Statement of Donald H. Layton
Chief Executive Officer, Freddie Mac
Before the Committee on Financial Services
U.S. House of Representatives
September 27, 2018

Chairman Hensarling, Ranking Member Waters and members of the Committee, thank you for inviting me to appear at this hearing.

Before getting into the details of my testimony, I wish to highlight my main theme: **The mortgage system we have today is fundamentally better than the one we had ten years ago, plain and simple. It is more safe-and-sound, more efficient and does a far better job of protecting taxpayers. Freddie Mac is similarly much better, with a substantially improved business model. We are absolutely not the government-sponsored enterprise (GSE) of the past.**

Working closely with the Federal Housing Finance Agency (FHFA) and at times the U.S. Treasury, we spent a good part of the last decade addressing what are widely regarded as major weaknesses of the pre-conservatorship GSE business model. We have also worked, and continue to work, to address material and costly inefficiencies in a mortgage system that has long been well known for being behind the times. The results have helped borrowers, renters, lenders, investors and mortgage market participants more broadly – and, most of all, the U.S. taxpayer.

These improvements also have paved the way for policymakers considering the future of housing finance.

My testimony is divided into four parts.

First, I will briefly discuss how we have served our Congressionally-mandated mission over the past ten years.

Second, I will set out the four major weaknesses of the pre-conservatorship housing finance system, and what we have done to address them. They were: (1) large investment portfolios used to enhance profits with subsidized funding, (2) an inadequate capital regime, (3) a bias towards large lenders, and (4) a massive concentration of mortgage credit risk in the two GSEs. The changes we have made to address these weaknesses are creating a fundamentally different and better housing finance system.

Specifically, working with FHFA, we have

- **Reduced our retained investment portfolio** by more than 70%, and repurposed it to support the core mission under the Charter, rather than to generate discretionary profits.

- **Created a modern, SIFI-consistent capital framework** to enhance safety- and soundness and enable our decision-making to be in the true interest of taxpayers.

- **Leveled the playing field** for community banks and other small lenders.

- **Created entirely new markets to efficiently transfer most of the credit risk** of both single-family and multifamily mortgage guarantees to private capital markets – on a cost-efficient basis and structured so that it is nearly certain that the risk transfer will be completed as intended.[1] My testimony will particularly highlight the creation of the credit risk transfer (CRT) markets, arguably the single most important development in the housing finance system over the past decade. Freddie Mac has played a well-recognized leadership role in that development, in both the single-family and multifamily businesses.

Essentially, CRT has created a greatly improved business model for the GSEs; we now buy and distribute most of the credit risk of new guarantees instead of simply holding it. It has successfully put a large and ever-growing amount of private capital at the heart of the mortgage system to absorb losses before taxpayers could be called upon to cover them. That has clearly been a top priority for many working on housing finance reform. This change in business model also has the potential to reduce Guarantee Fees (G-Fees) over time, and has already substantially reduced the systemic risk to the U.S. financial system represented by what prior to CRT was an extreme concentration of mortgage credit risk.

Third, I will discuss our efforts to improve the efficiency and safety and soundness of the mortgage finance system, especially through technology-based innovation. The mortgage industry had long been inefficient in ways that harmed borrowers, renters, lenders and investors. I will note that those efforts are in support of the statutory mission given to us by Congress, within the four corners of our charter and fully approved by the FHFA as our conservator and safety-and-soundness regulator.

[1] An explanation of the issue of transaction completion certainty is on page 12.

Finally, per the Committee's specific request in its invitation to testify, I will provide some brief comments regarding housing finance reform.

I come to the conclusions in my testimony based on my background, my experience with the pre-conservatorship GSEs, my experience running Freddie Mac for the past six years and my fiduciary responsibility to the FHFA and taxpayers.

In terms of my background, I am a career financial services executive with broad experience, over four decades long at this point, in wholesale banking and capital markets, both domestic and international, as well as U.S. retail banking and the securities industry. I gained this experience after spending almost 30 years at JP Morgan Chase and its predecessors, rising from a trainee to being one of its top three executives, retiring in 2004. I later served as Chairman and then CEO of E*TRADE during the Financial Crisis, and was also appointed to the Board of American International Group (AIG) by the U.S. Treasury as part of its rescue of the company.

And while my career was outside of the specialized mortgage finance system, I did become very familiar with Freddie Mac and Fannie Mae, dealing with them routinely in both the capital markets and in the mortgage lending business. As a result, I saw first-hand what was good in their activities. In particular, they helped preserve relatively inexpensive mortgage loans for the broad middle and working class, with the 30-year, fully-amortizing fixed-rate loan as its core component.

However, I also saw critical flaws that eroded public confidence in the GSEs, as discussed above and more fully below. For these reasons, I am in no way an apologist for the pre-conservatorship GSEs. Quite the opposite; only by admitting their weaknesses can we effectively address and materially reduce them.

Moreover, as the CEO of a company in conservatorship that receives capital support from the U.S. Treasury, I have publicly stated from my first day that I took my position as a form of public service. In fact, as mentioned above, my fiduciary responsibility is not to private shareholders but to FHFA as our conservator, and behind it the American taxpayer. I take that responsibility very seriously.

I accepted the challenge of leading Freddie Mac with the understanding that the conservatorship would *not* maintain the flawed status quo. Instead, FHFA would actively reform the GSEs – to build upon the good and to remedy the flaws, as much as possible under current law. So, I am here to talk about the Freddie Mac and the GSE housing finance system *as they exist today*, after the extensive work we have done during the ten years of conservatorship to improve them *within the laws on the books today and under the policy directives given to us by FHFA as our conservator*.

The result has been substantially improved safety and soundness and efficiency of the company and the entire housing finance system, along with substantially reduced taxpayer exposure to our risks.

These efforts are vitally important to borrowers, renters, lenders, investors or anyone else with a stake in a liquid, stable and affordable housing finance system. They are unarguably vital to protecting taxpayers. And, they should be important to any policymaker considering the future of housing finance.

I. FREDDIE MAC HAS SUCCESSFULLY SERVED ITS MISSION THROUGHOUT CONSERVATORSHIP

Freddie Mac and Fannie Mae were placed into conservatorship at the height of the Financial Crisis with an overarching goal of keeping the mortgage finance system functioning. We achieved that goal across three vitally important dimensions.

- **We have provided critical liquidity to the primary mortgage market.** We continued to purchase mortgages from our lender partners each and every business day, despite very adverse market conditions in the early years. Over the past 10 years, we have provided *nearly $4 trillion in liquidity* to the primary market, funding home purchases, mortgage refinances and rental housing for *more than 22 million families*. In so doing, we provided the counter-cyclical support to the mortgage market that was desperately needed in the conservatorship's early years, especially as private market sources of mortgage credit dramatically retreated during the crisis.

- **We have helped stabilize the housing market and communities.** We helped *more than one million families avoid foreclosure* through loan modifications, forbearance, short sales and other measures. We provided this assistance through the government-designed Home Affordable Mortgage Program (HAMP) and also through our own foreclosure prevention programs. We also gave *more than 1.4 million underwater or near-underwater homeowners* much needed financial relief by refinancing their mortgages through the government-designed Home Affordable Refinance Program (HARP) as well as our own proprietary offerings. Through these efforts we not only assisted financially stressed homeowners, we also helped stabilize the market and whole communities. I want to note these programs were also designed to properly respect the interests of the taxpayers who back us.

- **We have responsibly provided low and middle income (LMI) access to credit.** After the foreclosure crisis peaked and the housing market began to

recover, we worked with FHFA to responsibly increase access to credit for LMI borrowers. Promoting broad access to credit is core to achieving our mission – both in terms of supporting the overall mortgage market and in meeting our statutory affordable housing and Duty-to-Serve obligations. Doing it responsibly means we have done and continue to do the hard and creative work needed to provide LMI access to credit while maintaining safety and soundness in our credit quality.

- **And, we are achieving these goals while also properly managing credit risk quality.**

  For the Single-Family book of business, our serious delinquency rate peaked in the early years of conservatorship at 3.98%; as of June 30, 2018 (the most recent public figures available), it was down to 0.82%, *a decline of nearly four-fifths* – the lowest level in more than a decade. (As a point of comparison, at its peak, the serious delinquency rate was more than 30% for the subprime market and 9.67% for the overall market.[2])

  Furthermore, our credit risk is still concentrated in our legacy portfolio (i.e. loans purchased before 2009, as well as HARP and other relief refinance loans purchased since 2009). These loans comprise 20% of our total single-family guarantee book, and have a serious delinquency rate of 2.14%, accounting for 91% of our credit losses. By contrast, our non-legacy Single-Family loan portfolio (loans purchased since 2009, excluding HARP/relief refinance loans) now comprises 80% of our book, but accounts for only 9% of our losses. It also has a serious delinquency rate of just 25 basis points (0.25%), a level regarded as quite good, aided in no small part by rising house prices since 2011.

  At an aggregate level, these statistics show that our Single-Family credit quality is being responsibly managed. That is the result of the success of our policy of making our "credit box" the consumer equivalent of "investment grade" – rather than "speculative" grade, also known as "junk" quality. It also balances our goals of broadly supporting the mortgage markets and LMI access to credit while operating responsibly on behalf of the taxpayers.

  Similarly, in our Multifamily business, which has been meeting the strongly rising demand for rental housing, the credit quality of our guarantee book of business is not just good, it is superb. Our Multifamily delinquency rate as of June 30 was *just 0.01%*, an extraordinarily low level.

[2] Source: Mortgage Bankers Association's National Delinquency Survey.

Please note that because of our CRT program, discussed below, losses from these delinquencies increasingly are charged directly to private market investors, rather than to us. This further protects taxpayers.

II. WE HAVE ADDRESSED THE FOUR KEY WEAKNESSES OF THE HISTORIC GSE SYSTEM

I have occasionally heard or read statements to the effect that nothing has changed at the GSEs during the past 10 years. I know first-hand nothing could be further from the truth – the conservatorship has become anything but a "status quo operation." In fact, to further protect taxpayers during an extended conservatorship, we have made many improvements to the structure and operations of Freddie Mac. These include addressing what I believe are the four most important and broadly recognized weaknesses in the old GSE system. We have implemented these reforms in close concert with and under the supervision of FHFA (and sometimes in coordination with the U.S. Treasury), led by three FHFA directors serving under Presidents from both parties, while keeping fully within the bounds of our charter and the terms of the conservatorship.

Our business activities also are strongly shaped by FHFA's annual Conservatorship Scorecards, which set specific policy goals for Freddie Mac each year. Broadly speaking, these goals are aimed at making both Freddie Mac and the broader housing finance system work better for homeowners, renters, taxpayers, the American economy and the overall financial system.

As you have asked my views of the FHFA, it should be noted that FHFA is a relatively "young" financial institutions regulator compared to those with which I have previously dealt, and at the same time serves as a conservator operating in totally uncharted territory. Notwithstanding, I have found it to broadly conduct its affairs diligently and honorably, true to its statutory obligations and professional rather than political in orientation. Its senior people with whom I personally deal, in my experience, are smart, hard-working and knowledgeable. Indeed, the proof of the pudding is that its direction of Freddie Mac and Fannie Mae while in conservatorship has ensured that they remain reliable sources of liquidity for housing finance as well as agents for reform of the mortgage system. I believe this view is shared broadly within the mortgage banking industry, based upon my interactions with its leaders.

Working with FHFA, we have addressed all four major weaknesses.

1. **We reduced the retained portfolio by more than 70% and now use it to support our mission.**

The original Preferred Stock Purchase Agreement (PSPA) with the U.S. Treasury, put into place at the time the conservatorship was established, substantially addressed the GSEs' previously unlimited ability to build up discretionary investment portfolios, funded by borrowings that were inexpensive because of the unpaid-for implied guarantee by the U.S. government. At its peak, Freddie Mac's retained portfolio exceeded $800 billion; today it is under $250 billion, as mandated by the PSPA.

As one key example of this decline, our investment in private-label mortgage-backed securities (PLS) – which was clearly an independent and discretionary investment – peaked at $180 billion in 2006, making us possibly the single largest owner of PLS in the world at that time. (PLS are mortgage-backed securities not issued or guaranteed by Freddie Mac, Fannie Mae or Ginnie Mae.) Our PLS holdings have shrunk 98% since then, and today we have just $3 billion.

Today, we use the $250 billion limit in the retained portfolio to support the guarantee businesses, for example, purchasing defaulted loans out of securitizations to facilitate modifications and make good on our guarantee to investors in those securities. The PSPA and FHFA requirements prohibit us from once again taking on independent and discretionary investments, a restriction that I feel is totally right and proper.

2. **We now have a modernized, SIFI-based capital framework to enhance safety and soundness, which enables us to make decisions in the interest of the taxpayers who support us.**

Another well-recognized weakness of the pre-conservatorship GSEs was inadequate capitalization, even judged by the standards of that time, when financial system capitalization generally was not strong. There is consensus on the need for strong capital standards for the GSEs upon potentially exiting conservatorship.

While we remain in conservatorship, the amount of capital we are permitted to have on our books today – $3 billion is our allowed "buffer" – is quite small versus what would be required to support our risks. Because of the capital support provided by Treasury under the PSPA, the market nonetheless has confidence in us to be a near-Treasury-quality debt issuer. In practical terms, then, we have a lot of capital behind us residing at the US Treasury. And we pay for that support via the "profit sweep" clause of the PSPA rather than an overt fee.

However, our lack of capital on our own books creates a challenge for management in operating our business. A well-developed regulatory capital system has two core

purposes. The first, and more commonly discussed, is to generate a level of capital in the aggregate that is the minimum amount the regulated financial institution should hold to help ensure safety and soundness and market confidence. The second purpose is to give management a framework to make everyday risk-versus-reward decisions properly and efficiently. This requires a capital system that can drive such day-to-day decision-making. For us, it will answer core questions like "Is the price of a particular CRT transaction a good deal for the taxpayer who supports us, or a bad deal?" or "Is selling this package of non-performing loans a good deal for the taxpayer, or a bad deal?" Without such decision-making being made on a high-quality economic basis, it cannot be truly safe and sound nor in the interest of the taxpayer.

Accordingly, Freddie Mac developed a modernized GSE risk-based capital system in 2012 and 2013, based upon the principles behind what Systemically Important Financial Institutions (SIFIs) must use in the broader financial system. (The SIFI requirements primarily require capital needed to withstand a "severe adverse" economic and market scenario plus a going-concern buffer that will retain market confidence.) While the system Freddie Mac developed indicates generally how much capital we would need if we were not under conservatorship, it just as importantly gave us the needed rules to drive our everyday risk-versus-reward decision-making in all our CRT transactions, all our legacy asset sales and more. It is this system that gave us the confidence to do such transactions, knowing that we were not asking the taxpayer to overpay to have risk taken off our books. It is this system that helps ensure we are being good stewards of the taxpayers' money.

In 2017, the FHFA finished development of its own version of a modern, SIFI-consistent capital system, which it called the Conservatorship Capital Framework (CCF). It then mandated that the GSEs use CCF while in conservatorship for decision-making, for the precise reasons I cite above. Because our homegrown system was very similar to the CCF in almost all major aspects, we were able to adopt it fairly easily.

3. **We have leveled the playing field for community banks and other smaller lenders.**

A third major deficiency prior to conservatorship was a bias towards large lenders in the single-family market. This manifested itself most importantly in lower G-Fees for the very largest lenders. FHFA has ended this practice, requiring "*level G-Fees*."

We also maintain a robust cash window, which enables small lenders to access the global capital markets, even when selling us one or two loans at a time. The alternative for them is to sell their loans to the large aggregators with whom they

may compete. And, we have dedicated more technology, customer support and other resources to smaller lenders than prior to conservatorship. This has contributed to the growing share of our business coming from outside our ten largest lenders (52% as of June 30, 2018).

We believe that level G-Fees, a vibrant cash window and enhanced support are essential to ensure that community banks and other smaller lenders retain equal access to the secondary market. Small lenders also value knowing that, given our role as a GSE under our charter, Freddie Mac will not cross-market other products or services to their customers, as aggregators may.

4. **We now transfer most of the concentrated credit risk of new single-family and multifamily mortgages to private capital markets - on a cost-efficient basis and structured so that there is a near certainty that the risk transfer will be completed as intended. This has the potential to be the biggest single improvement in the housing finance markets in decades and is putting private capital increasingly at the heart of the housing finance system for the first time in many years.**

As I have stated, the development of CRT arguably is the biggest improvement in the GSE system in at least a decade. That is because it represents a change to a fundamentally new and improved business model that delivers large and important benefits at three policy levels:

CRT has substantially reduced systemic risk

The concentration of monoline mortgage risk at the two GSEs of approximately $5 trillion has long been regarded one of the largest systemic risks in the financial system. The GSEs, in the 1970s, changed their business model with the development of the pass-through mortgage-backed security ("MBS") to shed the interest rate and liquidity risk of the mortgages they owned and sell them to investors, with the GSEs acting as operating intermediaries between borrowers and the buyers of those pass-through MBS. Today, such securities represent over 80% of our entire balance sheet. Nevertheless, the retention of the credit risk by the GSEs – by guaranteeing the investors in those MBS that they would not suffer credit losses – still left a near-$5 trillion concentration of mortgage *credit* risk with the two GSEs, and this was the underlying cause of the need for the government to put the companies into conservatorship. Simply put, when the mortgage asset class caught a severe cold, the GSEs got pneumonia.

This was regarded by many as an unavoidable consequence of being a mortgage monoline by our charters, with no way to avoid it. But in reality, given the evolution of the global capital markets in the last several decades, holding onto the credit risk

in the historic manner became a business model choice. And we have chosen to change our business model.

With CRT, a large majority of this credit risk is increasingly being passed through to investors, just as we do with interest rate and liquidity risk. When the business model transition is complete, with the credit risk transferred to diversified investors in the global capital markets, this source of systemic financial risk will have been reduced to a minimum.

At this time, Freddie Mac's Multifamily business has almost completely converted to the new business model, having begun in 2009. New flows of multifamily mortgages have roughly 90% of their credit risk – as measured by the requirement for capital on that credit risk according to the FHFA's CCF system – passed through to private market investors. Since it has been doing this since 2009, its entire book of business has almost turned over and about 80% of the credit risk that it would require on its entire guarantee portfolio has been put into investors' hands.

At this time, the Single-Family business is following a similar path, but it only began in 2013 and deals with a larger and more complex guarantee business. New flows of single-family mortgages have, for the last few years, had about 60% of their mortgage credit risk passed through to private market investors; but with further development of the transactions to transfer such risk, we have now just begun to do transactions that pass through 80% to 90% of the risk. On the entire book of single-family business, about 25% of all capital required to support credit risk has been laid off to private market investors, with this ratio expected to grow by close to 10 percentage points a year. This means, on present trends, it will reach the roughly fully-converted status our Multifamily business has attained in just five years or so. And by that time, Freddie Mac plans to transfer in the range of 75% of the credit risk on its entire book of both single-family and multifamily mortgages to a diversified set of private investors.

By using CRT, we have increased returns to taxpayers

In conservatorship, there is a fundamental question to be asked: *Is the taxpayer earning a good return on its support of the company's risks through the PSPA?* There is much focus on whether draws under the PSPA occur and how much money we have paid Treasury above the amount we borrowed – $112.4 billion paid on $71.6 billion borrowed to date. However, there is also the question of whether the underlying profitability of the company is adequate compensation to the taxpayer for the risks taken. This question will also be very important to policymakers as they

contemplate housing finance reform because it directly relates to the key question of whether sufficient private capital can be raised on reasonable economic terms to re-privatize the companies or their activities, in whole or part.

In both cases, CRT is a key tool by which Freddie Mac has raised the returns it earns on its risk. Simply put, for good and long-standing fundamental reasons, private capital markets investors of many types have a lower investment return hurdle than a large, leveraged and systemic-sized financial institution such as Freddie Mac. As a result, a pool of mortgage loan guarantees has a return on the remaining risk after CRT that is higher than prior to the transaction – because the G-Fees paid away to CRT investors is proportionately lower than the amount of risk being reduced. As a result, the returns on our remaining retained risk rise, to the point where it is our belief that the taxpayer is currently getting a *good and reasonable return* on the support they provide to Freddie Mac.

To earn less than a reasonable return means the taxpayer is implicitly subsidizing our operations on an ongoing basis, rather than just being a backstop in an extraordinary distressed situation. Given our financial performance of late, with returns bolstered by CRT, there is no significant implicit ongoing subsidy of this type by the taxpayer, and the PSPA is only functioning as a distress market backstop.

CRT may lead to lower Guarantee Fees

Third, focusing on single-family guarantees, CRT allows us to finance those guarantees at a lower cost than would otherwise be the case. So, in the long run, Guarantee Fees can be lower than they otherwise would be in almost all market situations. That obviously is a major potential benefit of switching to a CRT-based business model.

Realities and limitations of CRT

There are three additional points to be made to fully understand, at a policy level, the realities and limitations of CRT, especially in the single-family business which is, I have found, the overwhelming focus of policymakers.

First, credit risk transfer has a cost which can be acceptable or not. We pay part of our G-fee to investors for them to take the risk. At all times, we need to ensure that the cost is not too high. To pay too much would be, in conservatorship, a case of taxpayers paying private markets too high an amount to reduce their exposure to our risks – and that would not be a good thing. Using the CCF, we always ensure that the cost of such risk transfer is economic and a good deal for the taxpayer. Since

Freddie Mac began the program five years ago, excepting a few pilot transactions, the cost to the taxpayer has always been properly low.

Second, in most CRT transactions, the private market provider of the risk transfer - usually a capital markets investor or an insurance company - does not take on the risk of non-payment directly from the borrower. Instead, Freddie Mac incurs the credit loss first, and the provider of the risk transfer must then reimburse us for the loss. (This structure is necessitated in order to leave in place, in the single-family guarantee business, the existing pass-through MBS business model with the associated TBA market, which is a key policy goal.) Thus, there is a risk that such CRT transactions will be ineffective if Freddie Mac does not receive such reimbursement, on time and in full, as required by the transaction documents – which can be many years, even decades in the future.

Thus, in order to be of any practical value, a CRT transaction must have a structure where the certainty of the performance of that reimbursement in full and on time is nearly certain. Without such near certainty, the CRT is really just "on paper" and not a true transfer of risk. In the most common CRT transaction, Freddie Mac ensures that near certainty by, at the outset of the transaction, obtaining cash or cash equivalents equal to the maximum amount it could be reimbursed; unused amounts are returned to the CRT counterparty at the final maturity of the transaction. (Such cash may also be held by a trustee on our behalf.)

Freddie Mac will only enter into CRT transactions where there is a near certainty of on-time and in full reimbursement, as a classic safety and soundness matter and also to protect taxpayers from exposure to our risks. The Financial Crisis demonstrated that such mechanisms had not been properly developed in the past (in particular with respect to mortgage insurance), with consequent major losses to the company, and so it is now understood to be an on-going requirement in the future.

And third, CRT is still an evolving field. The specifics of our transactions are constantly evolving to appeal to more types of investors, to be more efficient and certain and to lower costs. There are also specialized accounting requirements to be addressed. For Freddie Mac, it is most of the way to being fully mature in the Single-Family business – and closer every year. CRT is substantively fully mature in Freddie Mac's Multifamily business.

In summary, working with FHFA, we addressed the four major deficiencies of the historic GSE system while in conservatorship. In this sense, we have provided a template that policymakers may wish to consider using in creating the future system.

III. FREDDIE MAC HAS INNOVATED TO IMPROVE THE EFFICIENCY AND SAFETY AND SOUNDNESS OF THE MORTGAGE FINANCE SYSTEM

Freddie Mac also has undertaken a number of efforts, working with FHFA, to help improve the efficiency and safety and soundness of the portion of the housing finance system that sells mortgages to the GSEs. These efforts fall broadly into two categories: those led by FHFA as conservator and those developed by the GSEs through competitive innovation. Below are illustrative examples of both categories. The ultimate intended beneficiaries of our initiatives are borrowers (who can enjoy cost savings and/or improved service from greater efficiencies) and taxpayers (who face reduced risk of loss in a safer and sounder system).

FHFA-led efficiency and safety and soundness initiatives

Representations and warranties (R&W) reform. One housing finance system weakness revealed during the Financial Crisis was a very poorly designed R&W system. It allowed poor quality mortgage "manufacturing" to go undetected for years, and was addressed only after a loan went into default. Once this was broadly understood, lenders viewed it as a source of additional – and unnecessary – risk in the mortgage lending process. In response, lenders selling loans to the GSEs created "overlays" (additional requirements on top of GSE requirements), which restricted their usage of the full credit boxes of the GSEs and reduced lending. Working with FHFA, Fannie Mae and the industry, we made significant improvements to our R&W framework. Today, the quality of loans sold to us is very much improved, based partly upon frequent quality-control review feedback the GSEs provide to customers.

Additionally, early or even immediate relief from liability for breach of certain representations and warranties provides lenders with much greater certainty that the loans they sell to us meet our requirements. This, in turn, has dramatically reduced overlays, and the mortgage banking marketplace now broadly utilizes the full credit boxes of the GSEs. That is particularly helpful in our responsibly to meet affordable lending goals.

Mortgage data standardization. Since May 2010, at FHFA's direction, Freddie Mac and Fannie Mae have been working to standardize information and data provided by the mortgage industry. This was a visionary initiative led by FHFA, which recognized that the mortgage finance system lagged other parts of the financial system in terms of both efficiency and innovation. The initiative mandated standard datasets for both mortgage origination and other key parts of the mortgage process, including servicing. It also mandated electronic instead of paper-based

transmission to the GSEs. This boosts industry efficiency, improves the quality of data for the GSEs and lenders, and provides greater clarity and certainty for loan purchases. It also provided the basis for many GSE-led efficiency initiatives, as noted below.

Competitive innovation-led efficiencies

Freddie Mac competes for the business of its lending customers, mainly with Fannie Mae but also broadly with others. And as in other industries, this competition has been the source of innovation, based heavily on advances in data and technology. It ultimately can lead to improved service to borrowers at lower cost. Furthermore, losses suffered during the Financial Crisis and the Great Recession have made Freddie Mac keenly aware of the risks we face, and much of our innovation is explicitly intended to reduce those risks and thereby protect taxpayers.

Loan Advisor Suite. Freddie Mac's Loan Advisor Suite (LAS) is a set of integrated software applications that help lenders originate high quality mortgages for sale to Freddie Mac. It includes tools for underwriting new loans, evaluating risks on existing loans, valuing collateral, pricing loans, tracking R&W relief on loans, and post-funding quality control. These tools are designed to substantially increase operational efficiencies, to reduce origination costs to lenders by, we roughly estimate, up to $1,000 per loan, and can enable many loans to be closed in as little as 15 days or less. In a competitive market, these savings eventually should pass through to borrowers.

Automated Collateral Evaluation. Last year, Freddie Mac launched an online digital tool that offers an automated appraisal alternative for us to employ in our risk analysis when consumers are buying homes or refinancing existing mortgages. Our Automated Collateral Evaluation (ACE) tool assesses the need for a traditional appraisal by leveraging proprietary models, data from multiple listing services, public records as well as a wealth of historical home value data. For a modest percentage of loans, ACE determines that a traditional appraisal is not needed because the automated valuation of the collateral provides equal or improved accuracy. In these cases, borrowers can save roughly $500, and closing times can be reduced by up to 7-10 days. Based on the expected percentage of times a traditional appraisal is waived, applied to our entire book of business as it turns over, we estimate borrowers in the aggregate could save between $500 million and $1 billion.

IMAGIN mortgage insurance pilot. Freddie Mac's recently launched Integrated Mortgage Insurance (IMAGIN) pilot features an enhanced form of Charter-compliant mortgage insurance on high-LTV loans. Insurance coverage is provided by an

affiliate of the country's largest mortgage insurer, with reinsurance provided by a panel of Freddie Mac-chosen and -approved insurers and reinsurers. IMAGIN addresses several structural weaknesses with traditional mortgage insurance that pose significant risks to Freddie Mac and thereby taxpayers. It does this by:

- **Reducing wrong-way risk** (i.e., a mortgage monoline GSE being insured by a mortgage monoline mortgage insurer, so that the MI will be under stress just when needed most by the GSE), by attracting additional and more diversified sources of private capital.

- **Improving safety and soundness** in two key ways:
    - Reducing counterparty risk by enabling us to fully control with whom and in what amounts we run the risk that monies due us under the insurance policies might not be paid in full and on time.
    - Increasing the certainty of being paid for insured losses (via collateralization, prohibiting independent MI rescissions and denials), by having the insurers agree to use our standards for payment of claims.

- **Primary market lenders also benefit** under IMAGIN versus traditional MI.
    - Lenders will be more willing to lend to low-down-payment borrowers, due to the certainty of coverage being higher.
    - IMAGIN also reduces costs to lenders by eliminating duplicative loan document and data submissions to MIs.
    - And by not allowing selective MI pricing discounts for large lenders, IMAGIN supports a level playing field for community banks and other small lenders.

I have heard concerns that our work here amounts to "Charter creep" or "expanding our market footprint." In reality, each and every one of our efforts is consistent with the letter and the spirit of our Charter, a fact confirmed by FHFA. Moreover, each goes through an extensive FHFA review process that takes months and sometimes years. Once approved, FHFA closely supervises to ensure that innovations are carried out in a safe and sound manner and remain foursquare within the bounds of the Charter.

These reviews are also designed to ensure that our initiatives serve good public policy. We do not undertake, and in my experience the FHFA does not approve, initiatives which are primarily aimed at enhancing our bottom line by utilizing privileges we have but which are not available to private market competitors.

IV. HOUSING FINANCE REFORM

The Committee asked for my thoughts on housing finance reform. My role and that of my colleagues at Freddie Mac in such efforts is to be a technical adviser to policymakers and others in the policy community. As the members of the Committee know all too well, this is a highly complex issue that ultimately requires policymakers to make a series of social, economic and political tradeoffs. There is no technically "right" or optimal solution. There are, however, solutions that, in their basic design or specific details, have key features:

- A good likelihood of operational success, where the intended results actually occur as promised and intended,
- A transition to the new system which does not cause undue disruption or collateral damage to homeownership and financing, and
- "Unintended consequences" are minimized.

I respectfully offer three suggestions to help inform Congress's deliberations.

Be reasonably certain reform will work as intended. This requires thoroughly examining (1) the objectives for a reformed housing finance system proposal, (2) exactly how those objectives will be met and (3) the reasonableness of the underlying assumptions. For example, if one objective is to place private capital in a first loss position ahead of a government guarantee, a number of questions need to be answered. These include how capital is defined, how much capital will be required and who sets that requirement, where does that capital come from, what is the cost and terms on which it will be provided (and what is the resulting impact on Guarantee Fees), whether the capital is sufficient to enable mortgage demand to be met, and how much it be available at various stages of the economic cycle. These types of critical design questions, in my view, have not been fully addressed by most of the reform proposals I have seen. Any reform that does not clearly answer questions such as these, or relies on unsubstantiated or overly optimistic assumptions, has a substantial risk of not working as intended. Reform needs to work in practice, not just in theory.

Minimize the potential for disruption or collateral damage to homeownership and housing finance during the transition. Not only do policymakers need to decide where they want to go, they also must carefully consider how they plan to get from here to there, and what obstacles they might encounter along the way. In general, the greater the number, scope and breadth of changes policymakers make to the current housing finance system, the greater the risk that the current system

performs poorly during a transition, which is likely to take several years at a minimum. Successful reform depends on the current system functioning well until a new one is in place. Similarly, it will take time to provide clear "rules of the road" to would-be participants in a reformed system, whose willingness to invest or otherwise commit to the new system will be critical to the success of any reform effort. Simply put, you can build it, but without clear rules, they may not come, and it also will be very hard to predict how and when they will come.

Policymakers also should recognize that the success of any reform approach will be tied in part to maintaining the functionality of the current system throughout the transition. You cannot decimate the current system to create the new system – for example, taking away key operational assets – and expect the current system to run well (or at all) until the new system is functional and investors arrive in sufficient number, a process likely to take many years.

Build on the progress achieved during conservatorship. In the earlier years of conservatorship, mortgage reform proposals were oriented toward a "clean sheet of paper" approach. However, all such proposals so far have been stymied by a variety of concerns, including (1) the difficulty of going from a high-level idea to the actual detailed mechanics, with consequent loss of confidence that it could be implemented without undue collateral damage or that it would work as intended and (2) the realization by many industry participants, especially smaller mortgage lenders, that a "clean sheet of paper" approach would be very risky for their business models and potentially to homeownership as well.

Today, from my position in the housing finance system, it appears that business people who make a living in the mortgage industry, their trade associations and many other stakeholders increasingly favor the incremental or "evolutionary" approach of keeping what works or has been already reformed, and fixing the remaining problems with the system. As detailed above, a great deal of reform has taken place during the past 10 years, addressing many of the weaknesses of the GSEs and the overall housing finance system. Building on these successes makes the task of legislative reform easier to achieve because a major portion of the work has already been done. It also increases the likelihood that reform will work as intended, while minimizing the potential for disruption.

I believe that the following reforms, many of which have already been developed by the FHFA and the GSEs during conservatorship, are among the key elements necessary to make the housing finance system function smoothly while minimizing both costs for the borrowing public and risks for taxpayers:

- Strong, modernized and SIFI-consistent risk-based minimum regulatory capital requirements
- CRT based upon sound economics and risk management, rather than non-economic statutory requirements
- A functioning common securitization platform supporting a single security
- Limits on the retained portfolios (in part, through limits on approved assets)
- Level G-Fees across lender sizes and volumes
- Uniform (i.e., standardized) data requirements
- Robust cash windows
- A responsible regime for financing low-down-payment mortgages that is safe and sound as well as cost efficient.

CONCLUSION

In closing, those of us tasked with improving the GSE system while it is in conservatorship have made extraordinary progress over the past ten years. The decision not to pursue a status quo conservatorship, but an active reformist one that advances the U.S. housing finance system, has been a major success in my view.

Speaking from my position as CEO of Freddie Mac, we addressed the major weaknesses of the old system and enhanced the efficiency of the market. We did that within the four corners of our Charter and invariably in service of our mission of increasing liquidity, providing stability and promoting affordability in America's primary mortgage markets.

However, as my testimony should make clear, this was not a solo activity. The mortgage lenders (who are our customers) and the broader mortgage industry were involved. Most of all, we did it working closely with, and under the supervision of, the FHFA as our conservator and regulator. That includes numerous FHFA staff and spans multiple agency directors. And none of this would have been possible without the capital support provided by taxpayers through the U.S. Treasury. We always remain mindful of this and have sought to be good stewards of that support.

As you debate the future of housing finance reform, I respectfully suggest that policymakers seriously consider incorporating into legislation the truly *non-partisan and professional* progress achieved during conservatorship – and the benefits it has created for borrowers, renters, lenders, investors and, most of all, taxpayers.