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℠.[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

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[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. Fre*ddie 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]

[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.

[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.

[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 (Follows)

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 THEOFFICER 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 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

Notes:

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.

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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.

Appendix C (Follows)

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)

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[SM] 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***

Contacts

Global Debt Marketing:
Jon Prince, Managing Director
Susan Thomas, Director
Denise de Bombelles, Manager

Global Funding Desk:
Jerome Lienhard, Senior Vice President, Global Funding
Louise Herle, Vice President & Treasurer

John Radwanski, Senior Director, Short-Term and Structured Debt

Corporate Communications:
Gisela Vallandigham, Director

Legal:
Michael Fox, Attorney

Freddie Mac

We Open Doors®

FREDDIE MAC
DEBT SECURITIES
MARKETING
8200 Jones Branch Drive
McLean, VA 22102
USA
703.903.3700
www.freddiemac.com/debt