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OVERSIGHT OF GOVERNMENT SPONSORED ENTERPRISES' ACCOUNTING PRACTICES

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

ON

THE ROLE OF A FEDERAL FINANCIAL SAFETY AND SOUNDNESS REGULATOR, AN APPROACH TO EXAMINING ACCOUNTING PRACTICES, AND CONTROLS OVER FINANCIAL REPORTING, EXECUTIVE COMPENSATION, CORPORATE GOVERNANCE, AND LEGISLATIVE ENHANCEMENTS

JULY 17, 2003

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OVERSIGHT OF GOVERNMENT SPONSORED ENTERPRISE ACCOUNTING PRACTICES

THURSDAY, JULY 17, 2003

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:02 a.m., in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

I would like to welcome today's witness, Mr. Armando Falcon, the Director of OFHEO. Freddie Mac and Fannie Mae play an integral role in the national housing market. Through their financing activities in the secondary mortgage market, the Enterprises bring capital market liquidity to our housing markets and have contributed to the unprecedented rate of homeownership in the United States, with relatively low mortgage interest rates.

As the number of homeowners has grown, so have the Enterprises. Collectively, Fannie Mae and Freddie Mac carry an astronomical $1.6 trillion in assets on their balance sheets and have outstanding debt of almost $1.5 trillion. Much of this debt is held by banks, and more than 80 bond funds have invested at least half of their assets in the Enterprises' debt. In addition, the Enterprises hold about 45 percent of the total outstanding residential debt.

The investment demand for the Enterprises' debt is attributable in part to Fannie Mae and Freddie Mac's status as Government Sponsored Enterprises. As such, the Enterprises receive a number of statutory benefits, including an exemption from State and local taxes and certain regulatory requirements and the availability of a line of credit with the U.S. Treasury.

Because of these benefits, Wall Street has assumed the Federal Government implicitly guarantees the Enterprises' debt and treats the Enterprises' debt as a near equivalent to Treasury notes. The market belief in this implied guarantee continues, despite explicit disavowals from the Enterprises and also the Federal Government.

As the Enterprises grew their balance sheets and developed a more prominent role in the national housing market, Congress created OFHEO in 1992 to regulate the safety and soundness of the Enterprises. OFHEO has created an examination program that analyzes, among other factors, the Enterprises' capital reserves, risk portfolio, risk management, and corporate governance.

Effective oversight of the Enterprises' management and operations is needed to maintain the market's confidence in the fiscal health of the Enterprises and the continued growth of the secondary mortgage market.

On June 4, 2003, OFHEO delivered its annual report to Congress and declared that its, "examinations found both enterprises"—that is, Fannie mae and Freddie Mac—"to be financially sound and well-managed."

While this report noted the ongoing restatement of Freddie Mac's financial statements, OFHEO declared that the "audit functions of Freddie Mac are independent and effective."

OFHEO also stated in the report that it "remains satisfied" that Freddie's board of directors and executive management are taking the appropriate action to address the accounting problems. This report did not discuss the scope of the accounting problems at Freddie Mac or any imminent management changes.

Despite OFHEO's positive pronouncement regarding Freddie Mac's audit functions, we have come to learn about troubling events and issues surrounding Freddie Mac's accounting policies and practices.

Although the proper application of Financial Accounting Standard 133 to Freddie Mac's derivatives portfolio appears to remain the primary reason for the restatement, the press release on June 25 clarified that the accounting problems extend beyond the interpretation of an accounting rule. Baker Botts, a law firm, reported that Freddie Mac lacked sufficient accounting expertise and adequate internal controls and management. As a result, Freddie Mac personnel made numerous errors in applying the general accepted accounting principles.

In addition, Baker Botts noted that Freddie Mac knowingly executed certain non-GAAP transactions and accounting policies in order to "smooth" its earnings. I am concerned that Baker Botts reported that Freddie Mac lacked sufficient accounting expertise and adequate internal controls only a few weeks after OFHEO declared that Freddie Mac has effective audit functions.

In light of these events, I think it is important for the Banking Committee to take a critical and deliberative look at OFHEO's oversight of the Enterprises. Although we do not yet have the final conclusions of the ongoing investigations—that will be several months—we do have sufficient information to examine OFHEO's role in the process.

I believe that it is time to analyze the scope and sufficiency of OFHEO's regulatory authority over the Enterprises. The public must have confidence that OFHEO has the necessary authority and resources to effectively regulate the Enterprises.

To date, Freddie Mac has been cooperative with the Committee staff. I would expect nothing less and assume that this will continue to be the case. While I will refrain from judgment until the various investigations are completed, I expect complete cooperation with the Committee.

In due course, I believe the public must come to understand the full breadth of the accounting errors and management decisions that were made at Freddie Mac. I suspect that upon the completion of the various investigations into the circumstances surrounding

Freddie Mac's restatement, this Committee will hold hearings to review the findings and the conclusions. I look forward to hearing Director Falcon's testimony on this subject today.

Senator Johnson.

STATEMENT OF SENATOR TIM JOHNSON

Senator JOHNSON. I want to thank Chairman Shelby and Ranking Member Sarbanes for convening this oversight hearing on how the accounting practices at Government Sponsored Enterprises are regulated. I welcome Mr. Falcon here today.

No doubt the recent accounting problems and the subsequent personnel changes at Freddie Mac have rightfully come under scrutiny by the Office of Federal Housing Enterprise Oversight. Today's focus is not on the details of that review but, rather, on whether the current regulatory structure has lived up to expectations.

I believe that we in Congress need to take a measured approach on how we proceed in this matter, and it is vital that we not politicize the ongoing review.

That said, I applaud you, Mr. Chairman, for inviting Mr. Falcon, the Director of OFHEO, to give the Committee an overview of the regulatory structure in place to oversee accounting practices at the GSE's. Earlier this week, Mr. Falcon requested fiscal year 2003 supplemental appropriations to help complete the OFHEO review of Freddie Mac and to embark on a review of Fannie Mae's accounting as well. As a Member of both the Authorizing Committee and the Appropriations Committee, I am committed to ensuring that OFHEO has the necessary resources and tools to complete a thorough review and report its findings to Congress in a timely manner.

The OFHEO report will be an important reference for us as this Committee considers whether legislative action is needed to restore confidence in the regulatory structure of the GSE's. However, it is critical that we have full information before taking any drastic steps that could roil the housing markets.

Low interest rates and strong housing markets have played a major role in keeping our otherwise sluggish economy afloat. We, in Congress, need to be ever mindful of the importance our housing markets play in all aspects of our economy. Homeownership is one of America's great success stories. Homeownership has become essentially a prerequisite for entrance to middle-class prosperity in America. Combined, Freddie Mac and Fannie Mae have helped more than 75 million American families buy homes. Any knee-jerk reactions on the part of OFHEO or Congress could have unintended negative implications for our economy and for millions of Americans who have realized the financial and social benefits of homeownership.

Clearly, Congress will need to take a close look at the accounting practices that led to the current problems at Freddie Mac, including the role of OFHEO in overseeing such accounting. We also need to take a close look at whether OFHEO has policies in place to determine whether the GSE's have appropriate internal controls and expertise to evaluate when advice they receive from an external auditor may be wrong, especially with respect to complex financial transactions.

Mr. Chairman, at 10:30, I have an Appropriations Committee markup on four very important appropriations bills, and I will excuse myself at that time. I look forward to Mr. Falcon's testimony, and I look forward to working with you and Ranking Member Sarbanes to see to it that we do justice to this very important issue.

Chairman SHELBY. Senator Enzi.

STATEMENT OF SENATOR MICHAEL B. ENZI

Senator ENZI. Thank you, Mr. Chairman.

Today, we will be learning about a situation that appears to be very similar to the types of situations that prompted us last year to pass the Sarbanes-Oxley Act. However, there are significant differences in this situation that warrant us to take a step back so that we can thoroughly understand the facts before taking any action, if action is necessary.

Our discussion here today should not be limited to the financial accounting of certain derivatives transactions, but should include an in-depth discussion as to whether sufficient regulatory oversight was present to comprehend those transactions.

Just yesterday, Chairman Greenspan spoke at length about how financial derivatives have greatly enhanced our Nation's economy. Many types of financial entities use derivatives to provide greater stability to their balance sheets. This is especially important for the housing industry and, in particular, for Government Sponsored Enterprises.

As an accountant, I understand and appreciate the need to have appropriate accounting standards that accurately reflect the balance sheet of the company. With respect to accounting for derivatives, Financial Accounting Statement 133 extensively details how companies account for derivatives transactions.

I will be very interested to see the final reports of investigation underway by the Office of Federal Housing Enterprise Oversight and the Securities and Exchange Commission, as well as the final report of the outside independent investigator hired by Freddie Mac. These reports will give us a greater understanding of the true nature of the circumstances surrounding the restatement of Freddie Mac's financial statements.

With respect as to whether there was sufficient regulatory oversight on this matter, I am not convinced that there was. While the Office of Federal Housing Enterprise Oversight claims that it was on top of the situation at each step of that process, it presents a less than compelling argument for its case. It was not too long ago that the Agency requested and received monies to hire additional staff. At that time the Agency clearly understood that it had sole responsibility to oversee the complex financial instruments used by the Government Sponsored Enterprises. It appears that the regulator placed too much reliance upon the financial statements prepared by Arthur Andersen without having sufficient checks and balances to review and comprehend the financial statements.

I would greatly appreciate an explanation of how OFHEO is using the new employees it had been authorized to hire. Just days ago, the Director of OFHEO wrote to the Senate and House appropriators claiming the need for $4.5 million in additional funds to support the special investigation of Freddie Mac and to commence

a new review of Fannie Mae's financial statements. I am very troubled by this action as it indicates a significant weakness in the Agency's ability to accomplish its statutory mission. While I fully support providing the means necessary to help a Federal agency fulfill its mission, as we did with the Securities and Exchange Commission, I do not believe that we have been given sufficient information on how this agency is performing and whether new monies are justified.

Mr. Chairman, I thank you for holding this hearing.

Chairman SHELBY. Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman. I want to thank you again for holding this series of timely hearings on so many of the subjects we hear about. This one is particulary important.

The recent disclosure of the Freddie Mac auditing problems has put back on the front burner the issue of the regulation of Fannie and Freddie and even the structure of Fannie and Freddie. And I guess we have three general options to consider:

One is to make Fannie and Freddie just completely free market enterprises. I would very much oppose that. I think the blend of private sector strength, knowledge, acumen, and agility and the Federal Government's social responsibility, ability to fill in the cracks where the market just does not do a job—no one since Adam Smith believes that markets are perfect. I believe the public-private blend is the right way to go, and those who want to make Fannie and Freddie private I think miss that boat. If we can make them private, we can let private sector people do some of those functions and compete, and they can do it well.

The second is to leave things as they are regulatorily. If you are not going to restructure the public-private blend, what do you do regulatorily? And I think here, I, at least, Mr. Falcon, have some real doubts about OFHEO's ability to monitor safety and soundness. These are extremely complicated areas, and at least thus far, the track record is not terribly good.

So there is a third option, which is to take at least the safety and soundness aspects of the monitoring of Fannie and Freddie, which have become more and more important as Fannie and Freddie get bigger, and maybe even the whole responsibility of Fannie and Freddie and move it to Treasury. And that to me, at least on its surface, certainly needs exploration, but it makes some sense.

I think the Government should and can play a role in housing markets. I think Fannie and Freddie have done a very commendable job expanding homeownership in America. I have found in my State, as I said, when there are particular needs, Fannie and Freddie move into the gap, which private sector companies would not do. It is the benefit they gain from some association with the Federal Government that importunes them to do these things.

But in terms of just the quickness, speed, and complexity of the new products that Fannie and Freddie are putting out, it seems to me that in that area, which has effects on our entire financial system, Treasury is the most logical place to oversee these. And so that is something that I think we should explore, and when the question period comes up, Mr. Chairman, I will be asking Mr. Fal-

con why that shouldn't be done. It seems to me the burden has switched with the recent changes or with the recent things that we have seen.

So, I thank you again for holding this hearing and hope we can really begin actively exploring how we can make Fannie and Freddie—and I think they are very good—make them even better.

Chairman SHELBY. Senator Bunning.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman. I would like to thank you also for holding this very timely and important hearing today. I would like to thank Director Falcon for testifying.

Like my colleagues, I am very concerned about what has happened with Freddie Mac. It is very disconcerting that 3 days before Freddie's restatement, OFHEO put out a glowing report on Freddie. Then after the ouster of Freddie's executives, OFHEO put out a letter calling Freddie's situation a crisis and have asked for a supplemental appropriation to hire more accountants.

Obviously, everything was not okay when OFHEO put out its report. I read in *The Wall Street Journal* today that Baker Botts, who did the investigation of Freddie's accounting, disputes your prepared testimony. They say they were fully candid with OFHEO. They even go as far as saying the charge in your testimony was "a cheap shot and perhaps reflects the advice Director Falcon is getting from his staff." That is a very disturbing charge.

I also am concerned about the bill language that was sent up. Some of our friends in the House of Representatives have been stating that they believe Fannie and Freddie do not have an effective regulator. They would like to have the Department of the Treasury, like my good friend from New York has suggested, to regulate the GSE's.

Receiving major legislation like we have and requests for supplemental appropriations to hire more accounts so you can do your job give those friends of ours a lot of heavy ammunition.

Director Falcon, I have known you since you worked for Henry Gonzalez on the House Banking Committee. I know how long you have been in public service, and I thank you for that service. But I do not think this will be the most pleasant hearing you have ever been to.

I also think the man who will follow you will also have a very tough hearing, largely because of what has happened since January.

Once again, Mr. Chairman, thank you for holding the hearing.

Chairman SHELBY. Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman. This is a very timely and important hearing. I should note that housing continues to be a bright spot in an otherwise sluggish economy. This is because home equity has been a large and continuing source of funding to fuel consumer demand.

One important reason this has been possible is that the United States has the deepest, most liquid housing capital markets in the world. Fannie Mae and Freddie Mac are at the heart of that sys-

tem—companies that helped to bring $2.5 trillion to finance millions of homes here in America last year. It is very important to understand that we are dealing with a major sector of our economy and we have to be ever mindful of how what we do well impact upon it.

To address the system's safety and soundness, Congress created the Office of Federal Housing Enterprise Oversight, OFHEO. And our job here, of course, is to make sure that OFHEO has the tools to do its work, and to make sure that it pursues its work vigorously and effectively.

Fannie Mae and Freddie Mac have assets of about $1.6 trillion, nearly double the level they had in 1997. Their retained portfolios are valued at about $1.4 trillion. Together, the two companies have outstanding debt equal to about $1.5 trillion, and they have derivatives with a combined notional value of over $1.5 trillion. The size and complexity of these two companies and the central role housing plays in our economy makes it all that much more important to ensure that OFHEO has the kind of funding and sophistication it needs to do a good job.

It is in this light that I believe we need to ask whether OFHEO was sufficiently knowledgeable about the accounting problems as well as the internal control problems at Freddie Mac. We need to explore whether or not OFHEO took the appropriate action to address these problems, and whether or not it did so in a timely manner. Finally, we should consider whether or not we have given the regulator the tools it needs to do an effective job.

I should note that Mr. Falcon has been seeking independent funding over the last few years for OFHEO, parallel to what some financial regulatory agencies have available to them. This is a suggestion that has been made by a number of people for improving the regulatory structure for Fannie and Freddie.

I believe as we explore these questions about the activities of OFHEO, we should acknowledge that some amount of progress has been made in the nearly 3 years that Mr. Falcon has served as its Director.

He has, for example, guided the Agency to the completion of the risk-based capital rule that was many, many years overdue. In doing so, he resisted considerable pressure to adopt a process whereby the regulator would set the parameters of the risk-based capital stress test, but the institutions themselves would develop and run the actual model. We need to remember the dynamics that existed in the not too distant past. I believe OFHEO's decision to move forward with its own model has contributed to the fact that the current concerns about Freddie Mac have not, at least to this point, led to questions about the safety and soundness of that company.

This is a point worth emphasizing. The concerns that have led to this hearing today relate to the accounting for derivatives at Freddie Mac. But the economic effectiveness of those derivatives as hedges against risk have not at yet been put into question.

Finally, Mr. Chairman, as we examine OFHEO's efforts, I want to raise a concern I have about the effectiveness of the Federal Housing Finance Board. It appears that the Finance Board is seeking to reconfigure the membership and expand the powers of the

Federal Home Loan Bank System; without regard to its statutory authority and without regard to the significantly increased risk its proposed action would bring to the Home Loan Bank System.

As former Bush Administration official, Assistant Secretary of the Treasury Sheila Bair said, "The Federal Home Loan Bank System is taking risks for which it is not prepared and inviting scrutiny and controversy by forging ahead with activities that far exceed its Congressional charter and with which it has had no historic experience or expertise."

Mr. Chairman, I hope at some time in the near future we might have an opportunity to examine this issue.

In closing, I want to commend Chairman Shelby for his reasoned approach to the serious problems that have come to light at Freddie Mac. There are a number of investigations ongoing by a number of agencies—OFHEO, the SEC, the Board of Directors of Freddie Mac itself, and others. And, Mr. Chairman, I think it is prudent to first spend some time gathering the facts before coming to the conclusions about what action might or might not be appropriate. And I am pleased to join with you in that effort.

Thank you.

Chairman SHELBY. Senator Sununu.

STATEMENT OF SENATOR JOHN E. SUNUNU

Senator SUNUNU. Thank you, Mr. Chairman.

Welcome, Mr. Falcon, and to the extent that you might be taking consolation in the impending grilling of Mr. Brickell, I note that I think his confirmation hearing is next week, so you might keep that in the back of your mind.

This is an important hearing, and I thank the Chairman for setting the time. There are two broad sets of issues that I hope the Committee is able to spend time on in this and any subsequent hearings dealing with these issues, these two broad issues that I hope you will touch on in your testimony.

The first is simply the needs and capabilities of OFHEO. It is something you have spoken about at length before, not just to this Committee but to Appropriations Subcommittees as well, and I know it is important to you and it has taken up the focus of your time over the years. But it is important that we review those needs and capabilities given the current situation of personnel needs, financial needs, and the expertise, both for accomplishing your ongoing mission, which has been the regulator of the GSE's, but also with respect to the current accounting crisis, the accounting problems at Freddie Mac. We want to understand as deeply as possible—I certainly want to understand—the extent to which OFHEO has been properly equipped, is properly equipped, and that any changes in your organization or the resources and the needs of your organization are going to address the problems at hand and be effective at dealing with these problems.

The second set of issues is really looking a little further forward with some of the comments that Senator Schumer and Senator Sarbanes made, which is the role of OFHEO and the relationship OFHEO has to other regulators. The Federal Housing Finance Board was mentioned. We have the Office of Thrift Supervision, the OCC, and the Federal Reserve. Obviously, all of these organiza-

tions are involved in regulating financial services. All of them will touch on some of the same concerns and needs in industry that OFHEO has dealt with in the past. And I think it is important that this Committee begin to assess the relative strengths and weaknesses of these different financial regulators. That is obviously what the legislation Senator Bunning mentioned is trying to do. It has been put forward in the House. An argument is being made that we need to look at the organization of these regulatory bodies and at least consider changes in them in order to make them stronger. I would assume everyone, whether you are for or against the changes, the goal should be to make them as strong as possible and enable them to do their job.

We also want to make sure that these organizations and agencies are cooperating. I know you are looking into the accounting problems at Freddie Mac. The SEC is also looking into the accounting problems at Freddie Mac, and I am sure that the U.S. Attorney's office is as well. No matter who the enforcement or regulatory body is, we want to make sure that in an important investigation like this there is cooperation and, finally, that this alphabet soup of different regulators is not resulting in unnecessary duplication because that will limit the effectiveness of these organizations and perhaps create unintended consequences and a failure of the ability to do a good job or the allowance that Senator Sarbanes was talking about, the allowance of organizations to take on more risk than they are appropriately suited to do.

So, I hope that we can address both of these issues in the hearing, and I very much look forward to your testimony. Thank you for being here.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Dole.

COMMENTS OF SENATOR ELIZABETH DOLE

Senator DOLE. Mr. Chairman, in the interest of time, I will submit my opening statement for the record.

Chairman SHELBY. Without objection, so ordered.

Senator Hagel.

STATEMENT OF SENATOR CHUCK HAGEL

Senator HAGEL. Mr. Chairman, thank you. And, Director Falcon, thank you for coming before the Committee this morning.

I, too, have a statement, Mr. Chairman, that I will submit for the record.

Chairman SHELBY. Without objection, it will be put in the record.

Senator HAGEL. Thank you.

I have, as you know, and as does Senator Sarbanes, for the last 7 years on this Committee, been concerned about these issues as I have listened to my colleagues this morning talk about oversight responsibilities. Are we moving away from the original missions of these GSE's? Are they getting into troubled waters? And, obviously, we have a number of questions here that we are going to ask you that directly relate to troubled waters, specifically Freddie Mac. And I understand you will be also looking at Fannie Mae here shortly, if you are not already.

We need to take a long, broad, deep look, not just at your organization but I think all the GSE's. And I have suggested that over the years to the Chairman and to Mr. Sarbanes. So, I welcome Senator Sarbanes' thoughts, others, and I will, like all on this Committee, look forward to your testimony.

I would say also that what Senator Sununu has suggested and also our colleague from New York I think makes some sense, and next week, Mr. Chairman, Senators Sununu, and Dole and I will introduce legislation, very much patterned after the House legislation, to move OFHEO out of HUD into Treasury, along with a number of other dynamics that we think would strengthen your organization, institution, do the things that you, Mr. Director, have asked for which make some sense to deal with this.

Confidence is the coin of the realm in this business, and you know that clearly. And before we try and hang too much on you or your organization, we need to look at the institutional problems and the structural deficiencies that exist, partly because we have not kept up with the new challenges and the expanded focus that these GSE's have brought to themselves. And I do not think this Committee and other Committees over the years have paid much attention to it. So, we appreciate you coming before us. We appreciate what you and your team are doing. And we want to help you do your job.

With that, Mr. Chairman, I look forward to hearing the Director's comments.

Chairman SHELBY. Senator Corzine.

COMMENTS OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman. I join my colleagues in thanking you on having this hearing. I think this is an absolutely essential oversight function that we need to perform with regard to the GSE's. I hope that we do not lose track of how important, while we are going to through this process, the GSE's are to the provision of liquidity and support for the housing market, which is one of the most effective in anyone's conception of the beginning and institution of these institutions.

I have a full statement for the record.

Chairman SHELBY. Without objection, it will be made part of the record.

Senator CORZINE. And I will save my remarks for the questions.

Chairman SHELBY. Mr. Falcon, your written statement will be made part of the record in its entirety. You proceed as you wish.

STATEMENT OF ARMANDO FALCON, JR.
DIRECTOR, OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Mr. FALCON. Thank you, Mr. Chairman. I will try to summarize my statement, but there is much to cover so I hope you will allow me to go beyond the normal time frames.

Chairman SHELBY. Go ahead.

Mr. FALCON. Mr. Chairman, Ranking Member Sarbanes, and Members of the Committee, I appreciate the opportunity to appear before you. My testimony today will focus on the circumstances

leading up the Freddie Mac restatement effort and OFHEO's role as a safety and soundness regulator.

By the way, thank you, Mr. Chairman and Ranking Member Sarbanes, for the very responsible and judicious manner in which the Committee has handled this matter. I also want to assure you of OFHEO's full cooperation as the Committee proceeds with its own oversight of this matter. Given our ongoing investigation, I ask for the Committee's understanding if I am restrained in my testimony as facts are still being verified and circumstances evaluated.

On January 22, 2003, Freddie Mac announced it would reaudit and restate its financial statements for 2000 and 2001. The company also announced that its external auditor would delay certification of Freddie's year-end 2002 financial statements until the restatement process was complete. Five months later, on June 6, the board removed the company's top three officers. OFHEO, the SEC, and a U.S. Attorney have ongoing investigations of the company and its accounting practices. These extraordinary actions reflect the culmination of developments over several years, during which time OFHEO has fulfilled its safety and soundness mission. I will begin by describing the major developments in chronological order.

The sequence of events begins in 1999 with preparation for implementation of FAS 133. FAS 133 is not the only accounting rule involved in this matter, but it plays the most important role.

FAS 133 requires an entity to recognize all derivatives as either assets or liabilities and reflect those instruments at fair value in the financial statements.

In 1999 and 2000, OFHEO's examiners assessed the development and implementation of Freddie Mac's plans with respect to several new significant accounting standards, including FAS 133. That assessment led us and Freddie Mac to the conclusion that the company needed to strengthen its accounting expertise and financial reporting internal controls. Freddie Mac addressed these issues with the adoption of the Financial Reporting Controls Improvement Plan in late 2000. The goal of the FRCIP was to achieve the same level of controls in the financial accounting and financial reporting area that were present across the other areas of the company and in the operating business units.

In the fourth quarter of 2000 and in the first quarter of 2001, Freddie Mac entered into several FAS 133 transition transactions. PricewaterhouseCoopers would later identify these transactions as being inconsistent with GAAP and in need of correction before the 2002 financial statements could be certified. Thus, the problem we address today began in 2000.

As 2001 began, FAS 133 took effect. Arthur Andersen certified each quarter's financial statements under the new FAS 133 pronouncement as GAAP compliant. Strengthening expertise and reducing the reliance on manual systems were important aspects of the Improvement Plan introduced in 2000, and in 2001 OFHEO's examiners continued to evaluate the progress of the company against this remediation plan. We continued to press management to ensure progress continued in implementing the plan. By May 2001, approximately one-third of the plan had been completed.

During this period, OFHEO planned enhancements for its examination program. In 2000, I decided to create an examination team

dedicated to accounting matters. In January 2001, we designed a comprehensive plan to enhance OFHEO's examination program, which included such an accounting team. A cornerstone of that plan was to more than double the size of the examination staff, adding depth and additional specialized skill sets. A portion of the funding was first received in 2002.

Late in 2001, Arthur Andersen was under public scrutiny because of its role as the audit firm in a number of high-profile Federal investigations. Given these developments, Freddie Mac's Board of Directors considered whether they should keep Arthur Andersen or select a new independent accounting firm. Freddie Mac solicited OFHEO's views concerning the retention of Arthur Andersen. OFHEO opined that, given the circumstances, retention of the firm created a higher-risk situation for Freddie Mac.

On March 6, 2002, the audit committee chose PwC as Freddie Mac's independent public accountants for the year 2002.

I should note that up to this point, the audit opinions of Arthur Andersen on the consolidated financial statements of Freddie Mac for 2000 and 2001 did not contain any adverse opinion or disclaimer of opinion, nor were they qualified or modified as to uncertainty, audit scope, or accounting principles. As it had done for years, Arthur Andersen certified the financial statements of Freddie Mac as having been prepared in accordance with GAAP.

PwC began its audit engagement immediately after being selected by the audit committee. In the course of its audit, PwC initiated a process of identifying various accounting policies and accounting issues to be discussed with Freddie Mac's management.

In July 2002, PwC identified the allowance for loan and lease losses as a critical accounting matter that needed to be resolved before it would certify Freddie Mac's 2002 financial statements. OFHEO was actively involved in these discussions.

PwC felt that Freddie Mac was too conservative in its loss estimates and coverage to be consistent with GAAP. Freddie Mac agreed to reduce the reserve by $246 million, whereupon PwC certified the second quarter financial statements.

Accounting policies and issues continued to be addressed by PwC, management, and the board throughout 2002. Progress appeared on track for the certification of fiscal year 2002 financial statements.

OFHEO continued to evaluate and monitor the status of the accounting policies under discussion between PwC and Freddie Mac. Examiners continued in 2002 to evaluate progress on the Improvement Plan at least quarterly.

I will move to 2003 now. In mid-January 2003, PwC informed the audit committee that they would be meeting with representatives of PwC's national office about unresolved policy matters in connection with certification of Freddie Mac's financial statements. On Monday, January 20, 2003, PwC notified the audit committee that they were uncomfortable with certain accounting treatments applied during the FAS 133 transition, and that until its concerns were resolved, they would not be able to certify the company's 2002 financial statements using the accounting policies from prior periods. Even though the policies had been approved by Arthur Andersen, PwC considered that they were not GAAP compliant. OFHEO

was made aware of these developments that very day and met with Freddie Mac officials the following day.

Arthur Andersen was no longer an operating firm at this point. Thus PwC could not undertake a normal transition pursuant to the AICPA guidance for successor accountants. Instead PwC would have to undertake additional substantive testing. The Board of Directors of Freddie Mac decided that PwC should conduct a reaudit and restatement of the prior period financial statements.

The net cumulative effect of the new accounting treatments was an increase in income in prior periods, thus increasing the amount of capital on a cumulative basis. Further, OFHEO, PwC, and the audit committee considered the effects of the accounting policy changes on the fair value statements of Freddie Mac. All the parties involved concluded that there was no meaningful impact on the fair value statements. This meant the underlying economics for Freddie Mac's positions were materially unaffected by the timing changes in recognizing income under GAAP.

During this time, examiners were on-site at Freddie Mac gathering more information about the issues and the action plan that was being developed in connection with the reaudit. Freddie Mac announced the reaudit on January 22, 2003, and that there would be a delay in the publication of 2002 certified financial statements.

With the restatement, it was clear that a forensic review of the accounting issues raised by PwC would be appropriate. The law firm of Baker Botts was retained by the audit committee to perform this task. OFHEO's accounting team began continuous surveillance of the restatement process on January 22, 2003.

In May, OFHEO observed slippage in the restatement process against established time lines. Since January 2003, PwC and Freddie Mac have had more than 500 people working on the process 6 days a week. There was considerable work that needed to be done between production of statements and producing the tables and disclosures to accompany those statements. On May 8, PwC informed the senior board members and counsel that PwC would not accept the representations of CFO Vaughn Clarke and President David Glenn and the reasons therefore.

On May 27, OFHEO was briefed on the Baker Botts work for the audit committee. In response to a question from OFHEO, Baker Botts expressed no concern regarding inappropriate or improper behavior by management. Subsequent to this meeting, OFHEO learned the very troubling information regarding the conduct and integrity of management and matters related to the restatement process, indicating the board's counsel had not been fully forthcoming. This lack of candor contributed to my decision on June 7 to initiate an OFHEO investigation rather than wait for the Baker Botts report.

Mr. Chairman, I will begin a discussion of the key events from June 4 to June 7 that have drawn so much attention. First, I would note that the Freddie Mac Board of Directors was holding a regularly scheduled meeting on Thursday, June 5 and Friday, June 6.

On Wednesday, June 4, David Glenn met with the board's outside law firm, Baker Botts, and informed them that he had altered and, in some cases, could not produce pages from a notebook that had been requested by the company. That evening, counsel from

Baker Botts informed the lead outside Director of Mr. Glenn's confession.

On Thursday, June 5, Freddie Mac's Board was informed of Mr. Glenn's admissions and determined that action was required. The morning of June 5 OFHEO was informed that Freddie Mac's Board wanted an urgent discussion with us when the board concluded its deliberations. The board's deliberations continued into the next day, Friday, June 6.

On June 6, during the day, the board made a decision to separate from the firm Messrs. Brendsel, Glenn, and Clarke, and on the appointment of Messrs. O'Malley, Parseghian, Petersen, and Baumann. The board communicated to OFHEO immediately on the actions regarding the management changes. Later in the day on June 6, I was informed about the circumstances surrounding Mr. Glenn's termination. I instructed counsel to the board to appear at OFHEO's offices on Saturday, June 7, and report to us on all matters surrounding the management changes.

On the morning of June 7, OFHEO senior staff and I met with representatives of Freddie Mac's Board to learn the details of recent events. I would note that much of what was addressed that day was known to OFHEO and had been subject to the restatement process. However, new information relating to Mr. Glenn's actions and the termination and the replacement of senior management was given to us for the first time. I was particularly displeased to learn about the lack of confidence in Mr. Glenn expressed a month earlier to Freddie Mac by PwC. I considered the disclosures regarding Mr. Glenn to be a clear signal of a breakdown in the integrity of Freddie Mac's control environment at the highest levels, and sent the letter to the board that day, initiating an OFHEO investigation and taking additional steps.

Having discussed our specific regulatory role over the restatement process at Freddie Mac, I would now like to put it in a more general context. First, the role of a financial safety and soundness regulator, and second and more specifically, the Agency's regulatory approach in examining accounting practices and controls.

OFHEO uses a safety and soundness approach in supervising the Enterprises that is analogous to the Federal Reserve System's and the Office of the Comptroller of the Currency's approach to supervising large-and-complex banking organizations. The foundation of these approaches is that the management of these firms should be held responsible for monitoring and managing the institution's exposure to risk. By looking at the firm's risk management procedures and internal controls, the safety and soundness regulator assesses whether the firm's ability to manage risk matches the level of risk it assumes. In addition, the supervisory process also reviews the firm's performance in complying with the company's own internal policies as well as other prescriptive requirements.

In short, safety and soundness supervision is directed toward identifying material problems or emerging problems and seeing that they are appropriately corrected and the company's financial solvency is not threatened. Safety and soundness regulators do not review accounting policies for conformance with GAAP, nor do we certify that the company's financial statements are consistent with GAAP. We require an independent auditor to certify that a com-

pany's financial statements are in conformance with GAAP. We review transactions to ensure that they are consistent with sound risk management. The work of the independent auditor is to conduct its audit and report on the company's annual financial statements.

In regards to executive compensation, I wrote to the board of directors on June 7, 2003, indicating that it must explain its rationale for any termination packages for Messrs. Brendsel, Glenn, and Clarke. Further, I directed the board to inform these individuals that their termination packages are subject to OFHEO review and approval, and for any employee discharged for misconduct, that OFHEO could direct indemnification of Freddie Mac for losses incurred. We directed Freddie Mac not to transfer funds, stock, or options to these three individuals, and Freddie Mac is complying.

Turning now to the OFHEO report to Congress. We reported that Freddie Mac's overall internal control framework and the management of the internal control framework are effective. We stated, however, that Freddie Mac's release of audited financial statements was being delayed pending a reaudit of past financial statements, and that Freddie Mac had agreed that certain accounting treatments applied in the past were incorrect. We informed Congress at that time of our opinion regarding the reaudit. We further advised Congress that Freddie Mac's Board of Directors had undertaken efforts to enhance expertise and controls in the area of financial accounting and operational control, that we had evaluated the board's and management's plans in that regard and that we were satisfied that these actions were appropriate steps to address the situation.

In my view, these statements clearly indicate that although the overall framework is effective, OFHEO is ensuring that the board and management devote serious attention and remedial efforts to the area of financial reporting and related controls. OFHEO activities in this regard are highlighted in my earlier testimony.

Finally, Mr. Chairman, I would like to bring to the Committee's attention an urgent funding matter. Earlier this week, I submitted a fiscal year 2003 Supplemental Funding Request of $4.5 million to the Senate and House Appropriations Committees. The requested funds will support two critical objectives. First, the funds will support the ongoing special investigation of Freddie Mac, and the investigation is already well under way and is building on information gathered over the course of the restatement process. Second, OFHEO intends to conduct a special accounting review of Fannie Mae. The special review would independently evaluate the accounting policies at Fannie Mae and examine whether their implementation is resulting in a high-level of conformance with GAAP. While I do not have a specific concern about Fannie Mae's accounting practices, such a review would be most prudent under the circumstances.

Mr. Chairman, I know this is an oversight hearing and not a legislative hearing, so if and when the Committee decides to consider legislation in this area, I have attached some recommendations for your consideration.

In summary, Mr. Chairman, is this a serious matter? Yes. Is there a crisis? No. While challenges lie ahead, Freddie Mac remains safe and sound. At the end of our investigation we will

present all the facts, conclusions, and recommendations for the Committee's consideration.

Mr. Chairman, thank you for the opportunity to testify, and I would be pleased to answer any questions the Committee may have.

Chairman SHELBY. Thank you. Mr. Falcon, Freddie Mac has reported that it expects the reaudit to increase its earnings for 2000 through 2002 by $1.5 to $4.5 billion. This is a rather large misstatement to have occurred under your watch. How can the public be confident that OFHEO is and has been addressing this problem? How can we be confident that a similar problem will not occur in the future.

Mr. FALCON. Mr. Chairman, the range of adjustment to earnings will be in the range from, I think it is, $1 to $4.5 billion.

Chairman SHELBY. That is a spread though.

Mr. FALCON. That is a spread, yes, Mr. Chairman.

Chairman SHELBY. And a lot of money.

Mr. FALCON. That is a lot of money, and that is a cumulative effect over the 2-year period involved here. It is a serious matter. But I would note, Mr. Chairman, that these are real earnings. We are not talking here about hypothetical or manufactured earnings, and at the end of this process their capital will go up by the amount of that spread. So this is a serious matter.

Chairman SHELBY. I think their stock has gone up, has it not?

Mr. FALCON. I have not checked today. Mr. Chairman, let me also say that while this is a significant amount, my primary focus is the conduct of the company. I think it is important for us to get to the bottom of all the facts surrounding the conduct of the company and everyone involved and ensure that we do whatever is necessary so that this does not happen again.

Chairman SHELBY. Would you describe the scope and the mandate of your ongoing investigation, and how it differs from the annual examination process? In other words, what are you trying to determine here in your investigation?

Mr. FALCON. We are trying to determine the circumstances of the restatement, how these transactions were accounted for in the company's financial statements, and the role of individuals involved. We are also looking to see whether or not there was any intentional misapplication of GAAP in order to further some company policy. If that is the case, we will certainly take appropriate action to make sure that we do whatever is necessary so that it does not happen again, Mr. Chairman.

Chairman SHELBY. When do you think this final report will be completed?

Mr. FALCON. We would like to complete it by the end of September. We are working very hard to stay on that target. It is also essential that we do obtain some additional appropriations. That would help us stick to that goal, Mr. Chairman.

Chairman SHELBY. There are some differences here between your report and the Baker Botts report, which is the law firm that Freddie Mac retained to do an inside investigation. Some of us are troubled that OFHEO declared in its annual report that Freddie Mac's accounting functions were, "effective." Yet Baker Botts has reported that Freddie Mac lacked sufficient accounting expertise

and adequate internal controls. Could you explain OFHEO's, your basis for reaching your conclusion, and the disparity with the conclusions reached by Baker Botts?

Mr. FALCON. Mr. Chairman, I do not think there is a disagreement between us on that point. If there is a misperception based on our annual report, that we were unaware of problems or that we were not working to correct those problems, I hope I have dispelled that misperception with my testimony. I have tried to detail very precisely how going back to the year 2000, we had them working to correct accounting problems and problems with their internal controls.

Chairman SHELBY. Senator Sarbanes and I have received a letter from Baker Botts basically challenging certain statements in your testimony today. Of course, I will ask this be made part of the record, and if you have not gotten a copy of it, we will give it to you.

Mr. FALCON. I have not, Mr. Chairman.

Chairman SHELBY. We will certainly do this now. I think this is important to you and to the Committee. We will distribute that.

Mr. FALCON. May I address that, Mr. Chairman?

Chairman SHELBY. Sure.

I think Senator Bunning alluded to that earlier.

Mr. FALCON. Yes.

Chairman SHELBY. I am sure he will want to get into it.

Mr. FALCON. Since that time Baker Botts has been cooperating with us, and they are cooperating fully I think. But at this point in time they were asked a direct question, Mr. Chairman, "Are you aware of any inappropriate conduct on the part of the company?" The answer was no. They were further asked, "Is there anything that we should know, related to your work up to this date?" The answer was no.

About a month before this conversation, the counsel was fully aware of circumstances surrounding PwC's inability to take the representations of Messrs. Clarke and Glenn. The circumstances surrounding their conduct is certainly the type of activity that the regulator would expect to be informed about by Board's counsel, Mr. Chairman. I stand by what I have said in my testimony.

Chairman SHELBY. But it is disputed. They dispute what you say. You realize there is a dispute here?

Mr. FALCON. I accept that, Mr. Chairman.

Chairman SHELBY. Okay. Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

I want to go back to a couple of questions that Chairman Shelby asked, which I thought were right on point.

You make the point that the net cumulative effect of the new accounting treatments for Freddie Mac was an increase in income in prior years, thus increasing the amount of capital on a cumulative basis. I think that is in your testimony and you just stated it again in response to the question.

Mr. FALCON. Yes, sir.

Senator SARBANES. But this really raises the implication that had the errors resulted in a reduction in prior year income, that the Enterprise might have been undercapitalized, that would all have been unbeknownst to the regulator. As you know, the mistake

that was made, as it turns out, was such that there is an increase in income in prior years and therefore there is an increase in the amount of capital. Of course you did not know that. It could have turned out that there was a reduction in some prior years and therefore a decrease in capital. As it turned out, it worked in the right direction, so to speak, but how do we get at the fact that it was all happening unbeknownst to the regulator?

Mr. FALCON. That is a good question, Senator Sarbanes, and what we are working to do at OFHEO is to build an in-house team of accountants. They can take a look at issues like this. While we could not possibly have the amount of staff necessary to review all policies and transactions to ensure that the external auditor is adhering to the highest standards of GAAP, we would like to build the capacity in-house to at least be able, on a selective basis, review some of the major and the perhaps novel issues that come up in accounting when new standards are brought into effect. I think that is an important part of our program that we are trying to develop going forward, and we developed this plan beginning in the year 2001, and last year we began to get the appropriations to staff up for that expertise.

Senator SARBANES. Do you think that the OFHEO reviews have been prepared to simply accept the audit functions? In other words, I gather you are not going behind the auditor; is that correct?

Mr. FALCON. We are ensuring that they do their job pursuant to industry standards as they work to certify the financial statements, but we are not taking a qualitative look at the judgments they make as to whether a particular accounting policy is consistent with GAAP. We did not try to interpret the GAAP the way they do. If we did, that is a practice that was, as you know, Senator, widely discredited in the 1980's. Regulatory Accounting Principles accounting is something that we have worked to avoid, not just at OFHEO but all the safety and soundness regulators.

Senator SARBANES. How do you avoid the situation we just had here? I mean, you tell us in your June 2002 report to the Congress, "The audit functions exceed safety and soundness standards." I am quoting now from your report. "The internal and external audit functions have the appropriate independence. The management of the internal audit department is effective." Then the 2003 report, this past June, "The audit functions are independent and effective. The internal and external audit functions have the appropriate independence."

Now, only a few days after we received the report the Freddie Mac Board got rid of these chief officers because of lack of progress on addressing the accounting and internal control problems at Freddie Mac.

Mr. FALCON. Those statements, Senator, reflect our overall assessment of various risk factors, and we report in the annual report on our overall assessment of how they are doing for that calendar year, and we report that in the annual report. My testimony points out, and our 2002 annual report points out that there is a restatement going on and that we are working on improving deficiencies in their financial reporting, internal controls, as well as gaps in their accounting expertise.

What I think is appropriate and what I take from your comments, Senator, is that we should go back, and as we begin to issue successive annual reports, that perhaps we should have a lower threshold of what gets included in this annual report. We have included things that we think affect our assessment of the company overall. Perhaps we should go back and include matters that while they do not affect our assessment of the company, might be significant enough that we should include them anyway in the annual report, and that is what we have to consider doing going forward.

Senator SARBANES. My time is up. I just want to be clear on one thing. You have an investigation now going on, correct?

Mr. FALCON. Yes, sir.

Senator SARBANES. OFHEO itself has an investigation that was launched on June 7; is that correct?

Mr. FALCON. Yes, sir.

Senator SARBANES. And are you looking more broadly than the accounting functions or is it focused on the accounting functions?

I know you cannot go into the nature and scope in a public session of your investigation, but can you answer that question?

Mr. FALCON. Yes. It is focused on the accounting transactions that are at issue here, those issues raised by PwC. It does involve more than one accounting rule interpretation beyond just FAS 133. We are looking at those transactions and circumstances involved in applying GAAP and the role of everyone in the company in these matters.

Senator SARBANES. And when will that report be submitted?

Mr. FALCON. Our goal is to complete it and submit it to you by the end of September, Senator.

Senator SARBANES. Thank you.

Chairman SHELBY. Senator Enzi.

Senator ENZI. Thank you, Mr. Chairman.

I do have a series of questions that deal with the request for the $4.5 billion in additional moneys. I would hope that I could submit those to Mr. Falcon in writing, because the answers would probably be more detailed—and probably boring.

Chairman SHELBY. And his answers would be to you and to the Committee, I trust?

Senator ENZI. Yes; I would be happy to share them, and that would allow me to ask some other questions. Of course, another one of them that I am going to submit is: In your testimony, you discuss that OFHEO has adopted corporate governance principles similar to those adopted in the Sarbanes-Oxley Act, and I would like you to describe the exact corporate governance provisions that you have adopted and the parallel sections in Sarbanes-Oxley. But I will not ask you to do that while you are here, either; I will be submitting that one.

In your written testimony, you state that "OFHEO has been working with enterprises since 1999 on financial accounting of derivatives transactions." In 2000 and 2001, did OFHEO give any specific written guidance to the Enterprises on how to account for derivatives transactions? Did the guidance give details on how to account for cashflow derivatives transactions? And how many financial experts on derivatives did OFHEO employ during those years? Is that another one for the record?

Mr. FALCON. Yes. I do not think we have given the Enterprises any written guidance on the implementation of FAS 133. I will double-check that, but I am pretty certain. Our role in this is to oversee the work of the internal controls and the work of the external auditor and ensure that if the external auditor has any qualifications about their certification that those matters are appropriately addressed by the company.

I am sorry, Senator, I do not think I remember the second half of your question.

Senator ENZI. I will submit that one, too.

In your written testimony, you state that you do not conduct forensic accounting work unless a need arises, and that you rely on this auditor, and that you require enterprises to engage forensic professionals to investigate irregularities when they arise.

How do you determine when an audit statement submitted to you would require a forensic accounting professional? Prior to this incident with Freddie Mac, have you ever required an enterprise to hire a forensic accountant, and what were the circumstances if you did?

Mr. FALCON. We have not. Certainly the circumstances surrounding the need for a reaudit and restatement of 2 prior years rose to the level of requiring a forensic review.

I would have to take each circumstance on a case-by-case basis to determine whether or not one was necessary as additional issues arose.

Senator ENZI. I will do a follow-up on that one in writing as well, because we need some more detail on that.

The risk-based regulations established by OFHEO require you to release a risk-based capital model that the Enterprises can use to calculate their risk-based capital reserves. In light of these recent events at Freddie Mac, will you need to reissue the risk-based model for 2002?

Mr. FALCON. No, we are not expecting that there is a need to do that. However, if we see any significant changes in the data that the risk-based capital stress test runs on, we will consider whether there is a need to rerun the stress test for any particular quarter, and if there is a need to alter our capital findings with respect to Freddie Mac. But it is my expectation that that will not be necessary. The risk-based capital stress test runs on data that is not dependent on the accounting issues involved here; it runs off raw data, which is not really affected here.

Senator ENZI. But is it showing the information that you need?

Mr. FALCON. Yes. We are getting all the information we need in order to continue to run our risk-based capital stress test.

Senator ENZI. Okay. I will submit some more questions, if they are not covered today, Mr. Chairman.

Chairman SHELBY. Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman.

I want to go back to this gap of $1.5 to $4.5 billion. It sounds to me like we do not yet have a handle on the issues that are underlying what is determining the problem that actually has come out in all this discussion.

What is the explanation of such a wide range? It is an extraordinary gap that I find hard to understand how it cannot be

explained. I could understand at the margin a couple of hundred million here or there on derivatives—even that is a lot of money—but $3 billion—I would not understand it in the context of reviewing the risk management, the performance of a company—any company. It is mind-boggling to me that there is such a gap in place.

What are some explanations that would allow that to actually be?

Mr. FALCON. It is a large number. One of the issues related to this is that under FAS 133, if you designated certain hedges, certain derivatives as hedging derivatives, they qualify for cashflow accounting or fair value accounting. Here, they are accounted for as fair value hedges, and they are assembled in pools. If the pool gets tainted through inadequate documentation for any derivative that makes up this pool, the entire pool is tainted, and you have to unwind, and the entire pool no longer receives the FAS 133 fair value hedge designation. So that is having a large impact on the earnings—a cumulative effect on their financial statements. That is just one of the explanations, but I think one of the largest ones.

Senator CORZINE. The thing I do not understand is that the risk-based regulatory structure that has been put in place that you all administer to look at has to look at the particular transactions that go into the book that is made up. It leads me to wonder why there were not red flags about that with regard to the pools that you are talking about in the context that is different than I am hearing this discussion. It is not just an accounting issue, because these pools either had certain risk characteristics that fit into the model for measurement or not.

Mr. FALCON. I guess a point I should make clear, Senator, is that the economics of these transactions remain sound—most of them, I should say. From a risk standpoint, these are effective hedges against the company's risk. This is an accounting issue as to when you recognize the income from changes in market value on these derivatives. So the accounting issues aside, these are sound transactions from a risk management standpoint.

Senator CORZINE. I accept that statement, but the fact is that they needed to be measured for the risk model to see whether the risk model was actually working and doing what it is supposed to do for the purposes of safety and soundness that your oversight is supposed to derive. So if a particular pool or swaption or whatever transaction is going up and down in price, it has a different risk-weighting in a model at some point in time, and I do not understand why there were not red flags thrown out by the risk model that would indicate that there were underlying accounting problems. It does that, and it bothers me that there are still $3 billion of unexplained elements when the risk model needs to be able to tie to the accounting factors. It does not make sense to me based on my own understanding of how you put together financial statements and how the risk models would work from my own experience.

Without being able to explain this $3 billion, it makes me worry about the risk models, I guess is what I am suggesting, that we are using for oversight. Is it a concern of yours?

Mr. FALCON. I would like to go back and take a look at it and make sure we adequately address your concern here. What we do

look at is the underlying economic purpose of these transactions and ensure that they are appropriate to hedge against the risk of the underlying transaction.

I will have to go back and look at to what extent a closer review of those internal models have helped us identify a problem here. I will take that back and look at it.

Senator CORZINE. I actually would like to see—and we can do this at a different time and place—but I would like to understand why the individual items that are part of the risk management tool relating to underlying assets—why that was not showing up as a measurable change in value in the oversight models that you all use, because it should have been reflective, in my view, in the underlying accounting that is coming out if we are going to have a comprehensive—but I go back to that I cannot explain in my own mind how, at least at this stage, we have a $3 billion gap.

Mr. FALCON. Okay.

Senator CORZINE. Thank you.

Chairman SHELBY. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

Director Falcon, why didn't you start your investigation when the original restatement was announced? Why did you wait until Freddie ousted their top corporate executives?

Mr. FALCON. Senator, we have remained focus on fulfilling our primary mission here. Our mission is to ensure the safety and soundness of these two companies. It was my judgment that the most important task at hand in order to ensure their safety and soundness was to get this reaudit complete, to get the restatements done, because it is not a good position for a large company like this to be in to not be operating without certified financial statements.

We focused our time and energies on making sure this restatement process was brought to a conclusion as soon as possible.

Senator BUNNING. But how big a red flag to you have to have?

Mr. FALCON. Oh, certainly, if the board was not going to undertake action to get a forensic review going with the use of an outside counsel—which is a process that is not uncommon for safety and soundness regulators—we frequently task the board to take certain actions including the hiring of any outside investigators to look at issues.

Senator BUNNING. Well, if the board thought it was so essential to fire the top three officials in the company, why wouldn't that red flag be the regulator?

Mr. FALCON. If I had known some of the circumstances that would emerge later that led to the termination of these three individuals, I would have started our investigation in January.

Senator BUNNING. If you felt that Freddie's outside counsel was not being forthcoming, why did not you start your full investigation then, instead of waiting until June 7?

Mr. FALCON. It was June 7, Senator, when I concluded that I was not receiving all the information that I should have been receiving.

Senator BUNNING. It was not until then?

Mr. FALCON. Right.

Senator BUNNING. Your staff briefed the Committee staff earlier this week. They informed staff that some anonymous letters were received and then investigated by Baker Botts, who dismissed the

charges in the letters. Did the charges in those letters have anything to do with what actually happened? If Baker Botts was not forthcoming as you have stated in your prepared testimony, why did you then rely on them to investigate the charges in the anonymous letters?

Mr. FALCON. That is a subject of our investigation. We are looking at the circumstances surrounding the allegations contained in those letters.

Senator BUNNING. But why would you give it to someone that you have criticized in your own testimony today as not being forthcoming?

Mr. FALCON. As soon as I concluded that they were not being entirely forthcoming, I took action to initiate an investigation.

Senator BUNNING. But you gave the investigation to them.

Mr. FALCON. At a point in time when I thought it was appropriate that the board should engage outside counsel to undertake this, while we focused on ensuring the safety and soundness of the company through getting the restatement process concluded.

Senator BUNNING. Does it disturb you that 18 months after Freddie said they would register with the Securities and Exchange Commission, they still have yet to do so? Would that have anything to do with the earnings and restatement and all the things that have come up, that 18 months ago, Freddie Mac said that they were going to register with the Securities and Exchange Commission their securities? They still have not done it. Does that raise a red flag for you?

Mr. FALCON. It cannot happen until this restatement is concluded.

Senator BUNNING. Well, now it cannot, but we are a month later than June, so instead of having 18 months, they had 17 months prior to that time.

Mr. FALCON. Up until January of this year, it appeared that the audit of the 2002 financial statements was on track. It was not until January 2003 that PricewaterhouseCoopers brought to the board's attention these FAS 133 issues and notified the board that they would not be able to certify those 2002 statements until these accounting issues were properly resolved.

That is the point in time when it became clear that they would not be able to register under the 1934 Act because they would have this restatement process pending; and that triggered a whole sequence of events that we have been working on since.

Senator BUNNING. Okay. That was a year after they said they were going to register with the SEC.

Mr. FALCON. Right. But it was expected that there would be about a year lead time before they actually registered.

Senator BUNNING. So you are saying that the restatement was the hang-up?

Mr. FALCON. No. There was a lead time necessary for the SEC to do its due diligence with the company——

Senator BUNNING. I understand that.

Mr. FALCON. —as preparation for their formal registering with the SEC under the 1934 Act, and there was an amount of lead time that needed to occur before they got everything lined up.

Senator BUNNING. A last question, Mr. Chairman.

Chairman SHELBY. Please go ahead.

Senator BUNNING. Don't you think that after this mess is cleaned up, it would be necessary as one of the top priorities to make sure that Freddie does register with the SEC so there is another body that looks at exactly what the regulating body is supposed to be doing?

Mr. FALCON. A regulating body that oversees the work of——

Senator BUNNING. The SEC would be another group of people that would look at the same thing that you are supposed to be doing right now in earnings, in statements of earnings, in audited reports, and things that are required by the Securities and Exchange Commission.

Mr. FALCON. The SEC's requirements are subject to the SEC's enforcement and review, but we have our own set of disclosure standards that we require of the company, and we also oversee those disclosures and the enforcement of proper disclosures under our own standards, Senator.

Senator BUNNING. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Stabenow.

STATEMENT OF SENATOR DEBBIE STABENOW

Senator STABENOW. Thank you, Mr. Chairman.

Welcome, Mr. Falcon.

First, I would ask, Mr. Chairman, that my opening statement be placed in the record.

Chairman SHELBY.Your statement will be made part of the record without objection.

Senator STABENOW. Thank you very much.

Before asking a question, I just want to step back for a moment in terms of what is happening in the housing market. We all know that the housing sector has really been one of the bright spots—the only bright spot—in a stagnant economy, and that as we look from the individual's perspective, they are more likely now to be counting on the equity in their homes than they are to be counting on the stock market when it comes to retirement.

So as we look at these broader issues, I know that in the secondary housing market, Fannie Mae and Freddie Mac have been very important in providing opportunity for people to be able to have that home.

So, Mr. Chairman, as we move forward, I would just ask that we use the same due diligence and deliberation that we have on other issues before this Committee, where we will take our time to do this right, to make sure that we are looking seriously at the issues that are raised——

Chairman SHELBY. You are absolutely right.

Senator STABENOW. —but not doing it in a way, as the Chairman I am sure would agree, that would undercut our ability to maintain this very important secondary market, and that we look at the regulatory system but that we not assume because one piece went wrong that the entire system is broken. So, I am pleased to be a part of a discussion about that.

When we talk about the issues that we have today, in your testimony, you point out that safety and soundness regulators do not review accounting policies for conformance with GAAP, nor do you

certify that a company's financial statements are consistent with those principles.

Do you believe that OFHEO should take a more active role in determining whether or not the GSE's are following proper accounting procedures, or do you believe that should be done by private auditors? Where do you fall now, looking back at this, and what role do you think—not only that OFHEO currently has—but what role do you think you should have as it relates to the GSE auditors?

Mr. FALCON. I think that for us to build up the capacity to, in effect, certify the financial statements would require a massive increase in the size of the Agency. I think that what is important for us to do is to be able to have the capacity to look at the implementation of new standards as they are brought forward by FASB and have more depth in accounting expertise in our program so that we can more fully evaluate the implementation of those policies and look at the interpretations of FASB and be able to just somehow ensure that they are using the highest standards of GAAP in implementing certainly new standards, at least. But I do not think it would be efficient for us to try to bring in the amount of staff that will be necessary to substitute our judgment for the external auditors' as to what is consistent with GAAP. I do not think we want to go down the road of imposing regulatory accounting principles.

The integrity of the external audit function has to be ensured here, and hopefully, through some amount of expertise in the accounting areas, we can build that up in the company—hopefully we can do so.

Senator STABENOW. So you are really indicating that at this point, you believe you lack sufficient funds to be able to take that next step in terms of more aggressive oversight, more specific oversight?

Mr. FALCON. We would like additional funding, Senator, so that we can as quickly as possible continue to build up this expertise in the Agency. I do not think the lack of the resources has hindered our ability to fulfill our mission—certainly both companies remain safe and sound because I think we are fulfilling our mission—but it would be useful for the Agency to have additional resources. And beyond that, it would be useful for the Agency to have the ability to establish its own resource needs and obtain those resources on a real-time basis. That would require giving the Agency permanent funding by removing us from the appropriations process, and that is something, as Senator Sarbanes said, that I have been advocating since I arrived at the Agency.

Senator STABENOW. One other question, Mr. Chairman, as it relates to derivatives.

Chairman SHELBY. Go ahead.

Senator STABENOW. We have been talking about that a lot this morning, and I am wondering—there are two schools of thought. One is that use of derivatives is too risky; the other is that they are important for hedging risk. I am wondering what your position overall is on these financial tools and whether or not Fannie Mae and Freddie Mac should be using them.

Mr. FALCON. Derivatives are an integral part of the Enterprises' interest rate risk management. If they are used as hedging devices

and not as speculative devices, they are a very useful risk management tool. Indeed, Fannie Mae's ability to manage their risk related to their retained mortgage portfolio would be difficult and costly if it were not for the use of derivatives. And the way the Enterprises use them, I think they are a very appropriate risk management device.

Senator STABENOW. Mr. Chairman, thank you. I would just say on a positive note that I think that as we talk about registering with the SEC, we should note that Fannie Mae has done so on a voluntary basis, and I would congratulate them for that and hope that Freddie Mac would be doing the same.

Chairman SHELBY. Thank you.

Senator Sununu.

Senator SUNUNU. Mr. Falcon, you said that despite these accounting irregularities, OFHEO is still confident about the safety and soundness of both GSE's; and I believe in an answer to Mr. Enzi's question, you indicated that these accounting issues did not figure into or affect the result or the outcome of the stress test. Is that correct?

Mr. FALCON. Yes, Senator.

Senator SUNUNU. Then, if that is the case—and I reserve judgment—why do you need more money to beef up all of these accountants and oversight capability in these areas if they are not affecting the stress test and have not affected the safety and soundness at all?

Mr. FALCON. First, there is the supplemental. That is necessary so that we can finish this investigation of Freddie Mac, and I want to be able to come to this Committee and assure you with the fullest amount of confidence that there are no issues related to Fannie Mae's accounting, and that is why we have included funds for that in our supplemental request.

Senator SUNUNU. You seem to have concluded, though—and maybe this is where there is a misunderstanding—have you concluded that any potential issues with Fannie Mae's accounting will or will not affect the stress test or the safety and soundness?

Mr. FALCON. Will the—I am sorry, I am not sure I——

Senator SUNUNU. In answer to Senator Stabenow's question, you suggested that these accounting issues have not affected the safety and soundness——

Mr. FALCON. Yes.

Senator SUNUNU. —of either GSE that you oversee; and in response to Mr. Enzi's question, you said these accounting issues do not affect the stress test. So in this case, what additional information do you need to get at or want to get at with regard to accounting that the SEC or another regulator will not be able to get at?

Mr. FALCON. For these supplemental funds, we need to ensure that our internal resources are not spread so thin on this investigation that we cannot continue with the daily work that we do at the Agency. In addition, it has been clear to me for a long time now that the Agency needed to build the depth in at least its examination program, and we are working to try to do that. Those resources are needed, and we have needed additional resources to utilize our stress test as an analytical tool.

It is not just a capital standard. We utilize it through holding certain variables constant and adjusting others to help us analyze where the strengths and weaknesses lie in the company. We want to continue to do more with the stress test to allow it to help us—it will complement our examinations work and our research work.

Senator SUNUNU. I appreciate that, and that is of great concern to me, which is why I was somewhat surprised to hear the answer to Mr. Enzi's question as to whether or not these accounting issues affect the performance of the stress test and the risk-based capital standard.

It would seem to me that should not be the case, that these accounting issues and variations should have had some impact there, and let me at least lay out what I think the reason would be.

There are a lot of things that I might bluff on or suggest that I know a little bit about, but FAS 133 is way down on the list. I know this is a very complicated accounting standard, and I understand the reasons for the standard and the rationale and the importance of marked to market in certain circumstances.

But insofar as I do understand it, Freddie was using or interpreting FAS 133 in a way that allowed them to smooth out their earnings. And you might argue if they did not use it in a particular way, their earnings would have been much more volatile.

Earnings volatility should affect your perception of safety and soundness, it seems to me, and should affect the market's perception of how an entity would perform in an economically stressful environment.

Your answer to Mr. Enzi's question suggested to me that earnings volatility is not part of the stress test or part of the risk-based capital standard. Is that the case?

Mr. FALCON. The risk-based capital stress test is a snapshot and point in time based on at the end of each quarter for each company, and it runs off raw data, millions of pieces of raw data that is aggregated into what we call a risk-based capital report. This risk-based capital report flows through the stress test, and it produces a capital requirement.

Now, the issues here with respect to GAAP do not affect the raw data that the stress test needs to run on. What would be affected, Senator, is probably the minimum capital standard, but there, because we will see an increase to earnings, their capital will go up, and they will actually have a larger surplus under our minimum capital standard.

Senator SUNUNU. That makes sense, but it did not quite answer my question. The stress test is carried out over a time series; is that correct?

Mr. FALCON. Yes.

Senator SUNUNU. So you are projecting into the forward changes in interest rate and economic information over time. But if a company had a specific earnings volatility or very high earnings volatility, wouldn't they perform differently in that time series?

Mr. FALCON. The volatility will show up at the end of each quarter's statement. As they pull back income from later quarters into earlier quarters, that will affect each quarter's earnings statement. But again, this runs off of raw data.

The economics of these transactions are still sound, by and large—there are a few transactions which I cannot get into—but the economics of these transactions are that they are still sound risk management practices and that their fair value statements are not going to change and did not change as a result of this.

So as we have looked at this very closely, this is a serious matter, but it is a matter of the timing of recognition of income and not the fact that they do not have this income.

Senator SUNUNU. Thank you, Mr. Chairman.

Chairman SHELBY. Thank you.

Senator Reed.

COMMENTS OF SENATOR JACK REED

Senator REED. Thank you very much, Mr. Chairman, and thank you for holding this hearing.

We have a very important and fundamental responsibility to ensure the safety and soundness of all these GSE's. That is our job, and we cannot do it without an effective and vigilant OFHEO in this case, because it is a day-to-day proposition to monitor the activities of these GSE's, and we have not had that capacity or even that focus.

We all recognize that the GSE's have provided extraordinary benefits to our economy and to our people, and that is not the question here at all. The question is really do you have the tools to do a very important job—and again, we depend upon you to ensure the safety and soundness—not the stock market value of the companies, not what they are doing, but essentially that we can depend that these companies are well-run, safe, and sound.

In that context, let me ask—and at this point in the hearing, most of these questions have been asked, and I apologize; please indulge me—as I understand it, the major issue here was the fact that the accounting treatment caused Freddie Mac to essentially smooth out their earnings so that they would not have the volatility we talked about. And today, you say that your judgment is that it is safe and sound.

What about the future because of this? I think this was part of the dialogue that you had with Senator Sununu. I think the future presumes that you found no systemic problems, and that the decisions that were made with respect to smoothing out will not irrevocably lead to problems in the future. Can you make those conclusions today?

Mr. FALCON. I cannot guarantee you that there will not be problems in the future, but I think what you can expect to see with the company is that there will be greater volatility in its quarterly earnings. That is a result of some of the actions that had to be taken to unwind some of these FAS 133 designations as hedges for some of these derivatives.

That is probably the biggest impact that you will see going forward as a result of the restatement.

Senator REED. Now, in a positive light, you are aware of those potentials, and you are taking steps at OFHEO to anticipate problems and respond to them; is that correct?

Mr. FALCON. Yes, sir.

Senator REED. It seems to me that the reason we are here really is because of the presumption—a rebuttable presumption—that OFHEO missed some things in this process—and again, I say that is a rebuttable presumption. But it seems to me that when you get to the questions of regulatory problems in terms of regulatory agencies, there are a couple of categories, and I would like just for the record to run down these categories.

Sometimes it is a lack of expertise; sometimes it is a lack of personnel and resources, you simply do not have enough people or computer programmers or consultants that you can hire; sometimes it is a lack of emphasis or focus by the leadership, and they just miss the point that was the most critical point; and then, sometimes it is the lack of jurisdiction—you do not have the authority.

Let us go through those. One, lack of expertise—do you think you have the appropriate expertise in the Agency to deal with this new world of derivatives and other complicated transactions?

Mr. FALCON. Absolutely, Senator. We would like to add more depth to these areas, we absolutely have the expertise necessary.

Senator REED. Two, lack of personnel and/or resources.

Mr. FALCON. Again, that gets to the issue about how we would like to have more depth across the organization. We would like to bring in more resources and personnel.

Senator REED. Okay. And that is something that is our responsibility to provide; is that correct?

Mr. FALCON. Yes.

Senator REED. Thank you.

Three, lack of emphasis and focus—do you feel that you were looking at the right things, giving guidance—not you, personally, but institutional leadership, identifying the right potential problems and the right areas you had to focus on?

Mr. FALCON. I think we will conduct a self-assessment and determine whether or not there is anything we could do better. But when you have a situation where there is a breakdown in integrity, that is not something that you can always catch right away. Ultimately, you do catch these things through your examination activities and your ongoing surveillance of the companies. But I think we were fulfilling our obligations as the regulator.

Senator REED. Finally four, lack of jurisdiction—were there areas of concern that you saw, but you simply did not have the authority or the tools to get at them because we had not given you those tools?

Mr. FALCON. No, I do not think so, Senator. Aside from the resource question, it would be helpful to have some clarification to the Agency's authorities, but we think that our enforcement powers are adequate—again, we would like some clarifications—and that we do have the tools necessary to do our job.

Senator REED. Thank you. Again, let me emphasize how critical your job is—

Mr. FALCON. Thank you.

Senator REED. —because we assume that these institutions are being vigorously regulated and that they are safe and sound, and we depend upon you to ensure that our assumption is real.

Mr. FALCON. Thank you.

Senator REED. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Hagel.

Senator HAGEL. Mr. Chairman, thank you.

Director Falcon, I have not had an opportunity to look through the recommendations that you attached to your testimony this morning, and I look forward to reviewing those recommendations. The first question I have is about responsibilities of OFHEO, and in fact this question may be included in your recommendations.

What is your opinion on whether OFHEO should have a broader, wider responsibility for its oversight responsibilities beyond safety and soundness to include mission of GSE's?

Mr. FALCON. The way this works right now, by way of background, to answer your question, is HUD is the mission regulator, and they have responsibility for program approval and general mission authority. And as a safety and soundness regulator, our function—there is a bifurcation between the two functions. However, it is the responsibility of every safety and soundness regulator to ensure that the companies they regulate are in full compliance with all the applicable laws and regulations. So where we see a clear violation of any law or regulation, it is our responsibility to step in and ensure that that conduct does not happen.

But that is when you are in areas where there is black and white. In the area of the Enterprises' charters, there is a great deal of ambiguity as to what is permissible and what is not. And since we already have the enforcement responsibility, including if HUD decided that certain activities could not be engaged in by the companies, we are an enforcement arm, and we would take enforcement action at HUD's initiation.

Given that we have the responsibility in these areas, I am suggesting just taking it a step further and let us go ahead and resolve issues where there is ambiguity as well.

Senator HAGEL. And that is included in your recommendations that you included in your testimony?

Mr. FALCON. We attached them, yes, sir.

Senator HAGEL. Good. Well, I will pursue that, and we will have other conversations about it, but I thank you.

As I have listened to your testimony and the questions here today, it is apparent—and you understand this—that we are talking about something larger than just a straight accounting function, enforcement function, of your agency to help these GSE's stay within the boundaries, obviously, of clear, accountable standards.

One of the questions I would have in that regard is do you think earnings pressures, coupled with Congressional mandates, people pushing down on GSE's sometimes because the mission is affordable housing, and the congressional mandates and the pressures, do you think that that affects or could affect safety and soundness of these institutions because—I know you understand where I am going with this—these sometimes are not always the best ingredients for the most profitable outcome. I am going to follow up with a couple more questions on this point, but let us resolve this first with your answer.

Mr. FALCON. The question is would market pressures——

Senator HAGEL. Do all these earnings pressures, coupled with Congressional mandates, the mission being affordable housing—and that is not always as profitable as other more private institu-

tions—do they present more of a risk, less of a risk, or is it neutral to safety and soundness?

Mr. FALCON. I think that as long as the company maintains the highest levels of integrity and the intent to stay consistent within the boundaries of the charters, and as long as the circumstances are such that they can continue to grow as a company without needing to step outside the bounds of their charters, it is not clear to me that the market pressures about meeting earnings expectations might force them to do something that they would not otherwise. Let me just leave it at that, Senator.

Senator HAGEL. Let me get into another area, then, that is a bit attached to this. Lately, we have all noted that the GSE's have been purchasing their own mortgage-backed securities. Does that present more or less of a risk, no impact to these institutions?

Mr. FALCON. It does present additional risk in the form of interest rate risk to the company. If they did not hold mortgages in their retained portfolio, they would not have that interest rate risk. It is something that they work to manage very diligently. But the maintenance of a retained mortgage portfolio does present, in addition to the credit risk, an interest rate risk component.

Senator HAGEL. Mr. Chairman, I know my time is up, but may I ask one very short question?

Chairman SHELBY. Go ahead, Senator.

Senator HAGEL. Do you consider stockholder equity to be relevant in considering the financial health of GSE's?

Mr. FALCON. The level, or the value of shares?

Senator HAGEL. Both—level, value—any stockholder equity in those institutions.

Mr. FALCON. Shareholder equity is a component of their capital.

Senator HAGEL. So it is very relevant?

Mr. FALCON. Yes, as long as it is a component of their capital, and they are required to meet minimum capital requirements, yes.

Senator HAGEL. Do you think that is an issue that is a problem with GSE's today, Fannie, Freddie?

Mr. FALCON. Their capital levels?

Senator HAGEL. Yes.

Mr. FALCON. I think they are able to withstand some very severe financial shocks. Our stress test imposes severe swings in interest rates, the highest possible historical credit losses on the companies. It is a very robust and stressful test, and it is one that no one else is subject to. We have devised it in a way pursuant to Congressional specifics in law that it is very stressful, and they meet it.

Senator HAGEL. Thank you very much, Mr. Chairman.

Chairman SHELBY. Thank you, Senator Hagel.

Senator Schumer, I know you have been going back and forth between Committees.

Senator SCHUMER. Thank you, Mr. Chairman.

I have been going back and forth, and to the witness, I apologize. We have a lot of doings in Judiciary, so I am trying to run back and forth.

The first point I want to make—and I just want to underscore this—is that I could not agree more with Senator Sarbanes in terms of the importance of housing in today's economy and the im-

portance of Freddie and Fannie as unique tools to help that housing market.

The real question here, the real riddle, is how do we deal with the oversight function. Fannie and Freddie are extremely important not only to the housing market—although they are probably the two most important entities to that—but also to our whole financial structure and markets, because they have such a huge amount of loans and everything else that they hold.

In fact, a while ago, when we were more sanguine about a budget surplus, and they thought the 30-year Treasury would go the way of all flesh—now there is a move to bring it back—some people talked about Fannie and Freddie being the marker. So very important, and I do not want my concerns about the auditing and oversight functions here, which are very serious ones, to be misjudged as, well, let us change the function of Fannie and Freddie. I would like them to pretty much keep doing what they are doing. You might twist the dial a little bit here, twist the dial a little bit there, but I think there needs to be better oversight and better understanding of how they integrate with the general financial markets, and hence, that is why I talked earlier about the Treasury doing the oversight at least of the auditing function. Treasury does oversight of other auditing functions that this Committee might regulate here and there, so it is not a unique situation.

My view would be—and I know that Congressman Baker has a bill to put it into the OTS; I am not sure it belongs in OTS; that is a path to treat Fannie and Freddie just like another bank—my view would tend to be that we should have—or we should consider, because all of this is tentative—maybe a special office in Treasury, the Office of GSE's, that would oversee Fannie and Freddie and maybe some of the other GSE's as well which might need some oversight—Home Loan Banks, Sallie Mae, and all these other places; who knows?

So my question—and I guess it is not even a question, because you may be the wrong person to ask, Mr. Falcon—but have you given some thought to any kind of restructuring? Obviously, none of us is very happy here on either side of the aisle with what has happened with the recent oversight.

Do you think that OFHEO structurally is the right place for this auditing and oversight function to be, or would Treasury be a better place? Tell me what you think.

Mr. FALCON. I think what is most important here is that you have a regulator that is independent, that is adequately funded and that has all the authorities necessary to fulfill their job. As long as you fulfill those principles, where it resides I do not think is of much consequence. If you moved OFHEO to Treasury, and you intended to keep its status as an independent agency, which I think our lessons from the savings and loan crisis tell us we absolutely want to do, then I do not think it accomplishes much to move OFHEO from one department to another if the goal is to maintain independent regulation.

I think that what is absolutely essential here is allowing the regulator the resources and tools to do its job. Where we are currently situated works. We operate as an independent agency. We work

well with HUD whenever there is a need for us to work on issues where there is overlap.

What I think is important to consider is to just ensure that the Agency has what it needs. Beyond that, I do not know if just moving OFHEO anywhere else accomplishes much.

Senator SCHUMER. Well, I had a fourth factor that you need, and maybe it is subsumed in your three, and that is expertise. These days, the financial instruments that the GSE's engage in are way beyond the understanding of mere mortals. I think it would be a safe thing to say that there is not a Senator or a Member of Congress who understands these complicated derivatives and hedges, and if something happens—if Krakatoa explodes 6 years from now, we can figure out a way to hedge that and make sure that mortgages are still paid or whatever—God knows what they do.

So Treasury seems to know these things better than your agency, and I was not here, and I deeply apologize because I am very interested in this subject, but we had a very controversial nominee in the Judiciary Committee. So the question is can OFHEO do this. And the second question—because there have been things wrong in the past, and I do not think just saying well, we did not have the resources is enough here, and I do not think it is going to satisfy any Member of this Committee—but the second question is does it make sense to split the functions between two agencies. What would you think of that—the auditing function, the OFHEO part, in Treasury somewhere, I would put it—not in OTS—but the mission part and working with the housing market staying in HUD. Could that work, or would that provide too many encumbrances? Give me your view on that.

Mr. FALCON. Well, on the second question, it works now. HUD is the mission regulator, and we are the safety and soundness regulator. We operate as an independent entity within HUD. So it works right now, having a bifurcation of the two functions.

But allow me to respectfully disagree with you, Senator, on the issue of expertise. No one knows these companies better than the people at OFHEO. The way they use derivatives, the way they manage the risk, the way they conduct themselves—I think this agency has a body of expertise that is unmatched relative to these two companies.

Senator SCHUMER. How did it blow it so badly last month?

Mr. FALCON. The companies are safe and sound. We have fulfilled our mission. I do not think we blew it. If we were here talking about two companies that were insolvent, then I would agree with you——

Senator SCHUMER. They actually misstated their results on the down side, not the up side, but that would have had effect a year or two from now the opposite. You must admit that you cannot have been happy with what happened in the last couple of months.

Mr. FALCON. Absolutely. I am unhappy with a lost paperclip at the companies. Any slight issue that comes up where it might affect their safety and soundness, we try to get on top of as quickly as possible.

This is a situation where you had a breakdown in the integrity at a two levels, a breakdown in the integrity of the internal controls as a result of the conduct of top management of the company,

and I think you had a breakdown in the integrity of the external auditing process. I venture to say that but I probably should not, because our investigation is still ongoing, so let me qualify my statements there and reserve judgment until we have concluded our investigation.

But I think we have fulfilled our obligation; the companies are safe and sound. I do not like the fact that this restatement was necessary. I do not like the fact that the magnitude of this is high. But what I am most concerned about is their safety and soundness. They remain safe and sound. The economics of these transactions remain sound as a risk management technique.

Senator SCHUMER. Okay. But you are saying that splitting the function works now, and you could split it in a different way down the road.

Mr. FALCON. Yes.

Senator SCHUMER. Thank you, Mr. Chairman. I appreciate the Committee's indulgence.

Chairman SHELBY. Thank you, Senator Schumer.

Mr. Falcon, Freddie Mac's restatement includes a review of Freddie's accounting policies and practices regarding derivatives—we have been talking about that this morning—the classification of debt instruments and the use of reserve accounts.

In the course of OFHEO, your organization's, examination of the Enterprises, has OFHEO noticed significant differences between Freddie Mac and Fannie Mae with respect to these accounting policies? For example, does Fannie Mae account for its derivatives and hedging transactions in a manner that is different from Freddie, and did OFHEO ever recommend a preferred accounting practice?

Mr. FALCON. The two companies have taken a different approach on the FAS 133 for accounting for derivatives, Mr. Chairman. As you know, you can take a fair value approach, you can take a cashflow approach, and a third one for foreign currency risk.

Chairman SHELBY. But is one necessarily better than the other, or are they just different?

Mr. FALCON. Certainly the approach that Freddie took was more difficult to implement. They took the fair value approach, which required that they match the derivatives with the underlying hedge. Fannie Mae has taken a cashflow approach which will result in more volatility, and we have seen that since this was implemented.

Chairman SHELBY. Okay. To what extent is your examination analysis dependent on audited financial statements? In other words, do you have the means to double-check the accuracy of the data that you use in the examination process?

Mr. FALCON. Yes, we do, Mr. Chairman.

Chairman SHELBY. Okay. Regarding Fannie Mae, on July 14, you submitted an appropriations request for $4.5 million to continue the Freddie Mac investigation and announced the initiation of a special review into Fannie Mae. Given the similarity between Fannie and Freddie, both GSE's, I understand your decision to do so, but the circumstances surrounding the two companies, however, appear to be quite different at times. Fannie Mae has not, as far as I know, announced a pending restatement of its financial statements and has not up until now experienced a significant change

in management as a result of the restatement process. Is that right?

Mr. FALCON. Yes.

Chairman SHELBY. Aside from your concerns, have there been any events or circumstances at Fannie Mae that triggered your review, other than you looking at Freddie Mac and saying, Gosh, maybe we should look closer at Fannie Mae?

Mr. FALCON. I think whenever we see a problem at one company, we always look at the other, just to make sure.

Chairman SHELBY. Sure. I did not say not do it; I am just curious.

Mr. FALCON. Yes, right. But in answer to your question, Mr. Chairman, we are not aware of any specific concerns that we have with respect to Fannie Mae.

Chairman SHELBY. Okay. Could you just, for the Committee, give us a basic outline of the scope and mandate of this special review and how it would differ, if it does, from a routine examination practice that you use at OFHEO every day?

Mr. FALCON. It will differ in the respect that we do not, as part of our routine examination process, attempt to undertake a qualitative review of the accounting policies of a company and determine whether or not the policies are consistent with GAAP. This is a one-time, unique situation where we are going to, through the use of these funds and some outside assistance, take a qualitative look at a high level to ensure that there is the highest conformance with GAAP.

So that is how this is a departure from our normal examination process.

Chairman SHELBY. Mr. Falcon, I personally feel that agency actions and regulations should receive the maximum amount of public input as possible. In your proposal, you request that OFHEO be exempt from the Federal Advisory Committee Act. Clearly, this would reduce the public oversight of OFHEO's activities.

Currently, it is my understanding that only two—two—agencies have this exemption—the Central Intelligence Agency and the Federal Reserve for the interest rate deliberations with the Federal Open Market Committee. Why is this exemption authority being requested by you?

Mr. FALCON. It is also, by the way, Mr. Chairman, being requested by others.

Chairman SHELBY. It has not been granted, though; only two, the CIA and the Federal Reserve.

Mr. FALCON. Right.

Chairman SHELBY. And you can see why.

Mr. FALCON. It is not critical to the Agency, Mr. Chairman.

Chairman SHELBY. Okay. It is just something you would like to have, but it is not central to what you do.

Mr. FALCON. Yes, sir.

Chairman SHELBY. How many formal enforcement actions has OFHEO ever taken against either Freddie Mac or Fannie Mae, or any other GSE?

Mr. FALCON. We have not had to take any enforcement actions to date. We have taken one supervisory action. But the Enterprises

do a good job of responding to any concerns we raise, so things have not had to rise to the level of an enforcement action to date.

Chairman SHELBY. Currently, you have now and have had enforcement powers.

Mr. FALCON. Yes, sir.

Chairman SHELBY. But you have not really exercised them, have you?

Mr. FALCON. Right. Enforcement powers are usually when all else fails.

Chairman SHELBY. I will call on Senator Sarbanes, and then I will wrap up. Thank you.

Senator SARBANES. Thank you, Mr. Chairman.

It is my understanding that since 1997, five individuals have served in the role of Corporate Controller at Freddie Mac, three as permanent controllers, and two on an interim or acting basis. Can you explain the reason for the high turnover and what impact that might have on the company's accounting and internal control functions, and is this the thing that OFHEO would note and take into account in exercising its oversight responsibilities? It seems to me it would be a matter of concern if you look at a major enterprise of this sort, and they are bouncing the corporate controller in and out of there almost every year from these figures, at least.

Mr. FALCON. That is a good question. Stability in that position I think is important to both companies, and the fact that they have had such turnover as you referred to in that position, you would not prefer that there be that kind of turnover.

The circumstances surrounding—I think three of them were permanent, and two were interim; at least one case that I can recall was a promotion, and I am not sure of the circumstances of the other. It is an area where we would like to see more stability in the company, Senator.

Senator SARBANES. I take it that your inquiry and that of Baker Botts are both directed to what happened or in a sense, what went wrong; is that correct?

Mr. FALCON. Yes, Senator.

Senator SARBANES. I am concerned about what is being done as we move on and look ahead. In your statement, you say that the Governance Committee of the Board of Freddie Mac adopted a finance function governance plan back in mid-May, proposed by the new executive vice president overseeing the accounting and control functions at Freddie Mac.

Is that plan being implemented? Is it a strong plan? In other words, while you are looking at what went wrong, what is being done to make sure that things are being brought up to standard now?

Mr. FALCON. That plan incorporates and supersedes the plan that was adopted previously, toward the end of 2000, and this plan is designed to take that a step further and ensure that the company maintains best-in-class standards in the financial reporting and accounting areas. We are working closely with the company to ensure that it accomplishes that result.

Senator SARBANES. We will go back and review what happened, but how much confidence do you have as we move forward that any gaps have been closed and that we are operating in a—that is

"gap" spelled with one "a" in this instance, not with two—that we are operating according to standards that give us some sense of security?

Mr. FALCON. I think that with the new focus of the company and with the creation in this area of accounting in our examination program, I cannot guarantee that there will not be issues that arise, but I think we will be as vigilant as possible to ensure that if issues do arise, our utmost priority here is to make sure that they do not affect the safety and soundness of the companies, that they maintain adequate capital, that their credit and interest rate risk are properly managed, that their asset quality remains good.

As long as all those fundamentals remain sound, then we expect that they will be able to withstand issues like this that arise. So if other instances came up, I think that what we want to make sure of is that those issues do not threaten their solvency.

Senator SARBANES. Of course, one of the things that has happened here is that the directors and the audit committee of Freddie Mac did move to take corrective action against management abuse; is it correct to have that perception?

Mr. FALCON. Yes, Senator. They replaced top management when they were confronted with the evidence of problems with the current management, and they did take the appropriate action at that time.

Senator SARBANES. Well, we will have to follow this very closely. Let me ask one final question. Jerry Knight, a financial columnist for *The Washington Post,* wrote on June 30 a column in which he said, "We now know that people at Freddie Mac did not understand their derivatives, and they are among the biggest users of them in the world."

Of course, that is a rather disconcerting statement. And recently, Warren Buffett and Alan Greenspan have both noted the high concentration of derivatives among a relatively small number of financial institutions. This may raise a concern about systemic risk in our financial system. The GSE's are among two of the largest users of derivatives.

What special steps, if any, has OFHEO taken to limit the likelihood of any systemic problems created by the use of derivatives?

Mr. FALCON. I disagree with the article. These two companies do understand derivatives; they do understand how to use them as risk management tools. In the case of Freddie Mac, what they did not understand how to do properly was account for them, and that is what we are looking at right now, at accounting issues. These derivatives remain effective risk management tools, and the economics are sound with these derivatives; it is just the accounting.

But we will continue to look at the companies' use of derivatives. We assess whether or not they are used as sound risk management devices and not as speculative devices where they might have an exposure to changes in interest rates because there is not an offset on the companies' balance sheets.

We have a very active oversight program with our examiners through the use of our capital standards and our research functions. Earlier in the year, we produced a very significant systemic risk report where we also looked at the big picture implications of the companies' derivatives use.

So, I think we are well on top of issues related to the companies' use of derivatives, Senator.

Senator SARBANES. Would you say that your expertise and competence within OFHEO with respect to derivatives exceeds the expertise and competence of the two institutions for whom you are the regulator?

Mr. FALCON. I would not necessarily want to say who is better than who, but I think we each have the expertise necessary to fulfill our functions and our missions, Senator.

Senator SARBANES. Thank you, Mr. Chairman.

Chairman SHELBY. Thank you.

Some of the testimony today that I have been hearing is troubling. You are the prime regulator, but it seems from the testimony today that you have been in the dark, that it was not OFHEO that found something wrong with the accounting problems at Freddie Mac, but that Freddie Mac internally did this through PricewaterhouseCooper and disclosed this to you or alerted you to what was going on. Is that fair?

Mr. FALCON. Yes. PwC identified these issues, yes.

Chairman SHELBY. Okay. I want to go back to something that Senator Sarbanes mentioned earlier in the hearing. If you were in the dark—and it seems that you were as a regulator—we have been probably lucky, all of us, and fortunate that, assuming that these earnings are going to be upward instead of downward—in other words, more capital instead of less capital—on Freddie Mac, assuming that the restatement at the end of the day is between $1.5 and $4.5 billion upward as the market seems to indicate and people believe. But you would not have known as the regulator had it been a huge loss instead of appreciation in value, more money, and that is troubling because it seems to me that you cannot assume anything. And if you are the primary regulator, I think we will continue to look at this. We have a hearing next week on the nomination of your successor, and I am sure we will get into this some more.

We all realize that GSE's have done a lot of good, and as you and others have said, they are strong and well-run. But as the regulator, I am not sure you knew that, or that you knew what was going on, and if Freddie Mac internally through their accountants had not disclosed this, would you have ever known? So it is deeply troubling to us. Are you basically—and I do not mean you individually—but is OFHEO up to the task, considering the amount of money that the GSE's are involved in and how important they are in the secondary mortgage market to our economy, our housing market, and everything that goes with it?

I think these are real questions that we will continue, Senator Sarbanes, to grapple with, and we should.

We appreciate your appearance today.

Mr. FALCON. May I say something, Mr. Chairman.

Chairman SHELBY. Do you want to respond to some of that?

Mr. FALCON. Yes, please. Let me try to explain it this way. If there were going to be a loss as a result of this restatement, I do think we would have known——

Chairman SHELBY. Now, wait a minute—how would you have known if you did not know that there was going to be an upward

thing? I think the statement that Senator Sarbanes got at earlier is very important.

Mr. FALCON. Right. The underlying economics of these transactions were sound. These are real earnings. These are not manufactured earnings.

Chairman SHELBY. I did not say they were.

Mr. FALCON. Right. But my point is that had there been a loss here, it would have meant that the economics of these transactions were not sound, that they were not effectively hedging.

Chairman SHELBY. But sir, how would you have known——

Mr. FALCON. Through our examination process——

Chairman SHELBY. —if you did not know anything about what was internally going on—I would not say "anything," but——

Mr. FALCON. Well, we were fully aware of these transactions, and we were aware of the accounting of these transactions. We had to examine these transactions to make sure that they were effective hedging activities.

What we were not second-guessing was what was the proper accounting treatment for these transactions. But if these transactions were not effective as hedging devices, it would have shown up in the economics of these transactions, and that poor economics would have resulted in a loss to the company, and regardless of how you account for that, we would have picked that up through our examination program.

Chairman SHELBY. Sir, how would you have known that the financials would show a loss if you did not know what was really going on inside?

Mr. FALCON. We would have been aware of the economics of the transaction and been able to assess whether——

Chairman SHELBY. But how would you have been aware?

Mr. FALCON. Through our examination program, we look at all these transactions. We look at them at a transactional level to ensure that where they have a certain amount of interest rate risk or credit risk related to their activities, they are effectively managing that risk. And if we saw there was a mismatch between the two, it would send a signal to us that something needs to be done here. And again, that is why these were and are effective economic hedges for the company. It is a matter of how you recognize the income—do you recognize it over time or do you recognize it all at once—that depends on the application of the accounting standards.

Chairman SHELBY. Had you ever inquired about all of that?

Mr. FALCON. We were making sure that the company and their accounting firm were going through the steps that they needed to follow, applying industry standards for doing their work——

Chairman SHELBY. Didn't you make a report on about the first of June about Freddie Mac and Fannie Mae?

Mr. FALCON. I am sorry, Senator?

Chairman SHELBY. About their salaries and everything.

You made a report—didn't OFHEO have a report on them——

Mr. FALCON. —in our annual report?

Chairman SHELBY. Absolutely.

Mr. FALCON. Yes, Mr. Chairman, we did.

Chairman SHELBY. And you did not mention any of the other problems.

Mr. FALCON. Yes, and that is where I would like to assure you, Mr. Chairman, and the Committee that going forward, I think the Agency needs to be sure that even if issues do not rise to the level where we have to qualify our assessment of the company, we will take a more active look at including more detail in that annual report, and I think you have a right to expect that out of us.

Chairman SHELBY. I think it has been a troubling but also an illuminating hearing. Thank you very much.

Mr. FALCON. And you have been fair.

Thank you, Mr. Chairman.

Chairman SHELBY. The hearing is adjourned.

[Whereupon, at 12:21 p.m., the hearing was adjourned.]

[Prepared statements and response to written questions supplied for the record follow:]

PREPARED STATEMENT OF SENATOR CHUCK HAGEL

Mr. Chairman, thank you for convening this important and timely hearing, and welcome to Mr. Falcon—I look forward to your testimony.

There is no doubt that the housing GSE's have been successful in carrying out their mission of creating a secondary market for home mortgages. The housing market has remained strong through tough economic times, and homeownership is at an all time high in this country.

Fannie Mae and Freddie Mac are unique institutions that are chartered by Congress, limited in scope, and are imposed with Congressional mandates, yet they are publicly traded companies with all the earnings pressure that Wall Street demands. Additionally, Fannie and Freddie enjoy an implicit guarantee by the Federal Government that has aided them in developing substantial clout on Wall Street. With their influence in the markets, their ability to raise capital at near-Treasury Bill rates, and their use of the most sophisticated portfolio management tools, Fannie and Freddie today are no longer simply secondary market facilitators for mortgages.

Freddie Mac's recent disclosure of management failures and accounting deficiencies resulting in upwards of $4.5 billion in understated earnings precipitated the need for Congress to exercise its oversight of GSE's. I have been assured by our Chairman that today's hearing will not be the only opportunity we have to address this issue and other important questions surrounding Government Sponsored Enterprises.

It is critical that this further examination includes a look at the extent to which the GSE's have strayed from their central job of mortgage securitization. We should look at how exemption from SEC regulation, State regulation, and income taxes might create an unfair advantage for GSE's as they compete with private-sector companies.

If we are to continue to provide GSE's with the framework to operate under an implied Government backing, I believe that they should be held to a higher standard than private organizations and subject to more scrutiny than the private sector. Furthermore, I believe it is possible to realign oversight and operating rules for Fannie and Freddie without jeopardizing the strong housing market that America enjoys today.

It is my view that the Office of Federal Housing Enterprise Oversight (OFHEO) could better regulate these financial institutions if it is moved out of HUD and into the Treasury Department. Treasury currently regulates banks and other financial institutions through the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS), and it has the experience and expertise needed to supervise Fannie Mae and Freddie Mac—it's a natural fit.

This reform is important to restoring and maintaining the confidence that investors and the markets require. In light of the recent problems at Freddie Mac, it is even more important.

Mr. Chairman, I thank you again for holding this hearing today. It is a good first step toward awareness of the problems and reform of the system. I look forward to working with you and this Committee as this issue moves forward.

PREPARED STATEMENT OF SENATOR JON S. CORZINE

Mr. Chairman, thank you for convening this important hearing on oversight of the accounting practices of Government Sponsored Enterprises (GSE's). These institutions serve as pillars of America's housing market by providing liquidity that has helped make the American Dream of homeownership a reality for millions of families.

Having said that, recent developments at Freddie Mac serve as cause for alarm. The ongoing accounting investigation at the company, the shake-up of its management team, and the seeming lack of internal controls are all troubling. Viewed together, they call into question, and require this Committee to consider, the adequacy of the regulation provided for Freddie Mac, as well as Fannie Mae, to ensure their safety and soundness.

The size and complex financial structures of the two organizations—which account for billions of dollars in mortgage-finance dollars—along with their impact on our capital markets, on pension and mutual funds, and on individual investors, require a regulator that is both credible and capable at providing rigorous oversight.

In my opinion, the current state of GSE regulation fails to meet these critical tests. That is why I have come to the conclusion that GSE oversight would benefit by moving OFHEO—and its safety and soundness responsibilities—to the Department of the Treasury, as a new, separate division with funding authority that moves

them out of the appropriations process. However, in my view, the underlying housing mission of the GSE's—the annual housing goals and oversight of fair housing—should remain with HUD.

Such a move would instill confidence in investors, our capital markets, and Members of Congress that GSE oversight is in the hands of a strong, robust, and credible regulator.

No doubt, Mr. Chairman, there will be a wide variety of GSE "reform" proposals floated. As we consider these proposals, I hope we will ensure they do not alter the structure and regulation of our GSE's in a manner that undermines the liquidity, innovation and speed to market of the products they bring to our housing market. All these features of GSE's have contributed to making America's housing finance system the most successful in the world. And our housing market has been one of the few positives in this economy.

I want to thank our witness, OFHEO Director Falcon, for joining us and providing us with his testimony today. I look forward to his thoughts regarding the Freddie Mac issue, and the current state of GSE regulation.

PREPARED STATEMENT OF SENATOR DEBBIE STABENOW

Thank you, Mr. Chairman. I appreciate your calling this hearing today. Welcome Mr. Falcon. I am glad that you are here before us and I look forward to hearing your testimony today.

Mr. Chairman, the housing sector has been one of the few bright spots in a generally stagnant economy. We are very fortunate to have had an unprecedented level of homeownership and refinancing activity over the past few years. For most Americans, homeownership is a source of personal pride. And, for many of our citizens, it is not the stock market, but rather the equity they develop in their homes that becomes their principal sources of savings for retirement. In addition, cashing out equity has enabled many Americans to reduce their higher interest debt burdens and continue making personal purchases that boost the economy.

We, in Congress, have always put a premium on homeownership through various policies we have enacted. There is, however, much more that we should be doing. I believe that there are several pieces of housing legislation that we should act on in the 108th Congress. For example, I believe that we should support bipartisan initiatives such as the housing redevelopment tax credits in S. 875 and S. 198 and the First-Time Homebuyers' Tax Credit Act, S. 1175. These bills are stimulative and would help to keep housing a thriving part of our economy.

I am much less certain, however, that we should rush to pass new legislation affecting the secondary mortgage market. The markets created by Freddie Mac and Fannie Mae have been critical to increasing the amount of money available to make mortgages and these markets have helped to reduce the cost of homeownership. Just because one of the GSE's is facing some questions about its accounting is not a sufficient reason to assume the entire regulatory system is broken. Indeed, recreating the Agency rather than fixing any existing problems could, in the short-run, make the regulator less efficient—something we most certainly do not want to do.

Mr. Chairman, I urge caution. There are modest, but obvious and important steps Congress can take. We can act to ensure that OFHEO has the resources both in the short-run and in the long-run to be an effective regulator. I know that senior staff at OFHEO spend a great deal of resources worrying about whether or not they will get the annual appropriations that they are seeking. We should make sure they have a reliable source of funding.

We should also make sure that, as Mr. Falcon's tenure at OFHEO winds down, we approve a new Director only if that new Director will be a strong and aggressive regulator. I would like to see someone who will inspire confidence in the markets and has widespread support from both sides of the aisle.

I suspect that critics of the good work that Fannie Mae and Freddie Mac do every day see a unique opportunity in the current controversy at Freddie. I would suggest that they not get too excited about using this as an opportunity to attack the two companies on a broad set of unrelated issues. This Committee has a history of being thorough and cautious about such things. And, no Member on this Committee wants to do anything that would roil the housing market.

Any major changes to the regulatory framework for Fannie and Freddie should only be considered after an exhaustive comprehensive exploration of any shortcomings in the existing regulation of the GSE's.

I want to work with Chairman Shelby and Ranking Member Sarbanes to understand what happened at Freddie Mac and I want to be sure that both GSE's are

adequately capitalized, well managed, and can continue to serve an important role in the housing sector. I hope today's hearing will be a starting point to accomplish just that.

PREPARED STATEMENT OF SENATOR JACK REED

I would like to thank Chairman Shelby for scheduling this hearing on Regulatory Oversight of Government Sponsored Enterprise Accounting Practices. I also would like to thank Armando Falcon, Director of the Office of Federal Housing Enterprise Oversight (OFHEO), for joining us this morning.

We are here today to talk about OFHEO's oversight of the safety and soundness of Freddie Mac and Fannie Mae, in particular its oversight of Freddie and Fannie's accounting practices.

As we all know, the Government Sponsored Enterprises (GSE's) have played an invaluable role in creating a stable and liquid secondary mortgage market in our country, and this has resulted in our country having one of the highest homeownership rates in the world. Strong and effective oversight of the GSE's to ensure their safety and soundness for the public at large is clearly an important part of their long-term success.

As a result, we need to do everything we can to make sure OFHEO has the staff expertise and resources it needs to quickly adapt to overseeing new products and methods at the GSE's. We need to make sure that OFHEO's mission is focused, the lines of authority are clear, it has the tools it needs to thoroughly analyze and evaluate the GSE's complicated financial transactions, and that it is well-insulated from outside influences.

Although the GSE's have been given certain benefits by the Federal Government, they also must bear certain burdens. They must be subject to rigorous government oversight and they must abide by more conservative standards than other financial institutions in the market.

Needless to say, I look forward to today's testimony and hope it can clarify some of this Committee's concerns about OFHEO's oversight of the GSEs' accounting practices and any potential impacts on the ability of OFHEO to ensure the safety and soundness of Fannie Mae and Freddie Mac.

PREPARED STATEMENT OF ARMANDO FALCON, JR.

DIRECTOR, OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

JULY 17, 2003

Mr. Chairman, Ranking Member Sarbanes, and Members of the Committee, I appreciate the opportunity to appear before you. My testimony today will focus on the Freddie Mac restatement process, OFHEO's role as a safety and soundness regulator, more specifically, the Agency's approach to examining accounting practices and financial controls at the Enterprises, and a status report on the related issues of Executive Compensation and Corporate Governance. In addition, I have attached some legislative recommendations for the Committee's consideration to enhance OFHEO's role as safety and soundness regulator.

Introduction

On January 22, 2003, Freddie Mac announced that it would reaudit and restate its financial statements for 2000 and 2001. The company also announced that its' external auditor would delay certification of Freddie's year-end 2002 financial statements. Five months later, on June 7, the board removed the company's top three officers. OFHEO, the SEC, and a U.S. Attorney all have ongoing investigations of the company and its accounting practices. These extraordinary actions reflect the culmination of developments over several years. Given our ongoing investigation, I ask for the Committee's understanding if I am restrained in my testimony, as facts are still being verified and circumstances evaluated. I will begin by describing the major developments in chronological order.

Lead-Up to FAS 133 Preparation and Implementation—1999

First, the sequence of events begins with the preparation, in 1999, for implementation of Financial Accounting Standards Board (FASB) Statement No. 133—Accounting for Derivative Instruments and Hedging Activities (FAS 133). FAS 133 is not the only accounting standard involved in this matter, but it plays the most important role. FAS 133 establishes accounting and reporting standards for derivative

instruments, including certain derivative instruments embedded in other contracts, (collectively referred to as derivatives) and for hedging activities.

FAS 133 requires an entity to recognize all derivatives as either assets or liabilities in the financial statements and reflect those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as: (a) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment; (b) a hedge of the exposure to variable cashflows of a forecasted transaction; or (c) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction. The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation.

Under FAS 133, an entity that elects to apply hedge accounting is required to establish at the inception of the hedge the method it will use for assessing the effectiveness of the hedging derivative and the measurement approach for determining the ineffective aspect of the hedge. Those methods must be consistent with the entity's approach to managing risk.

I would now like to turn to OFHEO's examination strategy to cover FAS 133 preparation at the Enterprises in 1999. The routine 1999 examination work was conducted at the same time OFHEO's examiners were expending considerable efforts to ensure that both Enterprises were prepared for, and all essential systems across the two companies would be fully compliant with Y2K goals. Because of the critical nature of Y2K readiness, examiners conducted extensive testing and validation of systems preparedness. Against this backdrop, the FAS 133 examination strategy required the examination team to maintain expertise and working knowledge of the accounting standard and its potential effects on each Enterprise; evaluate and assess the Enterprises timeline for implementation; evaluate the strategy each Enterprise was pursuing for its implementation of the accounting pronouncement and analyze the effects of FAS 133 on financial statements. In addition, our examiners would continue to evaluate the external accountant's position on the accounting policy guidance associated with implementing FAS 133; assess the systems enhancements to conduct hedging and financial reporting under FAS 133; and evaluate and monitor implementation readiness and event management, including contingency preparations for the transition.

In the second half of the year, FASB unexpectedly delayed the implementation date of FAS 133, from January 1, 2000 to January 1, 2001, so that companies could focus their attention on Y2K.

Transition Period to FAS 133 Readiness—2000

In 2000, OFHEO's examiners assessed the development and implementation of Enterprise plans with respect to several new significant accounting standards, including FAS 133. At the same time, they reviewed the effectiveness of Y2K efforts and the effects on the financial safety and soundness of a 20 percent decline in the volume of originations; an increase in the proportion of Enterprise purchases of single-family mortgages evaluated through automated underwriting systems; and the increased use of sophisticated technology for risk management across the companies.

In evaluating preparations for the implementation of FAS 133, examiners were actively evaluating: systems preparation, implementation strategies, impact analysis, documentation specifications, portfolio management strategies, and the approvals from management, the board and the internal and independent external accountants involving FAS 133 implementation. We recognized the substantial progress that had been made on the preparations and the considerable analysis that had been performed. Further, we noted the additional efforts that were underway to deal with the remaining systems and documentation challenges associated with implementing and operating with FAS 133.

In late 2000, the audit committee approved the Financial Reporting Controls Improvement Plan (FRCIP). The FRCIP was designed to address issues affecting financial accounting and financial reporting that had been identified by the company, its independent auditors, and OFHEO. The goal of the FRCIP was to achieve the same level of controls in the financial accounting and financial reporting area that were present across the other areas of the company and in the operating business units.

OFHEO's examiners evaluated the FRCIP and Freddie Mac's progress in completing the FRCIP in a number of ways. In 2000, examiners evaluated and communicated with management about the FRCIP itself, ensuring if it was reasonably designed to address the root causes of the identified weaknesses. Also, in 2000, examiners assessed the design of the tools both management and the board's audit committee intended to use to measure and report progress in implementing the

FRCIP. On a regular basis, examiners were assessing the progress toward completion of the FRCIP and communicating our assessments to the company.

In the fourth quarter of 2000 and the first quarter of 2001, Freddie Mac entered into several transactions to minimize the impact of FAS 133. PwC later identified these FAS 133 transition transactions as accounting issues needing correction before the 2002 financial statements could be certified.

Implementation of FAS 133—First Quarter 2001

In 2001, OFHEO's examiners continued their ongoing evaluation of FAS 133's implementation and its impact on the Enterprise, with respect to business activities, risk management strategies, and portfolio management. Among the variety of features our examiners were reviewing, were the operational aspects associated with FAS 133 and the company's quarterly closing practices. When reviewing the quarterly closings, we noted the sign-offs and notations of the company's auditors. Our review found no reservations or qualifications associated with Arthur Andersen's certification of the quarterly and year-end 2001 financial statements and the conformance of those financial statements and disclosures with GAAP.

FAS 133 was implemented in first quarter 2001. Arthur Andersen certified each quarter's financial statements under the new FAS 133 pronouncement as GAAP compliant. At this same time, extensive interpretations continued to be produced on FAS 133 by FASB.

While OFHEO was conducting its FAS 133-related examination activities, we were also dedicating examiners to assess the impact of record levels of originations, new corporate governance standards and record volumes of purchases, and securitization on both Enterprises safety and soundness. OFHEO examiners were also evaluating the timeliness and effectiveness of the Enterprises actions to meet the final Risk-Based Capital Rule.

Need to Strengthen Expertise and Controls—2001

After preparing for FAS 133, the actual implementation of this accounting standard further highlighted aspects of Freddie Mac's financial accounting and financial reporting areas that needed strengthening. It became more apparent to OFHEO and Freddie Mac that, while the overall control structure for the company was strong, in the financial accounting and financial reporting area there was an apparent need to strengthen expertise and reduce the reliance on manual systems. Strengthening expertise and reducing the reliance on manual systems were important aspects of the FRCIP introduced in 2000, and examiners continued in 2001 to evaluate the progress against this remediation plan. We continued to press management to ensure progress continued in implementing the FRCIP and maintaining the plan's implementation remained an important corporate priority.

OFHEO felt the control environment at that point in financial accounting and financial reporting was stable, but in need of strengthening. The FRCIP was designed to address the identified weaknesses and to strengthen the control environment in the financial control and financial reporting area to a level consistent with the control environments across the other parts of Freddie Mac. While there were weaknesses in the financial accounting and financial reporting area, the manual processes did mitigate those control weaknesses in the operating process and resulted in Freddie Mac's ability to produce reliable financial records. Upon completion of the work to reengineer the financial accounting and financial reporting process, there would be a more timely, efficient, and streamlined process that would not depend upon manual systems to ensure the reliability of financial information.

In context, Freddie Mac maintained effective internal controls in its various business areas. The area covered by FRCIP was the financial accounting and financial reporting area, which represents a subset within the larger finance area, and an even smaller subset within the overall company.

OFHEO's examiners continued in 2001 to evaluate progress on the FRCIP at least quarterly by, for example, analyzing and testing the quarterly progress reports to the audit committee, internal audit, senior management, and Arthur Andersen, and evaluating the events reached or expected, major milestones, schedule overruns, and the level of completion of each project. Examiners concluded that by mid-2001 approximately one-third of the FRCIP had been completed. As a result of a national search, Freddie Mac brought in a new Senior Vice President—Corporate Controller, charged with responsibility for the accounting and control function. This key milestone was achieved in October 2001, and by year-end 2001 Freddie Mac completed Phase I of the FRCIP, which included reconciliations, and deployment of integrated and automated cash management, bank account and transactional reconciliations and billings/receivables functionalities. In 2002, OFHEO's examiners continued their ongoing assessments of progress under the FRCIP, and determined that the new ac-

countability model and Operation Risk Management Unit, when implemented, would strengthen Freddie Mac's financial accounting and reporting processes.

Also during this period, OFHEO was planning enhancements for its examination activities. In 2000, I had meetings with the Chief Examiner, and we outlined plans for strengthening OFHEO's examination program. Among our discussions was an idea to create an examination team dedicated to accounting matters. In January 2001, the Chief Examiner delivered a plan designed to enhance OFHEO's examination program. A cornerstone of that plan was to more than double the size of the examination staff, adding depth and additional specialized skill sets to deal with complex issues associated involving the supervision of the Enterprises.

The plan to strengthen OFHEO's examination program included the formation of a group for specialized examination activities, including a team of accountants. After receiving this plan in January 2001, I began advocating within the Administration and with Congress the importance of OFHEO obtaining the resources to begin implementing this plan and enhancing our examination program. In the second-half of 2002, we were able to start populating our team of accountants with skilled technicians who would be dedicated to accounting matters at the Enterprises.

New Outside Auditor—2001

Late in 2001, Arthur Andersen was under public scrutiny because of its role as the audit firm of record in certain high-profile Federal investigations and bankruptcy filings. Given these developments in late 2001 with Arthur Andersen, Freddie Mac's Board of Directors and executive management deliberated whether they should keep that firm or select a new independent accounting firm. Freddie Mac solicited OFHEO's views concerning the retention of Arthur Andersen. OFHEO opined that given the circumstances, retention of the firm created a higher-risk situation for Freddie Mac.

The audit committee decided to change independent accountants and interviewed two potential firms in the first quarter of 2002. The Committee decided to switch to PwC for Freddie Mac's independent public accountants for the year ending December 31, 2002. Freddie Mac made a public announcement of this decision on March 6, 2002. The audit opinions of Arthur Andersen on the consolidated financial statements of Freddie Mac for the fiscal years ending December 31, 2000 and 2001 did not contain any adverse opinion or disclaimer of opinion, nor were they qualified or modified as to uncertainty, audit scope, or accounting principles. In separate management letters, Arthur Andersen shared its concern with senior management on a number of items that had also been independently noted by OFHEO.

Engagement of PwC—2002

OFHEO evaluated and tracked changes being made through its routine examination activities in 2002 regarding the engagement of PwC and the work of the audit committee. PwC began its audit engagement immediately after being selected by the audit committee. OFHEO examiners had an introductory meeting with PwC managers for the Freddie Mac audit on March 5, 2002. PwC was ratified as the independent public accountant at Freddie Mac's May 2, 2002 Annual Shareholders Meeting. In the course of its audit, PwC initiated a process of identifying various accounting policies and accounting issues to discuss with Freddie Mac's management. Both Freddie Mac management and PwC conveyed the nature of these discussions to the audit committee. In the normal course of business, PwC met with the audit committee in executive session on these matters.

Additional Expertise Added at Freddie Mac—2002

Consistent with OFHEO's concerns, some important staffing decisions in the finance area were announced at Freddie Mac during 2002, adding necessary expertise. In June, a new Senior Vice President for Operational Risk Oversight was hired. On June 18, the board announced the creation of a new senior level executive position and national search, for an Executive Vice President of Finance, consistent with the goals outlined in the FRCIP. The newly created position would be responsible for the overall finance, accounting, corporate planning, tax, shareholder relations, and market risk and operating risk oversight functions of the company. The CFO and the Corporate Controller would continue in their respective roles and they would report to the new Executive Vice President—when hired. Until the new position was filled, the Corporate Controller had a direct administrative reporting line to the COO and a direct communication line with the audit committee, similar to the CFO's reporting line. The current EVP and CFO—Mr. Vaughn Clarke—no longer had the Corporate Controller reporting through him, and notified the company of his intentions to leave Freddie Mac. On March 19, 2003, Freddie Mac announced that Mr. Martin Baumann had filled the newly created EVP of Finance position.

ALLL Accounting Matter Identified—2002

OFHEO was actively involved in the discussions that were taking place between PwC and Freddie Mac regarding the Allowance for Loan and Lease Losses (ALLL). The ALLL was identified in July 2002 by PwC as a critical accounting matter that needed to be resolved as they worked toward certifying Freddie Mac's financial statements.

A special audit committee meeting was held on July 16, 2002 where PwC raised the ALLL issue for Freddie Mac—it was too conservative in its loss estimates and coverage per PwC's determination under GAAP. PwC felt this matter on the ALLL needed to be resolved before Freddie Mac's release of second quarter financial statements on July 23, 2002.

OFHEO and Freddie Mac representatives met on July 22, 2002 to gather information about the final size of the adjustments being made to Freddie Mac's financial statements. The adjustment was a $246 million reduction in the ALLL. On the same day, the audit committee had a special meeting to review the final analysis and approve the adjustment for release to the public in the July 23, 2002 release of financial statements.

Accounting policies and issues continued to be worked on by PwC, management and the board throughout 2002. Progress appeared on track for the certification of fiscal year 2002 financial statements. As of fourth quarter 2002, the ALLL was the only accounting issue that had risen to the level of PwC expressing reservations to the audit committee relating to that firm's ability to certify Freddie Mac's statements and that had been resolved in July 2002. OFHEO continued to evaluate and monitor the status of the accounting policies under discussion between PwC and Freddie Mac during 2002, as well as the actions and decisionmaking by the audit committee. Examiners continued in 2002 to evaluate progress on the FRCIP at least quarterly. This included examiners testing selected work products and evaluating project management and reporting.

Unresolved Accounting Matters under FAS 133—2003

PwC came to the Freddie Mac Board in mid-January 2003 and informed the audit committee they would be meeting with representatives from PwC's national office about unresolved accounting policy matters, related to FAS 133 implementation. On Monday, January 20, 2003, PwC notified the audit committee that they were uncomfortable with certain accounting treatments applied during the FAS 133 transition. Furthermore, until its concerns were resolved, it would not be able to certify the company's 2002 fiscal financial statements using the accounting policies from prior periods, even though the policies had been approved by Arthur Andersen as GAAP compliant. OFHEO was made aware of these developments on that day and met with Freddie Mac officials the following day.

The nature of the major accounting issues identified through the restatement process include:

1. The erroneous accounting treatment of the company's Securities Sales and Trading Group (SS&TG) as a third-party broker dealer;
2. Inadequate documentation and testing of certain derivative instruments and their valuations accounted for as hedge instruments for accounting purposes;
3. The erroneous transfer of mortgage securities out of the "held-to-maturity" and trading accounts;
4. The treatment of mortgage sales transactions as financings;
5. Accounting for certain cash transactions used to manage interest rate risk as if they were derivatives; and
6. Omitting the recognition of the guarantee fee and credit obligations embedded within sold PC's.

These transactions are the subject of our investigation, and I will have more to say about them in my final report.

Because Arthur Andersen was no longer an operating firm at this point, PwC could not undertake a normal transition pursuant to the AICPA guidance for successor/predecessor accountants. Instead, PwC would have to undertake additional substantive testing. The board of directors determined that PwC should conduct a reaudit of the prior period financial statements.

OFHEO, PwC, and the audit committee evaluated the nature of the accounting issues. Among the factors considered was the cumulative effect of the adjustments flowing from the change in accounting treatments. The net cumulative effect of the new accounting treatments was an increase to income in prior periods, thus increasing the amount of capital on a cumulative basis. This would also result in considerable volatility in those prior periods. Further, OFHEO, PwC, and the audit

committee considered the effects from the accounting policy changes for any potential effect on the fair value statements of Freddie Mac. All concluded there was no meaningful impact on the fair value statements, which meant the underlying economics for Freddie Mac's risk positions were materially unaffected by the timing changes in recognizing income for the GAAP statements being restated.

Examiners were on-site at Freddie Mac gathering more information about the issues and the action plan that were being formed to address the reaudit. Freddie Mac announced the reaudit and the delay in 2002 certified financial statements on January 22, 2003.

Based upon the reaudit of prior periods, Freddie Mac said it would be restating 2000 and 2001 annual results and quarterly financial results for 2001. Along with delays in issuing certified 2002 financial results and prior period restatements, there would be delays in issuing certified quarterly financial statements for the first and second quarter of 2003. The timeline was to have the restatements done in approximately 6 months.

The restatement process has involved the reevaluation of over 100 accounting policies, which resulted in the identification of approximately 20 major issues that will affect the financial statements.

These accounting changes will result in about half of the company's derivatives being marked to market through current period earnings as opposed to being deferred and recorded into earnings over time. In addition, all mortgage securities will be marked to market either through OCI or current period earnings. In addition, previously off-balance sheet guarantee fees and obligations relating to approximately one-half of the guarantee business will now be recorded on balance sheet at fair value, with changes reported in current period earnings. These changes will most likely result in increased volatility and decreased future earnings.

Heightened Focus—January 2003 to Present

In mid-January 2003, it was clear that a forensic review of selected accounting issues raised by PwC would be appropriate. The law firm of Baker Botts was retained by the audit committee to perform diagnostic and forensic work associated with the restatement process. The scope of Baker Botts' engagement is to conduct a review of the facts and circumstances surrounding certain transactions and other matters related to the restatement process. OFHEO's plans were to monitor and consider the work of Baker Botts, while concentrating the Agency's efforts on the reaudit and restatement process. When the restatement process neared its completion, OFHEO would consider the progress and adequacy of the counsel's review and determine whether the Agency would need to undertake its own forensic review.

At this point, OFHEO focused on its mission—safety and soundness—and emphasized to Freddie Mac the importance of properly concluding the reaudit and publishing certified financial statements. In addition, OFHEO concurred with the board's decision to engage outside counsel for forensic and related work.

OFHEO's accounting team began continuous surveillance of the restatement process on January 22, 2003, focusing on: The accounting issues surrounding the transactions that triggered the reaudit; the accounting policies/issues under consideration—being changed or affirmed; the organization and staffing of the project; the analysis of the cumulative effect of the restatement process; the preparation of adjustments; the methodology for establishing value estimates; the process for running ledgers and analyzing results; the quality control process; the plan for rolling out the revised financial statements; and the status of controls being embedded into the new processes as they are being built. In addition to the ongoing work of the accounting team, there were periodic updates and evaluations on the restatement process from January on.

February—In February, OFHEO continued its close evaluation of the restatement process. Specifically, OFHEO's accounting team scrutinized the organizational structure of the effort, the plan of action, and the resources and the timeline associated with the work on the restatement process.

March—OFHEO met with the board and its audit committee on March 6. In that meeting, there was considerable discussion relating to the restatement process, the reaudit, and OFHEO's posture toward completing the restatement process. Also in March, as noted earlier, Freddie Mac announced the hiring of Mr. Baumann as Executive Vice President for Finance. Mr. Baumann was given full responsibility for the restatement process by the board of directors and for formulating a plan of action for the post-restatement environment. Mr. Baumann is reporting directly to the board of directors until the restatement process is completed.

OFHEO remained engaged during the period the board considered a delay in the release of first quarter financial results to coincide with the restated financials for prior periods. On March 25, Freddie Mac announced the restatement process re-

mained on track. The company's expectation was still to have the restatement concluded as soon after the close of second quarter 2003 as practical—expecting to restate financials by mid-July 2003. Freddie Mac also notified the market they would not be releasing first quarter financials, rather, they would provide operating statistics and risk measures. The decision to delay first quarter financials was to provide those 2003 results consistent with the basis upon which the restated financials will be presented. In the March 25 release, Freddie Mac also identified additional accounting issues.

April—In April, Freddie Mac was moving toward the final stages of a complete review and affirmation of all the accounting policies. OFHEO continued to evaluate the work being conducted and the progress against the established timeline. Some additional accounting items were adding to the complexity of the task. Freddie Mac brought in third-party vendors to expedite the process after PwC approved the use of such vendors. On April 29, PwC informed the audit committee that they might not be able to accept the representations of top management.

May—In May, OFHEO observed slippage in the restatement process against established time frames. PwC and Freddie Mac had more than 500 people working on the process 6 days a week and this work had been continuous since January 2003. They were beginning to complete some of the adjustments. There was considerable work that needed to be done between production of statements and producing the tables and disclosure to accompany those statements. On May 8, PwC informed Senior Board members and counsel that PwC would not accept the representations of Vaughn Clarke and David Glenn.

On May 13, the board's Governance Committee at its weekly meeting approved the Finance Function Governance Plan (FFGP) presented by Mr. Baumann. This plan, superceding the FRCIP, addressed the considerable work that has been done to reengineer the process and enhance the controls for financial accounting and financial reporting. This plan, some of which will take almost 2 years to complete, is intended to build a finance environment incorporating a high level of professional standards and compliance that delivers comprehensive and understandable financial information. The objectives included addressing findings which had arisen during the restatement process and the work of Baker Botts and PwC.

In late May, OFHEO again observed the challenges against achieving the timeline with the additional accounting issues that were added in April. However, Freddie Mac continued to work toward the mid-July target. There were no new issues since April. Freddie Mac continued to work through all the adjustments and calculated the valuation estimates for prior periods. Some opportunities to strengthen controls noted during the restatement process continue being implemented by Freddie Mac.

On May 27, OFHEO was briefed on the Baker Botts work for the audit committee. The briefing covered the scope of the project, the nature of their forensic work and perspective on the status of their findings to date. In response to a direct question, Baker Botts expressed no concerns regarding the management team of inappropriate or improper management behavior. Subsequent to this meeting, OFHEO learned of very troubling information regarding the conduct and integrity of management in matters related to the restatement process, indicating the board's counsel had not been fully forthcoming. This lack of candor contributed to my decision on June 7 to initiate an OFHEO investigation.

Events of June 4 through June 7

Mr. Chairman, I will begin a discussion of the key events of June 4–7, that have drawn so much attention. First, I would note that the Freddie Mac Board of Directors was holding a regularly scheduled meeting on Thursday, June 5 and Friday, June 6.

On Wednesday, June 4, Mr. David Glenn met with the board's outside law firm—Baker Botts—and informed them that he had altered parts and had removed pages from a document that had been requested by the firm. That evening, counsel from Baker Botts informed the lead outside director of Mr. Glenn's admission.

On Thursday, June 5, Freddie Mac's Board was informed of Mr. Glenn's admissions and determined that actions were required. The morning of June 5, OFHEO was alerted that the board would have an urgent communication to discuss with us when the board's deliberations were concluded. the board's deliberations continued into Friday, June 6.

On Friday June 6, during the day, the board made decisions on the separation from the firm of Brendsel, Glenn, and Clarke and on the appointment of O'Malley, Parseghian, Petersen, and Baumann. The board communicated to OFHEO immediately on its actions regarding the management changes. Later that evening, I was informed about the circumstances surrounding Mr. Glenn. I instructed board coun-

sel to appear at OFHEO's offices on Saturday, June 7, to advise us on all the matters surrounding management changes.

On the morning of June 7, OFHEO senior staff and I met with representatives of Freddie Mac's Board to learn the details of recent events. I would note that much of what was addressed that day was known to OFHEO and had been the subject of the restatement. However, new issues relating to Mr. Glenn and the termination and replacement of senior management were also presented; particularly the lack of confidence in Mr. Glenn expressed a month earlier by PwC. I considered the information regarding Mr. Glenn a clear signal of a breakdown in the integrity of the Freddie Mac's control environment at the highest levels and sent a letter to the board that day initiating an OFHEO investigation.

Following this meeting, as occurred after the meeting on May 27, additional matters came to light and, again, reflected a lack of candor that concerned me deeply.

In the June 7 letter, I formalized with the board certain actions with respect to the restatement process. In addition, I tasked a special investigative team to explore and review accounting practices relevant to the restatement process at Freddie Mac and, in addition, management's progress in implementing an action plan that OFHEO directed the board to provide for the Agency's formal approval. The investigative team has also undertaken an investigation of employee misconduct. OFHEO is moving expeditiously on this review.

The Role of a Federal Financial Safety and Soundness Regulator

Having discussed our specific regulatory role over the restatement process at Freddie Mac, I would now like to put it in a more general context. First the role of a financial safety and soundness regulator and second, and more specifically, the Agency's regulatory approach in examining accounting practices and controls.

OFHEO uses a safety and soundness approach in supervising the Enterprises that is analogous to the Federal Reserve System's and the Office of the Comptroller of the Currency's approach to supervising large-and-complex banking organizations. The foundation of these approaches is that the management of these firms should be held responsible for monitoring and managing the institution's exposure to risk. By looking at the firm's risk management procedures and internal controls, the safety and soundness regulator assesses whether the firm's ability to manage risk matches the level of risk it assumes. In addition, the supervisory process also reviews the firm's performance in complying with the company's own internal policies, as well as other prescriptive requirements. In short, safety and soundness supervision is directed toward identifying material problems or emerging problems and seeing they are appropriately corrected before the company's financial solvency is threatened.

During the past decade, financial safety and soundness regulators and OFHEO have endeavored to continuously enhance the examination process to make it more risk-focused and to make greater use of technological innovations. Increasingly, safety and soundness supervision stresses the need for financial firms to implement sound risk management practices for: Active oversight of management by the board; clearly defined policies, procedures, and authority; comprehensive risk measurement and reporting systems; and adequate audits and systems of internal controls.

OFHEO's supervisory activities are designed to assess the Enterprises' risk profiles and require remedies where and when they are appropriate. They encompass evaluations of each Enterprise's asset quality, management of interest rate risk, liquidity management, capital adequacy, and their risk management strategies and risk management practices—including their internal controls and governance.

Safety and soundness regulators do not attempt to prescribe "regulatory accounting principles" for financial reporting. In fact, when accounting principles were prescribed in the 1980's by financial regulators, many of those standards were criticized after numerous financial institutions failed. Congress subsequently expressed its desire for financial safety and soundness regulators to rely upon established accounting principles (GAAP) for financial reporting standards (Section 121 of FDICIA). In OFHEO's 1992 Act, Congress directed OFHEO to do the same, that is, to pursue GAAP in their regulatory reporting requirements.

Safety and soundness regulators do not review accounting policies for conformance with GAAP, nor do we certify that a company's financial statements are consistent with GAAP. We expect an independent auditor to certify that a company's financial statements are in conformance with GAAP. We review transactions to ensure that they are consistent with sound risk management. The work of the independent auditor is to conduct its audit and report on the company's annual financial statements. The scope of the independent auditor's engagement must be sufficient to permit the auditing firm to determine and report upon whether the financial statements are presented fairly and in accordance with GAAP.

The internal and external auditors routinely work together in establishing the scope and frequency of audits to be performed. The independent auditor reviews the scope and adequacy of the internal auditing program.

Safety and soundness supervision does not replace an internal audit function for the Enterprises' Board of Directors. Internal audits are a governance/management control question. That is, the board of directors and executive management need to have the internal controls tested and assessed by units without business-line operating responsibilities, such as an internal audit group. Internal audit provides the board and the CEO, along with other members of senior management, with assurances concerning the effectiveness of controls.

Safety and soundness regulators do not perform forensic work (investigative work on what has occurred) unless a need arises. In fact, safety and soundness regulators frequently cause the board of directors to engage forensic professionals to investigate irregularities and share the results of their findings with the regulator. Subsequent to the findings from the forensic work, the regulator holds the board accountable for ensuring there are appropriate remediation plans and action items to address the issues that are identified.

OFHEO's Approach to Examining Accounting Practices and Controls Over Financial Reporting

The process of examining an Enterprise's accounting practices and related internal controls for financial reporting begins with a thorough study of the strategies and the techniques the board of directors has adopted to set the company's course, and to measure and evaluate management's performance in implementing the board's strategies. This step includes, for example, an evaluation of the board's committee structure, oversight practices and reporting conventions, and an assessment of the effectiveness of the overall control framework at the board level. The examination process also includes a "mapping" of the corporate structure management has adopted to facilitate the implementation of the board's strategies and the achievement of its objectives pertinent to financial reporting. The objective of the mapping process is to establish a roadmap of management's assigned responsibilities, duties, and functions that can then be used to identify key risk points in the internal control framework for financial reporting that warrant targeted evaluation and attention due to their potential impact on financial safety and soundness.

Having established an appropriate understanding of the overall control framework and its risk points by, for example, reviewing relevant policies, procedures, systems, tools, and management reporting, and by interviewing Enterprise management and personnel, examiners then sample selected transactions in order to test whether the framework actually functions as designed and intended. Depending on the nature of the examiners' focus, these sampling activities may include evaluations of the actions of a variety of different participants and their respective roles in the control framework, including management, technical staff, internal auditors, and independent auditors. During the course of their evaluations, examiners apply evaluative standards that reflect the professional standards appropriate for the actions under review, and reach conclusions that address the Enterprises' financial safety and soundness.

OFHEO's approach to examining accounting practices and internal controls for financial reporting should be familiar to the Committee, given that our approach is built on the same well-established concepts that form the core of applicable provisions of the Sarbanes-Oxley Act of 2002 and the SEC's regulations implementing the control-related provisions of that Act. Our examination approach also embraces fundamental precepts found in widely-recognized control frameworks such as the Internal Control-Integrated Framework published by the Committee of Sponsoring Organizations of the Treadway Commission (more familiarly known as "COSO"), the Guidance on Assessing Control published by the Canadian Institute of Chartered Accountants, and the Turnbull Report published by the Institute of Chartered Accountants in England & Wales. Moreover, we regularly consider practices adopted by other financial safety and soundness regulators, generally accepted auditing standards, and control-related methodologies and standards propounded by professional associations such as the Institute of Internal Auditors and the American Institute of Certified Public Accountants, and we enhance our evaluative techniques as necessary to maintain a position on the leading edge of this evolving field of expertise.

The Committee has requested information on OFHEO's role with respect to approving termination agreements for the executive officers of the Enterprises, including involvement in the recent termination agreements of Freddie Mac's executive officers. In addition, you sought information on OFHEO's corporate governance rule. Details on both follow.

Executive Compensation

OFHEO has broad authority to consider executive compensation, both as a specific matter of excessive compensation as well as a factor in the operational integrity of the Enterprises.

OFHEO draws authority from the explicit and implied authorities of its statute, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, PL 102–550, Title XIII; 106 Stat. 3672 (October 28, 1992). At the same time, other OFHEO authorities are delineated in certain sections of the chartering acts for the Enterprises.

Excessive Compensation. OFHEO is directed by statute to prohibit the payment of "excessive compensation" to executive officers; 12 U.S.C. 4513(b)(8). The prohibition on excessive compensation is tied to compensation that is ". . .not reasonable and comparable with compensation for employment in other similar businesses. . .;" 12 U.S.C. 4518(a). At the same time, OFHEO may not set or prescribe or set a specific level or range of compensation for such executives; 12 U.S.C. 4518(b).

Termination Benefits. OFHEO has authority to review and provide approval for "termination benefits." This authority is contained in the charter acts of the two Enterprises.

For example, in the Freddie Mac charter (Federal Home Loan Mortgage Corporation Act, 12 U.S.C. 1451 et seq.), Section 303(h)(2) provides that the Corporation may not enter into any agreement or contract to provide money or other things of current or potential value in connection with the termination of employment of any executive officer unless the agreement or contract is approved in advance by OFHEO; 12 U.S.C. 1452(h)(2). The statute provides for OFHEO to make such determination based on comparability of such agreements with officers at comparable companies. The statute covers contracts entered after the date of enactment, but provides that any "renegotiation, amendment, or change" after such date of enactment to any contract entered into before or after the date of enactment shall be considered entering into a new agreement or contract that OFHEO should review and provide its opinion.

In regards to Freddie Mac, OFHEO has undertaken certain actions relating to executive compensation. Specifically, I wrote to the board of directors on June 7, 2003 indicating it must explain its rationale for any termination packages for the individuals leaving the firm, specifically for Brendsel, Glenn, and Clarke. Further, I directed the board to inform these individuals that their termination packages are subject to OFHEO review and approval and, for any employee discharged for misconduct, that OFHEO could direct indemnification of Freddie Mac for losses incurred.

We have directed Freddie Mac not to transfer funds, stock, or options to these three individuals and Freddie Mac is complying. OFHEO is reviewing now the termination packages for Brendsel, Glenn, and Clarke.

I want to reiterate what I noted regarding OFHEO's authority in this area. First, we review executive compensation as a stand-alone matter, that is: Is such compensation excessive? And, second, as we proceed with the investigation, we look to the behavior of management and whether it comports with the standards of the corporation, violates any corporate governance rules or otherwise harms or threatens the safety and soundness of the corporation. If so, OFHEO would consider actions that would involve compensation, such as ordering restitution.

Corporate Governance

OFHEO has had in place for some time an active program of review for corporate governance at the Enterprises. Corporate governance is considered to be a major component of risk management and a fundamental ingredient in the safe and sound operation of the firms. Corporate governance under the examination program is composed of separate programs entitled Board Governance, Management Processes Program, Audit Program, and Management Information Program.

While OFHEO has strong statutory support for its corporate governance regime, in 2000, the Agency began a program of building up its regulatory infrastructure, putting in place rules to support its various functions and to strengthen its legal position. This program included a corporate governance rule. The rule generated a great deal of interest and OFHEO issued a Final Rule on June 2, 2002, effective on August 5, 2002.

The rule made clear that corporate governance is a key area of safety and soundness and it directed each of the Enterprises to elect a State law for the purposes of adhering to a body of corporate law. Both have done so. The rule required the companies to have committees and that they meet the highest applicable standards; both have such committees. A quorum of the board is required to transact business and no proxy voting is allowed; both have such policies. The rule required conflict

of interest policies; both have such policies. The rule mandated that the board meet its responsibilities and described the areas of key concern for Board oversight of senior management. Finally, the rule noted the authority of OFHEO to limit or restrict indemnification of current or former board members as part of its safety and soundness authority.

OFHEO's examination team has worked with the Enterprises to see that changes that were required have been put in place and that the Enterprises continue to address other requirements, such as changes mandated in the Sarbanes-Oxley Act.

Legislative Enhancements

I would like to submit for the Committee's consideration a series of legislative recommendations to add to OFHEO's broad authorities and to fill in a number of gaps between OFHEO's authorities and those of other financial regulators.

Paramount among these is permanent funding for the Agency. Other financial safety and soundness regulators are funded through assessments on the institutions they regulate; so is OFHEO. Only OFHEO, however, must move through the annual appropriations process. The budget process has had a limiting effect on the Agency's resources and may affect our ability to effectively address regulatory issues on a timely basis.

OFHEO must have more flexibility to respond to important issues, such as Freddie Mac's restatement of income, without stretching thin our ability to continually monitor the significant credit and interest rate risks being managed by the two Enterprises. The amount of resources needed to address the issues surrounding Freddie Mac's restatement is straining our resources. Permanent funding is needed to ensure that OFHEO can continue to effectively regulate the Enterprises. I am pleased that the Administration has endorsed this needed change.

The other recommendation I would like to highlight relates to charter compliance. I believe that the regulatory responsibility for ensuring that the Enterprises remain in compliance with their charters more properly resides with the safety and soundness regulator. Mission regulation would continue to reside in HUD in the form of affordable housing goals and fair lending enforcement.

OFHEO has the authority and responsibility for taking an enforcement action when an Enterprise violates any applicable law or regulation. In fact, under the current scheme, if HUD found that a new program was not permissible, HUD would turn to OFHEO to take any necessary enforcement action. In addition, OFHEO would take appropriate action if we independently determined that an Enterprise was in clear violation of its charter. OFHEO should have full authority, including in areas of ambiguity, for interpreting and enforcing charter compliance.

Without casting any doubt on HUD's abilities, I simply believe that public policy would be better served if OFHEO, with its active examination and oversight of the Enterprises, had full responsibility for charter compliance.

The draft proposal, attached with a summary, strengthens OFHEO with explicit receivership authority, removal authority, greater facility in hiring examiners, adds criminal penalties for certain violations of law, provides independent litigation authority and addresses certain gaps in OFHEO's enabling statute that have been addressed previously by regulation.

Notes on Recent Events and the OFHEO June 2003 Annual Report to Congress

Turning now to the OFHEO Report to Congress, we reported that Freddie Mac's overall internal control framework, and the management of the internal control framework, are effective. We stated, however, that Freddie Mac's release of audited financial statements was being delayed pending a reaudit of past financial statements, and that Freddie Mac had agreed that certain accounting treatments applied in the past were incorrect. We informed Congress at the time, of our opinion regarding the reaudit. We further advised Congress that Freddie Mac's Board of Directors had undertaken efforts to enhance expertise and controls in the area of financial accounting and operational control, that we had evaluated the board's and management's plans in that regard, and that we were satisfied that these actions were appropriate steps to address the situation. In my view, these statements clearly indicate that, although the overall framework is effective, OFHEO is ensuring that the board and management devote serious attention and remedial efforts to the area of financial reporting and related controls. OFHEO's activities in this regard are highlighted in this testimony.

With regard to internal controls, our examination program is consistent with applicable professional standards in that it addresses each Enterprise's overall internal control framework; that is, the framework that includes the following categories: (1) the effectiveness and efficiency of operations; (2) the reliability of financial re-

porting; (3) compliance with applicable laws and regulations; (4) and safeguarding the assets of the company. Consider that the term "internal control" encompasses five interrelated components—the control environment; risk assessment activities; control activities; information/communication; and monitoring. As you might imagine, companies as complex as Fannie Mae and Freddie Mac develop equally complex internal control frameworks. These frameworks encompass hundreds, perhaps thousands, of separate controls, including approvals, authorizations, verifications, reconciliations, segregation of duties, systems access limitations, and a myriad of others. In short, the integrity of the overall internal control framework is determined by considering the total picture, and when viewed in its entirety, a framework may exceed safety and soundness standards even though there are observed weaknesses or deficiencies in particular controls.

Examples of the application of this principle include practices adopted under standards established by the American Institute of Certified Public Accountants, and guidance provided by the SEC in recent rules implementing provisions in the Sarbanes-Oxley Act that pertain to assessments of internal controls over financial reporting. Specifically, it is common for an independent auditor to provide an unqualified opinion on management's reports of financial condition even though the auditor is aware of certain "reportable conditions." In the vernacular of the independent auditor, a reportable condition is a significant deficiency in the design or operation of the internal control structure that could adversely affect a company's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The common practice is for the auditor to communicate such deficiencies to management in the form of a management letter, while at the same time allowing its unqualified opinion to stand. As a separate example, under SEC rules, significant deficiencies that do not rise to the level of a material weakness do not preclude management from characterizing its internal controls over financial reporting as "effective." The SEC guidance prohibits management from deeming its controls effective if there are one or more *material weaknesses;* however, the SEC also observes that a material weakness constitutes a greater deficiency than a significant deficiency. In sum, I believe the standards we have applied in reaching our examination conclusions on internal controls are consistent with those established by both the AICPA and the SEC.

Before I move on, I would like to emphasize a point or two about information flow and the environment that preceded the publication of our Annual Report to Congress. The results and conclusions of the 2002 annual examination were based on the information gathered and evaluated during the course of our work during 2002. That information was supplemented by information obtained by OFHEO during 2003, from early January up to the time of the publication of the Annual Report to Congress. As I discussed earlier, OFHEO has devoted considerable effort and resources to this matter, and our efforts continue to yield new information. One should also consider that the board of directors' internal investigation is being conducted during 2003 as well, and that the board's investigation may yield new information. In addition, the Committee is aware that I initiated OFHEO's own special examination on June 7, little more than 1 week before the statutory delivery date for the Report to Congress; and it is possible that our special examination could give rise to new findings as well. I raise these facts to emphasize that the date on which the Report was due fell in the midst of a very fluid environment; nevertheless, I believe that the examination results and conclusions expressed in the Report to Congress regarding the overall internal control and framework at Freddie Mac are appropriate. Certainly, we will have more to say about the controls over financial reporting, improper earnings management, and corporate governance practices after the special examination has concluded. I assure you that I will provide the Committee with a timely notification and description of any substantive changes in our view of the internal control framework and corporate governance practices once I have the benefit of the results under the various investigations currently underway.

Supplemental Appropriations

Finally, I would like to bring to the Committee's attention an urgent funding matter. Earlier this week, I submitted an fiscal year 2003 supplemental funding request of $4.5 million to the Senate and House Appropriations Committees.

The requested funds will support two critical objectives: First, the funds will support the on going special investigation of Freddie Mac. The investigation is already well underway and is building on information gathered over the course of the restatement process. The requested resources are necessary to obtain contract services for investigative support and forensic accounting experts. Second, OFHEO intends to conduct a special accounting review of Fannie Mae. The special review would independently evaluate the accounting policies at Fannie and examine whether

their implementation is resulting in a high level of conformance to GAAP. While I do not have a specific concern about Fannie Mae's accounting practices, such a review would be most prudent under the circumstances.

OFHEO's goal of concluding the investigation of Freddie Mac expeditiously is dependent on receiving these funds as soon as possible. I would like to ask for the Committee's support in obtaining the additional funds.

Conclusion

In summary, Mr. Chairman, is this a serious matter? Yes. Is there a crisis? No. While challenges remain, Freddie Mac remains safe and sound. At the end of our investigation, we will present all the facts, conclusions, and recommendations for the Committee's consideration. Mr. Chairman, thank you for the opportunity to testify. I would be pleased to answer any questions you or Committee Members may have.

APPENDIX

Federal Housing Enterprises Financial Safety and Soundness Act Amendments of 2003

Office of Federal Housing Enterprise Oversight
July 17, 2003

Federal Housing Enterprises Financial Safety and Soundness Act Amendments of 2003

The attached bill and section-by-section summary address improvements to the statute that serves as the chartering document for the Office of Federal Housing Enterprise Oversight.

In brief, the bill would

-- enhance OFHEO's current risk based capital regime;

-- provide receivership authority;

-- conform OFHEO's permanent funding to that of other financial institution regulators;

-- make explicit OFHEO's ability to remove and to bar individuals who have engaged in unsafe and unsound conduct at an Enterprise, including institution-affiliated parties;

-- clarify OFHEO's ability to measure Enterprise behavior against their chartered mission and to disallow non-conforming activities and provide OFHEO responsibility for reviewing and approving new programs;

-- enhance the flexibility and availability of a number of existing enforcement tools, such as cease and desist orders; and,

-- improve OFHEO's ability to attract, retain and deploy personnel.

July 17, 2003

Federal Housing Enterprises Financial Safety and Soundness

Amendments Act of 2003

Section-by-Section Analysis

Sec. 1. Short title and table of contents.

The short title of this Act is the Federal Housing Enterprises Financial Safety and Soundness Amendments Act of 2003 (the Act).

TITLE 1 – EHANCEMENT OF SUPERVISION OF THE ENTERPRISES

Sec. 101. Duties and authorities of director.

Amends Section 1313 of the Housing and Community Development Act of 1991 (1992 Act) (12 U.S.C. 4513) by clarifying that the principal duties of the Director are to ensure that the enterprises operate in a safe and sound manner and comply with applicable laws, regulations and their charters; carry out their missions in a safe and sound manner and only through authorized programs; and maintain adequate capital.

Clarifies that the Director shall exercise general and incidental supervisory and regulatory authority over the enterprises, in accordance with this title, the Federal National Mortgage Association Charter Act, the Federal Home Loan Mortgage Corporation Act, and any other provisions of law.

Transfers authority to approve new programs from the Department of Housing and Urban Development to the Director.

Provides for independent litigation authority similar to that of other financial institution regulatory agencies. This provision will provide the Office with authority to defend and to enforce expeditiously its orders and subpoenas.

Exempts the Office from the Federal Advisory Committee Act (Pub. L. 92-463, as amended).

Amends section 1313 of the 1992 Act to add a section 1313A clarifying that the Director's regulatory and enforcement authority extends to determination of compliance with the enterprises' chartering acts—the Federal National Mortgage Association Charter Act and the Federal Home Loan Mortgage Corporation Act. The Director must promulgate regulations and orders to explain the procedures for determinations that activities are inconsistent with the enterprise charters.

Sec. 102. Accountants, economists, and examiners.

Amends Section 1317 of the 1992 Act by providing the Office the authority to hire accountants,

economists, and examiners using the same hiring procedures as apply to positions in the excepted service. This is modeled on authorities provided to other financial regulators, notably the SEC.

Sec. 103. Assessments.

Amends Section 1316 of the 1992 Act (12 U.S.C. 4516) to provide that if at any time amounts available from any assessment for any semiannual period for an assessment are insufficient to cover the expenses of the Office as the result of increased costs of regulation of an enterprise that is not classified as adequately capitalized or as the result of supervisory or enforcement activities involving one of the enterprises, the Director may make an immediate assessment against the affected enterprise to cover the amount of the deficiency for such semiannual period. If, at the end of any semiannual period for which an assessment is made, any amount remains from such assessment, such amount will be deducted from the assessment of the enterprise for the following semiannual period.

Provides OFHEO with permanent funding authority.

Provides that the assessments collected are not to be construed as government funds or appropriated monies, or subject to apportionment for the purposes of chapter 15 of Title 31, or any other authority.

Sec. 104. Prior approval authority for new programs.

Transfers to the Director from the Secretary of HUD the authority to approve new programs, which ensures review for their safety and soundness in addition to compliance with the Federal National Mortgage Association Charter Act and the Federal Home Loan Mortgage Corporation Act.

Provides that the Director must determine whether the enterprise can conduct the new program in a safe and sound manner and whether the new program is in the public interest.

Provides conforming amendments to Federal National Mortgage Association Charter Act and the Federal Home Loan Mortgage Corporation Act.

Sec. 105. Conforming loan limits.

Amends Section 302(b)(2) of the Federal National Mortgage Association Charter Act (12 U.S.C. 1717(b)(2)) and Section 305(a)(2) of the Federal National Mortgage Association Charter Act (12 U.S.C. 1454(a)(2)) by providing that conforming loan limitations must comply with such levels established by the Director.

Amends Part I of subtitle A of title XIII of the 1992 Act by requiring the Director to establish and maintain a house price index for adjusting the conforming loan limitations of the enterprises. In employing such index, provides the Director with discretion to take into consideration any other index or measure that

the Director considers appropriate.

Sec. 106. Risk-based capital test for enterprises.

Amends Section 1361 of the 1992 Act (12 U.S.C. 4611) by authorizing the Director, in defining the risk-based capital test, to make any assumptions that the Director considers appropriate regarding interest rates, home prices, and new business as well as appropriate percentage adjustments to be applied to cover operations risk.

Sec. 107. Minimum and critical capital levels.

Amends section 1362 and 1363 of the 1992 Act (12 U.S.C. 4612 and 4613) by providing the Director with the authority to set and adjust minimum and critical capital levels by regulation or order, which levels may not be lower than the level calculated in accordance with the statutory formula.

Sec. 108. Definitions.

Amends Section 1303 of the 1992 Act (12 U.S.C. 4502) by defining the term "enterprise-affiliated party" to mean any director, officer, employee, or controlling stockholder of, or agent for, an enterprise; any shareholder, consultant, joint venture partner, and any other person as determined by the Director (by regulation or case-by-case) who participates in the conduct of the affairs of an enterprise; and any independent contractor (including any attorney, appraiser, or accountant) who knowingly or recklessly participates in (1) any violation of any law or regulation; (2) any breach of fiduciary duty; or (3) any unsafe or unsound practice, which caused or is likely to cause more than a minimal financial loss to, or a significant adverse effect on, the enterprise. This conforms OFHEO authority to those of other financial regulators.

Subtitle B—Prompt Corrective Action

Sec. 131. Capital classifications.

Amends Section 1364 of the 1992 Act (12 U.S.C. 4614) by expanding the discretionary reclassification authority in connection with unsafe and unsound conditions or conduct by an adequately capitalized enterprise.

Prohibits, with certain exceptions, an enterprise from making a capital distribution if, after making the distribution, the enterprise would not be adequately capitalized.

Sec. 132. Authority over critically undercapitalized enterprises.

Amends Part I of subtitle B of the 1992 Act (12 U.S.C. 4631 *et seq.*) by adding a new section 1369E, which authorizes the Director to appoint a receiver for an enterprise that is classified as critically undercapitalized, upon written notice to the enterprise, the Secretary, the Committee on Financial Services of

the House of Representatives, and the Committee on Banking, Housing, and Urban Affairs of the Senate. Provides qualifications and authorities of receivers and judicial review of the decision to appoint a receiver.

This section codifies regulatory actions and enhances OFHEO authorities regarding capital classifications.

Subtitle C—Enforcement Actions

Sec. 151. Cease-and-desist proceedings.

Amends Subtitle C of the 1992 Act (12 U.S.C. 4631 *et seq.*) by providing that, if in the opinion of the Director, an enterprise or any enterprise-affiliated party is engaging or has engaged, or the Director has reasonable cause to believe that the enterprise or any enterprise-affiliated party is about to engage, in an unsafe or unsound conduct in conducting the business of the enterprise or is violating or has violated, or the Director has reasonable cause to believe that the enterprise or any enterprise-affiliated party is about to violate, a law, rule, or regulation, or any condition imposed in writing by the Director in connection with the granting of any application or other request by the enterprise or any written agreement entered into with the Director, the Director may issue and serve upon the enterprise or such party a notice of charges in respect thereof.

Clarifies that the cease-and-desist authority includes, but is not limited to, the same authority to issue an order requiring a party to take affirmative action to correct conditions resulting from violations or conduct or to limit activities of an enterprise or any executive officer or director of an enterprise or any enterprise-affiliated party as appropriate federal banking agencies have to take with respect to insured depository institutions under paragraphs (6) and (7) of section 8(b) of the Federal Deposit Insurance Act (12 U.S.C. 1818(b)(6) and (7)).

Enhances enforcement authority by broadening the bases for issuance cease and desist orders.

Sec. 152. Temporary cease-and-desist proceedings.

Amends Section 1372 of the 1992 Act (12 U.S.C. 4632) by expanding the issuance of a temporary cease-and-desist proceeding to enterprise-affiliated parties. Clarifies jurisdiction of judicial proceedings related to enterprise-affiliated parties.

Provides for enforcement of the temporary cease-and-desist order by the Director.

Sec. 153. Removal and prohibition authority.

Amends subtitle C of title XIII of the 1992 Act, and makes conforming amendments to the Freddie Mac Corporation Act and the Fannie Mae Charter Act by authorizing the Director to remove or suspend

enterprise-affiliated parties from office, or to prohibit such party from further participation in the conduct of the affairs of any enterprise. This makes explicit OFHEO authority in these situations.

The Director may exercise this authority if (1) such a party has committed a listed violation, misconduct, or breach; (2) the enterprise or its investors has suffered or will probably suffer financial loss or other harm or the enterprise-affiliated party has received financial gain or other benefit by from the violation, misconduct or breach and (3) the matter involves dishonesty by the party or willful or continuing disregard for the safety or soundness of the affiliated enterprise.

Authorizes the Director to notify appropriate federal banking agencies and other federal financial regulatory agencies of an individual's violation of this section.

Provides that if the suspension of one or more directors of the board of directors of an enterprise results in less than a quorum of directors not suspended, all powers and functions vested in the board of directors, are to vest in the remaining directors.

Authorizes the Director to appoint board members to serve temporarily as board members in the event all of the board members of an enterprise are suspended.

Provides for procedural requirements, including notice, hearings, and judicial review.

Sec. 154. Enforcement and jurisdiction.

Amends Section 1375 of the 1992 Act (12 U.S.C. 4635) by providing the Director with the authority to apply directly to the United States District Court for the District of Columbia, or the United States district court within the jurisdiction of which the enterprise-affiliated-party resides or the headquarters of the enterprise is located, for the enforcement of any effective and outstanding notice or order, or request that the Attorney General of the United States bring such an action.

Sec. 155. Civil money penalties.

Amends Section 1376 of the 1992 Act (12 U.S.C. 4636) by expanding the applicability of civil money penalties to enterprise-affiliated-parties and by clarifying that a civil money penalty may be imposed for conduct that the Director determines to be unsafe or unsound.

Sec. 156. Criminal penalty.

Amends Subtitle C of Title XIII of the 1992 Act (12 U.S.C. 4631 et seq.) by subjecting an enterprise-affiliated-party who is subject to an order to a criminal penalty if that enterprise-affiliated-party knowingly participates, directly or indirectly, (including by engaging in an activity specifically prohibited in such an order) in the conduct of the affairs of any enterprise without the prior written approval of the

Director.

Sec. 157. Subpoena authority.

Amends Section 1379D, as redesignated in Sec. 153 above, of the 1992 Act by deleting the requirement that the Director operates under the direction and control of the attorney general in enforcing subpoenas.

Sec. 158. General supervisory authorities.

Amends Subtitle C of the 1992 Act (12 U.S.C. 4631 *et seq.*) by inserting a new section 1379E , which provides that the Director is authorized to take enforcement actions under the 1992 Act and other formal and informal enforcement actions, including but not limited to requiring prompt supervisory actions under subtitle B, as the Director deems necessary to enforce the compliance of any enterprise or any enterprise-affiliated party with applicable laws, regulations, rules, or orders.

Subtitle D—General Provisions

Sec. 171. Conforming and technical amendments.

Provides for conforming and technical amendments to the 1992 Act, Department of Housing and Urban Development Act, Freddie Mac Corporation Act, and the Fannie Mae Charter Act.

Deletes section 1319G of the 1992 Act, which included special provisions that applied only to the first 18 months of OFHEO's existence.

Sec. 172. Term of Director.

Makes the Act consistent with provisions for the Comptroller of the Currency by providing that the Director may be removed upon reasons to be communicated by the President to the Senate; this is interpreted as meaning "for cause." Does not apply to incumbent.

Sec. 173. Effective date.

Provides that the amendments made are to take effect on, and shall apply beginning on, the date of enactment of this Act.

A BILL

To enhance the supervision of the government-sponsored enterprises, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE AND TABLE OF CONTENTS.

(a) SHORT TITLE.—This Act may be cited as the 'Federal Housing Enterprises Financial Safety and Soundness Amendments Act of 2003'.

(b) TABLE OF CONTENTS.—The table of contents for this Act is as follows:

Sec. 1. Short title and table of contents.

TITLE I—ENHANCEMENT OF SUPERVISON OF THE ENTERPRISES

Subtitle A—Enhancement of Supervision

Sec. 101. Duties and authorities of Director.

Sec. 102. Examiners, economists, and accountants.

Sec. 103. Assessments.

Sec. 104. Prior approval of Director for new programs.

Sec. 105. Conforming loan limits.

Sec. 106. Risk-based capital test for enterprises.

Sec. 107. Minimum and critical capital levels.

Sec. 108. Definitions.

Subtitle B—Prompt Corrective Action

Sec. 131. Capital classifications.

Sec. 132. Authority over critically undercapitalized enterprises.

Subtitle C—Enforcement Actions

Sec. 151. Cease-and-desist proceedings.

Sec. 152. Temporary cease-and-desist proceedings.

Sec. 153. Removal and prohibition authority.

Sec. 154. Enforcement and jurisdiction.

Sec. 155. Civil money penalties.

Sec. 156. Criminal penalty.

Sec. 157. Subpoena authorities.

Sec. 158. General supervisory authorities.

Subtitle D—General Provisions

Sec. 171. Conforming and technical amendments.

Sec. 172. Term of Director.

Sec. 173. Effective date.

TITLE I—ENHANCEMENT OF SUPERVISION OF THE ENTERPRISES

SEC. 101. DUTIES AND AUTHORITIES OF DIRECTOR

(a) IN GENERAL.—Section 1313 of the Housing and Community Development Act of 1992 (12 U.S.C. 4513) is amended—

(1) by amending subsection (a) to read as follows:

'SEC. 1313. DUTIES AND AUTHORITIES OF DIRECTOR.

'(a) DUTIES.—

'(1) PRINCIPAL DUTIES.—The principal duties of the Director under this title of the 1992 Act shall be to ensure that the enterprises—

'(A) operate in a safe and sound manner and comply with applicable laws, regulations, including the Federal National Mortgage Association Charter Act, and the Federal Home Loan Mortgage Corporation Act;

'(B) carry out their missions in a safe and sound manner and only through activities that have been authorized under, and are consistent with the purposes of, the provisions of federal law that charter the enterprises; and

'(C) maintain adequate capital.

'(2) OTHER DUTIES.—To the extent consistent with paragraph (1), the duty of the Director shall be to exercise general supervisory and regulatory authority over the enterprises in accordance with this title, the Federal National Mortgage Association Charter Act, the Federal Home Loan Mortgage Corporation Act, and any other provisions of law.

(2) in subsection (b)(1) by inserting ', and the Federal National Mortgage Association Charter Act and the Federal Home Loan Mortgage Corporation Act' after 'subtitle C' and before the semicolon;

(3) in subsection (b)(4) by inserting 'and receivers' after 'conservators';

(4) by inserting new subsection (b)(12) to read as follows:

'(12) approval of new programs under section 1319I; and;'

(5) by inserting new subsection (b)(13) to read as follows:

'(b)(13) the exercise of such incidental powers as may be necessary or appropriate to fulfill the duties and authorities set forth in subsection (a) and subsection (b) in the regulation of the enterprises.'

(6) by inserting new subsection (f) to read as follows:

'(f) EXEMPTIONS.—The Office shall be exempt from the Federal Advisory Committee Act (Pub. L. 92-463, as amended).'

(7) by inserting a new subsection (g) to read as follows:

'(g) LITIGATION AUTHORITY.—In enforcing any provision of this title, regulations or orders prescribed under this title, or any other law, rule, regulation, or order, or in any other action, suit, or proceeding to which the Director is a party or in which the Director is interested, and in the administration of conservatorships and receiverships, the Director may act in the Director's own name and through the Director's own attorneys. Except as otherwise provided, the Director shall be subject to suit (other than suits on claims for money damages) by any Enterprise or director or officer thereof with respect to any matter under this title or any other applicable law, rule, order or regulation thereunder, in the United States district court for the judicial district in which the Enterprise has its principal place of business, or in the United States District Court for the District of Columbia, and the Director may be served with process in the manner prescribed by the Federal Rules of Civil Procedure.'

(b) Subtitle A of the Housing and Community Development Act of 1992 (12 U.S.C. 4631 *et seq.)* is amended by inserting after section 1313 (12 U.S.C. 4513) the following new section:

'SEC. 1313A CHARTERING ACT COMPLIANCE.

(a) No Enterprise shall engage in any activity that the Director determines to be inconsistent with its respective chartering act.

(b) The Director, by regulation or order, shall establish procedures and standards to effect compliance with this section as contemplated in section 1313.

SEC. 102 . EXAMINERS, ECONOMISTS, AND ACCOUNTANTS.

(b) ENHANCED AUTHORITY TO HIRE ACCOUNTANTS, ECONOMISTS, AND EXAMINERS.—Section 1317 of the Housing and Community Development Act of 1992 (12 U.S.C. 4517) is amended by adding at the end the following new subsection:

'(g) APPOINTMENT OF ACCOUNTANTS, ECONOMISTS, AND EXAMINERS.—

'(1) APPLICABILITY.— This section applies with respect to any position of examiner, accountant, and economist at the Office, with respect to supervision and regulation of the enterprises, that is in the competitive service.

'(2) APPOINTMENT AUTHORITY.—The Director may appoint candidates to any position described in paragraph (1)—

'(A) in accordance with the statutes, rules, and regulations governing appointments in the excepted service; and

'(B) notwithstanding any statutes, rules, and regulations governing appointments in the competitive service.

SEC. 103 ASSESSMENTS.

Section 1316 of the Housing and Community Development Act of 1992 (12 U.S.C. 4516) is amended—

(1) in subsection (a) by striking ', to the extent provided in appropriation Acts,';

(2) in subsection (c)—

(A) by inserting '(1)' before the first sentence;

(B) by inserting 'for an assessment under subsection (a)(1) that are' after 'The semiannual payments'; and

(C) by inserting after subsection (c)(1) a new subsection (c)(2) as follows:

'(2) If at any time amounts available from any assessment for any semiannual period for an assessment under subsection (a)(1) are insufficient to cover the expenses of the Office as the result of increased costs of regulation of an enterprise that is not classified as adequately capitalized or as the result of supervisory or enforcement activities involving an enterprise, the Director may make an immediate assessment against the enterprise to cover the amount of the deficiency for such semiannual period. If, at the end of any semiannual

period for which an assessment is made, any amount remains from such assessment, such amount will be deducted from the assessment of the enterprise for the following semiannual period.'

(3) by striking subsection (e);

(4) in subsection (f), by redesignating subsection (f) as subsection (e) and in the third sentence by striking ', to the extent provided in appropriation Acts and subsection (e),' and substituting ', without fiscal year limitation,';

(5) by redesignating subsection (g) as subsection (f);

(6) by inserting a new subsection (g) to read as follows:

'(g) Notwithstanding any other provision of law, any assessment collected pursuant to this section shall not be construed to be government funds or appropriated monies, or subject to apportionment for the purposes of chapter 15 of title 31, or any other authority, and shall be available for carrying out the responsibilities of the Director, including any necessary administrative and non-administrative expenses of the Director in carrying out the purposes of this title, the Federal National Mortgage Association Charter Act, and the Federal Home Loan Mortgage Corporation Act.'

SEC. 104. PRIOR APPROVAL AUTHORITY FOR NEW PROGRAMS.

(a) Subtitle A, Part 1 of the 1992 Act—Title XIII of the Housing and Community Development Act of 1992 (12. U.S.C. 4501 et. seq.) is amended by inserting the following section—

SEC. 1319I PRIOR APPROVAL AUTHORITY FOR NEW PROGRAMS.—

(a) AUTHORITY.—The Director shall require each enterprise to obtain the approval of the Director for any new program of the enterprise before implementing the program.

(b) STANDARD FOR APPROVAL.—

Except as provided in paragraph (2), the Director shall approve any new program of an enterprise for purposes of subsection (a) unless—

(1) for a new program of the Federal National Mortgage Association, the Director determines that the program is not authorized under paragraph (2), (3), (4), (5) or section 302(b) of the Federal National Mortgage Association Charter Act, or under section 304 of such Act;

(2) for a new program of the Federal Home Loan Mortgage Corporation, the Director determines that the

program is not authorized under section 305(a)(1), (4), or (5) of the Federal Home Loan Mortgage Corporation Act; or

(3) the Director determines that the new program is not in the public interest.

(c) PROCEDURE FOR APPROVAL.—

(1) SUBMISSION OF REQUEST.—To obtain the approval of the Director for purposes of subsection (a), an enterprise shall submit to the Director a written request for approval of the new program that describes the program in such form as prescribed by order or regulation.

(2) RESPONSE.—The Director shall, no later than the expiration of the 45-day period beginning upon the submission of a request for approval, approve the request or submit to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate a report explaining the reasons for not approving the request. The Director may extend such period for a single additional 15-day period only if the Director requests additional information from the enterprise.

(3) FAILURE TO RESPOND.— If the Director fails to approve the request or fails to submit a report under paragraph (2) during the period under such paragraph, the request shall be considered to have been approved.

(4) REVIEW OF DISAPPROVAL.—

(A) UNAUTHORIZED NEW PROGRAMS.—If the Director submits a report under paragraph (2) of this subsection disapproving a request for approval on the grounds under subparagraph (A) or (B) of subsection (b), the Director shall provide the enterprise submitting the request with a timely opportunity to review and supplement the administrative record.

(B) NEW PROGRAMS NOT IN PUBLIC INTEREST.—If the Director submits a report under paragraph (2) of this subsection disapproving a request for approval on the grounds under subsection (b)(1)(C) or (b)(2)(B), the Director shall provide the enterprise submitting the request notice of, and opportunity for, a hearing on the record regarding such disapproval.

(b) Part 2, subtitle A of the 1992 ACT—Title XIII of the Housing and Community Development Act of 1992 (12. U.S.C. 4501 et. seq.) is amended by striking Section 1322 in its entirety.

SEC. 105. CONFORMING LOAN LIMITS.

(a) FANNIE MAE.—Section 302(b)(2) of the Federal National Mortgage Association Charter Act (12 U.S.C. 1717(b)(2)) is amended by striking the 7th and subsequent sentences to the end and by inserting the following new sentence:

'Such limitations shall comply with the conforming loan limitations established by the Director by regulation or order.'.

(b) FREDDIE MAC.—Section 305(a)(2) of the Federal National Mortgage Association Charter Act (12 U.S.C. 1454(a)(2)) is amended by striking the 6th and subsequent sentences to the end and by inserting the following new sentence:

'Such limitations shall comply with the conforming loan limitations established by the Director by regulation or order.'.

(c) HOUSE PRICE INDEX.—Part I of subtitle A of title XIII of the Housing and Community Development Act of 1992 (as amended by the preceding provisions of this Act) is amended by inserting the following new section 1319H (12 U.S.C. 4527):

'SEC. 1319H. HOUSE PRICE INDEX.

'The Director shall utilize a house price index to adjust the conforming loan limitations of the enterprises. In employing such index, the Director shall take into consideration any other index or measure that the Director considers appropriate.'.

SEC. 106. RISK-BASED CAPITAL TEST FOR ENTERPRISES.

Section 1361 of the Housing and Community Development Act of 1992 (12 U.S.C. 4611) is amended—

(1) in subsection (a)(2)(A), by inserting 'or change in such other manner as the Director considers appropriate,' after 'enterprise';

(2) in subsection (b)(1), by inserting after the period at the end the following:

'Notwithstanding subsection (a), the Director may, in the sole discretion of the Director, make any assumptions that the Director considers appropriate regarding interest rates, home prices, and new business.'; and

(3) in subsection (c)(2), by inserting 'or such other percentage as the Director considers appropriate' before the period at the end of the subsection.

SEC. 107. MINIMUM AND CRITICAL CAPITAL LEVELS.

(a) MINIMUM CAPITAL LEVEL.—Section 1362 of the Housing and Community Development Act

of 1992 (12 U.S.C. 4612) is amended—

(1) by striking subsection (b);

(2) by striking '(a) IN GENERAL.—'; and

(3) in the matter preceding paragraph (1), by inserting before 'the sum of' the following: 'the amount established by the Director, by regulation or order, as such amount may be adjusted from time-to-time by the Director to achieve the purposes of this title, that is not less than'.

(b) CRITICAL CAPITAL LEVEL.—Section 1363 of the Housing and Community Development Act of 1992 (12 U.S.C. 4613) is amended, in the matter preceding paragraph (1), by inserting before 'the sum of' the following: 'the amount established by the Director, by regulation or order, as such amount may be adjusted from time-to-time by the Director to achieve the purposes of this title, that is not less than'.

SEC. 108. DEFINITIONS.

Section 1303 of the Housing and Community Development Act of 1992 (12 U.S.C. 4502) is amended—

(5) by redesignating paragraphs (7) through (14) (as amended by the preceding provisions of this Act) as paragraphs (8) through (15), respectively; and

(6) by inserting after paragraph (6) the following new paragraph:

'(7) ENTERPRISE-AFFILIATED PARTY.—The term `enterprise-affiliated party' means—

'(A) any director, officer, employee, or controlling stockholder of, or agent for, an enterprise;

'(B) any shareholder, consultant, joint venture partner, and any other person as determined by the Director (by regulation, order, or case-by-case) who participates in the conduct of the affairs of an enterprise; and

'(C) any independent contractor (including any attorney, appraiser, or accountant) who knowingly or recklessly participates in—

'(i) any violation of any law or regulation;

'(ii) any breach of fiduciary duty; or

'(iii) any unsafe or unsound conduct,

which caused or is likely to cause more than a minimal financial loss to, or a

significant adverse effect on, the enterprise.'.

Subtitle B—Prompt Corrective Action

SEC. 131. CAPITAL CLASSIFICATIONS.

Section 1364 of the Housing and Community Development Act of 1992 (12 U.S.C. 4614) is amended—

(1) by striking subsection (a)(3)(A)(i) and redesignating '(ii)' and '(iii)' as '(i)' and '(ii)', respectively;

(2) by striking subsection (b) and inserting the following new subsection:

'(b) DISCRETIONARY CLASSIFICATION.—

'(1) GROUNDS FOR RECLASSIFICATION.— The Director may reclassify an enterprise under paragraph (2) if—

'(A) at any time, the Director determines in writing that an enterprise is engaging in conduct that could result in a rapid depletion of core capital or that the value of the property subject to mortgages held or securitized by the enterprise has decreased significantly;

'(B) the Director determines that an enterprise is in an unsafe or unsound condition; or

'(C) pursuant to section 1371(b), the Director determines that an enterprise is engaging in unsafe or unsound conduct.

'(2) RECLASSIFICATION.—In addition to any other action authorized under this title, including the reclassification of an enterprise for any reason not specified in this subsection, if the Director takes any action described in paragraph (1) the Director may classify an enterprise—

'(A) as undercapitalized, if the enterprise is otherwise classified as adequately capitalized;

'(B) as significantly undercapitalized, if the enterprise is otherwise classified as undercapitalized; and

'(C) as critically undercapitalized, if the enterprise is otherwise classified as significantly undercapitalized.';

(2) by redesignating subsection (d) as subsection (e); and

(3) by inserting after subsection (c) the following new subsection:

`(d) RESTRICTION ON CAPITAL DISTRIBUTIONS.—

'(1) IN GENERAL.— An enterprise shall make no capital distribution if, after making the distribution, the enterprise would not be adequately capitalized.

'(2) EXCEPTION.— Notwithstanding paragraph (1), the Director may permit an enterprise to repurchase, redeem, retire, or otherwise acquire shares or ownership interests if the repurchase, redemption, retirement, or other acquisition—

'(A) is made in connection with the issuance of additional shares or obligations of the enterprise in at least an equivalent amount; and

'(B) will reduce the financial obligations of the enterprise or otherwise improve the financial condition of the enterprise.

SEC. 132. AUTHORITY OVER CRITICALLY UNDERCAPITALIZED ENTERPRISES.

Part I of subtitle B of title XII of the Housing and Community Development Act of 1992 is amended by inserting the following new section 1369E :

'SEC. 1369E. APPOINTMENT OF RECEIVERS.—

'(a) APPOINTMENT.—

'(1) AUTHORITY.—Upon a determination that an enterprise is critically undercapitalized and a determination that the enterprise meets such other conditions for taking action pursuant to this subsection as the Director shall by regulation or order establish, the Director may, notwithstanding section 1367(a)(1), appoint a receiver for the enterprise in accordance with this section and in lieu of appointment of a conservator pursuant to section 1367. If the Director takes action pursuant to this subsection, the Director shall appoint the receiver not later than 30 days after providing notice under paragraph (2) of this subsection.

'(2) NOTICE.—Upon making a determination under paragraph (1) to appoint a receiver for an enterprise, the Director shall provide written notice to the enterprise, the Secretary, the Committee on Financial Services of the House of Representatives, and the Committee on Banking, Housing, and Urban Affairs of the Senate-'(A) that a receiver will be appointed for the enterprise;

'(B) stating the reasons for the appointment of the receiver; and

'(C) identifying the person or governmental agency that the Director intends to appoint

as a receiver.

'(3) QUALIFICATIONS.— The receiver shall be—

'(A) the Director or any other governmental agency; or

'(B) any person that—

'(i) has no claim against, or financial interest in, the enterprise or other basis for a conflict of interest; and

'(ii) has the financial and management expertise necessary to carry out the duties under subsection (c).

'(b) JUDICIAL REVIEW.—The provisions of section 1369(b) shall apply to the appointment of a receiver pursuant to this section and to the exercise of powers or functions of a receiver to the same extent that such provisions apply to the appointment of a conservator and the exercise of the powers or functions of a conservator.

'(c) DUTIES.—A receiver appointed pursuant to this section shall be appointed for the purpose, and shall have the duty, of liquidating or otherwise resolving and of winding up the affairs of the enterprise, in accordance with such regulations or orders as the Director may issue, and notwithstanding the second sentences of paragraphs (1) and (2)(B) of section 302(a) of the Federal National Mortgage Association Charter Act (12 U.S.C. 1717(a)) and section 303(c)(2) of the Federal Home Loan Mortgage Corporation Act (12 U.S.C. 1452(c)(2)).

'(d) REPLACEMENT, POWERS, LIABILITY PROTECTION.—The provisions of subsections (c) and (d) of section 1369, section 1369A, and section 1369B shall apply to a receiver appointed pursuant to this section to the same extent that such provisions apply to a conservator appointed pursuant to this subtitle. In addition to any powers under section 1369A, a receiver appointed pursuant to this section shall have such powers with respect to an enterprise, as the Director may by regulation or order provide, that the Federal Deposit Insurance Corporation has under section 11 of the Federal Deposit Insurance Act (12 U.S.C. 1821), as in effect at that time, with respect to an insured depository institution when acting as a receiver under such section.'.

Subtitle C—Enforcement Actions

SEC. 151. CEASE-AND- DESIST-PROCEEDINGS

Subtitle C of the Housing and Community Development Act of 1992 (12 U.S.C. 4631 *et seq.*) is

amended—

(1) by striking the title and subsections (a) and (b) of Section 1371 (12 U.S.C. 4631(a) and (b)) and inserting the following:—

'SEC. 1371. CEASE-AND-DESIST AUTHORITIES.

(a) ISSUANCE FOR UNSAFE OR UNSOUND CONDUCT AND VIOLATIONS OF RULES OR LAWS.—If, in the opinion of the Director, an enterprise or any enterprise-affiliated party is engaging or has engaged, or the Director has reasonable cause to believe that the enterprise or any enterprise-affiliated party is about to engage, in an unsafe or unsound conduct in conducting the business of the enterprise or is violating or has violated, or the Director has reasonable cause to believe that the enterprise or any enterprise-affiliated party is about to violate, a law, rule, or regulation, or any condition imposed in writing by the Director in connection with the granting of any application or other request by the enterprise or any written agreement entered into with the Director, the Director may issue and serve upon the enterprise or such party a notice of charges in respect thereof. The Director may not enforce compliance with any housing goal established under subpart B of part 2 of subtitle A of this title, with section 1336 or 1337 of this title, with subsection (m) or (n) of section 309 of the Federal National Mortgage Association Charter Act (12 U.S.C. 1723a(m), (n)), or with subsection (e) or (f) of section 307 of the Federal Home Loan Mortgage Corporation Act (12 U.S.C. 1456(e), (f));

(2) in subsection (c)(2), by striking 'or director' and inserting 'or enterprise-affiliated party'; and

(3) in subsection (d)(7), by inserting at the end –

'Such authority includes the same authority to issue an order requiring a party to take affirmative action to correct conditions resulting from violations or conduct or to limit activities of an enterprise or any executive officer or director of an enterprise or any enterprise-affiliated party as appropriate federal banking agencies may take with respect to insured depository institutions under paragraphs (6) and (7) of section 8(b) of the Federal Deposit Insurance Act (12 U.S.C. 1818(b)(6) and (7)).'

SEC. 152. TEMPORARY CEASE-AND-DESIST PROCEEDINGS.

Section 1372 of the Housing and Community Development Act of 1992 (12 U.S.C. 4632) is amended—

(1) by striking subsection (a) and inserting the following new subsection:

'(a) GROUNDS FOR ISSUANCE.—Whenever the Director determines that the violation or threatened violation or the unsafe or unsound conduct specified in the notice of charges served upon the enterprise or any enterprise-affiliated party pursuant to section 1371(a), or the continuation thereof, is likely to cause insolvency or significant dissipation of assets or earnings of the enterprise, or is likely to weaken the condition of the enterprise prior to the completion of the proceedings conducted pursuant to sections 1371 and 1373, the Director may issue a temporary order requiring the enterprise or such party to cease and desist from any such violation or conduct and to take affirmative action to prevent or remedy such insolvency, dissipation, condition, or prejudice pending completion of such proceedings. Such order may include any requirement authorized under subsection 1371(d).';

(2) in subsection (b), by striking 'or director' and inserting 'or enterprise-affiliated party';

(3) in subsection (d), striking 'or director' and inserting 'or enterprise-affiliated party'; and

(4) by striking subsection (e) and inserting the following new subsection:

'(e) ENFORCEMENT.—In the case of violation or threatened violation of, or failure to obey, a temporary cease-and-desist order issued pursuant to this section, the Director may apply to the United States District Court for the District of Columbia or the United States district court for the district in which the headquarters of the defendant is located or, if the defendant is an individual the district in which the defendant resides for an injunction to enforce such order, and, if the court determines that there has been such violation or threatened violation or failure to obey, it shall be the duty of the court to issue such injunction.'.

SEC. 153. REMOVAL AND PROHIBITION AUTHORITY.

(a) IN GENERAL.—Subtitle C of title XIII of the Housing and Community Development Act of 1992 is amended—

(1) by redesignating sections 1377 through 1379B (12 U.S.C. 4637-41) as sections 1379 through 1379D, respectively; and

(2) by inserting after section 1376 (12 U.S.C. 4636) the following new section:

‘SEC. 1377. REMOVAL AND PROHIBITION AUTHORITY.—

‘(a) AUTHORITY TO ISSUE ORDER.—Whenever the Director determines that—

‘(1) any enterprise-affiliated party has, directly or indirectly—

‘(A) violated—

‘(i) any law or regulation;

‘(ii) any cease-and-desist order which has become final;

‘(iii) any condition imposed in writing by the Director in connection with the grant of any application or other request by such enterprise; or

‘(iv) any written agreement between such enterprise and the Director;

‘(B) engaged or participated in any unsafe or unsound conduct in connection with any enterprise; or

‘(C) committed or engaged in any act, omission, or conduct that constitutes a breach of such party's fiduciary duty to the enterprise as defined by regulations issued by the Director or other applicable law;

‘(2) by reason of the violation, conduct , or breach described in any subparagraph of paragraph (1)—

‘(A) such enterprise has suffered or will probably suffer financial loss or other harm;

(B) the interests of the enterprise’s investors have been or could be prejudiced; or

‘(C) such party has received financial gain or other benefit by reason of such violation, conduct, or breach; and

‘(3) such violation, conduct , or breach—

‘(A) involves personal dishonesty on the part of such party; or

‘(B) demonstrates willful or continuing disregard by such party for the safety or soundness of such enterprise,

the Director may serve upon such party a written notice of the Director's intention to

remove such party from office or to prohibit such party from any further participation, in any manner, in the conduct of the affairs of any enterprise. The Director shall notify each "appropriate federal banking agency," as that term is defined at 12 U.S.C. 1813(q), and such other federal financial regulatory agencies as the Director considers appropriate of the notice that was served.

'(b) SUSPENSION ORDER.—

'(1) SUSPENSION OR PROHIBITION AUTHORITY.— If the Director serves written notice under subsection (a) to any enterprise-affiliated party of the Director's intention to issue an order under such subsection, the Director may suspend such party from office or prohibit such party from further participation in any manner in the conduct of the affairs of the enterprise, if the Director—

'(A) determines that such action is necessary for the protection of the enterprise; and

'(B) serves such party with written notice of the suspension order.

'(2) EFFECTIVE PERIOD.—Any suspension order issued under subsection (a)—

'(A) shall become effective upon service; and

'(B) unless a court issues a stay of such order under subsection (g) of this section, shall remain in effect and enforceable until—

'(i) the date the Director dismisses the charges contained in the notice served under subsection (a) with respect to such party; or

'(ii) the effective date of an order issued by the Director to such party under subsection (a).

'(3) COPY OF ORDER.—If the Director issues a suspension order under subsection (b) to any enterprise-affiliated party, the Director shall serve a copy of such order on any enterprise with which such party is affiliated at the time such order is issued.

'(c) PROCEDURES.—

'(1) ESTABLISHMENT.—The Director shall establish standards and procedures governing removal, prohibition, and suspension actions under this section. Such standards and procedures shall provide for written notice, stay of suspension, a hearing regarding continued

participation, a hearing under Section 1373 (12 U.S.C. 4633), review by the Director, issuance of appropriate orders, judicial review under Section 1374 (12 U.S.C. 4634), and enforcement by the Director under Section 1375 (12 U.S.C. 4635).

'(d) PROHIBITION OF CERTAIN SPECIFIC ACTIVITIES.—Any person subject to an order issued under this section shall not—

'(1) participate in any manner in the conduct of the affairs of any enterprise;

'(2) solicit, procure, transfer, attempt to transfer, vote, or attempt to vote any proxy, consent, or authorization with respect to any voting rights in any enterprise;

'(3) violate any voting agreement previously approved by the Director;

'(4) vote for a director, or serve or act as an enterprise-affiliated party; or

'(5) engage in other activities for or on behalf of an enterprise, except as specifically approved in writing by the Director.

'(e) INDUSTRY-WIDE PROHIBITION.—

'(1) IN GENERAL.—Except as provided in subparagraph (2), any person who, pursuant to an order issued under this section, has been removed or suspended from office in an enterprise or prohibited from participating in the conduct of the affairs of an enterprise may not, while such order is in effect, continue or commence to hold any office in, or participate in any manner in the conduct of the affairs of any enterprise.

(2) EXCEPTION IF DIRECTOR PROVIDES WRITTEN CONSENT.— If, on or after the date an order is issued under this section that removes or suspends from office any enterprise-affiliated party or prohibits such party from participating in the conduct of the affairs of an enterprise, such party receives the written consent of the Director, the order shall, to the extent of such consent, cease to apply to such party with respect to the enterprise described in the written consent. If the Director grants such a written consent, the Director shall publicly disclose such consent.

(3) The Director shall notify each "appropriate federal banking agency," as that term is defined at 12 U.S.C. 1813 (q), and such other federal financial regulatory agencies as the Director considers appropriate, of any order of removal or prohibition issued under this section and of any exception granted under paragraph (2).

'(f) APPLICABILITY.—This section shall only apply to a person who is an individual, unless the

Director specifically finds that it should apply to a corporation, firm, or other business enterprise.

‘(g) SUSPENSION OR REMOVAL OF ENTERPRISE-AFFILIATED PARTY CHARGED WITH FELONY.—

‘(1) SUSPENSION OR PROHIBITION.—

‘(A) IN GENERAL.—Whenever any enterprise-affiliated party is charged in any information, indictment, or complaint, with the commission of or participation in a crime involving dishonesty or breach of trust which is punishable by imprisonment for a term exceeding one year under State or Federal law, the Director may, if continued service or participation by such party may pose a threat to the enterprise or impair public confidence in the enterprise, by written notice served upon such party, suspend such party from office or prohibit such party from further participation in any manner in the conduct of the affairs of any enterprise.

‘(B) PROVISIONS APPLICABLE TO NOTICE.—

‘(i) COPY.—A copy of any notice under paragraph (1)(A) shall also be served upon the enterprise.

‘(ii) EFFECTIVE PERIOD.—A suspension or prohibition under subparagraph (A) shall remain in effect until the information, indictment, or complaint referred to in such subparagraph is finally disposed of or until terminated by the Director.

‘(2) REMOVAL OR PROHIBITION.—

‘(A) IN GENERAL.—If a judgment of conviction or an agreement to enter a pretrial diversion or other similar program is entered against an enterprise-affiliated party in connection with a crime described in paragraph (1)(A), at such time as such judgment is not subject to further appellate review, the Director may, if continued service or participation by such party may pose a threat to the enterprise or impair public confidence in the enterprise, issue and serve upon such party an order removing such party from office or prohibiting such party from further participation in any manner in the conduct of the affairs of the enterprise without the prior written consent of the Director.

‘(B) PROVISIONS APPLICABLE TO ORDER.—

'(i) COPY.—A copy of any order under paragraph (2)(A) shall also be served upon the enterprise, whereupon the enterprise-affiliated party who is subject to the order (if a director or an officer) shall cease to be a director or officer of such enterprise.

'(ii) EFFECT OF ACQUITTAL.—A finding of not guilty or other disposition of the charge shall not preclude the Director from instituting proceedings after such finding or disposition to remove such party from office or to prohibit further participation in enterprise affairs pursuant to subsections (a), (d), or (e) of this section.

'(iii) EFFECTIVE PERIOD.—Any notice of suspension or order of removal issued under this subsection shall remain effective and outstanding until the completion of any hearing or appeal authorized under paragraph (4) unless terminated by the Director.

'(3) AUTHORITY OF REMAINING BOARD MEMBERS.—If at any time, because of the suspension of one or more directors pursuant to this section, there shall be on the board of directors of an enterprise less than a quorum of directors not so suspended, all powers and functions vested in or exercisable by such board shall vest in and be exercisable by the director or directors on the board not so suspended, until such time as there shall be a quorum of the board of directors. In the event all of the directors of an enterprise are suspended pursuant to this section, the Director shall appoint persons to serve temporarily as directors in their place and stead pending the termination of such suspensions, or until such time as those who have been suspended, cease to be directors of the enterprise and their respective successors take office.

(b) CONFORMING AMENDMENTS.—

(1) 1992 ACT.—Section 1317(f) of the Housing and Community Development Act of 1992 (12 U.S.C. 4517(f)) is amended by striking 'section 1379B' and inserting 'section 1379D'.

(2) FANNIE MAE CHARTER ACT.—The second sentence of subsection (b) of section 308 of the Federal National Mortgage Association Charter Act (12 U.S.C. 1723(b)) is amended by striking 'The' and inserting 'Except to the extent action under section 1377 of the Housing and Community Development Act of 1992 temporarily results in a lesser number, the'.

(3) FREDDIE MAC CORPORATION ACT.—The second sentence of subparagraph (A) of

section 303(a)(2) of the Federal Home Loan Mortgage Corporation Act (12 U.S.C. 1452(a)(2)(A)) is amended by striking 'The' and inserting 'Except to the extent action under section 1377 of the Housing and Community Development Act of 1992 temporarily results in a lesser number, the'.

SEC. 154. ENFORCEMENT AND JURISDICTION.

Section 1375 of the Housing and Community Development Act of 1992 (12 U.S.C. 4635) is amended—

(1) by striking subsection (a) and inserting the following new subsection:

'(a) ENFORCEMENT.—The Director may, in the discretion of the Director, apply to the United States District Court for the District of Columbia, or the United States district court within the jurisdiction of which the headquarters of the enterprise is located, for the enforcement of any effective and outstanding notice or order issued under this subtitle or subtitle B, or request that the Attorney General of the United States bring such an action. Such court shall have jurisdiction and power to order and require compliance with such notice or order.'; and

(2) in subsection (b), by striking 'or 1376' and inserting '1376, or 1377'.

SEC. 155. CIVIL MONEY PENALTIES.

Section 1376 of the Housing and Community Development Act of 1992 (12 U.S.C. 4636) is amended—

(1) in subsection (a)—

(A) in the matter preceding paragraph (1), by striking 'executive officer or director' and inserting 'enterprise-affiliated party'; and

(B) by deleting the word 'or' at the end of paragraph (2), deleting the '.' and inserting ';' at the end of paragraph (4) and adding after paragraph (4) the following paragraphs,

'(5) violates any condition imposed in writing by the Director in connection with the grant of any application or other request by such enterprise;

(6) engages in any conduct the Director determines to be unsafe or unsound

(2) in subsection (b)—

(A) in paragraph (1), by inserting 'or enterprise-affiliated party' after 'enterprise' and by deleting '$5,000' and inserting '$10,000'.

(B) by deleting paragraphs (2) and (3) and inserting—

‘(2) SECOND TIER- Notwithstanding paragraph (1)—

`(A) if an enterprise, or an enterprise-affiliated party—

‘(i) commits any violation described in subsection (a);

‘(ii) recklessly engages in an unsafe or unsound conduct in conducting the affairs of such enterprise; or

‘(iii) breaches any fiduciary duty; and

‘(B) the violation, conduct , or breach—

‘(i) is part of a pattern of misconduct;

‘(ii) causes or is likely to cause more than a minimal loss to such enterprise; or

‘(iii) results in pecuniary gain or other benefit to such party,

the enterprise or enterprise-affiliated party shall forfeit and pay a civil penalty of not more than $50,000 for each day during which such violation, conduct, or breach continues.

‘(3) THIRD TIER.—Notwithstanding paragraphs (1) and (2), any enterprise that, or any enterprise-affiliated party who—

‘(A) knowingly—

‘(i) commits any violation described in any subparagraph of subsection (a);

‘(ii) engages in any unsafe or unsound conduct in conducting the affairs of such enterprise; or

‘(iii) breaches any fiduciary duty; and

‘(B) knowingly or recklessly causes a substantial loss to such enterprise or a substantial pecuniary gain or other benefit to such party by reason of such violation, conduct, or breach,

shall forfeit and pay a civil penalty in an amount not to exceed the applicable maximum amount determined under paragraph (4) for each day during which such violation, conduct, or breach continues.

‘(4) MAXIMUM AMOUNTS OF PENALTIES FOR ANY VIOLATION DESCRIBED IN PARAGRAPH (3).—The maximum daily amount of any civil penalty which may be assessed pursuant to paragraph (3) for any violation, conduct, or

breach described in such paragraph is not to exceed $2,000,000.'

(3) in subsection (d)—

(A) by striking ', executive officer or director' each place such term appears and inserting 'or enterprise-affiliated party';

(B) by striking 'request the Attorney General of the United States to';

(C) by inserting ', or the United States district court within the district in which the headquarters of the defendant is located, or, if the defendant is an individual, in which the defendant resides' after 'District of Columbia'; and

(D) by striking ', or may, under the direction and control of the Attorney General, bring such an action'.

(4) in subsection (g), by striking 'subsection(6)(3)' and inserting 'this section, unless authorized by the Director by regulation or order.'

SEC. 156. CRIMINAL PENALTY.

Subtitle C of title XIII of the Housing and Community Development Act of 1992 (12 U.S.C. 4631 et seq.) is amended by inserting after section 1377 (as added by the preceding provisions of this Act) the following new section:

'SEC. 1378. CRIMINAL PENALTY.—

'Whoever, being subject to an order in effect under section 1377, knowingly participates, directly or indirectly, (including by engaging in an activity specifically prohibited in such an order) in the conduct of the affairs of any enterprise without the prior written approval of the Director, shall be fined not more than $1,000,000, imprisoned for not more than 5 years, or both, nothwithstanding section 3571 of title 18.'.

SEC. 157. SUBPOENA AUTHORITY.

Section 1379D, as redesignated in Sec. 153 above, is amended in the first sentence of subsection (c)—

(1) by inserting after 'may', 'bring an action, or'; and

(2) by deleting 'or may, under the direction and control of the Attorney General, bring such an action.'

SEC. 158. GENERAL SUPERVISORY AUTHORITIES.

Subtitle C of the Housing and Community Development Act of 1992 (12 U.S.C. 4631 *et seq.*) is amended by inserting the following new section—

'Sec.1379E. GENERAL SUPERVISORY AUTHORITIES.

The Director is authorized to take enforcement actions under this title and other formal and informal enforcement actions, including but not limited to requiring prompt supervisory actions under subtitle B, as the Director deems necessary to enforce the compliance of any enterprise or any enterprise-affiliated party with applicable laws, regulations, rules, or orders.

Subtitle D—General Provisions

SEC. 171. CONFORMING AND TECHNICAL AMENDMENTS.

(a) AMENDMENTS TO 1992 ACT.—Title XIII of the Housing and Community Development Act of 1992 (12 U.S.C. 4501 et seq.), as amended by the preceding provisions of this Act, is further amended—

(1) in section 1315 (12 U.S.C. 4515) by striking subsection (f);

(2) in section 1319A (12 U.S.C. 4520)—

(A) by striking '(a) IN GENERAL- '; and

(B) by striking subsection (b);

(3) in section 1319C (12 U.S.C. 4522)—

(A) in subsection (a)(1), by inserting 'under this title' after 'redressed'; and

(B) in subsection (b), by inserting 'under this title' after 'issued';

(4) in section 1319D (12 U.S.C. 4523), by inserting `to conduct duties relating to the regulation and supervision of the enterprises' before the second comma;

(5) in section 1319E (12 U.S.C. 4524)—

(A) by inserting 'relating to regulation and supervision of the enterprises' before 'in accordance with'; and

(B) by inserting 'in functions relating to the regulation and supervision of the enterprises' before 'shall be made available';

(6) by striking section 1319G (12 U.S.C. 4526);

(7) in section 1361(e)(1) (12 U.S.C. 4611)(e)(1) by striking the first sentence and inserting the following new sentence: 'The Director shall establish the risk-based capital test under this section by regulation.'; and

(8) in section 1364(c) (12 U.S.C. 4614(c)), by striking the last sentence;

(9) in section 1367(a)(2) (12 U.S.C. 4617(a)(2)), by striking 'with the written concurrence of

the Secretary of the Treasury,';

(10) in section 1369A(i) (12 U.S.C. 4620(i)), by inserting 'having duties relating to regulation and supervision of the enterprises' before the period at the end;

(11) by striking section 1383; and

(12) by striking 'Committee on Banking, Finance and Urban Affairs' and inserting 'Committee on Financial Services' each place such term appears in sections 1319B, 1319G(c), 1328(a), 1336(b)(3)(C), 1337, and 1369(a)(3).

(b) AMENDMENTS TO FANNIE MAE CHARTER ACT.—The Federal National Mortgage Association Charter Act (12 U.S.C. 1716 et seq.) is amended in section 309(n)—

(1) in paragraph (1), by inserting `the Director of the Office of Federal; Housing Enterprise Oversight,' after 'Senate,'; and

(2) in paragraph (3)(B), by striking 'Secretary' and inserting 'Director of the Office of Federal Housing Enterprise Oversight'.

(c) AMENDMENTS TO FREDDIE MAC CORPORATION ACT.—The Federal Home Loan Mortgage Corporation Act is amended in section 307(f) (12 U.S.C. 1456).

(1) in paragraph (1), by inserting 'the Director of the Office of Federal Housing Enterprise Oversight Housing Finance Supervision,' after 'Senate,'; and

(2) in paragraph (3)(B), by striking 'Secretary' and inserting 'Director of the Office of Housing Finance Supervision'.

(d) AMENDMENT TO DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT ACT.—Section 5 of the Department of Housing and Urban Development Act (42 U.S.C. 3534) is amended by striking subsection (d).

SEC. 172. TERM OF DIRECTOR.

Section 1312(b) of the Housing and Community Development Act of 1992 (12 U.S.C. 4512(b)) is amended to read—

'(b) TERM.—The Director shall be appointed for a term of 5 years unless sooner removed by the President, upon reasons to be communicated by the President to the Senate.'

SEC. 173. EFFECTIVE DATE.

Except as specifically provided otherwise in this title, the amendments made by this title shall take effect upon, and shall apply beginning on, the date of the enactment of this Act.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM ARMANDO FALCON, JR.

Q.1. I would like to follow-up on my questions about the anonymous letters. Your staff briefed Committee staff and informed staff that some anonymous letters were received and then investigated by Baker Botts who dismissed the charges in the letters. Did the charges in those letters have anything to do with what actually happened at Freddie? What charges were made in the letters? Who were the letters sent to? Is there any idea of where they came from, a Freddie employee? An auditor?

A.1. The letters contain a series of charges which can be summarized as allegations of wrongdoing against Freddie Mac that they overstated their 1999 earnings by several hundred million dollars; that they commingled cash collateral in violation of security agreements and filed false or misleading financial and regulatory reports; and that they made a billing error of approximately $6 million in the account of Bank of America.

The allegations contained in the letters are not directly related to the accounting issues that have led to the company's restatement. The letters were sent to Fannie Mae, and Fannie Mae delivered them to Freddie. Although the letters indicated OFHEO and others were copied, we did not actually receive copies. The source of the letters continues to be unknown, they are anonymous.

Q.2. Can the Committee receive a copy of the letters?

A.2. OFHEO obtained the letters pursuant to a subpoena and confidentiality agreement. We would like to discuss this with the Committee and try to find a way to satisfy the Committee's request.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DOLE FROM ARMANDO FALCON, JR.

Q.1. Mr. Falcon, when were you informed of the Freddie Mac Board's decision to terminate the President and CEO, force the retirement of its CEO and force the resignation of its CFO? When you were informed and what exactly did the board or its representative tell you? How did they describe the situation?

A.1. I was informed of the board's decision to make the management changes on June 6, 2003. I was informed that the board had just concluded its deliberations and decided that a change was necessary in light of issues raised by the restatement.

Q.2. Mr. Falcon, in your testimony you say that Baker Botts told you of no management problem on May 27. Earlier in your testimony you state that on May 8 that PriceWaterhouseCoopers informed some Freddie Board Members that it "would not accept the representations" of some employees. This appears to be a key development in the reaudit. When and how did you learn of these PriceWaterhouseCoopers concerns? What did you do when you heard of these concerns?

A.2. On May 8, 2003, PriceWaterhouseCoopers (PwC) communicated to Freddie Mac's Board their unwillingness to accept the representations about the company's financial statements from Mr. Glenn and Mr. Clarke. On May 27, OFHEO's Chief Examiner was briefed by Mr. Doty on the status and latest developments in his

investigation. No mention was made of PwC's lack of trust in the two individuals, even when specifically asked if there was anything else we should know about the restatement and investigation.

OFHEO learned of the communication between PwC and the board in the June 7 meeting with Freddie Mac's representatives that I convened. I considered PwC's concerns to be a very material development. Learning about this material development almost 30 days after the information was communicated to the board concerned me deeply. The delay in learning this critical piece of information, coupled with other considerations, caused me to formalize and expedite aspects of our ongoing supervision of Freddie Mac's reaudit and restatement process and independently investigate certain aspects of potential management conduct. The formalization of our oversight activities and expediting our own independent evaluation of the factors causing the reaudit and restatement were reflected in my June 7 letter to Freddie Mac's Board of Directors.

Q.3. Mr. Falcon, I am very interested in the fact that 3 days before the board's shakeup OFHEO had publicly approved of the management's treatment of an earnings restatement that had been pending since January, stating "we remain satisfied that the board of directors and executive management are taking the appropriate action." How do you reconcile this with your letter that weekend which stated that the management shake-up "only goes a part of the way toward correcting serious problems" at Freddie Mac?

A.3. In the 2002 Annual Report to Congress, OFHEO included a paragraph covering the Freddie Mac reaudit and restatement process. The paragraph summarized OFHEO's assessment of Freddie Mac's efforts surrounding: The independent auditor's decision to delay its 2002 certification of financial statements, the board of director's decision to have prior period statements reaudited and restate those earlier periods, and the remediation program to address control matters in the financial accounting and operational control area. OFHEO concluded and reported to Congress that Freddie Mac's Board and its management took appropriate action to address the delay in the 2002 certified financial statements.

When the independent auditor delayed an opinion on the 2002 financial statements. OFHEO's focus was to ensure the company remained committed to getting the restatement process done well and in a timely manner. In addition, we evaluated a May 2003 Board-approved plan to addresses financial accounting and operational control weaknesses that superceded the Financial Reporting Controls Improvement Plan (FRCIP) approved by the board in 2000. Working to ensure that Freddie Mac's reaudit and restatement process was done well and in a timely manner had been our priority and remains a key concern as the safety and soundness regulator.

Beginning June 4, there were two key developments that caused me to send a letter on June 7 to the Freddie Mac Board of Director. First, there was the action of a senior Freddie Mac official that led to his termination, and triggered the board's decision to force the separation of two other senior executives on June 6. In tandem with those decisions, the board installed a new executive management team to lead the firm. The second key development was that

on June 7, I was presented with information suggesting there may have been past management decisions that resulted in smoothing the company's earnings by delaying income into future periods.

Up until June 6, OFHEO had been emphasizing to the board and its executive management the importance of getting the restatement process done well and in a timely manner. I decided to formally reemphasize this as a regulatory priority on June 7. Following the same rationale, I elevated OFHEO's routine supervisory efforts covering Freddie Mac's remediation plan to address control weaknesses in the financial accounting and operational control areas. I wanted to ensure OFHEO's supervisory priorities would remain a key focus of the new executive management team.

Distinct from the supervisory priorities involving the restatement process and control weaknesses at Freddie Mac, learning about management practices that may have been intended to manage earnings and violations of the company's code of conduct by a senior executive were troubling. These acts of misconduct by executive managers represent a serious problem if supported through our investigation.

Q.4. Mr. Falcon, some have suggested that the safety and soundness responsibilities of OFHEO should be transferred to the Treasury Department. What are your views on this proposal?

A.4. First and foremost, effective safety and soundness oversight requires the following three elements:

1. Independence from political influence;
2. Permanent finding outside the appropriations process; and
3. Full powers and authority to conduct oversight and take any necessary regulatory action.

With those fundamentals in place, OFHEO would be well-positioned for long-term success in either HUD or Treasury.

Q.5. Mr. Falcon, in your July 14 letter to the Senate Appropriations Committee. you indicated that OFHEO will now begin an "independent" review of Fannie Mae's accounting practices. However, the OFHEO handbook includes a lengthy list of checks which your examiners are to conduct precisely to review accounting and audit quality. I know OFHEO is not supposed to be the GSE's auditor, but your own handbook says that you were monitoring and ensuring appropriate accounting standards. Please comment on this apparent contradiction and also explain why OFHEO is only now undertaking an independent review of Fannie Mae? Please provide this Committee with a detailed list of dates on which examiners reviewed Fannie Mae accounting practices, the nature of this review, the manner in which it compares with that done by bank examiners, and the reasons why this review was not "independent."

A.5. There is no contradiction between the work outlined in my July 14 letter and the routine supervisory work conducted by OFHEO. The special review of Fannie Mae—which will be a comprehensive review of their accounting policies and whether their implementation is resulting in a high level of conformance with GAAP—is work that will be independent of the routine supervisory activities at OFHEO. The work proposed in my July 14 letter requires a forensic accounting investigation to ascertain the intent

behind the way Fannie Mae's management applies GAAP. OFHEO's routine supervisory activities do not include forensic accounting techniques. Similar to the other financial safety and soundness regulators, OFHEO does not regulate the accounting used by the Enterprises. OFHEO does advocate the appropriate application of GAAP by the Enterprises and the publication of accurate and meaningful financial disclosures. Like the depository regulators, OFHEO regards reputable independent auditors to possess expertise in accounting. The independent auditor's certification of a company's financial statements and disclosures is intended to provide assurances that management has fairly presented the financial statements in accordance with GAAP. Considering the current environment, I want to expedite our special forensic review of Fannie Mae's application of GAAP accounting, to answer questions that may be asked about Fannie Mae.

OFHEO's approach to reviewing independent audits and financial reporting is analogous to the other safety and soundness regulators. Allow me to provide more contour for the nature and scope of that approach. Over the years, there have been two forms of accounting principles that were used by financial firms for the preparation and reporting of financial condition and results. First, there were the accounting principles being prescribed by the regulators. During the 1980's there were a number of regulatory accounting principles (RAP) being prescribed. Many of these RAP standards were roundly criticized after the failures of numerous depository institutions and Congress expressed its desire for financial safety and soundness regulators to rely upon the established generally accepted accounting principles (GAAP) for financial reporting standards. The second and more widely recognized accounting principles are prescribed by GAAP, arguably a set of principles that are subject to interpretation and can result in similar transactions receiving different accounting treatments.

Investors and markets have learned to appreciate that GAAP is not precise. The accounting principles prescribed through GAAP were never meant to be rigid, but intended to allow for new business structures, as well as, new and innovative transactions. Therefore, GAAP is flexible to allow for the adaptation to changing circumstances, and not immune from debates in its application.

Section 121 of FDICIA directs the depository regulators to pursue GAAP in their regulatory reporting requirements. In OFHEO's 1992 Act, the Congress directed OFHEO to pursue GAAP in its regulatory activities.

Accounting standards are intended to provide the foundation for credible financial statements and other disclosures that are the key means for communicating a firm's operating result and its overall health, as well as making transparent the economic value of the firm. In addition, accounting standards' are intended to provide the foundation for disclosing reliable information to the marketplace which promotes enhanced market discipline. The foundation for credible financial statements and disclosure has obvious implications for the supervisor in its oversight of the safety and soundness of the financial firm.

Many of the accounting standards that have emerged in recent years deal with the most esoteric accounting policies and trans-

actions that FASB has prescribed. For instance, under FAS 133 the application of GAAP for certain transactions may very likely not reflect the underlying economics of the transactions.

Fannie Mae and Freddie Mac, like other large financial firms are required to engage an independent external auditor to audit their financial statements and disclosures. There are several roles performed by the independent auditor, and key among these roles is the performance of testing to conclude whether management has fairly presented the financial statements in accordance with GAAP. In that regard, the independent auditor provides a level of assurance that the financial statements are free of material misstatements and renders a final opinion, which carries the accounting firm's signature. That audit opinion falls into one of three categories: clean, or "unqualified," if the records amount to a fair representation of the company's underlying economic health; "qualified," if there are exceptions to an otherwise fair representation of the financial statements; or a "disclaimer," meaning the client's recordkeeping is so inadequate that the auditor cannot even render an opinion. For companies experiencing serious financial difficulties, the independent auditor is also supposed to state whether there is "substantial doubt" that the entity can continue as a "going concern" for a reasonable period of time. Fannie Mae has always received unqualified opinions on its financial statements from its independent auditors. Freddie Mac has also obtained unqualified opinions on its financial statements from its independent auditors. The certification of Freddie Mac's 2002 financial statements has been delayed by the firm's new auditors pending the reaudit and restatement of prior periods based upon the new firm's interpretation for the application of GAAP to certain accounting transactions.

The importance of the independent auditor's opinion that is rendered on a firm's financial statements has been bolstered by court cases that have established a public responsibility for the independent auditor which transcends any employment relationship with the management and board of directors of the firm being audited. When the independent auditor certifies the public reports of a company, their ultimate allegiance is to the corporation's creditors, stockholders, and to the investing public.

Like the depository financial safety and soundness regulators, OFHEO evaluates the work performed by the auditor and the independence of the auditor and the audit work. Through its supervisory programs, OFHEO has routinely considered the accounting policies of the Enterprises and tested the accounting practices on transactions. In our design, implementation and operation of the risk-based capital test, OFHEO has considered the accounting policies and practices of each Enterprise. We are required to consider the accounting treatments used by the Enterprises regularly in the administration of the risk-based capital test, in addition to carefully considering changes or innovations in accounting for transactions. Through our examination program, we routinely conduct transactional testing which includes a consideration of whether transactions are being accounted for consistent with the approved GAAP of the company. In 2002, with the addition of more resources to our examination program, we added a team dedicated exclu-

sively to accounting issues. This dedicated accounting team is used to augment routine examination testing that includes the consideration of accounting policies and practices. As well, this team of examiners is engaged with the Enterprises' accountants discussing and considering the proposed application of GAAP for new FASB pronouncements. As part of the examination testing, the quarterly closing and reporting processes are evaluated to determine if there are procedures employed to achieve GAAP compliance and test to see there are sign-offs on the financial statements by the independent auditors, and whether there are reservations noted by the auditor.

Like the depository regulators, an effective audit program is key in a quality risk management framework. We regularly evaluate the quality of the audit programs, the appropriateness of the audit work performed and the sufficiency of follow-up on audit findings in our safety and soundness examinations. When there are deficiencies recognized in aspects of the internal or independent external audit programs, the regulator ensures there is remediation for the deficiency. Generally, the examination activities covering the audit program covers: A determination of independence, a determination of professional proficiency; a determination of the appropriateness of the scope of work; a testing and determination of the completeness of audit work performed; an evaluation of management of the internal audit; a determination of the quality and sufficiency of follow-up and oversight by the board's audit committee; a determination of the appropriateness of the risk assessment process employed by auditors; and a determination of the auditors involvement in new policies, procedures, or practices. For more contour on what examiners are evaluating for the audit programs at the Enterprises, please refer to the attachment.

Table 7: Audit

Examination Objectives
Assess the overall adequacy and effectiveness of both internal and external audit functions and the management of the audit program.
Identify and evaluate any changes occurring in internal and external audit functions or roles as well as the potential impact on the Enterprise.
Communicate OFHEO's determinations about the audit program and effect changes when appropriate.
Follow-up on examination findings and planned initiatives by the Enterprise that impact the audit program.
Assessment Factors
Determine if the Audit Functions have the appropriate independence.
Determine if the auditors performing the work possess the appropriate professional proficiency.
Determine after consulting with the other examination teams if the scope of the audit work performed is appropriate.
Determine after consulting with the other examination teams if the performance of the audit work has been complete.
Evaluate the quality of the management of the Internal Audit Department.
Determine after consulting with the other examination teams the appropriateness of executive management's involvement and follow-up of identified audit issues. Determine the quality of the Board of Directors' involvement and follow-up of identified audit issues.
Determine after consulting with the other examination teams the quality of the auditor's risk assessment process.
Determine after consulting with the other examination teams the appropriateness of internal audit's involvement with new products and new initiatives. Share determinations with the examination team responsible for business process controls.

OFHEO Examination Program
Corporate Governance – Audit

ASSESSMENT FACTOR	EVALUTION CRITERIA
1. Determine if the Audit Functions have the appropriate independence	• Placement of the internal audit function in the management structure. • Internal audit's reporting line. • Internal audit manager's business operations responsibilities. • Who develops objective performance criteria used to evaluate the work of internal audit? • IA managers have no responsibilities for operating the business. • External audit engagement negotiated at arms-length. • The external audit engagement letter reviewed by audit committee. • External audit's reporting line. • IA has the opportunity to discuss with the Board audit findings without management present.
2. Determine if the auditors performing the work posses the appropriate professional proficiency	• Educational and professional background (certification) of the internal audit staff. • Continuing education opportunities for internal audit staff. • Professional background and expertise of external audit staff.
3. Determine after consulting with the other examination teams, if the scope of the work performed is appropriate	• Consistent with the nature, complexity, and risk in the Enterprise's on- and off-balance-sheet activities. • Consistent with risk assessment. • Consistent with approved audit plan. • Appropriate reliance on work of outsourcing vendor, external audit (for internal) and internal audit (for external). • Scope expands if significant issues arise or when significant changes occur in the Enterprise's environment, structure, activities, risk exposures or systems including: a) new management; b) areas or activities experiencing rapid growth; and c) new lines of business, products or technologies. • Consistent with the long-range goals of the Enterprise. • Responsive to the Enterprise's internal control needs.
4. Determine after consulting with the other examination teams, if the performance of the audit work has been complete	• Consistent with audit plan. • Describes the objectives of the audit work and lists the procedures that will be performed. • Includes a summary of key internal controls within each significant business activity. • Evaluates the information received. • Communicates results. • Follows up on findings. • Full scope audit work complies with professional standards. • Workpapers adequately document the work performed and support conclusions.
5. Evaluate the quality of the management of the Internal Audit Department.	• Background or experience provides an understanding of the audit function. • Ensures appropriate risk assessments are developed and maintained. • Ensures that audit plans are met, programs are carried out, and results of audits are promptly communicated to managers and directors. • Appropriate budget. • Establishes, updates, enforces policies and procedures to guide audit staff.

ASSESSMENT FACTOR	EVALUATION CRITERIA
6. Determine after consulting with the other examination teams, the appropriateness of executive management's involvement and follow-up of identified auditing issues. Determine the quality of the Board of Directors' involvement and follow-up of identified audit issues.	• Reviews and is appropriately informed of the internal audit manager's risk assessment. • Reviews and is appropriately informed of the scope of the audit plan. • Periodically reviews internal audit's adherence to the audit plan. • Considers requests for expansion of basic internal audit work when appropriate. • Fosters forthright communications and critical examination of issues. • Keeps informed of issues. • Tracks issues for follow up, including operating management's solutions. • Significant issues promptly brought to direct attention. • Significant issues promptly addressed. • Meets with management and the manager of internal audit. • Assesses whether internal control weaknesses or other exceptions are being resolved appropriately. • Promotes the internal audit manager's impartiality and independence. • Gives the manager of internal audit the opportunity to discuss findings without management being present. • Uses reasonable standards when assessing the performance of internal audit.
7. Determine after consulting with the other examination teams, the quality of the auditor's risk assessment process.	• Documents the understanding of the significant business activities and their associated risks. • Analyze the risks inherent in a given business line and potential risk due to control deficiencies. • Updated as need to reflect changes to the system of internal control or work processes, and to incorporate new lines of business. • Is appropriate for the institution's activities.
8. Determine after consulting with the other examination teams, the appropriateness of internal audits in new products and new initiatives. Share determinations with the examination team responsible for business process controls.	• Stage at which internal audit is first involved/apprised of new product. • Any internal audit review prior to going live with new product. • Timing of internal audit work after new product introduced. • Scope of work conducted during design, development and implementation of new products. • Internal audit's risk assessment of new products. ➢ Operational impact (policies, procedures, systems) ➢ Financial statement impact ➢ Compliance and regulatory impact. • Degree of integration and communication with other key stakeholders.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM ARMANDO FALCON, JR.

Q.1. Quoting from your June 15, 2003, Office of Federal Housing Enterprise Oversight (OFHEO) Annual Report to Congress, "Message From the Director," you wrote:

> On the occasion of our 10th Anniversary, it is with great pride that I report to Congress that the Office of Federal Housing Enterprise Oversight has developed into the strong, capable, and innovative regulator that Congress envisioned when it created the Agency only a decade ago. OFHEO today is actively and aggressively fulfilling its mission of ensuring the safety and soundness of Fannie Mae and Freddie Mac (the Enterprises).
>
> the Enterprises have remained safe and sound through another year of exceptional growth in the housing sector of our economy. In a year when more and more Americans have become homeowners, the public can take comfort in knowing that OFHEO is on the job, doing its part to ensure the strength and vitality of the Nation's housing finance system.

Later, on pages 37–38 in Chapter 4 of the report, when reporting on the Freddie Mac Examination Results and Conclusions, the report states:

> [Freddie Mac's] audit functions are dependent and effective. The Internal and External Audit Functions have the appropriate independence. Auditors performing the work possess appropriate professional proficiency. The scope of the audit work is appropriate, and the audit work is complete. The management of the Internal Audit department is effective. Executive management and the board of directors are appropriately involved with and follow up' on identified audit issues. The auditor's risk assessment process is effective. Internal Audit is appropriately involved in new products and new initiatives.

If OFHEO is "actively and aggressively fulling its mission," how did such accounting inadequacy fail to be addressed in OFHEO's examination of Freddie Mac's operations, especially since the implications of FAS 133 have been discussed and implemented since 1999? How can the public "take comfort in knowing that OFHEO is on the job" if it fails to effectively oversee such problems in an appropriate time frame? How can we be sure that another similar problem at Freddie, or Fannie for that matter, is not brewing? Why shouldn't such problems be discovered, disclosed, and addressed in real time in order for OFHEO to be an effective regulator that the public can really trust?

A.1. To begin, the public can take comfort in the fact that OFHEO has done its job because Freddie Mac's safety and soundness has not been called into question. The issues raised, while important, have not been about Freddie Mac's financial solvency. There are two distinct issues under discussion. The first issue involves the application of generally accepted accounting principles (GAAP) and the second issue involves questionable motives behind certain management decisions made during Freddie Mac's implementation of FAS 133.

First, there is the issue of accounting adjustments involving Freddie Mac's restatement process and PwC's delayed certification of Freddie Mac's 2002 financial statements. I take seriously the fact that the restatement adjustments will be substantial. I also take seriously the delay in 2002 certified financial statements. My concern was the reason OFHEO stressed to Freddie Mac the importance of completing the restatement process as expeditiously as possible and the equal importance of getting it done well. But, at the heart of the restatement process and the size of the adjust-

ments contemplated, this remains an accounting issue, more specifically the timing of income recognition. There is not a question of whether there will be billions of dollars more or less in income earned by Freddie Mac over the life of the existing transactions. Rather, the accounting issue involves the period in which those billions of dollars in income get recognized. In short, the fair value of the firm is not materially affected by the adjustments. But the GAAP reported net income in past and future time periods will fluctuate based upon where the income adjustments are recorded.

Like the other financial safety and soundness regulators, OFHEO does not regulate the form of accounting used by the Enterprises. OFHEO does, however, advocate the appropriate application of GAAP by the Enterprises and the publication of accurate and meaningful financial disclosures. Like the depository safety and soundness regulators, OFHEO regards reputable independent auditors to possess expertise in accounting. Fannie Mae and Freddie Mac like other large financial firms are required to engage independent external auditors to audit their financial statements and disclosures. A key role of the independent auditor is the performance of testing to conclude whether management has fairly presented the financial statements in accordance with GAAP. Freddie Mac obtained unqualified opinions through 2001 from its prior independent auditor. The new independent auditor's opinion on the 2002 financial statements was delayed due to the application of GAAP to certain transactions. More specifically, PwC expressed reservations about the application of GAAP for selected types of hedge accounting treatments due to the hedge documentation and the quarterly documentation of hedge effectiveness. While PwC was not comfortable with the hedge documentation on record, the prior auditor had been comfortable and signed-off on the accounting treatments and certified the 2001 financial statements.

Freddie Mac's audit functions are independent. Independence has been determined using the evaluative standards employed by OFHEO which incorporate criteria outlined by recognized sources. To determine the "independence" of the external auditor, examiners: (1) evaluate the "engagement" of the external audit firm to determine that it is an arm's-length transaction; (2) assess the access the external auditor has to the board (through the audit committee), including the frequency of meetings the external auditor has with the audit committee in executive session with no operating management present; (3) evaluate the terms and conditions of the "engagement," and the policies and practices of the external audit firm against the independence standards and guidelines of the AICPA (American Institute of Certified Public Accountants), the NYSE, and the SEC; (4) evaluate the nature and extent of nonaudit services provided by the external audit firm; (5) evaluate the expertise and staffing of the external auditor for the engagement; and (6) test the external auditors work papers to determine if identified matters are appropriately communicated and recorded. In addition to evaluating the independence of the external audit function, examiners evaluate other factors in determining the adequacy and sufficiency of the external audit.

In my testimony and in the Annual Report, I noted that for several years OFHEO has been working with Freddie Mac to see the

controls and expertise in the financial accounting and financial reporting areas are strengthened. While progress was noted, OFHEO continues to work with Freddie Mac to see that expertise and controls in the financial accounting and financial reporting areas continue to improve.

Q.2. Could you describe in detail what expertise the staff of OFHEO has in effectively evaluating and monitoring the various complex financial instruments that Fannie and Freddie employ for their respective operations on a regular basis? How does such expertise compare to your colleagues at the Treasury, the Federal Reserve, and private GSE analysts? Please explain in detail.

A.2. OFHEO has a talented staff of professionals with impressive and varied backgrounds. Our staff is composed of experienced professionals and technicians with many years of experience in regulation, the capital markets, the mortgage markets, in investment management, in financial analysis, in hedging, in financial engineering, in accounting, and in housing policy and research. Early in my term as the Director, I sought to increase the funding for the Agency to build the permanent staff and obtain the depth in human resources and expertise needed to administer our regulatory program. We have made significant progress in obtaining the staff and expertise to fulfill our mandate, and the multiyear plan that I am implementing seeks to build even further the depth and capacity in our personnel. However, there remains considerable work for a lean staff of professionals to accomplish in our safety and soundness oversight of these two companies.

OFHEO has deliberately hired seasoned professionals from numerous backgrounds. We have hired from within Government, from the private sector, and from academia. From the Government ranks, we have hired from the banking and thrift regulatory agencies (the Federal Reserve System, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the FDIC), from the GAO, and other Federal Agencies. From the private sector, we have hired from Wall Street firms, from commercial banking companies, from investment management firms, from consulting firms, from technology companies, from accounting firms, from investments banks, and from law firms. From academia, we have hired college professors and researchers. Through these three channels of hiring we have assembled an experienced group of professionals with a variety of technical, managerial, and policy-formulation backgrounds.

Through the skills sets employed by OFHEO, we have excellent knowledge of the mortgage and housing markets, the debt markets, the Enterprises' lines of business, investment management, hedging activities and techniques, the derivatives business, interest rate risk management, credit risk management, counterparty risk management, liquidity management, accounting, econometrics, and the legal frameworks for the Enterprises' business activities.

OFHEO's collective knowledge and understanding of Fannie Mae and Freddie Mac is without a doubt much greater than that of any other entity in the Government or private sector.

Q.3. I realize that Fannie and Freddie have voluntarily decided to file disclosures on the mortgage-backed securities with SEC, de-

spite being exempted from doing so by their charters. However, it is also my understanding that they do not want to register their debt securities. Would registration of the Enterprises' debt securities assist you in being a more effective safety and soundness regulator? Please explain in detail why or why not.

A.3. the Enterprises' disclosures related to their debt securities serve an important function. The disclosures promote market understanding and confidence and result in greater Enterprise access to the capital markets. Those disclosures are thus important to safety and soundness and should be mandatory rather than voluntary. This is the more important consideration than the actual act of registration. Accordingly, OFHEO has under consideration a regulation that would mandate debt disclosures equal to those of other publicly held companies.

Q.4. In your testimony, you recommend keeping OFHEO as a quasi-independent regulator housed within HUD. Please describe in detail how moving OFHEO and/or its oversight authority to the Office of Thrift Supervision (OTS) or the Department of the Treasury would harm or help OFHEO's ability to effectively regulate the GSE's.

A.4. First and foremost, effective safety and soundness oversight requires the following three elements:

1. Independence from political influence;
2. Permanent finding outside the appropriations process; and
3. Full powers and authority to conduct oversight and take any necessary regulatory action.

With those fundamentals in place. OFHEO would be well-positioned for long-term success in either HUD or Treasury.

Q.5.a. In your testimony, you highlight OFHEO's authority to review executive compensation packages to ensure they are not "excessive" as allowed in 12 U.S.C. 4518(a), which defines "excessive" compensation as such that is ". . .not reasonable and comparable with compensation for employment in other similar businesses." Please describe in detail how you interpret that definition of excessive compensation.

A.5.a. OFHEO carries out the statutory requirement to prohibit excessive compensation by comparing the compensation received by senior executive officers at Fannie Mae and Freddie Mac including all direct and indirect payment of benefits both cash and noncash, granted to or for the benefit of the executive officer, to that received by executives for employment in other similar businesses.

In addition to its ongoing review, OFHEO periodically undertakes a study to compare compensation provided by each Enterprise to executive officers to that provided by similar businesses to executive officers doing similar work. OFHEO retains an executive compensation consultant to assist in conducting the comparability studies. The comparator group for each Enterprise includes publicly held financial institutions or major financial services companies. The compensation policies of Fannie Mae and Freddie Mac are compared to a group of similar businesses through the use of proxy statements and survey data. OFHEO documents the compensation plans of Fannie Mae and Freddie Mac; conducts in-depth

interviews with Fannie Mae and Freddie Mac executive officers about the nature of their work and the compensation, received and examines the reasonableness and competitiveness of the compensation packages at those firms, as well as the pay mix and the extent to which compensation is performance-based. The comparability studies update and complement the ongoing monitoring by OFHEO of compensation actions taken by the Enterprises as well as compensation developments for executives at similar businesses.

Q.5.b. Based on what you know now, is the compensation for former Freddie Mac CEO Brendsel, former COO Glenn, and former CPO Clarke excessive? Please explain in detail. Have you reviewed the compensation of current Freddie Mac executives? If so are they excessive, according the above-mentioned definition? Please explain in detail.

A.5.b. OFHEO now has a special investigation underway which will address, among other matters, whether the compensation of former and current executives was excessive under the circumstances.

Q.6.a. On July 23, 2003, Baker Botts, LLP released a report on its investigations of Freddie Mac and how Freddie improperly used various accounting techniques to smooth out earnings. In your testimony, you suggested that the Baker Botts, LLP investigators were less than cooperative. Why was that the case? Please describe in detail the extent of their lack of cooperation.

A.6.a. On May 8,2003, PriceWaterhouseCoopers (PwC) communicated to Freddie Mac's Board their unwillingness to accept the representations about the company's financial statements from Mr. Glenn and Mr. Clarke. On May 27, OFHEO's Chief Examiner was briefed by Mr. Doty on the status and latest developments in his investigation. No mention was made about PwC's lack of trust in the two individuals, even when specifically asked if there was anything else we should know about the restatement and investigation.

OFHEO learned of the communication between PwC and the board in the June 7 meeting with Freddie Mac's representatives that I convened. I considered this to be a material development. Learning about this material development almost 30 days after the information was communicated to the board concerned me deeply. The delay in learning this critical piece of information coupled with other considerations caused me to formalize and expedite aspects of our ongoing supervision of Freddie Mac's reaudit and restatement process and independently investigate certain aspects of potential management conduct. The formalization of our oversight activities and expediting our own independent evaluation of the factors causing the reaudit and restatement were reflected in my June 7 letter to Freddie Mac's Board of Directors.

Q.6.b. Did OFHEO discover the various accounting techniques described in the report as being used by Freddie Mac to smooth out earnings as a part of its ongoing examinations activities? Please explain in detail why or why not.

A.6.b. OFHEO's Special Investigation Unit is looking at these issues; thus, our report will address them at completion of this investigation.

Q.6.c. The Baker Botts Report also names the current CEO, Gregory Parseghian, as being intimately involved in the various questionable transactions that prompted Freddie Mac's Board of Directors to dismiss COO Glenn and accept the resignations of CEO Brendsel and CFO Clarke. What role will OFHEO play in order to determine the extent of Parseghian's involvement? Please explain in detail.

A.6.c. OFHEO's Special Investigation Unit is looking at these issues; thus, our report will address them at completion of this investigation.