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ADDITIONAL ACCOUNTING AND MANAGEMENT FAILURES AT FANNIE MAE

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTEREPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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ADDITIONAL ACCOUNTING AND MANAGEMENT FAILURES AT FANNIE MAE

Wednesday, April 6, 2005

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:03 a.m., in Room 2128, Rayburn House Office Building, Hon. Richard Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Shays, Gillmor, Royce, Oxley, Kelly, Ney, Miller of California, Kennedy, Tiberi, Feeney, Hensarling, Davis of Kentucky, Kanjorski, Moore, Hinojosa, Baca, Lynch, Scott, Watt, Davis of Alabama, and Wasserman Schultz.

Mr. BAKER. I would like to call this meeting in the Subcommittee on Capital Markets to order.

Today, the committee meets for the purposes of receipt of additional testimony from the Honorable Armando Falcon, director, Office of Federal Housing Enterprise Oversight, on his interim report relative to accounting and management failures at Fannie Mae and the enterprise's observations as to the ongoing difficulties with these disclosures and potential recommendations for our future actions.

It, indeed, is disappointing to read press reports indicating that, in some cases, signatures that were even falsified to documents were not an incidental or irregular act of a single individual, but apparently, an ongoing business practice. This is deeply troubling in light of the underlying financial uncertainties that are already facing the Congress with regard to the capital adequacy of Fannie Mae and, to a lesser extent, Freddie Mac, and so I look forward with some anticipation to the director's information concerning these matters.

Time permitting, I would also bring to the director's attention legislation which was introduced yesterday on reform of the regulatory oversight process and to seek his insights on that legislation, if he so chooses.

Perhaps more importantly today is, after reading other press stories as of yesterday, it is my understanding the director has made clear to the White House his intention to depart his responsibility as director in the near term, and I feel I owe it to him, given our

longstanding professional working relationship, to make some comment.

As he would well acknowledge, we have had our moments. However, I would say, in the last 18 months of professional conduct, he has been more than exonerated and held in high esteem by all who have studied this matter. It has been a very difficult professional responsibility to be publicly critical of either of these enterprises, and you were held up to some significant criticism even by members of this committee on occasion. I just want to say to you that I think you have done an outstanding job and a valuable public service, to you and all members of your staff.

Should legislation be adopted, there is contained in the bill, at least as I proposed, significant rules of accommodation for transition for those in OFHEO to the new regulatory body, and this is, to a great extent, in recognition of the difficult work and, I think, the good reports that the agency has developed on the activities of the enterprises, and it is work that should not be overlooked or soon forgotten.

So, for those reasons, I commend you and wish you well in whatever future endeavors may bring you.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

We meet today to review the most recent developments concerning the special examination of Fannie Mae by the Office of Federal Housing Enterprise Oversight. As I have regularly noted in our past hearings on these matters, it is important and appropriate for our panel to conduct comprehensive and regular oversight over our housing government-sponsored enterprises to ensure that they fulfill their mission and operate safely and soundly.

At our first hearing this year, we heard from the chief accountant of the Securities and Exchange Commission about his decisions related to Fannie Mae's accounting practices. Today, we will follow up on that hearing by receiving testimony from a frequent witness before our panel, Armando Falcon, the Director of the Office of Federal Housing Enterprise Oversight. As always, I appreciate learning of his insights on these issues and, again, welcome him here.

I should also note that, because he will be leaving the agency next month, this appearance will likely be the last time that Director Falcon testifies before our panel in his current capacity. During his tenure, he has steadfastly worked to increase the agency's resources and its effectiveness.

The main focus of today's hearing is the March supplemental supervisory agreement between Fannie Mae's board and the Office of Federal Housing Enterprise Oversight. This agreement addresses additional deficiencies identified by the regulator during its ongoing special examination. These failings relate to insufficient internal controls, the improper application of accounting standards and inadequate corporate governance.

Like many of my colleagues, I am troubled by these latest revelations. As a government-sponsored enterprise with public responsibilities and private capital, Fannie Mae has a special obligation to operate fairly, safely and soundly. These newest disclosures indicate that the company fell short in meeting these responsibilities.

Nevertheless, I am also heartened that Fannie Mae, according to its regulator, is cooperating and working to address these issues in a responsible manner. I am also pleased that, although serious, these problems do not appear to pose a systemic risk, according to those most knowledgeable of the facts in these matters.

As we proceed today, I also suspect that some of my colleagues will return to the question of how best to modify the regulation of government-sponsored enterprise, including you, Mr. Chairman. It is in the public's interest that we ensure that Fannie Mae and Freddie Mac continue to operate safely and soundly. We must further ensure that these public-private entities achieve their public responsibilities for advancing home ownership opportunities.

As I said at our very first hearing on the oversight of government-sponsored enterprises in March of 2000, we need to have strong, independent regulators that have the resources that they need to get the job done. I can assure everyone that I continue to support the strong, world-class and independent regulation of Fannie Mae and Freddie Mac.

A strong and world-class independent regulator will protect the continued viability of our capital markets and promote confidence in Fannie Mae and Freddie Mac. It will also insure taxpayers against systemic risk and expand housing opportunities for all Americans.

In closing, Mr. Chairman, I commend you for your continued perseverance in these matters, and I look forward to hearing from our distinguished witness.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 26 in the appendix.]

Mr. BAKER. I thank the gentleman.

By a prior agreement of the chairman and ranking member, because of an expected recess of the committee at 11 o'clock for the address on the House floor, we have agreed to limit opening statements to the chair, ranking member.

And since neither Mr. Frank or Mr. Oxley are now present, I would make all members' statements part of the official record and move at this time to recognize Mr. Falcon for whatever statement you may choose to make, sir.

Proceed as you like. Your formal statement, as is the usual practice, will be made part of the record.

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

Mr. FALCON. Thank you, Mr. Chairman.

I will give a summary of my written testimony.

First of all, may I say thank you for your comments about the agency and my tenure there.

You, Mr. Chairman, and Mr. Kanjorski have been steadfast supporters of strong safety and soundness regulation and the agency. I appreciate that very much on behalf of the agency.

I am pleased to appear before you today to discuss OFHEO's supplemental agreement with Fannie Mae and the issues that gave rise to the agreement.

We have two objectives in our ongoing special examination of Fannie Mae. First, we must identify all the problems and fix them.

As my testimony today indicates, that task is not yet complete. Second, we must institute a comprehensive reform program to prevent problems from recurring. This program will include far stronger internal controls and corporate governance measures; an adequate investment in systems, processes and personnel; and the establishment of a corporate culture fully dedicated to compliance with the law, with GAAP and all relevant rules and regulations.

With the continued cooperation of the board and management, we expect that Fannie Mae will ultimately emerge from its troubles as a healthy, well-managed enterprise properly focused on fulfilling its public mission. That is the ultimate goal of the supervisory actions we have taken. I believe it is a goal now shared by Fannie Mae's board and its interim leadership as well.

As you are aware, last September, we entered into an agreement with the board of directors that set forth a series of matters requiring immediate attention, particularly in the area of accounting. The agreement also outlined longer-term remedial steps, such as changes in the company's compensation program and corporate structure. In addition, we required that the company maintain a 30-percent minimum capital surplus in order to address safety and soundness concerns.

More recently, we entered into a supplemental agreement with Fannie's board to address problems found by OFHEO. The agreement requires additional remedial steps in accounting policy and accounting management and expands on reforms in controls and corporate governance.

Significant among the corporate governance reforms was the requirement that Fannie Mae separate the chief executive officer and chairman of the board positions. We also required that the company report weekly to OFHEO on its efforts to meet capital requirements, including any corporate decisions on dividend payments or other matters that would affect the company's capital position.

In general, Fannie Mae has moved forward in addressing the matters set forth in our agreements. Experts have been engaged, studies undertaken, certain personnel changes have been made, and the company has formulated preliminary plans for new organizational structures and reporting lines.

OFHEO's special examination of Fannie Mae has revealed a significant number of new accounting problems at the enterprise. As with previous accounting problems, they reflect Fannie Mae's tendency towards overly aggressive interpretation of GAAP or, in certain instances, a willful disregard of accounting rules. They also reflect situations where Fannie Mae's accounting policies actually do comply with GAAP, but enterprise personnel have failed to follow those policies.

I have covered these issues in detail in my written statement, so I will not go into them further in my oral remarks.

During our special examination, we have also identified several problems involving procedures for preparing, reviewing, validating, authorizing and recording journal entries related to amortization adjustments. These issues include falsified signatures on journal entries; the failure to require that journal entry preparers determine the entries were valid and appropriate; a failure to require

that journal entries include supporting documentation, a lack of independent review of journal entries, and an absence of written policy guidance concerning journal entry procedures.

My written testimony describes the intent of our review in this area and because it is a matter under investigation, I cannot go into further detail beyond what is contained in my written statement.

As the scope of the Fannie Mae special examination has proceeded well beyond our expectations, we will need additional funds this year. Accordingly, we have used our special assessment authority to assess Fannie Mae an additional $5 million. However, while we have collected the funds, OMB has opined that due to a technical deficiency in the statute we may not spend the funds. While we do not agree with OMB's interpretation, we are bound by it.

I think this provides yet another example of why Congress must enact legislation to give the regulator the full authority it needs to do its job. Until then, I would ask the committee's assistance in resolving this funding matter.

Finally, Mr. Chairman, I would like to also end on a personal note, if I may. As you mentioned, my 5-year term as Director of OFHEO expired last October, but I have remained in the office to guide the agency through a very challenging period. With the most critical and pressing issues at the enterprises now addressed, I have decided to step down from my position next month.

I am proud of OFHEO's achievements during my tenure. The agency has successfully dealt with very serious problems at two of the largest financial institutions in the world, and we have done so without disrupting our financial markets, while allowing both enterprises to continue fulfilling their vital mission of making home ownership more affordable.

I am particularly proud of the efforts of OFHEO's employees and our conduct during the special examinations. Seldom does a safety and soundness regulator identify improper actions, with potentially billions of dollars of adverse impact, before they manifest themselves in a way that does permanent harm to the company.

It has been a privilege to serve the public as the Director of OFHEO, and I want to thank this committee for its support over the years.

Thank you, Mr. Baker. I would be happy to answer any questions the committee may have.

[The prepared statement of Hon. Armando Falcon Jr. can be found on page 30 in the appendix.]

Mr. BAKER. Thank you very much.

I do not know that your position would require you to make an assessment as to systemic risk potential, but, given the knowledge you have now gained pursuant to these inquiries, given the time it appears that the management lapse allowed practices inconsistent with GAAP to be engaged in, if unchecked, would you have had some concern about some potential future day when the numbers would not add up, the capital would have been inadequate and a systemic risk potential having been created?

Mr. FALCON. I would be concerned that, at some point in time, the problems we found in the company would manifest themselves

some way. Fortunately, we did find them before that occurred, but the practices of the company in terms of its approach towards compliance with regulations, be they accounting or internal controls or best practices in risk management, were not healthy.

Mr. BAKER. And had been engaged in on more than just, say, a single reporting quarter. This was year-over-year activity, not merely an aberrant activity.

Mr. FALCON. Yes.

Mr. BAKER. Do you have any window yet as to when Fannie would be in a position to give us certified or accurate financials?

Mr. FALCON. We cannot say with any degree of certainty right now, but I think a useful model might be to look at the Freddie Mac situation. There, it did take a couple of years for the company to produce financial statements, and it will take a couple of years beyond that to get timely. I think that might be a useful example of what might be involved here.

Mr. BAKER. There has been no resolution or determination yet made, however, with regard to the accounting treatment of the special purpose entities.

Mr. FALCON. Right.

Mr. BAKER. And I am speaking through you to Mr. Pollard because he was at a hearing not long ago relative to the First Beneficial matter in which he indicated to me at that hearing that that examination was still continuing. We do not yet have closure on any liabilities that may accrue from the transactions with First Beneficial, for example.

Mr. FALCON. Right. That is still the subject of an examination by OFHEO.

Mr. BAKER. My point in asking these series of questions is to make clear that, with your departure from the enterprise and there having been significant gains made, significant disclosures achieved, that there are matters of some consequence still pending which will require 18 months to a couple of years to get final resolution or closure. Would that be a fair statement?

Mr. FALCON. There is still a great deal of work before the agency and Fannie Mae. That is absolutely the case.

Mr. BAKER. I do not know that you would have had time, given your preparation for your appearance here today, to be familiar at all with the provisions of the bill now introduced relative to the creation of an enhanced regulator. Do you have any comment to make about the provisions that are included in the bill generally, or is there a specific area of concern you would like to bring to the committee's attention you do not feel is addressed by the bill?

Mr. FALCON. As you said, I have not had a chance to go through much of the details of the bill, but I think the intent of the legislation to provide the regulator with authorities on par with every other safety and soundness regulator is progress. Anything which fills the gaps in the regulator's authority to do its job would be a positive step forward. Beyond that, the details of any particular provision, I have not had a chance to review them.

Mr. BAKER. There has been some discussion primarily led by Chairman Greenspan as to the advisability of limiting the growth or even further reducing the size of the existing investment portfolio, as it is his view, according to press reports, that it does not

have a correlation to housing function. He had suggested even a hard-dollar limit of some $200 billion down from the $1.6 trillion currently engaged. Do you have any opinion as to whether it is advisable or not to have further restrictions on growth at the least or to pursue the reductions over time, in your view?

Mr. FALCON. The company does need to retain a portfolio of some amount towards liquidity needs. I think that is very evident. What that amount is I could not tell you where any cap should stand.

Mr. BAKER. But $1.6 trillion is more than adequate.

Mr. FALCON. Yes. It is clear, I think, that the current levels are more than adequate to provide for their legitimate safety and soundness needs for their risk management purposes. How much below the current levels would be necessary and then how much beyond that simply for other purposes would require some study.

Mr. BAKER. And it would be your concern, I presume, that if they were precipitously lowered over too short a period of time, that could have adverse consequences for the enterprises?

Mr. FALCON. Yes.

Mr. BAKER. Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

On the insufficient internal controls and improper application of accounting standards to meet adequate corporate governance, what did your final examination show, how long a period that existed—just in the last year, the last 2 years, the last 5 years, the last 10 years—or has it been endemic to the organization?

Mr. FALCON. It varies by issue, Congressman. There was one lapse in their systems that dated back 21 years, other matters may have taken place in the last 1 or 2 years, but, generally, I would say that they fall within the last 4 years or so.

Mr. KANJORSKI. I am concerned about, first of all, are these lapses. Are they of huge significance where they could put at risk the safety and soundness of the organization, or are they not that significant?

Mr. FALCON. I view the weaknesses in internal controls as very significant. As you know, there are many examples in history where lapses in internal controls have brought down large old financial institutions almost overnight. Barings Bank is one example of how internal controls can bring down a company, even a well-capitalized company. So lapses in internal controls, even though we often speak of them after the accounting issues, I think, are just as, if not more, serious than the accounting problems.

Mr. KANJORSKI. Were these lack of internal controls you found really substantial, though, in this particular instance?

Mr. FALCON. I think they were substantial. I do think they were because there were almost no controls in some instances. There was one example where one employee was allowed, through the lack of internal controls, to make a change in an accounting formula on the spreadsheet that resulted in an improper reporting of a billion dollars. It is that type of lack of internal controls that concern me. With proper internal controls, one employee could not go and make those changes without a couple of layers of verification before changes like that are made.

Mr. KANJORSKI. Well, I guess I do not sufficiently understand the nature and focus of the regulator's involvement, but what sort of

bothers me here is that your testimony says, in one instance, this problem existed over 21 years, and then substantial internal control failure.

Why wasn't this picked up by the regulator over the last several years or the last 10 years? That is what I do not quite understand. Is it because you did not get depthfully involved in the books before?

Under prior testimony before the committee, I understood that you were sort of like a meat inspector at a meat plant. You are there on a day-to-day basis and you watch the whole process as it evolves and you sit at their internal audit exit meetings and that you are made aware of everything that the corporate governance entity is made aware of.

Why didn't you pick this up? What is the why?

Mr. FALCON. I think you are accurate in your reasoning. It is the need to do things with adequate depth. When I took over the agency, we had 30 examiners, and I had our examination staff do a review, a benchmarking study, comparing our program to other regulators and how many examiners they would have on staff to supervise two companies of this size.

This benchmarking study showed that on average another regulator might have 60 or so examiners per institution. We were working with 15 examiners per institution, which is why we have moved over the last 5 years to try to increase our resources. I wish I had the number of examiners that I have today back then. Perhaps we would have had the ability to catch many of these problems.

Mr. KANJORSKI. But why didn't we catch some of them? I have been under the impression that over the years both Freddie Mac and Fannie Mae were fairly well-run organizations, and, every time we have had hearings over the last 5 years on this subject, that is what we were led to believe by both the regulators and by the company.

Now maybe some of the people that were testifying on behalf of the company did not even know these problems—is that your testimony—or their absence of knowledge is in itself a governance problem?

Mr. FALCON. I think many of these internal control problems revolve around accounting procedures and the recordkeeping activities of the company, and this is an area we have not looked at traditionally. Safety and soundness regulators rely on the outside audit function to do its job properly.

We have never second-guessed the external auditors to make sure that the company's statements are compliant with GAAP. That is the role of the external auditor, and only after the accounting problems were uncovered did it become very apparent that controls around the accounting activities of the company and its financial systems were inadequate.

Mr. KANJORSKI. So what you are telling us now is not only the internal accounting, it is also their external auditor that participated in this misrepresentation, either by omission or commission, and I would like you to sort of specify. Do you think it was by omission, or were they participants in it?

Mr. FALCON. Well, it is clear that the external auditor—in this case, KPMG—certified financial statements as compliant with

GAAP that we now know, obviously, were not compliant with GAAP. We are examining the question of whether that was just the result of inadequate work done by the auditor or was it the result of some complicity on the part of the auditor.

Mr. KANJORSKI. You have not determined that?

Mr. FALCON. No, Congressman.

Mr. KANJORSKI. Under present law, does the regulator have authority to not only punish the corporation or extract some fine or fee from the corporation but also from the other contracted parties, like the auditor, if errors like this are made? In other words, can you assess that auditor some penalty?

Mr. FALCON. We do not have that explicit authority. What we could possibly do is limit the company's ability to do business with certain counterparties.

Mr. KANJORSKI. What risk does the accounting firm run if they do not come forth with accounting principles that are according to GAAP? If they miss those either by omission or commission, are they at any risk or is that part of the game, do it so that you have a client and satisfy the client's needs?

Mr. FALCON. I think that spreads more to the responsibility of the PCAOB to examine whether or not the auditor in this instance properly did its job, and they are involved in that type of review.

Mr. KANJORSKI. Okay.

Thank you, Mr. Chairman.

Mr. BAKER. As much as is practicable, given our potential 11 o'clock recess, I am going to try to stick to the 5-minute rule pretty strictly to give as many members as possible a chance to be heard.

Mr. Shays?

Mr. SHAYS. Thank you.

Mr. Falcon, I wish you well in whatever you do in the future, and I thank you for your service to your country and in this capacity.

Having said that, I wish you were as good earlier as you have been in the last few years.

I want to understand why OFHEO became more aggressive. I felt like—and I will just say this—you basically were almost created by Fannie Mae and Freddie Mac in that you were doing what they wanted rather than what Congress needed until the last year or two. What explains, though, the difference in approach that you have had?

Mr. FALCON. With the resources available to us in more recent years, it allowed us more flexibility to cover more areas and, certainly, when the problems of Freddie Mac became apparent, it did illustrate a particular area where we needed to focus more of our attention, as traditionally we had not. So really, with the additional resources, it provided us with the means to become more thorough in how we went about examining the two institutions.

Mr. SHAYS. Well, I believe if you had done what you have done in the last year, we would not even be talking about a new regulator, and that is the sad part of this because we had Mr. Raines come before us, challenge your last findings, almost arrogantly dismissed it, and I thought you were very forceful and, frankly, somewhat courageous, and the SEC backed what you all had determined.

So I think you are going out in a way that is important, but it is sad that we never got a handle on Fannie Mae and Freddie Mac sooner. That is what is sad.

I would like to just ask you in regard to the illegal entries, the forged entries, what is the significance of it? I mean, I know they were illegal. Whose signatures were forged? And what is the significance of that? What does it mean? I want to understand what it means. I know it was illegal, but what does it mean in terms of its impact on the accounting?

Mr. FALCON. There was a breakdown in the integrity of the process by which financial statements are produced. The financial statements are produced from the ledgers of the company, and the ledgers' data is entered through preparers who will——

Mr. SHAYS. Well, was it false information besides forged signatures?

Mr. FALCON. This was related to the amortization entries. In our September report, we referred to some FAS 91 accounting.

Mr. SHAYS. Can you answer the question, though? I mean, were the amounts inaccurate?

Mr. FALCON. Yes, the amounts were improper under accounting rules. These were the so-called catch-up amounts that were adjustments.

Mr. SHAYS. Do we know how high it goes up in the organization?

Mr. FALCON. We do not at this time, but we are looking into that.

Mr. SHAYS. Yes. Is your statement as comprehensive as your knowledge of this, or are you saying less in your statement than you know?

Mr. FALCON. We are doing much more work in this area and, because of the sensitivity of it, we have only said what we thought might be appropriate to provide the committee with information, not do anything which might undermine our efforts.

Mr. SHAYS. So there is more to this story that you know that you are not really feeling comfortable to disclose.

Thank you, Mr. Chairman.

Mr. BAKER. I thank the gentleman.

Mr. Davis?

Mr. DAVIS OF KENTUCKY. Thank you, Mr. Chairman.

Mr. Falcon, I certainly wish you well as you move into another phase of your career.

Let me bring up a subject that, frankly, we have not talked about a lot this morning. As you know, there was an inspector general's report that I think came out back in December, if I am not mistaken. I think it happened while we were in recess. It may be that Congress was here for a day on the homeland security bill, but it was basically during a recess period, if I am not mistaken. I am sure the chair will correct me if I am wrong. If I am not mistaken, I do not think that we have had a hearing on the inspector general's report.

Have you reviewed the other contents of the report, Mr. Falcon?

Mr. FALCON. I have.

Mr. DAVIS OF KENTUCKY. And respecting my 5-minute timeframe, we do not have an opportunity to get into all of it, but my recollection of it is that there were some fairly stinging criticisms

of OFHEO that were contained in that report. Do you agree with that?

Mr. FALCON. Yes.

Mr. DAVIS OF KENTUCKY. I recall one observation in the report that OFHEO acted not as a disinterested party, but that OFHEO may have acted in a fairly aggressive way toward Fannie Mae, that it may have overstepped the bounds of being disinterested. Was that one of the observations in the report, as you recall it? I am not asking if you agree with it. Was that one of the observations?

Mr. FALCON. It has been a while since I have read it. I could not tell you all the details of it.

Mr. DAVIS OF KENTUCKY. So is that a pretty fair characterization, that the report critiqued OFHEO for not being a disinterested regulator?

Mr. FALCON. I think it was, yes.

Mr. DAVIS OF KENTUCKY. Well, obviously, OFHEO was still in existence, and so we do our task of creating a new regulator, which I think there is wide consensus that we will. Obviously, I presume that that report has some relevance to you in the last weeks of your tenure. I am a little bit concerned about the fact that you have not reviewed it in a while.

More importantly, can you tell me what steps, if any, OFHEO has taken to respond to any of the criticisms identified in the inspector general's report?

Mr. FALCON. I am not sure that any response was warranted.

Mr. DAVIS OF KENTUCKY. Was there any corrective action?

Mr. FALCON. The Justice Department, the Department of HUD determined that we had done nothing improper, and so that was the end of it.

Mr. DAVIS OF KENTUCKY. Did you make your own independent assessment of the report and its accuracy?

Mr. FALCON. I did.

Mr. DAVIS OF KENTUCKY. And what were your conclusions?

Mr. FALCON. I disagreed with the criticisms.

Mr. DAVIS OF KENTUCKY. I do not mean this pejoratively towards you, but I am having a mental picture in my mind that when you all came up with your report on Fannie Mae, Mr. Raines and Mr. Howard, I think, sat there, and they said fairly forcefully that they disagreed with your conclusions.

What suggestion would you offer us, Mr. Falcon, as to what you think this committee or this Congress should be doing to look at that report and to learn from it, because, obviously, as we create a new regulator, we are going to try to make sure they do a better job, frankly, than you all did. I would think that it is relevant what is contained in that report. What would you suggest Congress do, or do you think it would be appropriate, for example, if Congress had a hearing on that report?

Mr. FALCON. I think you should use the report as you would like, Congressman, but, as I said, the matters were reviewed by agencies outside my own and they determined there were no rules or laws broken, and that was the end of it.

Mr. DAVIS OF KENTUCKY. What about the portion of the report that said that there was contact between OFHEO and between some news organizations? Do you recall that part of the report?

Mr. FALCON. Vaguely.

Mr. DAVIS OF KENTUCKY. Well, now you say you recall it vaguely. That strikes me as being a fairly serious allegation, isn't it?

Mr. FALCON. I think agencies have contacts with the press all the time.

Mr. DAVIS OF KENTUCKY. Well, contacts with the press regarding a confidential document that was only meant for the board of directors of Fannie Mae. Presumably, that does not happen all the time, does it?

Mr. FALCON. I am not sure what you are referring to.

Mr. DAVIS OF KENTUCKY. Well, again, speeding along, as my time is about to run out, my recollection is there was a portion of the IG's report that said that there had been some leaking or some dissemination of the confidential report in a manner that would have violated OFHEO's internal standards. Tell me what steps you took to investigate that allegation that there were improper contacts regarding confidential documents.

Mr. FALCON. The matter was entirely investigated by the inspector general's office.

Mr. DAVIS OF KENTUCKY. What did you do as the person who runs OFHEO? Did you take any steps of your own?

Mr. FALCON. I do not know. I cannot tell you what the source of any leaks on any matter on any given day were.

Mr. DAVIS OF KENTUCKY. Did you investigate them?

Mr. FALCON. I cannot consume my time with trying to pursue it.

Mr. DAVIS OF KENTUCKY. Did you investigate it?

Mr. FALCON. I do not recall what it was, specifically what the document was. I do not.

Mr. DAVIS OF KENTUCKY. Well, I would assume this observation, Mr. Falcon, because my time is running out, I hope that, as we do construct a new regulator, that, frankly, that regulator is a little bit more attentive to the possibility that there could be problems in its own house because I am not sure that you have been sufficiently so in the last few months, but I do wish you well in the private sector.

Mr. BAKER. The gentleman's time has expired.

Mr. Hensarling?

Mr. HENSARLING. Thank you, Mr. Chairman.

Well, Mr. Falcon, I want to congratulate you for your service to your country, and I believe you are a gentleman who was tasked with a very important mission and one for which many of us believe you had insufficient resources in which to accomplish the mission that you were given.

Let me ask a few questions about your examination in regard to Fannie Mae not applying its own policies with regard to SSAS 65 as it relates to the booking of loans for sale or investment. I think that you have indicated that the problems with accounting for these loans were recently discovered, but the practice had been ongoing for over 20 years.

So how can Fannie be unaware that they were in breach for over 20 years and, indeed, how was it that, over a 20-year period, OFHEO did not discover this breach?

Mr. FALCON. It was just an error in their systems, which was not uncovered until the systems were upgraded in 2004. It was such

a precise error in, I believe a drill-down type issue that was not the type of thing that we caught.

Mr. HENSARLING. It is my understanding that when OFHEO discovered accounting problems at Freddie Mac that the executives of Fannie stated that they had reviewed all of their internal accounting practices and policies and that they had found no violations. We have since, obviously, learned, according to you, according to the SEC, that there have been a number of GAAP violations. So do you believe that OFHEO and this committee were purposely misled by executives at Fannie?

Mr. FALCON. I think that is certainly something that we are reviewing in the course of our special examination. While we do believe in certain instances there were willful violations of accounting principles, whether or not that was hidden from us or from the Congress is something we are still determining.

Mr. HENSARLING. Could it be said if de facto Fannie had the ability to designate their securities for accounting purposes as either held for investment or held for sale that that would give them an advantage over their competitors in the marketplace?

Mr. FALCON. It would provide certain accounting benefits if they were to classify some assets as held to maturity versus available for trading. Then they would not have to recognize any loss in market value in those assets. That is certainly the case.

Mr. HENSARLING. I think also in your testimony you indicated that, although a number of Fannie's policies were not GAAP compliant, obviously, a number of them were, but that Fannie personnel failed to follow through on these policies. So are there particular individuals who are being investigated for knowingly violating these GAAP principles?

Mr. FALCON. We are looking at the role that various employees of the company had in both the promulgation of the accounting policies as well as the role in the implementation of the policies. So you cover both ends. One, how is the improper policy formulated and adopted? And, secondly, if it was crafted properly; why wasn't it followed? That is the subject of further review by us.

Mr. HENSARLING. To speak somewhat prospectively in the limited amount time I have left, as you know, our Chairman Baker has introduced a comprehensive piece of legislation dealing with a new regulator for the GSEs, and I know that you have not had an opportunity to examine the particulars of that piece of legislation, but, conceptually, do you think that the GSE safety and soundness regulator should also have the authority of new programs and new activity review from your experience? If so, why?

Mr. FALCON. I think it should. The safety and soundness regulator is going to learn about these new activities anyway. We have to assign capital to them. We have to make sure that the risk of any new activities are properly managed so we will be intimately familiar with how those activities will impact the company.

Every other safety and soundness regulator also has a responsibility, when it conducts that review, to make sure that the activity is consistent with the terms of the charter of the entity. Compliance with laws, rules and regulations does also rise to a safety and soundness issue, so it is just a natural fit that both happen at the same place.

Mr. BAKER. The gentleman's time has expired.

Mr. Watt?

Mr. WATT. Thank you, Mr. Chairman.

Mr. Falcon, thank you for being here.

I want to change the focus from what we have been talking about to something else. I really have no interest in focusing on Fannie or Freddie's shortcomings in the past or your or OFHEO's shortcomings or successes in the past or on this committee's oversight shortcomings or successes in the past.

Throughout this process, my interest has been in the housing function, the housing mission of Fannie and Freddie, and on that, on page 11 of your prepared testimony, you come closest to addressing that issue.

You say during your tenure, "The agency has successfully dealt with very serious problems at two of the largest financial institutions in the world. We have done so without disrupting our financial system," which, of course, is true, but it has had some financial impact, and then you go on to say, "while allowing both enterprises to continue fulfilling their vital mission of making home ownership more affordable," which also, of course, is true because the mission is going on.

My concern is that there has, obviously, been some disruption of the ability to do the housing mission. Has your agency made any assessment of what impact this investigation and these financial disclosures have had on the ability of Fannie and Freddie to aggressively pursue the housing mission? I am not trying to assess whether that investigation went right or wrong. Obviously, it turned out to be right.

But what impact, if any, can you tell us this has had on aggressive pursuit of the housing mission and, more importantly, how can we more aggressively pursue that housing mission either through Fannie and Freddie or otherwise as we go forward in the structure of the regulatory institutions we put in place?

Give us whatever suggestions, as you have experienced this, both on the staff, in your regulatory position. What suggestions do you have for us about how we can more aggressively pursue the housing mission?

Mr. FALCON. I think the guaranteed side of their business where they purchase qualifying affordable housing goal type mortgages, that does continue, and it is proceeding at a healthy pace. Despite the problems the company has with their accounting issues and internal control problems, that side of the business remains sound.

So I can give you some comfort there, that while we are having to take some supervisory actions with the company to make sure that they continue to be as aggressive in fulfilling their mission as possible, when we get these other issues addressed properly over time, it will not deter them from continuing their guarantee side of their business.

I have always looked at our responsibility at OFHEO as part housing mission. A company that is experiencing severe financial difficulties is going to constrain the amount of work it can do in fulfilling its mission, and so the greater extent to which we can make sure that the company does not get into any kind of trouble

makes sure that there is no interruption in their ability to continue to fulfill the mission and innovate.

With a fully authorized, well-resourced regulator, I think there would be a good safeguard to make sure that there are not unnecessary interruptions in the company's business as a result of safety and soundness problems. The sooner we can get in there and identify and fix problems before they manifest themselves in the form of larger problems, I think, is only a benefit to the company's mission. A strong safety and soundness regulator is part of that.

Mr. BAKER. The gentleman's time has expired.

Just by way of notice to members who have——

I am sorry, Mr. Watt.

Mr. WATT. Mr. Chairman, could I have him address the prospective suggestions?

Mr. BAKER. Sir, please. That is all right. Okay.

Mr. FALCON. Prospectively, I think you could look at other examples of what has been done at other agencies. The AHP program of the federal home loan bank system is one possibility where you have some dedicated amount of funds that are used towards affordable and low-income housing.

But I would like to also think about it and possibly get back to you, Congressman, if I may.

Mr. WATT. That would be great. That way, it will not disrupt the chairman's schedule. I thank you. I would welcome any suggestions you have because I think you have a picture of this that probably is unique now, given your years of service in a number of different capacities. So I would welcome those suggestions.

Thank you, Mr. Baker.

Mr. BAKER. The gentleman's time has expired.

By way of prior announcement, we will likely adjourn shortly after 11 o'clock. I am told that the full committee will have a meeting commencing at 1 o'clock. They need to have access to the room by at least 12:30. The matter is on the floor. We will probably keep members beyond 12 o'clock. So, as members can expedite their comments, otherwise, we will have to take every member's comment and put it into the record for response. I will forward to the witness, if you so choose.

The next person here is Mr. Ney. You are up.

Mr. NEY. Thank you, Mr. Chairman.

On Monday, April the 4th, OFHEO—I think it was about a year in the making—added to their corporate governance rule. It takes effect in 60 days. What does that mean for Fannie?

Mr. FALCON. I think it is an important addition to our corporate governance measure that we have taken at the agency. It does include more guidance to the company in regards to the board of directors, the activity of the board, and it works to ensure that there is strong oversight exercised by the board. We think it is a good addition to a corporate governance rule that we already had out there.

Mr. NEY. Also, Fannie was given until September of this year, and that was to meet the 30 percent capital, and I think that was an extension. It was a 90 more days' extension.

Mr. FALCON. Originally, it was the end of June.

Mr. NEY. Do you believe they will be able to reach that goal?

Mr. FALCON. We monitor it very closely, and the plan that they have submitted to us does indicate that if everything happens as planned that they will meet the goal. If at any point between now and the end of September it looks like there are problems, then we will work with the company to make adjustments in the plan so that they can meet it by the end of September.

Mr. NEY. If they do not meet it, what happens?

Mr. FALCON. If they do not meet it, we will have to determine what additional remedial steps might be necessary in order to make sure that they can come into compliance with it as soon as possible.

Mr. NEY. People have raised today the issue with whether it was 20 years gone undetected or 5, you know, and that has been raised several times, and Fannie had brought this out to the attention of OFHEO actually about this problem that had been over a 20-year period.

I guess the question I have is: How did they not know and how did OFHEO, though, not know or, you know, over a certain period of time, you know, that they were operating in a faulty and inaccurate way?:

Mr. FALCON. This was a very technical problem in their accounting systems. Assets that were being classified as either available for sale or held to maturity were properly designated by the company at the time of purchase. However, the system itself categorized everything as held to maturity, and that was just not uncovered until 21 years later.

Mr. NEY. So it was more of a technical problem than something that was conspired to do this and not be found for 20 years.

Mr. FALCON. Yes. That is what we expect by that.

Mr. NEY. Can we expect another capital assessment of Fannie by OFHEO?

Mr. FALCON. Capital assessment? Yes, Congressman.

Mr. NEY. Or capital adequacy to report under.

Mr. FALCON. Yes.

Mr. NEY. The GSEs, I should say, not just Fannie Mae.

Mr. FALCON. Yes. We typically classify the enterprises at the end of every quarter for the previous quarter and, at the end of March, we would typically classify both. We only classified Freddie Mac. We are continuing to have discussions with Fannie Mae about their capital classification.

Under the terms of our regulation governing this, they have 30 days to comment on our proposed classification, and that is where this currently stands. When they give us their comments, we will take them into consideration and then determine what the proper classification will be.

Mr. NEY. Okay. Good luck with your ventures down the road.

I want to thank Chairman Baker for having this hearing. Thank you.

Mr. BAKER. I thank the gentleman.

Mr. Baca?

Mr. BACA. Thank you very much, Mr. Chairman.

Mr. Falcon, thank you very much for being here today.

As you know, I support a strong well-funded regulator, and I also support the work of Fannie Mae in providing—I say in providing—

housing to the underserved. Do you believe you have the necessary expertise within your agency to regulate GSE in a productive manner in an ever-growing complex market?

Mr. FALCON. I do, Congressman. I am very proud of the talented people we have at the agency.

Mr. BACA. When do you believe this process will be over because, in your report, you indicate that you have two objectives in an ongoing special examination of Fannie Mae. The first was to identify all the problems and fix it. In your testimony, you indicate that you have not completed that. There is also the second portion: Does the comprehensive reform program provide problems with recurring?

Mr. FALCON. Well, we would like to get it done as soon as possible. It is in our interest, the company's interest, and I know you would like to see it done as soon as possible.

I hesitate to give you a specific timeframe because just the new re-audit of the company by the new external auditor may possibly continue to uncover issues, even if we feel like our review is close to being brought to a conclusion. So we really need to work closely with them as they do their accounting review as well as ours.

I know that is not a good answer, but it is hard for me to pinpoint it. Our goal is to try to get it done as soon as possible.

Mr. BACA. Given the importance of the entity to home ownership, how will you know when you have fulfilled your obligation as a regulator thoroughly and fairly—and I say thoroughly and fairly—so that Fannie Mae can continue to further its home ownership in the country in a manner that is safe and sound?

Mr. FALCON. I think when the company has addressed the issues related to proper accounting policies, adequate internal controls and any additional remedial actions that have taken place, when the company is able to submit timely financial statements to the SEC, I think when all that comes together, we will feel comfortable that the company has put itself back on a solid footing, and that is the time that we would begin to consider lifting some of these supervisory steps that we have taken, like the 30 percent capital surcharge.

Mr. BACA. Are you providing guidance or assistance or training at this point to make sure that there is adequate accounting that is done, because that is part of the process and part of your auditing report, and that was the problem, I believe, that Davis asked originally when it was leaked out to the media without allowing them to correct their own particular problems before it went out. So are you now then providing the guidance, the training to assure that the proper accounting is done, the procedures and policies are followed?

Mr. FALCON. We are, and the board is also very actively engaged in this also. The company is working to retain many qualified individuals in the accounting field so that the company can begin to develop proper accounting policies, but we are working with them very closely.

Mr. BACA. Can you clarify the views of the amount of capital that Fannie Mae should have and how you arrive at that number? That is question number one.

And two is: Can you give a sense of under what condition you would be satisfied with remediation procedures not required to excess capital?

Mr. FALCON. Well, current capital levels are contained in the statute, 2-1/2 percent for on-balance sheet assets and 45 basis points for off-balance sheet. When we see safety and soundness concerns at either company, we exercise our discretion to require additional capital, but just for the time period where we see problems at each company.

Whether or not a permanent minimum capital level should be higher than 2-1/2 percent, we would have to study that issue a little more closely.

Mr. BACA. Okay. We know that Fannie Mae has taken a number of steps to address the problems that are very positive, even the change in its leadership right now because of its services. My question and final question would be: You indicated in your statement that OFHEO became more aggressive as resources became available. Who went after the resources, and why did they go after the resources to make sure that they were more aggressive?

Mr. FALCON. We have been pursuing additional resources since I first got to the agency. As I said earlier, it became very evident to me when I assumed my position that we just did not have adequate resources to properly fulfill our mission at OFHEO and, from the very beginning, I have been seeking to increase the agency's budget, and we have had much success in that. With the committee's support, our resources have increased.

Mr. BAKER. The gentleman's time has expired.

Mr. BACA. Hopefully, you will apply the same standard to other entities to as well have the same standards, same policies, same procedures and same aggressiveness in holding everybody else accountable as well.

Thank you.

Mr. BAKER. I thank the gentleman.

Chairman Oxley?

Mr. OXLEY. Thank you, Mr. Chairman.

Mr. Falcon, it is good to have you back, and, based on your announcement yesterday, I want to wish you Godspeed and success in whatever you do. You have led the OFHEO folks at a very difficult time and have done remarkable work, and our sincere congratulations and best wishes to you.

Let me ask you. The last time that OFHEO discovered accounting problems at Fannie, the SEC was engaged to determine whether Fannie needed to restate earnings. Based on your testimony and the recent discovery, will that process be followed as well, or has the SEC already made a determination in terms of whether Fannie Mae was GAAP compliant?

Mr. FALCON. The process that was followed previously, Mr. Chairman—by the way, thank you for your comments—was an extraordinary set of circumstances. Typically, the process involves the regulator working with the company and the company's external auditor on resolving any accounting issues that arise and, with the issues related to FAS 133 and 91, Fannie Mae decided to seek the input of the SEC on those accounting issues. So the SEC did provide guidance on them.

In this case, that has not happened. We are working with the company. We have met with the SEC to review these additional issues with them and have kept them fully apprised of what we are finding and answering any questions they may have, but the SEC is working with us under the standard process for these types of matters, and they have not been asked to intervene with a formal interpretation or answer like they were previously.

Mr. OXLEY. That could happen at some point, but it just depends on how the negotiations go with the private entity?

Mr. FALCON. It could, Mr. Chairman.

Mr. OXLEY. Okay.

Your testimony raised some concerns about internal controls at Fannie Mae, and that has been, obviously, an ongoing issue in corporate America for the last 3 or 4 years. I guess my question is: What role does OFHEO play in the whole issue of internal controls vis-a-vis the SEC and perhaps the Public Company Accounting Oversight Board? How does OFHEO's role fit into the overall issue of internal controls?

Mr. FALCON. We do work closely with PCAOB on this, and we have. They participate in many of the sessions and meetings that we have had, and, obviously, we have worked very closely with the SEC.

As a safety and soundness regulator, we do examine very closely for internal control deficiencies. In addition, obviously, under Section 404 of Sarbanes-Oxley, companies are required to certify the adequacy of their internal controls. So we work very closely to make sure that certain minimum, if not best practice, standards with regards to internal controls are met by the company, and we apply these standards through our examination program.

In addition, because of Sarbanes-Oxley, there are certifications that are required on the part of management so they have their own strong incentives now to make sure that internal controls are adequate. Where we see issues related to accounting disclosure matters that require some review by the SEC, we will have discussions with the SEC. We have a very good working relationship with them.

Mr. OXLEY. Is it fair to say then that the internal controls issue as it relates not just to a financial company in a general sense, but more particularly to a GSE is treated somewhat differently than say a steel company or an oil company?

Mr. FALCON. I would say not just because they are a GSE, but because they have a safety and soundness regulator. I think that the same levels of internal control review that we apply to Fannie Mae and Freddie Mac would also be applied with respect to any bank or thrift that is regulated by a safety and soundness regulator and that might very well be different from the type of internal control review that is applied with respect to a steel company.

Mr. OXLEY. Thank you.

Mr. Chairman, I just want to again compliment Mr. Falcon for his leadership and also to recognize Mr. Blumenthal. I know Mr. Falcon as an alumnus of this committee in his former iteration as the Banking Committee, and Mr. Blumenthal, who will be named as interim in your position, was a very able staffer over in the com-

mittee across the hall that I served on for a few years, and we look forward to working with him as well.

Thank you, Mr. Chairman.

Mr. FALCON. Thank you for your comments, Mr. Chairman.

Mr. BAKER. Thank you, Mr. Chairman.

I am advised that floor proceedings have now been initiated, and, at this time, I would ask members who have additional questions to please submit them for the record. We will get responses from Mr. Falcon.

I wish to again extend our appreciation to you for your appearance here today and for your good work.

Our meeting now stands adjourned.

Mr. HINOJOSA. Mr. Chairman, may I ask unanimous consent——

Mr. BAKER. Yes, Mr. Hinojosa.

Mr. HINOJOSA.——that the opening statement be part of the record?

Mr. BAKER. Yes, sir. All member statements have been made part of the record, and the record will remain open for 5 days for any additional correspondence members may choose to forward.

Mr. HINOJOSA. Thank you.

Mr. BAKER. The meeting stands adjourned.

[Whereupon, at 11:07 a.m., the subcommittee was adjourned.]

A P P E N D I X

April 6, 2005

Prepared, not delivered

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

Additional Accounting and Management Failures at Fannie Mae—- OFHEO's Efforts to Ensure Safe and Sound Operations
Wednesday, April 6, 2005

I want to welcome Director Falcon back to the Committee this morning. Director Falcon, following your announcement yesterday, we want to wish you the best in your future endeavors, and we should note your good work at OFHEO under trying circumstances. For those members who may not be aware, Director Falcon is an alumnus of the old Banking Committee, and I know you all join me in wishing him well.

This morning, we plan to discuss the recent agreement between OFHEO and Fannie Mae's board of directors, as well as the regulatory reform of the GSEs. I am also interested in learning more about the recently approved corporate governance rule issued by OFHEO which embodies the principles of the Sarbanes-Oxley Act.

Since the 106th Congress this Committee has held 21 hearings and has heard from 100 witnesses on GSE related matters. Director Falcon you are the 101st witness to testify before the Committee on GSE issues. Chairman Baker should be commended for his hard work in monitoring the GSEs over the years, and I am proud to be a cosponsor of the legislation he introduced yesterday to create a new GSE regulatory agency. This legislation will grant the agency the necessary powers to ensure the safe and sound operations of these complex enterprises. I would encourage my colleagues to join in support of this legislation.

In April 2003, we were all led to believe that the GSEs were running smoothly with only a routine accounting restatement in progress at Freddie Mac. What we have learned since then is that these enterprises were involved in revenue smoothing, the misapplication of accounting standards, and irresponsible corporate governance. The Federal Home Loan Bank System has also had its share of problems over the years with accounting problems and insufficient management. It is time for a new oversight structure for the GSEs that will give the regulator the tools it needs to prevent these problems from developing and permit swift action when problems do arise. It is our duty to structure a strong regulator to ensure that the housing market, the taxpayers and the financial system as a whole remain safe.

I hope to learn more details of the recent OFHEO agreement and why the Director felt it necessary to mandate new controls for revising, validating, authorizing and recording journal entries in the general ledger at Fannie Mae. Did the OFHEO special investigation uncover fraudulent activity at the enterprise? Were executives making changes to the general ledger without documenting these changes? I am also interested in additional details of the extent of the accounting problems to date.

We have heard from some that Congress should be cautious in its efforts to create a new regulator and that we need to be mindful not to harm the housing market. In truth, the housing markets are being threatened now by all of the various accounting and regulatory problems at the GSEs and by the lack of a regulatory agency with real power and real authority. A regulator with enhanced powers will ensure that our housing finance system recovers and becomes stronger and more resilient in the future.

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Opening Statement

Congressman Paul E. Gillmor (R-OH)

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

April 6, 2005

Hearing entitled: "Additional Accounting and Management Failures at Fannie Mae – OFHEO's Efforts to Ensure Safe and Sound Operations."

I want to thank Chairman Oxley and Chairman Baker for calling this hearing to discuss management failures at Fannie Mae and the recent agreement between the Fannie and OFHEO reached on March 7th. I am interested in hearing Director Falcon describe OFHEO's efforts to respond to recent scandals alleging accounting violations, internal control issues and corporate governance issues that could result in a restatement of earnings of more than $12 billion dollars. The March 7 agreement addresses some of the governance issues that this Committee has been looking at over the past few months but without a stronger regulator, we will have not done enough to ensure the safety and soundness that is sorely needed.

While I understand that Director Falcon will soon be leaving OFHEO, I look forward to hearing his suggestions for legislation and ways in which this Committee can create a stronger regulator able to provide safety and soundness to both the GSEs and the market.

Thank you again, Mr. Chairman, for scheduling this hearing and I look forward to an informative session.

OPENING REMARKS OF THE HONORABLE RUBEN HINOJOSA
HOUSE COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS
"ADDITIONAL ACCOUNTING AND MANAGEMENT FAILURES AT FANNIE MAE – OFHEO'S EFFORTS TO ENSURE SAFE AND SOUND OPERATIONS"
APRIL 6, 2005

Chairman Baker and Ranking Member Kanjorski,

I want to express my sincere appreciation for you holding this hearing today, and I want to welcome Director Falcon back to our Subcommittee. I look forward to his testimony.

Yesterday, Full Committee Chairman Oxley and Subcommittee Chairman Baker introduced the "Federal Housing Finance Reform Act of 2005." According to the Dear Colleague I received, the legislation will create a new, independent regulatory agency headed by a Director with authority over safety and soundness, as well as mission supervision. The Agency will supervise Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System. The Agency will have broad authority to regulate minimum and risk-based capital. The bill vests the Agency with the ability to approve new programs, and it establishes a structure to place a failed GSE into conservatorship or receivership.

I have not had time to review the bill because it was introduced only yesterday, but I intend to review it carefully and cautiously to determine whether to cosponsor it. As part of that process, I will compare it with its Senate counterpart introduced by Senators Hagel, Sununu and Dole. The Senate bill includes a very important provision on compensation at the GSEs.

As most of us are aware, OFHEO issued a report stating that Fannie Mae applied accounting methods that did not comply with Generally Accepted Accounting Principles (GAAP). On September 27, 2004, the Fannie Mae board of directors entered into an agreement with OFHEO to take actions in areas of capital, accounting, staffing, compensation, governance, and internal controls. Under this agreement, Fannie Mae was required to achieve a capital surplus equal to 30% of the enterprise's minimum capital requirement within 270 days. Fannie Mae must maintain this capital level until OFHEO's Director decides that the surplus requirement should be modified or ended. Fannie Mae also agreed to recalculate various accounting treatments over several years.

In December 2004, the SEC found that Fannie Mae's accounting for certain derivatives were not GAAP compliant and directed the enterprise to restate its previously reported financial statements, recognizing that Fannie Mae had overstated its earnings by an estimated $9 billion in core capital. In response, OFHEO classified Fannie Mae as significantly undercapitalized.

Since that time, Fannie Mae has issued $5 billion in preferred stock and cut its common stock dividend by 50%. Fannie Mae was given an additional 90 days, until September 30, 2005, to reach its targeted 30% capital surplus.

Having said that, I yield back the remainder of my time.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON ADDITIONAL ACCOUNTING AND MANAGEMENT FAILUERS AT FANNIE MAE

WEDNESDAY, ARPIL 6, 2005

Mr. Chairman, we meet today to review the most recent developments concerning the special examination of Fannie Mae by the Office of Federal Housing Enterprise Oversight. As I have regularly noted at our past hearings on these matters, it is important and appropriate for our panel to conduct comprehensive and regular oversight over our housing government-sponsored enterprises to ensure that they fulfill their missions and operate safely and soundly.

At our first hearing this year, we heard from the Chief Accountant of the Securities and Exchange Commission about his decisions related to Fannie Mae's accounting practices. Today, we will follow up on that hearing by receiving testimony from a frequent witness before our panel: Armando Falcon, the Director of the Office of Federal Housing Enterprise Oversight.

As always, I appreciate learning of his insights on these issues and again welcome him here. I should also note that because he will be leaving the agency next month, this appearance will likely be the last time that Director Falcon testifies before our panel in his current capacity. During his tenure, he has steadfastly worked to increase the agency's resources and its effectiveness.

The main focus of today's hearing is the March supplemental supervisory agreement between Fannie Mae's board and the Office of Federal Housing Enterprise Oversight. This agreement addresses additional deficiencies identified by the regulator during its ongoing special examination. These failings relate to insufficient internal controls, the improper application of accounting standards, and inadequate corporate governance.

Like many of my colleagues, I am troubled by these latest revelations. As a government-sponsored enterprise with public responsibilities and private capital, Fannie Mae has a special obligation to operate fairly, safely and soundly. These newest disclosures indicate that the company fell short in meeting these responsibilities.

Nevertheless, I am also heartened that Fannie Mae, according to its regulator, is cooperating and working to address these issues in a responsible manner. I am also pleased that although serious, these problems do not appear to pose a systemic risk according to those most knowledgeable of the facts in these matters.

As we proceed today, I also suspect that some of my colleagues will return to the question of how best to modify the regulation of government-sponsored enterprises, including you, Mr. Chairman. It is in the public's interest that we ensure that Fannie Mae and Freddie Mac continue to operate safely and soundly. We must further ensure that these public-private entities achieve their public responsibilities for advancing homeownership opportunities.

-more-

As I said at our very first hearing on the oversight of government- sponsored enterprises in March 2000, "we need to have strong, independent regulators that have the resources they need to get the job done." I can assure everyone that I continue to support strong, world-class and independent regulation for Fannie Mae and Freddie Mac.

A strong, world-class and independent regulator will protect the continued viability of our capital markets and promote confidence in Fannie Mae and Freddie Mac. It will also insure taxpayers against systemic risk and expand housing opportunities for all Americans.

In closing, Mr. Chairman, I commend you for your continued perseverance in these matters, and I look forward to hearing from our distinguished witness.

Opening Statement of the Honorable Bob Ney
Chairman, Subcommittee on Housing and Community Opportunity

Hearing on

"Additional Accounting and Management Failures at Fannie Mae – OFHEO's Efforts to Ensure Safe and Sound Operations"

Wednesday, April 6, 2005

I want to thank Chairman Baker for holding this hearing. It is my hope that this hearing will highlight the details of the supplemental agreement of March 7, 2005 between OFHEO and the Fannie Mae board of directors. This agreement supplements an agreement entered into between OFHEO and the board in September 2004 following the finding of significant accounting and management irregularities at the enterprise.

Although OFHEO's examination is still in progress, the findings to-date regarding deferred price adjustments and derivatives and hedging activities are serious and deeply troubling. Management's desire to portray Fannie Mae as a consistent generator of stable and growing earnings has turned the company from mortgage giant into an ideal representative of necessary regulatory reform.

As Chairman of the Housing Subcommittee, I have a keen interest in the strength of our secondary mortgage market. Fannie Mae and Freddie Mac were chartered by Congress to create a secondary trading market and to improve the functioning of home mortgage markets; as a result, the United States mortgage and credit markets are the envy of the world.

A strong, vibrant housing market also is vital to the health of our economy. Recent studies have found that housing accounted for more than one-third of economic growth from 2000 – 2002. Many observers, including Federal Reserve Chairman Alan Greenspan, have noted that mortgage refinancing provided crucial support to the economy during the past recession. It enabled homeowners to reduce their debt burdens and maintain adequate levels of consumer spending by tapping into the equity of their homes.

There can be no doubt that we must take steps to strengthen oversight of Fannie and Freddie by establishing a new 'world class' regulator. I look forward to working with the leadership of this committee as we consider legislation.

With the growing presence of GSEs in the capital markets and the possible risks they could pose to the financial system, reconstituting the safety and soundness regulator is a prudent step. Such a move would send an important signal that we understand the importance of government sponsored enterprises and the secondary mortgage markets in maintaining a stable housing economy.

As I have said before, I believe that there are several important components that are integral to providing enhanced regulation for GSEs while not impeding their ability to support affordable housing in America. Everyone agrees that strong regulatory oversight is critical to maintaining public confidence in this remarkable system. However, the liquidity that Fannie and Freddie provide to the market should not be compromised by unnecessary government regulation.

For more than 70 years, federal policy has encouraged homeownership. As we move forward, we must make certain that we do not begin to close the door to homeownership and curtail many Americans from realizing the American Dream.

Again, Mr. Chairman, I want to thank you for holding this timely hearing. I appreciate our witness taking the time to be here and I look forward to his testimony.

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES
U.S. HOUSE OF REPRESENTATIVES

STATEMENT OF ARMANDO FALCON, JR.
DIRECTOR, OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
ON
"REVIEW OF OFHEO'S SUPPLEMENTAL AGREEMENT WITH FANNIE MAE"

April 6, 2005

Chairman Baker, Ranking Member Kanjorski and members of the Subcommittee, I am pleased to appear before you today to address OFHEO's supplemental agreement with Fannie Mae, and the issues that gave rise to the agreement.

We have two objectives in our ongoing special examination of Fannie Mae. First, we must identify all the problems, and then fix them. As my testimony today indicates, that task is not yet complete. Second, we must institute a comprehensive reform program to prevent problems from recurring. That program will include far stronger internal controls and corporate governance measures; an adequate investment in systems, processes and personnel; and the establishment of a corporate culture fully dedicated to compliance with the law, with GAAP and with all relevant rules and regulations.

With the continued cooperation of the Board and management, we expect that Fannie Mae will ultimately emerge from its troubles as a healthy, well-managed enterprise, properly focused on fulfilling its public mission. That is the ultimate goal of the supervisory actions we have taken. I believe it is a goal now shared by Fannie Mae's Board and its interim leadership as well.

Fannie Mae
Special Examination and the September 2004 Agreement
Our special examination of Fannie Mae continues. As you are aware, last September we entered into an agreement with the Board of Directors that set forth a series of matters requiring immediate attention, particularly in the area of accounting. The agreement also outlined longer-term remedial steps, such as changes in the company's compensation program and corporate structure. In addition, we required that the company maintain a 30 percent minimum capital surplus in order to address safety and soundness concerns.

Supplemental Agreement
More recently, we entered into a supplemental agreement with Fannie's Board to address additional problems found by OFHEO. The agreement requires additional remedial steps in accounting policy and accounting management, and expands on

reforms in controls and corporate governance. Significant among the corporate governance reforms was the requirement that Fannie Mae separate the Chief Executive Officer and Chairman of the Board positions. We also required the company to report weekly to OFHEO on its efforts to meet capital requirements, including any corporate decisions on dividend payments or other matters that would affect the company's capital position.

Compliance with the Agreements

In general, Fannie Mae has moved forward in addressing matters set forth in our agreements. Experts have been engaged, studies undertaken, certain personnel changes have been made and the company has formulated preliminary plans for new organizational structures and reporting lines.

New Matters in the Special Examination: Accounting

OFHEO's special examination of Fannie Mae has revealed a number of significant new accounting problems at the Enterprise. As with previous accounting problems we have uncovered, they reflect Fannie Mae's tendency toward overly aggressive interpretation of GAAP, or in certain instances -- when compliance with GAAP would negatively affect the company -- a willful disregard of accounting rules. They also reflect situations where Fannie Mae's accounting policies actually do comply with GAAP, but Enterprise personnel have failed to follow those policies.

SFAS 65

The first new accounting problem OFHEO has found involves Fannie Mae's application of SFAS 65, "Accounting for Certain Mortgage Banking Activities." According to SFAS 65, held-for-sale (HFS) mortgage loans should be reported at the lower of cost or market value (LOCOM). If the market value falls below the cost, a valuation allowance is created to record the decrease in the market price. Held-for-investment (HFI) loans should be reported at amortized cost. SFAS 65 states that loans should be designated as HFI only if the entity has the intent and the ability to hold the loans for the foreseeable future or until maturity.

Fannie Mae was not applying its own policies on ensuring that the classification and sale of loans met the internally-developed policies for such transactions. In addition, it seems that Fannie Mae did not put in place controls and processes to help the company identify loans intended to be held-for-sale (HFS) within the poolable loan portfolio.

When Fannie Mae purchases mortgage loans from lenders, it either securitizes the loans or retains them in its mortgage portfolio. According to Fannie Mae policy, the loans the Enterprise retains in its mortgage portfolio are classified as HFI. The Enterprise uses the pooled mortgage loans to create securities that it either sells to a third party or holds in its portfolio.

At the time of acquisition of mortgage loans, the trading desk identifies the loans that will be used for pooling. At the end of the month of acquisition, Fannie Mae classifies these loans as HFI or HFS depending on what the Enterprise intends to do with the securities created. Fannie Mae's policy states that a loan designated as HFI can be sold or transferred to HFS only with the approval of the Enterprise's Controller.

During a system upgrade in 2004, the Enterprise discovered a major programming error: all loans acquired during a given month intended for pooling had been recorded as HFI at the end of the month, regardless of whether the loans were initially marked as HFS or HFI. In subsequent months, upon securitization and sale of the mortgage securities, the underlying loans were taken off the books, and gains or losses were booked. Since the program with this error had been created in 1983, but was not detected and corrected until 2004, faulty re-designations of loans continued for 21 years.

The fact that Fannie Mae operated a faulty and inaccurate system for more than two decades reveals serious system weaknesses. To properly report past financial results, OFHEO has asked Fannie Mae to identify and record HFS loans at LOCOM, and to properly calculate the gains and losses on sales. If past HFS loans cannot be identified and properly recorded, then doubts are raised about management's intent and ability to hold similar loans in HFI in the future.

SFAS 115

In the accounting area involving Fannie Mae's initial designation and possible transfer of securities within SFAS 115 categories, we believe that Fannie Mae has failed to comply with GAAP.

According to SFAS 115, the intent to classify securities should be determined at the time of acquisition of the security. Any subsequent re-designations should be accounted for as a transfer from one class to another at Fair Value.

At Fannie Mae, however, at the time of trade, the trader purchases and records each commitment as either HTM or available for sale (AFS), so that securities delivered on these commitments may be held in the appropriate account at the Federal Reserve Bank. Fannie Mae's accounting policy, however, allows the trader to re-designate the securities in the portfolio for accounting purposes at the end of the month in which the trade settles.

This process, called Intra-Month Re-Designation (IMRD), provides management with flexibility not allowed under GAAP. It permits Fannie Mae to wait until the end of the month in which a trade settles to make a decision on whether to sell or hold. Such decisions on SFAS 115 designations could be based upon gains or losses accrued after the trade date, or upon further analysis of the collateral underlying the mortgage-backed securities.

Prior to November 2003, Fannie Mae was performing a sorting and sifting process involving actual scoring of trades that allowed the Enterprise to retain high quality loans for its portfolio, while fulfilling matched buy and sell (MTBS) trades using lower quality collateral. The Enterprise referred to this process internally as "keep the best; sell the rest."

As mentioned, SFAS 115 requires that the intent for classification of securities be determined at the time of acquisition. Fannie Mae's IMRD process, however, has allowed the Enterprise to change its intent for classification at the end of the month of settlement -- even though its intent was previously specified at trade date.

OFHEO believes Fannie Mae's policy to designate securities at the end of the month of settlement violates GAAP. Any transfer of securities from HTM to AFS raises questions about management's intent and ability to hold similar securities in its HTM portfolio.

This practice appears to stand in stark contrast to the company's denials of engaging in "cherry picking" when the matter was reviewed by a 2003 Task Force on Mortgage Backed Securities Disclosure.

The next two accounting issues provide examples of Fannie Mae not applying its own internally-developed policies. Moreover, OFHEO questions whether the internally-developed policies in these areas are in compliance with GAAP.

SFAS 140 (Dollar Rolls)

The first issue involves SFAS 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." Fannie Mae enters into sales of securities from its HTM portfolio under agreements to repurchase the same or substantially similar securities at a later date. These are called dollar-roll repurchase agreements, or simply dollar rolls. Fannie Mae accounts for these transactions as financings rather than sales of securities. The transaction is not considered a sale if the Enterprise is entitled and obligated to repurchase the same or substantially similar securities before the securities mature, and the company effectively retains control of the transferred securities.

It appears, however, that Fannie Mae is not applying its own policies regarding the return of securities for such transactions. In addition, Fannie Mae also seems to have failed to develop policies to monitor adequate collateral.

Fannie Mae's practices may fail to meet the requirements of SFAS 140, which states that dollar roll transactions should be accounted for as secured lending transactions if they meet the conditions set forth in paragraph 47 of this particular Statement of Financial Accounting Standards. Failure to comply with any of the conditions would result in recording of the dollar roll transaction as a sale of a security.

Fannie Mae, uses securities classified as HTM for its dollar roll transactions. If the dollar roll transactions do not meet the criteria for a secured financing, the sale of an

HTM security will have occurred. If there is a recurring practice of selling securities out of the HTM portfolio as a result of a dollar roll failure, then the HTM portfolio could well be tainted, which in turn would require that Fannie Mae classify all HTM securities as AFS.

Statement of Position (SOP) Number 90-3 states that to consider redelivered securities as substantially similar, the underlying collateral for the MBS needs to have similar remaining weighted average maturities (WAM) that result in approximately the same market yield. Fannie Mae's accounting policy for dollar rolls considers securities within a WAM of plus or minus 24 months, and a yield of plus or minus ten basis points as substantially similar securities. Fannie Mae's accounting policy states that WAM and yield tolerance levels should be calculated as a weighted-average on the overall trades rather than on the individual securities.

It should be noted that while this was a long-standing policy of the Enterprise, Fannie Mae did not perform calculations until 2003, and even then only conducted the WAM test. Fannie Mae made the assumption that if the WAM test was met, then the yield test was met automatically.

Operational issues have also been identified in the review of these transactions. According to the Emerging Issues Task Force (EITF) Topic D 65, an entity is required to monitor the adequacy of the collateral received under a repurchase agreement or similar transaction. Yet we found no evidence that Fannie Mae monitors collateral for adequacy. Further, Fannie Mae does not appear to have policies and procedures in place to assure that sufficient cash and collateral is available during the term of its dollar roll transactions, in order to substantially fund the cost of purchasing replacement assets.

In sum, Fannie Mae neither applied its own policies for dollar rolls, nor did it develop procedures for monitoring collateral adequacy.

SFAS 149

SFAS 149 amended SFAS 133, effective July 2003. SFAS 149 requires that Fannie Mae account for certain purchase and sale commitments of mortgage-related assets as derivatives. Prior to the promulgation of SFAS 149, these instruments were not covered by SFAS 133. At Fannie Mae, such instruments include mandatory commitments to purchase or sell securities or loans into and out of the Enterprise's portfolio, as well as matched buy and sell trades.

Since the inception of SFAS 149, it appears that Fannie Mae has applied cash flow hedge accounting to certain transactions that it may have inappropriately deemed as being probable of occurring, had insufficient documentation in place for many transactions, inappropriately assumed perfect effectiveness in fair value hedges with non-zero fair values and inconsistently accounted for certain transactions.

To be exempt from derivatives accounting, SFAS 149 requires, among other things, that an entity document the basis for concluding that it is probable that a contract will not settle net, and will result in physical delivery. Fannie Mae's SFAS 149 policy document states that the Enterprise has elected not to put such documentation in place. Therefore, it treats these securities as derivatives.
However, in order to qualify for cash flow hedge accounting, SFAS 133 requires that the hedged forecasted transaction be probable of occurring. Fannie Mae's commitments to purchase and sell mortgage assets frequently do not result in delivery of the security. In order to establish that its forecasted transactions are probable of occurring for cash flow hedging qualification purposes, Fannie Mae developed a rolling twelve-month probability threshold, indicating the percentage of time all transactions accounted for using cash flow hedge accounting actually occurred. They appear to have applied this statistic in the aggregate rather than by product, channel or transaction type.

Fannie Mae's policy states that if its forecasted transactions occur at least 75 percent of the time, then they are probable of occurring as defined by SFAS 133. We understand that as long as this threshold is maintained in the aggregate, Fannie Mae continues to apply cash flow hedge accounting to 100 percent of its purchases and sales commitments.

In OFHEO's view, Fannie Mae's SFAS 149 policy represents circular reasoning in concluding that the Enterprise's transactions qualify for hedge accounting. Fannie Mae has indicated that it will not produce documentation outlining the basis for concluding that the transactions are probable of occurring for purposes of qualifying for when-issued securities for the scope exception. However, the Enterprise has stated that its transactions qualify for hedge accounting, which requires that the forecasted transaction being hedged is probable of occurring.

OFHEO further believes that the documentation Fannie Mae maintains for its portfolio commitments, which its treats as cash flow hedges, is insufficient. SFAS 133 requires an entity to have certain documentation in place, specifically regarding cash flow hedges. It states that the documentation at the inception of the hedge regarding identification of the forecasted transaction must have "sufficient specificity so that when a transaction occurs, it is clear whether that transaction is or is not the hedged transaction." Upon the adoption of SFAS 149, hedge documentation was expected to reflect the total purchase and sale commitments in the aggregate rather than by individual transaction, as required by SFAS 133.

Paragraph 65 of SFAS 133 requires that a hedging instrument must have a fair value equal to zero in order to apply matched terms and expect a perfect offset. When the MTBS sale is designated as a fair value hedge of the as-soon-as-pooled (ASAP) loans, it will have already been outstanding and will therefore not have a zero value. The practice of hedging the fair value of loans was discontinued in the first quarter of 2004 because Fannie Mae decided to begin accounting for the loans received under MTBS ASAP sales and held until settlement of the forward sale, as trading securities under SFAS 115. However, Fannie Mae treated the change as an accounting error because

they deemed the early-funded loans to have become securities on the day of early funding rather than when they were securitized upon settlement. Yet Fannie Mae did not restate past periods because it believed the change effectively resulted in the same earnings effect. OFHEO believes that Fannie Mae did not qualify for matched-terms accounting under SFAS 133 for 2003, and that a restatement of past periods was and is required.

Fannie Mae's accounting for forward commitments under SFAS 149 does not appear to have been followed consistently since the adoption of the amendment on July 1, 2003. Fannie Mae apparently was unable to fully implement SFAS 149 in the allotted time frame, which resulted in its accounting for transactions subject to SFAS 149 to evolve subsequent to adoption.

In sum, in certain instances Fannie Mae's FAS 149 accounting policies did not comply with GAAP, its internally developed policies were not followed and control weaknesses in key accounting areas were not addressed.

FIN 46

Fannie Mae has also created an accounting policy related to its MBS pool activities, which appears to have as a primary purpose the avoidance of consolidation under FASB Interpretation No. 46, "Consolidation of Variable Interest Entities," also known as FIN 46. OFHEO believes that in this area, the Enterprise has not complied with FIN 46. As part of its policy, Fannie Mae transferred securities between SFAS 115 categories, yet did not provide the required documentation to describe the rationale for the transfers.

Fannie Mae engages in purchases of loans and offerings of MBS. In certain instances, the Enterprise obtains 100 percent of the MBS issued in an offering. In addition, Fannie Mae may end up owning 100 percent of a particular MBS through purchases in the secondary market. Fannie Mae states that it uses Qualified Special Purpose Entities (QSPEs) to issue these MBS. QSPEs are exempt from FIN 46 consolidation unless the company has the unilateral ability to liquidate or change the QSPE.

In February 2003, Fannie Mae adopted an accounting policy that defined a unilateral ability to liquidate as equivalent to owning 100 percent of a pool. This policy allowed the company to improperly avoid consolidation in three ways. The first was to effect a transfer of wholly-owned pools of securities from AFS to HTM; second, sell one percent of the wholly-owned pool to a third party; and third, create "mega pools," the collateral of which was comprised of multiple wholly-owned pools. The Enterprise took this step so that the sale of one percent of a "mega pool" would render the consolidation issue moot.

As discussed, FIN 46 exempts QSPEs from consolidation, unless the company has the unilateral ability to liquidate or change the QSPE. FIN 46 does not give a definition of unilateral ability to liquidate. However, in reviewing the relevant literature, it appears that the sale of at least ten percent interest in a pool precludes the unilateral ability to

liquidate. A minority holding below the ten percent threshold would necessitate an analysis of facts and circumstances. Moreover, a clearly insignificant minority interest could result in a presumption that the majority holder has the unilateral ability to liquidate. Fannie Mae's policy provides no facts or circumstances to support its decision to use a one percent threshold. We do not believe that Fannie Mae's actions constitute a sufficient relinquishment of ownership to counter the presumption that it retains the unilateral ability to liquidate, and therefore must consolidate under FIN 46.

Fannie Mae developed a policy of transferring wholly-owned MBS pools to the HTM category. Its rationale for development of this policy was that accounting for HTM investment under FAS 115 and accounting for HFI loans under FAS 65 were similar. While OFHEO agrees that some of the accounting is similar, there remain a number of significant differences.

Investments of loans and securities represent separate accounts on the balance sheet. In addition, the impairment model for HTM securities under SFAS 115 may or may not recognize impairments for the same amounts or in the same periods as credit losses would be recognized for whole loans under SFAS 5 and SFAS 114. We question whether the transfer of wholly-owned pools to HTM precludes consolidation of these assets under FIN 46, and whether there is a valid business purpose for such transfers. Moreover, transfers of securities between categories should have supporting documentation that describes the rationale for the transfer.

OFHEO has directed Fannie Mae to examine each of the above accounting policies and assure that they comply with GAAP currently, and did so in the past.

Mr. Chairman, the accounting issues I have just outlined, do not constitute an all-inclusive list. As OFHEO continues its special examination and Fannie Mae completes its restatement, we expect additional accounting issues to surface.

Internal Control Issues: Journal Entry Controls

During our special examination we have also identified several problems involving procedures for preparing, reviewing, validating, authorizing and recording journal entries relating to amortization adjustments. These issues include falsified signatures on journal entries; failure to require that journal entry preparers understand the purpose for which the journal entry was made, or that journal entry reviewers and approvers determined that entries were valid and appropriate; failure to require that journal entries include supporting documentation; lack of independent review of journal entries; and an absence of written policy guidance concerning journal entry procedures.

During our special examination, a Fannie Mae employee testified that from 1999 through 2002, journal entries related to amortization bearing the employee's name and signature were, in fact, not prepared by the employee. Those entries were created after the closing process, a time when journal entries require heightened scrutiny.

OFHEO has directed Fannie Mae to determine the full extent to which journal entries with falsified signatures took place, and the circumstances surrounding such entries. OFHEO has also directed Fannie Mae to determine who falsified the signatures on journal entries, and why the falsified journal entries were not detected at the time of entry or afterward.

In addition, OFHEO obtained testimony from an employee in the Controller's division indicating that the employee did not have an understanding of the purpose behind certain journal entries the employee made. The employee further stated a willingness to have prepared any entry asked of the employee – and, in fact, did prepare such entries. OFHEO has directed Fannie Mae to determine the full extent to which employees made journal entries without having an understanding of the purpose behind the entry.

Other testimony received during our special examination indicates that Fannie Mae maintains no written policies requiring journal entry reviewers and approvers to determine that an entry is a valid and appropriate entry, let alone one that complies with GAAP. Testimony also indicates that at least one employee who approved journal entries relating to amortization had no formal responsibilities relating to amortization. Instead, that employee was responsible for business planning and budgeting. OFHEO has directed Fannie Mae to determine the full extent of journal entries made where the reviewer and approver did not determine validity or appropriateness.

Further, documents and testimony indicate that certain amortization adjustments did not have adequate supporting documentation. Moreover, Fannie Mae does not appear to have formal written policies governing documentation requirements to support journal entries. OFHEO has directed Fannie Mae to determine the full extent of journal entries lacking proper documentation, who was aware of the fact that proper documentation was not prepared and maintained, and what action, if any, was taken.
OFHEO's special examination has also identified documents and obtained supporting testimony indicating instances where Fannie Mae did not independently review journal entries. For example, testimony from one Enterprise employee concerning amortization adjustments indicates that another employee approved journal entries that the first employee instructed the second to make. OFHEO has directed Fannie Mae to determine the full extent of journal entries that it did not independently review.
These issues remain under investigation as part of the special examination.

Systems Limitations and Database Modifications

Fannie Mae uses a wide variety of systems for accounting and financial reporting. During the course of OFHEO's special examination, it has become evident that the Enterprise was overly reliant on end-user applications -- such as spreadsheets -- and employed other practices inconsistent with principles of sound internal controls. Our findings in this regard are consistent with our earlier discoveries of errors in the Enterprise's SFAS 149 accounting.

OFHEO believes that Fannie Mae's portfolio accounting system, known as STATS, has significant limitations. Among the problems we noted are that STATS cannot estimate amortization of deferred price adjustments, pursuant to SFAS 91; mark the mortgage-backed securities portfolio to market; account for dollar roll transactions; account for mortgage revenue bonds; or account for interest-only strips pursuant to EITF Issue No. 99-20.

In short, the STATS system cannot perform any of the calculations fundamental to properly account for almost the entire portfolio held by the Enterprise without substantial support from other internally-developed systems or spreadsheets. OFHEO has directed Fannie Mae to determine its potential exposure from its use of systems for portfolio accounting that are ill-suited for their intended purposes.

During the course of the special examination, Enterprise management informed us of numerous instances whereby technology applications support personnel, at the direction of management, would overwrite database records in order to make changes or corrections. The Enterprise, which referred to such database modifications as "DB mods," used them widely. Several Employees testified that DB mods could even be communicated via email.

The practice of allowing pervasive application of DB mods indicates a poor internal controls environment at the Enterprise. This environment is characterized by non-ledger based systems that are ill-equipped to support the accounting infrastructure; continuous access to production-level data by technology personnel, which can negate the positive effects of any other internal controls; and lack of specific records of the changes made through the DB mod process.

OFHEO has directed Fannie Mae to determine the extent to which the Enterprise employed DB mods and the affect on accuracy and reliability of financial statements.

Manipulation of Amortization Factors

SFAS 91 specifies requirements for calculating the amortization of premiums and discounts on securities. According to SFAS 91, it is possible to include forecasts of prepayments when determining the period of amortization for mortgage-backed securities. In the event that new information requires the period of amortization to change, a retrospective adjustment must be recorded currently into income. In addition, the prospective rate of amortization should be changed to reflect the new estimated life.

OFHEO's September 2004 report detailed a number of conclusions related to the Enterprise's practice of measuring and recording retrospective adjustments required by SFAS 91. Information received by OFHEO after the September report points to additional issues with the prospective amortization rates used by the Enterprise. Specifically, it appears that Fannie Mae employees made manual discretionary adjustments to future amortization rates in particular months. Such adjustments were

made to particular factors in the future factor array through special functionality in Fannie Mae's amortization model.

OFHEO's examiners found that Fannie Mae staff made substantial adjustments to certain factors that were to be used in future periods. In some cases, over 40 percent of unamortized balances were amortized in a particular month, a rate that is extremely anomalous, given that the level yield method would typically result in amortization for conventional mortgage-backed securities in the range of one to three percent per month. Such adjustments are difficult to detect in a normal auditing process and can have material effects on amortization income or expense. OFHEO has directed Fannie Mae to examine this issue and determine if there is a record of factor change adjustments, who approved them, and the aggregate effect of these factor changes on prior period financial results.

Funding

As the scope of the Fannie Mae special examination has proceeded well beyond our original expectations, we will need additional funds this year. Accordingly, we have used our Special Assessment authority to assess Fannie Mae an additional five million dollars. However, while we have collected the funds, OMB has opined -- due to a technical deficiency in the statute -- that we may not spend the funds. We do not agree with OMB's interpretation, but are bound by it. This provides yet another example of why Congress must enact legislation to give the regulator the authority it needs to do its job. Until then, this funding issue will need to be addressed.

Conclusion

Mr. Chairman, I would like to end on a personal note, if I may. As you know, my five-year term as Director of the Office of Federal Housing Enterprise expired last October. But I have remained in office to guide the agency through a very challenging period. With your help, and with the help of your colleagues on the Senate side, the White House, the Department of Housing and Urban Development, the Department of Justice and the Securities and Exchange Commission, I believe the most critical and pressing issues at the Enterprises have been addressed. Barring extraordinary circumstances, I have, therefore, decided to step down from my position on May 20, 2005 to explore new opportunities.

I am proud of OFHEO's achievements during my tenure. The agency has successfully dealt with very serious problems at two of the largest financial institutions in the world. We have done so without disrupting our financial system, while allowing both Enterprises to continue fulfilling their vital mission of making home ownership more affordable. I am particularly proud of the efforts of OFHEO in our conduct of the Special Examination of Fannie Mae. Seldom does a safety and soundness regulator identify improper actions, with potentially billions of dollars of adverse impact, before they manifest themselves in a way that does permanent damage to the company. This was done at a time when the outside auditor, a Big Four internationally-recognized

accounting firm, was certifying the financial statements as accurately reflecting the financial condition of the Enterprise. OFHEO has raised the bar in terms of effective safety and soundness regulation, and I have been privileged to lead the agency during this period.

With the continued assistance of OFHEO's talented staff, I expect Fannie Mae and Freddie Mac will ultimately emerge as more effective Government-Sponsored Enterprises, to the benefit of the U.S. economy and to all Americans.

It has been a privilege to serve as Director of OFHEO, and an honor to serve this wonderful country.

Thank you Chairman Baker, Members of the Subcommittee, for this opportunity. I will be pleased to answer any questions you may have.

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