

TESTIMONY OF PATRICIA L. COOK

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before the

**Committee on Financial Services
United States House of Representatives
May 22, 2008**

Chairman Frank, Ranking Member Bachus, members of the Committee.

Good morning. My name is Patricia L. Cook, and I am Executive Vice President and Chief Business Officer at Freddie Mac. Thank you for inviting me here today to testify on recent developments in the jumbo mortgage market.

Just over three months ago, on February 13, the President signed the Economic Stimulus Act of 2008. The Act included a temporary increase in the dollar limit for mortgages that Freddie Mac, Fannie Mae, and the Federal Housing Administration could purchase or guarantee from \$417,000 to a maximum of \$729,750 in high cost areas. The credit market crunch had made it difficult or impossible for borrowers in areas with high house prices, like parts of California, to get mortgages. Congress's expectation was that by allowing the GSEs and the FHA to participate in this market, mortgages in expensive areas would become more available and rates would drop.

Congress was right, and three months later, I am pleased to say that this expectation is being realized. The GSEs are becoming active buyers of "agency jumbo" mortgages, providing liquidity and driving rates down close to or at rates for ordinary conforming mortgages. As a result, mortgage money is beginning to flow into high-cost areas.

Freddie Mac's Response to Dislocations in the Mortgage Markets

The dislocations in the jumbo market were part of the larger turmoil in the credit markets generally. Because our statutory mission is to provide liquidity, stability and affordability to the nation's residential mortgage market, I want briefly to offer some context to describe how Freddie Mac is doing its part to help steady the entire conforming market before I discuss our actions in the new agency jumbo sector.

As the housing crisis of the past year has unfolded, Freddie Mac has remained a steadfast source of liquidity and stability to the mortgage markets, even as other sources of mortgage credit dried up.

- First, we use all the tools provided by our charter to maintain the liquidity, stability, and affordability of the entire conforming conventional mortgage market. This is the basic purpose for which Congress created us;
- Second, for delinquent mortgages we own, we are helping troubled borrowers avoid foreclosure and keep their homes; and
- Third, we are extending the liquidity and stability we bring to the conventional conforming market to the agency jumbo sector as Congress anticipated in the Stimulus Act.

1. Support for the Conventional Conforming Market

Since the housing crisis began in earnest last summer, we've seen an unprecedented drying up of liquidity in some sectors of the nation's mortgage markets – and a subsequent credit crunch that threatens to drag the entire economy into recession. The conventional conforming market supported by Freddie Mac and Fannie Mae has remained (with the government-insured sector) the only well-functioning segment of the market, and long-term fixed-rate conforming mortgages are still widely available and rates are low. Since the market downturn in this summer, the two GSEs have supplied \$900 billion in prime market liquidity, and conforming market borrowers have typically paid a full percentage point less on their mortgages than other borrowers. In the first quarter of 2008 alone, Freddie Mac and Fannie Mae guaranteed about 80 percent of all newly-originated conventional conforming mortgage debt – up from only 39 percent two years ago.

Let me offer one recent example of how we have been able to keep mortgage money flowing and rates low. In March, investors concerned about overall market conditions flocked to the safety of Treasury securities, causing mortgage spreads to comparable Treasuries to widen and mortgage rates to rise. We were able, however, to use our retained mortgage portfolio to sustain the demand for mortgages by entering into commitments to buy more than \$43 billion of mortgage securities. (OFHEO helped by removing its portfolio limits and releasing a third of our target capital surcharge.) The result was that rates on 30-year fixed rate conventional conforming mortgages actually fell to below 6 percent by the end of March. Our use of the portfolio to sustain demand and stabilize markets mirrored how we used the portfolio to ensure liquidity and stability in response to the market turmoil caused by the 1998 Russian debt crisis and the collapse of Long Term Capital Management – with the same benefits to borrowers.

I would also like to say a word about the price and credit quality of new mortgage originations, which I know has raised some concerns. To guard against the problems that led to the current crisis, in which risk was often seriously under-priced, almost every mortgage lender – not just the GSEs – has tightened credit standards and raised prices to better reflect the risks of lending mortgage money in uncertain times. While no one wants to see prices go up in times of strain, in perspective our price increases are quite modest.

2. Foreclosure Avoidance

This is the most difficult housing market we have seen in decades. Unfortunately, it seems clear that house prices have not yet reached bottom, especially in some hard-hit parts of the country. Even so, most of the mortgages we guarantee continue to perform very well relative to the rest of the market – only 0.77 percent of mortgages we guarantee were 90 days or more delinquent at the end of the first quarter of 2008 – but some borrowers do get into trouble.

When a borrower does become delinquent, however, we try hard to keep the family in their home. This is usually in the borrowers' interests and the interests of his or her neighbors and community. It is also in our interest, because foreclosures are expensive to all concerned.

We require our servicers to explore foreclosure avoidance measures with every delinquent borrower. We know from experience that the earlier the mortgage servicer starts to work with a delinquent borrower, the more likely the borrower is to be able to avoid foreclosure. For this reason, we emphasize early and frequent intervention with delinquent borrowers, as early as the first missed payment.

We reinforce this behavior by providing financial incentives to our servicers – per loan fees for completing repayment plans, modifications and other foreclosure alternatives – about \$12 million last year. These fees are in addition to the normal servicing fees we pay on each of the mortgages we own. We absorb these fees ourselves rather than pass them on to families who are already in financial trouble. We want every workout to be sustainable in the long run.

In 2007, we worked out approximately 50,000 mortgages – nearly 1,000 a week. This is more than twice as many loans as we were forced to foreclose. Even with worsening market conditions, we still expect workouts to substantially exceed foreclosures this year.

3. Freddie Mac's Activity in the Agency Jumbo Market

When Congress temporarily raised the dollar limit for mortgages in high-cost areas in February, the private investors who had typically financed the jumbo mortgages had largely abandoned the market. As a result, jumbo mortgages had become very expensive or even unavailable, creating significant hardships for borrowers in areas with high house prices.

Congress's decision to bring the GSEs into a part of the jumbo market is proving to be a remarkable success. The government, the GSEs and the FHA, and the primary market all responded very quickly to this emergency, given the complexity of the task. For Freddie Mac, the jumbo market was completely off limits under the law. We know the

conventional conforming market intimately because we have spent nearly 40 years developing our expertise and business systems, designed to manage to a single, national loan limit. The Stimulus Act asked us (and Fannie Mae and the FHA) to buy or insure mortgages with higher dollar amounts, different credit and performance characteristics, and from different borrowers than allowed before February, but only on a temporary basis.

We are beginning to see strong results. They have not been instantaneous, but have occurred very fast when you consider how big and complex a task this was. Here is the chronology:

- On February 13, the President signed the Stimulus Act, raising the loan limits for high-cost areas;
- On March 6, HUD identified 224 eligible high-cost areas, and OFHEO calculated the applicable loan limit for each of the 224 areas;
- Just six days later, on March 12, we announced credit terms and pricing on agency jumbo loans that met our credit specifications, which told the market that we had the capability and intention of buying these loans;
- In early April, we entered into commitments with several customers to buy portfolios of existing jumbo mortgages;
- On April 17, we announced that we expected to be able to buy \$10 - \$15 billion of new agency jumbo mortgages originated before the end of the year; and

Our April 17 commitment had the most dramatic impact. By putting a “bid in the market,” we increased liquidity; the bid meant that our customers not only knew that we would buy these mortgages, but also what price we would pay for them. Within a short time, we saw rates on eligible mortgages offered by some lenders drop as much as three-quarters of a percent from late March, to only about half a percent above rates for comparable non-agency jumbo mortgages. Now, many lenders are able to offer rates on high-quality agency jumbo mortgages that are a full percent less than other jumbos, and only about 20 basis points above non-jumbos, at the low end of historical spreads in stable market conditions. We expect this pricing will be the market norm for the agency jumbo mortgages through the end of the year.

These benefits do not accrue to all jumbo mortgages. One hard truth that the crisis has reinforced is the need for prudent credit standards. Freddie Mac wants the mortgages we finance to be sustainable for the borrower over the long term. We retain the credit risk on these mortgages; we do not use the Wall Street “originate to distribute” securitization model. So we purchase only agency jumbo loans that meet our current credit requirements for all mortgages. We buy only fixed-rate agency jumbo mortgages and certain conservative “hybrid” ARM products. Borrowers have to document their income and assets – no NINAs or SISAs. Maximum LTV is 90 percent of current appraised value for creditworthy borrowers.

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Of course, not all mortgages exceeding \$417,000 are eligible for sale to the GSEs. Rates on jumbo mortgages we cannot purchase, when they are available at all, will probably continue to be much higher than on mortgages that we will buy. Rate surveys do not make this distinction yet, which may be one reason that the public has not noticed lower agency jumbo prices until the press very recently began to report on their availability. Because it can take up to 90 days to close on a mortgage, volumes are still low, but will grow over time in response to increased availability.

Lower jumbo rates will become more widespread and durable as liquidity increases. At this time, there is no efficient securitization execution for agency jumbo mortgages because they are ineligible for inclusion in TBA (“To Be Announced”) mortgage securities and are therefore less liquid than mortgages at or below the permanent conforming loan limit. At the time the decision was made, we supported the exclusion, because the increase was temporary and because we did not want to risk damaging the liquidity of the entire TBA market, and possibly raising rates for all borrowers.

We are nevertheless able to support the agency jumbo market because we can use our retained portfolio to buy and hold agency jumbo mortgages. We are able to price more aggressively than if lenders had to sell securities into a less liquid mortgage market. In the long run, this is not sustainable, and if Congress decides to permanently increase the conforming loan limits, loans meeting the higher conforming limit will need to become eligible for TBA securities. If agency jumbo loans were made fully TBA-eligible, it would broaden the liquidity and depth of the bid for these mortgages. In the meantime, the GSEs’ ability to buy these loans for our portfolios has allowed liquidity back into the market and brought rates down.

Under the Stimulus Act, the higher loan limits are temporary. The benefits the GSEs have brought to the agency jumbo market will end for loans originated after December 31, unless Congress makes the increase permanent. That is for Congress to decide, and we will operate within whatever parameters it establishes. Without an extension, however, after the first of the year the affordability and availability of jumbo mortgages will depend on the willingness of Wall Street and depositories to fund them. If these investors return to the market, jumbo rates will still be more expensive than conforming mortgages but probably at premiums more closely resembling the historical 25 – 50 basis point spread. As we have seen over the past year, however, Wall Street is not nearly as reliable as the GSEs in times of market disruptions, and at some point the jumbo market could revisit the dislocations of 2007 – 2008.

I want to add a final, related point. On Tuesday, the Senate Banking Committee approved permanent loan limit increases for high cost areas of up to 132 percent of the ordinary conforming limit, to about \$550,000. This is considerably lower than the limits in the Stimulus Act. Since the effective date of the Senate bill is immediate, if passed it will create great short-run uncertainty in the marketplace because of the lower loan limits

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in the bill as compared to the Stimulus Act. This could undo most of the benefits that we describe above.

The Senate Banking Committee's bill also prohibits us from holding these mortgages in our retained portfolio, either in whole loan or securitized form. In the long run, the portfolio prohibition would create an inferior class of conforming mortgages, damaging liquidity, increasing prices, and posing difficult operational issues for the market. One key to the liquidity of the conforming market is the back-stop bid the GSEs provide for mortgages, especially in periods of market dislocation like the present. The Senate bill would eliminate our capability to offer that bid, with the probable result that they would almost certainly not be TBA eligible. It could return us to situation that existed before the Stimulus Act was passed.

I hope my testimony has been helpful, and thank your for the opportunity to appear before the Committee.