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FASB DERIVATIVE ACCOUNTING STANDARDS

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCE, TRADE, AND CONSUMER PROTECTION

OF THE

COMMITTEE ON ENERGY AND
COMMERCE
HOUSE OF REPRESENTATIVES

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FASB DERIVATIVE ACCOUNTING STANDARDS

TUESDAY, JULY 22, 2003

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON COMMERCE, TRADE,
AND CONSUMER PROTECTION,
Washington, DC.

The subcommittee met, pursuant to notice, at 2 p.m., in room 2123, Rayburn House Office Building, Hon. Cliff Stearns (chairman) presiding.

Members present: Representatives Stearns, Bass, Schakowsky, Markey, Davis, Stupak, Green, and Strickland.

Staff present: David Cavicke, majority counsel; Ramsen Betfarhad, majority counsel; Jill Latham, legislative clerk; Jon Tripp, deputy communications director; and Consuela Washington, minority counsel.

Mr. STEARNS. Good afternoon. The Subcommittee on Commerce, Trade, and Consumer Protection of the Energy and Commerce Committee, will come to order.

I welcome all our members and witnesses to the subcommittee's hearings on the Financial Accounting Standards Board, or as we know FASB, Derivative Accounting Standards. In particular, I wish to thank Mr. Baumann, Freddie Mac's Chief Financial Officer, for testifying this afternoon. I fully appreciate the fact that Mr. Baumann is limited in his ability to be responsive to all questions as Freddie Mac's restatement process is ongoing and not yet complete, and that Freddie Mac's restatement is subject to a number of investigations, including one by the SEC. I also welcome all the other witnesses, too.

The immediate trigger for this hearing was Freddie Mac announcing that it will restate its financial statements for the year 2002 to 2000, and that the restatement, to a great extent, was due to the misapplication of FAS 133, the 800-page FASB standard on accenting for derivative instruments and hedging activities. That misapplication, according to Freddie Mac's June 25 release, could increase retained earnings as of December 31, 2002, by between $1.5 to $4.5 billion.

Although the restatement in and of itself is a significant event worthy of a serious inquiry, it is however not the focus of this hearing, but the focus of a hearing after the release of Mr. Dowdy's report, the counsel retained by Freddie Mac's Board.

The purpose of this hearing is to explore the efficacy, helpful of course to the investors, of FASB's standard on accounting for derivative instruments in hedging activities. It is a standard providing

the investor with the transparency and disclosure to assess the economic impact of derivative contracts on a company. Does the derivative accounting and reporting standard enable the investor to compare financial statements of two similar companies based on their derivative positions? And essentially, my colleagues, the inquiry before the subcommittee is whether the standard is providing investors with meaningful and timely information about the impact of derivative instruments on a company's true economic condition?

Derivative instruments entail both significant benefit and risk for companies that have come to rely on them for managing the operating and market risk. This is significant considering that the cumulative value of derivative contracts outstanding today is in excess of $127 trillion. Freddie Mac and its first cousin, Fannie Mae, together hold over $1.6 trillion worth of derivative instruments as hedges against interest great risk.

These two government-sponsored enterprises are important case studies in the testing of the efficacy of accounting standards governing derivatives. They are important not only because of the sheer size of their derivative portfolio, but also because they play a key role in the vibrancy of our mortgage markets. The two combined either hold, trade, or guarantee over 50 percent of all conforming mortgages issued in this country and in securitizing mortgages provide greater liquidity to the mortgage markets.

The basic rule of FAS 133 is clear. All derivative instruments must be measured and recorded on the books, both income statement and balance sheet, at fair value. With that, the elegant simplicity of the rule ends. Multiple hundreds of pages are then devoted to the justification and explanation of "creative construct," called "special hedge accounting."

If a derivative instrument qualifies as a hedge, fluctuation in its fair value may be offset by changes in the fair value of the underlying hedge item, with a net effect on earnings being zero or nearly zero. Fannie Mae's financial 2002 statement is illustrative of the significance of special hedge accounting.

In 2002, Fannie Mae reported $4.6 billion in earnings under GAAP accounting, yet, a review of its annual fair value balance sheet shows that Fannie Mae lost billions of dollars in shareholder equity, nearly wiping out its earnings for that year. In correctly applying FAS 133, Fannie Mae used a special hedge accounting rule to defer the billions of dollars in lost shareholder equity to the future. Freddie Mac, on the other hand, in misapplying the FAS 133 rule, is expected to restate its earnings for the past few years upward by as much as $4.5 billion.

These are companies that are virtually in the same line of business encountering and applying FAS 133 with dramatically different results. Moreover, my colleagues, if two transactions such as two different hedging techniques bring about the same economic outcome, GAAP treatment of the two transactions should be similar, but in many cases are not.

This similar treatment is the objective that FASB should strive for to achieve through its standards, and I am not sure why today the accounting results of a transaction should deviate substantially from the economic results of the same transaction and, if we are wrong, perhaps our witnesses will explain that to us.

I understand that FAS 133, for example, is a stepping stone, an evolutionary step to a full fair value accounting for all derivative instruments. Such fair value accounting, in my view, will substantially reduce the difference between the accounting and economic results of the same transaction.

There are many good reasons for the special hedge accounting rules. Nonetheless, as I have advocated in the past, I think financial accounting standards should be free from special exceptions if such exceptions help obfuscate the real economic conditions of a company in the company's public financial statement.

And, last Congress, I, along with Chairman Tauzin, introduced a bill, H.R. 5058, seeking to establish general principles and objectives to be followed by FASB when establishing financial accounting reporting standards. I think FAS 133 and its application are an example of the need to have a more principle-based accounting system, free from special exceptions and undue complexity that, really, I don't think, serve investors well.

So, I look very much to the testimony of our witnesses and, with that, I call upon our ranking member for an opening statement.

Ms. SCHAKOWSKY. I want to thank Chairman Stearns for convening this important hearing today on FASB derivative accounting standards. Our subcommittee has an important responsibility to ensure that FASB's accounting rules provide clear and accurate information on the financial health of companies for workers, investors, and pension holders.

To their credit, FASB has a long history of working diligently to create clear accounting standards. Changes and innovation in our financial markets and political pressure have made this a daunting challenge. The expanded use of derivatives in our financial markets provides a clear example of just how difficult this challenge can be.

Derivatives, as we all know here, we are saying are trading instruments that are value-based on the price of another financial instrument like a bond or an exchange rate or an interest rate. Derivatives are popular in our financial markets because they enable companies and investors to diversify their portfolio and therefore reduce their exposure to risk.

The total value of derivatives outstanding is estimated by one of today's panelists to be $127 trillion, up from $3 trillion in 1990. In response to this market innovation, FASB went forward and worked to establish accounting rules for derivatives.

FASB began studying accounting for derivatives in September 1991. In 1996, after nearly 100 public meetings, unveiled a proposed standard that would require companies to account for derivatives in their quarterly statements based on their fair value. The sensible proposal was fiercely opposed by Federal Reserve Chairman Greenspan, Members of Congress, and nearly every major bank, securities firm, and insurance company.

In response to the proposal, some Members of Congress went as far as to introduce legislation that would have abolished FASB. I should note that Democratic Ranking Member Dingell was one of the few members who defended FASB. However, in the end, the opponents of the new standard overwhelmed FASB and, as a result, FASB's final rule known as FAS 133 created complicated standards that included over 500 pages of exception. The standard allowed

companies to distort their balance sheets and hide the true value of their derivatives.

I worry that a FASB attempt to clarify the rule will once again be overwhelmed by the same opposition and threaten to weaken the existing rule. I mention the history of FASB's derivative accounting rule to put today's hearing in its proper context.

Today we are going to explore Freddie Mac's accounting scandal. In January, Freddie Mac announced that it is restating its earnings from the past 3 years, and in June they dismissed their top three executives. The turmoil at Freddie Mac has put FASB's rule once again in the public spotlight. It has gotten the attention of Congress and the press because, as we all know, Freddie Mac is not just another company. Freddie Mac has a major impact on the housing market. This government-sponsored enterprise purchased $592 billion in mortgages in 2002, and helped finance homes for nearly 2.5 million low and moderate income families and families living in under-served areas.

It is in the best interest of our constituents to have a viable secondary housing market, and I am hopeful that Freddie Mac will emerge from this turmoil in a strong position. Their experience can help provide insight into how FASB derivative accounting standards are implemented in the marketplace.

Congress has responsibility to ensure that investors are protected, but I should note that at this point we do not know what happened at Freddie Mac, and we do not know its true impact on investors. In my estimation, this hearing is a bit premature. Freddie Mac has not yet restated its earnings. Freddie Mac's internal investigation has not been completed.

In June, Freddie Mac's Board of Directors hired the law firm of Baker Botts to conduct an internal investigation. I understand that their report is going to be released any day. Also, the FEC, the Office of Federal Housing Enterprise Oversight, and U.S. Attorney's Office are all investigating Freddie Mac's accounting and corporate governance as we speak. We will be in a better position to analyze Freddie Mac's accounting practices once the investigations have been completed. And so I hope that we will have another hearing once we gather more facts. I hope that as we continue to study FASB standards, we will take a closer look at how derivative accounting standards are used throughout our financial markets, not just at the GSEs, and I look forward to hearing the testimony of today's witnesses. Thank you.

Mr. STEARNS. Thank the gentlelady. The gentleman from Florida, Mr. Davis.

Mr. DAVIS. No statement, Mr. Chairman.

Mr. STEARNS. Then I think what we will do is we will go down and vote and recess the subcommittee, and I will be right back and we will start with our witnesses. The subcommittee is recessed.

[Additional statements submitted for the record follow:]

PREPARED STATEMENT OF HON. BARBARA CUBIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WYOMING

Thank you, Mr. Chairman, for holding this hearing. It is an excellent opportunity to further familiarize ourselves with how derivatives are accounted for and will lay the foundation for future action taken on this matter.

I would also like to thank the distinguished panelists for coming before the subcommittee. Your insight today will serve to advance the discussion of accounting standards so the most appropriate and effective legislative solution may be reached.

We are not here today to point fingers in search of a financial scandal. In the fallout of Sarbanes-Oxley we need to be sure we are seeking transparency and not embarking on a perpetual witch hunt.

Instead, the existing circumstances that led to the need for an investigation should be the focus of our discussion today. We must continue to analyze accounting standards and in particular FAS 133.

The factors in this debate are complex and numerous. The questions we must ask can be dizzying, and I suspect the answers will not differ. Is this particular rule doing more harm than good? By providing companies with complex flexibility in their compliance with FAS 133, is the purpose of this rule negated altogether? The fair value rule is established in twenty pages, but the next several hundred pages outline the flexibility afforded to companies in complying with the rule.

I look forward to the testimony and dialogue that will take place in order to obtain a better understanding of FAS 133, how it is used, what it communicates and how it can better serve its purpose. In the end, companies should be required to maintain and disclose accurate records while simultaneously being afforded the flexibility to communicate their potential to both investors and consumers without undermining public faith in our system.

I thank the Chairman again and yield back the remainder of my time.

PREPARED STATEMENT OF HON. W.J. "BILLY" TAUZIN, CHAIRMAN, COMMITTEE ON ENERGY AND COMMERCE

Derivatives are important financial instruments that provide companies opportunities to manage risk of core business functions. Derivatives can also be used as speculative instruments, creating the potential for enormous windfalls or losses for the parties to the contracts. Whatever the use, I think we all can agree that investors deserve to know the value of derivative contracts into which companies enter. Derivatives are no small part of business today—the total value of outstanding derivatives is estimated at more than $141 trillion through the end of last year. This is precisely what makes this hearing so important.

Today we are going to look at issues of accounting for derivatives. Federal Accounting Standard (FAS) 133 states that all derivatives should be accounted for at fair value. But this general rule is accompanied by a 500-page exception, known as special hedging rules. The special hedging rules enable companies to avoid recognizing gains or losses on certain derivatives in their income statements.

When looking at the application of FAS 133 by Freddie Mac and Fannie Mae, the comparability and transparency problems created by the special hedging rules become apparent. Both Fannie and Freddie are in the same business, they have the same charter, and they manage interest rate risk through derivative contracts. And both Fannie and Freddie use FAS 133 and its special hedging rules. Yet each comes up with a very different result. Freddie Mac has revealed that it made an error in its application of FAS 133 by treating certain derivatives as hedges when they should have been marked-to-market and reported in earnings. And while Fannie Mae's application of the special hedging rules is GAAP compliant, use of FAS 133 allowed Fannie to defer billions of dollars of losses to future years.

Do these results serve investors well? I ask our experts here today, should such similarly situated entities have such vastly different accounting results? If the special hedging rules were eliminated and all derivatives contracts had to be marked-to-market would comparability be enhanced?

I am certainly not coming down on the FASB here today—FAS 133 has much improved derivatives disclosure over the pre-1998 accounting models. I only suggest it does not go far enough. The examples of Fannie and Freddie force us to ask whether accounting standards for derivatives should be re-evaluated. As we address this question, I look forward to hearing from our distinguished panel. Thank you all for participating in this important hearing. I would also like to give a special thanks to Chairman Stearns. He has been a steadfast proponent of improving accounting standards and accounting disclosure. I thank him for his dedication to this issue. Mr. Chairman, I yield back my time.

PREPARED STATEMENT OF HON. HILDA L. SOLIS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. Chairman, thank you very much for holding this important hearing so that we may hear testimony from today's witnesses on the state of FAS 133 and the role its complexity may have played in the recent Freddie Mac restatement.

At the outset, Mr. Chairman, I want to say that it's very important we exercise oversight of our nation's housing GSEs.

However, we should not allow the reported accounting irregularities at Freddie Mac obscure the important role housing GSEs play in making affordable mortgage lending available to communities across the United States. Secondly, I do not want us to lose sight of the significant role housing has played in stabilizing our economy especially during this most recent economic downturn.

Housing GSEs were created to bring low cost capital to the housing market and it is a congressionally mandated obligation that, in my experience, they have done well.

Fannie Mae and Freddie Mac have harnessed their expertise in housing finance and greatly advanced access to low cost capital to millions of low and moderate-income Americans.

So I am eager to learn how these companies use derivatives to make lending more affordable to our constituents and how it is that FAS133 affects their mission.

I raise these matters because, at a time when we are all struggling for answers on how to get our nation's economy moving again, it is as important to focus not only on what needs to be fixed but also what functions well and should not be disturbed.

Mr. Chairman, we are here today to examine a singular aspect of the recent Freddie Mac restatement—and that is the role FAS133 played in that restatement.

I hope that we maintain that focus and sidestep the temptation to add to today's headlines at the expense potential long-term damage to one of the most robust segments of the economy.

On the specific subject of derivatives, I want to quote a portion of Alan Greenspan's testimony before the Senate Banking Committee, "What we have found over the years in the market place is that derivatives have been an extraordinarily useful vehicle to transfer risk from those who shouldn't be taking it to those who are willing to and are capable of doing so."

I think Mr. Greenspan's testimony is of particular relevance to us because it highlights that derivatives are used by any number of financial interests—not just GSEs—and also clearly indicates that their use spreads risk rather than concentrating it.

In closing, I look forward to hearing from these witnesses and learning how this Subcommittee, in guiding FAS 133, can help advance the missions of these companies.

PREPARED STATEMENT OF HON. ED TOWNS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Thank you, Mr. Chairman, for holding this second hearing on FASB issues this year. Your commitment to these issues is commendable. In particular, I am pleased the Subcommittee today has brought before us the issue of derivatives accounting standards. The complexity of these financial instruments seems to pale only when compared to the accounting for them. I, for one, look forward to the opportunity to discuss with the FASB witness and our other witnesses the fundamentals behind derivatives, and explore whether the way we ask companies to account for them is realistic and valuable to investors and other market players.

I am especially pleased that Freddie Mac is here today, given the company's recent prominence in the news on issues relating to accounting for derivatives and other hedges. It is timely that we hear from Freddie Mac regarding their use of these instruments and what pitfalls there may have been in accounting for derivatives. There may be lessons from this experience not only for Freddie Mac, but for other companies as well.

In that vein, while I have concerns about the accounting issues at Freddie Mac, I do want to be clear that I am not supportive of efforts to abolish Freddie Mac's charter. I support Freddie Mac's mission of improving affordable housing opportunities for the people of this country. Freddie Mac and Fannie Mae play a central role in the U.S. mortgage markets, which are the envy of the world. We must act carefully—even today—in assuring the capital markets that our examination is not a witch hunt, but a carefully measured analysis of derivatives accounting standards.

With that, I look forward to hearing from our witnesses. Again, thank you, Mr. Chairman.

PREPARED STATEMENT OF HON. GENE GREEN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Thank you, Chairman Stearns and Ranking Member Schakowsky, for holding this hearing on derivative accounting standards.

I applaud the subcommittee for its attention to this important issue.

I must note, however, that the timing of this hearing seems premature, if, as the Chairman has stated, we are here to examine the role that derivative accounting standards played in Freddie Mac's accounting problems.

The SEC, the DOJ, the Office of Federal Housing Enterprise Oversight and Freddie Mac's outside counsel are all conducting on-going investigations into Freddie's accounting practices.

Currently, all we know about accounting at Freddie Mac is what has appeared in the press and what Freddie Mac has told us: that company personnel made accounting errors in applying generally accepted accounting principles and that accounting policies were implemented to smooth earnings.

If we are here to draw policy conclusions from the accounting mistakes made at Freddie Mac, we should reserve judgment until the investigations are concluded and the results released. It is my hope that, at that time, the subcommittee will revisit this issue with respect to Freddie Mac.

In the meantime, I hope that the witnesses before us today can provide insight into the Financial Accounting Standards Board and, specifically, FAS 133.

My primary concern is that investors receive quality information about a company's financial situation, and I question whether the rule provides for an adequate level of transparency.

Furthermore, the complexity of this rule raises the question of whether it is applied in a consistent manner within and among companies. I am interested to hear from our witnesses if, in their opinion, the derivative accounting standards applied today open the door for confusion or misuse, and, ultimately, whether adherence to this standard paints the most accurate picture for investors concerning a company's financial health.

I thank the witnesses for appearing before us today and look forward to hearing their views on this issue.

Thank you, Mr. Chairman, and I yield back the balance of my time.

PREPARED STATEMENT OF HON. JOHN D. DINGELL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

I commend both Rep. Tauzin, the chairman of the full committee, and Rep. Stearns, the chairman of this subcommittee, for opening an inquiry in early June into the accounting problems at Freddie Mac, and for asking the Minority to participate in that inquiry. To that end, staff met with representatives of Freddie Mac on June 12, the Office of Federal Housing Enterprise Oversight (OFHEO) on June 16, the Financial Accounting Standards Board (FASB) on June 17, the Securities and Exchange Commission (SEC) on June 23 and on June 26, with representatives of the Baker & Botts law firm and FTI Consulting forensic accountants who are conducting the special investigation for Freddie Mac's board of directors (the so-called "Doty report"). The OFHEO and SEC inquiries had just begun. The committee staff has been unable to interview the PricewaterhouseCoopers accountants involved in the restatement or to review any board or accounting documents, nor have we received the Doty report yet. I look forward to these steps being completed so that we can make educated decisions on these matters and on what, if anything, these events may tell us about the efficacy of FAS 133, the accounting standard for derivative and hedge accounting.

While I welcome hearings on these issues, I believe today's hearing is premature. I am not convinced that we have the right witnesses before us. For example, Mr. Wallison's written statement spends roughly two pages criticizing GAAP accounting and the effectiveness of regulation in general, but all the rest of his testimony criticizes the substantive benefits and risks of the two housing GSEs and calls for (1) the privatization and breakup of Fannie Mae and Freddie Mac or (2) alternatively the constraining of their mortgage purchase and pooling activities, all matters outside the scope of our jurisdiction and the subject matter of this hearing.

FASB started studying accounting for derivatives and hedging in September 1991, and held 100 public meetings to discuss the complex issues in this project. FASB

and the SEC went forward respectively with proposed accounting and disclosure rules after several high-profile losses at companies and banks and municipalities caught investors, analysts, and regulators by surprise and pointed to the urgency and need for reforms. The main purpose of FAS 133 was simple: to get derivatives on the balance sheet at their fair value and present derivative gains as assets and derivative losses as liabilities.

The FASB and SEC met strong opposition from key Senators and Representatives, as well as the chairman of the Federal Reserve Board and the Comptroller of the Currency. Legislation was introduced in the Senate to authorize the bank regulators to exempt banks from any final FASB standard. Legislation was introduced in the House to make FASB an SRO under the SEC and require explicit SEC approval of all standards issued by FASB, impose a strict cost benefit analysis and burden on competition finding on all FASB proposals, and provide for immediate federal-court challenges of final FASB standards. The American Bankers Association, ABA Securities Association, International Swaps and Derivatives Association, Securities Industry Association, The Bankers Roundtable, and The New York Clearing House Association wrote a strong letter to FASB and the SEC labeling their proposals "a radical and disruptive change" and warned them to reconsider their plans. The Administration's nominee to head OFHEO was the chief lobbyist in the effort to tip over FASB and its proposal. Twenty-two banking, securities, insurance, and corporate executives, joined by Freddie, Fannie, and the Federal Home Loan Bank of Chicago also came together in strong opposition to the proposed standard. Twenty-three Members of the House Banking Committee wrote to FASB, urging it to consider alternative models for improving disclosure. I believe I was one of the few Members of Congress to write FASB in strong support of their goals and urging them to act promptly on this matter. Attached to this statement are copies of the aforementioned comment letters. In order to get a clear picture of FAS 133 practice, we need to look at what all of the major users are doing, not just at the GSEs.

Recent press reports, ("IASB 'to stand firm' following French attack," Financial Times, July 12, 2003) note that French President Jacques Chirac has written to the European Commission president in strong opposition to the International Accounting Standards Board's derivatives accounting reforms and pressing for concessions for the European banks that oppose the effort. The push toward international convergence means we have to take a broader look at this and other accounting issues. This also highlights the push toward principles-based accounting but I, for one, am skeptical about placing more reliance on the judgments of company managers and accountants who have betrayed the trust and confidence of the American public.

Finally, I commend Fannie Mae for successfully registering its common stock with the SEC in March of this year and, since then, for complying with all of its periodic reporting responsibilities to the SEC and to investors. I encourage Freddie Mac to complete its restatement so that it too can fulfill its commitment to become an SEC-registered company. This will not be a panacea, however. The GAO reported in its October 2002 report, *Financial Statement Restatements,* that the number of restatements by SEC-registered companies due to accounting irregularities had grown significantly—about 145 percent—from January 1997 through June 2002. Those 689 publicly traded companies lost billions of dollars in market capitalization as a result. The SEC faces a number of ongoing challenges in this regard.

I look forward to learning more about these matters. And I look forward to continuing my longstanding support for FASB and for high-quality and transparent accounting.

[Brief recess]

Mr. STEARNS. The subcommittee will reconvene, and I think we will start—Mr. Bass indicated he is going to waive his opening statement, so I think we will start with our witnesses, and we welcome all of them. Ms. Leslie F. Seidman, a member of the Financial Accounting Standards Board; Mr. Marty Baumann, Executive Vice President, Chief Financial Officer of Freddie Mac; Mr. Peter J. Wallison, the Resident Fellow of the American Enterprise Institute, and Dr. Thomas J. Linsmeier, Ph.D., CPA, at Russell E. Palmer Endowed Professor and Chairperson, Department of Accounting and Information Systems, Eli Broad College of Business, Michigan State University.

Let me welcome you, and I appreciate your patience. Ms. Seidman, I think we will start with you.

STATEMENTS OF LESLIE F. SEIDMAN, MEMBER, FINANCIAL ACCOUNTING STANDARDS BOARD; MARTIN F. BAUMANN, EXECUTIVE VICE PRESIDENT, CHIEF FINANCIAL OFFICER, FREDDIE MAC; PETER J. WALLISON, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE; AND THOMAS J. LINSMEIER, RUSSELL E. PALMER ENDOWED PROFESSOR AND CHAIRPERSON, DEPARTMENT OF ACCOUNTING AND INFORMATION SYSTEMS, ELI BROAD COLLEGE OF BUSINESS, MICHIGAN STATE UNIVERSITY

Ms. SEIDMAN. Thank you. I am Leslie F. Seidman, a Member of the Financial Accounting Standards Board. I am pleased to appear before you today on behalf of the FASB. I have brief prepared remarks, and I would respectfully request that the full text of my testimony and all supporting materials be entered into the public record.

Mr. STEARNS. By unanimous consent, so ordered.

Ms. SEIDMAN. The FASB is an independent private-sector organization subject to oversight by the United States Securities and Exchange Commission. Our independence from enterprises, auditors, and other constituents is fundamental to achieving our mission—to establish and improve standards of financial accounting and reporting for both public and private enterprises. Those standards are essential to the efficient functioning of the capital markets and the U.S. economy because investors and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make rational resource allocation decisions.

Beginning in the 1980's and continuing in the 1990's, as the use and the complexity of derivatives and hedging activities grew rapidly, many investors, creditors, and other users of financial statements were surprised and concerned by large unexpected losses on derivatives that were reported by several enterprises that had previously provided little if any information about those contracts in their financial reports.

Members of Congress, the SEC, the GAO, and the AICPA, as well as many investors, creditors, and other users of financial reports urged the FASB to develop and issue a standard that would provide comprehensive accounting requirements for derivatives and related hedging activities.

At the time, the existing standards applicable to the accounting for derivatives and hedging were incomplete. There were no specific standards for many types of derivatives and hedging activities. Where standards did exist, they were inconsistent. Where they did not exist, the practices that had developed varied widely. As a result, the financial statements of enterprises that used derivatives did not report their derivative and hedging activities in a way that users of those financial statements could compare or understand.

Following an extensive and open due process, described more fully in the full text of my testimony, in 1998, the FASB issued Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities.

Statement 133 requires that an enterprise report all of its derivatives as either assets or liabilities on the face of its financial statements and measure those instruments at their fair value.

Statement 133 also generally requires that any changes in the fair value of derivatives, or derivative gains or losses, be reported in the enterprise's earnings in the period of the change.

If, however, certain conditions are met, an enterprise may specifically designate a derivative as a hedge of a related item and receive special accounting for the combination of the derivative and the related item.

Hedge accounting reflects an entity's intended strategy between two separate items. Rather than applying the applicable standards to each component of the strategy, hedge accounting allows the entity to recognize the gains or losses on the derivative in the same period as the income statement effect of the hedged item. Entities engaged in risk management activities desire hedge accounting so that the income statement reflects the effect of their hedging strategies in the same period as the item being hedged. Because hedge accounting defers recognition of gains and losses on derivatives, numerous restrictive conditions must be met at the outset of the transaction and over the life of the transaction; these are called hedge criteria. The criteria differ, depending on the nature of the risk being hedged.

In general, a derivative may be specifically designated as a hedge of the exposure to changes in the fair value of an asset or liability, a fair value hedge, or as a hedge of the exposure to variable cash-flows of a forecasted transaction, a cash-flow hedge. The accounting for changes in the fair value, or the gains or losses, of the derivative differs depending on that designation.

For a derivative designated as hedging the exposure to changes in the fair value or price of an asset or liability, the gain or loss on the derivative is recognized in earnings in the period of change together with the offsetting loss or gain on the hedge item attributable to the risk being hedged. An example of a fair value hedge is the use of an interest rate swap to change the interest rate risk on a fixed-rate bond from fixed to floating. In a perfect hedge, hedge accounting will show net interest expense at the new floating rate. However, if the hedge is not perfect, the differences are required to be reported in earnings and, thus, are transparent to investors.

For a derivative designated as hedging the exposure to variable cash-flows of a forecasted transaction, the gain or loss on the derivative is initially deferred in a balance sheet account to the extent that the hedge is effective; the gain or loss is subsequently reclassified into earnings in the period that the related forecasted transaction affects earnings. An example of a cash-flow hedge is the use of an interest rate swap to change the risk profile on a floating-rate loan—the swap serves to lock in the interest cash-flows associated with the transaction. In a perfect hedge, hedge accounting will show net interest income at the new fixed rate. To the extent that the swap is not effective in offsetting the floating cash-flows on the loan, any ineffectiveness is reported in earnings immediately and separately disclosed.

An enterprise that elects to apply special hedge accounting is required to identify and document at the inception of the hedge (1) the specific items that are being hedged and the entity's risk management strategy; (2) the method it will use for assessing the effec-

tiveness of the hedging derivative, and (3) the measurement approach for determining the ineffective aspect of the hedge. Those methods must be consistent with the entity's overall risk management approach.

At the time Statement 133 was issued, the Board established a Derivatives Implementation Group of outside experts to assist the FASB in evaluating questions that companies might face as they began implementing the statement. More than 150 constituent questions have been answered through that effort.

In April 2003, the FASB issued an amendment to Statement 133 to clarify the scope of the statement and codify several issues that had been identified and resolved as part of the DOG process.

Consistent with its mission and Rules of Procedure, the FASB stands ready to consider any additional guidance or potential improvements to the accounting for derivatives and hedging activities.

Thank you, Mr. Chairman. I would be happy to respond to any questions.

[The prepared statement of Leslie F. Seidman follows:]

PREPARED STATEMENT OF LESLIE F. SEIDMAN, FINANCIAL ACCOUNTING STANDARDS BOARD

Chairman Stearns, Ranking Member Schakowsky, and Members of the Subcommittee: I am Leslie F. Seidman, a Member of the Financial Accounting Standards Board ("FASB" or "Board"). I am pleased to appear before you today on behalf of the FASB. My testimony includes a brief overview of (1) the FASB, (2) derivatives and hedging activities, (3) the basis for the Board's decision to develop and issue Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* ("Statement 133"), (4) the process the Board followed in developing Statement 133, (5) some of the key requirements of Statement 133, and (6) how the FASB has responded to requests for additional guidance and other improvements to Statement 133.

THE FASB

The FASB is an independent private-sector organization.[1] Our independence from enterprises, auditors, and other constituents is fundamental to achieving our mission—to establish and improve standards of financial accounting and reporting for both public and private enterprises.[2] Those standards are essential to the efficient functioning of the capital markets and the United States ("US") economy because investors and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make rational resource allocation decisions.

The FASB's independence, the importance of which was recently reaffirmed by the Sarbanes-Oxley Act of 2002 ("Act"),[3] is fundamental to our mission because our work is technical in nature, designed to provide investors and the capital markets with the most accurate possible yardstick to measure and report on the underlying economic transactions of business enterprises. Like investors, Congress and other policy makers need an independent FASB to maintain the integrity of a properly designed yardstick in order to obtain the financial information necessary to appropriately assess and implement the public policies they favor. While bending the yardstick to favor a particular outcome may seem attractive to some in the short run, in the long run an inaccurate yardstick (or a biased accounting standard) is harmful to investors, the capital markets, and the US economy.

The FASB's authority with respect to public enterprises comes from the US Securities and Exchange Commission ("SEC"). The SEC has the statutory authority to establish financial accounting and reporting standards for publicly held enterprises. For 30 years, the SEC has looked to the FASB for leadership in establishing and

[1] See Attachment 1 for information about the Financial Accounting Standards Board.

[2] See Attachment 2 for a discussion of the importance of the FASB's independence and neutral accounting standards.

[3] Sarbanes-Oxley Act of 2002, Public Law Number 107-204, Sections 108-109 (July 30, 2002).

improving those standards. The SEC recently issued a Policy Statement reaffirming this longstanding relationship.[4]

The Policy Statement, consistent with the language and intent of the Act,[5] also reemphasizes the importance of the FASB's independence described earlier. It states:

> By virtue of today's Commission determination, the FASB will continue its role as the preeminent accounting standard setter in the private sector. In performing this role, the FASB must use independent judgment in setting standards and should not be constrained in its exploration and discussion of issues. This is necessary to ensure that the standards developed are free from bias and have the maximum credibility in the business and investing communities.[6]

The SEC, together with the private-sector Financial Accounting Foundation,[7] maintains active oversight of the FASB's activities.

The FASB has no power to enforce its standards. Responsibility for ensuring that financial reports comply with accounting standards rests with the officers and directors of the reporting enterprise, with the auditors of the financial statements, and for public enterprises, ultimately with the SEC.

WHAT ARE DERIVATIVES AND HEDGING ACTIVITIES?

In general, a derivative is a contract between two or more parties that involves little or no up-front exchange of assets. The contract obligates one party to give up cash (or other assets) at some later date and entitles the other party to receive the cash. The amount of cash to be exchanged is often derived from two factors specified in the contract. Those factors are commonly referred to as the "underlying" and the "notional amount."

The underlying is a variable—usually a price index, an interest rate or interest rate index, a foreign exchange rate, or the price of a financial instrument or commodity. The notional amount is an amount of currency or a physical quantity (for example, a number of bushels or pounds). The product of the two (the underlying times the notional amount) determines the amount of cash to be exchanged. Some common examples of derivatives are options, swaps, forward contracts, and futures contracts.

Enterprises may use derivatives to hedge against or offset adverse changes in price or changes in cash flows. Derivatives also are used to seek extra returns, which is a form of speculation. Of course, a derivative usually is a two-edged sword. Many derivatives offer as much potential for loss as for gain.

WHAT WAS THE BASIS FOR THE BOARD'S DECISION TO DEVELOP AND ISSUE STATEMENT 133?

Beginning in the 1980s and continuing in the 1990s, as the use and the complexity of derivatives and hedging activities grew rapidly, many investors, creditors, and other users of financial statements were surprised and concerned by large unexpected losses on derivatives that were reported by several enterprises that had previously provided little if any information about those contracts in their financial reports.

Members of Congress, the SEC, the General Accounting Office,[8] the American Institute of Certified Public Accountants,[9] and many investors, creditors, and other users of financial reports urged the FASB to develop and issue a standard that would provide comprehensive accounting requirements for derivatives and related hedging activities.

At the time, the existing standards applicable to the accounting and reporting for derivatives and hedging activities were incomplete. There were no specific standards for many types of derivatives and hedging activities. Where standards did exist, they were inconsistent. Where they did not exist, the practices that had developed varied widely. As a result, the financial statements of enterprises that used deriva-

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[4] Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Exchange Act Release Nos. 33-8221; 34-47743; IC-26028; FR-70 (April 28, 2003).

[5] Sections 108-109; The legislative history of the Sarbanes-Oxley Act of 2002 is clear that the provisions of the Act relating to the FASB were intended to "strengthen the independence of the FASB . . . from . . . companies whose financial statements must conform to FASB's rules." Senate Report 107-205, 107th Congress, 2d Session (July 3, 2002), page 13.

[6] Page 5 of 8.

[7] See Attachment 1 for information about the Financial Accounting Foundation.

[8] United States General Accounting Office, Report to Congressional Requesters, *Financial Derivatives: Actions Needed to Protect the Financial System* (May 1994).

[9] AICPA Special Committee on Financial Reporting, *Improving Business Reporting—A Customer Focus* (December 1994).

tives did not report their derivative and hedging activities in a way that users of those financial statements could compare or understand.

Many enterprises reported only the current cash payments or receipts on their derivatives. For example, enterprises that were users of interest rate swaps usually reported only the amount of the next payment or receipt on the contract. Reporting only the next payment or receipt did not accurately represent the financial position of the users of the swap. If interest rates changed significantly following the initiation of the swap, one party could be expected to make relatively large future payments and the other could be expected to receive those payments. One party had an unrecorded asset and the other had an unrecorded liability.

Some of the other results of the incomplete and inconsistent accounting for derivatives were:

- Different enterprises reported very similar derivative activities differently, and even an individual enterprise could report similar activities differently.
- Gains and losses on derivatives used to hedge risks often were reported as liabilities and assets, rather than as income or expenses in the enterprise's income statement. Reporting an actual loss as an asset or a gain as a liability was misleading to the users of the financial statements.

WHAT PROCESS DID THE FASB FOLLOW IN DEVELOPING STATEMENT 133?

Because the actions of the FASB affect so many organizations, its decision-making process must be fair. The FASB carefully considers the views of all interested parties—users, issuers, and auditors of financial information. Our Rules of Procedure require an extensive due process. It involves public meetings, public hearings or roundtables, and exposure of our proposed standards to external scrutiny and public comment. The Board makes final decisions after carefully considering and analyzing the input of all parties. While this process is similar to the Administrative Procedure Act process used for federal agency rulemaking, it provides far greater opportunities for interaction with the Board by interested parties. It is also focused on making technical, rather than political or legal judgments.

Some of the highlights of the FASB's due process in developing Statement 133 are as follows:

- The Board began deliberating issues related to derivatives and hedging activities at public meetings in January 1992.
- The Board appointed outside experts who represented various points of views on the issues to a Financial Instruments Task Force ("FITF"). The FITF provided expertise, a diversity of viewpoints, and a mechanism for communicating with those who would be affected by any change to the accounting for derivatives and hedging.
- Between January 1992 and June 1996, the Board discussed issues related to the accounting for derivatives and hedging at 100 public meetings.
- In June 1996, the Board issued an Exposure Draft of a proposed standard.[10]
- Approximately 300 organizations and individuals responded to the Exposure Draft, some with multiple letters.
- The Board held four days of public hearings in November 1996. Thirty-six individuals and organizations testified. In addition, six enterprises participated in limited field tests of the provisions of the Exposure Draft.
- In December 1996, the Board met with the FITF to discuss the issues raised during the comment letter process and during the public hearings and field tests.
- The Board considered the comments and field test results during its redeliberations of the issues addressed by the Exposure Draft in 21 public meetings in the first 7 months of 1997.
- The FITF met again with the Board in April 1997 and discussed, among other things, proposed changes to the Exposure Draft reflected in a draft of the final Statement.
- In August 1997, a revised draft of the standards section of the final Statement and related examples was made available to the FITF and other interested parties for comment on the draft's clarity and operationality.
- The Board received approximately 150 comment letters on the revised draft and discussed those comments in 10 public meetings. Those comments led to additional changes to the requirements, intended to make the Statement clearer and more operational.

[10] FASB Exposure Draft, *Accounting for Derivative and Similar Financial Instruments and for Hedging Activities* (June 1996).

- The Board issued Statement 133 in June 1998.[11] As issued, Statement 133 was effective for all fiscal quarters of all fiscal years beginning after June 15, 1999, with earlier application encouraged.
- Following the issuance of Statement 133, some enterprises and auditors expressed concern about certain challenges they faced in applying Statement 133. Those challenges included organization-wide educational efforts and information system modifications that were made more difficult by the modifications and testing of systems to ensure their proper operation in the year 2000.
- On May 20, 1999, the Board issued an Exposure Draft that proposed deferring the effective date of Statement 133 for one year.[12] The Board received 77 letters of comment from respondents.
- In June 1999, the Board issued Statement of Financial Accounting Standards No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133* ("Statement 137").[13] Statement 137 deferred the effective date of Statement 133 to all fiscal quarters of all fiscal years beginning after June 15, 2000.

WHAT ARE SOME OF THE KEY REQUIREMENTS OF STATEMENT 133?[14]

Statement 133 requires that an enterprise report all of its derivatives as either assets or liabilities on the face of its financial statements and measure those instruments at their fair value.

Statement 133 also generally requires that any changes in the fair value of derivatives (gains or losses) be reported in the enterprise's earnings in the period of the change. If, however, certain conditions are met, an enterprise may specifically designate a derivative as a hedge of a related item and receive special accounting for the combination of the derivative and the related item in a manner that matches or offsets the earnings effect.

Hedge accounting is a special accounting practice that reflects an entity's intended strategy between two separate transactions. Rather than applying the applicable standards to each component of the strategy, hedge accounting allows the entity to recognize the gains or losses on the derivative in the same period as the income statement effect of the hedged item. Entities engaged in risk management activities desire hedge accounting so that the income statement reflects the effect of their hedging strategies in the same period as the item being hedged. Because hedge accounting defers recognition of gains and losses on derivatives, numerous conditions must be met at the outset of the transaction and over the life of the transaction; these are called hedge criteria. The criteria differ, depending on the nature of the risk being hedged.

In general, a derivative may be specifically designated (1) as a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment or (2) as a hedge of the exposure to variable cash flows of a forecasted transaction. The accounting for changes in the fair value (gains or losses) of the derivative differs depending on that designation.

For a derivative designated as hedging the exposure to changes in the fair value of a recognized asset or liability or a firm commitment (referred to as a fair value hedge), the gain or loss on the derivative is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributable to the risk being hedged. An example of a fair value hedge is the use of an interest rate swap to change the interest rate risk on a fixed-rate bond from fixed to floating. In a perfect hedge, hedge accounting will show net interest expense at the new floating rate. However, if the hedge is not perfect, the differences are required to be reported in earnings and, thus, are transparent to investors.

For a derivative designated as hedging the exposure to variable cash flows of a forecasted transaction (referred to as a cash flow hedge), the gain or loss on the derivative is initially deferred in other comprehensive income (which is a balance sheet account) to the extent that the hedge is effective; the gain or loss is subsequently reclassified into earnings in the period that the related forecasted transaction affects earnings. An example of a cash flow hedge is the use of an interest rate swap to change the risk profile on a floating-rate loan—the swap serves to lock

[11] See Attachment 3 for News Release, "FASB Derivatives Statement Now Available" (June 16, 1998).

[12] FASB Exposure Draft, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133* (May 20, 1999).

[13] See Attachment 3 for News Release, "FASB Delays Implementation Date for Derivatives and Hedging Standard" (July 7, 1999).

[14] See Attachment 4 for a summary of the requirements of Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (June 1998).

in the cash flows associated with the transaction. In a perfect hedge, hedge accounting will show net interest income at the new fixed rate. To the extent that the swap is not effective in offsetting the cash flows on the loan, any ineffectiveness is reported in earnings immediately and separately disclosed. Several other disclosures are required to help investors understand how and when the deferred amount will be reclassified into earnings.

An enterprise that elects to apply special hedge accounting is required to identify and document at the inception of the hedge (1) the specific item(s) that are being hedged and the entity's risk management strategy, (2) the method it will use for assessing the effectiveness of the hedging derivative, and (3) the measurement approach for determining the ineffective aspect of the hedge. Those methods must be consistent with the entity's approach to managing risk.

HOW HAS THE FASB RESPONDED TO REQUESTS FOR ADDITIONAL GUIDANCE AND IMPROVEMENTS TO STATEMENT 133?

Implementation Guidance

At the time Statement 133 was issued in June 1998, the Board was aware of the complexities associated with transactions involving derivatives and their prevalent use as hedging instruments. Because of that, even before Statement 133 was issued, the Board established a Derivatives Implementation Group ("DIG") of outside experts to assist the FASB in answering questions that companies might face as they began implementing the Statement.[15]

The responsibilities of the DIG were to identify practice issues that arose from applying the requirements of Statement 133 and to advise the FASB on how to resolve those issues. Public meetings of the DIG were held bimonthly during 1998, 1999, and 2000. The DIG identified and assisted the FASB in resolving more than 150 discrete issues relating to the implementation of Statement 133.

In 2001, as the number of new implementation questions diminished, the responsibility for addressing Statement 133 implementation issues was transferred from the DIG to the FASB's Emerging Issues Task Force.[16]

Amendments

Prior to Statement 133 becoming effective in July 2000, the FASB received numerous requests from enterprises and auditors to amend that Statement. The requests focused mainly on guidance related to specific issues that, if amended, would ease implementation difficulties. In analyzing those requests, the Board did not discover any new significant information suggesting that the framework of Statement 133 was inappropriate or that major changes should be made.

In June 2000, in response to the requests, the FASB issued Statement of Financial Accounting Standards No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities* ("Statement 138"), amending certain provisions of Statement 133.[17] In general, Statement 138 (1) expands the scope of certain transactions that are excluded from the requirements of Statement 133, (2) broadens the criteria that permit enterprises to qualify for special hedge accounting, and (3) clarifies certain provisions based on the recommendations of the DIG.

More recently, in April 2003, the Board issued Statement of Financial Accounting Standards No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* ("Statement 149").[18] Statement 149 amends Statement 133 largely to revise and further clarify the scope of Statement 133 and codify several issues that were identified and resolved as part of the DIG process.

Consistent with the FASB's mission and Rules of Procedure, the FASB stands ready to consider any additional implementation issues or proposed improvements to the accounting for derivatives and hedging activities.

Thank you, Mr. Chairman. I would be happy to respond to any questions.

[The attachments are retained in subcommittee files.]

Mr. STEARNS. I thank the gentlelady.

Mr. Baumann, we welcome your testimony.

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[15] See Attachment 3 for News Release, "FASB Appoints Task Force to Aid with Implementation Issues on Derivatives" (February 5, 1998) and Attachment 5 for a description of the Derivatives Implementation Group and a list of its members.

[16] See Attachment 1 for a description of the Emerging Issues Task Force.

[17] See Attachment 3 for News Release, "FASB Issues Amendment to Derivatives Standard" (June 15, 2000).

[18] See Attachment 3 for News Release, "FASB Issues Standard That Amends and Clarifies Accounting Guidance on Derivatives" (April 30, 2003).

STATEMENT OF MARTIN F. BAUMANN

Mr. BAUMANN. Chairman Stearns and Ranking Member Schakowsky, thank you for inviting me today to discuss financial accounting standards for derivatives.

My name is Martin F. Baumann. For more than 30 years, I worked at PricewaterhouseCoopers, where I was a partner, Global Banking Leader, and Deputy Chairman of the World Financial Services Practice. I have also been privileged to chair and serve on numerous accounting industry committees that prepared guidance on financial and accounting and reporting issues. In April of this year, I joined Freddie Mac as Executive Vice President of Finance.

Mr. Chairman, I applaud you for holding today's hearing, and for the subcommittee's long-standing commitment to improving accounting standards. I particularly want to commend you, Mr. Chairman, for your draft bill that addresses the important issues of principles-based and fair value accounting.

Before I begin, I would like to say a few words about recent events at Freddie Mac. Freddie Mac is undergoing the process of restating prior years' financial results. We candidly laid out the details of the restatement in a recent news release, which is attached to my testimony. Our intensive restatement process is expected to be concluded at the end of this third quarter. We have a comprehensive and aggressive remediation program in place which we have reviewed in detail with our primary regulator, OFHEO. Because the restatement is underway and the reasons giving rise to the restatement are the subject of Federal investigations. I am sure you can understand why I cannot comment further at this time on the restatement.

I also want to mention that, as previously announced, the outside directors of Freddie Mac's board have retained the firm of Baker Botts to review the facts and circumstances relating to certain accounting errors identified during the restatement process. I understand that the Baker Botts report may be completed and released by Freddie Mac's Board to the public very shortly, possibly as early as tomorrow.

The comprehensive nature of our restatement gives rise to two questions I would like to address. First, let me stress that Freddie Mac is unquestionably safe and sound. Our expertise in interest rate and credit risk management is widely recognized, and we consistently exceed our statutory and risk-based capital requirements. The restatement will result in significantly higher retained earnings and an increase in our regulatory capital.

Second, Freddie Mac will fulfill its commitments to register with the Securities and Exchange Commission. Following completion of our restatement, we will proceed expeditiously to resume our Form 10 registration process with the SEC.

On the subject of financial accounting standards, let me start with a clear an unequivocal statement. GAAP is the basis and touchstone for our financial reporting. My observations today on GAAP are offered as part of a healthy public dialog and in no way imply less than complete support for the standard-setting process and our commitment to fully comply with GAAP standards.

Freddie Mac fully supports the FASB's ongoing projects to increase the use within GAAP of fair value based measures for finan-

cial instruments. In fact, we have found that fair value measures are of increasing importance to investors and other market players. While we already provide a fair value balance sheet on an annual basis, Freddie Mac is now preparing to become one of the first financial institutions to provide investors with a fair value balance sheet on a quarterly basis. This will provide investors with an additional measurement tool along with our GAAP financial statements.

In discussing Financial Accounting Standard 133, my written testimony goes into some detail. Let me summarize by saying that while the derivatives we use are unquestionably economically effective in managing our interest rate risk, the accounting standards that apply to such derivatives go only part of the way to providing a full fair value presentation in GAAP reporting. This is because investment securities and derivatives are accounted for at fair value, but debt obligations are not. This presents a challenge for financial reporting because the two techniques we use to manage interest rate risk have highly similar economic results, yet the GAAP accounting treatment between them is quite different.

Let me conclude by saying a few words about a principles-based accounting framework. I believe such an approach holds the potential to improve financial reporting. Achieving its promise, however, will require rigorous oversight from Congress, regulatory and self-regulatory organizations. The challenges are significant, but the opportunity to improve investor understanding makes pursuit of principles-based accounting worthwhile.

Mr. Chairman, Freddie Mac is pleased to work with you toward meeting the highest standards of financial transparency and accountability. Thank you again for the opportunity to appear today.

[The prepared statement of Martin F. Baumann follows:]

PREPARED STATEMENT OF MARTIN F. BAUMANN, EXECUTIVE VICE PRESIDENT FINANCE AND CHIEF FINANCIAL OFFICER, FREDDIE MAC

Thank you, Chairman Stearns. Good afternoon. It's a pleasure to be here today. My name is Martin F. Baumann.

For more than 30 years, I worked at PricewaterhouseCoopers, where I was a partner, deputy chairman of the World Financial Services Practice, and the Global Banking Leader. Most of my career at PricewaterhouseCoopers was spent within its Financial Services Group, where I was responsible for certifying the financial statements for some of the largest U.S. and international banking, insurance, and other financial services clients.

During my career I also have been privileged to chair and serve on a number of accounting industry committees and task forces that prepared standards and guidance on various financial accounting and reporting issues. May I say that I am delighted to be on the same panel today as Leslie Seidman, with whom I have worked on critical banking industry matters.

In April of this year, I joined Freddie Mac, where I currently serve as Executive Vice President and Chief Financial Officer.

Mr. Chairman, I applaud the subcommittee for holding today's hearing, the fifth hearing since 2001 that has focused on financial accounting standards. The importance of transparent accounting and reporting standards is clear to everyone. I commend the subcommittee for laying before the public the importance of financial accounting standards before those issues hit the front pages. Mr. Chairman, I also want to state my support for the thrust of your effort to move GAAP toward a principles-based framework.

RESTATEMENT OF PRIOR YEAR FINANCIAL RESULTS

Before I talk about the issue that prompts today's hearing, let me say a few words about recent events at Freddie Mac. As you know, Freddie Mac is undergoing the

process of restating its prior year financial results. This restatement will affect the corporation's financial statements for 2002, 2001 and 2000. Freddie Mac's financial results for periods prior to 2000 will also be affected by the restatement. The impact of these corrections for periods prior to 2000 will be reflected as an adjustment to the beginning balance of retained earnings as of January 1, 2000.

Freddie Mac issued a progress update on its restatement on June 25, 2003. As we stated in that release, the information we disclosed "reflects poorly on Freddie Mac's past accounting, control and disclosure practices." A copy of that press release is attached to my statement. As you'll see from it, while Freddie Mac is now in the process of correcting accounting errors, it remains an extremely safe and sound financial institution.

The accounting corrections fall primarily into five categories. The four major categories are: security classification; accounting for derivative instruments; asset transfers and securitizations; and valuations of financial instruments. A fifth category includes numerous other accounting policies, practices and entries that, individually and in the aggregate, will have a smaller impact on cumulative retained earnings than the four other categories.

As we have disclosed to the public, this intensive process is ongoing and expected to be completed by the end of this third quarter. In the meantime, the reasons giving rise to the restatement are under investigation by the Securities and Exchange Commission, the Office of Federal Housing Oversight, and the Justice Department. In view of these pending investigations, I am sure you can understand why I cannot comment at this time on the details of these matters. It is our understanding with the Chairman that the hearing today is not about these matters, but rather about the more general policy issues raised by such accounting standards as FAS 133 relating to financial derivatives. I am delighted to be here on that basis to address the Subcommittee's questions.

In addition, as previously announced in our June 25 press release, the outside directors of Freddie Mac's Board retained the firm of Baker Botts, LLP to review the facts and circumstances relating to certain of the principal accounting errors identified during the restatement process. As previously announced, it is expected that the report of Board Counsel will be completed and that the Board will determine to release it to the public shortly.

FREDDIE MAC'S COMMITMENT TO DISCLOSURE

It is important to point out that Freddie Mac's new management took the initiative to candidly lay out these errors. We said at the time that the new management team and our Board of Directors is "determined to set high standards for candor and transparency in our financial reporting." In fact, I believe that taking the initiative to release this information is tangible evidence of the type of transparency and candor that Freddie Mac is working to create.

On the point of disclosure, Freddie Mac agrees with Undersecretary of the Treasury Peter R. Fisher, who in a speech last November talked about the importance of improving the quality of information that investors receive. In that speech, he said: "... investors have a fundamental right to see the companies in which they invest through the eyes of management." Freddie Mac is determined to meet this standard.

Freddie Mac is continuing to work closely with its independent auditor and other advisors to complete the labor-intensive restatement as quickly as possible without sacrificing accuracy. We are working toward completing the process and releasing results during this third quarter of 2003. At the same time, we are aggressively addressing the factors that contributed to the restatement. We know how to fix these shortcomings—and we will. We will emerge stronger than ever, with significantly improved accounting and disclosure practices that will meet the highest standards.

We have a comprehensive and aggressive remediation program in place, which we call our Finance Function Governance Project, led by me and reporting to the Governance Committee of our Board of Directors. This program is designed to ensure that we have the highest level of accounting expertise, compliance with GAAP and regulatory reporting, and fully accurate, timely, and transparent financial reporting. We have reviewed the plan in detail with our primary regulator, the Office of Federal Housing Enterprise Oversight (OFHEO) and will be providing them with regular updates.

FREDDIE MAC IS SAFE AND SOUND

The comprehensive nature of our restatement process has raised some questions I'd like to squarely address.

Freddie Mac is unquestionably safe and sound. As we have stated previously, we expect the restatement to result in significantly higher retained earnings. Commensurately, we expect an increase in our regulatory capital.

Freddie Mac is subject to strong capital requirements, which we consistently meet. Our regulatory capital requirements incorporate two different measures. One is a traditional, or minimum capital requirement. The other is a risk-based capital stress test that requires Freddie Mac to hold capital sufficient to survive 10 years of severe economic conditions.

The stress test results released by OFHEO have consistently shown that Freddie Mac has held substantially more capital than would be necessary to survive such extreme conditions. In line with this, on June 30, 2003, OFHEO classified Freddie Mac as adequately capitalized, OFHEO's highest rating.

Freddie Mac's business fundamentals are as strong as ever. As a result of our disciplined approach to the investment business, we expect a material increase in the fair value of shareholder equity in our fair value balance sheet as of year-end 2002 versus year-end 2001, in spite of a record low interest rate environment. We continue to attract funds from around the world to support homeownership in America. The recent pricing of our 2-year and 10-year debt issuances was extremely well received despite market volatility.

Freddie Mac will fulfill its commitment to register with the Securities and Exchange Commission. Freddie Mac is fully committed to completing the process of voluntarily registering its common stock with the Securities and Exchange Commission under the Securities Exchange Act of 1934. Last summer we voluntarily agreed to submit to the full panoply of the periodic financial disclosure reporting requirements that apply to registrants. We are enthusiastically, unequivocally, and irrevocably committed to completing this process, as our President and CEO, Greg Parseghian, said in a letter last week to Treasury Secretary John Snow, which is also attached.

Following completion of our restatement and re-audit, we will proceed expeditiously to resume our Form 10 registration process with the SEC. Voluntary Exchange Act registration will place our financial disclosures under the direct oversight of the SEC, thereby ensuring that our disclosures meet the standards of an SEC registrant. This is another part of our commitment to transparency in financial reporting.

Freddie Mac uses derivatives to manage risk, not speculate. Derivatives are a key tool used by Freddie Mac to manage the risk inherent in long-term fixed-rate prepayable mortgages, the mortgage of choice for most Americans. Chairman Alan Greenspan of the Federal Reserve Board, has praised the use of derivatives by Freddie Mac and Fannie Mae numerous times.

Through the use of derivatives and other asset-liability management strategies, Freddie Mac and other mortgage investors manage and reduce the interest rate risk inherent in owning consumer-prepayable mortgages. They do so by transferring some of the risk to high-quality third parties that are willing and able to assume and manage that risk. To say it another way: We use derivatives to hedge existing exposures—we do not use derivatives to speculate.

The accounting issues related to derivatives identified by Freddie Mac do not diminish or change the economic effectiveness of those derivatives. The restatement has no adverse impact whatsoever on the economic or fair value results we achieve through derivative instruments, which continue to prove very effective in managing risks. Our monthly disclosures around our interest rate risk levels and our forthcoming disclosure regarding the full fair value of Freddie Mac's balance sheet provide ample evidence that our derivatives usage is keeping low risk and not adversely affecting fair value.

Because our restatement is still underway, I cannot comment further at this time on specific accounting issues discussed in our June 25 press release. However, I would be pleased to meet with you again, or answer any written questions you might have after we have published our press release announcing the restatement results.

DISCUSSION OF ACCOUNTING ISSUES RELATED TO TODAY'S HEARING

Today I would like to address three matters related to U.S. generally accepted accounting principles, or GAAP, and the relevant accounting issues that this subcommittee has shown so much leadership in raising and addressing. First, I will discuss the increasingly important role that fair value measurement is having for purposes of GAAP financial reporting and disclosure. Second, I will discuss how Statement of Financial Accounting Standards No. 133, "*Accounting for Derivative Financial Instruments and Hedging Activities*," as amended, or SFAS No. 133, applies fair

value measurement concepts but still leaves a mixed measurement model for financial reporting. I will close with some thoughts concerning the conceptual framework used to craft new standards: Should they be principles-based or rules-based?

Before I begin, let me make a clear and unequivocal statement: GAAP is the basis and the touchstone for all financial reporting. For Freddie Mac, we are entirely committed to using GAAP as the primary basis for our on-going communications with our shareholders and other interested parties. Any observations regarding how GAAP works should be understood as offered as part of a healthy public dialogue regarding how to improve GAAP and in no way implies anything less than our wholehearted support for those responsible for standard setting and commitment to comply fully with all applicable GAAP standards.

FAIR VALUE AND GAAP

Freddie Mac fully supports the FASB's ongoing projects to increase the use within GAAP of fair value-based measures for financial instruments. Over the years, the FASB has made significant progress towards this objective. I agree with the FASB Chairman Robert Herz' statement that "...I think it's hard to argue with the conceptual merits of fair value as the most relevant measurement attribute. Certainly, to those who say that accounting should better reflect true economic substance, fair value, rather than historical cost, would generally seem to be the better measure." [1] Freddie Mac's support of fair value concepts is mindful of the views of a number of important capital markets participants. For example, the Bond Market Association, the International Swaps Dealers Association and the Securities Industry Association have expressed support for fair value measurement concepts in a March 2002 report, stating: "[S]ince fair value reflects current market conditions, it provides comparability of the value of financial instruments bought at different times. In addition, financial disclosures that use fair value provide investors with insight into prevailing market values, further helping to ensure the usefulness of financial reports." [2]

For its part, Freddie Mac understands that fair value measures are of increasing interest and importance to our investors. Our new management team is committed to providing investors with the information they need to understand how we view and manage the business, so that investors can value our business fairly and accurately. To that end, we announced in our June 25th press release that we will begin releasing quarterly fair value balances sheets in addition to our GAAP-based financial statements and related tables. Freddie Mac already provides a fair value balance sheet on an annual basis as part of our consolidated notes to financial statements, in accordance with SFAS 107. We are now preparing to become one of the first financial institutions to provide investors with a full fair value balance sheet on a quarterly basis, which will show mark-to-market gains and losses on our business and provide investors with an additional measurement tool along with our GAAP financial statements.

SFAS 133 AND APPLICATION OF FAIR VALUE MEASURES TO FINANCIAL INSTRUMENTS

Let me now turn to a discussion of SFAS 133 and its application of fair value measures to derivative financial instruments. As an introductory matter, let me underscore that Freddie Mac applies risk-management strategies with strict discipline. We use derivatives to reduce interest-rate risks that any mortgage investor faces. Our use of derivatives demonstrates our commitment to dispersing economic risks. We do not use derivatives to speculate or make bets on the direction of interest rates. To do so would be contrary to our risk management disciplines and to our statutory mission to provide liquidity to the mortgage market at all times. Prudent use of derivative instruments is essential to our ability to manage interest-rate risk in a wide variety of market scenarios and thus to fulfill the mission that Congress has directed to accomplish.

While the derivatives we use are unquestionably economically effective in reducing and dispersing our interest-rate risk, the accounting standards that currently apply to such derivatives only go part of the way to providing a full fair value presentation in GAAP reporting. This is because while investment securities and derivatives are accounted for at fair value, debt obligations are not. Allow me to provide

[1] "Meeting the Challenges of Financial Reporting in an Era of Change," Address of Robert H. Herz, AICPA 2002 National Conference on Current SEC Developments.

[2] Explanation and Benefits of Fair Value Accounting, prepared by The Bond Market Association, International Swaps & Derivatives Association, Securities Industry Association, March 26, 2002.

a simplified example drawn from our own experience that describes how investors manage interest-rate risk.

When a mortgage investor purchases standard single-family mortgages, it faces the risk that the homeowners on these mortgages will exercise the option to prepay their mortgages in a low interest-rate environment. For mortgage investors that finance their investment activities by issuing debt, these prepayments could leave the investor at risk, because the investor would be forced to re-invest prepaid mortgage proceeds in lower yielding assets, creating a potential future shortfall on the amount the investor owes on the debt used to fund the original mortgages. For this reason, prudent investors find ways to manage the prepayment risk associated with residential mortgages and mortgage securities.

A mortgage investor can finance its mortgage purchases using two techniques to manage this interest-rate, or prepayment, risk. One way is to issue debt with a call option embedded in it—so called "callable debt"—which gives the investor a right of prepayment similar to the one that borrowers have on their mortgages, thus eliminating most prepayment risk. The second technique for the investor is to issue non-callable debt while at the same time purchasing stand-alone options that accomplish the same financial result as the callable debt—making the investor whole in the event interest rates result in mortgage prepayments. These stand-alone options (for example, interest-rate swaps or "swaptions") are referred to as "derivative" financial instruments. In both funding techniques, the resulting interest-rate risk economics are the same. When Freddie Mac invests in mortgages, we choose between these two basic risk management techniques to achieve the lowest cost, because that translates to lower mortgage costs for consumers and sound economics for our business operation.

Here's the challenge in our financial reporting in this area: While these two techniques have highly similar economic results, the GAAP accounting treatment between them is quite different. Whether callable or non-callable, the debt that a mortgage investor issues will be reflected in financial statements on the basis of its historical cost, without regard to market value changes that might occur with respect to such debt over a period of time. But with respect to derivative financial instruments, SFAS 133 provides for the change in market value of such instruments to be directly reflected in financial statements from period-to-period.

Please understand that I support fair value measures with respect to derivative instruments. The crux of our challenge is that GAAP policies today provide for different measures of economically similar transactions—requiring fair value treatment for derivatives used with non-callable debt but requiring historic cost treatment for callable debt. In other words, current GAAP policies could be characterized as being in a transitional stage from historic cost to fair value measures. This mixed measurement model creates a challenge for all reporting companies in clearly explaining both the accounting results and the underlying economic results for transactions involving derivative instruments. It is absolutely essential that the management of these companies make every effort to provide transparent, informative and candid financial reporting to their investors. Freddie Mac is committed to that objective.

TOWARD PRINCIPLES-BASED ACCOUNTING

SFAS No. 133 is a rule-based standard attempting to establish guidelines for an industry that is growing in complexity and size each day. SFAS 133 is extremely detailed and highly prescriptive. While I agree with the underlying principle of this standard, which requires the recording of derivative instruments at fair value, a legitimate question can be asked as to whether companies, investors and practitioners might benefit from an approach that promised to reduce the enormous complexity in the rule's application. The Securities and Exchange Commission and the FASB, among others, have been studying the potential efficacy of adopting a U.S. financial reporting system based on principle-based standards.[3] Proponents of principles-based accounting in the United States envision that it would result in a fundamental shift away from the very detailed, rule-based standards, like SFAS 133, to standards under which companies and their auditors would determine appropriate accounting policies based on the economic substance of the transaction rather than its form. This is the framework on which many international accounting standards are based.

[3] Speech by Cynthia A. Glassman, U.S. Securities and Exchange Commission, 23rd Annual Ray Garrett Jr. Corporate Goverance and Securities Law Institute Northwestern University School of Law, Chicago, IL, April 10, 2003.

I believe that a principles-based accounting framework holds the potential to improve the representational faithfulness of financial reporting under U.S. GAAP. This is because a principles-based approach would ensure that all reporting companies meet the substance and not just the form of accounting rules. However, for such an approach to work, policymakers, including the Congress, would be well advised to focus on a number of questions. First, would there be a strong enough framework of oversight to guide the application of fundamental principles and ensure consistency? A principles-based framework could emphasize the judgment of company managers and accounting professionals. Second, clear, consistent—and, let me emphasize—readily comparable disclosures could be essential to ensure that a principles-based approach would provide clear disclosures with the proper level of information for investors.

Principles-based accounting holds enormous promise, but achieving its promise will require foresight from Congress and rigorous oversight from regulatory and self-regulatory organizations. The challenges are significant, but the opportunity to improve investor understanding makes pursuit of these challenges worthwhile.

CONCLUSION

Mr. Chairman, let me applaud you for holding this hearing to again focus on such important issues related to transparent accounting standards.

Mr. STEARNS. Thank you, Mr. Baumann.

Mr. Wallison.

STATEMENT OF PETER J. WALLISON

Mr. WALLISON. Thank you, Mr. Chairman. Thank you for inviting me to testify this afternoon on the subject of Fannie Mae and Freddie Mac. My testimony will focus on the efficacy of accounting in general, not specifically on FAS 133, and I ask that my written testimony be included with the committee's record.

Mr. STEARNS. By unanimous consent, so ordered.

Mr. WALLISON. Thank you, sir.

Accounting issues have dominated the news about Fannie and Freddie recently, for good reason. A failure or serious financial crisis at either of these companies could cause major losses to the government, to the taxpayers, and to the economy as a whole. This is not an enviable position for this country to be in, and it does not have to be so, but that is where we are today.

The concern about Freddie Mac's accounting is a reminder that we are relying on only two safeguards to protect our economy against a serious problem—accurate accounting and good regulation. The events of Freddie raise questions about both.

What exactly Freddie's management did is really irrelevant. The important point is that its management made serious misjudgments that were not reversed by its auditors, or caught by its regulator. What this shows is that in relying, as we do, on accounting and regulation, we are placing a lot of weight on two very thin reads.

Unfortunately, many people have the impression that accounting is some kind of exact science, that the numbers are all there and just have to be added up. This is not the case. Under Generally Accepted Accounting Principles, known as GAAP, there is a great deal of room for management judgment, and these judgments can radically change the financial statements. Let me give you an example.

On September 13, 2002, Fannie Mae transferred $135 billion of securities from the balance sheet classification "Held to maturity" to the classification "Available for sale." On that date, the market

value of these securities was higher than what Fannie had paid for them. By reclassifying these securities as Available For Sale, Fannie was able to carry them at their higher market value rather than at their cost. The effect of this was to add a significant amount to Fannie's shareholder equity. Thus, a technical management decision which had no effect on economic reality, made Fannie's balance sheet look healthier on September 14 than it looked on September 12.

This is what I mean when I say that we are relying on a weak read when we rely on a company's financial statements to alert us to impending problems.

The subject of the hearing today, FAS 133 and accounting for derivatives, only further complicates things and puts more opportunities for window-dressing into management's hands.

What about regulation? Again, in my view, a weak read. It appears that OFHEO, Freddie's regulator, was not aware of the scope of the company's financial problems. This should not surprise us. The managements of regulated companies frequently will not tell their regulator about problems until these have gotten completely out of hand. Before that, the hope is to work out the problem before the regulator finds out. Once the regulator knows, everybody knows. Exactly this seems to have happened in Freddie's case.

Again, the point is not this particular case, it is importance is that it should alert us to the fact that reliance on regulation to protect us against financial disaster is often, very often, misplaced.

Why is it especially important in this case to worry about accounting and regulation? Because the housing market is unique. It is at once the largest part of our economy, and it is dominated by two companies. In most other areas of the economy, there are a lot of companies. If one fails, as Enron failed, for example, the market sector carries on virtually unaffected. The housing market is not like that. If Fannie or Freddie fails or has a serious financial crisis, we can have systemic effects on our whole economy. Thus, although we could withstand some bad accounting and some regulatory failure in many other areas of the economy, we cannot risk this here.

Since accounting and regulation are such thin reads, the real question for Congress is whether the benefits provided by Fannie Mae and Freddie Mac outweigh their cost and the risk they create.

In my prepared testimony, I argue that Fannie and Freddie create enormous risk for the economy and the taxpayers, but provide no significant benefits to homeowners or to the housing market generally. They do not make homes appreciably more affordable, do not contribute significantly to home ownership in the United States, and appear to discriminate against minority or low-income borrowers.

Under these circumstances, the best course for Congress would be to eliminate the risks they pose by cutting their links to government. Although I favor complete privatization, if Congress is not prepared to do this at this point, there is a less dramatic way substantially to reduce their risks. Congress should prohibit Fannie and Freddie from buying back their mortgage-backed securities or accumulating substantial portfolios of mortgages.

Most of the limited benefits that Fannie and Freddie provide to the mortgage market comes from the issuance of their mortgage-

backed securities. When they do this, they take only credit risk, which is quite small. However, most of the financial risks come from buying back these securities and accumulating portfolios of mortgages. In this case, they take interest rate risk which is the same risk that caused the collapse of the S&Ls. Yet, buying back mortgage-backed securities and holding mortgages in portfolio doesn't have any effect on mortgage rates.

So Congress, simply by prohibiting them from repurchasing their own MBS, can largely eliminate the risk they create without affecting mortgage interest rates. I respectfully recommend this to you, Mr. Chairman, and to the subcommittee. That concludes my testimony. Thank you.

[The prepared statement of Peter J. Wallison follows:]

PREPARED STATEMENT OF PETER J. WALLISON, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. Chairman and members of the subcommittee: It is a privilege for me to testify this afternoon on the subject of Fannie Mae and Freddie Mac, and I'd like to congratulate and thank you, Mr. Chairman, for taking on an important task that deserves much more attention from Congress than it has received.

It is important to recognize the significance of the accounting problems at Freddie Mac—not because these problems are especially severe, but because they were a surprise and seem to arise from something so routine. From press accounts, it appears that Freddie attempted over many years to manage its earnings by manipulating the valuation of its derivatives. This is known as managing earnings, and its objective is to create a smooth upward curve. Freddie Mac was so good at this that it was nicknamed "Steady Freddie" on the Street. Some attention is now also being paid to Fannie Mae's financial reports, which, despite the vicissitudes of the mortgage market, interest rates and the economy generally, also showed the same smooth upward curve. Managing earnings is very easy to do under Generally Accepted Accounting Principles (GAAP)—so easy that many companies are suspected of doing it.

That is not so much an indictment of these companies as it is an indictment of the excessive reliance that has been placed on GAAP financial disclosure by the SEC, media commentators, and—most recently—Congress in enacting the Gramm-Leach-Bliley Act. The fact is that GAAP financials are highly malleable, and should not be considered an index of the financial condition or prospects of companies. Because the principal constituents of a GAAP earnings statement are predictions about the future—what losses will be suffered on a portfolio of receivables, what reserves should be established for future claims—bottom line financial results reflect simply the judgments of management rather than a true picture of the company's financial condition.

I mention this because many commentators and policymakers seem to believe that requiring Fannie Mae and Freddie Mac to file reports with the SEC will substantially reduce the risks they pose to the taxpayers and to the economy. This idea is as misplaced as requiring a whole new structure to regulate how accountants do audits, as Congress did in the Sarbanes-Oxley Act. No matter how effective an audit, it can never make financial statements prepared under GAAP more "accurate." The key decisions that are made by management in preparing a company's financial statements cannot be made by auditors, who can only determine whether GAAP has been followed. Accordingly, while I believe it would be worthwhile to have Fannie and Freddie register their securities with the SEC, we should not think that doing this—even if it produces improved disclosure—will protect us against the risks they pose.

Because of the uncertainties associated with GAAP, it is not correct to believe that Fannie Mae and Freddie Mac are financially strong companies simply because they are producing earnings or have strong-looking balance sheets. It's likely that they are both profitable and financially strong, but we really can't know for sure. A demonstration of this is the fact that OFHEO—Fannie and Freddie's regulator—was not aware of the true extent of the company's financial problems until advised of them one day before they were announced. If their regulator could not find their financial problems, how is the general public—or Congress—supposed to do it?

This points to another very weak reed in our general defense against the risks created by Fannie and Freddie. We count on regulators to find and correct the most

serious problems before they grow out of control. But in relying on regulation we are again deluding ourselves. Occasionally, regulators stumble upon things like bad accounting, but in most cases they are in the dark until someone tells them about the problem. Thus, I don't blame OFHEO, or believe that it is a weak or incompetent regulator because it failed to uncover or understand the gravity of the accounting problems at Freddie. This is what we should expect from any regulator, because it is the most likely outcome. Regulators work in the bowels of the organizations they regulate, but the big decisions—the ones that can really cause the losses at a company—are made at the top level, where regulators generally have no regular access.

Thus, we ought to be clear-eyed about both the effectiveness of regulation and the usefulness of GAAP accounting, and adjust our policies accordingly. In the case of Fannie and Freddie, as I will argue below, we can't afford to make a mistake. If their financial statements do not disclose their real vulnerabilities, and no regulator will find these vulnerabilities, we are courting serious problems if we continue to let them grow with the support of the federal government. In effect, we are creating a new S&L crisis, but one that will be much larger and more consequential for the economy.

We should keep in mind that, together, these companies had—at the end of 2002—approximately $3.3 *trillion* in liabilities. $1.5 trillion of this was in the form of debt, and $1.8 trillion in the form of guarantees of mortgage backed securities. Against these liabilities they hold only about 3 percent in capital—a percentage far lower than that permitted to regulated commercial banks. As outlined later in this testimony, obligations in this range pose enormous potential problems for the nation's taxpayers and for the economy at large.

But even these risks might be worth taking if Fannie and Freddie produced substantial benefits for the economy or for homebuyers. However, this is not the case. In fact, Fannie and Freddie deliver relatively little value to the economy or to homebuyers—and certainly not enough value to justify the risks they are creating. Since we are not likely to be protected against those risks either by better financial disclosure or regulation, it seems prudent to consider other ways that the risks might be reduced, preferably without any adverse effects on the mortgage markets or on homebuyers.

In the balance of this testimony, I will try to show that Fannie and Freddie provide relatively little benefit to the economy or to homebuyers generally, and that what little benefit they provide is overwhelmed by the risks they create. Since neither better accounting or auditing, nor better regulation, is likely to save us from the consequences of these risks, we should consider policies that will reduce risks in other ways. I believe the best way to eliminate these risks is to privatize Fannie Mae and Freddie Mac, and break them up into smaller competitive components, but I recognize that this idea is not at the moment politically feasible. So at the end of this testimony I suggest another way to substantially reduce the risks they pose, without either privatizing Fannie and Freddie or adversely affecting the mortgage market.

First, however, I will discuss the balance of benefits and costs that I see in Fannie and Freddie.

WEIGHING BENEFITS VS. RISKS

The case against Fannie Mae and Freddie Mac is very simple: they create enormous risks for the government, for the taxpayers, and for the economy as a whole, yet provide no significant benefit to homebuyers. Accordingly, Congress should take steps to cut their links to the federal government. Like the S&L crisis many years ago, procrastinating will only put off the day of reckoning, and the problem will be worse and more costly when Congress is finally compelled to act. Fannie and Freddie have been doubling in size every five years, and now have combined liabilities of $3.3 *trillion*. This is not a problem that can be safely or responsibly put off.

Fannie Mae and Freddie Mac were created for a single purpose—to provide liquidity for the housing finance system by creating a market for the mortgages made by banks and other mortgage originators. They did this very well. There is now a vibrant and efficient secondary market for residential mortgages. The technology has been developed, investors have been educated, a distribution system has been established. The structure will now operate without government assistance of any kind. In fact, in the so-called "jumbo" market—mortgages larger than Fannie and Freddie are permitted to buy—it operates entirely without any government backing. So Fannie and Freddie are no longer necessary for their original purpose. They should be thanked and sent home.

In fact, Fannie and Freddie know all this. So they have been diligent in creating a rationale for themselves that does not depend on their providing liquidity to the housing market. They have been advertising instead that they "open the doors to home ownership" by reducing the cost of mortgages, or that they are in "the American dream business" because they enable people to buy homes who might otherwise not be able to do so, or—implicitly—that they help minorities to become homeowners.

However, they do not really do these things. Let me take them one at a time.

Helping people afford homes. The basis for this claim is the correct observation that interest rates on mortgages purchased by Fannie and Freddie are somewhat lower than rates on so-called "jumbo" loans—which are sold in an entirely private secondary market. There have been many studies of the degree to which Fannie and Freddie provide lower interest rates to buyers who can qualify for conventional conforming loans. Table 1, attached, is a compilation of such studies that was presented at an AEI conference in October 2002. It shows that the effect of Fannie and Freddie's activities is to reduce interest rates on home mortgages by a very small amount—somewhere in the range of 25 basis points, or ¼ of 1 percent. If I can put this in perspective, every time the Fed lowers interest rates by one-quarter point, it has the same effect, and the Fed has done this 12 times in the last two years. Similarly, every time the Fed raises interest rates ¼ point it has the opposite effect. If that ¼ point were as important as Fannie and Freddie suggest in their advertising, thousands and thousands of American families would be frozen out of home ownership every time the Fed raises interest rates by ¼ point.

Moreover, this benefit comes almost entirely from the implicit support Fannie and Freddie receive from the government, not because of anything particularly special that Fannie and Freddie bring to the market. The Congressional Budget Office has estimated that in 2000 Fannie and Freddie received implicit government support with a value of about $10.6 billion, of which about two-thirds was actually made available to the mortgage market through lower rates. The balance, presumably, increased the share values of Fannie and Freddie by increasing their bottom line profitability, and went to management compensation.

This small one-quarter point benefit, however, is not a very good argument for continuing the implicit government subsidy. First of all, it's a very inefficient way of subsidizing the housing market. About one-third of the benefit the government has conferred on Fannie and Freddie goes to their shareholders and managements, rather than to create lower interest rates. This is surely an extreme form of corporate welfare, in which two managements and their investors are enriched in order to confer limited indirect benefits on homebuyers. If Congress wants to subsidize housing, it should be able to find a more efficient way to do it.

But second, and much more important, it isn't even clear that the subsidy—limited as it is—goes to homebuyers. It's entirely possible that it simply causes home prices to rise. In other words, it is a subsidy to home sellers and developers. I don't know of any studies that show this—nor of any studies that show the opposite—but it is common sense that to the extent that the monthly payments required of homebuyers are reduced, it provides an opportunity for home sellers to raise their prices.

Putting people in homes. Fannie and Freddie argue that the small reduction in interest rates that they pass along to the mortgage markets out of their implicit government subsidy contributes to the growth of home ownership in the United States by helping people buy homes. However, a study by the Census Bureau, also presented at an AEI conference in October, showed that the monthly cost of owning a home is not the obstacle that prevents renters from buying homes. The obstacle is the down payment. Renters do not generally have the financial resources necessary to buy their first home. Accordingly, the claim that Fannie and Freddie put people in homes by reducing interest rates is not true. No amount of interest rate reduction will make it possible for renters to become homeowners, because the problem for them is not the carrying cost of owning a home—it is the fact that they cannot accumulate the necessary down payment.

This reality led my colleague at AEI, Professor Charles Calomiris, to propose that Fannie and Freddie be completely privatized and the implicit subsidy they now receive used to provide down payment assistance to families who would otherwise be unable to purchase a home. Professor Calomiris estimated that this use of the Fannie and Freddie subsidy would permit more than 600,000 families, now renting, to buy homes.

Helping minority families. Through their advertising, which prominently displays photos of minority families in or in front of what are presumably their homes, Fannie and Freddie suggest that they provide special assistance to minority families hoping to become homeowners. And if they did this disproportionately—that is,

helped minorities or low income borrowers more than they helped middle class borrowers—that would be a powerful argument for preserving their current status.

But they do not do this. Instead, according to a study by Jonathan Brown of Essential Information, a Nader-related group, Fannie and Freddie buy proportionately *fewer* conventional conforming loans that banks make in minority areas than they buy in middle class white areas. Other studies have shown that the automated underwriting systems that Fannie and Freddie use to select the mortgages they will buy approve fewer minority homebuyers than similar automated underwriting systems used by mortgage insurers. There is at least one lawsuit against Freddie Mac by a minority homebuyer, arguing that he was unable to get a conventional conforming mortgage because of the exclusionary nature of Freddie's automated underwriting system.

The sad fact is that Fannie and Freddie—two government sponsored enterprises that have a government housing-related mission—do less for minority housing than ordinary commercial banks. Studies have repeatedly shown that banks and other loan originators make more loans to minority borrowers than Fannie and Freddie will buy. That in itself should be a scandal, together with the fact that both companies seek through their soft-focus advertising to create the impression that they are actually using their government benefits for the disadvantaged in our society.

So the US housing finance system gets very little benefit from the continued existence of Fannie Mae and Freddie Mac as government sponsored enterprises. The reduction in interest rates that they can point to as a result of their activities is really the result of their implicit government support, which is small in any case, and is swamped by macro changes in interest rates as a result of economic conditions. In any event, it isn't even clear that the lower rates operate as a benefit to homebuyers rather than home sellers. This small reduction in interest rates does not put people in homes or improve homeownership rates in the United States because most renters lack the down payment necessary to buy a home, not because they could not afford the monthly carrying cost of homeownership. And finally, despite the implications of their advertising, Fannie and Freddie seem to discriminate against minority homebuyers rather than assist them.

THE COSTS OF FANNIE AND FREDDIE

So the benefits of continuing Fannie and Freddie as GSEs are meager to non-existent. What then are the costs?

I have already cited the CBO estimate that Fannie and Freddie receive an implicit subsidy from the US government—in effect an extension of US government credit—with an annual value of at least $10.6 billion. That, however, is not the extent of their cost to the taxpayers. Because their securities directly compete with Treasury securities—in fact they have begun to issue securities on a regular schedule, just like Treasury, in order to be a more effective substitute—they cause Treasury interest rates to rise slightly, probably by a few basis points. On a total Treasury debt of several trillion dollars, those few basis points amount to hundreds of millions of dollars annually.

But these two costs do not begin to describe the potential costs to the government, the taxpayers and the economy of allowing Fannie Mae and Freddie Mac to continue to grow. Because Fannie and Freddie are implicitly backed by the US government, financial problems at either of them could require a government bailout. This is what Congress has had to do with other GSEs—most recently the farm credit system in the mid-1980s—and there is no reason to suppose that Congress would not step in if Fannie or Freddie, or both, were in financial trouble.

Until June of this year, when Freddie Mac dismissed its top three officers and announced that it would have to do a considerably bigger financial cleanup than we initially thought necessary, it was possible to say that both Fannie and Freddie were in strong financial condition and that there was no prospect of a bailout. Since then, however, there has been much more scrutiny of the financial statements of both companies, and at least some observers have pointed out that while Freddie might have been more profitable than it reported during the three years ending in 2002, Fannie Mae might actually have lost money, or made no profits, last year. That is not what Fannie reported, which was of course another huge annual increase in profitability. The problem is, because of the malleable nature of Generally Accepted Accounting Principles (GAAP), we don't really know how these complicated companies are doing. We would get a better picture of Fannie and Freddie's actual condition with better cash flow reporting, but that is not currently required by GAAP or the SEC.

In any event, however they are doing today, changes in interest rates and the economy generally could have a significant adverse effect on their financial health

in the future, and the taxpayers are ultimately responsible for assuring that they meet their obligations. It is important to remember in this connection that, at the end of 2002, Fannie and Freddie had an aggregate of $3.3 trillion in liabilities. Even a small part of this obligation—if it has to be made up by the taxpayers—will make the S&L bailout look like a dimestore operation.

But even that does not end the risks we all face with these two companies. Because they are integral to the health of the housing market, the failure of either of them could have a systemic effect—meaning an adverse effect on the economy as a whole. It's relatively easy to see how this might happen. Fannie and Freddie, together, purchase almost all the conventional conforming mortgages that come on the market each year. They currently hold or guarantee 75 or 80 percent of all conventional conforming mortgages and almost half of *all* residential mortgages in the United States. If either Fannie or Freddie were to lose the confidence of the capital markets, and were unable to purchase their share of new mortgages as these came on line, the entire residential finance system would be seriously disrupted—at least temporarily. Interest rates would rise and residential mortgages would be harder to get. This would rapidly affect the rest of the economy. Home sales would decline, construction would fall, sales of home furnishings and appliances would suffer.

This effect would be bad enough as it ripples through the economy. Much worse would be the effect on the financial system as a whole. Large numbers of banks and other financial institutions are major investors in the securities of Fannie and Freddie. They are encouraged to buy and hold Fannie and Freddie securities by a statutory exemption for these securities from regular restrictions on loans to one borrower. Declines in the value of Fannie and Freddie securities will reduce, and in some cases impair, the capital of all these financial institutions. Reduced or impaired capital will reduce the amount of credit they can provide, even outside the mortgage markets.

Altogether, then, the effects of a failure or severe financial crisis at either Fannie or Freddie could be systemic in character, not limited to the home mortgage markets. And since there are only two of these companies, it is accurate to say that the continued health of our economy depends on decisions by only two corporate managements. If one of them makes a grave mistake, the entire economy could suffer. And the recent events at Freddie Mac show that management judgments are far from infallible. We don't know the extent of the problems at Freddie, but we do know that the top management made serious errors of judgment. These, fortunately, do not appear to threaten systemic effects, but errors of judgment come in many shapes and sizes, and one day the error may be of a kind that cannot be repaired by accountants working around the clock.

WHAT TO DO

So what is to be done? We have a situation in which two companies create enormous risks for the taxpayers and the economy, but offer little in the way of benefits to anyone. Congress has it within its power to change this calculus in a number of ways. My preferred answer would be to privatize Fannie and Freddie and at the same time break them up into five or six smaller entities. In nature, diversity protects a species; in finance, diversity can protect an economy.

However, I am aware that this solution is not for the moment on anyone's radar screen. So I have a more modest proposal: Congress should prohibit Fannie and Freddie from buying back or accumulating any substantial portfolio of mortgages or mortgage backed securities (MBS).

Today, these companies do business in two very different ways: (i) they create pools of mortgages which are used to collateralize MBS that they guarantee and sell to investors, and (ii) they buy whole mortgages and repurchase the MBS they have already sold to investors.

These are two very different ways of performing their functions, and have very different consequences. When Fannie and Freddie create pools of mortgages and sell MBS backed by these pools, they are guaranteeing that investors will receive a stream of revenue derived from the interest and principal paid into the pools by homeowners paying off their mortgages. In this case, Fannie and Freddie are taking only credit risk—the risk that homeowners will not meet their mortgage obligations. This is not a very significant risk, especially today, when losses on mortgage pools have been running at 1 or 2 basis points.

However, buying and holding mortgages or MBS is an entirely different story. In that case, Fannie and Freddie must take interest rate risk in addition to credit risk. Interest rate risk—that rates will rise or fall—is a far greater risk than credit risk, and requires Fannie and Freddie to buy derivatives of various kinds to protect themselves against the vicissitudes of the credit markets. To put this in perspective,

it was interest rate risk that caused the failure of the S&Ls. They were holding mortgages that were paying, say, 5 percent, but in order to finance these loans they had to pay 10 or 12 percent for their funds when interest rates rose. With a negative spread like that, they weren't solvent for very long. Fannie and Freddie are in the same position, but their risks run two ways. The same thing happens to them if interest rates suddenly go up—they are holding mortgages that may yield less than the new rate they have to pay for their funds. But they also run risks if interest rates go down, since a portion of their portfolio is funded with longer term debt. If interest rates decline, homeowners refinance, and Fannie and Freddie end up holding, say, 4 percent mortgages, that they've funded with 5 percent liabilities. Another losing proposition.

Why, you might ask would Fannie and Freddie take such risks? Why would they buy back from investors the MBS on which the investors are already taking the interest rate risk? The answer is that, even after buying all that hedging protection through derivatives, it is still profitable for them to buy and hold their own MBS. In fact, it has been estimated that Fannie and Freddie own, in the aggregate, 34 percent of all MBS currently issued. With their government backing, they can borrow money at rates low enough so that they can do a rather simple arbitrage, profiting from the spread between their cost of funds and what the MBS are yielding.

Now one might think that somehow buying back their MBS will have the effect of lowering interest rates for mortgages, but this is not the case. Economists point out that borrowing funds to buy back other credit instruments is simply a wash. It doesn't have any effect on mortgage rates, which are a product of all the funds available in the capital markets.

Accordingly, what we have here is the classic case of privatizing the profits and socializing the risk. Fannie and Freddie profit from arbitraging their government backing, but the people really taking the risk are the taxpayers.

Accordingly, if Congress does not currently have the stomach for privatizing Fannie and Freddie, it can at least reduce the risk they pose to taxpayers and to the economy generally by prohibiting them from buying back the MBS they issue and from holding a large portfolio of mortgages. Instead, their activities should be limited to forming pools of mortgages and selling MBS that they guarantee. The risks on this—which is simply credit risk—are far less than the interest rate risk they have been taking, and it would have no effect on mortgage interest rates.

This is at least a temporary solution to the problems posed by Fannie Mae and Freddie Mac. Because we cannot rely on either accounting or regulation to protect the taxpayers and the economy against a serious mistake by the managements of Fannie or Freddie, or both, we should be thinking of ways to reduce that risk. By prohibiting the purchase of their own MBS or accumulating a large portfolio of mortgages, we can significantly reduce the risk that these two enterprises currently create for taxpayers and the economy, without any effect on interest rates on conventional conforming mortgages.

That concludes my testimony, Mr. Chairman.

Table 1
Estimates of the Jumbo/Non-Jumbo Mortgage Rate Differential

Study	Time Period	Regions	Data Screens	Results
Hendershott and Shilling (1989)	May-July 1986	California	❖ Fixed-rate ❖ Thrifts only ❖ No construction/purchase loans ❖ Term ≥ 25 ❖ LTV ≥ 70% ❖ No buydowns	❖ Contract rate 24 to 30 basis points ❖ Effective rate 29 to 39 basis points
ICF (1990)	May-July 1987 April-September 1987	California Illinois New Jersey Seven States	❖ Same as Hendershott and Shilling ❖ Effective rate ≥ 7.5% ❖ LTV ≤ 100%	❖ Six-month sample, seven states 23 basis points ❖ California 26 basis points
Cotterman and Pearce (1996)	Quarterly 1989-1993	California 11 States	❖ Fixed-rate ❖ Term ≥ 25 ❖ No buydowns ❖ LTV ≥ 70% ❖ LTV ≤ 100% ❖ Points ≤ 15% or $30,000 ❖ Effective rate ≥ 75th percentile of the effective rate on ARMs for the month ❖ Effective rate ≤ 2.05 percent above the monthly Ginnie Mae yield ❖ Loan amounts between $35,000 and $450,000 ❖ Thrifts and mortgage companies ❖ Used MIRS sample weights	❖ 25 to 50 basis points for California ❖ 24 to 60 basis points for the 11 states
Pearce (2000)	Quarterly 1992-1999	California 11 states	❖ Fixed-rate ❖ Term = 30 ❖ No buydowns ❖ LTV ≥ 70% ❖ LTV ≤ 90% ❖ Points ≤ 9% or $30,000 ❖ Effective rate ≥ 75th percentile of the effective rate on ARMs for the month ❖ Effective rate ≤ 1.1 percent above the	❖ California averaged 27 basis points ❖ 11 states averaged 24 basis points

Study	Time Period	Regions	Data Screens	Results
			monthly Freddie Mac survey yield ❖ Loan amounts between 20% and 200% of the conforming loan limit ❖ Thrifts and mortgage companies ❖ Does not use MIRS sample weights	
Ambrose, Buttimer, and Thibodeau (2001)	May-July of 1990-1999	Dallas	❖ Update of Cotterman and Pearce	❖ 24 basis points with out adjustment for house price volatility ❖ 16 basis points after adjusting for house price volatility
Naranjo and Toevs (2002)	1986-1998	No screen	❖ Fixed-rate ❖ Term ≥ 25 ❖ LTV ≥ 70% ❖ LTV ≤ 100% ❖ Fees ≤ 15% or $30,000 ❖ Delete top and bottom 5 percent based on effective interest rate ❖ Exclude commercial bank mortgages	❖ 8 basis points (1994) to 43 basis points (1989)
Passmore, Sparks, and Ingpen (2002)	1992-1999	California	❖ Fixed-rate ❖ Term = 30 ❖ LTV ≤ 80% ❖ Principal ≥ $125,000 ❖ Rate 5% to 12% ❖ Jumbo loans at least $20,000 above but less than twice the conforming loan limit	❖ 18 to 23 basis points
Congressional Budget Office (2001)	1995:Q1 to 2000:Q2	No screen	❖ LTV ≥ 20% and LTV ≤ 97% ❖ Principal between 25 and 200 percent of the conforming loan limit	❖ 4 to 35 basis points ❖ Average 22.8 basis points
McKenzie (2002)	1986-2000	No screen	❖ Fixed-rate ❖ Existing properties ❖ Term=30 ❖ Loan balances within a 75 percent tolerance around the conforming loan limit ❖ Excludes loans with a rate more than 50 basis points below or more than 200 basis points above the monthly median rate	❖ Range of annual estimates is from 10 basis points (1994) to 35 basis points (1989) ❖ Average is 22 basis points over the 1986-2000 period ❖ Average is 19 basis points over the 1996-2000 period

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Mr. STEARNS. I thank the gentleman. Dr. Linsmeier, welcome.

STATEMENT OF THOMAS J. LINSMEIER

Mr. LINSMEIER. Thank you, Chairman Stearns and members of the subcommittee. I appreciate the opportunity to testify today.

My written testimony contains my complete evaluation of FASB derivative accounting standards and my recommendations to Congress relating to Freddie Mac's situation.

During my oral testimony this afternoon, I would like to amplify on my written testimony by summarizing the political process resulting in the issuance of FASB Statement 133, evaluating the implications of my analysis for Freddie Mac and Fannie Mae, and outlining some recommendations with the aim toward providing better information for investors and regulators.

In part, Statement 133 was issued in response to a long list of derivative losses in the mid 1990's at companies such as Gibson Greetings, Proctor and Gamble, and Bankers Trust.

Prior to issuance of new FASB and SEC rules, there was a lack of transparency about derivatives and derivative risks in financial reports. To make derivatives risk transparent required recognition of derivatives at fair value—that is, estimated selling price—in the balance sheet. However, the FASB faced strong resistance by the issuer community to fair valuing any financial instruments in financial statements because it would make the economic results of their firms look more volatile.

The degree of income volatility, however, is exactly the type of information needed to understand the risks in returns associated with Freddie Mac and Fannie Mae because their business success depends on their ability to make money in volatile interest rate markets.

As stated in Statement 133, the FASB recognized that the ideal standard to make this volatility transparent is to fair value all financial, not just derivatives, in the balance sheet and income statement. Ferocious corporate lobbying efforts precipitating several congressional hearings, in part, caused the FASB not to propose this standard, but to take the interim step of fair valuing derivatives, but not other financial instruments in financial statements.

This political necessity created a demand for hedge accounting and the need to identify derivatives separately from all other financial instruments. Two issues that transformed a simple principle, fair valuing all financial instruments, into a complex standard.

Emboldened by their successes, corporate lobbyists increased the intensity of their cries for forms of hedge accounting models that further reduced income statement volatility, increasing the standard's complexity. The outcome is a complicated and lengthy hedge accounting standard that provides limited insight into overall risk exposures of an entity.

As suggested in my written testimony, despite these compromises and increases in complexity, I believe that the information available to investors post-Statement 133 is considerably better than pre-Statement 133.

Next, I address the implications of this analysis for standard-setting especially in relation to Freddie Mac and Fannie Mae, by raising and answering three questions.

First, is the complexity of FASB's derivative standards to blame for Freddie Mac's problems? I believe not.

Freddie's accounting problems were not limited to FASB's derivative standards. Freddie apparently, according to their press release, misapplied four different sets of accounting standards, two of which are not complex at all. In addition, despite the complexity of FASB's derivative standards, in contrast to Freddie, Fannie Mae prepares its reports in compliance with GAAP. Fannie's reports provide, to me, useful and understandable information about its interest rate risk exposures.

My conclusion is that complex accounting standards do not necessarily lead to confusing financial reports.

Second question: Would setting principles versus rules-based standards necessarily minimize financial statement issuers' problems leading to better information for Freddie's and Fannie's investors? I think likely not.

Freddie apparently violated both principles and rules-based standards in achieving its earnings targets. For principles-based standards to work, people need to apply the standards in investors' best interest promoting transparency, and that has been lacking in our markets over the last couple of years.

Rules-based standards have one advantage, they set bounds that monitors can more easily evaluate. Besides, it is my opinion that all FASB standards are principles-based, consistent with the Board's conceptual framework. The only issue that remains are the degrees of rules needed to make the standard effective. The extent of rules employed in each standard necessarily will vary depending on the nature of the transaction being accounted for, and the extent that political compromise necessary to get the standard passed. In my opinion, principles-based standard-setting should not be legislated, but should be a good foundation from which all standards are written.

Third, and last, how can Freddie's and Fannie's investors be better served? I have three recommendations for your consideration.

First, require the companies to prepare periodic financial reports in conformity with GAAP. Do not allow such compliance to be voluntary. This should make monitoring by regulators, boards of directors, and auditors effective, and will make Freddie's and Fannie's information more comparable to other financial institutions exposed to interest rate risk.

Second, redefine core capital measures to include unrealized derivative gains and losses on cash-flow hedges. As detailed in the Heard On The Street article in today's Wall Street Journal, currently these gains and losses resulting from current interest rate movements are excluded from income and core capital for periods up to 30 years, causing Fannie's core capital to be overstated by over $15 billion today.

Last, I recommend that there be facilitation of FASB's long-term goal of issuing a standard requiring the fair valuing of all financial instruments. That is the principle. This outcome will be best facilitated by congressional nonintervention in the standard-setting process, helping to insulate the FASB from undue political pressures like they experienced leading the 133, and allowing the

FASB's careful due process mechanism to work in the best interest of investors.

Information reported under such a standard will allow investors to best understand Freddie and Fannie's exposure to current interest rate changes. Thank you for your attention.

Mr. STEARNS. I thank you. I want to commend staff. I think we have had a balanced hearing here. We have heard pluses and minuses. Mr. Baumann, I was going to start off with you, but after hearing Mr. Wallison, I just want to ask him a question.

Do you believe disclosure under GAAP accounting to be deficient in communicating a true financial picture of a company to investors? I mean, just give me that overall feeling that you have, you know, at the very top here.

Mr. WALLISON. I don't think, Mr. Chairman, that financial disclosure under GAAP is, by itself, sufficient to give an investor, or a regulator, or the American people, or Congress——

Mr. STEARNS. Or even institutional investors or anybody——

Mr. WALLISON. [continuing] institutional investors, none of them get enough information simply from GAAP. GAAP is inherently a malleable subject, and the production of a bottom line number in GAAP depends on many judgments that management makes. Many of them are predictions about the future.

Mr. STEARNS. So if I submitted a GAAP document to you and said, "This is a really hot company, you should really invest in it," what would you—you would look at that and say, "Mr. Stearns, that just doesn't mean anything to me." What would you ask for?

Mr. WALLISON. Well, there are a couple of things that could be useful. First of all, there could be a lot more information about cash-flow. I don't think that the GAAP financial statement, as required now, provides enough information for investors to evaluate cash-flow.

One of the very interesting things that happened in Enron was that as Enron was reporting their fake earnings over a period of time, their stock was falling against the industry standards. Others in the industry were remaining about the same, but Enron stock was falling, and that is because their cash returns were negative while they were reporting earnings.

Mr. STEARNS. So you would just look at the cash-flow, period, and you——

Mr. WALLISON. You would look at cash-flow, that is exactly right. More cash-flow information would give an investor, an analyst, another way of judging whether the——

Mr. STEARNS. If you could wave a magic wand, you would redo all of FASB to make it more cash-flow based, rather than——

Mr. WALLISON. I would include much more cash information. I would have the SEC provide investors that they could evaluate cash-flow. I would require more cash-flow disclosure from the—the SEC should require it from companies. And then, in addition, there are many other things that could be requested, including financial indicators that——

Mr. STEARNS. Dr. Linsmeier, do you agree with him, or disagree? He is basically saying the GAAP is really not clear at all, does not provide any information, and he wants to see cash-flow.

Mr. LINSMEIER. I didn't hear him say that. I heard him say that given the GAAP basis statements, he would like more cash-flow to augment those statements to complete the understanding.

Mr. STEARNS. Okay. That is a better read of that. And do you agree with that? Or would you be happy with just a GAAP statement? Could you make enough analysis to invest your grandchildren's trust fund, if you just had a GAAP? Would you be satisfied with that?

Mr. LINSMEIER. Well, I think I would always like more information. I don't know about the cash-flow statement that Mr. Wallison just talked about because there is a cash-flow statement already in GAAP. And what I would have to understand better is what sort of analyses he would like to have in more detail, to improve that circumstance.

Mr. STEARNS. The gentlelady Schakowsky just mentioned in her opening statement how she hopes we will have a hearing after the Dowdy report comes out, and I agree with her and we intend to have that, and I commend her for making that reference.

Mr. Baumann, I appreciate your coming here. As you know, we are trying to work through this, and we have been seeking documents and to interview witnesses from Pricewaterhouse in connection with an inquiry into the accounting questions raised by Freddie Mac's restatement. And I guess my question is to you, will you help us and will you commit to provide us with the requested documents and access, of course, which is important for us to study this, to Pricewaterhouse in the next couple of weeks? Could we get your commitment on that?

Mr. BAUMANN. We are committed to helping all parties that are investigating Freddie Mac. There is an investigation underway by the SEC, by OFHEO, by the U.S. Attorney——

Mr. STEARNS. You have got your hands full.

Mr. BAUMANN. We are actively giving documents and access to all parties that have an appropriate jurisdiction to investigate us, and certainly we would be more than happy to make sure that you get all the information you need.

Mr. STEARNS. We had this jurisdiction during FASB, and of course dealing with FASB, we got to understand through Pricewaterhouse some questions, so we appreciate your cooperation here. Let me come back to you, Mr. Baumann.

By using the special hedging rules, FAS 133, Freddie sort of prevents investors from seeing the gains and losses in their derivative positions reflected in quarterly earnings that you report. Will Freddie Mac commit to stop using the special hedging rules so investors will have an accurate picture of the gains and losses in Freddie's derivative positions?

Mr. BAUMANN. Freddie Mac follows GAAP, and will follow GAAP in the future, to the extent we made some mistakes in the past. And Freddie Mac has no intention in the past or present to hide any gains or loss from any investors.

Mr. STEARNS. Special hedging rules. I guess the question is, will you commit to stop using these special hedging rules, and they are part of GAAP. So, we are just trying to say what kind of commitment are you going to make dealing with these special hedging rules?

Mr. BAUMANN. To the extent we use FAS 133 hedging standards, we will follow 133 and follow the rules in 133. To the extent they are special hedging rules or any other type of hedging rules in 133, we will follow them.

Mr. STEARNS. For example, do you think that investors should have the ability to see Freddie's gains and losses in derivative positions on a quarterly basis?

Mr. BAUMANN. Absolutely. First of all, we believe that there's a lot of information that investors get from financial statements. Getting back to the question you asked before, the GAAP financial statements present certain information about shareholders equity and other gains and losses are included in shareholders equity, but the fair value balance sheet includes all financial instruments mark to market at fair value, and present significant information to investors. We present that annually now, as all companies are required to do. We are committed now to present that fair value balance sheet quarterly so there would be complete transparency about the fair value of all of our financial instruments.

Mr. STEARNS. I appreciate your commitment on that. As we understand it, though, that if you use special hedging rules—and, Ms. Seidman, you can help me out here—if you use special hedging rules, then you are not able to commit to losses and gains in derivative positions on a quarterly basis, is that true? If he uses special hedging rules, that you cannot have a quarterly basis for reporting the gains and losses in these derivative positions, is that true?

Ms. SEIDMAN. It would depend on what specific type of hedging transaction they are engaging in. If they are engaging in a hedge of a fixed rate item, such as a loan or a debt instrument, the gain or loss on the derivative is reported in earnings quarterly throughout the life of the hedge. But the item being hedged is also being mark to market, which is what gives you the net offset in the income statement, whereas if they were hedging a floating rate instrument, that is the case where the gain or loss on the derivative is deferred onto the balance sheet——

Mr. STEARNS. Okay, understand. So the mark to market cannot be done on a floating interest rate whereas a fixed you can. So is my question fair to him to say you can't really commit to quarterly reports on the special hedging derivatives that are floating.

Ms. SEIDMAN. If the context of the question is limited to the cash-flow hedges, there remains a question of whether it would stay deferred on the balance sheet.

Mr. STEARNS. Okay. My time is expired. The gentlelady.

Ms. SCHAKOWSKY. Thank you. Ms. Seidman, is FASB itself looking at reviewing its standards of accounting for derivatives, and are proposals being made? Where are you in terms of reviewing those standards?

Ms. SEIDMAN. We have on our agenda a long-term project to potentially report all financial instruments at fair value in the balance sheet. Part of that effort would include derivative. However, before we are able to move to that potential objective, there are several remaining issues that we need to deal with that are quite important and must be resolved before we could achieve that goal. They include, first off, the appropriate level of guidance that is necessary to determine the fair value of a wide range of financial in-

struments, ranging from long-term debt where there are questions about how to reflect the changes in credit quality of the issuer, as well as some concern about the possibility in a fair value world, of reporting a liability at an amount less than what is owed.

Another area that we would like to consider is the distinction between liabilities and equity, for example, so that companies would know where the line is for what needs to be mark to market. And, last, we have a financial performance reporting project on our agenda which will help clarify the way gains and losses on all financial instruments would be reported in the financial statements—that is, whether those amounts would go to earnings, or whether they would go through other comprehensive income in a manner similar to some hedges today.

Ms. SCHAKOWSKY. And how long do you project that this kind of review and the recommendations that would result from that would take?

Ms. SEIDMAN. I am not in a position to give you a specific date on that, but one other point I would like to make is that we are working together with international standard-setters on this effort. To the extent that we could obtain international convergence on such an important area, that would be the desirable goal.

So, other standard-setters—for example, the International Accounting Standards Board—is a little bit behind us in this area. They have not yet issued their standard on accounting for derivatives. And I would like to note that the proposal that they are about to go out with largely mirrors Statement 133, which is an important point from a convergence standpoint. Here we have a much more recent standard-setting effort that is essentially coming to the same conclusion that the FASB did. So, they, too, view this as an interim step, and down the road we would like to then consider any remaining issues so that we could have a goal of all financial instruments at fair value.

Ms. SCHAKOWSKY. Thank you. Dr. Linsmeier, I am sorry I came in so late and didn't hear your testimony, but I have your testimony and I am looking at it. When you talk about the look to the future, the way to fix the problem described—I am looking at your slide show—is to issue a standard that requires full fair value accounting for all financial instruments in the balance sheets eliminates fair value hedge accounting. FASB foreshadowed the need for such a standard in FAS 133, and is currently considering issuing such a standard.

This standard was not issued previously due to—and I want to focus on this one—extreme political pressures by constituencies against fair value accounting for financial instruments for specific forms of hedge accounting that minimize the income statement effect of hedging transactions.

I am wondering from you—and I would also like to return then to Ms. Seidman—to see if you think that those political pressures are likely once again to thwart the issuance of such a standard.

Mr. LINSMEIER. I think that the political issues will be very important and there will be large pressure not to proceed forward on that project on the long-term basis. We can see in Europe right now that there is a big pushback right now by the banking community and by the European Union against even a standard like

Statement 133, and the politics are extremely powerful there. And I would suspect, without a doubt, that if there was a move to fair value all financial instruments, there would be significant political pressure to try to stop that.

Ms. SCHAKOWSKY. Are you aware of such pressure now, Ms. Seidman, and do you expect to encounter it as you move forward?

Ms. SEIDMAN. I concur with Dr. Linsmeier's assessment of the situation overseas. Even to get to the same level of standards that we have in this country, they are meeting a great deal of resistance in Europe.

One additional point that I would like to add is that even when we are able to move to a full fair value model, I think there is an element of our constituency whose concerns would still not be addressed, specifically, the large multi-national corporates whose balance sheets are not predominantly financial instruments, currently engage in hedging transactions—for example, to hedge forecasted purchases of inventory or overseas sales or that type of thing. Those are not financial instrument transactions per se, and they have expressed a significant need, and we certainly know that they do employ hedge accounting. So, a fair value approach doesn't resolve all of the need for hedge accounting.

Ms. SCHAKOWSKY. Thank you.

Mr. STEARNS. The gentleman from New Hampshire.

Mr. BASS. Thank you, Mr. Chairman. Mr. Chairman, I am not an accountant, and I am not a sophisticated investment advisor or consultant, so I am going to ask just one question of Mr. Baumann.

Freddie Mac has had some financial problems and I guess some misreporting of financial data and so forth. And in the course of presenting your testimony, you discussed a remediation process. I was wondering if you could take a moment or two to describe in some detail what the problem was, the remediation process that you undertook, and how we can be assured that this process will prevent further problems with Freddie Mac?

Mr. BAUMANN. Thank you, I would be glad to address that.

Mr. BASS. By the way, in a manner that people like me can understand.

Mr. BAUMANN. I am sure you will understand it. We have developed a comprehensive mediation plan which we have presented to our primary regulator, OFHEO. That remediation plan deals with all of the aspects that go around a company's financial accounting control and reporting processes. It starts at the top of the company, it starts at the board level, and ensuring that the information that—first of all, that the authorities granted by the board are fully carried out by officers and employees of Freddie Mac, and that they only operate in accordance with the boundaries of the authorities and limits granted by the board of directors, then ensuring that control processes are in place within the company that only transactions approved by those authorities are entered into, and no transactions outside of those authorities are entered into, and then ensures that all of those transactions are properly and correctly accumulated in our records and appropriately and correctly reported both back to the board, to investors, and to regulators in a very transparent way so that all constituencies fully understand what the business is we are in, how we execute it, how we do it in a con-

trolled fashion, and how we report that to, again, board, shareholders, regulators, and other interested parties.

Having all the necessary controls in a company isn't always a very exciting conversation to have, but it is absolutely fundamentally necessary to have strong accounting controls, to have experts that we are hiring to deal with the complex accounting rules that Ms. Seidman has talked about in FAS 133, and other areas. We need to be able to deal with all those rules, and we should be able to. There is no excuse for Freddie Mac's accounting problems other than it didn't have the right internal controls in place around accounting and financial reporting, that it didn't have the right expertise in place to handle all these types of transactions.

So this remediation plan will ensure that we have all those processes in place. It is a high-level plan. We review it weekly with the Governance Committee of our board of directors, and all the progress and steps that we are making are under the oversight of the board, and we are reviewing it regularly with our regulator, OFHEO, as well as with our auditors, PricewaterhouseCoopers.

Mr. BASS. Thank you, Mr. Chairman.

Mr. STEARNS. The gentleman from Massachusetts, and he was here when we put the gavel down, so he is entitled to 8 minutes.

Mr. MARKEY. I thank the Chair. And I am going to begin with a little song, if I can, Mr. Chairman. I thought I would break up the afternoon a little bit, and it goes to the tune of "Mac, the Knife." I just thought it might entertain and illuminate.

When those earnings rise on your balance sheet, dear,
And you want them out of sight,
Just do a swaps deal, says old Mac's execs,
And defer them with all your might.
You know, when the reserve account with its cash, babe,
Hides those earnings, it helps the spread,
Fancy derivatives has old Mac, dear,
So there is never, never a trace of red.
Now, on the sidewalk some sunny morning,
Lies investors just oozing life,
And someone is sneaking round the corner,
Could that someone be Mac, the Knife?

So that is my opening, Mr. Chairman. And now I am going to ask Mr. Baumann a few questions.

On page 2, Mr. Baumann, of your June 25, 2003 press release that you attached to your testimony, it sates that outside counsel engaged by Freddie Mac's board has found that "certain capital market transactions and accounting policies had been implemented with a view to their effect on earnings in the context of achieving Freddie Mac's goal of achieving steady earnings growth, and that the disclosure processes and disclosure in connection with those transactions and policies did not meet standards that would be required of Freddie Mac had it been an SEC registrant."

Now, Mr. Baumann, for many years Freddie Mac has claimed that its disclosures were as good, or better, than those required of SEC registered companies, and that all of its financial statements complied with generally accepted accounting principles.

Now we have the company in the middle of a massive restatement of its earnings for the last 3 years, a restatement which

Freddie Mac has said will increase earnings somewhere between $1.5 and $4.5 billion.

So let me begin by asking you, how could a company as large and as well respected as Freddie Mac underreport its earnings by that much, and why is there such a large margin of uncertainty about the size of the restatement?

Mr. BAUMANN. First, I thought the song was excellent, and I thought the song was very good, also.

With respect to the accounting errors, Freddie Mac didn't have the right accounting expertise in place to get the accounting right for certain accounting standards. As a result of that, certain assets will now be mark to market that were previously accounted for at cost. Certain derivatives will now be mark to market without the related asset or liability being marked with it, and in a declining interest rate environment, that has resulted in those mark to markets being a large increase to accumulated earnings in this $1.5 to $4.5 billion range.

Mr. MARKEY. And why is the spread so great right now, the size of the restatement? Why can't you get it closer than 1.5 to 4.5?

Mr. BAUMANN. We wanted to make sure when we did this—we still had a lot of work remaining with respect to completing the restatement. We are dealing with very large numbers in terms of the size of our balance sheet and the size of the derivatives involved. And we wanted to make sure that we didn't announce a number that was either too low or too high such that we would confuse investors.

Mr. MARKEY. It just seems like an awful big range of uncertainty. As a matter of fact, it is almost a scary level of uncertainty, $1.4 billion to $4.5 billion for one company.

Mr. BAUMANN. I agree, it is a very large number.

Mr. MARKEY. Now, the quote I read you earlier from Freddie Mac's press release seems to acknowledge that Freddie Mac was managing earnings using derivatives transactions. Isn't it true that Freddie Mac's management was trying to exploit FASB's hedge accounting rules in order to avoid having to report the fair value of its derivatives positions in its earnings statements?

Mr. BAUMANN. The report of Baker Botts will be made public very shortly, possibly as early as tomorrow. Baker Botts was hired by the board, independent counsel to review all of the facts and circumstances surrounding the accounting errors and the issues around it, and that report will get into the causation of all of these errors. And I think I would be premature to comment in advance of that.

Mr. MARKEY. Your press secretary acknowledges that the disclosure processes and disclosures that were made in connection with these transactions and policies didn't meet the standard that would be required of an SEC registrant. Can you tell us in what specific ways did these disclosure processes and disclosures not comply with the standards required of SEC registered companies?

Mr. BAUMANN. The press release says that board counsel has presented preliminary findings, and so these comments are from board counsel. It is board counsel's view as to whether or not these disclosures met standards of appropriateness or not.

Mr. MARKEY. So you don't agree with your counsel's conclusion on that subject?

Mr. BAUMANN. I didn't say that. I said these were board counsel's findings, we were referring to the quote, sir.

Mr. MARKEY. Have you been briefed on the basis for that statement that was made?

Mr. BAUMANN. I have reviewed the accounting errors and the related accounting disclosures.

Mr. MARKEY. Have you talked to the counsel about the conclusion which they reached on that subject with regard to the SEC requirements? Has he talked to you about that?

Mr. BAUMANN. Certainly, board counsel has been spending a lot of time——

Mr. MARKEY. Has he talked to you about it?

Mr. BAUMANN. Has board counsel talked to me?

Mr. MARKEY. About the differentiation between the SEC requirements and what you had been required—did he talk to you about that?

Mr. BAUMANN. Not in great detail.

Mr. MARKEY. But he did talk to you about it?

Mr. BAUMANN. Yes.

Mr. MARKEY. And in his outline of the differences, do you have any reason to disagree with what the counsel said to you?

Mr. BAUMANN. Based upon what board counsel has presented to me, I have no disagreements with his findings at this point in time.

Mr. MARKEY. Okay. That is that if you had been an SEC registered company, that you may have avoided this problem in terms of the disclosure which you would have been required to make.

Mr. BAUMANN. Freddie Mac is committed to the registration process now. We have begun the SEC registration process, and we will commence completing that process as soon as the restatement is done.

Mr. MARKEY. Now, the same statement makes reference to Freddie Mac's use of certain reserve accounts and other adjustments that were known departures from GAAP and that were not considered material at the time, and were made with a view to their effect on earnings. That is all part of your press statement.

Now, that says to me that Freddie Mac was using your reserves to manipulate or manage earnings and that you knew at the time you were doing this, and that your accounting didn't conform with GAAP. Can you explain to us how you can make use of a reserve account to affect earnings and have it not be material?

Mr. BAUMANN. I can't explain that, but that is what the company appeared to have done in the past, according to board counsel.

Mr. MARKEY. But if you were successful in affecting earnings, wouldn't it be, by definition, have been a material transaction?

Mr. BAUMANN. I think that largely Staff Accounting Bulletin 99 of the SEC would say that if the adjustment impacts earnings, that that should be disclosed.

Mr. MARKEY. So if the transaction caused the company to meet or exceed the consensual analysis prediction regarding your earnings, that would be material.

Mr. BAUMANN. That would probably be material in those cases.

Mr. MARKEY. Thank you, Mr. Chairman, my time is expired.

Mr. STEARNS. Thank the gentleman. Mr. Strickland, the gentleman from Ohio.

Mr. STRICKLAND. Thank you, Mr. Chairman. Mr. Wallison, I read in your testimony that you say that your preferred answer would be to privatize Fannie and Freddie, and at the same time break them up into five or six smaller entities. You also say that you are aware that this solution is not for the moment on anyone's radar screen. But just speculating for a moment that this could be accomplished, if these privatizations were to take place, as you would like to see, how can you say with a high degree of certainty that their important affordable housing mission would be met by other financial services companies. Is that a concern to you?

Mr. WALLISON. Yes, it would be a concern to me, but I don't think the—first of all, I don't think Fannie and Freddie are meeting the affordable housing objectives that probably Congress would want them to meet because there is a conflict between their government mission and their necessity as private corporations to maximize profitability. And so the benefits that Freddie and Fannie receive from Congress in the form of government backing coming from a number of links results in their using much of that benefit for shareholder compensation and management compensation, and not fully using that benefit for the assistance to affordable housing.

So I would not expect that if Fannie and Freddie were privatized and there was full competition in the market among a whole range of companies offering secondary mortgage market services, that there would be any substantial decline in the amount of affordable housing support that comes from the government. In fact, if the government, if Congress took the benefits that Fannie and Freddie get, which has been estimated by CBO to be about $10 billion a year, and made that available directly for down payment support for people who cannot otherwise—or don't otherwise have the down payment necessary to buy housing, that would really advance the housing objectives of Congress to a degree that Fannie and Freddie do not do.

Mr. STRICKLAND. Could I ask the others, how would you respond to the answer I just received, do you have concerns about what would happen following privatization, or do you agree? I am just interested in how you would respond to the answer you just heard. Mr. Baumann?

Mr. BAUMANN. Well, let me first respond that I think when Congress gave certain powers, the charter to Freddie Mac and Fannie Mae to expand home ownership in America, it has been one of the true success stories in America about home ownership in an otherwise dour economy. In the last couple of years, the housing sector has been enormous, and the increase in value that people have received in their homes that they have, or the ability to refinance in this low interest rate environment and save themselves millions of dollars in total, the benefits to the consumer from the legislation that was passed that enabled Freddie Mac and Fannie Mae to do what we do has been one of the truly enormous success stories around.

Mr. STRICKLAND. So you would take exception with Mr. Wallison's assessment of the situation regarding the management's use of the resources available to it?

Mr. BAUMANN. I would take exception, I would take complete exception, as I think the facts would demonstrate as well.

Mr. STRICKLAND. And, Dr. Linsmeier, I assume that you may be sort of the objective observer in this. I am interested in what you may say.

Mr. LINSMEIER. I don't really have a deep opinion about this. I think both sides of the argument have been put forward by the two individuals that spoke before me and, frankly, I am glad I am not a Member of Congress and have to decide between these two points of view.

Mr. STRICKLAND. Mr. Chairman, I yield back my remaining 25 seconds. Thank you.

Mr. STEARNS. Thank the gentleman. The gentleman from Michigan, Mr. Stupak.

Mr. STUPAK. Thank you, Mr. Chairman. First of all, Mr. Chairman, I ask unanimous consent that members put their opening statements in the record.

Mr. STEARNS. By unanimous consent, so ordered, and all members will have, after the hearing, sufficient time to put their additional comments in, and questions.

Mr. STUPAK. Did you extend it to all members?

Mr. STEARNS. To all members.

Mr. STUPAK. Thank you, Mr. Chairman. Ms. Seidman, back in the late 1990's, I supported FASB's proposal to require that companies report derivatives at fair value. I know Ranking Member Dingell was very involved in the issue, and that former FASB Chairman Jenkins was also supportive of this as well.

Do you believe that the accounting exceptions for hedge funds should be amended, or that other regulatory measures regarding GAAP principles could be made to ensure greater transparency and openness with regard to transactions that are the subject of today's hearing, so that we can better protect investors? And I ask this partly because I wonder how it is that there can be such a differing accounting occurring with Freddie Mac and Fannie Mae, and whether this means there is too much wiggle room in the current guidelines, and in light of the Enrons and everything else, we want to make sure we are doing all we can to protect future investors and we don't have anymore scandals like this. Can you try and explain that a little bit?

Ms. SEIDMAN. May I just clarify the question? You are essentially asking whether we would continue to support hedge accounting rules, the need for hedge accounting rules, and my opinion on whether there is too much wiggle room?

Mr. STUPAK. Right.

Ms. SEIDMAN. The first thing, I don't have access to information about Freddie Mac or Fannie Mae's particular circumstances. One thing that may be not widely understood, and for good reason, is that there are different types of hedge accounting practices going on that are intended to mirror different transactions. So what you might see in Freddie Mac's case might actually be responding to a different transaction than what you see in Fannie's case. And I

would agree that the accounting for them is very different. I would need to know the facts and circumstances to really give you an informed opinion about that.

When FAS 133 was developed, though, it carried for many prevalent hedge accounting practices that had been in place for decades really before. But what we did that was different in 133 was significantly narrow the circumstances when hedge accounting was allowed. There had to be a specific transaction identified, a specific risk. Documentation has to be made at inception of the transaction, along with a discussion of how effectiveness is going to be assessed. Those additional criteria make this accounting standard much more restrictive than the practices had been in the past. Plus, along with that, there is a disclosure package to help investors—not to say it pejoratively—but to unwind it if they so choose.

So it seems that the combination of fair value disclosure, very restrictive hedge criteria, and supplemental disclosure about hedge ineffectiveness we would stand behind as giving a transparent picture of companies that elect hedge accounting at this point.

Mr. STUPAK. Is there anything different you would have us put in FASB that would help strengthen it, or especially Rule 133? Conceivably the rules are okay, you just have to apply the proper circumstances to the derivative you are dealing with.

Ms. SEIDMAN. That would be my perspective. We really couldn't be clearer about the need to designate up front the transactions that you are entering into, and the methods that you are going to use to assess effectiveness over time.

Mr. STUPAK. Thank you. Dr. Linsmeier, while we do not know the full extent of the accounting problems at Freddie Mac, could you clarify whether the accounting mistakes they made actually had any real economic effect jeopardizing any underlying financial structure or capital? They understated their earnings. All the ones we have had up to this, Enron and everyone else, always overstated their earnings. So is there any real economic effect jeopardizing capital or financial structure?

Mr. LINSMEIER. I only can react based on my reading of their press release of their apparent problems, and I am a little befuddled by the general reaction of the market that it is a nonissue because income will increase as a result of the adjustment because what the truth is, if income is increased in this period, it is going to be decreased in a later period. That is what happens with accrual-based accounting methods. And I think the implication of the accounting changes once they are announced—and we will know much better the truth of that when they are—will be that there will be greater volatility in income exhibited by Freddie Mac. Greater volatility might suggest greater risk, and that might have implications on the cost of capital. To the extent to which that insignificant and how it affects the economy in general, it is way too early to be able to tell, but volatility is an issue.

Mr. STUPAK. I think the chairman said we are going to have some more hearings, maybe we could have a better handle on it then.

Mr. Baumann, if I may ask one question, just sitting here listening to all this—and I apologize I didn't make all of it as I was in some other meetings—but when you take a look at this, if you

earnings are understated, most shareholders who invested between 2000 and 2002, and let us say they pulled out because they didn't feel they were getting good enough return, has any thought been given on how do you make these people whole? If earnings were greater than they should have been, they should have gotten greater return on their shares?

Mr. BAUMANN. The earnings should have been, as you said, about $1.5 to $4.5 billion greater. Certainly, investors got very high returns. Freddie Mac stock was one of the highest performing stocks over the past number of years. So the returns on equity have been very high in the company. But having said that, there are a number of class action lawsuits against the company in the context of bad financial reporting in the past. So Freddie Mac will have to answer to those shareholders who feel that they were misled in the past, and the company will have to resolve those matters.

Our press release on June 24 did acknowledge the fact that cumulative increases in the past will result in offsets in the future, so we did acknowledge that, as you have indicated, and that this would cause greater GAAP earnings volatility, but that GAAP earnings volatility. The fair value of our equity will not change under either circumstances, and we think that is an important supplemental measure that we disclose.

Mr. BASS [presiding]. Thank you. The chair recognizes the gentleman from Texas for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman. Coming from a district in Houston, it is interesting that we have concern about accounting standards hiding profits instead of hiding losses. Our committee has broad jurisdiction, so I am glad we can take up hiding losses as well as hiding profits.

Mr. Wallison, the American Enterprise Institute suggests—I agree—that there might have been better use for some of that profit to buydown down payments, and I have to admit I am somewhat surprised the American Enterprise Institute would make that suggestion. Although I understand it is a quasi-government corporation, they owe a duty to the taxpayers because of that, and I would hope that would be something Freddie Mac would consider. And, again, having a very urban area, we work all the time to try to make housing affordable with both these agencies in the secondary market, in moderate priced homes.

Ms. Seidman of FASB and Mr. Baumann of Freddie Mac, Mr. Linsmeier suggests that FASB issue a standard that requires fair value accounting and eliminates fair value and cash-flow hedge accounting. I would like you to comment on whether this suggestion would be practicable and feasible from an accounting perspective. It seems like it would paint a better picture for the investors as to the company's true financial health. I would just like to see how you would respond to that. Again, it is an unusual situation that you are hedging profits and not losses over a long-term period but, again, the investors I think should have the best information possible to make that determination. Do you have a comment on that?

Ms. SEIDMAN. Sure. Statement 133 was an interim solution to an immediate problem to address the accounting for derivatives. The Board at the time absolutely would have preferred to address the

accounting for all financial instruments at fair value, but given the urgency of the matter and the large number of unresolved issues that would allow us to move toward a full mark to market model, we made an interim step in requiring that all derivatives be reported on the balance sheet at fair value. Because that left unattended the accounting for a wide variety of other financial instruments, what we had was what we call a "multi-attribute" model—that is, some were carried at cost, some at market, and some at the lower cost or market—that is what really causes the need for hedge accounting. If derivatives are being used to mitigate risk and those other risks aren't also carried at fair value, hedge accounting allows you to bridge between the two to recognize the gains and losses in the same period.

Having said that, we have on our agenda an ongoing project to consider the issues that would be necessary for us to move toward a fair value accounting model. Included among those are specifically how certain types of items should be measured. For example, there are deposit bases of financial institutions that raise some very interesting and difficult questions, the whole area of accounting for liabilities at fair value, and then the very important question of how should the gains and losses be reported—should they be in the income statement as part of earnings, or should they be in the balance sheet as part of equity.

So we continue to work on those remaining questions with the ultimate goal of moving toward a mark to market model. That is something we like to do in concert with international standard-setters to the extent we possibly can.

Mr. GREEN. Mr. Baumann.

Mr. BAUMANN. I agree with the comments of Ms. Seidman. What I would say is that companies have a responsibility to follow GAAP, but also to ensure that additional information is provided to investors at all times so they fully understand the company's financial condition and results and future prospects. So that is not only providing GAAP financial statements and accounting for all transactions in accordance with GAAP, but providing other information such as quarterly fair value information so that investors can understand how transactions might look under a fair value basis at the same time as they are looking at it under a GAAP basis which may not be fair value. Beyond that, companies also should disclose much more information about the nature of the business, the risks and uncertainties in the business, and how those risks and uncertainties are being managed. So it is not just the GAAP financial accounting. I think GAAP rules are fine, there is no problem with the GAAP rules today, they can always be improved, but it is the combination of reporting around GAAP, fair value, and other comprehensive disclosures that enable investors to get a true picture of a company.

Mr. GREEN. Mr. Chairman, I know I am out of time, but I would like to, one, ask if there is a timeline, Ms. Seidman, on that effort, but also the concern I have after going through what we did with the energy companies, and Enron in particular, but also other companies such as WorldCom. Do you think FAS 133 is applied consistently across the board, not depending on the company but to all companies.

And with that, Mr. Chairman, again, I appreciate your calling the hearing.

Ms. SEIDMAN. With respect to the timeline, I am not able to give you an estimate of exactly when we might get to the point of issuing a fair value statement. There are a number of steps in the interim that will each take a bit of time.

As I mentioned before, we would like to do this in concert with international standard-setters who are in a bit of a catch-up mode with the United States. We are out front on these issues, and they need to get some basic accounting standards in place before they are willing to consider a more comprehensive review of the subject.

Mr. GREEN. Do you think 133 is applied consistently from company to company, again, for some stability to the market or to the investors?

Ms. SEIDMAN. My best way to respond to that is to the extent that companies have similar transactions, if the companies both elected hedge accounting using the same derivative instruments, I believe that the reporting that they would provide would be consistent.

Having said that, companies enter into hedging transactions in very different ways, and hedge accounting itself is elective. So, to some degree, there is a lack of comparability between companies. However, one guiding principle that 133 does achieve is that all derivatives that are being used are on the balance sheet at fair value. And to the extent that these elections are made, they are required to be disclosed.

Mr. GREEN. Mr. Chairman, again, thank you, and I am glad the subcommittee is having this hearing and hope it will keep this issue on our agenda for sometime in the future so we can be updated on the progress.

Mr. STEARNS I thank the gentleman, and I appreciate his encouragement because we intend to have a second hearing on this. And as you know, we have jurisdiction over FASB. We don't have the Security and Exchange Commission, which the Commerce Committee did have before the 108th Congress, so we are not fully engaged with the SEC, but we are with FASB.

Mr. GREEN. I think we can get to some issues by using our jurisdiction on FASB.

Mr. STEARNS. For sure. Let me conclude perhaps by, Mr. Baumann and Dr. Linsmeier. Mr. Baumann, you talked about fair value for securities and for debt and for derivatives. If we had that, would we need to have special hedging accounting rules, if we had the fair value mark to market?

Mr. BAUMANN. No, you are absolutely right. If securities, assets, liabilities, and derivatives or all financial instruments were accounted for at fair value, we wouldn't have any particular hedging rules for accounting purposes. So that would be the simplest method of accounting reporting.

Mr. STEARNS. Dr. Linsmeier, what do you think of that?

Mr. LINSMEIER. For financial institutions, very definitely that would be the case because their assets and liabilities are virtually all financial instruments.

Ms. Seidman raised the issue whether there should be special accounting or hedge accounting for multi-national corporations that

use derivatives to hedge risks in non-financial instruments. I think that will be an issue that will come to the fore, and that multi-national corporations, or corporations in general, will push back not to lose that opportunity. I have no sympathy to continuing hedge accounting once full fair value of financial instruments occurs.

Mr. STEARNS. Ms. Seidman, we have had reform in the banking industry with the Graham-Leach-Bliley bill. We have had reform in the auditing with the Sarbanes-Oxley recently. And after hearing the testimony this morning of the witnesses, don't you think we should have enormous reform, substantial reform in the area of auditing? Don't you think the time has come now? Accounting standard setting, just what you are involved with, don't you think we need reform, substantial reform?

Ms. SEIDMAN. Mr. Chairman, we have a number of efforts underway to reconsider the way we are setting standards, the way we are publishing standards, and——

Mr. STEARNS. So you don't agree, you think you are doing fine?

Ms. SEIDMAN. No, no, no, to the contrary. In response to the call for, for example, principle-based standards, we issued a solicitation of comment among our constituents to raise the question, is there a better way for us to write standards. And along those lines, there was general agreement that there is room to improvement to issue less detailed standards with fewer exceptions. But there is not a consensus on when a principle is sufficiently robust that it is not a rule.

In terms of the overall standard-setting community, there have been a number of monumental steps in the last year and a half where, for example, the AICPA and the FASB reached an agreement to, over a period of transition, consolidate the standard-setting efforts in our country so that it is easier for companies to monitor and comply with standards that are ultimately set. So we are constantly in a process of re-evaluating the way we are setting standards and the way they are communicated, to try and improve.

Mr. STEARNS. Revenue recognition, I think you took 20 years to study that. I think you took 10 years to study special purpose entities. I don't think anybody, in any industry, would think it would require that long a period of time for you to study these things. And having gone through the Enron, the WorldCom, the Imclone, the Qwest, and all those, I would think you would answer the question, yes, there should be substantial reform in FASB, period, with no qualifying comment, because Members of Congress, when I talk to them, I mean, they feel pretty strong about this, that there has got to be some change here and something done. And, of course, Sarbanes-Oxley is attempting to do it. But I would think if you don't lead the charge here, that there is going to be some culpability.

Ms. SEIDMAN. I couldn't agree more. I hope that my comments have not been misunderstood. We agree that we should respond to issues quickly——

Mr. STEARNS. Quickly doesn't mean 20 years or 10 years.

Ms. SEIDMAN. I completely agree with you.

Mr. STEARNS. That is indefensible, that you would take 20 years to study revenue recognition. And when we listened to Enron and all the very complex ways they dealt with special purpose entities

and that you took 10 years to define how that worked, it made all of us who are on the oversight committee—I mean, we just couldn't comprehend how this could be more clear.

Ms. SEIDMAN. That particular standard, the consolidations area, is a much broader project than just special purpose entities. When the issues involving special purpose entities came to the fore in the last few years, we identified that as a more urgent matter and brought it to resolution much more quickly.

Mr. STEARNS. Mr. Wallison, I am going to let you have perhaps almost the end remark here. What would you do if you were in a position with FASB, would you suggest substantial reform of FASB, and what would you do?

Mr. WALLISON. Well, I guess the concern that I would have is that we tend to think that no matter what rules and principles FASB develops, we will get a better set of disclosures. In fact, accounting is not really like that, it is based on predictions of what is going to happen in the future. Very frequently, it is based on changes in classification, and it leaves very much open to decisions by management.

As I said at the outset, Mr. Chairman, the most important thing that we should be considering here with Fannie Mae and Freddie Mac is to look at the risks that they create and realize that just by improving accounting we are not going to be able to inform ourselves adequately about those risks.

Mr. STEARNS. I understood that. Do you have documented anywhere where you said they are getting $10 billion of subsidy from the Federal Government, both Freddie Mac and Fannie Mae?

Mr. WALLISON. That is a report of the Congressional Budget Office in 2001. They did one in 1996 and they did another in 2001, and in 1996 the estimate was about $6 billion. By 2001, it had become $10 billion a year. It is probably much higher now because the larger they get, the larger the subsidy they are receiving from their government support.

Mr. STEARNS. You haven't yet called for privatization of them, though. I heard you sort of qualify that when you were talking about it. Is that your position, that you are just asking that they be more—have quarterly reports that they report to the SEC, but are you calling for privatization?

Mr. WALLISON. Well, my preferred position would be privatization, complete privatization, and as Mr. Strickland suggested, breaking them up so that they are not too big to fail. But I understand that politically that is going to be very difficult to do, and so there is a very simple way to reduce their risks very substantially, and that is to forbid them from buying back their mortgage-backed securities or accumulating large portfolios of mortgages. That would reduce their risks and still not make any significant change in their effect on mortgage interest rates.

Mr. STEARNS. Mr. Baumann, I will let you have the closing comments, if there is anything you want to close before we shut down?

Mr. BAUMANN. Thank you. With respect to the risks that have been addressed, there has been no question that Freddie Mac has extremely strong interest rate risk and credit risk capabilities, and GAAP accounting has not called into question at all the safeness

and soundness of Freddie Mac, and how well Freddie Mac manages those risks.

With respect to Freddie Mac's purchases of mortgage securities, the fact that we have hundreds of billions of dollars of purchases of mortgages, we and Fannie Mae, add further liquidity to the marketplace which, at the end of the day, gets back into the cost of the mortgage to the consumer and helps reduce the cost of that mortgage to the consumer.

So, I repeat that Freddie Mac and Fannie Mae have done tremendous amounts in terms of fulfilling the charter and the mission that Congress asked us to do many years ago.

Mr. STEARNS. Mr. Green, any additional comments?

Mr. GREEN. No.

Mr. STEARNS. If not, again, I want to thank the witnesses, particularly for your patience when we had to go vote, and the subcommittee is adjourned.

[Whereupon, at 4:15 p.m., the subcommittee was adjourned.]

[Additional material submitted for the record follows:]

Statement of Fannie Mae

Before the

Subcommittee on Commerce, Trade, and Consumer Protection
Committee on Energy and Commerce
United State House of Representatives

Hearing on FASB Derivative Accounting Standards

July 22, 2003
2:00 PM
2123 Rayburn House Office Building

We commend the Subcommittee on Commerce, Trade, and Consumer Protection for holding today's important hearing on FAS 133 and the standards of accounting for derivatives. This is a critically important issue that impacts a wide variety of participants in the financial services industry.

Fannie Mae is a congressionally chartered, privately owned financial services company. Chartered in 1938, Fannie Mae has operated as a privately capitalized corporation since the late 1960s. Fannie Mae's stock trades on the New York Stock Exchange (FNM). Fannie Mae ranks 45th in Fortune's 2003 Global 500 and is the 2nd largest corporation in the U.S. in terms of assets. We are the largest investor in home mortgages in the United States.

Fannie Mae operates exclusively in the secondary mortgage market, where we help to ensure that funds are available to home buyers in every state across the country, every day. We do this by accessing the international capital markets to provide liquidity to banks, mortgage banks, credit unions, and a variety of other financial institutions that use such available funds to originate mortgage loans to consumers. There are two primary ways in which we accomplish this mission. First, we purchase mortgage loans that are originated by financial institutions and hold these loans in our portfolio. Second, we issue mortgage-backed securities (MBS) in exchange for pools of mortgage loans that we receive from financial institutions. Fannie Mae's on-balance sheet mortgage portfolio totaled just over $812 billion on 6/30/03.

Fannie Mae's Use of Derivatives

Our business involves the management of two key risks: credit risk and interest rate risk. We manage interest rate risk by issuing various forms of debt, including "bullet

debt" (fixed-rate debt securities that pay interest periodically and principal at the end of the agreed upon term), "callable debt" (debt that we can redeem prior to its stated end date at a price established at the time of borrowing), and by supplementing these debt issues with derivatives (such as an interest-rate swap) which provide more funding flexibility and efficiency.

While Fannie Mae is one of largest end-users of derivatives, it is important to note a few key features of our derivatives use:

- We use derivatives to manage and reduce interest rate risk.
- We are only an end-user of derivatives; that is, we do not speculate or take positions using derivatives.
- Fannie Mae uses only the most straightforward, easy to understand, and easy to value types of derivatives (interest rate swaps, swaptions, and interest rate caps).
- Fannie Mae is a small portion of the overall derivatives market. According to BIS data, we represent approximately 0.4% of the total market for derivatives, and approximately 0.7% of the market for interest rate derivatives.
- Fannie Mae only enters into derivative contracts with investment grade counterparties. As of June 30, 2003, all of our counterparties were rated A-/A3 or higher.
- Fannie Mae requires our derivatives counterparties to post a significant amount of collateral. Fannie Mae's total exposure on derivative contracts was $5.384 billion at June 30, 2003. However, as of the same date we held collateral totaling $5.087 billion to offset the risk that a counterparty might default on payments due, which could result in Fannie Mae having to replace the derivative with a different counterparty at a higher cost. Therefore, Fannie Mae's net exposure to derivatives was $297 million at June 30, 2003 (or approximately $0.20 per share vs. 2002 core business earnings of $6.31 per share).

In testimony before the Senate Banking Committee on July 16, 2003, Federal Reserve Board Chairman Alan Greenspan re-iterated his long-held views on the benefits of derivatives:

> "What we have found over the years in the marketplace is that derivatives have been an extraordinarily useful vehicle to transfer risk from those who shouldn't be taking it to those who are willing to and are capable of doing so."

We agree with Chairman Greenspan and applaud any efforts, such as today's hearing, that have the potential to improve the standards used to account for these important financial instruments.

Derivatives Accounting and Financial Reporting

FAS 133, Accounting for Derivative Financial Instruments and Hedging Activities, became effective for Fannie Mae in January 2001 and requires companies to record the current market value of derivative instruments on their balance sheets. By requiring all derivatives to be recorded at their current market value, while related assets and liabilities do not obtain the same treatment, financial statements produced under FAS 133 give an incomplete and misleading picture of a company's financial performance, net worth and overall risk position. As a result, to supplement our GAAP earnings and to give investors a fuller picture of our business performance, Fannie Mae publishes quarterly core business earnings.

The difficulties created by FAS 133 are not unique to Fannie Mae. Bank regulators, for example, have decided not to include unrealized gains and losses recorded under FAS 133 through the accumulated other comprehensive income component of equity to determine capital adequacy, as such changes fail to reflect overall risk accurately. Bank regulators fully understand that financial statements produced under this standard are not a good measure of a corporation's financial position and risk profile.

Securities Registration and Disclosure

Fannie Mae has voluntarily registered its equity securities with the SEC under the Securities and Exchange Commission Act of 1934. As part of this process, the SEC reviewed our financial disclosures and critical accounting policies. Today, we file the same corporate disclosure documents with the SEC as any other publicly traded company. Although our decision to register with the SEC was a voluntary one, our registration with and regulation by the SEC is now binding and irrevocable. As Treasury Secretary John Snow noted in testimony given on July 9, 2003, "once you go [into SEC regulation] under '34, you don't go out." Additionally, Fannie Mae is fully bound by the relevant provisions of the Sarbanes-Oxley Act of 2002.

Congressmen Chris Shays and Ed Markey have recently introduced legislation that would require Fannie Mae and Freddie Mac to register their debt securities and mortgage-backed securities under the Securities and Exchange Act of 1933. Because of the disruption it would cause to the housing market, this legislation is opposed by the Administration and the housing and housing finance industries. (A list of trade groups opposing Shays/Markey follows this release.) In response to a question posed by Congressman Chris Shays, also on July 9, 2003, Secretary Snow said, *"there doesn't seem to be any difficulty with [Fannie Mae and Freddie Mac's securities] issuances."*

Virtually all of the key housing industry associations and non-profit organizations have previously expressed opposition to this legislation, including the following:

National Association of Homebuilders
National Association of Realtors
Mortgage Bankers Association of America
Independent Community Bankers of America
National Association of Federal Credit Unions
National Association of Counties
America's Community Bankers
Enterprise Foundation
National Bankers Association
National Urban League
League of United Latin American Citizens
National Immigration Forum
National Council of La Raza
National Association of Hispanic Real Estate Professionals
National Association of Real Estate Brokers
National Multi Housing Council
National Association of Mortgage Brokers
National Bankers Association
America's Mortgage Cooperative
National Association of Local Housing Finance Agencies
Local Initiatives Support Corporation
Council of State Community Development Agencies

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Accounting and Management Problems at Freddie Mac

Mark Jickling
Specialist in Public Finance
Government and Finance Division

Summary

Freddie Mac, one of the two government-sponsored enterprises that dominate the secondary market for home mortgages, announced in January 2003 that its financial reports for the past three years would have to be restated. Reaction to the news was mild; the markets assumed that interpretations of complex accounting rules were at issue rather than fundamental economic problems at Freddie Mac. On June 9, 2003, without providing any new information about the nature of the accounting issues, Freddie dismissed its top three executives. This action raised the specter of an Enron-like financial scandal, and Freddie's stock price plunged by nearly 20%. On June 25, Freddie issued a press release with new details about the ongoing restatement.[1] Freddie's expectation is that earnings for 2000 through 2002 will be revised upward by $1.5-$4.5 billion. The accounting corrections will involve reclassification and/or revaluation of certain securities and derivative financial instruments. The June 25th statement admitted that accounting controls had been weak and that certain accounting decisions and market transactions had been implemented to "smooth out," or reduce volatility in reported earnings. Regulatory agencies and federal prosecutors have begun investigations, and several committees in Congress have held or scheduled hearings. H.R. 2575 would restructure Freddie's regulator, while H.R. 2022 would end its exemption from certain securities disclosure requirements. This report will be updated as new information becomes available.

Background

Freddie Mac is a government-sponsored enterprise (GSE) that plays an important role in the secondary mortgage market. Like Fannie Mae,[2] its rival GSE, Freddie buys mortgages from lenders and repackages them in the form of securities, which it may hold

[1] See: [www.freddiemac.com/news/archives/corporate/2003/restatement_062503.html].

[2] Freddie Mac was formally chartered as the Federal Home Loan Mortgage Corporation, and Fannie Mae as the Federal National Mortgage Association.

or sell to public investors. Freddie finances its purchases of mortgage loans by selling bonds: either bonds backed by its own financial resources (called "straight debt"), or mortgage-backed securities, where interest and principal payments made by homeowners are passed through to holders of the bonds. As GSEs, Fannie and Freddie are exempt from state and local taxes, from certain regulatory requirements, and have a line of credit with the U.S. Treasury. Their most significant advantage, however, is what is called the implicit guarantee – although the bonds they sell are not backed by the full faith and credit of the U.S. government, market participants behave as though they were. Because the markets do not believe that the Treasury would allow Fannie or Freddie to default, the GSEs are able to sell securities paying lower rates of interest than other financial institutions.

Over 60% of all single family mortgage debt has been sold in the secondary market, or "securitized." As the leading players in this market, the housing GSEs represent an extraordinary concentration of financial risk. There is a strong public interest in ensuring that Freddie and Fannie remain financially strong; in 1992, Congress created the Office of Federal Housing Enterprise Oversight (OFHEO), a safety and soundness regulator dedicated exclusively to oversight of these two institutions.

The savings and loan crisis of the 1980s illustrated the riskiness of the mortgage market. If interest rates rise, financial institutions may find that their cost of funds exceeds their income from long-term, fixed-rate mortgages. If rates fall, homeowners refinance their mortgages and reduce income streams to institutions, which must still pay off debt previously issued at higher interest rates.[3] Protecting themselves from interest rate risk is critical to the GSEs, and it appears that strategies to avoid, or "hedge," risk are partly responsible for Freddie's recent accounting problems.

Freddie Mac's Accounting Problems

Since 2000, interest rates have fallen dramatically – mortgage rates from over 8% to about 5.2%. The fall in rates had two major impacts on Freddie Mac's financial statements. Both Freddie's bond portfolio[4] and the derivatives contracts Freddie had purchased to hedge the risk of falling interest rates[5] increased sharply in value. Under generally-accepted accounting principles (GAAP), these gains in asset value should have been reported as current income. However, Freddie chose accounting treatments for these asset gains that deferred recognition of income until later years. The restatement of earnings is based upon Freddie's and its new auditor's decision that these accounting policies were incorrect.

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[3] There is also the possibility of a sharp fall in housing prices. See CRS Report RL31918, *U.S. Housing Prices: Is There a Bubble?* by Marc Labonte.

[4] Bond prices rise when interest rates fall, because old bonds then pay higher interest relative to newly-issued bonds.

[5] Derivatives are financial instruments whose value is linked to changes in some price or variable, in this case interest rates. To hedge against falling rates, Freddie purchased interest rate swaps in which Freddie agreed to pay floating-rate interest to the swap dealer, while the swap dealer agreed to pay Freddie a fixed rate of interest. (The size of the payments is calculated by reference to a notional principal amount that does not actually change hands.) As rates fell, Freddie's floating rate obligation diminished, while it continued to receive the fixed payment.

Much of Freddie's bond portfolio was held in an accounting category called "held to maturity" (HTM). This meant that the bonds would not be sold, and that therefore day-to-day fluctuations in their market value were irrelevant; all that mattered was the amount of principal and interest payments, which was fixed and known in advance. These bonds were carried on Freddie's balance sheet at historical cost, which meant that increases in the bonds' market value (as interest rates fell after 2000) were essentially ignored, and did not appear as current earnings. However, during the 2000-2002 period, some of the bonds classified as HTM were sold. As a result, the restatement will reclassify the entire portfolio of bonds as "available for sale" (AFS), and changes in market value will be recognized. Gains in the bonds' value over the period will appear in the restated earnings as either current earnings or stockholders' equity.[6]

Derivatives accounting is governed by FAS 133 of the Financial Accounting Standards Board (FASB).[7] Under FAS 133, the fair value of all financial derivatives must be calculated at the end of each accounting period ("marked-to-market"). Changes in fair value from the previous accounting period must be reported as current income, unless the derivatives are used for hedging. If a derivative is used to hedge an asset, the value of that asset – the hedged item – will move in the opposite direction to the derivative's value. Thus, a fall in the price of the hedged asset will be offset by a gain in the derivative (or vice versa). Under FAS 133, the firm can recognize as earnings both the change in the derivative's value *and* the offsetting change in the hedged item's. If the gains and losses are closely correlated, the net effect on reported earnings will be very small or zero.

There is another form of hedge accounting under FAS 133, covering derivatives held to hedge a future transaction or cash flow. Since the hedged item in this case does not yet exist, it cannot be marked to market and used to offset gains in the derivative's fair value. However, FAS 133 allows the gain or loss in a derivative used to hedge a future event to be assigned to comprehensive income, a subcategory of stockholders' equity. When the future transaction or cash flow occurs, the derivative is marked to market and changes in fair value are recognized as current income, but presumably gains or losses in the derivative will be offset by the hedged item.

Either form of hedge accounting has the effect of reducing the impact of changes in derivatives' fair value on current earnings and the bottom line. To qualify for this accounting treatment, however, FASB requires that there be a close relationship between changes in the value of the derivative and the hedged item. Derivatives that do not meet FASB's hedge test are considered speculative trading instruments, and changes in fair value from period to period must be recognized and reported as current earnings.

Freddie Mac, like most U.S. corporations that use derivatives, states in its annual report that it does not use derivatives for speculative purposes. In its June 25th press release, however, Freddie concludes that "a majority of the corporation's derivatives in 2001 and 2002 will not qualify as accounting hedges. Gains and losses from the change in fair value of these derivatives will directly affect current period earnings as a result of

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[6] Stockholders' equity is separate from current earnings; it represents the proprietary interests of the owners (stockholders) of a corporation, or the going-concern value of assets over liabilities.

[7] See CRS Report 98-52, *Derivatives: A New Federal Accounting Standard.*

removing previously recorded gains and losses related to certain hedged items and recognizing gains and losses previously deferred in shareholders equity."

Freddie's press release identifies other accounting changes and cautions that there may be others not yet identified. Based on current information, the accounting treatments of derivatives and bond portfolios appear to be the major factors in the restatement. In both cases, the drop in interest rates to1950s levels produced unexpected windfall gains in the value of financial instruments. Freddie chose not to recognize these gains to avoid creating an impression of earnings volatility, knowing that these gains would be reversed if the trend in interest rates turned upwards. According to the June 25th statement, accounting policies were designed "with a view to their effect on earnings in the context of Freddie Mac's goal of achieving steady earnings growth." In other words, Freddie sought to "smooth out" reported earnings and reduce volatility by deferring earnings that should have been recognized under GAAP to future years. From all information now available, these accounting decisions, and the associated management and control issues, are what is behind the recent shake-up at Freddie Mac, and not any fundamental economic problem or financial weakness in the GSE's operations.

Freddie Mac's Management and Regulatory Problems

The June 25th press release noted several actions designed to remedy weaknesses in accounting and management controls. These include the expansion of senior accounting staff, creation of an operating risk oversight unit, and strengthening the review of accounting and other critical business operations. In conjunction with OFHEO, Freddie has embarked on a "comprehensive remediation program," to effect "broad changes in the finance function."

Questions remain about why the situation unfolded as it did, particularly why the top management changes were made so dramatically and with so little public explanation. The sudden dismissals led many observers (and shareholders) to assume the worst: that a major scandal was in the offing. Information disclosed in the June 25th press release and in press accounts does not suggest that any major violations of securities or criminal laws have occurred.

The "smoothing out" of reported earnings through questionable interpretations of GAAP is something that the Securities and Exchange Commission (SEC) normally regards as a violation of accounting rules.[8] The SEC's view is that if a firm deals in volatile financial instruments, that volatility should be fully reflected on its accounting statements. However, smoothing out is not viewed with the same seriousness as fraudulently inflating reported earnings, as Enron, WorldCom, and others have allegedly done to conceal fundamental economic or financial problems. In 2002, the SEC settled charges against Microsoft that it had smoothed out earnings by creating "reserve

[8] The SEC's authority over Freddie is limited by the exemption from SEC regulation granted by Freddie's authorizing statute. In 2002, Freddie announced that it would voluntarily comply with SEC disclosure requirements (as did Fannie Mae), but full SEC reporting has been delayed by the re-audit process.

accounts," that were not sanctioned by GAAP.[9] When quarterly earnings were higher than planned, Microsoft would add money to the funds; when earnings were low, the reserve funds would be used to boost reported earnings. (The funds held between $200 and $900 million.) Microsoft was ordered to cease and desist from committing accounting violations and other violations of federal securities law, but was not fined or otherwise penalized. If Freddie were registered with the SEC, it might be the subject of a similar order.

The original federal charters granted the GSEs an exemption from SEC registration and reporting requirements, but in recent years some have called for repeal of that exemption.[10] The June 25th release notes that Freddie's disclosure practices "did not meet standards that would have been required of Freddie Mac had it been an SEC registrant." H.R. 2022 would require the housing GSEs to register with the SEC and to comply with the reporting requirements applicable to any other firm that sells securities to the public.

There have been calls to reform regulation of the housing GSEs. H.R. 2575 would merge OFHEO with the Office of Thrift Supervision.

As for the criminal investigation announced by federal prosecutors in Northern Virginia, where Freddie has its headquarters, no information is yet available about which specific acts may be considered criminal. Press reports have focused on the withholding (or destruction) of pages in a personal notebook kept by Freddie's former chief financial officer and requested by counsel to the board of directors, but it is not clear whether or not such actions violate any federal securities law.

The fact that Freddie Mac's former management's conduct may not constitute criminal fraud, and that the institution appears to remain financially sound, does not mean that the episode can be dismissed lightly. If Freddie's management cut corners with accounting rules to conceal an inconvenient excess of earnings, how might it respond to a shortfall in earnings that might presage serious trouble in the company? The size of the housing GSEs and the volume of their debt held by other financial institutions make management and regulatory reform important public policy issues.

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[9] See SEC Press Release 2002-80, June 3, 2002.

[10] See CRS Report RS21263, *Fannie Mae, Freddie Mac and SEC Registration and Disclosures.*

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Correction Appended

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HEADLINE: Fannie Mae's Accounting Finds Critics Of Its Own

BYLINE: By ALEX BERENSON

BODY:

Regulators, lawmakers and investors have battered Freddie Mac, the country's second-largest mortgage financier, since it fired its president two weeks ago, after the company said he failed to cooperate with an internal inquiry into its accounting.

Now some money managers and independent accounting experts are raising questions about the profits reported by Fannie Mae, Freddie Mac's even larger corporate cousin. Fannie Mae appears to have suffered a big loss last year that was obscured by the complexity of its accounting, they say. Fannie Mae strongly disputes their analysis.

Fannie Mae, a government-sponsored company that owns or guarantees about 25 percent of all mortgages in the United States, is known for its political savvy in Washington and is highly respected on Wall Street. The company reported $6.4 billion in profit in 2002, the seventh consecutive year its earnings increased more than 10 percent.

But the money managers argue that Fannie Mae's fair-value balance sheet, a short statement that offers a once-a-year snapshot of the market values of all the company's assets and debts, presents a more accurate picture at its earnings than its cheery income statement. The balance sheet shows that Fannie Mae lost billions of dollars when interest rates plunged last summer, nearly wiping out its profit for the year, the money managers say. Accounting rules enabled Fannie Mae to keep those losses out of its profit report, but the losses will reduce the company's earnings in the future, the managers say.

"On an economic basis, they made no money last year," said Lawrence Kam, president of Sonic Capital, a Boston hedge fund that has sold Fannie Mae stock short, betting that its price will decline. "That's the simplest way to put it."

Dwight Jaffee, a professor of finance and real estate at the University of California at Berkeley who has studied mortgage markets for 35 years and who wrote a paper last year on interest-rate risk at Freddie Mac and Fannie Mae, said the Sonic Capital analysis appeared to be "exactly right." Mr. Jaffee cautioned that he could not confirm the details of Mr. Kam's analysis. (Mr. Jaffee said that in the last week, he had sold short a small amount of Fannie Mae stock. "I'm putting my money where my mouth is," he said.)

Mr. Kam, Mr. Jaffee and others are not contending that Fannie Mae broke any accounting rules, but rather that standard measures of profit and loss do not capture the underlying economic reality of its business. Last year, Fannie Mae reported $6.4 billion in "core earnings," a nonstandard accounting measure that is used by the company and widely followed by Wall Street analysts, and $4.6 billion in profits under standard accounting rules.

Fannie Mae disputes the Sonic Capital analysis and says that its reported profit reflects the reality of its business, although it acknowledges that it was hurt when interest rates dropped. Several company officials said in interviews last week that investors were wrong to try to determine the company's profit simply by measuring year-over-year changes in its balance sheet.

"Our core business earnings provide a better measure of our financial results and better reflect our risk-management strategies," a spokesman for **Fannie Mae,** Chuck Greener, said. Jayne Shontell, the director of investor relations, said investors should look at the company's core earnings, its earnings under standard rules and its balance sheet.

The details of the argument are complicated, but it boils down to this: last year, **Fannie Mae** underestimated how fast interest rates would decline and homeowners would refinance their mortgages, Mr. Kam and others say. As a result, it did not protect itself from the risk that some of its higher interest-rate mortgages would be replaced with lower-yielding ones, and it lost money as a result. Those losses will only become evident in **Fannie Mae's** income statement over the next several years, as the company receives less interest than it had expected, but they are already obvious on its balance sheet.

On the other hand, Freddie Mac, which hedged more of the refinancing risk, has acknowledged that it understated its profit in 2001 and 2002. It has said it expects to restate them upward when it completes an audit of its financial statements later this year. Freddie Mac fired David W. Glenn, its president, and forced out two other executives for failing to cooperate with the internal inquiry.

In arguing that **Fannie Mae** had large losses last year, Mr. Kam and others are relying on the fair-value balance sheet, which gives a once-a-year picture of the company's assets and debts, calculated as of Dec. 31.

Under standard accounting rules, **Fannie Mae** measures the changes in value of some of its assets and debts each year, while ignoring changes in others until later, leading to very complicated accounting treatments. Fair-value balance sheet accounting is conceptually much simpler. It tries to measure how much money would be left to shareholders if **Fannie Mae** were forced to liquidate all its assets, including all derivatives contracts, and use the money to repay its debts.

Fannie Mae's assets are mainly the mortgages it has bought from banks, while its debts are mainly bonds it has sold to investors to pay for those mortgages. Essentially, both **Fannie Mae** and Freddie Mac are giant, highly leveraged bond funds. They make some money from providing guarantees that mortgages held by other investors will be repaid even if homeowners default. But most of their profit comes from the spread between the interest they pay on their debt and the interest they receive from mortgages.

For example, if Fannie holds a mortgage paying a 7 percent interest rate and finances it with a bond on which it pays 6 percent, it keeps the one percentage point difference. The business is complicated because homeowners can prepay mortgages whenever they like, while the lenders do not have that option with the majority of the bonds they issue. If rates fall, and the 7 percent mortgage on Fannie's books is replaced by a 5 percent mortgage while the company still must pay 6 interest percent on its debt, its profit has turned into a loss.

Fannie Mae and Freddie Mac use a variety of strategies to hedge that risk. They exploit computer models to figure out how many mortgages are likely to be prepaid, and to adjust their mixture of short- and long-term debt in response. They also issue some callable debt, which gives them the option to prepay bondholders, and enter into some derivatives contracts whose value will rise if rates fall.

But neither company hedges all its prepayment risk, because doing so is expensive and lowers profit. **Fannie Mae** hedges less than Freddie Mac, according to risk models published by both companies, as well as a study last year by the Office of Federal Housing Enterprise Oversight, which regulates Freddie Mac and **Fannie Mae.**

Last year, as interest rates on 30-year mortgages fell to about 6 percent in September from 7.1 percent in April, homeowners rushed to refinance, and **Fannie Mae** found itself with too much long-term debt and not enough mortgages.

Generally, **Fannie Mae** tries to keep what it calls the "duration gap," a measure of the difference between when it receives payments on mortgages and when its debts are due, to six months or less. By August 2002, that had grown to 14 months.

To balance its portfolio, **Fannie Mae** bought more mortgages and called back some debt, the spokesman, Mr. Greener, said. But in doing so **Fannie Mae** replaced older, higher-interest mortgages with lower-interest mortgages.

The effect can be seen on the company's 2002 balance sheet, Mr. Kam said. While **Fannie Mae** reported $6.4 billion in "core profits" from its existing portfolio of mortgages, its net assets actually fell slightly, indicating that many of the new mortgages it had bought during the year would not be as profitable as the ones they replaced.

"When you don't properly hedge, and interest rates move in a direction faster and more brutally than you expect it, then you incur economic losses," he said.

A comparison of **Fannie Mae's** balance sheet with its reported profits shows that since 2000, the income that the company has reported to shareholders has risen almost $10 billion more than the value of its net assets, even after adjusting for cash it has paid to stockholders in dividends and share repurchases.

Mr. Greener, of **Fannie Mae,** said relying too much on the balance sheet to judge results is a mistake. Fair-value accounting can produce counterintuitive results, he said. For example, the company benefits from a widening spread between the interest rate it receives on its mortgage portfolio and the rate it pays on its debt, he said. But the wider spread can actually lower **Fannie Mae's** net asset value, he said, since the debt it issued earlier will be revalued upward.

Mr. Kam acknowledged that Mr. Greener's example was possible, but he said that it did not explain the difference between the balance sheet and the income statement at **Fannie Mae.** Freddie Mac, which has roughly the same spreads as **Fannie Mae,** has had a much smaller divergence between the two, which he said proves that the gap at **Fannie Mae** was related to its failure to hedge, not changes in the interest rate spread.

"They're trying to make something that was a calamity into some sort of positive," Mr. Kam said. "It's disingenuous."
http://www.nytimes.com

CORRECTION-DATE: June 24, 2003, Tuesday

CORRECTION:

An article in Business Day yesterday about the accounting practices of **Fannie Mae,** the mortgage financing giant, referred incorrectly to the recent departure of two executives at its corporate cousin Freddie Mac. While Freddie Mac dismissed its president, David W. Glenn, and accused him of failure to cooperate with an internal accounting investigation, it did not cite that reason in seeking the resignations of Leland C. Brendsel, the chief executive, and Vaughn A. Clarke, the chief financial officer. The company has not elaborated on their departures.

GRAPHIC: Graph: "Deepening Divide"
The discrepancy between what **Fannie Mae** has reported as its earnings each year and the actual change in value of its net assets has increased by almost $10 billion in three years.

Graph tracks CUMULATIVE CHANGE IN NET VALUE OF ASSETS, CUMULATIVE REPORTED EARNINGS* and SHORTFALL ($9.7 billion at end of 2002) since 1990.

*Based on generally accepted accounting principles through 2000. For 2001 and 2002, **Fannie Mae** used core earnings, which the company says are comparable.
+Adjusted for dividends and share repurchases.

(Source: Company reports)(pg. C2)

LOAD-DATE: June 23, 2003