Statement of the Honorable Armando Falcon, Jr., Director of OFHEO,
before the
House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises Hearing
on
The Office of Federal Housing Enterprise Oversight's December Report of the Special Examination of Freddie Mac

January 21, 2004

Mr. Chairman, Ranking Member Kanjorski, and Members of the Subcommittee, I appreciate the opportunity to discuss with you OFHEO's Report of the Special Examination of Freddie Mac. My prepared testimony will summarize the key findings and conclusions, and I request that the Subcommittee include the full text of the report in the record. My testimony expresses my own views and not necessarily those of the President or the Secretary of Housing and Urban Development.

A year ago tomorrow, Freddie Mac announced that completion of its 2002 financial audit would be delayed and that earlier periods would be reaudited. A switch in external auditors – from Arthur Andersen to PricewaterhouseCoopers – had triggered a reevaluation of Freddie Mac's accounting policies, especially those relating to hedge accounting treatments for derivatives occasioned by implementation of FAS 133. Ultimately, a much broader range of accounting policies was reconsidered. Many were changed, resulting in one of the largest corporate financial restatements ever; including a cumulative net increase in retained earnings of $5 billion.

The reaudit and restatement process raised questions beyond the selection of accounting policies. On June 7, as Freddie Mac prepared to announce the abrupt departure of three of its principal officers, I ordered a special examination of the conditions and activities that led to the accounting failures and management changes. This examination was to expand and supplement an ongoing OFHEO examination of the financial condition of the Enterprise and its reaudit and restatement process.

Our previous examination work had engendered increasing concern about weaknesses in controls and personnel in accounting areas. I believed that the removal of three members of the management team only went part of the way toward correcting serious problems with management practices and controls. We created a special examination unit that ultimately comprised 24 staff members taken from several OFHEO departments on a full or part-time basis. The group was tasked with reviewing the events leading to the restatement and deficiencies in accounting practices and controls. I further asked that the report of the special examination make recommendations for any additional steps that needed to be taken to help ensure the continuing safe and sound operations of the Enterprise.

I instructed the Board of Directors of Freddie Mac to provide its full cooperation with the special examination and to make available to the special examination all communications to the Board and management regarding deficiencies in accounting practices or its investigation of employee misconduct. I also instructed the Board to provide an explanation of its rationale for the compensation packages the Enterprise proposed for the three individuals in light of the circumstances surrounding their departures.

I also informed the Board of Directors that, in the case of personnel terminated for misconduct, OFHEO would object to any re-employment of these individuals, and that OFHEO could hold them liable for indemnification to Freddie Mac for losses that may have resulted from their conduct.

Finally, I instructed the Board to provide to OFHEO, for review and approval, plans to address reform of the supervision of accounting practices by management; personnel and systems changes; plans for implementing accounting services quality controls; and a program for routine communications by the Board with OFHEO on the progress of the plan of remediation.

The special examination unit reviewed documents generated by the operations of Freddie Mac or obtained by OFHEO over ten years in the course of its regular examination process. Documents, including emails and audio tapes, were produced by the Enterprise pursuant to OFHEO subpoena. OFHEO also obtained, pursuant to subpoena, testimony under oath from numerous employees and members of the Board of Directors of Freddie Mac. In developing this information, OFHEO has cooperated with the Securities and Exchange Commission and the Office of the United States Attorney for the Eastern District of Virginia.

Although some aspects of the special examination are not complete, the bulk of the work was finished this past fall, and I asked for a report of the examination containing the findings and conclusions reached thus far, along with appropriate recommendations, which you received in December.

REPORT SUMMARY

In the early 1990s, Freddie Mac promoted itself to investors as "Steady Freddie," a company of strong and steady growth in profits, and the company developed a corporate culture that placed a very high priority on achieving such results. The examination showed that, to do so, Freddie Mac used means that failed to meet its obligations to investors, regulators and the public. The company employed a variety of techniques ranging from improper reserve accounts to complex derivative transactions to push earnings into future periods and meet earnings expectations. Freddie Mac cast aside accounting rules, internal controls, disclosure standards, and the public trust in the pursuit of steady earnings growth. The conduct and intentions of the Enterprise were hidden and were revealed only by a chain of events that began when Freddie Mac changed auditors in 2002.

Corporate Culture and "Tone at the Top"

The corporate culture fostered by the "tone at the top" resulted in intense and sometimes improper efforts by the Enterprise to manage its reported earnings, compromised the integrity of many employees, and limited the effectiveness of its internal control structure. The culture placed an inordinate emphasis on meeting the expectations of Wall Street analysts regarding earnings levels and steady growth, but it neglected key elements of the infrastructure of the Enterprise needed to support growth. Freddie Mac created and maintained reserve accounts that did not comply with GAAP and entered into transactions with little or no economic substance to achieve desirable accounting results.

A tension developed between the more administrative elements of Freddie Mac, responsible for supporting and reporting transactions, and the "financial engineers," who designed products and strategies to achieve corporate earnings goals. Compounding that problem, the Enterprise managed its general and administrative expenses to a rigid guideline, regardless of the level of profits. The preoccupation of management with adhering to expense limits resulted in an insufficient allocation of resources—both dollars and staffing—to divisions responsible for accounting, financial reporting, and internal controls. The lack of attention by senior management and the Board of Directors to those functions resulted in transactions not being recorded in financial statements in accordance with GAAP. Finally, senior management and the Board failed to establish and maintain adequate internal control systems.

Improper Management of Earnings

By 1999, Freddie Mac had established a practice of engaging in transactions for the express purpose of managing its reported earnings. Freddie Mac used several strategies to shift earnings into future reporting periods, reflecting the proclivity of management to increase operations risk in the quest for more stable earnings.

Although some of the most egregious examples relate to the desire of management to address earnings volatility challenges associated with the implementation of Statement of Financial Accounting Standards 133 (FAS 133), there were numerous other instances when Freddie Mac management misused accounting resources or engineered transactions with little or no economic substance to obtain specific accounting results:

- Management executed several interest rate swap transactions that moved $400 million in operating earnings from 2001 to later years. Those transactions had virtually no other purpose than management of earnings —specifically, making operational results appear to be less volatile than they were.

- Management created an essentially fictional transaction with a securities firm to move approximately $30 billion of mortgage assets from a trading account to an available-for-sale account. Other than to reduce potential earnings volatility, the transaction had no other meaningful purpose.

- Freddie Mac adopted, and then quickly reversed, a dubious change in its methodology for valuing swaptions. That change had the effect of reducing the value of the derivatives portfolio of the Enterprise by $730 million.

- On at least one occasion, a transaction was entered into at the instruction of management for the purpose of disguising the effective notional amount of the Freddie Mac derivatives portfolio and thereby allay the concerns of an investor.

- From 1998 to 2002, management purposefully kept loan loss reserves at an unusually high level by using aggressive assumptions, even though actual and foreseeable credit losses were rapidly declining. Both management and the Board of Directors were aware that the Securities and Exchange Commission had criticized that practice as an inappropriate form of earnings management.

- Freddie Mac used another, non-GAAP reserve to dampen earnings fluctuations occasioned by unpredictable premium amortization caused by changing mortgage prepayment speeds. Management changed key assumptions in the calculation of the reserve when necessary to achieve a desired earnings result.

Management went to extraordinary lengths to avoid undesirable accounting results. It then failed to disclose to the public information that would have revealed more fully the nature of transactions undertaken to manage earnings and the intent to do so.

Incentives Created by Executive Compensation

The compensation of senior executives of Freddie Mac, particularly compensation tied to earnings per share, contributed to the improper accounting and management practices of the Enterprise. The size of the bonus pool for senior executives was tied, in part, to meeting or exceeding annual specified earnings per share targets. It was not tied directly to smoothing earnings growth, but actions to shift earnings from one quarter to future periods helped ensure that earnings per share goals, and consequently the bonuses based upon them, would be achieved in the future.

Freddie Mac used a corporate scorecard involving a formulaic approach to setting the size of the corporate bonus pool. Achieving earnings per share targets played a substantial role in the formula, but former CEO Leland Brendsel and former COO David Glenn also exercised considerable discretion over the outcome. The informal process by which Mr. Brendsel and Mr. Glenn revised the scorecard results, and therefore the amount of funds available for individual bonuses, further contributed to the importance of achieving earnings per share targets.

Weak Accounting, Auditing and Internal Controls

The management of a corporation is responsible for maintaining a control environment that will, among other things, accurately record transactions to provide for published financial statements that are consistent with the true financial condition of the firm. In that regard, the obsession of Freddie Mac with steady, stable growth in earnings was at the expense of proper accounting policies and strong accounting controls. Weaknesses in the staffing, skills, and resources in the Corporate Accounting Department of the Enterprise led to weak or nonexistent accounting policies, an over-reliance on the external auditor, weak accounting controls, and an overreliance on manual systems. Given the size of the company and its role in the housing finance and capital markets, those weaknesses effectively increased the systemic risk posed by the Enterprise.

The deficiencies of the company resulted in improper accounting of many complicated transactions in which the Enterprise engaged during the period of the restatement. Although management developed plans to address identified weaknesses, those plans were neither well conceived nor fully implemented.

The Internal Audit Department of Freddie Mac did not accept responsibility for the reliability and integrity of the financial information of the Enterprise, did not follow-up effectively on identified deficiencies, and did not communicate effectively with management and the Board. In combination, the weaknesses in Corporate Accounting and Internal Audit meant that there were weak points at each major control juncture at Freddie Mac.

Management and the Board failed to meet their responsibilities for sound accounting policies and a strong internal control system to assure that financial statements were prepared in accordance with GAAP. The Board appeared to operate under the misconception that as long as the external auditor signed off on an accounting policy or a process, its responsibilities and those of management were fulfilled.

Inadequate Disclosure

In some instances, Freddie Mac knowingly circumvented prevailing public disclosure standards in order to obfuscate particular policies and specific capital market and accounting transactions. A disdain for appropriate disclosure standards, despite oft-stated management assertions to the contrary, misled investors and undermined market awareness of the true financial condition of the Enterprise. Overly general disclosures reflected a conscious decision by Freddie Mac to provide minimal amounts of specific, useful information.

Freddie Mac executives, without objection from the non-executive members of the Board or its Audit Committee, accepted a convenient and mechanical but inadequate definition of materiality accepted by the external auditor in order to exempt from scrutiny and specific disclosure as “immaterial” accounting errors of up to five percent of profits, or $100 million to $285 million.

Within Freddie Mac, no one took responsibility and was ultimately accountable for public disclosures. Failure to assign responsibility and accountability for disclosure to an internal division contributed directly to inaccurate corporate and financial reporting. Such a lack of assigned responsibility reflected the low regard executive management had for that function.

Board of Directors

For the most part, the same long-tenured shareholder-elected Directors oversaw the same CEO, COO, and General Counsel of Freddie Mac from 1990 to 2003. The non-executive Directors allowed the past performance of those officers to color their oversight. Directors should have asked more questions, pressed harder for resolution of issues, and not automatically accepted the rationale of management for the length of time needed to address identified weaknesses and problems. The oversight exercised by the Board might have been more vigorous if there had been a regular turnover of shareholder-elected Directors or if Directors had not expected to continue to serve on the Board until the mandatory retirement age or beyond. Conversely, the service periods of the presidentially appointed Directors are far too short, averaging just over 14 months, for them to play a meaningful role on the Board.

Recommendations

Based on these findings, the examination report recommended that a broad range of actions be taken by OFHEO and Freddie Mac. The report concluded that OFHEO must ensure that Freddie Mac has established an adequate remediation plan and is allocating the necessary resources to establish a new corporate culture that rewards integrity and the acceptance of responsibility, and that penalizes failure to meet appropriate standards of conduct. Remediation must also eliminate existing accounting and control weaknesses, including infrastructure planning for future growth and a dedication to adequate management of operations risks.

The report also detailed a number of specific actions, and I have appended a list of them at the end of my written testimony. To improve the effectiveness of the Board of Directors, Freddie Mac should separate the functions of the Chief Executive Officer and the Chairman of the Board, impose strict term limits on Directors, and require that the Board meet more frequently. The report further recommended that OFHEO establish a materiality standard for the provision of sufficient information by management to the Board.

To address Freddie Mac’s general neglect of operations risks and compliance issues, the report recommended that Freddie Mac establish a formal compliance program and a position of Chief Risk Officer, reporting directly to the CEO, with explicit responsibility for operations risk, as well as credit and market risk. In addition, Freddie Mac's Internal Audit Department needs to be strengthened so that it can play a more effective role.

To address accounting weaknesses, the report recommended that OFHEO consider requiring a periodic change of external audit firms. Freddie Mac needs to establish and maintain superior accounting controls and prevent undue reliance on its external auditor. It should also document the legitimate business purpose of every significant business transaction.

To address inappropriate managerial incentives, the report recommended that Freddie Mac refocus its compensation program more on long-term goals, not on short-term earnings.

Until remediation efforts have taken full effect, Freddie Mac remains exposed to substantial management and operations risk. The report recommended that OFHEO consider addressing this concern by requiring Freddie Mac to hold significant regulatory capital surpluses, at least until it can produce timely and GAAP – consistent financial reports.

Finally, the report recommended that OFHEO take three additional steps to reduce the possibility of future Enterprise difficulties. First, OFHEO should implement regulations that provide for mandatory disclosure, similar to that required of SEC-registered companies, and build staff resources necessary to oversee compliance if Congress does not repeal the exemptions of the Enterprises from securities law. Second, OFHEO should expand its capacity to detect and investigate misconduct by including more substantive tests of the internal control frameworks at the Enterprises, including procedures to identify pressures to commit fraud and opportunities to carry it out. Third, OFHEO should conduct a special examination of the accounting practices of Fannie Mae.

OFHEO SUPERVISORY ACTIONS

Mr. Chairman, I want to inform you not just about the report, but also about actions taken prior and subsequent to its release.

OFHEO has been active in carrying out its supervisory responsibilities. OFHEO directed Freddie Mac to provide continuous briefings for us on implementation of their remediation plan, which already addresses some of the recommendations in the report. OFHEO directed the holding of termination benefits for separated employees pending its review. OFHEO directed that the current CEO and General Counsel be terminated.

Next, OFHEO entered into a consent order with the company's former COO David Glenn and secured both his cooperation in our investigation and a very strong civil money penalty. OFHEO then entered into a consent order with the company securing a significant civil money penalty and imposing a plan of action on the company that requires that issues identified by our investigation be addressed, including "tone at the top" and corporate culture, internal controls, review of existing Board and senior management practices and compensation, and changes to the role of Board Chairman and company CEO and terms for the Board of Directors. Finally, OFHEO is pursuing legal actions requiring the termination for cause of the company's former CEO and CFO.

Our review of Freddie Mac practices continues, as we now will look into counterparty activities and oversee Freddie Mac's implementation of the consent order.

I have undertaken actions at OFHEO as well. Our examination force is being strengthened. A new office of chief accountant will elevate our work in the important field of corporate accounting and reporting and a new office of compliance will expand our capacity to address ongoing Enterprise compliance with OFHEO rules and requirements and be available to investigate more deeply targeted areas of concern.

On this latter point, I would note that we have, within budget constraints, begun our review of accounting and corporate controls at Fannie Mae.

THE CURRENT BUDGET SITUATION

Mr. Chairman, I would like to close my testimony with an urgent appeal to the Committee for assistance in obtaining our 2004 budget. Once again, the appropriations process has placed severe constraints on our operations. The short-term continuing resolutions we are operating under prevent us from hiring the additional examiners, accountants and analysts we need to strengthen our oversight. In addition, we are unable to hire the forensic accounting help we need to assist in the Fannie Mae review.

If a long-term CR is enacted which freezes OFHEO's budget at 2003 levels, we will need to scale back oversight at the very time that greater oversight has never been more urgent. I urge the Committee to help OFHEO get its full resources as soon as possible.

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