by the U.S. House Financial Services Subcommittee on Capital Markets

From the office of...

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Tuesday, March 27, 2001

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BENTSEN STATEMENT ON HOUSING GOVERNMENT-SPONSORED ENTERPRISES OVERSIGHT HEARING

(WASHINGTON, D.C.) -- As a Senior Member of the House Financial Services Committee, Congressman Ken Bentsen (D-TX) issued the following statement for today's hearing.

Hearing to Review Voluntary Agreement by Government-Sponsored Enterprises
The Honorable Kenneth E. Bentsen, Jr.
of Texas
before the Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises
Tuesday, March 27, 2001

Mr. Chairman, Thank you for holding this hearing today on the progress on the Voluntary Agreement reached last year by the two government-sponsored enterprises, Fannie Mae and Freddie Mac. As one of the original supporters, I am very pleased that Chairman Baker has agreed to hold this hearing today so we can learn more about the progress that these two housing government-sponsored enterprises (GSEs) have made to meet this program.

I believe that this Voluntary Agreement will help to increase the public confidence in Fannie Mae and Freddie Mac. The Voluntary Agreement calls for these GSEs to implement a six-point plan to increase transparency in the capital markets. These six points include 1) issuing publicly-traded subordinated debt and externally-rated subordinated debt over the next three years; 2) obtaining an annual rating for each company; 3) disclosing a new monthly statement on each company's sensitivity to interest rate changes; 4) disclosing quarterly statements on sudden decline in property values; 5) maintaining greater liquidity; and 6) performing an interim risk-based capital stress test. The last point is especially important since the current regulator of these housing GSEs, the Office of Federal Housing Enterprise Oversight (OFHEO), has not issued its final risk-based capital rules.

I am looking forward to hearing from our witnesses about their efforts to make these companies more accessible and accountable to the public. With additional market and credit information, taxpayers and investors will learn more about their financial strengths and weaknesses. I believe that this program is appropriate and will help to ensure that our secondary mortgage market remains the envy of the world. The voluntary agreement is an important step in ensuring that the government-sponsored enterprises adhere to market disciplines and thus avoids any risk to the taxpayers.

Congressman Joseph Crowley
Remarks: Hearing - Capital Markets
March 27, 2001

Thank you Chairman Baker and ranking Member Kanjorski for holding this important hearing today on the state of two of our nations' most important Government Sponsored Enterprises, Fannie Mae and Freddie Mac

I welcome the opportunity of our two witnesses today to discuss their implementation of the six commitments agreed to between Freddie Mac and Fannie Mae and this Subcommittee last year

As a representative of a middle and working class district in Queens and the Bronx, I have had the opportunity to see firsthand the good work of the two housing GSE's represented here today - Freddie Mac and Fannie Mae

We have all come to appreciate -- but sometimes to take for granted -- how great our American system for housing finance is, and how much it depends upon the successful operation of the secondary market for home mortgage loans

In fact, in the United States secondary mortgage marketplace is the envy of the world

I firmly believe that the high percentage of home ownership for all Americans is directly linked to Freddie and Fannie's economic impact

For banks like Maspeth Federal Credit Union and others in New York City and around the country, the secondary market provides expanded opportunities for them to compete with larger commercial banks by offering lower mortgage interest rates

As home ownership rates have risen to the highest rate in our history - we would be derelict to ignore the importance of Freddie and Fannie in achieving this goal.

In fact, under the housing guidelines established by Congress in 1992, whereby both GSE's were given housing goals to be adjusted annually by HUD, we see that again, Freddie and Fannie have both exceeded their percentage goals in providing housing to low and moderate income individuals, underserved individuals and special affordable housing

And many of my constituents have benefited from Freddie Mac and Fannie Mae's services

While I know some people have raised concerns about the activities of Freddie and Fannie, I understand that we will see that both housing GSE's have not only lived up to the commitments outlined last year, but in some instances far surpassed them

Again, Freddie and Fannie are serving as industry leaders

So Mister Chairman , Members of the Committee, I look forward to what we will hear today, but caution everyone to remember the old adage, "if it ain't broke, don't fix it"

Again, I thank Chairman Baker and Ranking Member Kanjorski

OPENING STATEMENT

Voluntary Enhancement, Capital Strength, Disclosure and Market Discipline

Rep. Stephanie Tubbs Jones

Good Morning, Chairman Baker, Ranking Member Kanjorski and Members of this Committee. Mr. Chairman, I ask unanimous consent that my full statement be included in the Record.

Mr. Chairman, we are here this morning to review the voluntary agreements that were established to improve capitalization, information disclosure, and market discipline. Many of us on this committee remember and sat through six GSE hearings in which we examined in great detail Fannie Mae and Freddie Mac.

From those hearings, we examined their safety and soundness to an exhaustive length. And I must note that, at no time, did we find there to be any safety and soundness issues.

Fannie Mae and Freddie Mac pledged themselves to six Voluntary Commitments. Those commitments included periodic issuance of subordinated debt. Liquidity Management and Contingency Planning. Interim Implementation of Risk-based Capital Stress test. New interest-rate risk disclosures. New credit risk disclosures and public disclosure of annual rating. For every one of these commitments, Fannie and Freddie have either completed or will complete. These commitments put them at the forefront of financial services organizations, not just in the United States, but in the world, with respect to financial disclosures.

I am proud to hear of this progress made by both Fannie and Freddie in stepping up to the challenge and thereby demonstrating that they are both solid and sound institutions. Their success is America's success.

Mr. Chairman, I hope our review this afternoon will allow Fannie Mae and Freddie Mac to continue to fulfill their housing mission and do what they do best. Their mission is an important mission. I am not as concerned about a market share war, but I am concerned about affordable housing in the 11th Congressional District, homeownership for those still seeking a piece of the American dream, and also special housing needs of the elderly.

Housing, Mr. Chairman, is still a key public policy concern. Despite the pundits who claim that we do not need to improve our homeownership rates, I believe just the opposite. There are citizens, all across this nation, including the 11th Congressional District, who are struggling with skyrocketing rents as well as inadequate housing stock. GSEs were established to address these problems. All I say is, "Let them do the job." Again, "if it ain't broke, why fix it." Let Fannie and Freddie continue to ***"lead the mortgage finance industry in making credit available for low- and moderate-income families."***

I am glad today that we have representatives from the GSEs to make their own case. I want to extend a welcome to Chairman Leland Brendsel, Freddie Mac and Timothy Howard, Executive Vice President and Chief Financial Officer, Fannie Mae.

I realize Mr. Chairman that putting a family into a home is much more than originating a mortgage, automated underwriting systems or implicit/explicit relationships. Putting a family into a home provides a family with, in many instances, its first real asset or even provides a legacy for future generations. Homeownership, I believe, is one of the key first steps to true empowerment. Thus, we cannot continue our "GSE review", that could, in effect hurt citizens looking for affordable housing and to purchase a home.

With the provisions granted GSEs, I believe in the importance of safety and soundness, disclosure and market discipline. I believe that the GSEs have met this challenge. Afterawhile, Mr. Chairman, our reviews of these GSEs become counterproductive. I am sure, in light of predatory lending abuses, insurance abuse and financial scams impacting pension plans and individual citizens, there are some other areas for our subcommittee to review and investigate.

Do not misunderstand me. I have greatly appreciated the process of reviewing institutions that play very critical roles in financial services and mortgage industries. But, I do not know of any other entity that have received this much attention and have shown they are operating within charter and mission and are sound operationally.

I do know, Mr. Chairman, that there are many large companies who make the claim that the GSEs do not play fair. I understand that. However, if the GSEs are within charter, let them do what they were challenged to do back in 1992. Let us not legislate where legislation is not needed.

Mr. Chairman, I do not support efforts to increase the regulatory burden placed on GSEs, burdens that will ultimately be passed on to consumers. If the information suggests GSEs have not done what they are required to do, let's fix it and move on. If the GSEs, however, are on track and are accomplishing their mission, again, let us move on.

I do question the merits of some of these large companies. Where were they when people could not get a mortgage, get affordable housing and develop special housing stock. Where were they? No where to be found.

I hope that our review this afternoon serves to clear the record about GSE safety and soundness. I realize that there is much more to be done by GSEs. While homeownership rate sit at or around 67%, and some say saturated, there is still room for improvement for those left out of this nation's prosperity as African American and Hispanic homeownership rates are still under 50% (47.8%) and 47.5% respectively. Let them improve.

Thank you, Mr. Chairman, for the opportunity to present my remarks. I look forward to this hearing.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON THE STATUS OF THE
VOLUNTARY COMMITMENTS
MADE BY FANNIE MAE AND FREDDIE MAC

TUESDAY, MARCH 27, 2001

Mr. Chairman, before commenting further on today's proceeding, I must first commend you for your continued leadership on government-sponsored enterprise, or GSE, issues. In the 106th Congress, in addition to passing legislation to modernize the Federal Home Loan Bank System, we held hearings over five days and a roundtable on legislation designed to reform the regulation of the housing GSEs and eliminate some of their statutory benefits. Although that bill did not become law, it did help lead to the development by Fannie Mae and Freddie Mac of the six voluntary commitments, the subject of today's hearing. You played an important role in raising public awareness about these issues and deserve congratulations.

During our lengthy hearings last year on GSE regulation, I also believe that we reached consensus on several points. First, we agreed that we have the world's most successful housing finance system and gained an appreciation for the important role that the GSEs play in that system. Second, we agreed that Fannie Mae and Freddie Mac have grown significantly in recent years. Finally, we agreed that we must have strong, independent regulators for the housing GSEs. These regulators must also have the resources they need to get the job done.

As one of the few remaining Committee Members who participated in the entire congressional battle to resolve the savings and loan crisis, I am acutely aware of the need to protect taxpayers from risk. It is in the public's interest that we ensure that Fannie Mae and Freddie Mac continue to operate safely and soundly. We can best achieve this goal by pursuing a three-pronged supervisory approach that includes regular congressional oversight of, continued effective government regulation over, and increased market discipline for the two GSEs.

Through our extensive studies last year and our hearing today, we are fulfilling our obligation in Congress to conduct regular oversight of the GSEs. In addition, OFHEO, is, fom my perspective, operating increasingly effectively as the safety and soundness regulator for Fannie Mae and Freddie Mac. The agency has, for example, developed and implemented a robust, comprehensive, and continuous examination program that works, and it will soon publish its long-awaited risk-based capital standard to round out its existing capital standards.

The voluntary commitments recently developed by Fannie Mae and Freddie Mac to promote market discipline complete the third leg of my supervisory tripod by strengthening capital adequacy and increasing transparency. The overall package, in my view, constitutes a sound set of measures that supplement OFHEO's formal regulatory regime and augment congressional oversight. The voluntary commitments are also consistent with the prevailing thinking of the leading minds on risk management.

At our press conference last October on the voluntary commitments, I noted that when implemented the initiatives would hopefully become a complement to, and not a substitute for, OFHEO's already strong safety and soundness examination program and capital requirements. In that vein, I asked OFHEO to review the regulatory environment surrounding the voluntary measures in advance of today's hearing. In his response, OFHEO's director notes that "[b]y making these enhanced disclosures, Fannie Mae and Freddie Mac improve the public's awareness about their financial condition and risk management practices." I agree and would ask, Mr. Chairman, unanimous consent to submit this letter into the record.

If we once again decide to pursue legislative action affecting the GSEs in the 107th Congress, we must ensure that we do not diminish their ability to work efficiently. We should also, in my view, explore modernizing their mission. For example, the GSEs could work to improve economic development in our nation's distressed areas. They could also work to create a secondary market for investments made pursuant to the Community Reinvestment Act. These worthy ideas merit our prudent consideration.

Finally, throughout last year's deliberations on GSEs, I consistently noted that we must move forward cautiously in this area so as to ensure that we maintain the delicate balance that has led to more than 67 percent of all American families owning their homes. On at least one occasion last year, however, our Committee's actions discouraged investors and raised homeownership costs. As we proceed today, we must renew our efforts to ensure that we do not repeat that mistake. Mr. Chairman, I therefore look forward once again to carefully, deliberately, and objectively examining the many issues related to the housing GSEs in the 107th Congress.

OFHEO OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
1700 G STREET NW WASHINGTON DC 20552 (202) 414-3800

March 27, 2001

The Honorable Paul Kanjorski
Ranking Member
Subcommittee on Capital Markets, Insurance,
And Government Sponsored Enterprises
U.S. House of Representatives
Washington, DC 20515

Dear Congressman Kanjorski,

I am responding to your office's request that OFHEO provide background on the regulatory environment surrounding the voluntary measures agreed to last October by Fannie Mae and Freddie Mac. I appreciate this opportunity to provide you with my thoughts.

As you know, international financial regulators have been working to enhance the global standards used to regulate large and complex financial firms. The authoritative international body of financial regulators, the Basel Committee on Banking Supervision, has espoused a three-pillar approach to enhancing safety and soundness regulation for large and complex banking firms. Generally, the three pillars are:

- Prudential capital standards – consisting of more standardized measurements of risk and definitions of capital;
- Prudential supervision – consisting of some level of regulatory testing and verification of systems, processes, controls, and reporting; and
- Market discipline – consisting of greater transparency through public disclosure allowing market forces to better differentiate among institutions' risk profiles.

The regulatory program OFHEO has adopted to regulate the safety and soundness of Fannie Mae and Freddie Mac is consistent with the three pillars of the Basle Committee on Banking Supervision and may well be complemented by the heightened market scrutiny evolving from the voluntary agreement.

Consistent with the first pillar, OFHEO enforces a minimum capital standard which is very similar to the risk-based capital standard to which banks are currently subject. Also, OFHEO has completed its risk-based capital test and is in the final administrative stages of implementing the rule. The combination of minimum capital and the risk-based capital stress test will subject Fannie Mae and Freddie Mac to the most sophisticated effort yet to link capital to risk while maintaining a capital floor.

Consistent with the second pillar, OFHEO conducts comprehensive annual risk-based examinations of Fannie Mae and Freddie Mac. Unique to OFHEO is the fact that the process employed in examining the Enterprises' safety and soundness as well as the results and conclusions of the annual examinations are available to the public. In it's January 31, 2001 letter to Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises Chairman Richard Baker (Comparison of Financial Institution Regulator's Enforcement and Prompt Corrective Action Authorities: GAO-01-322R), the General Accounting Office (GAO) stated that,

> "Under the Safety and Soundness Act, the Director of OFHEO is required to provide Congress with an annual report that includes a description of any actions take by the Director, as well as the results of the Enterprises' examinations. These disclosure provisions may encourage early resolution of issues to avoid disclosure of OFHEO's concerns. The bank regulators and FHFB do not have such a disclosure requirement."

In line with Basle's third pillar, on October 19, 2000, Fannie Mae and Freddie Mac (the Enterprises) joined a bi-partisan group of Members of Congress in announcing six commitments covering financial operations and financial disclosures.

As we stated in our 2000 Report to Congress, we believe:

> "Market discipline of Fannie Mae and Freddie Mac is a potentially important complement to safety and soundness regulation of the Enterprises. If creditors have accurate and timely information on the financial risks of Fannie Mae and Freddie Mac and believe that they are exposed to material risk of loss if the Enterprises get into financial trouble, they will take steps to ensure that the Enterprises strike an appropriate balance between risk and return. By enhancing market discipline, greater transparency has the potential to limit the systemic risk that Fannie Mae and Freddie Mac may pose to the financial system."

By making these enhanced disclosures, Fannie Mae and Freddie Mac improve the public's awareness about their financial condition and risk management practices. Increased awareness about Fannie Mae's and Freddie Mac's financial condition and risk management practices allows market forces to better differentiate the credit premium to be attached to each Enterprise's debt instruments and offerings.

With that said, I want to provide you with what OFHEO is already doing on each of the six areas of the agreement.

Commitment #1 – Periodic Issuance of Subordinated Debt

The first area the Enterprises agreed to take action is in the issuance of publicly traded and externally rated subordinated debt on a semi-annual basis. This subordinated debt is to be issued in an amount such that the sum of core capital and outstanding subordinated debt will equal or exceed 4% of on-balance-sheet assets over a three-year phase-in period.

Some proponents advocate that subordinated debt may serve as an effective means of detecting market signals. When considering the Enterprises' sub debt, only time will tell if the markets will treat this debt truly as an investment at risk. If investors are able to treat this debt as if it does not carry an implied government guarantee, it may well be an effective means at providing added market discipline.

Regardless, OFHEO already routinely evaluates the Enterprises' funding composition, the cost of funds and other metrics during its examination of liquidity and liquidity management. Our 2001 examinations are already assessing, through our continuous risk-based activities, the Enterprises' compliance with this commitment and the accuracy of public reporting.

Commitment #2 – Liquidity Management and Contingency Planning

The Enterprises committed to maintain their management practices for liquidity consistent with the principles of sound liquidity management prescribed by the Basel Committee on Banking Supervision. In particular, the Enterprises committed to maintain at least three months worth of liquidity assuming there is no access to public debt markets.

Through its comprehensive examination program, OFHEO has already been assessing the quality of liquidity and liquidity management. Liquidity management and contingency planning are evaluated continuously against the ten assessment factors prescribed in OFHEO's Liquidity Management Program. OFHEO has been engaged in a dialogue with the Enterprises as they have developed the measurement for how they will be reporting under this voluntary commitment, and we will be examining for the accuracy of the reporting they will provide going forward.

Commitment #3 – Interim Implementation of Risk-based Capital Stress Test

Pending final promulgation of OFHEO's risk-based capital standard, the Enterprises will implement their version of a risk-based capital stress test and disclose whether they pass or fail the test on a quarterly basis.

OFHEO's work on the risk-based capital requirement is completed. Pending the publication of a final rule and its effective date (one year later), the Enterprises will operate their independent stress-test versions of the 1992 Act's requirements.

As with the Enterprises' other internal models, OFHEO's examination activities evaluate the quality of these proprietary tools and the validation processes. OFHEO has recognized the growing importance of internal models and automated methodologies by: establishing a dedicated examination group for internal models; hiring examination staff with expertise to conduct the examination work; and publishing OFHEO's methodology for examining the Enterprises' internal models (EG-2001-01).

Commitment #4 – Increased Interest-Rate Risk Disclosure

The Enterprises will publicly disclose on a monthly basis (beginning with first quarter 2001) the expected financial impact of immediate adverse changes in interest rates and the slope of the yield curve.

Through a comprehensive examination program, OFHEO already examines the level of interest rate risk exposure at the Enterprises and the quality of their interest rate risk management tools and practices. Interest rate risk exposure along with the resulting exposure from various changes in the level of interest rates or changes in the yield curve are continuously monitored by a team of qualified and experienced examiners. The Enterprises' exposure to interest rate risk is continuously assessed using a series of safety and soundness standards published in OFHEO's Interest Rate Risk Program within its annual risk-based Examination Program.

OFHEO has been engaged in a dialogue with the Enterprises as they have developed the method for how they will be reporting under this voluntary commitment, and we will examine and assess the accuracy of these reports.

Commitment #5 – Increased Credit Disclosure

The Enterprises will publicly disclose the results of portfolio credit risk sensitivity analyses on a quarterly basis that demonstrates the expected financial impact of an immediate 5% decline in house prices.

Through a comprehensive examination program, OFHEO already evaluates the portfolio sensitivity resulting from sharp and immediate declines in collateral values. The examination analyses covering changes in collateral values are among the various vulnerability analyses that are continuously evaluated throughout the year by OFHEO's examiners. OFHEO has a team of qualified and experienced examiners who are continuously monitoring and testing the Enterprises' credit and counterparty vulnerabilities using a series of safety and soundness standards contained in OFHEO's Credit Risk Program as set forth in the published Handbook that details the processes for OFHEO's annual risk-based Examination Program.

OFHEO remains engaged in a dialogue with the Enterprises as they develop the method for how they report credit risk exposure including the requirements of this voluntary commitment. We have already included an evaluation of the accuracy of the reporting for this commitment into our 2001 (and future) examinations.

Commitment #6 – Public Disclosure of an Annual Rating

The Enterprises have obtained a rating that assesses the risk to the government (and will be continuously updated) from a nationally recognized statistical rating organization and the Enterprises have reported that rating to the public.

OFHEO intends to remain apprised of the developments and pronouncements about the ratings on each Enterprise's risk to the government. However, OFHEO is uniquely positioned as the safety and soundness regulator, and enjoys unfettered access to the information and records of the Enterprises as wells as to management and the directors of these companies. Through our access and routine receipt of reports and data along with frequent interaction with management, directors and staff, OFHEO remains better informed about the financial operations and condition of these companies than the rating agencies. In fact, through OFHEO's examination program, we have teams of examiners continuously on-site at both Enterprises throughout the year. These examiners are routinely conducting discussions with management, employees and directors in addition to monitoring and testing the processes, reports and controls at Fannie Mae and Freddie Mac.

Conclusions

It is clear that the commitments forged between Congress and the Enterprises can complement OFHEO's formal regulatory regime. The market discipline that accrues from increased transparency is only one of the three pillars we support in the safety and soundness regulation of large and complex financial firms. We believe the market transparency pillar is an augmentation of, not a substitute for, OFHEO's strong safety and soundness examination program and capital requirements. In combination, these features achieve a world-class framework for the regulation and oversight provided to Fannie Mae and Freddie Mac.

If I can be any further assistance to you or your colleagues while the Enterprises' safety and soundness and capital adequacy, please do not hesitate to contact me.

Sincerely,

Armando Falcon

Armando Falcon, Jr.
Director

OPENING STATEMENT OF REP. GARY MILLER

Subcommittee on Capital Markets, Insurance and GSEs
Hearing on the October Agreement by Fannie Mae and Freddie Mac
March 27, 2001

Mr. Chairman, I want to commend you for holding today's hearing on the six voluntary initiatives that Fannie Mae and Freddie Mac agreed to undertake last Fall. I want to further commend both you and Congressman Kanjorski for your leadership last year that culminated in the announcement on October 19, 2000.

While they are no substitute for the risk-based capital standards imposed by OFHEO, the addition of these six initiatives represents a major commitment by these two enterprises to remain at the forefront of financial institution risk management and disclosure practices. I am comforted knowing that these two GSE's will have additional capital in the form of subordinated debt, as well as increased liquidity in the event of a serious disruption in the capital markets. Furthermore, greater disclosure with respect to their interest and credit risk, and greater transparency in terms of each GSE's financial condition shall prove to be a positive early warning signal.

Again, Mr. Chairman, I thank you for holding this hearing and look forward to hearing from the two witnesses on their progress of implementing these initiatives. It is my hope that these steps will prove to be the model that other large financial institutions will someday come to emulate.

Opening Statement
House Financial Services Committee
Chairman Michael G. Oxley
March 27, 2001
Hearing in the Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee
Voluntary Agreement of Freddie Mac and Fannie Mae

Many Members of our Committee are taking on some important issues for the first time. Government Sponsored Enterprises, better known as GSEs, is one of those issues. I am pleased that we are having this hearing today, so that Members have an opportunity to learn about the vital role the GSEs play in our housing finance system and overall economy.

Expanded homeownership is a top priority for us. Congress created Fannie Mae and Freddie Mac to broaden consumer access to mortgage credit. Fannie and Freddie developed a secondary market for conventional mortgages and then a wider market for mortgage securities. Fannie and Freddie have greatly advanced their housing mission and are a real success story.

In order to continue benefiting America's families, Fannie Mae and Freddie Mac must operate according to the highest standards. They are two of the leading financial institutions in this country and they occupy a central role in the mortgage and capital markets. Fannie and Freddie are well-managed, highly sophisticated businesses. However, in light of their size and growth, a number of concerns have been raised. These include the adequacy of their supervision, the nature of their mission, and the risk they could pose to the financial system in the event of a downturn.

The voluntary agreement reached last October addresses many of those concerns. I congratulate Chairman Baker, Ranking Member Kanjorski, and the leadership of Fannie Mae and Freddie Mac on this meaningful and timely agreement. The commitments to meet higher capital, risk management, and disclosure standards are impressive and commendable. I look forward to hearing from the witnesses about the specifics of those commitments, the progress they have made in implementing them, and their future plans.

In addition, we should take a look at the existing framework for regulating Fannie Mae and Freddie Mac. We should consider whether the current division of regulation between OFHEO and HUD ought to be streamlined and whether the regulators have the powers they need to be effective. More effective regulation, along with improved market discipline resulting from the voluntary agreement, could give Congress and the markets even greater confidence in Fannie and Freddie.

I look forward to the Committee's responsible oversight of the GSEs.

WRITTEN STATEMENT OF LELAND C. BRENDSEL

CHAIRMAN AND CHIEF EXECUTIVE OFFICER

FREDDIE MAC

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS,

INSURANCE

AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

March 27, 2001

Good afternoon Chairman Baker, Congressman Kanjorski and Members of the Subcommittee. It is a pleasure to be here. I am Leland C. Brendsel, Chairman and Chief Executive Officer of the Federal Home Loan Mortgage Corporation, known as Freddie Mac.

Freddie Mac plays a vital role in financing homeownership and rental housing for the nation's families. Our job is to attract global capital to finance America's housing. This requires that we maintain the confidence of the Congress, the public and the investor community.

I. SIX COMMITMENTS PLACE FREDDIE MAC AT VANGUARD OF WORLD FINANCIAL PRACTICES

Last October, I came here to commit Freddie Mac to a six-point plan to ensure we remain at the vanguard of world financial practices. Today, I am pleased to report that our implementation is nearly complete. Freddie Mac pledged to:

1. Publicly disclose our independent rating
2. Maintain a high degree of liquidity
3. Issue subordinated debt on a semi-annual basis
4. Implement a risk-based capital stress test on an interim basis
5. Publicly disclose a forward-looking measure of credit risk every quarter
6. Publicly disclose our interest-rate risk every month

We have successfully implemented the first five commitments. The sixth commitment will be implemented with our regular monthly public disclosure in April.

Freddie Mac already is among the "best in class" for risk and capital management and disclosure practices. With these commitments we raised the bar, pledging to meet or exceed recommendations of international experts in financial regulation. With the implementation of these commitments, Freddie Mac and Fannie Mae will supply more information to the market than any other financial institution. We believe these new practices and disclosures can be a model for all financial institutions.

In fact, Moody's Investors Service said that the commitments "set new standards not only for themselves [Freddie Mac and Fannie Mae], but for the global financial market."[1] We asked former FDIC Chairman William Seidman for his assessment. He concluded:

> *Your package of disclosures and standards puts [Freddie Mac] in a position of providing more and better public information than any another financial institution, both regulated and non-regulated, of which I am aware.*[2]

Our six-point plan is on the cutting edge of financial practices and disclosure. The steps we took were reinforced in recent months by the Working Group on Public Disclosure, also known as the

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[1] *New Freddie Mac & Fannie Mae 'Open Book' Policy: A Positive Credit Development*, Moody's Investors Service (October 2000).

[2] Memorandum of L. William Seidman to Freddie Mac (December 13, 2000).

Shipley Commission[3]; a joint study and report to Congress by the Federal Reserve Board and the Department of Treasury on the Feasibility and Desirability of Mandatory Subordinated Debt[4]; and the New Basel Capital Accord proposed by the Basel Committee on Banking Supervision. On March 23, 2001, supervisory guidance released by the Federal Reserve urged large banks to adopt Shipley Commission recommendations.[5]

II. FREDDIE MAC'S VITAL MISSION

Freddie Mac is a shareholder-owned corporation that was chartered by Congress to create a stable flow of funds to mortgage lenders in support of homeownership and rental housing. Since our inception in 1970, Freddie Mac has purchased more than $2 trillion in residential mortgages, financing homes for more than 27 million families.

Because of the high level of support provided by Freddie Mac and the secondary market, America enjoys the world's best housing finance system. Mortgage funds are available whenever and wherever they are needed. Mortgage rates are lower, saving homeowners thousands of dollars in interest payments. Thirty-year fixed-rate mortgages are plentiful, protecting families against unexpected interest rate increases. In addition, the availability of low-downpayment loans has helped open the door of homeownership to more low- and moderate-income families.

Throughout our history, Freddie Mac has been a pioneer in innovation, exploring new frontiers that create a faster, more efficient and less costly mortgage finance system. Our innovation in financial instruments attracts global investors to finance America's housing. As a result, homebuyers can compete for funds in the capital markets alongside the largest corporations.

Our vision is to constantly find new ways to appeal to investors, to get investor funds to lenders in local communities as efficiently as possible, and to finance homeownership for as many families as possible. For example, in 1995 we introduced Loan Prospector®, Freddie Mac's automated underwriting service. Loan Prospector has revolutionized the mortgage origination process, reducing the time and expense of getting a loan. The process is also much more fair. Every piece of information is evaluated the same way for every borrower, every time, with an accuracy no human underwriter can match. Greater accuracy and fairness expanded homeownership opportunities, particularly for minority families.

The benefits we bring are well documented. In a recent report, former Director of the Office of Management and Budget Jim Miller and economist James Pearce estimated that borrowers save between $8 billion and $23 billion each year in mortgage interest.[6] Perhaps the best evidence of the benefits we bring is in the weekly real estate section of major newspapers. For example, in its Saturday Real Estate section, *The Washington Post* provides two sets of mortgage interest

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[3] Letter of the Working Group on Public Disclosure (January 11, 2001).

[4] *The Feasibility and Desirability of Mandatory Subordinated Debt*, Report to Congress by the Board of Governors of the Federal Reserve System and the Department of the Treasury, December 2000. (March 23, 2001).

[5] Board of Governors of the Federal Reserve System, Supervisory Staff Report SR 01-6 (March 23, 2001). See Appendix A.

[6] Pearce, James E. and Miller III, James C., "Freddie Mac and Fannie Mae: Their Funding Advantage and Benefits to Consumers," 29 (2001).

rates: those for mortgages we buy (currently up to $275,000 for a single-family home) and those for jumbo loans. Invariably, conforming mortgage rates are lower than those on higher-balance loans by as much as 50 basis points.

Freddie Mac's activities also help stabilize our nation's economy. When the economy turns down, interest rates tend to fall. That spurs home sales and spending, which in turn generates jobs and economic growth. On January 15 of this year, *Barron's* observed:

> *[i]f the Fed has staved off a recession, some of the credit should go to Freddie Mac and Fannie Mae. By helping to transmit the benefits of the central bank's rate cuts to the mortgage market, these agencies have done their part in cushioning the impact of the Nasdaq knockdown on the American consumer.*[7]

Lower mortgage rates enable existing homeowners to refinance their mortgages, putting real money back in their pockets. The easing of mortgage interest costs and the strength of the housing market are among the few bright spots on today's economic horizon.

III. THE COMMITMENTS REST ON "THREE PILLARS" FRAMEWORK

Over the past few years, world leaders in financial institution regulation have embraced principles of risk management that are forward-looking and market-oriented. This new approach seeks to closely align an institution's capital to the various and particular risks that it faces. Supported by sophisticated analytical techniques and technologies, the new approach is superior to the traditional reliance on static capital ratios, which have been the primary regulatory tool for the past several decades.

Freddie Mac believes that the emerging consensus creates a unique opportunity to significantly strengthen the housing finance system of the 21st century. In considering the appropriate scope, design and components of Freddie Mac's voluntary commitments, we applied core principles drawn from the "three pillars" capital framework set forth by the Basel Committee on Banking Supervision in its June, 1999 consultative paper,[8] recently reissued in a second and more comprehensive set of consultation documents.[9] The 1999 Basel Consultative Paper and the 2001 New Basel Capital Accord propose a capital adequacy framework to replace the 1988 Capital Accord for U.S. bank capital standards. In contrast to the 1988 Accord, which relied heavily on simple ratios to set capital standards, the new framework more accurately aligns capital requirements to the actual risks incurred by regulated institutions.

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[7] Ablan, Jennifer, "Despite Treasury Selloff, More Fed Easing Ahead?" *Barron's Online* (January 15, 2001).
[8] *A New Capital Adequacy Framework*, Consultative Paper on Capital Adequacy No. 50, Basel Committee on Banking Supervision (June 1999) (the "1999 Basel Consultative Paper").
[9] *The New Basel Capital Accord*, Consultative Document, Basel Committee on Banking Supervision (January 2001) (the "2001 Basel Accord").

The framework of both the 1999 Basel Consultative Paper and the 2001 Basel Accord rests on the three pillars:

- Capital, which ensures that institutions are adequately capitalized for the risks they take
- Supervisory review, which provides independent oversight to ensure that institutions remain adequately capitalized over time
- Market discipline, which imposes strong incentives on institutions to conduct their business in a safe and sound manner

The three pillars framework represents a new consensus around the issues of capital strength, supervision and market discipline. To a great degree, Freddie Mac's financial management already reflects these core principles, as demonstrated below:

Pillar 1: Capital

Viewed against the first pillar, capital, Freddie Mac already is in a strong position. There is broad consensus that Freddie Mac is currently safe, sound and well capitalized. We have a 30-year record of successfully managing our business in a rigorous and disciplined way. The tools we have developed to manage both credit and interest-rate risk are second to none, and our exposure to credit and interest-rate risk both remains at very low levels.

We operate in one and only one business that has very low credit risk – the mortgages on people's homes. Because of the value attached to homeownership, families invariably pay their monthly mortgage payment first and faithfully. There is more than $500 billion in home equity standing between Freddie Mac and the risk of default on the mortgages we own. By funding mortgages nationwide, the geographic diversity of our mortgages mitigates the risk of local economic downturns. We are further protected through the use of third-party credit enhancements on a large share of our mortgage purchases.

Interest-rate risk is the risk that changes in the level of interest rates could adversely affect the value of a portfolio and could lead to mismatches in the expected cash flows between assets and liabilities. We manage the interest-rate risk on the mortgages we buy and hold using extremely disciplined and conservative standards. Our world-class management of interest-rate risk encompasses funding mortgages with an appropriate variety of mortgage securities, callable debt and other financial instruments.

Not only is Freddie Mac highly skilled at managing risk, we are extremely well capitalized for the risks we take. We manage our business to hold enough capital to withstand 10 years of economic stress resembling the Great Depression. In addition to our own rigorous capital management, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the GSE Act) subjects us to both a minimum capital requirement and a true risk-based capital standard. Our minimum capital requirement applies to both on-balance sheet and off-balance sheet assets, unlike bank capital standards. Our risk-based stress test is the industry's toughest, requiring us to withstand ten years of extremely severe stress. Pending implementation of the risk-based capital stress test, we already manage ourselves to that high standard.

Pillar 2: Supervisory Oversight

Freddie Mac operates under the continuous oversight of the Congress and our regulators, HUD and the Office of Federal Housing Enterprise Oversight (OFHEO). HUD focuses on Freddie Mac's achievement of our mission. Safety and soundness is the responsibility of OFHEO.

OFHEO carries out a detailed and comprehensive examination program, which includes continuous on-site examinations and quarterly capital determinations. OFHEO's highly regarded examination staff focuses all day, every day on two companies in one line of business. By comparison, examiners of large banks must inspect activities ranging from annuities to foreign currencies to commercial loans to credit cards taking place at hundreds of subsidiaries here and around the world. Despite Freddie Mac's comparatively few business lines, there are roughly the same number of examiners reviewing Freddie Mac as there are reviewing a large bank's dozens of business lines in remote locations.

Currently OFHEO assesses our financial strength using the minimum capital standard.[10] Each quarter, our regulator has determined that Freddie Mac is adequately capitalized, which is the highest rating. OFHEO is required to communicate examination results as well as its determination of our capital strength in an annual report to Congress.

Pillar 3: Market Discipline

Greater transparency through public disclosure imposes strong incentives on institutions to conduct their business safely and soundly. If investors perceive that a company's financial condition has deteriorated, they will require the company to pay them more to assume the higher level of risk.

While market discipline is not a replacement for strong capital and vigilant oversight, it is a necessary and desirable complement to the other two pillars. Recently, Federal Reserve Chairman Alan Greenspan called market discipline the "first line of regulatory defense."[11] In a speech to the American Bankers Association, he stated that:

> *We are moving toward a system in which ... public disclosure and market discipline are going to play increasing roles, especially at our large institutions, as a necessity to avoid expansion of invasive and burdensome supervision and regulation. Bank regulators are perforce being pressed to depend increasingly on greater and more sophisticated private market discipline, the still most effective form of regulation.*[12]

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[10] The GSE Act established a minimum capital requirement as the sum of 2.5 percent of on-balance sheet assets and 0.45 percent of outstanding mortgage-backed securities and other off-balance sheet obligations. 12 U.S.C. 4813.
[11] Remarks by Federal Reserve Chairman Alan Greenspan in his address "Banking Supervision," before the American Bankers Association, Washington, D.C. (September 18, 2000).
[12] Ibid.

Our safety and soundness regulator has also endorsed market discipline as integral to financial regulation. In its most recent annual report to Congress, OFHEO stated:

> *Market discipline of Fannie Mae and Freddie Mac is a potentially important complement to safety and soundness regulation of the Enterprises. If creditors have accurate and timely information on the financial risks of Fannie Mae and Freddie Mac and believe that they are exposed to material risk of loss if the Enterprises get into financial trouble, they will take steps to ensure that the Enterprises strike an appropriate balance between risk and return. By enhancing market discipline, greater transparency has the potential to limit the systemic risk that Fannie Mae and Freddie Mac may pose to the financial system.*[13]

In terms of financial disclosure, Freddie Mac already is state-of-the-art. Freddie Mac's annual report and quarterly information statements presently provide public information related to credit risk through extensive discussion, analysis and quantification of types of credit risk exposures, including the "at-risk" share of delinquent loans by year of origination, original and estimated current loan-to-value ratios, and geographic concentrations.

Freddie Mac's interest-rate risk disclosures also compare favorably with disclosures from leading financial institutions. Our quantitative methodologies measure the change in portfolio market value or net asset value that would be caused by immediate parallel upward or downward shifts in interest rates across the entire yield curve.[14] In addition, Freddie Mac makes qualitative disclosures of other interest-rate and market risks (such as basis risk and volatility risk) as well as various operational risks (such as financial modeling risk). Freddie Mac currently provides these disclosures on a quarterly or annual basis, which exceeds the annual disclosure requirements required by the SEC.

Last year, Freddie Mac requested that PriceWaterhouseCoopers (PWC) compare Freddie Mac's public risk disclosures with those of selected financial institutions generally recognized to be providing best-in-class risk management disclosures.[15] PWC found that our risk management disclosures "are among the best of the risk management disclosures provided by the recognized best-in-class group included in this study."[16] PWC considered our disclosures "above average" in all risk management categories, including specifically market risk, credit risk, capital management and derivatives.[17] Finally, PWC concluded that Freddie Mac (voluntarily) satisfied all the applicable disclosure requirements specified not only by the SEC, but also by the Financial Accounting Standards Board and other regulatory bodies.[18]

Our six commitments will only enhance the frequency and quality of our disclosures.

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[13] Office of Federal Housing Enterprises Oversight, 2000 Report to Congress, at 33, (June 15, 2000).

[14] Freddie Mac's quantitative disclosures employ sensitivity analysis, one of three methods of quantitative disclosure prescribed by SEC. SEC rules require SEC registrants to provide quantitative disclosure about market risk sensitive instruments, and permit them to use (1) a tabular presentation of fair value information and of contractual terms, (2) a sensitivity analysis or (3) a value-at-risk methodology.

[15] PriceWaterhouseCoopers, "Freddie Mac: Risk Disclosure Benchmarking Study" (May 15, 2000).

[16] Id. p.4.

[17] Id. at 5.

[18] Id. at 4.

IV. OUR COMMITMENTS MEET OR EXCEED RECOMMENDED BEST PRACTICES

As I will describe below, Freddie Mac's six commitments meet or exceed current industry best practices, as well as the recommendations of numerous international experts in financial risk management and disclosure.

Commitment 1: Public Disclosure of Independent Rating

What we pledged. Freddie Mac committed to obtain an annual rating from a nationally recognized statistical rating organization and to disclose this rating to the public. This rating assesses our independent financial strength, known as a risk-to-the-government rating.[19]

What we accomplished. On February 27, 2001, we announced that Freddie Mac had fulfilled this commitment with the release of our "AA-" risk-to-the-government rating from Standard & Poor's (S&P). Only five bank holding companies in the United States currently maintain an S&P rating of AA- or better on long-term senior debt.

We originally pledged to obtain a rating once a year. Now Freddie Mac is going beyond that. We have asked S&P for a continuous "surveillance" rating. This means that S&P will be obligated to notify the public if there is ever a change in our financial position that affects the rating.

Why it's important. Independent ratings are crucial to our financial system. Every day, millions of securities change hands on the basis of rating agency opinions of financial quality. Freddie Mac's commitment to seek an annual independent rating provides a readily discernible measure of capital strength that promotes market discipline. Ratings provide an independent early warning signal to the public and Congress regarding our financial condition.

In the preamble of the recent joint agency proposed rulemaking on risk-based capital standards for recourse and direct credit substitute transactions,[20] the federal bank and thrift regulatory agencies stated:

> *In the opinion of the agencies, ratings have the advantages of being relatively objective, widely used and relied upon by investors and other participants in the financial markets. Ratings provide a flexible, efficient, market-oriented way to measure credit risk.*[21]

How we measure up. A rating of AA- places Freddie Mac at the top tier of financial institutions.

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[19] In 1991, the Treasury requested Standard & Poor's to conduct a "risk-to-the-government" rating of Freddie Mac, based on criteria furnished by the Treasury. In 1992, Congress added a ratings component to the regulatory framework. The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 provides that the Director of OFHEO may contract with a nationally recognized statistical rating organization to conduct a review of Freddie Mac and Fannie Mae. In 1996, the Director contracted for a "risk-to-the-government" rating on the both companies. Using the criteria developed by the Treasury in 1991, the ratings process resulted in a AA- rating for each company. Our senior debt continues to be rated AAA by Standard & Poor's.

[20] 65 Fed. Reg. 12320,12321 (March 8, 2000).

[21] *Id.*

Commitment 2: Liquidity Management and Contingency Planning

What we pledged. Freddie Mac will comply with the 14 principles of sound liquidity management set forth by the Basel Committee on Banking Supervision. In addition, Freddie Mac will maintain more than three months' worth of liquidity to meet our financial obligations, assuming we have no access to public debt markets.

Freddie Mac will also maintain contingency plans for handling such a liquidity crisis. The plans will involve the use of short-term investments (primarily cash and Federal Reserve funds), as well as the liquidation of non-mortgage assets and repurchase transactions using mortgage securities from Freddie Mac's retained portfolio. Freddie Mac will conservatively estimate the amount of cash to be generated by asset sales and repurchase transactions.

Freddie Mac will maintain at least 5 percent of on-balance sheet assets in a liquid, marketable portfolio of non-mortgage securities in order to facilitate liquidity.

What we accomplished. On March 8, 2001, we announced that we met the liquidity commitment. We meet the Basel Committee's 14 principles of liquidity management. In addition, we are holding enough liquid, high-quality assets so that we can meet all of our financial obligations, even in the event of a market disruption so severe that we are unable to issue debt for three months.

Why it's important. Freddie Mac's liquidity commitment is completely aligned with recommendations made by the Basel Committee on Bank Supervision. In February 2000, the Committee released 14 principles of sound liquidity management for large banks.[22] Four of these principles are considered "crucial" for banks of any size or scope of operations: 1) good management information systems; 2) analysis of net funding requirements under alternative scenarios; 3) diversification of funding sources; and 4) contingency planning, applying a variety of "what-if" scenarios to liquidity plans and projections. Freddie Mac is holding ourselves to all 14 principles.

Freddie Mac's liquidity commitment, together with public disclosure, will provide strong assurances to investors about Freddie Mac's financial strength. Regardless of disruptions in the capital markets that may make it impossible to borrow, Freddie Mac has the means to meet our financial obligations for at least three months. This commitment is subject to continual oversight by OFHEO, which has a well-developed examination program focusing on liquidity.

How we measure up. The Basel Committee suggested that large institutions be prepared to weather a liquidity crisis of between one and three months. In its 1999 liquidity paper, the Basel Committee pointed out:

> *[t]he relevant time-frame for active liquidity management is generally quite short . . . . Banks which are reliant on short-term funding will concentrate primarily on managing their liquidity in the very short term (say the period out to five days). . . . Other banks (i.e., those*

[22] "Sound Practices for Managing Liquidity in Banking Organizations," Consultative Paper No. 69, Basel Committee on Banking Supervision (February 2000). See Appendix B.

that are less dependent on the short term money markets) might actively manage their net funding requirements over a slightly longer period, perhaps one to three months ahead.[23]

We chose to maintain adequate liquidity for a full three months.

Our liquidity commitment exceeds current market practices and represents a new best practice for financial institutions. For example, the Federal Housing Finance Board recently adopted a minimum liquidity requirement for the Federal Home Loan Banks. The rule requires the FHLBs to withstand only five days without access to the debt markets.[24] This rule appears to assume that a liquidity crisis lasting any longer than this would necessitate assistance from the Federal Reserve System, the U.S. Treasury or the Congress.[25] Freddie Mac's liquidity contingency plans assume no such assistance.

Commitment 3: Periodic Issuance of Subordinated Debt

What we pledged. Freddie Mac will issue publicly traded and externally rated subordinated debt on a semi-annual basis, according to the following terms:

- The subordinated debt will be issued 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 following a three-year phase-in period.

- Freddie Mac subordinated debt will have an average maturity of at least five years and will be structured to resemble standard subordinated debt issuance by a bank or bank holding company.

- The loss absorption features are tailored to Freddie Mac's regulatory framework. Interest payments will be suspended and accumulate for up to five years if (a) core capital falls below 125 percent of critical capital levels; or (b) core capital falls below minimum capital levels and, pursuant to Freddie Mac's request, the Secretary of the Treasury exercises his or her discretionary authority under Freddie Mac's charter to purchase its obligations.

- Subordinated debt will be in addition to, not a substitute for, required equity capital.

What we accomplished. On March 21, 2001 we met our subordinated debt commitment with the issuance of $2 billion of our 10-year Subordinated Debt Securities, known as Freddie SUBS[SM] [26] By the end of a three-year phase-in period, the combination of our core capital and outstanding subordinated debt will equal or exceed 4 percent of on-balance-sheet assets.

As we continue to implement this commitment on a semi-annual basis, we expect that by the end of a three-year phase-in period, there will be an additional $8 billion to $10 billion of investor

[23] Basel Liquidity Paper, at 7, par. 28.
[24] FHFB Final Rule, 66 Fed. Reg. at 8261-321 (January 30, 2001).
[25] 65 Fed. Reg. at 43431 (July 13, 2000).
[26] See Appendix C for more information.

funds standing in front of our senior debt holders. Since we announced our plans to issue subordinated debt, we have heard directly from global investors that this extra layer of protection will carry significant value in the marketplace.

Why it's important. 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 will provide a direct and quantitative market-based indication of our financial strength.

Former FDIC Chairman Seidman noted that "in times when an institution is under stress, one would expect that spread to widen dramatically, which is why a commitment to issue subordinated debt periodically, in good times and bad, is a very meaningful commitment."[27] Chairman Greenspan likened the use of subordinated debt to a "canary in the mine," alerting investors and the public of potential financial weakness well before any regulatory or other governmental intervention would be needed.[28]

Subordinated debt is a tool for market discipline. The joint report by the Federal Reserve and the Treasury said issuing subordinated debt contributes to market discipline. While the report stopped short of recommending mandatory issuance by banks, Freddie Mac stepped up to the challenge of frequent, large issues.

Our commitment also enhances Freddie Mac's capital position.[29] Combined with core capital, the amount of outstanding subordinated debt will grow to represent 4 percent of Freddie Mac's total assets by the end of the three-year phase-in period.

How we measure up. According to a 1999 Federal Reserve study, typically only the largest banks and bank holding companies issue subordinated debt, and most banks' subordinated debt is not publicly traded.[30] Moreover, no bank has voluntarily committed to issue publicly traded subordinated debt on a regular basis to enhance its transparency and market discipline.

Commitment 4: Interim Implementation of Risk-Based Capital Stress Test

What we pledged. Pending final promulgation of the risk-based capital stress test envisioned in the GSE Act, Freddie Mac will implement a risk-based capital stress test and disclose the test outcome on a quarterly basis.[31]

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[27] Memorandum of L. William Seidman to Freddie Mac, December 13, 2000.

[28] Testimony of Federal Reserve Board Chairman Alan Greenspan in his re-nomination hearing before the Senate Banking Committee (January 26, 2000).

[29] *Cf.* Speech by Federal Reserve Board governor Lawrence Meyers before the Conference on Reforming Bank Capital Standards, New York (June 14, 1999) ("Subordinated debt issued in place of insured deposits also provides an extra 'cushion' for the deposit insurance fund…").

[30] *"Using Subordinated Debt as an Instrument of Market Discipline,"* Federal Reserve Study Group on Subordinated Debt and Debentures, Staff Study 172 (December 1999).

[31] The interim implementation provides a near-term "bridge" of stress testing and public accountability pending completion of final risk-based capital regulations by OFHEO. In no way does our disclosure substitute for OFHEO's promulgation of a final risk-based capital rule.

The test parameters, such as the interest-rate shocks used in the test, are those contained in the GSE Act. Freddie Mac will publicly disclose the parameters of the test, including the default and prepayment models, as well as the quarterly stress test outcome.

What we accomplished. On March 26, 2001, we met our commitment to implement, with the disclosure that Freddie Mac passed this test as of December 31, 2000. on an interim basis, the risk-based capital stress test envisioned in GSE Act. The test requires Freddie Mac to survive a 10-year downturn in real estate markets, much like the Great Depression.

Why it's important. The stress test required by the GSE Act is innovative, stringent, dynamic and more responsive to risk than any ratio-based capital regulation.[32] It requires Freddie Mac to maintain positive capital during a 10-year period in which significant adverse circumstances occur. It simulates the most important risks faced by Freddie Mac – credit risk and interest-rate risk – during a very severe environment and ensures that Freddie Mac survives such an environment for 10 years.

- The credit risk portion of the stress test is based on the assumption that defaults and losses on mortgages occur throughout the United States at a rate and severity equal to the highest default rates experienced in a regional downturn.[33] In implementing this extremely severe scenario, OFHEO has proposed to use the actual default experience of the collapse of real estate in the oil-belt in the 1980s. The default rates on mortgages with low down payments during this period were approximately 25 percent; loss rates were approximately 60 percent.

- At the same time that real estate values are assumed to plummet, the test subjects Freddie Mac to survive severe swings in interest rates. The GSE Act mandates a stress test in which yields on 10-year Treasury bonds fall or rise by as much as 600 basis points.[34]

- Finally, the GSE Act requires a 30 percent add-on to required stress capital to account for management and operations risk.[35]

How we measure up. Freddie Mac's risk-based capital stress test is the toughest test in the financial industry and is entirely consistent with the 2001 New Basel Capital Accord. A 1999 study conducted by the economic consulting firm IPS-Sendero concluded that the thrift industry would run out of capital after five years of this stress test and would need to triple its capital to survive.[36] After reviewing this statutory stress test, former FDIC Chairman William Seidman concluded: "The risk based capital standard set forth in the 1992 GSE Act creates a very stringent capital standard, one that could be devastatingly stringent if applied to most other financial institutions."[37]

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[32] 12 U.S.C. §4611.
[33] 12 U.S.C. §4611(a)(1).
[34] *Id.* at §4611(a)(2).
[35] *Id.* at §4611(c)(2).
[36] *Thrift Industry Analysis: Implications of Risk-Based Capital Stress Test Requirements* IPS Sendero (Aug. 19, 1999).
[37] Memorandum of L. William Seidman, Jacqueline Pace and David S. Chung to Freddie Mac (March 29, 2000).

Commitment 5: New Credit Risk Disclosures

What we pledged. Freddie Mac will initiate public disclosure of credit risk sensitivity analyses and results on a quarterly basis. Quantitative disclosure will include a sensitivity analysis of 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. Qualitative disclosure will include a discussion of results and any material changes in risk modeling assumptions.

What we accomplished. On March 26, 2001, we disclosed the impact on Freddie Mac of a 5 percent decline in house prices everywhere around the country. Since we began keeping track of house-price changes in 1975, we've never seen a mass decline of this magnitude.

Why it's important. Freddie Mac's commitment to disclose quarterly our exposure to credit risk will provide investors with information on credit risk that no other financial institution provides. Most credit risk disclosure is backward looking, focusing on charge-offs and loans that are already delinquent and in default. This type of information is useful, and Freddie Mac will continue to report it. The addition of our new credit-risk disclosure, which predicts exposure to a worsening economy, provides forward-looking insights into our business.

How we measure up. By subjecting ourselves to this rigorous test, Freddie Mac has set a new standard in the measurement and reporting of mortgage credit risk. The Basel Committee issued a paper in July 1999 regarding best practices for credit risk disclosure[38] stating the Committee's expectation that banks disclose sufficient, timely, and detailed information to allows market participants to perform meaningful evaluations of the bank's credit risk profile.[39] Our commitment is consistent with the Basel approach.

Commitment 6: New Interest-Rate Risk Disclosures

What we pledged. Freddie Mac will initiate public disclosure of interest-rate risk sensitivity analyses and results on a monthly basis. Quantitative disclosure will include the impact on Freddie Mac's financial condition of both a 50 basis-point shift in interest rates and a 25 basis point shift in the slope of the Treasury yield curve. Qualitative disclosure will include a discussion of the results and any material changes in risk modeling and assumptions.

What we accomplished. We will begin the monthly disclosure of interest-rate risk in mid-April, as part of our regular public disclosures. We will disclose the impact on Freddie Mac of an abrupt change in our funding costs. 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.

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[38] "*Best Practices for Credit Risk Disclosure*," Basel Committee on Banking Supervision, Basel, July 1999 ("Basel Credit Paper").

[39] These best practice recommendations are consistent with the recommendations concerning hedge fund disclosures in "*Hedge Funds, Leverage and the Lessons of Long Term Capital Management*" a report of the President's Working Group on Financial Markets (April 1999). The President's Working Group (comprised of representatives from the Department of Treasury, Federal Reserve Board, Securities and Exchange Commission and Commodities Futures Exchange Commission) concluded that the current scope and timeliness of information about hedge funds was limited and recommended that "more frequent and meaningful information on hedge funds should be made public."

Why it's important. In modern financial markets, interest-rate and other market risks can expand and contract at great speed. To understand the impact of rapidly changing interest-rate environments and manage their investment positions, investors need current information about their risk exposure.

How we measure up. Freddie Mac's commitment to monthly disclosure of interest-rate risk significantly raises the bar; no other financial institution reports interest-rate risk as frequently. Our commitment also exceeds the recommendation of the Shipley Commission. In its January report to the Federal Reserve, the SEC and the OCC, the Commission recommended quarterly disclosure of interest-rate risk. In supervisory guidance released on March 23, 2001, the Federal Reserve urged large banking organizations to adopt Shipley recommendations to improve both their quantitative and qualitative disclosures.[40] The Letter also encouraged institutions to seek new avenues, such as company websites, for disseminating financial information more frequently than regular annual or quarterly disclosures.[41] Freddie Mac has begun using its website at freddiemac.com to give the public and our investors greater financial information, particularly about our six commitments.

Taken together, our six commitments represent a watershed in financial practices and disclosure. They ensure that Freddie Mac maintains extremely strong risk-management practices and continues to meet or exceed world-class disclosure standards. Former FDIC Chairman Seidman stated that the "package is well conceived, in that its various elements complement one another, so that the effect of the whole is greater than the sum of the parts."[42]

VI. THE COMMITMENTS SUPPORT OUR CONTINUING MISSION

Freddie Mac is a mission-driven company. You can count on us to relentlessly search the globe for the lowest cost funds and to constantly look for better ways to deliver these funds to communities across America. As a result, more families than ever before can afford to buy a home. In addition, they compete on an equal footing with the largest corporations for low-cost funds in the world's capital markets.

To meet our mission, Freddie Mac is relentlessly wringing out every unnecessary cost and barrier to homeownership; we are pushing the limits of technology; and we are searching the globe to find the lowest costs funds for housing.

Over the next 10 years, America's families will need an additional $6 trillion dollars to fund their mortgages. Freddie Mac will open doors of opportunity 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.

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[40] Board of Governors of the Federal Reserve System, Supervisory Staff Report SR 01-6 (March 23, 2001).
[41] Federal Reserve Advisory Letter (March 23, 2001).
[42] Memorandum of L. William Seidman to Freddie Mac (December 13, 2000).

Recently, HUD Secretary Martinez captured the essence of why housing holds a special place in the nation. He said:

> *We believe that if you help a man or a woman buy a home, you're helping to make a better citizen. Homeownership is vital in creating strong communities. It helps average Americans build equity and increase their household wealth.*[43]

More than ever, the country needs Freddie Mac's strength and vitality. The six commitments demonstrate our determination to remain safe and sound, and finance housing for generations to come.

* * * * *

Thank you for the opportunity to appear today. Freddie Mac is a great Congressional success story. I am pleased that we have been able to work closely with Chairman Baker and the Members of this Subcommittee to ensure that Congress is confident that Freddie Mac is meeting our very important mission in a safe and sound manner. I look forward to working together to secure the future of our housing finance system and, with it, the dreams of millions of families.

[43] Remarks by HUD Secretary Mel Martinez to National Association of Counties' Legislative Conference (Mar. 5, 2001).

APPENDIX A

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 01 - 6 (SUP)
March 23, 2001

TO THE OFFICER IN CHARGE OF SUPERVISION AND SUPERVISORY STAFF AT EACH FEDERAL RESERVE BANK AND TO EACH LARGE, DOMESTIC BANKING ORGANIZATION SUPERVISED BY THE FEDERAL RESERVE

SUBJECT: Enhancements to Public Disclosure

The Federal Reserve has long supported meaningful public disclosure by banking and financial organizations with the objective of enhancing market discipline and fostering stable financial markets. Public disclosure and market discipline are important complements to bank supervision and regulation. With sufficient information, market participants can better evaluate counterparty risks and adjust the availability and pricing of funds in ways that can promote more efficient financial markets and sound practices by banks. In order to advance public disclosure efforts and to strengthen market discipline regarding banking organizations, the Federal Reserve has worked with other regulators, accounting authorities, users of financial statements, and the banking industry.

Earlier this year, the private sector Working Group on Public Disclosure issued a report recommending several enhancements to public disclosure for large banking organizations and securities firms in the areas of credit and market risk.[1] The Working Group agreed on some broad principles, including observing that disclosures should reflect information that is consistent with an organization's approach to risk management. The group recommended that disclosures should explain how risk within a firm changes over time and should evolve with innovations in a

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[1] In April 2000, the Federal Reserve established the Working Group on Public Disclosure with the participation of the Office of the Comptroller of the Currency and the Securities and Exchange Commission. The Working Group's members were senior executives from major domestic and foreign banking organizations and securities firms, and the group was chaired by Walter Shipley, retired chairman of Chase Manhattan Bank. Its objective was to recommend improvements in public disclosure by large financial institutions. This objective was fulfilled by setting forth a number of recommendations in a letter to the federal agencies, sent on January 11, 2001. The report and the agencies' accompanying joint press release and response letter are available on the Federal Reserve Board's website at www.federalreserve.gov/boarddocs/press/general/2001.

firm's risk management practices. The group also suggested that disclosures should balance quantitative and qualitative information and include clear discussions about a firm's risk management processes.

In addition to these broad principles, the Working Group recommended several specific practices that would enhance current disclosures. These include quarterly disclosure of some market risk information now disclosed annually and enhanced quarterly disclosures about credit concentrations and credit quality. In particular, the Working Group recommended that firms disclose:

1. Aggregate high, average and low trading value-at-risk (VAR) over the quarter.

2. High, average, and low trading VAR by major risk category (e.g., fixed income, currency, commodity, and equity) over the quarter, including diversification effects.

3. Quantification of how well market risk models performed (e.g., histogram of daily trading revenues compared to average VAR over the quarter).

4. Current credit exposures by internal rating, reflecting the effects of netting, collateral, and other credit protection. Firms should provide explanatory information on their ratings, including, if appropriate, how they compare to external ratings. Recognizing that it might be inappropriate or not feasible to include certain credit products in this disclosure (e.g., debt securities in trading inventory), firms should make it clear which products are included. Distinguishing between loan and other credit exposures also would be helpful.

5. Information about the maturity profile of transactions giving rise to material current credit exposures.

6. Insight into credit concentrations (e.g., industry sector and country risk).

Private sector efforts, such as those of the Working Group, and official regulatory initiatives can help to foster a consensus and advance thinking on what constitutes sound or best practice regarding public disclosure. The Federal Reserve believes that the types of disclosures recommended by the Working Group, when properly executed, can enhance the transparency of well-managed institutions. Accordingly, the Federal Reserve encourages each large banking organization to use these recommendations as it seeks to enhance its disclosures and convey more effectively information about its risk profile. The Securities and Exchange Commission and the Office of the Comptroller of the Currency are also encouraging large securities firms and financial institutions involved in lending and trading activities to consider the Working Group's recommendations as they develop enhanced disclosures. Many of the enhanced disclosures are appropriate for quarterly and annual financial reports, though firms also may want to consider other forums (e.g., public websites) to disclose quantitative and qualitative information outside of routine financial reports.

Large banking organizations are encouraged to balance the need for information on a firm's risk profile and performance over time with disclosures that will provide a basis for reasonable comparisons across firms involved in similar activities. In this regard, large banking organizations are encouraged to provide meaningful information based on their particular risk management strategies and risk profiles, recognizing that, as risk management practices evolve, opportunities will increase to provide additional relevant information that is more comparable across firms.

The Federal Reserve will continue its dialogue on public disclosure with other domestic and foreign regulators and the financial industry, and is exploring additional ways of addressing disclosure issues and encouraging sound disclosure practices in connection with the ongoing supervisory process. In this regard, supervisors will consider the recommendations of the Working Group in efforts under way to improve public disclosures, including the project to revise the Basel Capital Accord. Furthermore, the Federal Reserve plans to issue additional guidance later this year that addresses the role of the supervisory process in promoting sound practices for qualitative and quantitative disclosures.

Reserve Banks are asked to distribute a copy of this SR letter to domestic financial and bank holding companies with consolidated total assets of $10 billion or more. Given the increased efforts to foster enhanced transparency and market discipline at the international level, the Federal Reserve will share this guidance with supervisors of large foreign banks, as well as members of the Basel Committee on Banking Supervision. Questions may be directed to Gerald Edwards, Associate Director and Chief Accountant - Supervision, at (202) 452-2741, Charles Holm, Assistant Director, at (202) 452-3502, or Gregory Eller, Project Manager, at (202) 452-5277.

Richard Spillenkothen
Director

Appendix B

BASEL SOUND PRACTICES FOR MANAGING LIQUIDITY

From "*Sound Practices for Managing Liquidity in Banking Organisations*" Consultative Paper No. 69, Basel Committee on Banking Supervision (February 2000)

Principle 1: Each bank should have an agreed strategy for the day-to-day management of liquidity. This strategy should be communicated throughout the organization.

Principle 2: A bank's board of directors should approve the strategy and significant policies related to the management of liquidity. The board should also ensure that senior management takes the steps necessary to monitor and control liquidity risk. The board should be informed regularly of the liquidity situation of the bank and immediately if there are any material changes in the bank's current or prospective liquidity position.

Principle 3: Each bank should have a management structure in place to execute effectively in the liquidity strategy. This structure should include the ongoing involvement of members of senior management. Senior management must ensure that liquidity is effectively managed, and that appropriate policies and procedures are established to control and limit liquidity risk. Banks should set and regularly review limits on the size of their liquidity positions over particular time horizons.

Principle 4: A bank must have adequate information systems for measuring, monitoring, controlling and reporting liquidity risk. Reports should be provided on a timely basis to the bank's board of directors, senior management and other appropriate personnel.

Principle 5: Each bank should establish a process for the ongoing measurement and monitoring of net funding requirements.

Principle 6: A bank should analyze liquidity utilizing a variety of "what if" scenarios.

Principle 7: A bank should review frequently the assumptions utilized in managing liquidity to determine that they continue to be valid.

Principle 8: Each bank should periodically review its efforts to establish and maintain relationships with liability holders, to maintain the diversification of liabilities, and aim to ensure its capacity to sell assets.

Principle 9: A bank should have contingency plans in place that address the strategy for handling liquidity crises and include procedures for making up cash flow shortfalls in emergency situations.

Principle 10: Each bank should have a measurement, monitoring and control system for its liquidity positions in the major currencies in which it is active. In addition to assessing its aggregate foreign currency liquidity needs and the acceptable mismatch in combination with its domestic currency commitments, a bank should also undertake separate analysis of its strategy for each currency individually.

Principle 11: Subject to the analysis undertaken according to Principle 10, a bank should, where appropriate, set and regularly review limits on the size of its cash flow mismatches over particular time horizons for foreign currencies in aggregate and for each individual currency in which the bank operates.

Principle 12: Each bank must have an adequate system of internal controls over its liquidity risk management process. A fundamental component of the internal control system involves regular independent reviews and evaluations of the effectiveness of the system and, where necessary, ensuring that appropriate revisions or enhancements to internal controls are made. The results of such reviews should be available to supervisory authorities.

Principle 13: Each bank should have in place a mechanism for ensuring that there is an adequate level of disclosure of information about the bank in order to manage public perception of the organization and its soundness.

Principle 14: Supervisors should conduct an independent evaluation of a bank's strategies, policies, procedures and practices related to the management of liquidity. Supervisors should require that a bank has an effective system in place to measure, monitor and control liquidity risk. Supervisors should obtain from each bank sufficient and timely information with which to evaluate its level of liquidity risk and should ensure that the bank has adequate liquidity contingency plans.

Freddie Mac

We Open Doors®

Inaugural Issue March 2001

FREDDIE MAC DEBT SECURITIES

Freddie *SUBS*℠

Introduction

Freddie Mac announced on December 15, 2000 its intention to issue subordinated debt securities, called Freddie *SUBS*℠, on a semi-annual basis. With the amount outstanding expected to grow to $8 billion to $10 billion over a three-year phase-in period, Freddie *SUBS* are expected to become an important part of Freddie Mac's mortgage funding program.

Further, issuance of these new securities fulfills one of the six voluntary commitments (see box at right) announced in October 2000 to enhance the company's capital strength, transparency and market discipline. With these commitments, Freddie Mac will remain at the forefront of financial institution risk management and disclosure. (*http://www.freddiemac.com/corporate/about/six_commitments/summary.html*)

The six voluntary commitments set a new standard for financial institutions and have been drawn from the principles and standards embraced by leading financial regulators, including the international Basel Committee on Banking Supervision. As Freddie Mac Chairman and CEO Leland Brendsel noted in a recent speech, "Last October, Freddie Mac announced six commitments to enhance our already strong capital position and world-class financial practices and disclosure. We made these commitments voluntarily so that there will be no doubt in anyone's mind that Freddie Mac will be able to serve our vital mission for generations to come."

Six Voluntary Commitments

1. Periodic Issuance of Subordinated Debt
2. Liquidity Management and Contingency Planning
3. Interim Implementation of Risk-based Capital Stress Test
4. New Interest-Rate Risk Disclosures
5. New Credit Risk Disclosures
6. Public Disclosure of Annual Rating

The Role of Subordinated Debt

Subordinated debt can play several important roles in a companys risk management practices. First among those roles is that subordinated debt can supplement a company's capital base.

Second, the market's valuation of subordinated debt that is publicly traded and externally rated can reflect a market measure of the company's overall financial strength, risk profile and capital levels.

Subordinated Debt and "Market Discipline"

Many experts in the financial regulatory community have identified periodic issuance of subordinated debt as an effective mechanism for promoting market discipline for financial institutions. Market discipline is defined in the proposed *New Basel Capital Accord* (2001) as "greater transparency through public

(continued on page 2)

Freddie Mac obligations. Freddie Mac's securities are obligations of Freddie Mac only. The securities, including any interest or return of discount on the securities, are not guaranteed by and are not debts or obligations of the United States or any federal agency or instrumentality other than Freddie Mac.

No offer or solicitation of securities. This document includes information related to, or referenced in the offering documentation for, certain Freddie Mac securities. Freddie Mac securities may not be eligible for offer or sale in certain jurisdictions or to certain persons. This information is provided for your general information only, is current only as of its date and does not constitute an offer to sell or a solicitation of an offer to buy securities. The information does not constitute a sufficient basis for making a decision with respect to purchase and sale of any security. All information regarding or relating to Freddie Mac securities is qualified in its entirety by the relevant offering circular and any related supplements. Investors should review the relevant offering circular and any related supplements before making a decision with respect to the purchase or sale of any security. In addition, before purchasing any security, please consult your legal and financial advisors for information about and analysis of the security, its risks and its suitability as an investment in your particular circumstances.

disclosure, imposing strong incentives on institutions to conduct their business in a safe, sound and efficient manner."

Certain aspects of the Freddie *SUBS* structure promote market discipline. Freddie Mac has committed to issue Freddie SUBS twice yearly. This means that new issues of Freddie *SUBS* will be priced in the market on a regular basis. In addition, the interest-deferral feature of Freddie *SUBS* (which is described more fully below) links the payments on Freddie *SUBS* and Freddie Mac's level of core capital.

In conjunction with regular disclosures of interest-rate and credit risk exposures, and the capital standards to which the company already adheres, periodic issuance of subordinated debt will prompt market scrutiny that will create an additional barometer of Freddie Mac's capital and financial strength.

Expected Issuance of Freddie *SUBS*

Freddie Mac has committed to issue Freddie *SUBS* twice yearly, in an amount such that the sum of core capital, loan loss reserves and outstanding Freddie *SUBS* will equal or exceed 4% of on-balance-sheet assets plus 0.45% of off-balance-sheet mortgage-related securities. Over a three-year phase-in period, Freddie Mac currently expects the amount of Freddie *SUBS* outstanding to grow to $8 billion to $10 billion. Given the relatively small size of the U.S. dollar investment-grade subordinated debt market and the preponderance of "A" and "BBB" debt in the market, Freddie *SUBS* could represent a significant portion of the high-quality segment of this market.

The weighted average maturity of outstanding Freddie *SUBS* will be at least five years. Subject to this test, Freddie Mac may issue both short and long maturities, ranging from 2 to 30 years. Issuance of Freddie *SUBS* will not change in any way Freddie Mac's commitment to issue large, liquid senior Reference Note℠ securities according to the published financing calendar.

Freddie *SUBS*—
Product Structure Subordination

Freddie *SUBS* will be unsecured subordinated debt obligations of Freddie Mac issued under Section 306(a) of the Federal Home Loan Mortgage Corporation Act (the "Freddie Mac Act"). Freddie *SUBS* will rank junior in right of payment to all of Freddie Mac's existing and future Senior Obligations, which include all of Freddie Mac's debt obligations, liabilities in respect of Freddie Mac's guarantees of mortgage-related securities, Freddie Mac's outstanding 8.25% Subordinated Capital Debentures due 2016 and Zero Coupon Subordinated Capital Debentures due 2019, and all other obligations except obligations that by their terms expressly rank equally with or junior to Freddie *SUBS*.

As of December 31, 2000, Freddie Mac had $444.5 billion of outstanding total liabilities, and $822.3 billion of total guaranteed mortgage-related securities (including $246,209 million held in Freddie Mac's retained portfolio), all of which would have constituted Senior Obligations at that date.

Deferral of Interest—Structure

An important feature of Freddie *SUBS* is the interest deferral provision. Under the terms of the voluntary commitment, Freddie Mac must defer the payment of interest on all outstanding Freddie *SUBS* if, as of the fifth business day prior to an interest payment on any Freddie *SUBS*:

(1) Freddie Mac's "core capital" is below 125% of its "critical capital" requirement, OR

(2) Freddie Mac's "core capital" is below its "minimum capital" requirement, and the Secretary of the Treasury, acting at the company's request, exercises his or her discretionary authority pursuant to Section 306(c) of the Freddie Mac Act to purchase the company's debt obligations.

Deferral on an issue of Freddie *SUBS* may extend for a period of up to five years but not beyond the maturity date of the issue.

(continued on page 3)

If Freddie Mac defers payment of interest on Freddie *SUBS*, interest will continue to accrue and compound semi-annually at the stated coupon on the Freddie *SUBS*. Freddie Mac will pay all deferred interest, as well as interest on that deferred interest, on all Freddie *SUBS*, as soon as Freddie Mac no longer is required to defer interest under the terms described above, and has repaid all debt obligations, if any, purchased by the U.S. Secretary of the Treasury.

During periods when Freddie Mac defers interest payments on Freddie *SUBS*, Freddie Mac may not declare or pay dividends on, or redeem, purchase or acquire, its common stock or its preferred stock.

Deferral of Interest—Function

Because of the interest deferral feature, prices for Freddie *SUBS* are expected to reflect the market's view of the adequacy of Freddie Mac's capital relative to its risks, rather than reflecting the subordination of the debt alone. This should make Freddie *SUBS* a more comprehensive measure of changes in Freddie Mac's risk profile than subordinated debt that does not include such an interest deferral feature.

Moreover, for Freddie *SUBS*, interest payments will be automatically suspended if the deferral triggers described above are met; Freddie Mac has no discretion to defer interest payments under these circumstances. As a result of both the interest deferral and the subordination features of Freddie *SUBS*, risks borne by Freddie *SUBS* investors will be significantly different than for senior debt holders.

Capital Definitions

Freddie Mac will use the core, critical and minimum capital levels most recently announced by the Office of Federal Housing Enterprise Oversight (OFHEO), pursuant to its then current methodology for calculating those levels, to determine whether the interest deferral triggers have been met. OFHEO currently announces Freddie Mac's capital levels on a quarterly basis.

Key Capital Definitions

Core capital =
- Par or stated value of common stock +
- Par or stated value of non-cumulative perpetual preferred stock +
- Paid-in capital +
- Retained earnings

Critical capital requirement =
- 1.25% of on-balance-sheet assets +
- 0.25% of net outstanding mortgage-backed securities +
- 0.25% of other off-balance-sheet obligations

(calculated in accordance with OFHEO's methodology)

Minimum capital requirement =
- 2.50% of on-balance-sheet assets +
- 0.45% of net outstanding mortgage-backed securities+
- 0.45% of other off-balance-sheet obligations

(calculated in accordance with OFHEO's methodology)

Freddie Mac's Minimum, Critical and Core Capital Levels

(dollars in billions)

As of Dec. 31	2000	1999	1998	1997	1996
Core Capital	$14.4	$12.7	$10.7	$7.4	$6.7
Required Critical Capital	$7.2	$6.3	$5.3	$3.7	$3.4
Core Capital as a % of Required Critical Capital	199%	202%	202%	201%	199%
Required Minimum Capital	$14.2	$12.3	$10.3	$7.1	$6.5

(continued on page 4)

No Acceleration Right
Freddie *SUBS* will not permit the holders to accelerate the maturity of the securities upon default or the occurrence of any other event.

Form and Listing
Freddie *SUBS* will be issued in book-entry form on the book-entry system of the U.S. Federal Reserve Banks. Freddie Mac expects to apply to list individual issues of Freddie *SUBS* on the Luxembourg Stock Exchange.

Freddie *SUBS* Ratings
In order to provide investors with an independent assessment of credit risk, each issue of Freddie *SUBS* is expected to be publicly rated by Moody's Investors Service, Inc. and Standard & Poor's Credit Market Services, a division of The McGraw-Hill Companies, Inc.

Currently, Freddie *SUBS* have been assigned:
- A prospective rating of Aa2 from Moody's
- A preliminary rating of AA- from Standard & Poor's

Freddie Mac has the following additional ratings, which are current as of March 9, 2001:
- Freddie Mac's senior unsecured debt is rated Aaa by Moody's and AAA by Standard & Poor's.
- Freddie Mac's preferred stock is rated aa3 by Moody's and AA- by Standard & Poor's.
- Freddie Mac has received a "risk to the government" rating of AA- from Standard & Poor's.

Freddie *SUBS* and Government/Agency Indices
Freddie Mac has been informed that (a) Lehman Brothers will include Freddie *SUBS* in the agency component of its Global Aggregate Bond Index and U.S. Aggregate Bond Index; (b) Merrill Lynch will include Freddie *SUBS* in the agency component of its Global Broad market Index and U.S. Broad market Index; and (c) Salomon Smith Barney will include Freddie *SUBS* in the agency component of its World Broad Investment-Grade Bond Index and U.S. Broad Investment-Grade Bond Index.

Conclusion
Supplementing its existing risk and capital management and disclosure practices with the six voluntary commitments made in October 2000 keeps Freddie Mac in the vanguard of evolving financial institution management practices. Periodic issuance of Freddie *SUBS* is a critical component of these voluntary commitments.

Information
Additional information on Freddie *SUBS* can be found at: ***www.freddiemac.com/debt***

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VOLUNTARY COMMITMENTS TO ENHANCE RISK MANAGEMENT, CAPITAL AND DISCLOSURE PRACTICES AND STANDARDS

Freddie Mac plays a vital role in the housing finance system and its safety and soundness is a matter of substantial public importance. Freddie Mac announced on October 19, 2000 that it is voluntarily implementing a series of commitments regarding its risk management, capital strength and disclosure practices. Freddie Mac's performance with respect to these commitments will be subject to continuous supervisory examination.

The following is an overview of the six components of the voluntary commitments and the status of Freddie Mac's implementation of each commitment.

1. Periodic Issuance of Subordinated Debt

Summary of Commitment

Freddie Mac will issue publicly traded and externally rated subordinated debt on a semi-annual basis. On December 15, 2000, Freddie Mac announced the major features of its forthcoming Subordinated Debt Securities Program ("Freddie SUBS℠"), which was designed pursuant to this commitment. Freddie SUBS will be issued in an amount such that the sum of Freddie Mac's core capital (defined below), loan loss reserves and outstanding Freddie SUBS will equal or exceed the sum of 4 percent of its on-balance-sheet assets and 0.45 percent of off-balance-sheet mortgage securities, following a three-year phase-in period. Freddie Mac's core capital ("core capital") consists of the par value of outstanding common stock (common stock issued less common stock held in treasury), the par value of outstanding perpetual preferred stock, additional paid-in capital and retained earnings, as measured under accounting principles generally accepted in the U.S. ("GAAP"). The terms of the Freddie SUBS will provide for interest payments to be suspended for up to five years under contractually defined conditions of financial stress. The subordinated debt will be in addition to, and not a substitute for, the equity capital Freddie Mac is required to hold under its Congressional charter.

Implementation Status

The initial offering of Freddie SUBS is scheduled to occur in March 2001 with the issuance of $2 billion of 10-year bullet debt. Freddie Mac plans to issue Freddie SUBS at least twice yearly. Over a three-year phase-in period, the amount of Freddie SUBS outstanding is expected to grow to between $8 billion and $10 billion. Quarterly updates regarding issuances of Freddie SUBS will be provided in conjunction with Freddie Mac's release of its quarterly financial results and will be posted on its Web site (www.freddiemac.com).

Additional detail regarding the Freddie SUBS program is provided in "LIQUIDITY AND CAPITAL MANAGEMENT—*Liquidity*."

2. Liquidity Management and Contingency Planning

Summary of Commitment

Freddie Mac will maintain more than three months' worth of liquidity based on the assumption that it is unable to access the new issue public debt markets. Freddie Mac also will maintain at least 5 percent of on-balance-sheet assets in a liquid, marketable portfolio of non-mortgage securities to facilitate liquidity. Additionally, Freddie Mac will meet the 14 principles espoused by the Basel Committee on Banking Supervision ("Basel Committee") in its February 2000 paper entitled "Sound Practices for Managing Liquidity in Banking Organisations." Management believes these actions will reduce the possibility that Freddie Mac's ability to meet its financial obligations could be disrupted during any future financial crisis.

Implementation Status

Freddie Mac met the new liquidity standard as of December 31, 2000 (see "LIQUIDITY AND CAPITAL MANAGEMENT—*Liquidity*—Liquidity Risk Management"). This disclosure will be updated in conjunction with the release of Freddie Mac's quarterly financial results and will be posted on Freddie Mac's Web site.

3. Interim Implementation of Risk-Based Capital Stress Test

Summary of Commitment

Freddie Mac will implement an interim risk-based capital stress test and disclose the test results on a quarterly basis, pending final promulgation of a risk-based capital standard by the Office of Federal Housing Enterprise Oversight ("OFHEO"). Specifically, the corporation will disclose whether it has sufficient capital to withstand 10 years of extremely adverse interest-rate and credit conditions. The parameters Freddie Mac uses in this interim stress test, such as changes in interest rates and the associated levels of borrower defaults and prepayments, will be based on the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 ("GSE Act"). Freddie Mac's interim implementation of the risk-based capital stress test will provide information about Freddie Mac's capital strength pending completion of OFHEO's final risk-based capital regulations.

Implementation Status

Freddie Mac met its interim risk-based capital stress test requirement as of December 31, 2000 (see "LIQUIDITY AND CAPITAL MANAGEMENT—*Capital Management*—Capital Adequacy"). Freddie Mac will be updating this disclosure via postings on Freddie Mac's Web site approximately 60 days following the end of each quarter.

4. New and More Frequent Interest-Rate Risk Disclosures

Summary of Commitment

Freddie Mac will enhance its current quarterly interest-rate risk disclosure by initiating public disclosure of quantitative interest-rate risk sensitivity on a monthly basis. The more frequent and enhanced quantitative interest-rate risk disclosure will show the expected impact on the net market value of Freddie Mac's interest-earning assets and liabilities that would result from an immediate, adverse 50 basis point parallel shift in the Treasury yield curve and from a 25 basis point change in the slope of the Treasury yield curve.

Implementation Status

Freddie Mac will commence monthly disclosure of quantitative interest-rate risk sensitivity following first quarter 2001. Monthly updates will be provided in connection with Freddie Mac's publication of its Monthly Volume Summary, and its release of quarterly financial results, which are posted on Freddie Mac's Web site.

5. New Credit Risk Disclosure

Summary of Commitment

Freddie Mac will initiate public disclosure of credit risk sensitivity on a quarterly basis. The new disclosure will show the expected financial impact on Freddie Mac of an immediate 5 percent decline in house prices.

Implementation Status

Freddie Mac has implemented this commitment with the disclosure of its credit risk sensitivity results as of December 31, 2000 (see "RISK MANAGEMENT— *Credit Risk*—Mortgage Credit Risk— *Credit Risk Sensitivity*"). This disclosure will be updated quarterly in Freddie Mac's Information Statement Supplements, which are posted on its Web site.

6. Public Disclosure of Credit Rating

Summary of Commitment

Freddie Mac will obtain an annual credit rating from a nationally recognized statistical rating organization and disclose this rating to the public. The rating will assess the risk to the government, or the independent financial strength, of Freddie Mac, thereby serving as an independent evaluation to the public of the corporation's financial condition.

Implementation Status

Freddie Mac has obtained a "risk-to-the-government" rating of "AA-" from Standard & Poor's ("S&P"). As of December 31, 2000, only five U.S. bank holding companies had senior debt rated "AA-" or higher by S&P. At Freddie Mac's request, this rating will be maintained by S&P on a continuous, "surveillance" basis, which means that S&P will be obligated to notify the public if the rating is ever affected by a change in Freddie Mac's financial condition.

RISK MANAGEMENT

Freddie Mac is subject to two primary business risks: *(i)* credit risk and *(ii)* interest-rate and other market risks. Freddie Mac is also exposed to operational and other related risks. Management of these risks affects both the level and stability of the corporation's long-term value and short-term earnings.

Credit Risk

Freddie Mac's primary exposure to credit risk is associated with the mortgages in its total mortgage portfolio ("mortgage credit risk"). The corporation is also subject to credit risk associated with the issuers of non-mortgage securities held in the liquidity and contingency investment portfolio, as well as from the institutions with which it conducts business ("institutional credit risk").

Mortgage Credit Risk

Mortgage credit risk is the risk that the corporation will not receive amounts due from mortgage borrowers because of borrower defaults, potentially resulting in a loss if Freddie Mac is unable to collect amounts due through restructuring of the mortgage, sale of the underlying property or other loss mitigation activities.

Credit Risk Management Oversight: Freddie Mac's Board of Directors oversees the corporation's credit risk management. Under the Board's oversight, Freddie Mac's senior management is responsible for the day-to-day management of the corporation's credit risk activities. Freddie Mac also maintains a credit risk oversight function that reports directly to the Vice Chairman and President. Its purpose is to independently monitor the corporation's credit risk exposure and assess the effectiveness of the corporation's credit risk management systems and processes.

Credit Risk Management Strategies: Freddie Mac's management of mortgage credit risk comprises three broad areas:

- Establishing and enforcing sound underwriting and quality control standards, increasingly through the use of automated underwriting;
- Obtaining credit enhancements on higher-risk mortgages; and
- Executing loss mitigation activities to resolve non-performing loans.

Freddie Mac manages mortgage credit risk by using automated underwriting systems and other tools to evaluate the credit quality of the mortgages it purchases. It secures partial protection against the risk of default on purchased mortgages through the use of primary mortgage insurance and various forms of credit enhancement, and it seeks to reduce the corporation's overall exposure to credit losses by using a variety of loss mitigation techniques to prevent non-performing mortgages from proceeding to foreclosure. In addition, Freddie Mac monitors a number of factors relating to the type, location and other characteristics of purchased mortgages, as well as the sensitivity of credit losses to changes in house prices, as part of its ongoing effort to manage mortgage credit risk.

During the last few years, Freddie Mac has been prudently expanding its efforts to serve alternative market segments in which it purchases conforming mortgage loans with relatively higher risk characteristics than mortgages traditionally purchased by Freddie Mac. In 2000, Freddie Mac purchased a higher volume of loans with higher risk profiles through the purchase of mortgage securities backed by such loans. At December 31, 2000, Freddie Mac's total mortgage portfolio included approximately $12 billion of such securities, representing less than 1.5 percent of the total portfolio. Approximately 40 percent of these securities were rated "AAA" by at least one nationally recognized credit rating agency, 7 percent were rated "A" and 53 percent were rated "BBB". These securities are covered by credit enhancements of various types that management believes are appropriate in view of the returns on equity generated by these investments and the expected losses on the underlying mortgages.

Underwriting Standards and Quality Control—Freddie Mac seeks to ensure that the mortgages it purchases are protected by the borrower's willingness and ability to repay the mortgage obligation and by adequate equity in the underlying property. Increasingly, automated underwriting tools such as Loan Prospector and other quantitative credit risk management tools are used to evaluate and monitor credit risk for single-family mortgages. During 2000, 56 percent of Freddie Mac's single-family purchase volume was evaluated prior to purchase using Loan Prospector, compared with 50 percent in 1999. Loan Prospector combines loan-to-value ("LTV") ratios and other loan and borrower characteristics to generate credit risk classifications that enable Freddie Mac and lenders to evaluate overall loan risk. These statistically based risk assessments increase the ability of Freddie Mac and mortgage lenders to distinguish among single-family loans based on their likelihood of default.

The corporation also manages the quality of its single-family mortgage purchases by monitoring seller/servicers' compliance with its underwriting standards through quality control reviews and on-site audits and investigating situations involving possible fraud.

As part of its post-purchase quality control review process, Freddie Mac uses Loan Prospector® tools to evaluate the credit quality of virtually all single-family mortgages that were not evaluated by Loan Prospector prior to purchase. Particular focus is placed on performing quality control reviews of purchases identified as high-risk mortgages. For multifamily mortgages, Freddie Mac manages risk primarily using a combination of intensive underwriting and strict requirements on the mortgage lenders eligible to participate in Freddie Mac's multifamily programs.

Credit Enhancements—For most of the mortgages in its total mortgage portfolio (which are either held as whole loans or PCs), Freddie Mac retains the primary risk of loss in the event of default by the borrower on the underlying mortgage loan. Some of these mortgages are higher LTV mortgages, which are required by Freddie Mac's charter to be covered by primary (or loan-level) mortgage insurance (or certain other credit protections) to be eligible for purchase by Freddie Mac. Loans for which loan-level mortgage insurance is the only external protection against credit loss are not classified as credit-enhanced mortgages. Mortgages in this category are included in Freddie Mac's "at-risk" mortgage portfolio.

For certain other mortgages, Freddie Mac shares part of the default risk by transferring a portion of that risk to various third parties through a variety of credit enhancement vehicles, other than primary mortgage insurance (see "RISK MANAGEMENT—*Credit Risk*—Institutional Credit Risk"). Mortgages in this category are referred to as "credit-enhanced" mortgages. Pool insurance is the most prevalent type of credit enhancement protecting Freddie Mac's mortgage portfolio. Pool insurance covers a large group of similar loans, in contrast to loan-level mortgage insurance, which is obtained for individual loans. Pool insurance contracts expire after no fewer than 8 years, and typically cover losses ranging between 0.80 percent and 1.50 percent of the original unpaid principal balance of the pooled loans at the time of purchase. For the pool insurance contracts that expire before the completion of the mortgage term, Freddie Mac ensures that the contracts cover the period of time during which it is most likely that the related mortgages may default. In addition to pool-insured loans, Freddie Mac's credit-enhanced mortgages include loans protected by reinsurance, collateral (including cash or marketable securities) pledged by a lender, or recourse agreements under which the lender repurchases loans that default. Freddie Mac benefits from these credit enhancements to the extent that mortgages default at expected levels, typically resulting in the corporation's receipt of collateral or cash proceeds that offset credit losses. In exchange for this potential future benefit, Freddie Mac receives a lower guarantee fee on securitized mortgages that are credit-enhanced.

A portion of the corporation's total mortgage portfolio consists of mortgage securities issued or guaranteed by entities other than Freddie Mac. These investments, referred to as "Non-Freddie Mac securities," include (*i*) mortgage securities issued or guaranteed by agencies such as Ginnie Mae, (*ii*) mortgage revenue bonds guaranteed by state and local government agencies, and (*iii*) home equity and commercial mortgage-backed securities.

Table 1 presents the composition of Freddie Mac's total mortgage portfolio, showing the amounts of credit-enhanced mortgages, guaranteed non-Freddie Mac mortgage investments and the at-risk mortgage portfolio.

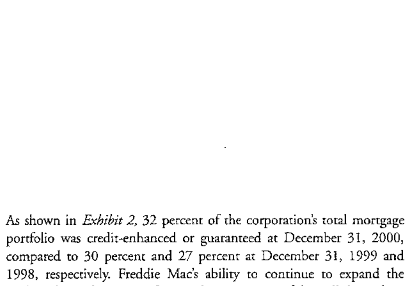
TABLE 1 – TOTAL MORTGAGE PORTFOLIO BY CREDIT-ENHANCED AND AT-RISK COMPONENTS

December 31,	2000		1999	
(dollars in millions)				
Credit-enhanced or guaranteed:				
Mortgages[1]	$ 225,268		$ 200,602	
Non-Freddie Mac mortgage securities[2]	80,244		56,569	
Total Credit-enhanced or guaranteed	$ 305,512	32%	$ 257,171	30%
Freddie Mac at-risk[3]	656,282	68%	605,155	70%
Total Mortgage Portfolio	$ 961,794	100%	$ 862,326	100%

(1) Includes loans for which the lender or a third party has retained primary default risk by pledging collateral or agreeing to accept losses on loans that default. Freddie Mac retains secondary default risk on credit-enhanced mortgages to the extent losses exceed the level covered by the applicable credit enhancement.
(2) Includes non-Freddie Mac mortgage securities held in the retained portfolio that are protected by the credit gurarantee of various agencies, bond insurance policies or senior/sub-ordinated bond structures.
(3) Includes those mortgages for which Freddie Mac has assumed primary default risk. These mortgages are either held as whole loans or securitized as Freddie Mac PCs.

As shown in *Exhibit 2*, 32 percent of the corporation's total mortgage portfolio was credit-enhanced or guaranteed at December 31, 2000, compared to 30 percent and 27 percent at December 31, 1999 and 1998, respectively. Freddie Mac's ability to continue to expand the credit-enhanced portion of its total mortgage portfolio will depend on management's evaluation of the credit quality of new business purchases and the future availability of effective credit enhancements at prices that permit an attractive return on credit-enhanced mortgage investments.

EXHIBIT 2 – TOTAL MORTGAGE PORTFOLIO (AT-RISK VS. CREDIT-ENHANCED)



While the use of credit enhancements reduces Freddie Mac's exposure to mortgage credit risk, it increases the corporation's exposure to institutional credit risk, that is, the risk that the provider of the credit enhancement may not perform its contractual responsibility (see "RISK MANAGEMENT—*Credit Risk*—Institutional Credit Risk").

Loss Mitigation Activities—Despite the corporation's underwriting standards, mortgages may become non-performing due to changes in general economic conditions, changes in the financial status of individual borrowers or other factors. *Table 2* summarizes the corporation's non-performing, restructured and seriously delinquent loans.

TABLE 2 – NON-PERFORMING LOANS, TROUBLED DEBT RESTRUCTURINGS AND SERIOUS DELINQUENCIES

December 31,	2000	1999
(dollars in millions)		
Non-accrual loans(1)	$ 729	$ 685
Real estate owned	348	438
Total non-performing assets	1,077	1,123
Troubled debt restructurings(2)	747	623
Serious delinquencies(3)	2,506	2,245
Total	$ 4,330	$ 3,991

(1) Includes loans for which interest income is recognized on a cash basis. For single-family loans, this population is determined using statistically based models. For multifamily loans, the population includes all loans 90 days or more delinquent.
(2) Includes previously delinquent loans that have been modified and are performing in accordance with the modified terms.
(3) Includes single-family loans 90 days or more delinquent, excluding all loans disclosed as non-accrual. For multifamily loans, the population includes all loans 60 days or more delinquent but less than 90 days delinquent.

Loss mitigation activities are a key component of Freddie Mac's strategy for managing and resolving non-performing assets and lowering credit losses. These activities influence the amounts recovered by the corporation on delinquent mortgages and real estate owned ("REO"). Freddie Mac emphasizes early intervention in delinquencies and alternatives to foreclosure. Foreclosure alternatives are intended to reduce the number of delinquent mortgages proceeding to foreclosure and, ultimately, reduce Freddie Mac's total losses by eliminating a portion of the costs related to foreclosed properties.

Loan modifications and pre-foreclosure sales are the two foreclosure alternatives most often carried out by servicers on behalf of Freddie Mac. A loan modification is an agreement that changes one or more of the original terms of a mortgage for qualifying borrowers, usually the loan's interest rate or payment period. A pre-foreclosure sale is a transaction in which Freddie Mac accepts less than full payment of the amount owed on a defaulted mortgage in exchange for the sale of a home prior to foreclosure. In 2000, Freddie Mac executed foreclosure alternatives on a total of 5,157 loans, consisting of 3,851 loan modifications and 1,306 pre-foreclosure sales.

Over the years, Freddie Mac has developed innovations that assist servicers to manage non-performing loans more effectively. These innovations include Early Indicator℠, a system that determines the probability that delinquent loans will continue through to foreclosure, and Servicer Performance Profiles℠, which are confidential reports by which Freddie Mac evaluates the performance of its mortgage servicers based on their management of performing and non-performing loans.

Credit Risk Profile: As part of the corporation's credit risk management practices, Freddie Mac monitors certain loan characteristics such as product mix, LTV ratios and geographic concentration, which may affect the default experience on the corporation's mortgage portfolio.

Product Mix—Product mix affects the credit risk profile of Freddie Mac's total mortgage portfolio. *Table 3* presents the distribution of Freddie Mac's total mortgage portfolio by mortgage product type.

TABLE 3 – TOTAL MORTGAGE PORTFOLIO

December 31, (dollars in millions)	2000		1999	
TOTAL MORTGAGE PORTFOLIO BALANCES:				
Mortgages and Freddie Mac PCs				
30-year single-family fixed-rate	$ 637,664	66%	$ 567,396	66%
15-year single-family fixed-rate	161,186	17	169,922	20
ARMs/floating-rate	48,897	5	36,114	4
Balloon/resets	11,726	1	15,508	1
Total single-family	859,473	89	788,940	91
Multifamily	22,077	2	16,817	2
Total mortgages and Freddie Mac PCs	881,550	91	805,757	93
Non-Freddie Mac mortgage securities[1]				
Fixed-rate	65,512	7	42,626	5
ARMs/floating-rate	14,732	2	13,943	2
Total non-Freddie Mac mortgage securities	80,244	9	56,569	7
Total mortgage portfolio	$ 961,794	100%	$ 862,326	100%

(1) Non-Freddie Mac securities are categorized based upon the product type of the mortgage collateral underlying the security.

In general, 15-year, fixed-rate mortgages exhibit the lowest default rate among the types of single-family mortgages owned by Freddie Mac, due to the accelerated rate of principal amortization on these mortgages and the credit profiles of borrowers who seek and qualify for them. The next lowest rate of default is associated with 30-year, fixed-rate mortgages. Balloon/reset mortgages typically default at a higher rate than fixed-rate mortgages. ARMs normally pose the greatest risk of default among single-family mortgages. While ARMs are typically originated with interest rates that are initially lower than those available for fixed-rate mortgages, their interest rates also change over time based on changes to an index or reference interest rate. As a result, the borrower's payments may rise or fall, within limits, as interest rates change. As payments increase, the risk of default also increases.

LTV Ratios— Freddie Mac's principal safeguard against credit losses for mortgages in its at-risk portfolio is provided by the borrower's equity in the underlying properties. The likelihood of single-family mortgage default depends not only on the initial credit quality of the loan, but also on events occurring subsequent to origination. Accordingly, Freddie Mac monitors the LTV ratio at the date of mortgage origination, as well as the estimated current LTV ratio, which reflects estimated house-price appreciation occurring after the date of mortgage origination. The estimated current LTV ratio compares the current unpaid principal balance of the mortgage to the estimated current market value of the property securing the mortgage. Historical experience has shown that defaults are less likely to occur on mortgages with low estimated current LTV ratios. To the extent that Freddie Mac is able to sell a property for an amount that equals or exceeds the unpaid balance of a defaulted mortgage loan (plus amounts incurred as carrying and disposition costs), it can avoid credit losses in the event of a default on an at-risk mortgage. Additional protection against credit loss on its at-risk mortgages with higher original LTVs is provided by loan-level mortgage insurance.

The distribution of Freddie Mac's single-family portfolio by original and estimated current LTV range is presented in *Tables 4* and *5*, respectively.

TABLE 4 – ORIGINAL LTV RATIO RANGE

December 31,	2000	1999	1998
Below 70%	31%	32%	33%
Above 70% to 80%	42	42	42
Above 80% to 90%	14	15	15
Above 90% to 95%	11	10	10
Above 95%	2	1	—
Total	100%	100%	100%

TABLE 5 – ESTIMATED CURRENT LTV RATIO RANGE[1]

December 31,	2000	1999	1998
Below 70%	65%	59%	52%
Above 70% to 80%	16	19	21
Above 80% to 90%	13	16	18
Above 90% to 95%	2	2	3
Above 95%	4	4	6
Total	100%	100%	100%

(1) Current market values are estimated by adjusting the value of the property at origination based on changes in the market value of house prices since origination.

Geographic Concentration—Freddie Mac mitigates the potential adverse effect of changing local and regional economic conditions on its credit results by maintaining a geographically diverse mortgage portfolio. The geographic distribution of Freddie Mac's mortgage portfolio generally reflects the distribution of outstanding U.S. residential mortgage debt. Further information on geographic credit concentrations is provided in Note 9 to the Consolidated Financial Statements.

Credit Performance: The effectiveness of Freddie Mac's credit risk management is reflected primarily in the level of defaulted mortgages and the level of credit losses relative to the total mortgage portfolio. Effective risk management and favorable economic conditions, particularly house-price appreciation, were key drivers of these measures of credit performance in 2000. *Table 6* and the following discussion address the credit performance of Freddie Mac's single-family and multifamily mortgage portfolios.

TABLE 6 – CREDIT PERFORMANCE

Year ended December 31, *(dollars in millions)*	2000	1999	1998
Delinquencies, end of period[1]			
Single-family:[2]			
At-risk portfolio[3]	0.37%	0.39%	0.50%
Total portfolio	0.50%	0.43%	0.49%
Multifamily:[4]			
Net carrying value	$ 9	$ 23	$ 40
Percentage	0.04%	0.14%	0.37%
REO, end of period			
Single-family	$ 346	$ 437	$ 569
Multifamily	2	1	5
Total	$ 348	$ 438	$ 574
REO activity			
Properties in inventory-beginning of period	5,619	6,781	8,402
Properties acquired	9,532	11,474	15,490
Properties disposed	(10,587)	(12,636)	(17,111)
Properties in inventory-end of period	4,564	5,619	6,781
Net charge-offs (recoveries)			
Single-family:			
Foreclosure alternatives[5]	$ 11	$ 14	$ 58
REO acquisitions	21	45	61
Total single-family	32	59	119
Multifamily	(4)	(3)	(3)
Total	$ 28	$ 56	$ 116
Number of single-family foreclosure alternatives settled[5]	5,157	5,517	6,535
Credit-related expenses			
Provision for mortgage losses	$ 40	$ 60	$ 190
REO operations expense:			
Single-family	66	99	151
Multifamily	—	—	1
Total	66	99	152
Total credit-related expenses	$ 106	$ 159	$ 342
Credit losses[6]			
Single-family	$ 98	$ 158	$ 270
Multifamily	(4)	(3)	(2)
Total credit losses	$ 94	$ 155	$ 268
Total credit losses/average total mortgage portfolio[7]	1.1bp	2.0 bp	4.1bp
Reserve for mortgage losses, end of period	$ 784	$ 772	$ 768

(1) Includes mortgages and Freddie Mac PCs purchased for Freddie Mac's total mortgage portfolio.
(2) Based on the number of mortgages 90 days or more delinquent.
(3) Includes only those loans for which Freddie Mac has assumed primary default risk. Excludes loans for which the lender or a third party has retained primary default risk by pledging collateral or agreeing to accept losses on loans that default.
(4) Based on net carrying value of mortgages 60 days or more delinquent.
(5) Primarily consists of loan modifications and pre-foreclosure sales.
(6) Equal to charge-offs plus REO operations expense.
(7) Average total mortgage portfolio excluding non-Freddie Mac securities.

Single-family—The single-family at-risk delinquency rate declined 2 basis points from year-end 1999 to 37 basis points at December 31, 2000. The single-family total portfolio delinquency rate increased 7 basis points from year-end 1999 to 50 basis points at December 31, 2000 primarily due to increased delinquencies on FHA/VA mortgages and other credit enhanced loans.

REO properties in inventory continued to decline in 2000, both in terms of dollar amount and number of properties held, with dispositions outpacing acquisitions. The single-family REO balance was $346 million at December 31, 2000, down from $437 million and $569 million at December 31, 1999 and 1998, respectively. Acquisitions of single-family REO properties declined to their lowest level since 1992.

Single-family credit losses totaled $98 million in 2000, a 38 percent and 64 percent decline from losses experienced in 1999 and 1998, respectively. The decline in credit losses was due primarily to declining REO acquisitions and lower loss severity rates on defaulted mortgages. Lower loss severities reflect continued strong home prices in conjunction with the expanded use of credit enhancements on new purchases in recent years.

Table 7 presents the distribution of the single-family mortgage portfolio and at-risk delinquencies by year of origination.

TABLE 7 – SINGLE-FAMILY MORTGAGE PORTFOLIO AND AT-RISK DELINQUENCIES BY YEAR OF ORIGINATION

December 31,	2000		1999	
Year of origination	Dollars in Millions[1]	At-Risk Delinquency Rate[2]	Dollars in Millions[1]	At-Risk Delinquency Rate[2]
Pre-1992	$ 30,511	0.89%	$ 35,897	1.00%
1992	32,230	0.38%	37,475	0.45%
1993	84,830	0.28%	96,961	0.29%
1994	35,324	0.60%	39,289	0.66%
1995	31,801	0.84%	35,660	0.87%
1996	50,451	0.77%	56,252	0.77%
1997	64,976	0.34%	71,715	0.29%
1998	233,175	0.17%	248,673	0.09%
1999	185,131	0.20%	167,018	0.04%
2000	111,044	0.11%	—	—
Total	$ 859,473	0.37%	$ 788,940	0.39%

(1) Balance of total single-family mortgage portfolio (at-risk and non-at-risk mortgages combined) for respective period presented by year of origination.
(2) At-risk delinquency statistics are based on loans 90 days or more delinquent plus foreclosures in process and approved as a percentage of the total number of loans in the year of origination. Includes only those loans for which Freddie Mac has assumed primary default risk. Excludes loans for which a lender or a third party has retained primary default risk by pledging collateral or agreeing to accept losses on loans that default. In some cases the lender's or third party's risk is limited to a specific level of losses at the time the credit enhancement becomes effective.

Freddie Mac expects continued strong credit performance in 2001, although it is anticipated that delinquency rates are likely to rise above the historically low levels prevailing during 2000. Freddie Mac has increasingly purchased or required credit enhancements on its mortgage portfolio in recent years. As shown in *Table 7*, mortgages originated in 1998 or later represented more than 60 percent of the corporation's single-family portfolio at December 31, 2000. These mortgages, which have significant credit enhancement protection, are approaching their peak default years (generally, three to five years after origination) (see "FORWARD-LOOKING STATEMENTS").

Multifamily—The multifamily delinquency rate was 0.04 percent at December 31, 2000, down from 0.14 percent and 0.37 percent at December 31, 1999 and 1998, respectively. The decline from both December 31, 1999 and 1998 reflects decreases of $14 million and $31 million, respectively, in the net carrying value of non-performing multifamily mortgages. Multifamily recoveries totaled $4 million in 2000, compared to recoveries of $3 million in 1999 and 1998. Recoveries in 2000, 1999 and 1998 resulted from the collection of certain amounts previously deemed uncollectible. The corporation has not experienced losses on its multifamily loan portfolio since Freddie Mac redesigned its multifamily programs in 1994.

Credit Risk Sensitivity: Freddie Mac's commitments to enhance risk management, capital and disclosure standards include the quarterly disclosure of credit risk sensitivity (see "VOLUNTARY COMMITMENTS TO ENHANCE RISK MANAGEMENT, CAPITAL AND DISCLOSURE PRACTICES AND STANDARDS"). Management believes that this new disclosure will illustrate the soundness of the corporation's credit risk management strategies and enhance investor confidence in the financial strength of Freddie Mac.

Changes in house prices are an important factor in determining Freddie Mac's exposure to mortgage credit risk. A higher rate of appreciation in the value of a residential property is correlated with higher prices obtained in the event of default, resulting in lower levels of credit loss for

Freddie Mac. In addition, higher house-price appreciation results in lower LTV ratios and, as a result, lower defaults. Freddie Mac analyzes the sensitivity of expected credit losses on the corporation's single-family mortgage portfolio to an instantaneous change in house prices. The sensitivity analysis assumes that there is an immediate 5 percent decline in the current level of house prices and that house prices return to trend for 10 years after this initial 5 percent downward shock. Total credit losses over the 10-year period are discounted to present value. Although the credit risk sensitivity model estimates the potential future effect on Freddie Mac's credit losses that would result from an assumed instantaneous downward movement in house prices, it does not represent an actual current loss to Freddie Mac. Freddie Mac maintains reserves to provide for estimated lossses incurred on its total mortgage portfolio (see Notes 1 and 3 to the Consolidated Financial Statements).

Freddie Mac uses a model of mortgage defaults and prepayments estimated by OFHEO to determine expected credit losses. The model is described at OFHEO's Web site (www.ofheo.gov). The mortgage and default model is the same model used in the interim risk-based capital stress test with the exception of loss severity rates. Loss severity rates are reduced in half to reflect recent experience when determining expected credit losses. Loss severity rates are then increased by 5 percentage points to reflect the 5 percent decline in house prices when determining the sensitivity of expected credit losses. The model also incorporates the protection provided by primary mortgage insurance and credit enhancements by generating two separate present values for expected credit losses. The first value assumes that none of the mortgage insurance and credit enhancements currently covering the mortgages owned by Freddie Mac has any mitigating impact on Freddie Mac's credit losses, while the second value gives full effect to Freddie Mac's mortgage insurance and credit enhancements.

Using the methodology described above, Freddie Mac estimates that as a result of the assumed 5 percent decline in house prices, the present value of credit losses over the 10-year period covered by the model would be:

- $710 million higher, before the receipt of primary mortgage insurance and credit enhancements; and
- $215 million higher, after the receipt of primary mortgage insurance and credit enhancements.

Institutional Credit Risk

Freddie Mac is subject to credit risk from institutional counterparties to the extent they do not fulfill their obligations to Freddie Mac under the terms of specific contracts or agreements. Freddie Mac's primary institutional credit risk exposure arises from agreements with the following counterparties:

- Mortgage servicers;
- Mortgage insurers;
- Guarantors of non-Freddie Mac securities held in the retained portfolio;
- Issuers and guarantors of investments held in the liquidity and contingency portfolio; and
- Counterparties to derivative financial instruments entered into by the corporation.

Freddie Mac is exposed to institutional credit risk arising from the insolvency of mortgage servicers that remit monthly principal and interest payments on mortgages to Freddie Mac or that guarantee the performance of certain mortgages. To protect itself against this risk, Freddie Mac requires servicers to meet minimum net worth, insurance and other eligibility requirements, and institutes remedial actions against seller/servicers that fail to comply with these standards including the right to transfer or terminate its relationship with the seller/servicers.

Freddie Mac also bears institutional credit risk relating to the non-performance of mortgage insurers that insure purchased mortgages. Freddie Mac manages this risk by regularly monitoring its exposure to individual mortgage insurers. Freddie Mac also performs periodic on-site audits of mortgage insurers to ensure compliance with its eligibility requirements and to evaluate their management and control practices. Substantially all mortgage insurers providing primary mortgage insurance coverage on single-family mortgages purchased during 2000 were rated "AA" or better by S&P, with 68 percent rated "AA+" or better. In addition, state insurance authorities regulate mortgage insurers.

Freddie Mac is also exposed to institutional credit risk to the extent that the guarantors or the third parties providing credit enhancements on the non-Freddie Mac securities held in the retained portfolio become insolvent. Non-Freddie Mac securities consist of agency and non-agency mortgage-related securities. Agency mortgage-related securities present minimal institutional credit risk exposure to Freddie Mac due to the high credit quality of the issuers. Ginnie Mae securities, for example, are backed by the full faith and credit of the U.S. government. Non-agency mortgage-related securities are exposed to both mortgage and institutional credit risk. The corporation mitigates the mortgage credit risk associated with these securities through guarantees provided by senior/subordinated bond structures, bond insurers or a combination of both. The potential insolvency of bond insurers that guarantee these securities also poses institutional credit risk. Freddie Mac manages the institutional credit risk associated with its non-agency mortgage-related securities by only purchasing securities meeting the corporation's investment guidelines and by performing ongoing analysis to ensure the creditworthiness of the issuers and servicers of non-Freddie Mac securities and the bond insurers that guarantee those securities. To ensure creditworthiness of non-agency securities, the corporation may perform additional analysis, including on-site visits, review of financial information, verification of loan documentation, review of underwriting or servicing processes and similar due diligence measures.

TABLE 8 – CREDIT CHARACTERISTICS OF NON-FREDDIE MAC MORTGAGE SECURITIES

December 31,	2000		1999	
	Dollars in Millions	% AAA Rated[1]	Dollars in Millions	% AAA Rated[1]
Agency Mortgage Securities	$ 37,294	100%	$ 19,860	100%
Non-Agency Mortgage Securities:				
Home equity securities	15,393	97%	13,808	96%
Commercial mortgage-backed securities[2]	10,716	97%	7,822	96%
Mortgage revenue bonds	6,953	83%	5,690	79%
Manufactured housing securities	2,896	89%	4,693	92%
Other mortgage-related securities	6,992	94%	4,696	91%
Total	$ 80,244	97%	$ 56,569	95%

(1) Credit rating of non-agency mortgage securities is designated by at least two nationally recognized statistical rating agencies.
(2) Consists of securities backed by pools of loans that included significant amounts of multifamily mortgages.

More than 46 percent of the non-Freddie Mac mortgage securities owned by the corporation consist of agency mortgage securities, which are generally not separately rated by credit rating agencies but are viewed as having a level of credit quality at least equivalent to non-agency mortgage securities rated "AAA." The remaining 54 percent, or $42.95 billion in principal amount, of the corporation's non-Freddie Mac mortgage securities consist of the specific types of non-agency mortgage securities shown in *Table 8*. Of this amount, approximately $40.25 billion, representing nearly 94 percent of the non-agency mortgage securities, are rated "AAA." A relatively small portion of the securities in each non-agency category is rated below "AAA." The mortgage revenue bond category contains the highest percentage of securities rated below "AAA." All of the mortgage revenue bonds owned by Freddie Mac are rated "A" or higher. Freddie Mac manages the credit risk on its mortgage revenue bond portfolio by monitoring rating agency evaluations of issuer creditworthiness and by limiting its investments in the securities of any single issuer.

Institutional credit risk also arises from the insolvency of issuers or guarantors of investments held in Freddie Mac's liquidity and contingency investment portfolio, which is used to meet both anticipated and unanticipated liquidity and working capital requirements (see "LIQUIDITY AND CAPITAL MANAGEMENT—*Liquidity*"). Instruments within this portfolio are investment grade at the time of purchase, primarily short-term in nature and diversified among various issuers, thereby mitigating to a significant extent the institutional credit risk inherent in this portfolio. In addition, management regularly evaluates these investments to determine if any impairment in fair value requires a write down of the asset's carrying value.

As discussed later, Freddie Mac uses derivative financial instruments primarily in connection with its interest-rate risk management activities ("RISK MANAGEMENT—*Interest-Rate and Other Market Risks*—Derivatives Portfolio"). Exchange-traded derivative financial instruments, such as futures contracts, decrease the corporation's exposure to institutional credit risk since changes in the value of open exchange-traded contracts are settled daily. The use of over-the-counter derivative financial instruments exposes Freddie Mac to institutional credit risk that arises from the possibility that a counterparty will be unable to perform according to the terms of the derivatives contract. Freddie Mac mitigates its exposure to institutional credit risk related to over-the-counter derivative contracts by using master netting agreements. These agreements provide for the netting of amounts receivable and payable under all transactions covered by the master netting agreement between Freddie Mac and a single counterparty in the event that the master agreement is terminated due to non-performance.

In addition to using master netting agreements, Freddie Mac manages institutional credit risk associated with derivative financial instruments by limiting its selection of counterparties to only those institutions having credit ratings among the highest available from major rating agencies. The corporation also limits its exposure to any one counterparty, regularly monitors financial positions and, in many cases, requires collateral in order to manage institutional credit risk. At December 31, 2000, the three largest counterparties (based on notional or contractual amounts outstanding), each with an independent credit rating of "A+" or better, accounted for approximately 39 percent of the notional amount of the corporation's outstanding over-the-counter derivative financial instruments. Freddie Mac's management of credit risk related to derivative financial instruments is discussed further in Note 9 to the Consolidated Financial Statements.

The corporation's aggregate exposure to institutional credit risk for derivative financial instruments can be estimated by calculating the "net replacement value," or replacement cost, of all outstanding non-exchange traded derivative financial instruments for each counterparty with which the corporation was in a net gain or "positive fair value" position, after taking into account the offsetting provided for through master netting agreements. Net replacement value differs from the "net fair value" of Freddie Mac's derivatives presented in *Table 10*-Derivative Financial Instruments. "Net replacement value" includes only those derivatives for which Freddie Mac is exposed to institutional credit risk on over-the-counter derivatives in a net gain position. In contrast, the "net fair value" includes all derivatives, both exchange-traded and over-the-counter, regardless of whether they are in a net gain or loss position. The corporation's estimated exposure to institutional credit risk related to its derivative financial instruments, based on net replacement values was $1.5 billion at December 31, 2000, compared to $4.7 billion at December 31, 1999. The decrease in the corporation's credit risk exposure reflects changes in interest rates and the mix of derivatives which decreased the replacement value of these contracts with several of Freddie Mac's largest counterparties (see "RISK MANAGEMENT—*Interest-Rate and Other Market Risks*—Derivative Financial Instruments"). Freddie Mac's exposure to institutional credit risk can fluctuate from period to period due to changes in interest rates and/or foreign exchange rates.

Of the total estimated exposure to institutional credit risk on derivative financial instruments in a net gain position, $1.5 billion was fully collateralized at December 31, 2000. Freddie Mac's policy for requiring collateral from counterparties is based on independent credit ratings, estimated credit risk exposure on net replacement values and internal assessments of counterparty credit quality. In addition, it is the corporation's policy to limit its uncollateralized risk-adjusted credit exposure to any one counterparty from all investment and derivative activities to less than 1 percent of "Stockholders' equity." To date, Freddie Mac has not incurred any credit losses on derivative financial instruments or set aside specific reserves for institutional credit risk exposure. Management does not believe such reserves are necessary, given the corporation's collateral and counterparty policy requirements.

Interest-Rate Risk and Other Market Risks

Disciplined management of interest-rate risk and other market risks is critical to Freddie Mac's ability to manage its debt financing and securitization financing activities. Successfully managing these risks requires consistently maintaining acceptable levels of risk exposure while meeting the corporation's thresholds for return on equity and targets for net interest income. Freddie Mac's risk management objective is to produce long-term returns that are relatively insensitive to changes in interest-rate and other market risks.

Freddie Mac's primary exposure to interest-rate and other market risks is associated with its portfolio of mortgage investments financed with debt—Freddie Mac's retained portfolio. These mortgage-related investments offer potentially higher investment returns than those likely to be achieved through securitization financing. However, the retained portfolio also exposes the corporation to a higher degree of interest-rate risk and other market risks, and requires a commitment of higher levels of capital per dollar of mortgages financed.

Management Oversight of Interest-Rate and Other Market Risks

Freddie Mac's Board of Directors oversees the corporation's risk management process. Under the Board's oversight, Freddie Mac's senior management is responsible for managing the corporation's activities relating to interest-rate and other market risks. Members of senior management serve on a Risk Management Committee responsible for setting risk thresholds, expected return on equity and net interest income targets and for reviewing the quality of actual results. A separate group is responsible for the day-to-day risk management strategies and rebalancing activities.

Freddie Mac also maintains a market risk oversight function that reports directly to the Chief Financial Officer. This group is responsible for identifying all of the corporation's interest-rate risk and other market risk exposures, and providing senior management with an independent evaluation of whether the risks are effectively identified, measured, managed and controlled. The market risk oversight function independently monitors risk exposure levels on a daily basis relative to internal operating limits on the amount of the corporation's risk exposure to interest-rate risk and other market risks.

Interest-Rate Risk

Interest-rate risk is the risk that changes in the level of interest rates or changes in the shape of the Treasury yield curve could affect adversely the market value and future earnings of Freddie Mac. Freddie Mac's interest-rate risk exposure results primarily from the uncertainty as to when borrowers will pay the outstanding principal balance of their mortgages ("prepayment risk"). A mortgage borrower has the option, usually without penalty, to make unscheduled payments of additional principal or to completely pay off a mortgage loan before its scheduled maturity date. A borrower also has the option to make only scheduled principal payments on a mortgage up to its stated maturity, such as 30 years in the case of a 30-year mortgage. This option may cause the mortgage to have a life longer than the expected life of a typical mortgage, which prepays in full before its stated maturity.

A borrower's ability to shorten the life of a mortgage or hold it until its stated maturity makes the timing and amount of mortgage prepayments very sensitive to changes in interest rates. A significant decline in interest rates may lead to higher prepayments and a shorter expected life for a mortgage than originally projected. Conversely, a significant increase in interest rates could lead to lower than anticipated prepayments and a longer expected life for a mortgage than originally projected. As the mortgage origination process continues to become faster and less expensive for mortgage borrowers, prepayment levels are likely to become increasingly sensitive to changes in interest rates.

Sources of Interest-Rate Risk

Retained Portfolio: Prepayment risk is a key factor in investment, funding and hedging decisions made for the retained portfolio. Differences between estimated and actual mortgage prepayments can cause mismatches between the expected cash flows from the mortgage assets in the retained portfolio and the interest expense on the liabilities that fund them. Freddie Mac mitigates prepayment risk with a funding strategy that employs callable and non-callable debt instruments, with maturities ranging from short-term securities to 30-year bonds, and various types of derivative financial instruments which provide the flexibility to closely match cash flows from debt financing with the expected cash flows from its investments.

Interest-rate risk associated with the retained portfolio can affect adversely Freddie Mac's net interest income in both rising and falling interest-rate environments. When interest rates fall quickly, net interest income may be reduced if borrowers prepay their mortgage loans faster than anticipated and Freddie Mac is able to reinvest the proceeds only in lower-yielding investments. When interest rates rise quickly, net interest income may be reduced if Freddie Mac must refinance maturing debt at higher rates and mortgages are outstanding longer than anticipated. The corporation's mix of short-term, long-term and callable debt, callable preferred stock and its use of derivative instruments help offset the potential decline in net interest income resulting from these changes in market conditions.

Securitization Financing: The management and guarantee fee income Freddie Mac receives from its securitization financing activities also is exposed to interest-rate risk. Changes in interest rates may affect adversely the future income that Freddie Mac receives from securitization financing, and thus affect the corporation's market value and future earnings. A change in interest rates that causes mortgage prepayments to increase may affect adversely Freddie Mac's guarantee fee income if prepayments exceed the volume of new mortgage purchases being securitized. In addition, the average guarantee fee on securitized mortgages will decline if new mortgage purchases are securitized at lower fee levels than the mortgages that prepay. Securitized mortgages also expose Freddie Mac to interest-rate risk because of timing differences between Freddie Mac's receipt of payments from mortgage borrowers and its subsequent passthrough of those payments to PC investors. These timing differences can lead to significant interest expense, particularly in a rapidly declining interest-rate environment. If the interest rate Freddie Mac must pay to a PC investor is higher than the rate at which Freddie Mac can reinvest payments received from mortgage borrowers, Freddie Mac bears the cost difference, recognized as interest expense, for the time period between when the borrower pays Freddie Mac and when Freddie Mac pays the PC investor (see Note 1 to the Consolidated Financial Statements). The magnitude of this risk is partially offset because the expected prepayments on the mortgages and the PCs that finance them are closely matched.

Trading Portfolios: Freddie Mac's SS&TG unit and external money managers actively trade mortgage-related securities to support the market for Freddie Mac's Gold PCs. The primary goal of these activities is to improve the liquidity of Gold PCs and strengthen relationships with mortgage security investors. SS&TG's mortgage portfolio and the portfolios managed by Freddie Mac's external money managers are exposed to interest-rate risk. These trading portfolios are subject to Freddie Mac's risk measurement and management standards, which helps to minimize losses when there are significant changes in interest rates.

Amortization of Premiums and Discounts: When mortgage-related investments are purchased or sold at amounts above or below par value, the resulting premiums or discounts (reported on Freddie Mac's Consolidated Balance Sheets as "Purchase and sale premiums, discounts and deferred fees") are deferred and recognized as interest income or expense over the estimated lives of the underlying mortgages using the effective interest method (see Note 1 to the Consolidated Financial Statements). The amount of interest income or expense that must be recognized is sensitive to large changes in interest rates and mortgage prepayments. When investments are purchased at a premium, a higher amortization rate results in an increase in the level of interest expense and a reduction in net interest income. Conversely, when investments are purchased at a discount, a higher amortization rate results in an increase in net interest income.

Measurement of Interest-Rate Risk

Parallel Treasury Yield Curve Shifts: Freddie Mac's most significant market risk exposure arises from changes in the level of interest rates. Freddie Mac measures this risk on a daily basis by estimating the expected loss that would result from an immediate, adverse 50 basis point parallel shift (up or down) in the current Treasury yield curve. The assumed parallel shift in interest rates means that each point along the Treasury yield curve, from the shortest to the longest maturities, is changed by the same 50 basis points. The 50 basis point rate change approximates the impact of a severe tightening or easing of rates and, statistically, represents the change in Treasury rates that would be expected over a one-month period within a 95 percent confidence interval. Given this assumed change in Treasury rates, Freddie Mac calculates the expected change in mortgage and debt rates using information about their historical relationship to Treasury securities.

Freddie Mac's daily risk exposure is stated in terms of Portfolio Market Value Sensitivity ("PMVS"), which is the estimated percentage decline in Freddie Mac's market value of equity (referred to as "portfolio market value") for a given adverse rate change. PMVS encompasses the sensitivity of Freddie Mac's portfolio market value to duration and convexity risk. The corporation uses PMVS to gauge the strength and durability of its projected investment returns. PMVS includes the valuation of all of Freddie Mac's interest-rate sensitive assets and liabilities (with preferred stock treated as a debt equivalent), including its off-balance-sheet financial instruments. The PMVS methodology also takes into account the market value of projected cash flows from Freddie Mac's securitization financing activities.

Non-Parallel Treasury Yield Curve Shifts: Freddie Mac's portfolio market value also is exposed to interest-rate risk arising from non-parallel shifts in the yield curve (such as a flattening or steepening) when the cash flows of its assets and liabilities are not exactly matched. This is referred to as yield curve risk. Due to the option of the borrower to prepay a mortgage or hold it until its stated maturity, which makes future prepayments impossible to predict with certainty, some degree of cash flow mismatch exists at all times. Freddie Mac measures yield curve risk by monitoring the sensitivity of its portfolio market value to changes in interest rates along all points of the yield curve. As part of the enhanced interest-rate risk disclosure that Freddie Mac has committed to provide, Freddie Mac will commence monthly disclosure of the impact on its portfolio market value of a 25 basis point change in the slope of the yield curve (see "VOLUNTARY COMMITMENTS TO ENHANCE RISK MANAGEMENT, CAPITAL AND DISCLOSURE PRACTICES AND STANDARDS"). Freddie Mac manages yield curve risk by selecting a funding mix that closely matches the cash flows of its mortgages. During 2000, Freddie Mac consistently maintained its yield curve risk level below 2 percent of portfolio market value under the yield curve scenario that will be used for the new monthly disclosures.

Freddie Mac supplements its PMVS and yield curve risk measurements with other interest-rate modeling and tools, including stress tests, that measure the effect on the corporation of more severe interest-rate and credit environments for purposes of evaluating the adequacy of the corporation's capital (see "LIQUIDITY AND CAPITAL MANAGEMENT—*Capital Management—Capital Adequacy*").

Freddie Mac uses proprietary and external financial and risk models to estimate interest-rate risk. These models use a range of possible interest-rate scenarios to project estimated mortgage prepayments. The use of financial models to measure interest-rate risk exposes Freddie Mac to certain operational and other related risks (see "RISK MANAGEMENT—*Operational and Other Related Risks*—Business and Financial Model Risk").

Interest-Rate Risk Management Strategies and Results: Freddie Mac issues many different types of debt and actively rebalances its funding mix to protect its portfolio market value. Derivative financial instruments have become increasingly important in Freddie Mac's overall strategy for managing interest-rate risk.

Funding Transactions—Freddie Mac finances retained portfolio investments using a mix of debt and derivative financial instruments that enable it to closely match cash outflows with the cash inflows from the corporation's mortgage investments. Freddie Mac uses various instruments, including short-term debt, callable and non-callable long-term debt and derivative financial instruments, to maximize its ability to reprice debt when mortgages prepay faster than expected. Freddie Mac's ability to maintain this flexibility depends on its ability to issue debt and buy and sell derivative financial instruments at a reasonable cost.

Rebalancing Transactions—Freddie Mac executes interest-rate risk management (or "rebalancing") transactions to provide protection against changes in interest rates that may occur over both short- and long-term time periods. To provide short-term protection, Freddie Mac typically buys or sells derivative financial instruments, such as U.S. Treasury futures or interest-rate swaps, to closely match the expected life of its assets and liabilities. In addition, Freddie Mac obtains long-term protection from wider swings in interest rates by purchasing put and call options to change the characteristics of the debt used to finance the mortgages purchased. Rebalancing transactions help Freddie Mac maximize the amount of debt that it has the option to reprice when interest rates are rapidly declining (call options), and to minimize the amount of debt that must be repriced when interest rates are rapidly increasing (put options).

Use of Derivative Financial Instruments—Freddie Mac enters into derivative financial transactions as an end user in connection with its investment funding and market risk management activities. Derivatives are a critical component in executing funding and rebalancing transactions to reduce risk and preserve value. Generally, derivatives are used to tailor Freddie Mac's funding mix to provide more durable investment returns even if cash flows change over time due to changing mortgage prepayments. By using derivatives, Freddie Mac is better able to match the expected cash flows of its assets and liabilities and reduce the corporation's exposure to interest-rate and/or foreign currency risk than through the issuance of debt alone. Freddie Mac's use of derivatives primarily involves swaps and options. The effect of these transactions on Freddie Mac's interest-rate risk profile is reflected in PMVS.

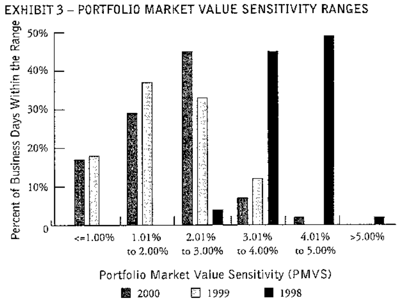
Swaps: Interest-rate swaps are used to adjust Freddie Mac's mix of short-term and long-term debt to provide protection against relatively small, near-term interest-rate changes. Swaps can be used as a component of the funding mix when mortgage assets are purchased, and also as a rebalancing tool to adjust the duration of assets and liabilities. When assets are purchased, combining swaps with fixed-maturity debt financing often can provide greater interest-rate risk management flexibility and lower effective funding costs than callable debt. Swaps involve basis risk, which is the risk that changes in the interest-rate spread between different financial instruments could affect portfolio market value. Freddie Mac primarily enters into swaps linked to the London Interbank Offered Rate ("LIBOR") (see "OTHER MARKET RISK—Basis Risk").

Options: Freddie Mac uses options, primarily options on interest-rate swaps (called "swaptions"), to protect against larger interest-rate changes. A swaption is an option to enter into an interest-rate swap in the future on terms that are established when the option contract is initiated. The swaption buyer pays a purchase premium for the right to enter into the swap at some future date. Swaptions provide protection against changes in interest rates similar to the protection provided by callable debt and their terms can be tailored to closely match the characteristics of a mortgage. When interest rates fall, Freddie Mac's exercise of a swaption under which it makes floating-rate payments would shorten the effective maturity of the corporation's debt and reduce its funding costs. When interest rates rise, Freddie Mac's exercise of a swaption under which it makes fixed-rate payments would provide protection against increased funding costs by lengthening the effective maturity of debt.

Risk Management Results— PMVS will vary over time depending on a variety of factors, including the level of interest rates relative to the average coupon of portfolio assets, liquidity in the market for hedging instruments and the cost of purchasing interest-rate protection in the derivatives and callable debt markets. Monitoring and managing PMVS is one element of Freddie Mac's overall investment management strategy that involves maintaining acceptable levels of risk, achieving thresholds for return on equity and meeting targets for net interest income.

Exhibit 3 illustrates the percentage of business days PMVS was within certain ranges during 2000 as compared to 1999 and 1998.

EXHIBIT 3 – PORTFOLIO MARKET VALUE SENSITIVITY RANGES



As indicated in *Exhibit 3*, PMVS was 3.00 percent or less for approximately 91 percent of the business days in 2000, compared to 88 percent and 4 percent of the business days in 1999 and 1998, respectively. Additionally, PMVS was 2.00 percent or less for more than 46 percent of the business days in 2000. At December 31, 2000, each 1 percent of PMVS was equal to a potential dollar value loss of approximately $109 million. It is important to recognize that while

PMVS is a measure of the potential future loss in portfolio market value arising from an assumed shift in interest rates, it does not represent an actual current loss to Freddie Mac.

At the end of 1998, mortgage interest rates had fallen below the average coupon of the mortgage assets in the retained portfolio, significantly increasing the likelihood of mortgage prepayments. As a result, PMVS was 3.9 percent as of December 31, 1998, based on a 50 basis point shift in Treasury rates. In 1999, Freddie Mac purchased substantial amounts of protection against rising interest rates, including derivatives that reduced short-term funding exposure and put swaptions that limited exposure to a significant rise in long-term funding costs. Because of these rebalancing actions, PMVS was 0.8 percent at the end of 1999, substantially lower than at the end of 1998 even though interest rates had risen during 1999 and exceeded the average coupon of the retained portfolio.

During the second half of 2000, Freddie Mac purchased call options and entered into pay-floating swaps as interest rates declined, shortening the duration of the debt portfolio to match the shortened duration of the mortgage portfolio. At the end of 2000, PMVS was 2.5 percent, based on a 50 basis point shift in Treasury rates, reflecting Freddie Mac's rebalancing actions and an average coupon rate for the retained portfolio which was near the year-end level of mortgage rates.

There have been wide fluctuations in interest rates in each of the past two years. During 1999, the interest rate on ten-year Treasury securities increased by 180 basis points over the course of the year. In 2000, interest rates were volatile, with the 10-year Treasury rate declining 170 basis points from its peak early in the year. Because of Freddie Mac's risk management strategies and the risk profile it maintained during the past two years, the corporation's fair value of equity as of December 31, 2000 increased by $1.3 billion to $12.4 billion on an after-tax basis (see Note 13 to the Consolidated Financial Statements).

Historical levels of PMVS will not necessarily be indicative of future results. As noted above, PMVS will vary over time and could be higher than the unusually low levels that were experienced in 1999 and 2000 (see "FORWARD LOOKING STATEMENTS").

The corporation also measures and monitors interest-rate risk assuming more severe changes in interest rates. Estimates of PMVS at the end of December 31, 2000, 1999 and 1998, assuming a 100 basis point adverse parallel shift of the current Treasury yield curve, as well as a 50 basis point adverse shift, are presented in *Table 9*. *Table 9* also provides the potential dollar value loss in portfolio market value as a percentage of interest-earning assets.

Freddie Mac will commence monthly disclosure of the impact on its portfolio market value of an adverse 50 basis point change in the level of Treasury rates beginning with the results for first quarter 2001 (see "VOLUNTARY COMMITMENTS TO ENHANCE RISK MANAGEMENT, CAPITAL AND DISCLOSURE PRACTICES AND STANDARDS").

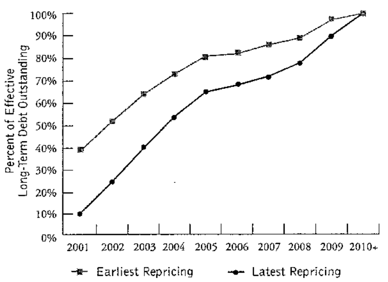
Exhibit 4 illustrates the cumulative percentage of Freddie Mac's contractual long-term debt plus the effect of derivative contracts ("effective long-term debt") outstanding at December 31, 2000 that will reprice in future years assuming that *(i)* all effective callable debt is repriced at the earliest possible call date and *(ii)* no debt is repriced until its scheduled maturity.

TABLE 9 – PORTFOLIO MARKET VALUE SENSITIVITY ASSUMING PARALLEL SHIFTS OF THE TREASURY YIELD CURVE

As of	Portfolio Market Value Sensitivity		Potential Dollar Value Loss in Equity (millions)		Potential Dollar Value Loss as a Percent of Interest-Earning Assets	
	50bp(1)	100bp(1)	50bp(1)	100bp(1)	50bp(1)	100bp(1)
December 31, 2000	2.5%	8.5%	$ 272	$ 924	0.1%	0.2%
December 31, 1999	0.8%	2.9%	$ 102	$ 366	–	0.1%
December 31, 1998	3.9%	14.0%	$ 362	$ 1,300	0.1%	0.4%

(1) Assumed basis-point ("bp") parallel shift of the Treasury yield curve.

EXHIBIT 4 – CUMULATIVE REPRICING OF EFFECTIVE LONG-TERM DEBT(1)



(1) Includes the impact of derivative contracts that effectively create long-term debt.

The top line illustrates the cumulative amount of the corporation's effective long-term debt that is available for repricing either through maturity or exercise of the call option each year. These early repricing opportunities provide substantial protection against prepayment risk. The bottom line shows the cumulative final maturity of the corporation's effective long-term debt, assuming that no debt is called, but rather that each instrument remains outstanding until its final maturity. These long final maturities provide protection if prepayments are slowed and the lives of the corporation's retained mortgage investments are extended. In 2001, approximately 11 percent of the effective long-term debt outstanding as of December 31, 2000 is scheduled to mature. However, an additional 28 percent, for a total of 39 percent, of effective long-term debt could be called by Freddie Mac should interest rates fall and prepayments of mortgage-related investments accelerate.

Other Market Risks

In addition to interest-rate risk, Freddie Mac monitors and manages its exposure to other market risks.

Basis Risk: Basis risk is the risk that changes in the interest-rate spread between different financial instruments could affect adversely Freddie Mac's portfolio market value or its net income. Freddie Mac is primarily exposed to basis risk as a result of using interest-rate swaps and Treasury-based derivatives. Freddie Mac buys mortgage assets opportunistically when returns meet internal thresholds. As part of its strategy for funding these purchases, Freddie Mac maintains an ongoing commitment to its debt investors through regular weekly auctions for its Reference Bills, and an annual calendar for debt issuances under its Reference Note and Reference Bond programs. As a result, the corporation may use swaps and futures contracts to adjust the cash flows of the debt issued under these programs to match cash flows of the less predictable mortgage purchase activity.

For example, Freddie Mac uses pay-floating (receive-fixed) interest-rate swaps in combination with the issuance of Reference Notes to shorten the effective maturity of its debt. Because the floating-rate payments of swaps are based on LIBOR, Freddie Mac is exposed to the basis risk resulting from potential changes in the spread between LIBOR and interest rates on Reference Notes. Conversely, pay-fixed (receive-floating) interest-rate swaps are used in combination with the issuance of Reference Bills to lengthen the effective maturity of Freddie Mac's debt. In this case, Freddie Mac is exposed to the basis risk resulting from potential change in the spread between LIBOR and Reference Bills. For example, if a swap contract has a term of five years and the Reference Bills used to fund a mortgage asset purchase have a three-month maturity, Freddie Mac must issue Reference Bills in 19 subsequent auctions. Freddie Mac's basis risk is the risk that the Reference Bills issued in the subsequent auctions must be sold at spreads to LIBOR that are less favorable than the initial issue, raising overall funding costs. Freddie Mac's management of basis risk includes internal operating limits on the amount of basis risk exposure. Rebalancing actions are taken to ensure that the risk level is maintained within those limits. The corporation's strategies to mitigate basis risk may, in certain scenarios, have a favorable impact on Freddie Mac's net interest income.

Volatility Risk: Volatility risk is the risk that changes in market expectations regarding the volatility of future interest rates could affect adversely the corporation's portfolio market value. This expectation, known as implied volatility, is embedded in option prices. When Freddie Mac purchases mortgage-related investments, it implicitly sells a prepayment option to the mortgage-borrower. Similarly, when Freddie Mac issues callable debt or uses certain derivative financial instruments, it implicitly buys a call option to match the cash flow characteristics of the prepayment option embedded in the mortgages. When implied volatility increases, mortgages decline in value because the uncertainty of prepayments increases. The volatility risk of the options embedded in Freddie Mac's mortgage investments is mitigated by the options purchased by Freddie Mac through callable debt or derivatives. However, the volatility risk in the mortgages is not fully offset because the volatility of mortgage investments and options is not exactly the same. Increases in the implied volatility of interest rates have a greater effect on the options embedded in mortgage-related investments than on the options embedded in callable debt or derivative financial instruments, exposing Freddie Mac to increases in the level of volatility. In addition, management may choose not to make extensive use of option-based derivatives to hedge volatility risk when it concludes that such use could involve significant additional hedging expense that may exceed the expected risk management benefits. Freddie Mac monitors volatility risk by measuring exposure levels on a daily basis and maintains internal operating limits on the amount of volatility risk exposure. Rebalancing actions are taken to ensure that the risk level is maintained within the operating limits. Freddie Mac evaluates hedge market liquidity and option costs in its management of volatility risk to minimize risk and maximize future earnings.

Derivatives Portfolio

Table 10 summarizes the notional or contractual amounts of derivative financial instruments by type and their related net fair value. Freddie Mac estimates the fair value of derivative financial instruments using discounted cash flow models based on current market interest rates and estimates of interest-rate volatility (see "RISK MANAGEMENT—*Credit Risk*—Institutional Credit Risk").

TABLE 10 – DERIVATIVE FINANCIAL INSTRUMENTS

December 31,	2000		1999	
	Notional or Contractual Amount	Net Fair Value	Notional or Contractual Amount	Net Fair Value
(dollars in millions)				
Interest-rate contracts:				
Interest-rate swaps				
Pay fixed	$ 141,637	$ (5,346)	$101,243	$ 1,978
Pay floating	129,208	2,609	22,375	(385)
Basis[1]	7,043	(8)	2,962	(2)
Interest-rate caps	12,416	153	19,533	742
Interest-rate floors	403	4	403	3
Futures and options[2]	135,581	2,008	267,737	2,674
Forward sales	35,839	(327)	—	—
Treasury-based contracts[3]	2,200	111	8,894	278
Foreign currency swaps	10,208	539	1,097	(82)
Total	$ 474,535	$ (257)	$424,244	$ 5,206

(1) Interest-rate swaps in which Freddie Mac pays and receives a floating rate, but which are based on two different indexes.

(2) A majority of options held by Freddie Mac were options to enter into interest-rate contracts (or swaptions).

(3) Excludes exchange-traded derivative financial instruments, such as Eurodollar and Treasury-based futures contracts, which are included in the "Futures and options" caption.

At December 31, 2000, the notional balance of Freddie Mac's derivative financial instruments totaled $475 billion, compared to $424 billion at December 31, 1999. Additionally, at December 31, 2000 and 1999, the net fair value of the corporation's derivative financial instruments was a payable of $257 million and a receivable of $5.2 billion, respectively. The decrease in the net fair value of the corporation's derivative financial instruments resulted from a decline in interest rates during the latter part of 2000 as well as a change in the mix of the corporation's derivatives due to ongoing risk management strategies. While derivative financial instruments reduce Freddie Mac's overall exposure to interest-rate and foreign currency risk, they increase the corporation's exposure to institutional credit risk (see "RISK MANAGEMENT—*Credit Risk*—Institutional Credit Risk"). In addition, derivative financial instruments may also subject the corporation to operational risk (see "RISK MANAGEMENT—*Operational and Other Related Risks*—Hedging Risk"). Further information regarding derivative financial instruments is presented in Notes 1, 7 and 9 to the Consolidated Financial Statements.

SFAS No. 133, which Freddie Mac implemented on January 1, 2001, significantly revised the accounting treatment of derivative financial instruments. Among other changes, the new standard requires derivative instruments to be recorded and carried on the balance sheet at their current fair value, with changes in the fair value of hedged items reflected in net income or "stockholders' equity" depending on the hedge relationship (see "EFFECT OF NEW ACCOUNTING STANDARDS" and Note 1 to the Consolidated Financial Statements).

Operational and Other Risks

Operational Risk: Operational risk is the risk of loss due to human error, system failures, fraud, or circumvention or failure of internal controls. Freddie Mac mitigates operational risk by following comprehensive financial and operating policies and procedures, and by regularly evaluating the effectiveness of its internal control structure. The corporation's policies and procedures include controls to ensure that system-generated data are reconciled to source documentation in a timely fashion. Freddie Mac also performs reasonableness and validity tests to ensure the accuracy of its financial information. The corporation's Internal Audit Division, which reports to the Board as well as to the corporation's management, regularly monitors Freddie Mac's compliance with established policies and procedures, and evaluates Freddie Mac's internal control structure. In addition, Freddie Mac maintains a continuity plan for critical business processes and systems in the event of disasters.

Hedging Risk: Hedging refers to the buying or selling of financial instruments to protect the corporation's portfolio market value or future earnings from adverse changes in the level and shape of the yield curve, and the volatility of interest rates. Hedging risk is the risk that hedging transactions do not effectively meet their objectives. The effectiveness of Freddie Mac's hedging strategy depends on its ability to execute hedging transactions when they are needed and at a reasonable price. To manage this aspect of hedging risk, Freddie Mac monitors market liquidity on a daily basis, and uses a variety of hedging instruments to reduce its dependence on the liquidity of any individual hedge market. Freddie Mac is also subject to the risk that hedging instruments do not provide effective protection. Freddie Mac manages this risk by adjusting its hedging strategies based on actual and expected market relationships.

Business and Financial Model Risk: The proprietary and external business and financial models used by Freddie Mac also expose the corporation to risk. For example, the mortgage prepayment model used by Freddie Mac, a valuation tool for projecting expected levels of mortgage prepayments in differing economic environments, is a core model used in conjunction with other valuation models for measuring and managing the corporation's exposure to credit and interest-rate risk. Operational failure related to the corporation's mortgage prepayment model could affect adversely the value, or future earnings, of the corporation. Freddie Mac mitigates operational risk related to this and other valuation models by benchmarking model results to market estimates of external parties. In the case of forecasting models, Freddie Mac mitigates operational risk by performing periodic comparisons of actual results to forecasted results and adjusting forecast models and assumptions accordingly. The corporation's use of external models exposes the corporation to the risk that the models might become unavailable to Freddie Mac.

LIQUIDITY AND CAPITAL MANAGEMENT

Liquidity

Freddie Mac's business activities present liquidity demands driven by maturities of debt, purchases of mortgages, payments of principal and interest to mortgage security holders and general operations. The corporation's sources of cash to meet the needs of its business activities and general operations include issuances of long-term and short-term debt, issuances of common and preferred stock, cash flows from operating activities and repayments of mortgage investments. Because of its financial performance and its regular and significant participation as an issuer in the funding markets, the corporation's sources of funding have remained adequate to meet its liquidity needs.

During 2000, Freddie Mac issued a total of $93.3 billion and $2.2 trillion in long-term and short-term debt, respectively, to support its business activities. A significant portion of debt issued in 2000 occurred through the corporation's primary debt financing programs: Reference Notes and Reference Bonds for longer-term financing and Reference Bills for shorter-term financing. These debt-financing programs enable the corporation to sell large issues of long-term and short-term debt that provide investors with high-quality, liquid debt securities. During 2000, Freddie Mac issued $58 billion of non-callable U.S. dollar-denominated Reference Notes and $617 billion of short-term debt under the corporation's Reference Bill program. Additionally, under the corporation's new EuroReference Note Programme, the corporation issued €10 billion of 10-year notes (see "BUSINESS REVIEW—*Debt Financing*"). The corporation plans to issue Reference Notes and Reference Bonds totaling $90 billion in accordance with its previously announced financing calendar for 2001. The financing calendar will continue to provide clarity and transparency with regard to the timing of new debt issues and reopening of prior issues, the anticipated size of individual offerings and settlement dates. As investor demand continues to grow for these debt securities, management believes its debt financing programs could, over the long term, produce a reduction in the corporation's debt financing costs (see "FORWARD-LOOKING STATEMENTS").

In December 2000, Freddie Mac announced its Freddie SUBS program as part of a series of voluntary initiatives to strengthen transparency, capital adequacy and market discipline. Freddie SUBS will be issued in an amount such that the sum of Freddie Mac's core capital, loan loss reserves and outstanding Freddie SUBS will equal or exceed the sum of 4 percent of its on-balance-sheet assets and 0.45 percent of off-balance-sheet mortgage securities following a three-year phase-in period. This subordinated debt will be in addition to, and not a substitute for, the equity capital Freddie Mac is required to hold under its Congressional charter. The amount of Freddie SUBS outstanding is expected to grow to between $8 billion and $10 billion over the phase-in period.

The weighted average outstanding maturity of Freddie SUBS will be at least five years, while the maturity of any single Freddie SUBS issue may range from 2 through 30 years. The terms of Freddie SUBS will provide that interest payments will be suspended and will accumulate for up to five years in the event that Freddie Mac's core capital (*i*) falls below 125 percent of critical capital levels; or (*ii*) falls below minimum capital levels and, if pursuant to Freddie Mac's request, the Secretary of the Treasury exercises his or her discretionary authority under Freddie Mac's Congressional charter to purchase Freddie Mac debt obligations (see "REGULATORY MATTERS" for a discussion of minimum and critical capital requirements). In January 2001, Freddie Mac announced that Freddie SUBS received preliminary ratings of "Aa2" from Moody's Investors Service, Inc. ("Moody's") and "AA-" from S&P.

Freddie Mac maintains a liquidity and contingency investment portfolio used to manage recurring cash flows and meet other cash management needs, maintain capital reserves to meet mortgage funding needs, provide diverse sources of liquidity and help manage the interest-rate risk inherent in mortgage-related investments. The liquidity and contingency investment portfolio enables Freddie Mac to deploy fully its available capital and fulfill its purpose of providing a stable and reliable supply of mortgage credit nationwide. This portfolio is important to Freddie Mac's financial management and its ability to provide liquidity and stability to the mortgage market. At December 31, 2000 and 1999, the liquidity and contingency investment portfolio totaled $49 billion and $42 billion, respectively, and consisted principally of cash and cash equivalents, asset-backed securities, corporate debt securities, and other highly rated marketable assets that can be readily converted to cash. The corporation recognizes net interest income on the liquidity and contingency investment portfolio. Further information regarding the liquidity and contingency investment portfolio is presented in Note 4 to the Consolidated Financial Statements.

Liquidity Risk Management—Freddie Mac has committed to maintain more than three months' worth of liquidity, assuming no access to public debt markets, to reduce the possibility that the corporation's operations are disrupted during a significant financial crisis. Freddie Mac's commitment is consistent with the principles of sound liquidity management set forth by the Basel Committee. To calculate its compliance with this commitment, Freddie Mac forecasts all of its cash needs over the next three months. All potential sources of liquidity available during the three months are then identified. These sources include certain investments in the liquidity and contingency portfolio, funding available from mortgage repurchase activities, and mortgage asset liquidations. As of December 31, 2000, Freddie Mac met the commitment to maintain more than three months of liquidity.

To facilitate liquidity, Freddie Mac also has committed to maintain at least 5 percent of on-balance-sheet assets in liquid, marketable non-mortgage securities. As of December 31, 2000, Freddie Mac also met this commitment.

Capital Management

Freddie Mac manages its capital resources to provide attractive returns on common equity while maintaining sufficient capital to satisfy internal capital adequacy standards and regulatory capital requirements, and to absorb unforeseen losses that might arise in fulfilling its mortgage guarantee obligations and conducting its business programs.

Capital Transactions

Table 11 summarizes the components of Freddie Mac's capital.

TABLE 11 – CAPITAL

December 31, *(dollars in millions)*	2000	1999	1998
Common stock:			
Par value	$ 152	$ 152	$ 152
Additional paid-in capital	429	474	494
Preferred stock (at redemption value)	3,195	3,195	2,807
Retained earnings	11,629	9,736	8,083
Treasury stock, at cost	(1,024)	(866)	(821)
Core capital	14,381	12,691	10,715
Reserve for mortgage losses	784	772	768
Total capital	15,165	13,463	11,483
Subordinated borrowings	145	130	162
Adjusted total capital	$ 15,310	$ 13,593	$ 11,645

During 2000, the corporation added more than $1.7 billion to total capital, largely driven by earnings growth partially offset by common stock repurchases and payment of common and preferred stock dividends. The increase in the total capital provided the corporation with the flexibility to respond to growth opportunities during 2000. Freddie Mac did not issue preferred stock in 2000. On January 26, 2001, Freddie Mac issued $325 million of variable-rate non-cumulative preferred stock. The proceeds from this offering will help the corporation respond to growth opportunities during 2001.

The corporation did not redeem any preferred stock during 2000. The corporation's outstanding 5.81 percent and 5.3 percent preferred stock issues have been redeemable since October 27, 1998 and October 30, 2000, respectively. The corporation's outstanding 1996 variable-rate and 6.125 percent preferred stock will become redeemable on June 30, 2001 and December 31, 2001, respectively. No other issue of Freddie Mac's preferred stock outstanding at December 31, 2000 will become redeemable in 2001. Freddie Mac's capital structure may be influenced by the redemption and replacement of all or part of these preferred stock issues, which could result in changes in the corporation's mix of common and preferred equity funding. Redemption of preferred stock in future periods will depend primarily on interest-rate levels.

In 2000, "Accumulated other comprehensive income, net of taxes" ("AOCI") increased $1.622 billion, although this increase does not affect the corporation's total capital or core capital. In accordance with the guidance provided by SFAS No.115, "Accounting for Certain Investments in Debt and Equity Securities," available-for-sale ("AFS") securities are marked to fair market value with unrealized gains and losses reported through the AOCI component of "Stockholders' equity." Under SFAS No. 115, the market value adjustment on AFS securities is limited to the securities themselves and therefore does not include the offsetting market valuation on the debt instruments funding these investments. Freddie Mac's AFS assets, which consist of liquidity investments and certain structured mortgage securities (primarily non-Freddie Mac mortgage securities), totaled $95 billion at December 31, 2000, up from $62 billion at December 31, 1999. Freddie Mac increased the relative proportion of assets classified as AFS in the first quarter 2001 in conjunction with the corporation's adoption of SFAS 133. The magnitude of the change in the mark-to-market valuation of the corporation's AFS portfolio is influenced primarily by the size of the portfolio, the general level of interest rates and credit risk premiums. Substantial changes in these factors could result in further market value fluctuations (see "FORWARD-LOOKING STATEMENTS" and "EFFECT OF NEW ACCOUNTING STANDARDS").

Freddie Mac actively manages capital to provide attractive returns on common equity and to return capital to shareholders through common stock repurchases when prudent. During 2000, Freddie Mac returned $258 million to shareholders through common stock repurchases pursuant to the corporation's stock repurchase program, an increase over 1999's common stock repurchases of $92 million.

In addition to its corporate stock repurchase program, Freddie Mac occasionally repurchases common stock to satisfy obligations under its stock-based compensation plans (see Note 8 to the Consolidated Financial Statements for further information on the corporation's stock-based compensation plans). The amount of capital actually available to repurchase common stock will be affected primarily by mortgage portfolio growth opportunities, Freddie Mac's assessment of the adequacy or sufficiency of its capital, as well as the implementation of regulatory risk-based capital standards (see "VOLUNTARY COMMITMENTS TO ENHANCE RISK MANAGEMENT, CAPITAL AND DISCLOSURE PRACTICES AND STANDARDS—*Liquidity Management and Contingency Planning*" and "REGULATORY MATTERS—*Capital Standards*").

Capital Adequacy

Freddie Mac regularly assesses the adequacy of its capital. Management believes that Freddie Mac should hold capital sufficient to satisfy its financial obligations, even if economic circumstances deteriorate unexpectedly and severely. Freddie Mac uses a stress test methodology to assess its capital adequacy.

The stress test methodology for assessing capital adequacy is a type of scenario analysis used by many firms to evaluate their financial strength under adverse business conditions. The focus of Freddie Mac's stress tests is on the risks embedded in the current book of business and current capital levels supporting this book of business; accordingly, these stress tests assume a "wind-down" mode with no new business or capital. In reality, Freddie Mac has the ability to engage in new business, change its risk or raise capital as economic conditions change.

Management believes that stress tests are more effective than traditional capital-to-asset ratios in determining the adequate amount of capital for several reasons:

- A stress test is a portfolio approach to measuring risk and capital adequacy, capturing credit and interest-rate risks, as well as the interactions among those risks;

- Stress tests give credit for risk-reducing strategies such as the use of callable debt, credit enhancements and capital market instruments such as swaps, options, caps, floors and credit derivatives; and

- Stress tests are forward-looking, calculating the impact of changes in the economic environment on financial performance.

Interim Risk-Based Capital Stress Test

In October 2000, Freddie Mac committed to disclose the results of an interim risk-based capital stress test that is consistent with the GSE Act, pending issuance and implementation of a final risk-based capital standard by the OFHEO (see "VOLUNTARY COMMITMENT TO ENHANCE RISK MANAGEMENT, CAPITAL AND DISCLOSURE PRACTICES AND STANDARDS"). This constitutes the first of the regular quarterly disclosures of the interim risk-based capital stress test.

The interim risk-based capital stress test used by Freddie Mac is based on the comment letter, available at Freddie Mac's Web site, that Freddie Mac submitted in response to OFHEO's proposed risk-based capital rule (see "REGULATORY MATTERS — *Capital Standards*"). The interim stress test estimates the amount of capital Freddie Mac would need to satisfy its current obligations over a 10-year period of extreme economic conditions, assuming no new business or capital as required by the GSE Act.

Freddie Mac simulates its financial performance under these stressful economic conditions using mortgage behavioral models proposed by OFHEO, with adjustments to correct for data issues as discussed in the comment letter, to predict mortgage cash flows. Freddie Mac then uses an accounting model to translate the predicted mortgage cash flows, as well as simulated cash flows of liabilities and off-balance-sheet obligations, into income statements and balance sheets for each of the 10 years of the stress period. The comment letter provides a more detailed discussion of the methodology underlying the interim risk-based capital stress test. The capital needed to satisfy the interim standard is equal to 130 percent of the amount necessary to satisfy all of Freddie Mac's financial obligations under each of the two stress test scenarios. The 30 percent additional capital beyond what is required to cover credit risk and interest-rate risk captured by the stress test is an additional cushion for management and operations risk.

The two stress test scenarios are defined by large changes in interest rates and house prices. These factors affect the performance of Freddie Mac's portfolio because they affect the level of mortgage defaults and prepayments as well as Freddie Mac's cost of funds. *Table 12* describes these two scenarios relative to a baseline in which interest rates do not change and house prices appreciate at an average annual rate of 3 percent. At December 31, 2000, Freddie Mac had sufficient capital to satisfy the interim risk-based capital standard under both stress test scenarios.

TABLE 12 – STRESS TEST ECONOMIC SCENARIOS

Economic Scenario	Interest-Rate Change(1)	House-Price Change(2)
Rising-rate environment	75%	(13%)
Falling-rate environment	(50%)	(28%)

(1) The change in the general level of interest rates as represented by the change in the 10-year Constant Maturity Treasury rate relative to recent historical levels as given by the GSE Act. The interest rate shock occurs in the first 12 months of the simulation, with rates remaining at their new levels for the rest of the stress period.

(2) The house-price change is the difference in the level of house prices at the end of the fifth year of the stress scenario relative to the baseline scenario. Since defaults occur with a lag relative to the house-price changes, house-price changes in the early years of the stress periods are most relevant for default behavior. The rising-rate environment includes an inflation adjustment relative to the falling-rate environment as stated in the comment letter.

Freddie Mac and Fannie Mae:

Their Funding Advantage and Benefits to Consumers

by

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Executive Summary

The benefits that American consumers derive from the activities of Freddie Mac and Fannie Mae and the advantages these private corporations receive from their federal charters are central issues in the public discussion of their role in the housing finance system. At the request of Freddie Mac, we independently analyzed a 1996 report that the Congressional Budget Office prepared on this subject (the "1996 Study") and then addressed the benefits to consumers and to the corporations.

- We first find that the 1996 Study both understated the consumer benefits and overstated the firms' advantage in borrowing funds (the "funding advantage"). The study used faulty data and inappropriate methodology.

- We estimate that Freddie Mac and Fannie Mae generate interest-cost savings for American consumers ranging from at least \$8.4 billion to \$23.5 billion per year. In contrast, we estimate that the value Freddie Mac and Fannie Mae indirectly receive from federal sponsorship in the form of their funding advantage ranges from \$2.3 billion to \$7.0 billion annually. Thus, even using the lowest estimate of consumer benefits and the highest estimate of the funding advantage in our range of estimates, the value of consumer interest-cost savings resulting from Freddie Mac and Fannie Mae's activities significantly exceeds the value of their funding advantage.

    - Freddie Mac and Fannie Mae also provide benefits beyond those that can be quantified in terms of savings on mortgage interest expense by homeowners. These include the maintenance of liquidity in the mortgage market during periods of financial turbulence and the expansion of homeownership opportunities for low-income and minority families. No attempt to quantify these additional consumer benefits was made here.

- We also find that federal sponsorship of Freddie Mac and Fannie Mae provides a "second best" structure for a housing finance system assuming that the "first best" system would have no government involvement at all. This is because Freddie Mac and Fannie Mae supply housing finance more efficiently than could the depositories alone. Banks and thrifts receive federal support in the form of deposit insurance, access to Federal Reserve Bank liquidity, and Federal Home Loan Bank advances and as a result they have an average cost of funds lower than Freddie Mac and Fannie Mae.

In summary, the 1996 Study was deficient in many respects. A more accurate approach shows that, under current federal sponsorship of Freddie Mac and Fannie Mae, consumers receive benefits significantly greater than the funding advantage received by the two corporations.

I. Introduction

Congressman Richard Baker (R-LA), Chairman of the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises of the Committee on Banking and Financial Services of the U.S. House of Representatives, has requested that the Congressional Budget Office ("CBO") update its 1996 estimates on the funding advantage and benefits to families resulting from Freddie Mac and Fannie Mae's activities (the "1996 Study").[1] The 1996 Study attempted to quantify the advantages that Freddie Mac and Fannie Mae derive from their Congressional charters and the benefits Freddie Mac and Fannie Mae provide to consumers. The Department of the Treasury, the Department of Housing and Urban Development, and the General Accounting Office prepared similar studies.[2]

Freddie Mac and Fannie Mae are government-sponsored enterprises ("GSEs") that play an important role in the secondary market for residential mortgages. Operating under essentially identical federal charters, the two firms benefit from lower costs and larger scale than they would have in the absence of federal sponsorship. Freddie Mac and Fannie Mae use these advantages to reduce the cost of mortgage credit and provide other benefits to homeowners. The lower yields they pay on their securities are often characterized as a "funding advantage" or even as a "subsidy" when comparing Freddie Mac and Fannie Mae to purely private corporations that have no nexus to the government. The 1996 Study attempted to quantify the funding advantage resulting from federal sponsorship and the benefits conveyed to mortgage borrowers.

The 1996 Study generated substantial controversy. It was well received by those who support a change in the charters of Freddie Mac and Fannie Mae. Others observed that the analysis contained serious flaws that led to an understatement of the net benefits provided by the

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[1] Letter dated July 12, 2000 from Representative Richard H. Baker to Mr. Dan L. Crippen, Director, Congressional Budget Office, requesting updates of estimates contained in Congressional Budget Office (1996).

[2] Department of the Treasury (1996); Department of Housing and Urban Development (1996); and General Accounting Office (1996).

two housing enterprises. In anticipation of the forthcoming CBO report, we were asked by Freddie Mac to review the 1996 Study and provide current analyses.

In this report, we address these fundamental questions:

- Are there major errors in the 1996 Study, and, if so, what are they?
- What are reasonable values for the funding advantage that Freddie Mac and Fannie Mae receive and the benefits that Freddie Mac and Fannie Mae's activities provide consumers?
- Would consumers be better or worse off in the absence of federal sponsorship of Freddie Mac and Fannie Mae?

These questions are answered in the following sections. Section II addresses errors in the data and methodology used in the 1996 Study. That study was deficient in many respects. We find that it systematically overstated the funding advantage received by Freddie Mac and Fannie Mae and understated the benefits to consumers. A repeat of these mis-measurements in the new report would render its findings and conclusions without credible foundation. Section III quantifies the funding advantage realized by Freddie Mac and Fannie Mae through their charter relationship with the federal government. Section IV addresses the benefits provided to consumers by the activities of Freddie Mac and Fannie Mae. We find that the benefits are much greater than the funding advantage. Section V includes an analysis of the market for mortgage credit and identifies certain efficiency-enhancing effects that follow from Freddie Mac and Fannie Mae's charters. We find that federal sponsorship of Freddie Mac and Fannie Mae supplies housing finance more efficiently than would depositories alone. The final section contains concluding remarks.

We find that the funding advantages and benefits must be expressed as ranges of estimates rather than as particular values. This follows from the underlying changes in market conditions over time and from the inability to obtain precise estimates of key relationships. Our fundamental conclusion is unqualified, however. Under present institutional arrangements in the mortgage lending industry, it would be a mistake to withdraw or curtail federal sponsorship of Freddie Mac and Fannie Mae. Because of Freddie Mac and Fannie Mae, consumers enjoy savings on their mortgages that are substantially greater than the funding advantages that are derived from Freddie Mac and Fannie Mae's charters.

II. The Approach Used by CBO in 1996 Overstated the Funding Advantage and Understated Benefits to Consumers

The CBO used a simple framework to quantify the funding advantage and the benefits to consumers. The first step in deriving the funding advantage was estimation of spreads that measure the differences in yields on Freddie Mac and Fannie Mae securities and similar securities issued by fully private firms. The second step was multiplying those spreads by the outstanding balances of Freddie Mac and Fannie Mae securities. A parallel procedure was used to derive the benefits to consumers. A spread estimating the effect of Freddie Mac and Fannie Mae on mortgage interest rates was applied to the outstanding amount of conforming mortgages held by Freddie Mac and Fannie Mae. In applying this framework in 1996, CBO overstated the funding advantage and understated the benefit to consumers.

The 1996 CBO estimate of the funding advantage was overstated in that:

1. It treated all Freddie Mac and Fannie Mae debt as long-term debt, ignoring the lower funding advantage on short-term debt.
2. It incorrectly measured the funding advantage on long-term debt and mortgage-backed securities ("MBS");

The 1996 CBO estimate of the consumer benefits was understated in that:

1. It ignored the benefits of Freddie Mac and Fannie Mae's activities on conforming mortgages not purchased by them;
2. It failed to recognize that the unadjusted spread between rates on jumbo and conforming mortgages does not capture the full impact of Freddie Mac and Fannie Mae on mortgage rates.

Overstating the Funding Advantage

Freddie Mac and Fannie Mae issue four types of securities to fund their purchases of mortgages: short-term debt (with maturities less than one year); long-term bullet debt; long-term callable debt (which can be called or retired early); and MBS. CBO overstated the funding advantage for Freddie Mac and Fannie Mae for each of these securities. First, the funding advantage on long-term debt was used for short-term debt even though empirical evidence demonstrates that short-term debt receives a lower funding advantage. Second, CBO failed to adjust its estimates of the funding advantage on long-term debt to account for the better liquidity of GSE debt. Third, the funding advantage on long-term callable debt was mis-measured, resulting in a significant overstatement of the funding advantage on this debt. Fourth, CBO overstated the funding advantage for MBS.

Overstatement of the funding advantage on short-term debt

The distinction between long-term and short-term debt is significant. The range of estimates for the funding advantage on short-term debt is substantially lower than for long-term debt. As we discuss further in the next section, the estimated funding advantage for short-term debt ranges from 10 to 20 basis points, while the corresponding range for long-term debt is 10 to 40 basis points.[3] At the same time, the share of short-term debt is large. The proportion of debt outstanding at year-end 1995 that was due within a year was about 50% for both Freddie Mac and Fannie Mae. At the end of third quarter 2000, the proportions were 41% for Fannie Mae and 45% for Freddie Mac.[4] This difference in the term of debt, and its implication for estimating the funding advantage, were ignored by CBO in its 1996 report. The appropriate approach is to compute separate funding advantages for short-term and long-term debt.

[3] Freddie Mac's and Fannie Mae's practice of synthetically extending the maturity of debt with swaps and other derivatives does not matter for the assessment of the short-term funding advantage. They participate in the swap market at the same prices as other large financial institutions. Thus, the funding advantage on short-term debt whose maturity is extended is no higher than the funding advantage for short-term debt whose maturity is not extended.

[4] These figures were obtained from the 1996 annual reports and third quarter, 2000 investor-analyst reports of Freddie Mac and Fannie Mae.

Measuring spreads on long-term debt

Analysts estimate the Freddie Mac and Fannie Mae funding advantage in debt issuance by comparing yields on debt issued by Freddie Mac and Fannie Mae and debt issued by firms that lack federal sponsorship but are perceived as otherwise similar to Freddie Mac and Fannie Mae. Such comparisons are sensitive to the choice of firms judged to be similar to Freddie Mac and Fannie Mae, to the period under consideration, and to how similar other private securities are to Freddie Mac and Fannie Mae securities with respect to such technical characteristics as default risk, callability, time-to-maturity, and amount issued. No such comparison is perfect. There are always some differences between the Freddie Mac and Fannie Mae securities and the comparators.

For its 1996 report, CBO utilized spreads from a commissioned study by Ambrose and Warga (1996). The authors were careful to limit their comparison of Freddie Mac and Fannie Mae securities to private securities that were similar in a number of important respects. However, they did not take into account the higher liquidity of Freddie Mac and Fannie Mae debt that results from the scale of their security issuances and the consistency of their presence in the securities markets. Withdrawal of federal sponsorship might reduce the amount of debt they issue, but they would still likely be among the largest private issuers in the market. Large issues generally are more readily marketable and therefore carry lower yields. Thus, yield comparisons that do not take issue size, volume outstanding, and other determinants of liquidity into account will overstate the yield spreads.[5]

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[5] The Ambrose and Warga study has other methodological deficiencies that were revealed by academic reviewers at the time the study was prepared (see, for example, Cook (1996) and Shilling (1996)). The spreads reported are averages obtained from monthly data. The sample of comparable debt issues varies widely over the ten-year period studied, but the authors report very limited information on how the levels and dispersion in the distribution of spreads varies over time. This may be a concern because months in which the number of possible comparisons is small receive as much weight in arriving at the final averages as months with large numbers of possible comparisons. Because the margin of error is higher in the months with few comparisons, those months should

Misuse of spreads on callable debt

The 1996 CBO procedure uses a weighted average of the spreads on callable and bullet debt to derive its estimate of the funding advantage. Because the spread on callable debt used by CBO was extraordinarily high (more than twice the spread on bullet debt), this approach resulted in an average spread on long-term debt that was considerably higher than would have been obtained from spreads on bullet debt alone.

Callable debt generally has an initial period where the debt cannot be called, after which it may be called, or bought back by the issuer at a stated price before maturity. It is far more difficult to compare yields across callable bonds because yields are extremely sensitive to the specific call features of a bond, for example, the length of the initial non-call period, the call price, and the maturity. Further, the projected yield depends on one's forecast of the volatility of interest rates over the investor's holding period of the bond, as volatility effects the probability that interest rates will fall sufficiently to trigger a call.

The difficulty of comparing yields on callable debt is exacerbated by the lack of data on callable bonds by other issuers. Freddie Mac and Fannie Mae issue significant amounts of callable debt because it provides an effective hedge for the mortgage assets that they are funding. Few other corporations have this need and regularly issue callable debt. In 1999, the GSEs accounted for most of the callable debt market.

Incorporating callable spreads into the derivation of the funding advantage on long-term debt was inappropriate. First, the callable spreads are very difficult to measure, as noted above. Second, there is no evidence to indicate that the funding advantage on callable debt is larger than that on non-callable debt. Callable debt is essentially long-term debt with an "option" to turn the debt into short-term debt. Market prices for callable debt reflect the value of the bullet debt plus the value of the call provision. The value of the call provision is determined in the derivatives market where Freddie Mac and Fannie Mae have no advantage over other market participants.

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receive less weight in the overall average. Failure to reflect these deficiencies in its application of the Ambrose and Warga data led CBO to treat the funding advantage as being more precisely estimated than it actually was.

Therefore, a more appropriate approach to estimate the funding advantage on callable debt would be to use spreads on long-term debt that can be more accurately measured.

Funding advantage on MBS

CBO included a component for MBS in its estimate of the overall funding advantage. As with the debt component, the funding advantage on MBS was derived from an estimated spread using yields on Freddie Mac and Fannie Mae securities relative to yields on comparable securities issued by other firms. The difficulty with this approach is that "private-label" MBS are very different from Freddie Mac and Fannie Mae MBS. Private-label MBS have lower volume, less frequent issuance, less liquidity and more complex features that investors must analyze. In particular, private-label MBS are typically "structured" securities where the cash flows on the underlying mortgages are divided among various investors. Consequently, estimates of the relevant spreads are very rough approximations. Most are based on the impressions of market participants rather than documented statistical comparisons subject to verification by other researchers. If these estimates were to be used, the estimates would need to be adjusted downward for the much greater liquidity of Freddie Mac and Fannie Mae securities.

After assessing the available information, CBO concluded that the relevant MBS spread was between 25 and 60 basis points. Although this range errs on the high side, we appreciate the recognition, reflected in the broad range, that the spread is not subject to precise estimation. However, the CBO did not carry this cautious approach into the calculation of the funding advantage. The agency used 40 basis points as its baseline value to estimate the MBS component of the funding advantage, and its sensitivity analysis considered a deviation of only 5 basis points from that value.

We believe that the relevant MBS spread is significantly less than 40 basis points and would fall between the spreads on short-term and long-term debt. In part, the basis for this opinion is the recognition that Freddie Mac and Fannie Mae are earning modest rates of return on their MBS business. Annual reports indicate that the two enterprises earn guarantee fees of approximately 20 basis points, which must compensate them for bearing default risk and other costs. Thus, Freddie Mac and Fannie Mae do not appear to be retaining much, if any, funding advantage through the issuance of MBS. Furthermore, MBS are backed by or "collateralized" by the underlying mortgages. Debt, on the other hand, is uncollateralized. As a result, perception of credit quality plays less of a role in valuing MBS than debt, because the investor has the assurance of quality from the mortgage collateral. Therefore, the funding advantage on MBS would be less than the funding advantage on the long-term debt.

Understating Benefits to Consumers

CBO estimated the benefits to consumers from Freddie Mac and Fannie Mae by multiplying a long-term average of the spread between interest rates on jumbo and conforming fixed-rate mortgages by the volume of mortgages financed by Freddie Mac and Fannie Mae.[6] This procedure understates the savings to borrowers on two accounts. First, it does not incorporate the effect on *all* conforming mortgage rates of the activities of Freddie Mac and Fannie Mae, including the reduction in rates on the conforming mortgage loans they do not purchase. Second, the jumbo-conforming spread understates the full effect that Freddie Mac and Fannie Mae have on mortgage rates.

The jumbo-conforming spread

Nearly all observers agree that Freddie Mac and Fannie Mae reduce interest rates on all conforming mortgage loans. The most dramatic evidence of this fact is found in comparisons of interest rates for loans above and below the conforming loan limit.[7] These rate comparisons can be found listed in newspapers around the country.

Freddie Mac and Fannie Mae are not allowed to purchase loans for amounts above the conforming limit. The effect this limitation has on interest rates is graphed in Exhibit 1. In this chart, the average interest rates in a range of loan size categories are shown relative to average interest rates for the category just below the conforming loan limit (which in 1998 was

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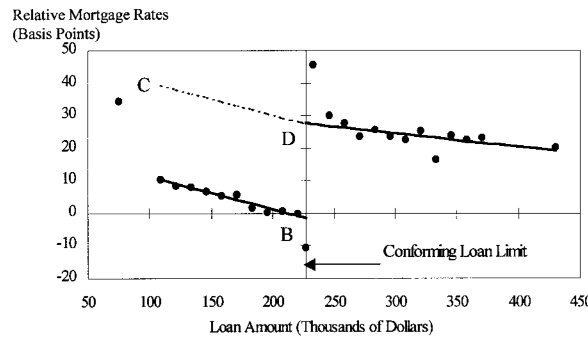
[6] In practice, the amount financed is measured as the (annual average) balance outstanding of mortgages in portfolio or pooled into MBS.

[7] The 2001 conforming loan limit is $275,000 for one-family properties. Higher limits apply in Alaska, Hawaii, Guam and the U.S. Virgin Islands.

$240,000).[8] The graph shows that mortgage interest rates decline steadily with loan size until the conforming limit is reached. Then rates take a sharp jump upward before resuming their decline. This relationship is consistent with the proposition that net economic costs of originating and servicing decline with loan size.[9]

The gap between the dotted line, CD, and the solid line AB, is the direct measure of the jumbo-conforming spread.

Exhibit 1
Relative Mortgage Rates and Loan Amount
(Fixed Rate Mortgages, California, 1998)



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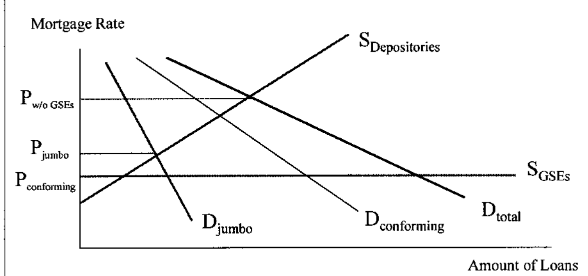
[8] The exhibit plots relative mortgage interest rates for fixed-rate loans in the Monthly Interest Rate Survey ("MIRS") after adjusting for origination week, lender type, new versus existing home, and loan-to-value intervals. The points plotted are averages computed over intervals with width of $12,500. Exceptions are the endpoints and the average for loans made for exactly $240,000. Readily obtainable mortgage rates found in newspapers make none of these adjustments.

[9] This phenomenon underlies empirical specifications that have been used in previous research on the conforming loan limit. See Cotterman and Pearce (1996) and Hendershott and Shilling (1989). The reasons for the inverse relationship between loan size and net economic costs include significant fixed costs of origination, servicing and real-estate-owned disposition that cause average costs per loan dollar to decline dramatically with loan size. These

Freddie Mac and Fannie Mae reduce rates on jumbo loans as well as on conforming loans

CBO used the average jumbo-conforming spread estimated over the 1989-1993 interval as its measure of the effect of Freddie Mac and Fannie Mae on mortgage interest rates. This approach assumes that the line CDE in Exhibit 1 represents the relationship between mortgage rates and loan size that would be observed in the absence of Freddie Mac and Fannie Mae. As we show below, this assumption understates consumer benefits because Freddie Mac and Fannie Mae almost certainly reduce interest rates on jumbo loans as well as on conforming loans.

Exhibit 2
Jumbo-Conforming Spreads Understate Consumer Savings



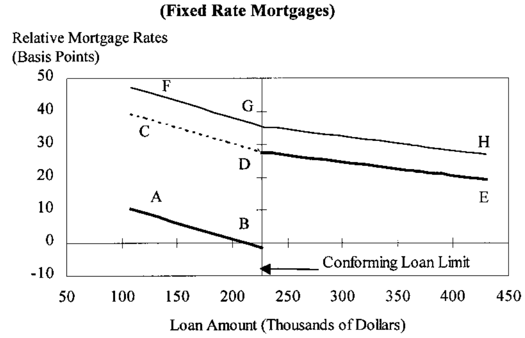
A theoretical argument for this point is illustrated in Exhibit 2. In this graph, the mortgage interest rate in the absence of Freddie Mac and Fannie Mae is found at the intersection of the depository supply curve ($S_{Depositories}$) and the total mortgage demand curve (D_{total}). When supply from Freddie Mac and Fannie Mae is introduced, there emerge two mortgage rates, both

factors more than offset a slightly more expensive prepayment option for jumbos and some evidence that default rates are higher for very-low-balance and for super-jumbo loans.

lower than the rate that would prevail in their absence. The rate for jumbo loans is determined by the intersection of the depository supply curve and the demand curve for jumbo loans (P_{jumbo}). The rate for conforming loans is determined by the intersection of the GSEs supply curve and the demand curve for conforming loans ($P_{conforming}$). Thus, the presence of Freddie Mac and Fannie Mae reduces rates on both jumbo and conforming loans, and the jumbo-conforming differential understates the savings to mortgage borrowers.

This reasoning suggests that mortgage rates in the absence of Freddie Mac and Fannie Mae would lie on line FGH in Exhibit 3 rather than line CDE. The jumbo-conforming spread would understate the effect of Freddie Mac and Fannie Mae on mortgage rates by the distance between segments CD and FG.

Exhibit 3
Freddie Mac and Fannie Mae Also Lower Jumbo Rates
(Fixed Rate Mortgages)



Partial versus full benefits to borrowers

This analysis does not take into account the fact that Freddie Mac and Fannie Mae are restricted to a market that has other federally-subsidized participants. Depositories have been, and continue to be, substantial holders of residential mortgages. They have access to insured deposits, which carry explicit federal guarantees, and low-cost advances from the Federal Home

Loan Banks ("FHLBs") — institutions with federal sponsorship similar to that of Freddie Mac and Fannie Mae.

Consequently, Freddie Mac and Fannie Mae compete with other subsidized participants. Thus, the estimates of the spreads on securities are not strictly comparable with the estimates of the interest rate effect. The security spreads are estimated on a *gross* basis, while the effect on mortgage interest rates is *net* of the effect of depositories. The amount by which depositories reduce interest rates on jumbo loans would have to be added to the effect indicated in Exhibit 3 to obtain the total effect of Freddie Mac and Fannie Mae on conforming mortgage rates.

The point that depositories also receive a funding advantage relative to firms without access to any federally supported sources of funds is illustrated in Exhibit 4.[10] The chart shows that the 11th District Cost of Funds Index ("COFI"), which reflects the cost of funds for western savings associations, is below the yield on comparable Freddie Mac and Fannie Mae debt. Similarly, the spreads to certificates-of-deposit ("CD") yields show that banks have lower cost of funds.

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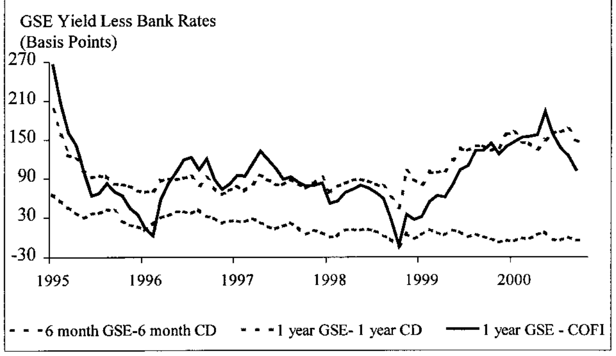
[10] The yield spreads are 6-month GSE debt less the 6-month CD yield, one-year GSE debt less the one-year CD yield, and one-year GSE debt less the 11th FHLB district COFI.

Exhibit 4
Amount by which Bank Cost of Funds are Below GSE Yields



An issue deserving further research is the extent to which the funding advantage accruing to banks benefits consumers. Exhibit 5 demonstrates that, unlike Freddie Mac and Fannie Mae, the depositories provide substantial support to the jumbo market.[11] As well, relative to Freddie Mac and Fannie Mae, these depositories, the largest FHLB advance holders, have a lower share of net mortgage acquisitions (originations plus purchased loans, less loans sold) in the low- and moderate-income market. In the Home Mortgage Disclosure Act ("HMDA") data, 93 percent of all jumbo loans for which income is reported are made to borrowers with incomes above 120 percent of the area median. From the data presented in Exhibit 5, one can infer that approximately one-half of FHLB advances are being used to fund jumbo mortgage loans, loans

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[11] Source: FHLB System 1999 Financial Report, Thrift Financial Reports, 1999, Home Mortgage Disclosure Act data, 1999. FHLB advances for the top 10 advance holding members are from page 17 of the Federal Home Loan Bank System 1999 Financial Report. FHLB advances for Commercial Federal Bank, Dime Savings Bank, and Standard Federal Bank are from their respective Thrift Financial Report filings line item SC720 (Advances from FHLB). Low- and moderate-income shares are the percent of dollars reported in HMDA going to borrowers with incomes less than the area median income; includes all conventional refinance and home purchase loan originations and purchases for single-family residences, net of loans sold.

made disproportionately to upper-income borrowers. In contrast, despite being given access to low-cost funding from the FHLBs, the top FHLB advance holders extended only 20 percent of their net conventional, single-family mortgage acquisitions (weighted by dollars) to low- and moderate-income borrowers in 1999, according to HMDA. Freddie Mac's 31 percent low-and moderate-income share (dollar-weighted) is higher than every one of the top FHLB advance holders.

Exhibit 5
Federal Home Loan Bank Advances and Shares of Net Mortgage Acquisitions (1999)

Institution	FHLB Advances December 31, 1999 (Millions of Dollars)	Low and Moderate-Income Shares (Percentages)	Jumbo Shares (Percentages)
Washington Mutual Bank, FA, Stockton, CA	45,511	14	55
California Federal Bank, San Francisco, CA	23,377	2	75
Washington Mutual Bank, Seattle, WA	11,151	19	41
Sovereign Bank, Wyomissing, PA	10,488	18	44
Charter One Bank, SSB, Cleveland, OH	9,226	22	38
PNC Bank, NA, Pittsburgh, PA	6,651	17	46
Bank United, Houston, TX	6,593	4	68
Norwest Bank, MN	6,100	23	37
World Savings Bank, FSB, Oakland, CA	5,655	18	42
Astoria FS&LA, New York City, NY	5,305	4	77
Commercial Federal Bk, a FSB, Omaha, NE	4,524	27	24
Dime Savings Bank of NY, New York City, NY	4,463	2	58
Standard Federal Bank, Troy MI	4,222	21	30
Top FHLB advance holders (total)	143,265	14	52
Freddie Mac	n.a.	31	0
Fannie Mae	n.a.	29	0

Benefits to consumers in addition to reductions in mortgage rates

Efficiencies in underwriting and increases in low-income and minority homeownership

Freddie Mac and Fannie Mae provide benefits beyond reductions in interest rates on mortgage loans. These benefits include increased availability of information provided to consumers, standardization of the mortgage lending process, and more objective qualifying criteria through the development of automated underwriting. Freddie Mac and Fannie Mae have also increased the availability of low-down-payment mortgages. Such loans make mortgage financing more available to low- and moderate-income families. Recent research indicates that home ownership for these families and minority families are 2% to 3% higher as a result of the efforts of Freddie Mac and Fannie Mae (Quercia, McCarthy, and Wachter (2000), and Bostic and Surette (2000)).

Improved dynamic efficiency and liquidity

Freddie Mac and Fannie Mae also increase the dynamic efficiency of the mortgage market, a point ignored by CBO. In periods of turbulence in the capital markets, Freddie Mac and Fannie Mae provide a steady source of funds. These conditions occur relatively frequently. Since 1992, the capital markets have had two episodes of abnormal shortages of liquidity—one beginning in late 1994 following the Orange County bankruptcy and another in 1998 and 1999 when important developing countries devalued their currencies and Russia defaulted on some bonds. Recent research indicates that the activities of Freddie Mac and Fannie Mae " ... returned capital to the mortgage market. That action not only stabilized the price of mortgage-backed securities, it also stabilized home loan rates during the credit crunch of 1998" (Capital Economics (2000)).

Lower risk to taxpayers

If the roles of Freddie Mac and Fannie Mae were reduced substantially, many presume that withdrawal of federal sponsorship would reduce taxpayer risk in direct proportion to the removal of risk from the books of Freddie Mac and Fannie Mae. This presumption ignores the likely expansion of other federally-sponsored participants that support housing. Yezer (1996) notes that such charter revocation would lead to expansion of the demand for Federal Housing Administration ("FHA") mortgages. The analysis of Miller and Capital Economics (2000), discussed in Section V (and illustrated in Exhibits 2 and 12) indicates that mortgages held by depositories would also increase. These reallocations of mortgage credit would shift additional risk to the FHA insurance and deposit insurance programs. Additionally, families would bear more interest rate risk because, when faced with higher rates on fixed-rate mortgages, they will increase their use of adjustable-rate mortgages ("ARMs"). On balance, in addition to reallocating resources to less efficient housing finance participants, charter revocation would likely increase risks to taxpayers.

Summary

In summary, CBO's 1996 report was deficient in many respects. The approach used overstated the funding advantage Freddie Mac and Fannie Mae derive from their charters, understated some components of consumer benefits, and ignored others. In addition, the use of point estimates for the various spreads, rather than ranges, provides the misleading impression that the funding advantage and benefits to consumers can be quantified precisely. A repeat of these mis-measurements in the new report would render its findings and conclusions without credible foundation.

We turn next to our own assessment of the advantages afforded Freddie Mac and Fannie Mae through their federal charters, followed by our assessment of the benefits derived by consumers.

III. Estimates of Funding Advantages to Freddie Mac and Fannie Mae

CBO overstated the subsidy involved in debt-funded mortgages. The 1996 CBO report estimated that the funding advantage to Freddie Mac and Fannie Mae between 1991 and 1994 was 70 basis points. As we show below, this figure is far above the range of estimates available from other sources. Recall that the CBO estimate is a weighted average of estimates for callable and noncallable long-term debt, and it treats all debt as long-term debt.

Several alternative measures are summarized in Exhibit 6. The LIBOR[12] - Agencies spread indicates that Freddie Mac and Fannie Mae issue short-term debt at 10 to 20 basis points below LIBOR, which is a *short-term* funding cost of certain highly rated banks.[13] The long-term, noncallable spreads show how yields on Freddie Mac and Fannie Mae debt compare with yields on debt rated AA.[14] The estimates cover a range of sources and methodologies. The first estimate, 10 to 30 basis points, is from a study by Salomon Smith Barney that compares specific

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[12] London Inter-Bank Offer Rate ("LIBOR").

[13] In this table, we use spreads to Agencies as reported in Bloomberg. Bloomberg includes Freddie Mac, Fannie Mae, the FHLBs and government agencies that issue debt in its "Agencies" category.

Freddie Mac or Fannie Mae issues with specific securities issued by two of the largest non-financial corporations and one large financial corporation. All the comparable securities were AA-rated, with large outstanding issue volumes. The second estimate, from Bloomberg, uses a proprietary methodology to adjust for important differences in the characteristics of the securities being compared. The third row is taken from a study by Toevs (2000) using data on Fannie Mae debt and market data from Lehman Brothers. The last estimate is from Ambrose and Warga (1996), a study whose deficiencies were discussed above.

Exhibit 6
Estimates of the Debt Funding Advantage

Short-Term Spreads	Basis Points
LIBOR – Agencies Spread:[1]	10-20
Long-Term Spreads	
Highly liquid AA Debt-Freddie Mac & Fannie Mae[2]	10-30
Highly liquid AA Debt – Agencies[3]	37
AA Financials Debt –Fannie Mae[4]	34
AA Financial Debt – Fannie Mae[5]	32 - 46

[1]Bloomberg data, 12-month term, short term debt.
[2]Salomon Smith Barney (August 2000).
[3]Bloomberg data, 5-year average.
[4]Toevs (2000) for the period 1995-1999.
[5]Ambrose & Warga (1996) for the periods (1985-90) and (1991-1994).

Exhibit 6 does not include any entries for spreads on callable debt. These spreads are difficult to measure accurately because callable debt securities are not issued in significant amounts by other corporate issuers and are very heterogeneous. In particular, appropriate comparisons of callable debt must hold constant the restrictions on the call options of the various securities. A given callable debt issue typically will have some restrictions, such as how soon the issuer may exercise the call option. These restrictions can be important to the value the debt issue commands in the marketplace. For example, a security that allowed the issuer to exercise

[14] Standard and Poor's (1997a) rated Freddie Mac and Fannie Mae AA- on a stand-alone basis.

the option after one year will have a lower value than a security that does not allow the issuer to exercise the option until five years have passed. Thus, given the difficulty in obtaining valid spreads for callable debt, a preferable approach is to use spreads on noncallable debt.[15]

Exhibit 6 illustrates that alternative estimates of the relevant noncallable spread range from 10 to 40 basis points. The estimates are obtained from a variety of sources and were generated using several methodologies. They are all substantially below the 70 basis points used in the 1996 CBO report. Use of a weighted average of spreads on callable and noncallable debt accounts for some of the inflation in the CBO estimate. We understand that CBO may not incorporate callable spreads into its analysis in the forthcoming report, and if this is true the change will move the CBO estimate closer to the alternative estimates. But the spread will still likely be overstated if the Ambrose-Warga methodology is used to estimate noncallable spreads.

CBO's Sensitivity Analysis

As exhibited above, it is necessary to use ranges rather than single numbers to express the extent to which Freddie Mac and Fannie Mae benefit from a funding advantage for long-term debt. In its 1996 report, CBO recognized that it was using spreads that were measured imperfectly and included a brief sensitivity analysis[16] to illustrate the effect of variation from baseline assumptions for some key parameters, including the spreads on long-term debt. The Ambrose-Warga presentation of results on yield to maturity used mean values for relatively long intervals. This provided almost no basis to assess the stability of the spreads over time or the amount of dispersion in spreads at a point in time. In the absence of either of these elements, it is difficult to have confidence in the estimates. This is particularly true given the methodological

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[15] An alternative would be to estimate the fair value of the call option through an option-adjusted spread calculation before the yields are compared. See Kupiec and Kah (2000).

[16] Although we agree that including a sensitivity analysis is, in principle, a useful exercise, we believe that the analysis in the 1996 CBO report understated the dependence of the CBO's conclusions on assumptions about the precise values of key parameters. In the case of debt funding spreads, CBO's attempt to conduct a valid sensitivity analysis was handicapped by the limited information on dispersion in yield spreads between Freddie Mac and Fannie Mae and other private companies provided in Ambrose and Warga's study.

shortcomings identified above and the disparity between the Ambrose-Warga estimate and the available alternatives we present in Exhibit 6.

The CBO sensitivity analysis of the debt funding advantage would have benefited from additional information on how spreads vary, both over time and across other debt issues at a point in time. In the absence of such information, CBO considered a very small reduction in the debt spreads, of 10 basis points, from the 70 basis points used in the primary calculations. This reduction covered only a small fraction of what we know of the possible dispersion of spread values and it closes little of the gap between the CBO figure and alternative estimates. Thus, the sensitivity analysis did not accurately portray the fragility of the 1996 CBO estimates of the funding advantage.

Estimates of the Funding Advantage

Using the information in Exhibit 6, and debt and MBS balances outstanding for Freddie Mac and Fannie Mae, funding advantage spreads are provided in Exhibit 7. The spread on the MBS, reflecting both its long-term nature, and its collateral value, likely falls between the values of the spreads on short-term and long-term debt. We calculate the MBS funding advantage using a spread of 10 to 30 basis points.[17] Higher amounts would be inappropriate given the 20 basis point guarantee fees that the corporations earn and the significant liquidity differences between their MBS and private-label MBS.

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[17] Freddie Mac and Fannie Mae's MBS are backed by real-property collateral as well as a corporate guaranty. Thus a proxy for the funding advantage on MBS, net of liquidity and credit quality, could be the yield spread between five-year, AAA-rated bullet debt and comparable Freddie Mac and Fannie Mae debt. In a report, Freddie Mac (1996, p. 33) computed this spread to be about 23 basis points over 1992-1996.

Exhibit 7
Estimates of the Funding Advantage
(Data as of September 30, 2000)

	Balances Outstanding (Billions of Dollars)				
Security Type	**Freddie Mac**	**Fannie Mae**	**Totals**	**Spread (basis points)**	**Funding Advantage (Billions of Dollars per Year)**
Short-term Debt	181	251	432	10-20	0.4 - 0.9
Long-Term Debt	226	356	582	10-40	0.6 - 2.3
MBS	559	701	1.260	10-30	1.3 - 3.8
Total Funding Advantage					2.3 - 7.0

Exhibit 7 summarizes our estimates of the total funding advantage received by Freddie Mac and Fannie Mae through their government sponsorship. Since this calculation is based on a range of spreads for individual components (short-term debt, long-term debt, and MBS), the resulting aggregate must be expressed as a range as well. In each case above, we have been careful to reflect reasonable estimates – on the high side as well as the low side. While we might be inclined to narrow this range, out of an abundance of caution we have included the results of reputable analyses and methodologies that bracket what we consider the more likely figures.

Multiplying the spread range of 10 to 20 basis points for short-term debt by the short-term debt balances outstanding of Freddie Mac and Fannie Mae gives an estimate of their annual funding advantage for short-term debt that ranges from \$0.4 billion to \$0.9 billion. Similarly, the estimates for the annual funding advantage on long-term debt and MBS are \$0.6 billion to \$2.3 billion and \$1.3 billion to \$3.8 billion respectively. Thus, our estimate of the total annual funding advantage for Freddie Mac and Fannie Mae ranges from \$2.3 billion to \$7.0 billion.

IV. Estimates of the Benefits to Mortgage Borrowers Provided by Freddie Mac and Fannie Mae's Activities

Estimates of the full benefits to mortgage borrowers must take consideration of several factors. First, Freddie Mac and Fannie Mae operate directly only in the conforming market. They may only purchase loans at or below the conforming loan limit. The bulk of these loans are fixed-rate mortgages. However, Freddie Mac and Fannie Mae also affect the rates on adjustable-rate and jumbo mortgages, effects ignored by the previous CBO analysis. Additional evidence on the benefits of Freddie Mac and Fannie Mae activities can be inferred from borrower behavior, such as borrowers' utilization of adjustable- versus fixed-rate loans. Measuring the full effect of Freddie Mac and Fannie Mae on conforming loans requires estimates of their effect on jumbo loans and estimates of the effect of depositories on jumbo loans.

Estimates of the Jumbo-Conforming Spread

Direct estimates of the effects on conforming, fixed-rate mortgages

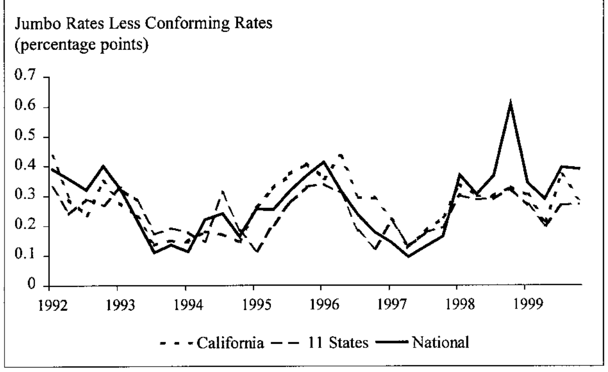
The 1996 CBO report used a figure of 35 basis points as its estimate of the jumbo-conforming spread. CBO derived this figure from the commissioned study by Cotterman and Pearce, which evaluated the spread from 1989 through 1993. The 35 basis points reflected an average of relatively high values in the early part of the period and relatively low values toward the end.

Since 1993 the differential has fluctuated. Exhibit 8, from Pearce (2000), charts the path of rates on conforming, fixed-rate mortgages between 1992 and 1999. Three measures are charted in the exhibit. Two are extensions of the 1996 Cotterman and Pearce analysis estimating the differential for California and for 11 states with large numbers of jumbo loan originations. These estimates adjust for risk factors and loan size. The third is an extension of the series charted in Freddie Mac (1996).[18] Averages for these series, over the 1992-99 period, range

[18] The data used for the national series for jumbo rates come from HSH Associates (1992-1998), and Banxquote (1999), and for conforming rates from the Primary Mortgage Market Survey (Freddie Mac). This series is not risk-adjusted.

between 24 basis points and 28 basis points. All three series are in the neighborhood of 30 basis points in 1998 and 1999, when origination rates were very high.

Exhibit 8
Jumbo Rates Exceed Fixed-Rate Conforming Mortgage Loan Rates



Indirect estimates of the jumbo-conforming spread using ARM shares

Exhibit 8 displays unadjusted and risk-adjusted direct estimates of the jumbo-conforming differential. Additional evidence on the benefits of Freddie Mac and Fannie Mae activities can be inferred from borrower behavior, such as borrowers' utilization of adjustable-rate versus fixed-rate mortgages ("FRMs"). Freddie Mac and Fannie Mae activities have larger effects on rates of FRMs than ARMs because their funding cost advantage is larger on long-term debt than on short-term debt.[19] First-year rates on ARMs are generally below rates on FRMs, and research by Nothaft and Wang (1992) (as well as others cited by Nothaft and Wang) has shown that the ARM share will decrease generally as the spread between rates on ARMs and FRMs narrows. Thus, Freddie Mac and Fannie Mae reduce the ARM share of conforming loans by narrowing the

[19] ARMs are priced off short-term yields, whereas FRMs are priced off long-term yields. For spreads see Exhibit 7.

spread between rates on ARMs and FRMs. This effect was noted previously by Hendershott and Shilling (1989).

The research on the determinants of ARM shares indicates that we should expect that a 30-basis-point narrowing of the spread between rates on FRMs and ARMs will produce a 10-percentage point reduction in ARM share.[20] The estimates presented in the exhibit above indicate that between 1992 and 1999 rates on conforming FRMs averaged 24 to 28 basis points below rates on jumbo FRMs. This difference implies that we should expect the ARM share to be about 8 to 10 percentage points lower for conforming loans than for jumbo loans.

Pearce (2000) compares the ARM shares in the jumbo and conforming markets using the MIRS data. The comparison was restricted to loans with 15- and 30-year terms to maturity and loan-to-value of at least 60%. The ARM share among conforming loans for amounts between 75% and 99% of the conforming limit was compared to the ARM share among jumbo loans between 115% and 150% of the conforming limit.

The results are shown in Exhibit 9. The jumbo-conforming difference in ARM shares is much larger than the 8 to 10 percentage points expected from the directly-estimated conforming loan differential. The difference in ARM shares ranges between 13 and 36 percentage points in California and between 14 and 29 percentage points in the 11-state aggregate. The differences in ARM share averaged 23.6 percentage points in California and 21.6 percentage points in the 11 states. Differences of this magnitude are consistent with conforming loan differentials much larger than 30 basis points. If a differential of 30 basis points in rates on FRMs was expected to reduce ARM share by 10 percentage points, a 20+ percentage point reduction in ARM share among conforming loans is consistent with a reduction in interest rates on conforming FRMs of 60 basis points or more.

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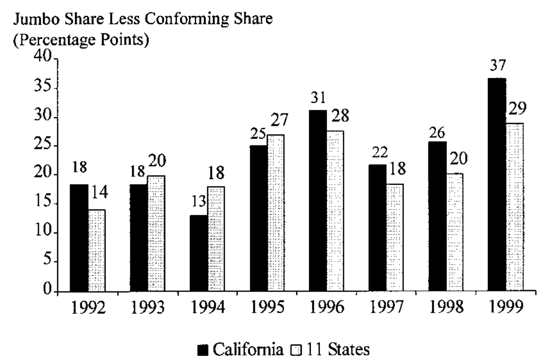
[20] Nothaft and Wang (1992). Also, in their concluding section, Hendershott and Shilling (1989), estimate that a 30-basis-point conforming loan differential would reduce the conforming ARM share by 10 percentage points in 1987 and 11 basis points in 1988.

Exhibit 9
Jumbo ARM Shares Exceed Conforming ARM Shares



Incorporating effects on jumbo loan rates

So far we have presented two approaches, direct and indirect, to quantifying the difference between rates on jumbo and conforming fixed-rate loans. The direct estimates quantify differences in interest rates that can be observed directly. We use a range that spans two measures for the direct estimates.[21] The first is an unadjusted measure of the empirical differences between the two sets of loan rates. The second is a risk-adjusted differential obtained by Pearce's update using the Cotterman and Pearce methodology. As an alternative, indirect measure, obtained from inferring the jumbo-conforming differential through the ARM share effect, we use the Nothaft and Wang methodology. These direct and indirect measures are substitute methods for examining the jumbo-conforming differential. The indirect estimates take intangible considerations into account. However, neither of these approaches identifies the full effect of Freddie Mac and Fannie Mae on conforming, fixed-rate loans. Neither takes into account the effect of Freddie Mac and Fannie Mae on jumbo loan rates. Furthermore, neither takes into account the effect that depositories would have on mortgage rates in the absence of federal sponsorship of Freddie Mac and Fannie Mae. Thus, both are *partial* measures of the effect of the two housing enterprises on mortgage rates.

Measuring the full effect of Freddie Mac and Fannie Mae on conforming loans requires estimates of their effect on jumbo loans and estimates of the effect of depositories on jumbo loans. Unfortunately, the data to obtain either of these estimates do not exist because we do not observe a fully private market. In the discussion below we will estimate the dollar amount of borrower savings by applying interest-rate effects to outstanding mortgage balances. In order to recognize the presence of these hard-to-measure effects, we will use a conservative value of 5 basis points for each. Thus, the directly-measured effect yields a partial reduction in mortgage rates of 29 to 33 basis points when the effect of Freddie Mac and Fannie Mae on jumbo rates is added and a total reduction of 34 to 38 basis points when the effect of depositories on jumbo rates is added. Similarly, the indirectly-measured spread (of 30 to 60 basis points) yields a partial reduction of 35 to 65 basis points and a total reduction of 40 to 70 basis points.

An additional benefit that needs to be accounted for is the reduction in rates on conforming ARMs. Evidence from the Primary Mortgage Market Survey (PMMS) indicates that rates on conforming ARMs are about 5 basis points lower than rates on jumbo ARMs. This suggests that the direct effect of Freddie Mac and Fannie Mae on conforming ARM rates is about 5 basis points. Assuming that depositories reduce jumbo ARM rates by about 5 basis points, the total effect on ARM mortgages is about 10 basis points.

Estimating Dollar Savings to Borrowers

The savings to borrowers are estimated by applying the interest rate reductions to the appropriate balances. The discussion above identified separate interest rate effects for fixed-rate conforming loans, adjustable-rate loans, and jumbo loans. It also pointed out that the estimates of the jumbo-conforming spread should be adjusted for the effects that Freddie Mac, Fannie

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[21] The average difference in commitment rates on fixed-rate, conforming mortgages over the 1992–1999 period is 28 basis points. The average effect from application of the Cotterman and Pearce methodology over this time period provides a range of 24 to 26 basis points.

Mae, and the depositories have on jumbo loan rates. In the discussion below, we present two series of benefit estimates that begin with the jumbo-conforming spread and progressively incorporate the various adjustments. At the end we present two alternative ranges.

The most conservative estimate applies the directly-estimated jumbo-conforming spread, a range of 24 to 28 basis points, to the outstanding balances of conforming, fixed-rate mortgages, which is currently about $3.3 trillion.[22] This procedure yields a range of $7.9 billion to $9.2 billion. This estimate is a counterpart to the 1996 CBO benefit estimate, except that it includes all conforming fixed-rate mortgages rather than just those that have been purchased by Freddie Mac and Fannie Mae. Although this range understates the full effect of the two GSEs on conforming mortgage interest rates, it lies completely above the $2.3 to $7.0 billion range estimated for the funding advantage. If we add in benefits to borrowers using conforming ARMs (5 basis points applied to $0.37 trillion) and jumbo loans (5 basis points applied to $0.65 trillion), the range increases to $8.4 billion to $9.7 billion.

These ranges do not adjust the jumbo-conforming spread for the separate effects of Freddie Mac and Fannie Mae and depositories on jumbo loan rates. We have assumed that these two effects, which we cannot measure, would each be about 5 basis points. Incorporating this assumption raises the range on the (fixed-rate) jumbo-conforming spread to 34 to 38 basis points, and the total benefit range becomes $11.7 billion to $13.0 billion.

A parallel set of estimates can be constructed using the indirect estimate of the jumbo-conforming spread of 30 to 60 basis points. This range implies that benefits to borrowers using conforming, fixed-rate loans range from $9.9 billion to $19.7 billion. Adding in benefits to conforming ARM and jumbo borrowers implies a range of $10.4 billion to $20.2 billion. Adjusting the fixed-rate, jumbo-conforming spread for the effect of Freddie Mac and Fannie Mae and the depositories on jumbo rates brings the total to $13.6 billion to $23.5 billion.

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[22] The outstanding balances cited in this paragraph are based on the following figures: conventional loans totaling $4.30 trillion, of which 15% are jumbo and 85% are conforming. Within the conforming market, 90% are assumed to be fixed-rate and 10% are assumed to be ARMs.

Overall, then, we have two *alternative* ranges for the full benefits. Using the directly-estimated spread, the range is $11.7 billion to $13.0 billion. Using the indirectly-estimated jumbo-conforming spread, the range is $13.6 billion to $23.5 billion. Both these ranges are well above our range for the funding advantage ($2.3 billion to $7 billion).

Exhibit 10

Effects on Conventional Mortgage Rates, 1992 - 1999

		Measurement*	**Spread (basis points)**
Effects on Mortgage Rates of Freddie Mac & Fannie Mae	Conforming Fixed-Rate Market: Alternative Measures	1. CFRM: Direct Estimate (Commitment Rates)	28
		2. CFRM: Direct Estimate (Pearce, 2000)	24 – 26
		3. CFRM: Indirect Estimate (Pearce, 2000)	30 – 60
	Jumbo Market	4. JFRM: (Assumed)	5
	Conforming ARM Market	5. ARM: (Commitment Rates)	5
		Partial Benefits Range: (Conforming + Jumbo) CFRM: Direct (1&2 + 4) CFRM: Indirect (3 + 4) ARM: (5)	 29 – 33 35 – 65 5
Effects on Jumbo (FRM & ARM) Rates from Subsidies to Other Financial Institutions		6. (Assumed)	5
		Full Benefits Ranges: FRM Direct (1&2+4+6) FRM Indirect (3 + 4 + 6) Conforming ARM (5 + 6) Jumbo (4)	 34-38 40-70 10 5
TOTAL BENEFITS ($billions)		**Partial Direct**** **Full Direct** **Full Indirect**	**$ 8.4 - $ 9.7** **$11.7 - $13.0** **$13.6 - $23.5**

* CFRM: conforming, fixed-rate market; JFRM: jumbo fixed-rate market. The fixed-rate conforming single-family market, is $3.3 billion. The ARM market is $0.37 billion and the jumbo market is $0.65 billion (9/30/00). **Direct without depositories' measures $8.4 to $9.7. Direct with depositories' having a five basis point effect on jumbo rates measures $11.7 to $13.0.

It is important to recognize that the jumbo-conforming differential understates the measure of the benefits provided by Freddie Mac and Fannie Mae because the jumbo rate is already lowered by benefits provided to the jumbo market by financial institutions with government support. That is, the jumbo market also benefits directly from government support through both the existence of the FHLBs and deposit insurance, and indirectly from Freddie Mac and Fannie Mae. The *total* benefit to consumers, including direct and indirect effects of Freddie Mac and Fannie Mae on conforming, fixed-rate mortgages and the additional effects on fixed-rate mortgages from subsidies held by all financial institutions in the jumbo market is in the range of $13.6 to $23.5 billion.

V. Freddie Mac and Fannie Mae Increase Efficiency

To this point we have focused on the key question raised in the 1996 CBO report—the extent to which the Freddie Mac and Fannie Mae funding advantage generates benefits to consumers or been absorbed by the two enterprises. Our findings in this area effectively rebut CBO's 1996 conclusion that a large percentage of the funding advantage is absorbed. They do not, however, address a more general objection to federal sponsorship that has been raised in discussions of Freddie Mac and Fannie Mae. This objection claims that federal sponsorship through the credit markets distorts the allocation of resources that would otherwise arise from the interaction of supply and demand in competitive markets. In the case of housing-related GSEs, the claim is that their activities result in "too much" housing at the expense of other components of the nation's capital stock, such as factories, offices, and business equipment.

In this section we address that point. As we have pointed out, Freddie Mac and Fannie Mae are not the only federally sponsored entities participating in the residential mortgage market. Federally insured depositories (banks and thrifts) fund over half—$2.4 trillion—of the conventional mortgages outstanding, either directly through their loan portfolio or indirectly though their MBS holdings (Exhibit 11).[23] Freddie Mac and Fannie Mae fund about one-third of

[23] The total residential market includes single-family and multifamily mortgages. The sources for these data were the Federal Reserve Board, Federal Deposit Insurance Corporation, Office of Thrift Supervision, Freddie Mac and Fannie Mae; data were as of June 30, 2000.

this amount. The remainder is divided among the FHLBs, mortgage companies, insurance companies, pension funds, individuals, and other investors. Analyzing economic efficiency and the benefits and subsidies requires understanding the cost structures and the risk characteristics of the mortgage market.

Exhibit 11
Holders of Residential Mortgage Assets
as of June 30, 2000

Mortgage Debt	Trillions of Dollars
Total Residential	**$5.4**
FHA/VA/RHS/Ginnie Mae	$0.8
State & Local Governments	$0.1
Total Conventional	**$4.5**
Depositories & FHLBs	$2.4
Freddie Mac & Fannie Mae	$0.8
Households	$0.1
Other	$1.2

Competitive Balance

The competitive balance in the industry depends on which charter can provide funds and manage risks at the lowest cost.[24]

Freddie Mac and Fannie Mae are more efficient than the depositories in three activities:

- Channeling funds from the global capital markets to mortgage markets;
- Managing mortgage interest-rate risk; and
- Managing mortgage credit risk.

In the management of interest rate risk, Freddie Mac and Fannie Mae take advantage of opportunities to issue callable debt. They also operate at a large scale and are able to spread the expense of sophisticated interest rate risk management across a large volume of risks. IPS Sendero (1999) documents the continued existence of significant interest rate risk in the thrift industry.

In the management of credit risk, the traditional advantage held by Freddie Mac and Fannie Mae has been superior exploitation of geographic diversification. Quigley and Van Order (1991) and Regional Financial Associates (1998) document the importance of geographic diversification in risk reduction. Although elimination of restrictions on branching makes this advantage potentially smaller today than it was in prior decades, it is still an important consideration, because many local and regional banks and thrifts hold significant mortgage portfolios.

Another important advantage for Freddie Mac and Fannie Mae in credit risk management is their prominent role in the development of automated underwriting systems. Credit risk evaluation and management is rapidly shifting from the rules of thumb used in manual underwriting to the rigorous statistical analysis of default risk that supports mortgage scoring and automated underwriting. Straka (2000) and Standard and Poor's (1997b) summarize this transformation. Freddie Mac and Fannie Mae have access to larger and more comprehensive data files on loan performance than other major mortgage market participants. This resource gives them an advantage in development of models with strong predictive power across a broad range of risks.

Depositories have a few advantages of their own, beyond their federal sponsorship. They have more local-market knowledge that can be exploited in the assessment of credit risk. They also have opportunities to sell other products to their mortgage customers. These advantages enable depositories to fund some loans at costs below what they otherwise would incur.

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[24] Van Order (2000a) describes the "dueling charter" framework for depositories and Freddie Mac and Fannie Mae, while Van Order (2000b) provides a more technical discussion.

Second Best Solution

Some critics of Freddie Mac and Fannie Mae contend that their federal sponsorship distorts resource allocation in that credit is diverted into residential real estate from other uses that, at the margin, have higher values. It is not our purpose here to address the desirability of promoting the financing of housing. Rather, we simply note that this argument fails to take into account the distortions introduced by federal deposit insurance.[25]

Exhibit 12 presents an analysis of the removal of the funding advantage to Freddie Mac and Fannie Mae in a situation where the implicit subsidization of the mortgage market through depositories is retained. The exhibit is taken from an illustration by Miller and Capital Economics (2000), who conclude that "... revoking the GSEs' charters would reduce welfare (economic efficiency). Thus, we conclude that revoking Freddie Mac's and Fannie Mae's charters cannot be justified on the grounds of economic efficiency" (page 14).

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[25]Chairman Greenspan has often noted the existence of a funding advantage for banks. "Government guarantees of the banking system – deposit insurance and direct access to the Fed discount window and payment system guarantees – provide banks with a lower cost of capital than would otherwise be the case." Testimony, House of Representatives, Commerce Committee, April 28, 1999.

Exhibit 12
Efficiencies from Freddie Mac and Fannie Mae: the Second Best Argument

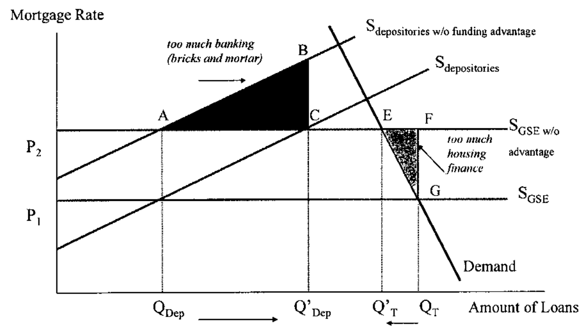

Exhibit 12 indicates that Freddie Mac and Fannie Mae provide an efficient allocation of resources from a "second best" perspective. Elimination of Freddie Mac and Fannie Mae's funding advantage would provide an efficiency improvement (triangle EFG) in that some of the excess housing finance would be removed from the market. This improvement would be more than offset by an efficiency loss resulting from an increase in (high cost) production by depositories (triangle ABC). Thus, elimination of Freddie Mac and Fannie Mae's federal sponsorship would lead to a loss of allocative efficiency, not a gain.[26] The loss would be greater the larger is the funding advantage of depositories relative to Freddie Mac and Fannie Mae. We next consider what the magnitude of the funding advantage, given deposit insurance, might be for the depositories.

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[26] This result depends on the relative elasticities of the demand and supply curves. See Capital Economics (2000) for the full discussion.

Cost of Funds Comparisons

The GSE-AA spreads presented in Exhibit 6 do not provide a complete picture of the funding of Freddie Mac and Fannie Mae relative to other financial market participants. One must also address the sources of funds available to banks and thrifts issuing federally insured deposits. Exhibits 13 and 14 (as well as Exhibit 4 provided earlier) show that Freddie Mac and Fannie Mae have no funding advantage at all relative to depositories. Exhibit 13 lists average spreads from 1995-2000 between depository instruments and relevant GSE yields. Exhibits 4 and 14 plot these spreads on a monthly basis.

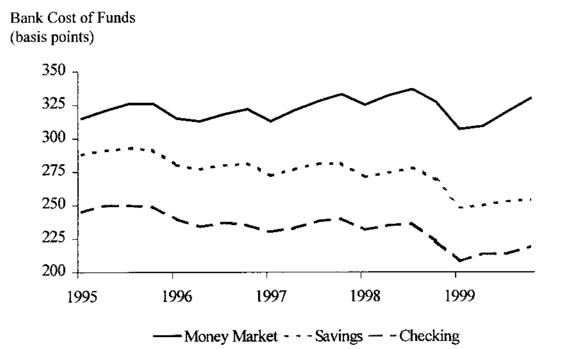
Exhibit 13
Bank Cost of Funds Are Below GSE Yields

Bank Cost of Funds less GSE Yields:

6 month CDs:	-103 bps
One year CDs:	-16 bps
11th District COFI:[1]	-95 bps
Money Market:	-322 bps
Savings Accounts:	-274 bps
Checking Accounts:	-233 bps

[1]The FHLB-San Francisco, 11th District, Monthly Weighted Average Cost of Funds

Exhibit 14
Bank Cost of Funds (1995-1999)



Using several alternative series based on data from bank call reports and Bloomberg, we clearly demonstrate that depositories have an average cost of funds below that of Freddie Mac and Fannie Mae. As shown above, this implies that charter revocation of Freddie Mac and Fannie Mae would lead to less efficiently supplied housing finance.

VI. Conclusions

The funding advantages that Freddie Mac and Fannie Mae derive from their federal charters and the benefits they provide to homeowners cannot be measured precisely and are better expressed as ranges. Reasonable estimates of the ranges reveal that the benefits to homeowners far exceed the funding advantages of Freddie Mac and Fannie Mae. We find:

- The 1996 CBO study overstated the funding advantage received by Freddie Mac and Fannie Mae and underestimated the benefits provided by them. CBO incorrectly treated all debt as long-term debt despite the lower funding advantage on short-term debt and included separate spreads for callable debt and noncallable debt despite the difficulties inherent in measuring callable spreads. Rather than the 70 basis point funding advantage contained in CBO's 1996 report, we believe a better estimate places that funding advantage in the range of 10 to 40 basis points. Further, the 1996 CBO report did not incorporate the effect Freddie Mac and Fannie Mae have on conforming loans not purchased by them or on jumbo loans.

- Benefits to consumers provided by Freddie Mac and Fannie Mae far exceed the Freddie Mac and Fannie Mae funding advantage. The benefits to consumers are at least $8.4 billion and may be as high as $23.5 billion. The funding advantage to Freddie Mac and Fannie Mae lies between $2.3 billion and $7.0 billion.

- In addition, Freddie Mac and Fannie Mae provide benefits, not measured in this paper, beyond those that can be quantified in terms of savings on mortgage interest expense by homeowners. These benefits include maintenance of liquidity in the mortgage market during periods of financial turbulence and expanding homeownership opportunities for low-income and minority families.

- Given that depositories would subsidize housing finance in the absence of Freddie Mac and Fannie Mae, federal sponsorship of Freddie Mac and Fannie Mae provides a second best structure that supplies housing finance more efficiently than could the depositories alone. Depositories receive funding advantages through deposit insurance, access to Federal Reserve Bank liquidity and FHLB advances and have an average cost of funds lower than Freddie Mac and Fannie Mae.

In summary, CBO's 1996 report was deficient in many respects. The methodology used overstated the funding advantage Freddie Mac and Fannie Mae derive from their charters, and the evaluation of consumer benefits understated some components and ignored others. A repeat of these mis-measurements in the new report would render its findings and conclusions without credible foundation. A more accurate approach shows that the current arrangement benefits consumers much more than any funding advantage received by Freddie Mac and Fannie Mae.

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GSE Creep into Subprime Could Hurt Margins

■ BY ERICK BERGQUIST

Fannie Mae and Freddie Mac's automated underwriting systems have quietly begun accepting more loans on the lower end of the credit spectrum, according to brokers and lenders nationwide.

Approved loans with Fair, Isaac scores of 580 to 620 are now commonplace, some brokers and lenders said. One lender said an accepted loan with a 540 score recently crossed his desk.

Predictably, subprime lenders, like many in the financial services sector, contend that the GSEs are unfair competitors because they get government advantages.

Whether or not that is the case, the idea that Fannie and Freddie would dip their toes further into subprime lending has lenders concerned that their margins will shrink and their profits erode. They also fear they will lose business as prime lenders snap up their loans by offering better rates.

"They are absolutely going to eat the subprime market alive," said Tom Jarboe, an Irwin Mortgage Corp. branch manager in Walnut, Calif. "They are picking

See pag 11

Poaching? Dallas sees approved loans that "should not fit" the GSEs.

GSEs Seen Squeezing Subprime Lenders' Margins

Continued from page 1

the cream of the crop of subprime."

An executive at a major subprime lender said as the GSEs "get further into the nonconforming business, they put a squeeze on margins, making it more difficult for people to survive."

As the Fannie and Freddie underwriting systems accept loans with lower scores, subprime lenders will have no choice but to go further and accept even higher-risk loans, this official added.

When Fannie's Desktop Underwriter and Freddie's Loan Prospector achieved widespread use, the lowest credit score the systems would accept was 720, several sources said. But this threshold began to fall in 1999 and appears to be continuing its descent, the sources said. Charles Bachman, owner of Tri-County Mortgage Co. in Larchmont, N.Y., said the number of subprime borrowers he has been able to put into conventional loans has increased 50%.

William D Dallas, chief executive officer of 1st Franklin Financial, a San Jose, Calif., subprime lender, said these types of loans "should not fit Fannie and Freddie guidelines." The GSEs "have come into our category for a reason," he added.

It is unclear whether Fannie and Freddie are directly soliciting the lower Fair, Isaac scores. Several sources said the GSEs do not tell lenders what scores are acceptable, so it is up to them to use "trial and error" to determine what loan characteristics the automated underwriting systems will tolerate.

Further, several sources said "glitches" in the underwriting systems themselves are responsible for the acceptance of low scores. According to these sources, many mortgage brokers have figured out how to manipulate the systems to push through loans that in the past would have been rejected.

Nonetheless, Dean Memsick, a broker at Platinum Mortgage Group Inc. in Omaha, said he was told by Republic Mortgage Insurance Co., the company through which Platinum gains access to Desktop Underwriter, that he could accept loans with a 580 Fair, Isaac score. Loans with scores from 580 to 600 are generally classified as B-grade credits, he said.

Mercy Jimenez, Fannie's senior vice president of single-family marketing, said it does not use Fair, Isaac scores "in a final determining way" to accept or reject loans.

Jimenez: Fannie doesn't use the scores "in a final determining way."

"No one, single variable in and of itself drives a Desktop Underwriter decision," she said. "It's not only looking at credit history but weighing variables like equity-to-loan ratios, debt-to-income ratios, the purpose of loan, and what kind of property is involved."

Moreover, officials from the two GSEs candidly acknowledge they have liberalized their automated underwriting systems' guidelines to widen the field of borrowers they can accept for loans.

Under highly publicized subprime programs, Fannie and Freddie have been buying loans made to borrowers with slightly impaired credit for more than a year. Under the programs, borrowers get better rates than they would for a typical subprime loan, and if payments are made on time for two years, the interest rate is reduced.

"If a borrower is Fannie Mae-eligible and deserves a lower cost on a mortgage as defined by their credit quality, he or she should get that," Ms. Jimenez said. In fact, Fannie has boosted its program "10% to 20%" since January after an 18-month pilot run, she said.

The program, which now includes 100 lenders, bought $1.6 billion of loans last year.

Freddie officials say the company buys its subprime loans in two ways. First, it bought $9.5 billion of Alt-A and A-minus loans through its automated underwriting system last year, officials said.

But Freddie also says it buys higher-risk loans through subprime lenders such as Option One Mortgage in Irvine, Calif. Because of the higher risk, the lender is required to take the first loss position on the loan and to service it. Freddie bought $8 billion of loans through this program last year.

Yet many subprime lenders say that by offering conventional loan rates to subprime borrowers, Fannie and Freddie are not adequately pricing these borrowers' risk.

"They are applying A-market loan-to-values to very low Fico score credit," said Charles Coudriet of Saxon Mortgage in Glen Allen, Va. "They're taking on a lot of risk that eventually could be laid at the foot of the taxpayers without proper assessment." However, many analysts who follow Fannie Mae and Freddie Mac defend their policies.

J.T. Marcell, a broker at Better Mortgage Brokers Inc. of Upland, Calif., and president of the California Association of Mortgage Brokers, said that by accepting lower-quality loans, Fannie and Freddie are improving the market for consumers, many of whom will now get better rates.

Yet subprime lenders remain deeply concerned.

"Fannie is taking the spreads out of the business," said a subprime lender who asked to remain anonymous. "If you're a New Century, you're toast."

Mr. Dallas of 1st Franklin Financial said the GSEs "have opened the spigot on subprime originations." His message to Fannie chairman Franklin Raines is: "'I told you so, I knew you would, and you better tell your shareholders you're into subprime.' I don't think a lot of times they know." ■

L. William Seidman

1025 Connecticut Avenue N.W., Suite 1008 Washington, DC 20036 (202) 530-0810

TO:	Federal Home Loan Mortgage Corporation (Freddie Mac)
FROM:	L. William Seidman
DATE:	December 13, 2000
RE:	Freddie Mac and Fannie Mae Commitments to Enhance Capital Strength

You have asked that I review voluntary measures announced by Freddie Mac and Fannie Mae on October 19, 2000. Specifically, you have asked that I conduct an analysis of how effectively each of the six elements of the voluntary measures is in addressing safety-and-soundness concerns, particularly from a regulator's point of view, bearing in mind that regulators use markets as a supplement to direct supervision and oversight.

I have reviewed the materials that you have provided me with respect to your voluntary enhancements and I conclude that this package of disclosures and standards puts you in a position of providing more and better public information than any other financial institution, both regulated and non-regulated, of which I am aware. Moreover, the package is well conceived, in that its various elements complement one another, so that the effect of the whole is greater than the sum of the individual elements. For example, the interest-rate and credit-risk disclosures will be useful to investors in the subordinated debt issuances, and the ratings agencies will take all of the additional information into account when determining annual ratings for Freddie Mac and Fannie Mae. It is my view that these <u>major</u> steps will improve the ability of the regulators and the market place to evaluate your safety and soundness.

In addition, with respect to the commitments being "voluntary," once the market becomes acquainted with these enhancements, the penalty for withdrawing them likely would be so severe that it would be unacceptable. Although these components still would be "voluntary" in the sense that they can be withdrawn legally, it seems to me market expectations will make them mandatory for all practical purposes.

With respect to the specific components of the package I have the following comments.

1. Periodic Issuance of Publicly Traded, Externally Rated Subordinated Debt

Many in the regulatory world have advocated that large financial institutions be required to issue subordinated debt periodically, both to enhance capital and, more importantly, to allow the market to value the quality of the institution issuing the debt. I believe that the commitment to issue such debt is a significant step in addressing safety and soundness concerns.

The commitment to periodically issue subordinated debt may, depending on the response of the market, serve as a substantial aid in the determination of the credit worthiness of Freddie Mac and Fannie Mae. Subordinated debt generally will be quoted at a yield substantially higher than senior, non-subordinated debt, even in good times. More importantly, in times when an institution is under stress, one would expect that spread to widen dramatically, which is why a commitment to issue subordinated debt periodically, in good times and in bad, is a very meaningful commitment.

One would expect your subordinated debt, particularly taking into consideration provisions for deferral of interest payments, to trade at a substantially higher yield than ordinary debt. However, in Freddie Mac's case, the market's treatment of subordinated debt may be influenced by assumptions regarding the extent to which possible government support of the Corporation in times of financial emergency would have a favorable impact on holders of subordinated debt. If the yield differential between subordinated and senior debt is small, then such debt's usefulness as a market evaluation of credit would be minimal. In contrast, a wider spread would suggest that the subordinated debt is serving its purpose. Since it is unknown at this point how the market will evaluate such subordinated debt, it would be useful to issue such debt and see whether it will provide a good indication of the market's view of your institution's safety and soundness.

Of course, the subordinated debt also will be useful as a supplement to the capital you maintain as a cushion against losses. I note that you have committed that your combined core capital plus subordinated debt will equal or exceed four percent of your on-balance sheet assets, a percentage that is roughly comparable to that required under bank capital standards.

2. Liquidity Management and Contingency Planning

Including liquidity as a component of your package is consistent with the work of the Basel Committee. As quoted in its February 2000 remarks on Sound Practices for Managing Liquidity on Banking Organization, the Committee believes that liquidity - the ability to fund increases in assets and to meet obligations as they become due - is crucial to the ongoing viability of any financial organization. The importance of liquidity transcends an individual institution since a liquidity shortfall at a single organization can have systemic repercussions. Hence, the Committee believes that the proper management of liquidity is among the most important safety and soundness activities conducted at financial institutions.

In those remarks, the Committee noted that the relevant time frame for active liquidity management depends on the nature of an institution's business and that institutions less dependent on short-term money markets might actively manage their net funding requirements over a period of one to three months ahead. Clearly, the three-month minimum time frame for the liquidity standards you are committed to meeting covers the conservative end of that range. Moreover, the three-month minimum time frame set forth in your commitments contrasts sharply with the recently proposed rules for the Federal Home Loan Banks, which would require those institutions to maintain sufficient liquidity to withstand not less than five days of inability to borrow in the capital markets.

In evaluating your safety and soundness, the market should view your commitment to meeting liquidity standards that will ensure your institution's ability to handle significant, sustained liquidity crises as significant. While it may be less of a challenge for your institution to meet this standard in good times like the present, the strength of this particular component of the package is your commitment to continue to meet this standard and to disclose that fact, during times of economic stress.

3. Interim Implication of a Risk-based Capital Stress Test

You are proposing, pending the final promulgation of risk-based capital standards by the Office of Federal Housing and Enterprise Oversight, to do an interim implementation of the risk-based capital stress standard set forth in the 1992 GSE Act and to disclose the results on a quarterly basis. You will be applying the stress test mandated by law, which has been delayed for too long. However, as you have stated publicly, an interim implementation is no substitute for OFHEO's promulgation of a final risk-based capital rule.

The interim adoption of these standards for use in evaluating the ability of your institution to meet economic shocks clearly will be useful to regulators and the market. Since stress testing is one of the most effective tools for evaluating an institution's financial risk, formal use of stress tests will be a desirable step in providing information about the effectiveness of Freddie Mac and Fannie Mae in managing risk. As you know, the Basel Committee strongly recommends this type of capital stress test as a safety and soundness test. This step is one that will be of benefit in testing your financial soundness.

4. New Interest Rate Risk Disclosures

You are committing to initiate public disclosures of interest rate risk sensitivity analysis on a monthly basis. To my knowledge, no other financial institution provides such disclosure, and it will be of great utility in evaluating the financial soundness of your institution. Interest rate risk management continues to be of major importance, and monthly disclosure is particularly appropriate. Your monthly testing on the basis of a fifty basis point shift in interest rates and a twenty-five basis point change in the slope of the yield curve is an excellent complement to the quarterly stress testing of your institution against the larger, sustained interest-rate shocks of the statutory risk-based capital standard. Overall, I think that this particular step is an outstanding move toward allowing the market and regulators to evaluate your institution's financial soundness.

5. New Credit Risk Disclosures

You are committing to initiate public disclosure of credit risk sensitivity analysis on a quarterly basis. I understand that the corporation is committed to showing the financial impact of an immediate five percent decline in housing prices which, while outside of recent post-war experience, is moderate compared with the severe house-price shocks assumed under the statutory risk-based capital standard.

I believe that this type of disclosure on a quarterly basis will be a useful contribution to those evaluating the corporation's financial position and credit soundness. As far as I know, no other financial institution provides such information to the market place. Moreover, many financial institutions would be unable to furnish such disclosure due to the lack of appropriate internal records. Thus, I think this disclosure will be useful to the market place and is a major milestone in disclosure.

6. Public Disclosure of Annual Rating

You have committed to obtaining an annual rating from a nationally recognized statistical rating organization and to disclose the rating to the public. This rating, as I understand it, would be done on a "risk-to-the-government basis." Thus, this rating will be done without consideration of possible implicit government guarantees. This independent analysis of your financial position is another step that should help regulators do their jobs. It should be of major interest both to the government and to the public. This rating will be done by a nationally recognized credit rating agency such as Standard and Poors or Moody's, and I am sure that they will be conservative in issuing this rating. This is a very important safety and soundness initiative and it will provide new information in the evaluation of Freddie Mac's financial position.

Conclusion

In conclusion, this package of commitments puts you at the forefront of financial disclosure today. I commend the spirit underlying these commitments and encourage you to continue in your leadership role in setting financial disclosure standards for other financial institutions, as markets and market needs evolve.

Statement of J. Timothy Howard

Executive Vice President and Chief Financial Officer, Fannie Mae

Before the House Subcommittee on Capital Markets, Insurance, and GSEs

March 27, 2001

Thank you, Chairman Baker. Fannie Mae welcomes the opportunity to review with the Subcommittee our implementation of the voluntary safety and soundness initiatives that we announced last October with you, Congressman Kanjorski, and other Members of Congress. My name is Timothy Howard, and I am Executive Vice President and Chief Financial Officer at Fannie Mae and a member of our Office of the Chairman. I joined Fannie Mae in 1982 and have served as CFO since 1990. In this position, I am responsible for all of Fannie Mae's financial activities, including strategic and business planning, investor relations, corporate accounting, capital markets activities, and the asset acquisition, liability issuance, and interest rate risk management of the company's mortgage investment portfolio.

I would first like to take a few minutes to commend you and the other Members of this Subcommittee for your stewardship of a housing finance system that has helped so many Americans achieve the dream of homeownership. The U.S. housing finance system today is strong, vibrant, safe, sound, and serves consumers better than ever. It is also the best system in the world in putting people in homes with the mortgages they prefer at rates they can afford. This is due in no small part to the careful scrutiny, sound judgement and constructive action of Congress over the years.

Last year, in particular, the Subcommittee examined a wide range of issues related to the housing finance system and Fannie Mae's role in that system. The Subcommittee posed important questions regarding our safety and soundness, and we were pleased to have the opportunity to discuss our risk management practices and other aspects of our business both in this hearing room and in other meetings with you, your staff, and other policymakers. And while we are among the best managers of mortgage risk in the world, these discussions made it clear that there were additional measures we could put in place that would assure you that our safety and soundness protections are at the forefront of evolving world practices.

To formulate these measures we turned to the experts: the reports and studies of the Basel Committee on Banking Supervision, the Office of Federal Housing Enterprise Oversight (OFHEO), the Federal Reserve, and other policymakers and market participants who analyze risk in the financial markets.

After a comprehensive review of these recommendations, Fannie Mae and Freddie Mac, in conjunction with policymakers, crafted a set of proposals designed to place the two companies at the leading edge of safety and soundness practices. These proposals, which we announced with you last October, include commitments to issue subordinated debt, obtain an annual credit rating, enhance our liquidity planning, disclose more information about interest rate risk and credit risk sensitivity, and implement and disclose the results of an interim risk-based capital standard. Taken together, these initiatives will give investors and policymakers more information about Fannie Mae's risk exposure -- and confidence that Fannie Mae can manage that exposure -- than they can get from any other financial institution.

I want to emphasize that these voluntary initiatives are a layer of safety and soundness protection *in addition to* the cutting-edge regulatory regime that Congress constructed in the Federal Housing Enterprises Financial Safety and Soundness Act of 1992. That regime includes a rigorous on-site examination program, minimum capital levels, and a strict risk-based capital test designed to ensure that Fannie Mae is adequately capitalized to withstand a severe economic shock for ten years.

Of course, safety and soundness are not ends in themselves. Fannie Mae is a mission-driven company, chartered by Congress to provide liquidity in the U.S. housing finance system and expand affordable housing. Despite misguided statements to the contrary, we do not believe the national housing market is "saturated." Precisely because Fannie Mae's ability to fulfill our mission is so critical to our nation's support for homeownership, we recognize that we must be at the vanguard of safety and soundness protections.

Mr. Chairman, the homeownership rate in America stands today at a record 67.5 percent, but the gap between whites and minorities is frankly alarming. Seventy-four percent of white Americans own their homes, but that figure is less than 50 percent for minorities. Fannie Mae and Freddie Mac, mortgage lenders, mortgage insurers, and the rest of the housing finance industry have a great deal of work to do, and Fannie Mae is proud to be part of the solution. Together with our existing capital and supervisory regime and our state-of-the-art risk management practices, the initiatives we announced in October were designed to assure policymakers and investors that Fannie Mae is fully prepared to help close that gap.

Of course, these new voluntary initiatives are only valuable to the extent that we implement them thoroughly and assiduously. And that is why we committed to you, Mr. Chairman, that we would implement all of these initiatives within the first quarter of 2001. Implementation on such an aggressive schedule was not a simple proposition. Each initiative required the work of teams of people at the highest levels of the company, in several cases creating financial structures and disclosures that have little precedent among financial institutions.

I am pleased to report to you and to the rest of the Subcommittee today that we now have put all of the initiatives in place. We issued our first $1.5 billion of subordinated debt in January. We received a stand-alone credit rating in February. In early March, we put in place our liquidity plan. And yesterday we disclosed our credit risk and interest rate risk sensitivities and the results of our interim risk-based capital test. I would like to describe how we have implemented each of these initiatives, and note where we have gone beyond the announcement of last October.

Subordinated Debt. The October announcement included a pledge to issue publicly traded and externally rated subordinated debt. We included subordinated debt because it offers real benefits to the market and policymakers:

- It is an important way to crystallize the views of thousands of investors into a clear signal to policymakers as to how investors view the company's financial condition.

- It provides an incentive for subordinated debt holders to monitor our risk position very carefully. Because the terms of the subordinated debt require the suspension of interest in the event of severe financial difficulty, significant shifts in the yield of Fannie Mae subordinated debt will signal to regulators and others that the company may have increased its risk position.

- It serves as an additional cushion of capital on top of Fannie Mae's required equity capital as defined by its statutorily required minimum levels and its risk-based capital stress test.

On January 23, 2001, Fannie Mae announced the inaugural issue of its Subordinated Benchmark Notes program: $1.5 billion of securities with a maturity of 10 years.[1] We also signaled our intention, consistent with our commitment in October, to continue to issue such Notes quarterly during 2001 and on at least a semi-annual basis thereafter. We expect that by 2003, we will have $12 to $15 billion in subordinated debt outstanding, with an average maturity of five years.

The securities received a Aa2 rating from Moody's Investors Service and a AA- rating from Standard and Poor's (S&P). The rating agencies rated the subordinated debt separate and apart from Fannie Mae's relationship with the federal government. In assigning its AA- rating, S&P stressed that it did not regard the Subordinated Notes as being backed by the government. They wrote: "Unlike Standard & Poor's triple-'A' rating on the senior obligations of Fannie Mae, which incorporates implied government support, the rating on the subordinated debt assumes that the government would not intervene to prevent payment default on the instrument."[2] Moody's said that "the debt ratings assigned to the GSEs have the exact same meaning as those assigned to all other firms in the USA and elsewhere. They express Moody's opinion of the ultimate credit risks of a particular debt instrument taking into consideration all relevant factors."[3]

By the terms of the subordinated debt Fannie Mae issued, interest payments will be automatically suspended if certain capital tripwires are activated and, should the company ever experience difficulties, holders of subordinated debt securities will stand in line behind senior debt creditors and MBS investors before they can recover their principal. Unlike other subordinated debt issues, the interest deferral cannot be delayed by Fannie Mae or by any other party if the defined conditions occur. For these reasons, a consensus of market analysts agreed that Fannie Mae subordinated debt would be regarded by the market as different from its senior debt and would trade at a discount to our senior debt. This has proven to be the case.

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[1] Fannie Mae, News Release, January 23, 2001 (www.fanniemae.com/news/pressreleases/1110.html).

[2] Standard and Poor's CreditWire, Rating Assigned to Fannie Mae Subordinated Benchmark Notes, Jan. 24, 2001.

[3] *Fannie Mae and Freddie Mac Subordinated Debt Rating Rationale*, Moody's Investor Services Special Comment, Mar. 2000, at 3.

The prices at which our subordinated debt has traded indicate that the market is behaving consistently with analyst expectations. The Note was initially priced at 98 basis points over the 10-year U.S. Treasury and 22 basis points over the November 2010 Fannie Mae Benchmark Note. Approximately $250 million traded during the course of the day at spreads as tight as 17 basis points to Fannie Mae's 10-year senior note before closing the day at 18.5 basis points. Since issuance, our subordinated debt has traded in large size, with pricing ranging from 18 to 28 basis points higher in yield than our senior debt. Our subordinated debt is actively quoted on Telerate page 544, giving investors real price transparency. In terms of spread, it is useful to compare Fannie Mae's subordinated debt issuance to that of the largest bank holding companies (BHCs). As of March 23, the three largest BHCs had subordinated debt that traded at spreads of 5 to 25 basis points to their senior debt.

Moody's summarized the beneficial results from subordinated debt, emphasizing the difference between it and Fannie Mae's and Freddie Mac's senior securities:

> *The subordinated debt issued by Freddie Mac and Fannie Mae will, in combination with common and preferred equity, improve senior debtholders' position in the highly unlikely event of a liquidation or similar event. This should help to alleviate concerns about the systemic risks from GSE failure and help to provide an early warning signal to the marketplace in times of stress.... The GSEs' proposed subordinated debt also would not benefit from the same degree of implied support that senior enjoys and could face mandatory interest payment suspension.*[4]

With the unique features of this subordinated debt and the liquid market that we expect to develop, Fannie Mae has created a new class of fixed-income assets for investors. Our planned, regular, and large-size issuances of subordinated debt also validate the idea of a dynamic and active subordinate debt market as a means of market discipline. Fannie Mae expects that the market will use its collective expertise in measuring our risk profile, capital adequacy and financial health each time we bring new issue of Subordinated Benchmark Notes to market, as well as in ongoing trading in the secondary market. In doing so, Subordinated Benchmark Notes will truly be the "canary in a coal mine" that is crucial to establishing Fannie Mae at the forefront of financial institutions globally in adhering to the highest standards of market discipline.

As Morgan Stanley wrote recently,

> *"Spreads between the Subordinated Benchmark Notes and its senior Benchmark Notes will provide a real time indicator of investors' perceptions of the adequacy of Fannie Mae's capital relative to the risks it faces. Going forward Fannie Mae will have an additional yardstick with which to gauge the success of its capital policies. In striving to keep these spreads stable, Fannie Mae will have an incentive to communicate more extensively about the risks it faces and how it manages its capital in relation to these risks. This increased transparency to*

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[4] *New Freddie Mac and Fannie Mae "Open Book" Policy: A Positive Credit Development*, Moody's Investor Services Special Comment, Oct. 2000, at 4.

which Fannie Mae is already committed will enable investors to better assess Fannie Mae's risk and the adequacy of its capital."[5]

Annual Rating. A second initiative we announced in October was that we would obtain an annual rating from a nationally recognized statistical rating organization of the company's "risk-to-the-government" or independent financial strength, and that we would disclose this rating to the public.

On February 27, 2001, S&P assigned a AA- "risk to the government" rating to Fannie Mae. Only five commercial bank holding companies, and no thrifts, have a rating this high on their senior debt. This rating, according to S&P, "refers to the inherent default risk of a federally-related entity operating under its authorizing legislation, but without assuming an infusion of cash from the government." S&P incorporates into the rating such criteria as an evaluation of Fannie Mae's business fundamentals, including the company's competitive position, evaluation of management and its strategies, and examination of relevant financial measures.

At Fannie Mae's request, S&P's "risk to the government" rating will be maintained on a continuous, "surveillance" basis. This goes beyond the annual rating that Fannie Mae committed to obtain last October. Under a surveillance rating, S&P will continuously monitor our financial position and change the rating -- with an accompanying press release -- if our risk posture changes.

In summarizing its analysis of Fannie Mae's credit strength, S&P wrote:

Fannie Mae has demonstrated consistently good operating performance over a sustained period of time, testifying to its ability to manage the risks inherent in holding a portfolio of mortgage loans and the strength of its franchise as one of two government sponsored mortgage guaranty agencies. It has successfully weathered changing conditions in the demand for mortgage guaranties, several regional housing market declines, and changing interest rate environments. Asset quality is very strong, and the risk profile of its portfolio of mortgages remains very low. Capitalization has been stable, and is expected to remain so given the regulated nature of the company.

With this "risk to the government" rating, Fannie Mae now has outstanding a full range of ratings, including those on senior debt, subordinated debt and preferred stock. This suite of ratings gives investors a clear, comprehensive, and ongoing assessment of Fannie Mae's credit position. And combined with the daily updates to the prices of our subordinated debt, Fannie Mae now has more signals than any other company of how market professionals view the company's risk posture.

Liquidity. The third initiative from the October package that we completed this quarter was an enhancement of Fannie Mae's liquidity management. When we looked at the recommendations from the Basel Committee, we noted -- in addition to market discipline

[5] Morgan Stanley Product Note on Fannie Mae Subordinated Benchmark Notes, Jan. 2, 2001.

measures -- an emphasis on improved liquidity management. In its February 2000 paper recommending enhanced liquidity management for banks, the Basel Committee noted that:

> *Liquidity, or the ability to fund increases in assets and meet obligations as they come due, is crucial to the ongoing viability of any banking organisation.... Sound liquidity management can reduce the probability of serious problems. Indeed, the importance of liquidity transcends the individual bank, since a liquidity shortfall at a single institution can have system-wide repercussions.*[6]

Based on the discussions of safety and soundness that we had with the Subcommittee and other policymakers last year, Fannie Mae wanted to ensure that we met the very highest standards of liquidity management. As a result, we committed to:

- Maintain three months worth of liquidity, as recommended by the Basel Committee, calculated on the assumption that the company has no access to the public new-issue debt markets during this period;
- Maintain at least five percent of our on-balance sheet assets in a liquid, marketable portfolio of non-mortgage securities; and
- Comply with the 14 principles of sound liquidity management set forth by the Basel Committee in February 2000.[7]

On March 12, 2001, Fannie Mae announced that we had met this commitment. We have a contingency plan in place to ensure that we could meet our funding needs for three months without access to the agency debt markets. We are maintaining more than five percent of our on-balance sheet assets in high-quality, liquid, non-mortgage securities. In fact, Fannie Mae's ratio of liquid assets to total assets was 8.1 percent as of December 31, 2000, and we intend to disclose this ratio to the public on a quarterly basis. And last, our liquidity plan meets the 14 principles for sound liquidity management set forth by the Basel Committee and satisfies our safety and soundness regulator.

We have briefed OFHEO on our liquidity plan, and OFHEO has confirmed that the plan would assure that Fannie Mae could function for three months without access to the new issue debt markets.

These commitments were in addition to a rigorous liquidity program at Fannie Mae. We manage our liquid assets under strict investment guidelines reviewed and approved by our Board of Directors. Under these limits, liquid assets have an explicit goal of zero credit losses. Fannie Mae's typical liquid assets are money market paper and AAA-rated securities. Understandably,

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[6] Basel Comm. on Banking Supervision, *Sound Practices for Managing Liquidity in Banking Organizations*, Consultative Paper No. 69 (Feb. 2000) at 7.

[7] Basel notes that "[t]he relevant time-frame for active liquidity management is generally quite short . . . . Banks which are reliant on short-term funding will concentrate primarily on managing their liquidity in the very short term (say the period out to five days). . . . Other banks (i.e., those that are less dependent on the short term money markets) might actively manage their net funding requirements over a slightly longer period, perhaps one to three months ahead."

the margins on these high quality, liquid investments are significantly lower than those Fannie Mae earns on its mortgage portfolio, but that is the opportunity cost the company pays to maintain a safe cushion of liquidity.

By virtue of the company's sound liquidity practices and its commitment to maintain more than three months worth of liquid assets, Fannie Mae is positioned not only to withstand swings in the markets, but also to provide liquidity to the market when other financial firms withdraw. Thus, for example, during the market turbulence in the second half of 1998, when other investors withdrew from the market, Fannie Mae stepped up its mortgage purchases -- largely by drawing down liquid assets -- which maintained the stability of the mortgage market and kept mortgage rates at historic lows for homebuyers.

New Risk Disclosures. Our subordinated debt issuance and annual ratings can serve as excellent signals to policymakers and investors, but the company needs to be at the leading edge of risk disclosures for those signals to be as accurate as possible. The fourth and fifth of our October initiatives that we completed were our new monthly interest rate risk sensitivity disclosures and new quarterly credit risk disclosures.

- **Interest Rate Risk Disclosures**

In October, Fannie Mae committed to disclose on a monthly basis the impact on Fannie Mae's financial condition of a plus or minus 50 basis point instantaneous change in interest rates and an instantaneous 25 basis point shift in the slope of the yield curve in both directions. Yesterday, we made our first monthly interest rate risk disclosure under this commitment to investors and the public. Going beyond the commitment we made in October, Fannie Mae released the two primary measures of interest rate risk that the company uses in managing its interest rate business: portfolio net interest income at risk and effective asset/liability duration gap.

Fannie Mae's net interest income at risk measure will disclose the sensitivity of Fannie Mae's projected net interest income to an immediate 50 basis point increase or decrease in interest rates and a 25 basis point increase or decrease in the slope of yield curve. Net interest income at risk will compare projected net interest income under the more adverse of the interest rate and yield curve scenarios with projected net interest income without the interest rate shocks. We will calculate and disclose our net interest income at risk over both a one- and four-year period. For the four-year disclosure, the net interest income at risk calculation will reflect the percentage difference in cumulative net interest income over the period.

Yesterday, Fannie Mae disclosed that as of February 28, 2001, the company's net interest income at risk from a 50 basis point change in interest rates was 3.0 percent over the next one year, and 2.1 percent over the next four years. The company's net interest income at risk from a 25 basis point change in the slope of the yield curve was 3.2 percent over the next one year, and 5.2 percent over the next four years.

These changes in interest rates and in the slope of the yield curve encompass about 95 percent of the actual changes that are likely to occur. Fannie Mae generally expects its net income at risk measures to range between one and five percent.

In addition, we announced that we would supplement our net interest income at risk disclosure with monthly disclosure of the company's effective asset/liability duration gap. Effective duration is a measure of the sensitivity of a security's value to changes in interest rates, and is commonly used in fixed-income portfolio management. Fannie Mae has successfully used effective duration gap as an internal risk management tool for a number of years, and we report on duration management to our Board of Directors. We also report this information as of year-end in our Annual Report to shareholders.

We announced yesterday that as of February 28, 2001, the effective duration gap of our mortgage portfolio was a negative two months. A negative duration gap indicates that the effective duration of the portfolio's liabilities exceeds the effective duration of its assets by that amount, while a positive duration gap indicates the opposite. Fannie Mae has a target range for its effective duration gap of plus or minus six months. When the portfolio's duration gap moves outside this range -- which it can do if interest rates move quickly or by large amounts -- the company rebalances its assets and liabilities to bring the duration gap back within the target band.

Fannie Mae's interest rate risk disclosures follow the recommendations of the New Basel Accord and the report of the Working Group on Public Disclosure, headed by Walter V. Shipley. Both recommend that risk disclosures be consistent with internal risk management practices. Net interest income at risk and duration gap are the primary portfolio risk measures at Fannie Mae. Basel further proposes that disclosures incorporate expected future activity, and that sophisticated disclosures use multiple simulations of interest rates. Fannie Mae's net interest income at risk measure is based on projected future activity over the next one and four years, and both net interest income at risk and duration gap are calculated using at least three hundred interest rate paths.

– **Credit Risk Disclosures**

We also committed in October to disclose on a quarterly basis the sensitivity of expected credit losses from a five percent drop in property values. On March 26, Fannie Mae released to investors and the public our first quarterly credit risk disclosure under this commitment.

To calculate our credit risk sensitivity, Fannie Mae uses internal credit models, as recommended by Basel, to project the present value of all future credit losses. We then calculate the present value of losses assuming an immediate five percent decline in the value of all properties securing mortgages owned or guaranteed by Fannie Mae. Following this decline, home prices are assumed to increase at the same long-run rate embedded in the company's credit pricing models. Projected default incidence and loss severity are consistent with the assumed changes in home prices. The sensitivity of future credit losses is the dollar difference between credit losses in the baseline scenario and credit losses assuming the immediate five percentage point home price decline.

Yesterday, we announced that as of December 31, 2000, the company's net sensitivity of future credit losses, taking into account the effect of credit enhancements, was $295 million. This figure reflects a gross credit loss sensitivity of $1,065 million without the effect of credit enhancements, and is net of projected credit risk sharing proceeds of $770 million.

Fannie Mae's current low level of sensitivity to credit losses reflects the quality of our existing book of business, the impact of our loss mitigation techniques, and the effectiveness of our credit enhancement and risk-sharing strategies. While slightly less than 40 percent of Fannie Mae's single family portfolio as of December 31, 2000, was covered by credit enhancements, we project that our credit enhancement counterparties would absorb $770 million, or 72 percent, of the increase in credit losses that would result from a five percent home price shock.

We expect our credit risk sensitivity to vary over time based on a number of factors, including the composition of the company's credit portfolio, recent home price changes, the level of interest rates, and the amount of mortgage insurance and other credit enhancements that reduce Fannie Mae's losses.

Interim Implementation of the Risk-Based Capital Rule. The final component of the October 2000 voluntary initiatives is our commitment to implement on an interim basis the risk-based capital stress test included in the 1992 Act and disclose to the public whether we passed or failed the test. We will run this interim implementation only until the final risk-based capital standard is adopted by OFHEO.

The stress test spelled out in the 1992 Act requires Fannie Mae to hold sufficient capital to withstand an unprecedentedly severe economic and financial shock that extends for ten years, without defaulting on our obligations. The test includes severe adverse interest-rate movements and nationwide depression-level conditions in residential real estate lasting throughout the decade-long period. The required level of current capital is an amount sufficient for Fannie Mae to remain solvent in every quarter throughout the ten-year span of adverse economic conditions plus, for good measure, an additional 30 percent to account for operations risk.

As Fannie Mae Chairman and CEO Frank Raines testified before the Subcommittee last May, the "possibility of these two credit and interest-rate scenarios happening simultaneously is vanishingly small." Very few such companies could survive for ten years the type of environment assumed in Fannie Mae's stress test. Indeed, a study commissioned by Fannie Mae found that the thrift industry would have to boost its capital base by between sixty and ninety percent in order to be able to survive the type of scenario envisioned by Fannie Mae's stress test.[8]

Fannie Mae has run its own internal version of the risk-based capital stress test since 1993, and has built capital and managed its business to remain in compliance with that test. For purposes of the voluntary disclosure, Fannie Mae constructed an interim implementation of the risk-based capital test using OFHEO's Notice of Public Rulemaking 2 (NPR2) as a basis, modified to reflect subsequent changes implemented or suggested both by OFHEO and the company.

OFHEO's NPR2 was published in the *Federal Register* in April 1999, and is extensively documented. Since April 1999, OFHEO has made corrections to NPR2, and the corrections are

[8] Dave Dufresne, *Risk-Based Capital and the Thrift Industry: Implications of Risk-Based Capital Stress Test Requirements* 7 (IPS-Sendero, Feb. 1999).

noted on the OFHEO website. In constructing our interim stress test, Fannie Mae incorporated OFHEO's NPR2 changes along with the changes we recommended in our March 10, 2000, comment letter to OFHEO and other refinements enumerated on our website (www.fanniemae.com). OFHEO has not given us an opinion on our implementation or indication that it supports this or another implementation of the standard.

Fannie Mae will disclose whether it has passed or failed its interim risk-based capital test as of the end of each quarter, and also give an indication of the amount by which its total capital exceeds or falls short of the calculated risk-based requirement.

I am pleased to report to the Subcommittee that we had sufficient capital to pass our interim version of the OFHEO risk-based capital test as of December 31, 2000, and that our capital cushion on that date was between 10 and 30 percent of total capital. We were able to pass the interim risk-based capital test because of the substantial amount of hedging and loss-sharing arrangements in which we engage. Typically between 45 and 50 percent of Fannie Mae's liabilities consist of callable debt or other option-based instruments. Our reliance on mortgage insurance and credit risk sharing arrangements reduce credit risk exposure and allow the company to withstand the stresses in the risk-based capital test.

Fannie Mae's interest rate risk and credit risk disclosures complement the results of our quarterly stress test, which has extremely stringent interest rate and credit condition assumptions over a ten-year period, and far exceed the practices of other financial institutions. In summarizing the value of the package of disclosures to which Fannie Mae and Freddie Mac committed themselves, Moody's stated:

> *These financial disclosure commitments by Fannie Mae and Freddie Mac set new standards not only for them, but also for the global financial market.*
>
> *The provision by Fannie Mae and Freddie Mac of periodic, detailed risk information to the broad market will permit better independent reviews and monitoring of their risk profiles and should substantially reduce the uncertainty about their actual financial health as well as dampen any systemic risks they present.*
>
> *The regular disclosure of their interest and credit risk exposure, combined with stress testing of their capital base, should significantly increase market comfort with their risk management disciplines and capital adequacy. The stress test, in particular, will show whether the two GSEs have sufficient capital to withstand very harsh market developments over a long period.*[9]

Conclusion

I very much appreciate the opportunity that you have given us, Mr. Chairman, to come before the Subcommittee to talk about how we are implementing the six voluntary initiatives that we announced with you last October. As I said earlier in this statement, and as you have

[9] Moody's Investor Service, *Op. Cit.* at 4.

emphasized in your oversight of Fannie Mae and Freddie Mac, our safety and soundness are critical to the housing finance system and to the million of Americans who have yet to achieve the dream of homeownership.

These six new measures, combined with the regulatory mechanisms Congress enacted in 1992, place Fannie Mae at the vanguard of risk management and disclosure practices worldwide, with cutting-edge regulatory discipline bolstered by cutting-edge market discipline.

Fannie Mae has relied on multilayered, redundant risk management practices for the past decade. We now have added multilayered, redundant disclosure and transparency practices, with both a greater quantity and a greater quality of information and disclosure. We now put out more -- and more timely -- information to the public, investors and policymakers than any other financial institution in the world.

If policymakers or investors have a question or concern about how Fannie Mae is doing, there are several ways to find out. They can look at the results of our supervision exams, our capital levels, our stress test results, our external rating reports, our regular reports on how the economy is affecting our business, or changes in the value of our subordinated debt. No financial company in the world will give policymakers and investors more information about its financial condition than Fannie Mae does.

Our implementation of the six voluntary initiatives ensures that Fannie Mae will remain one of the safest, soundest financial institutions in the world. Our subordinated debt rating and our risk-to-the-government rating are among the strongest in the industry. We have more than adequate liquidity to survive for three months assuming no access to the capital markets. We could endure the worst economic shocks in history -- shocks that few other financial institutions could survive -- with significant capital left over.

Mr. Chairman, Congressman Kanjorski, thanks to your leadership and our partnership, our safety and soundness regime is now consistent with the best thinking in the world, and it goes well beyond any government-chartered bank or financial institution today.

Together, we have produced an even safer, sounder Fannie Mae, a stronger U.S. housing finance system, and a better chance for more Americans to own a home. And we have done even more than that. What we have created together in Fannie Mae is nothing less than a new model for financial institutions in America and around the world.

Thank you for inviting Fannie Mae to testify before the Subcommittee today. We look forward to continuing to work with you on these and other important issues.

FannieMae

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April 30, 2001

The Honorable Richard H. Baker
Chairman
Subcommittee on Capital Markets, Insurance, and
Government Sponsored Enterprises
Committee on Financial Institutions
Washington, D.C. 20515

Dear Mr. Chairman:

I would like to respond to your request of March 27 for more information on how our subordinated debt is trading in the marketplace and to share with you some additional information about our risk management practices.

The inaugural issue of Fannie Mae's 10-year subordinated debt was priced on January 25, at a spread to our senior debt of 22 basis points. Since that time, spreads on our sub debt have moved within a ten basis point range, trading as narrow as 18 basis points above our senior debt and as wide as 28 basis points. At the close of the market on April 27 the spread on our sub debt again was 22 basis points -- right where it was initially priced. These spread movements are well within the range of the subordinated debt spreads of high-quality commercial banks over the same time period.

Investors and dealers have told us that our subordinated debt carries a yield premium because of its exposure to adverse credit events. There is no doubt in investors' minds that our subordinated debt is much more exposed to credit than our senior debt. We expect that as Fannie Mae issues more subordinated debt in the future, the increased trading and liquidity in these securities will provide an active and liquid mechanism for investors to express their views on our credit condition. As I noted in my testimony, we intend to issue subordinated securities every quarter in 2001 and at least semiannually thereafter. This past Friday we announced our second subordinated debt issue -- $1.5 billion with a 5-year maturity. We expect to price this issue some time this week.

You also noted during the March 27 hearing that you were concerned about the consolidation of our risk counterparties and our ability to hedge risk appropriately. While consolidation has in fact occurred throughout financial services, Fannie Mae today has less concentration among our derivatives counterparties that we had five years ago. Despite our size we are a relatively small participant in the derivatives market. We deal only in the safest areas of that market, and have negligible financial exposure within it.

Mergers and acquisitions -- and the growing size and market position of the largest U.S. commercial banks -- have certainly led to an increase in concentration on the asset side of our business. In 2000, 75 percent of the single-family loans Fannie Mae purchased or guaranteed were originated by just 25 lenders. Five years ago, in 1995, 75 percent of our mortgage business came from 85 lenders.

On the debt side, only the largest investment banks have access to the worldwide investor base that we require to attract global capital to the U.S. housing finance market. In both 1995 and 2000, we did about 55 percent of our business with 5 securities dealers, and about 80 percent of our business with 10 securities dealers.

For derivatives, the concentration is similar. In 1995, we did 71 percent of our derivatives business with 5 firms, and 94 percent with 10 firms. In contrast to the concentration that has occurred on the lending side, however, we recently have reduced the concentration of our derivatives counterparties. In 2000, 64 percent of our derivatives business was done with our top 5 counterparties, and 90 percent with our top ten.

It also is important to note that on a relative basis Fannie Mae remains a very small participant in the derivatives market. As of December 31, 2000, Fannie Mae's derivatives book of $334 billion was about three-tenths of one percent of the overall derivatives market, which (according to the Bank for International Settlements) exceeded $100 trillion on that date. In comparison, the largest U.S. participant in the derivatives market -- a commercial bank -- had a derivatives book of over $20 trillion.

In addition, because Fannie Mae does not trade in derivatives, our exposure within this market is quite limited. Even had all of our derivatives counterparties defaulted on March 31, 2001, our maximum possible loss would have been $29 million after tax. That is only two percent of the net income we reported for the first quarter, and barely one-tenth of one percent of our capital base. In fact, our losses would have been lower than $29 million because all of our derivative contracts are collateralized. In the unlikely event that any of our counterparties experience financial difficulty, the terms of our contracts require them to post collateral in an amount sufficient to cover our exposure.

I appreciate the opportunity to discuss these issues with you in more detail. In our view, our subordinated debt program is off to a very strong start. And we believe there is no reason for concern about our exposure to derivative counterparties.

Fannie Mae remains fully committed to state of the art risk management and disclosure practices, and we look forward to working with you as we strive to remain at the forefront in both.

Sincerely,