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

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"REPORT OF FINDINGS TO DATE, SPECIAL EXAMINATION OF FANNIE MAE"

OCTOBER 6, 2004

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee; thank you for inviting me to testify about OFHEO's special examination of Fannie Mae. As always, my testimony reflects my own views, and not necessarily those of the Secretary of HUD or those of the President.

Before getting to my comments on the report, I'd like to introduce two of my staff. On my right is Chris Dickerson, OFHEO's chief compliance examiner and one of our derivatives experts. On my left is Wanda Deleo, our chief accountant. Both are leading the work of the special examination and are here to assist me in answering technical questions on the report.

Background

In July of last year, I announced that OFHEO would conduct a special examination of Fannie Mae's accounting policies, internal controls and financial reporting. While the special examination continues, our safety and soundness mandate requires that when we find problems, we move quickly to remedy them, rather than wait until the entire examination is complete. The report represents our findings to date, and it serves as the basis for the actions we have taken.

The report raised such serious safety and soundness concerns that we brought them to the immediate attention of the Board. To the Board's credit, it became very engaged in the examination, and moved quickly to reach an agreement with OFHEO on a plan of remediation. The agreement constitutes an important first step toward resolving OFHEO's concerns and ensuring safe and sound operations at the Enterprise.

Report on Findings to Date

Let me turn now to the substance of the report. It documents Fannie Mae's pervasive and willful misapplication of Generally Accepted Accounting Principles as well as critical operational deficiencies. The report's findings have implications in four areas of major concern to OFHEO:

1. the validity of Fannie Mae's previously reported financial results;

2. the adequacy of its regulatory capital;

3. the quality of senior management's supervision of the Enterprise; and

4. Fannie Mae's overall safety and soundness.

The accounting problems OFHEO identified focus on two critical areas: 1) premiums, discounts and deferred price adjustments associated with mortgages and mortgage-backed securities; and 2) derivatives and hedging activities.

In developing accounting policies and practices in these critical areas, Fannie Mae violated GAAP, specifically SFAS 91 and SFAS 133.

The accounting violations cannot be dismissed as mere differences of interpretation in accounting rules. Fannie Mae understood the rules and simply chose not to follow them.

Fannie Mae's development of improper accounting policies and practices can be traced back to a corporate culture and operating conditions characterized by the following:

- a desire on the part of senior management to portray Fannie Mae as a consistent generator of stable and growing earnings;
- an ineffective process for developing accounting policies;
- an operating environment that tolerated weak or non-existent internal controls;
- key person dependencies and poor segregation of duties;
- incomplete and ineffective reviews by the Enterprise's office of auditing;
- an inordinate concentration of responsibility vested in the chief financial officer; and
- an executive compensation structure that rewarded senior management for meeting goals tied to earnings-per-share, a metric that can be subjected to senior management manipulation.

<u>SFAS 91</u>

The accounting problems at Fannie Mae that OFHEO has uncovered relate mainly to SFAS 91 and SFAS 133. Let me briefly describe each.

SFAS 91 applies to accounting areas critical to Fannie Mae's business. SFAS 91 governs the amortization of balances related to mortgages and mortgage-related securities including premiums and discounts, and buy-ups and buy-downs on guarantee fees.

Senior management developed accounting policies and selected and applied accounting methods to improperly reduce earnings volatility related to amortization. Fannie Mae improperly delayed the recognition of income to create a "cookie jar" reserve that it could dip into whenever it best served the interests of senior management. Those interests included smoothing earnings and meeting earnings-per-share targets linked to executive bonuses.

An important example of how this worked took place in 1998 when external events caused a plunge in interest rates, which in turn led to an acceleration of mortgage prepayments. As a result, Fannie Mae faced a more rapid premium amortization in the Enterprise's mortgage portfolio than expected.

In December, management's own amortization models specified that $400 million in premium amortization expenses had to be recorded on Fannie's books in 1998. However, management decided to record only $200 million that year. Fannie Mae deferred the remaining $200 million to 1999, and recorded it incrementally throughout that year. KPMG, Fannie's outside auditor, cited the Enterprise's action on this matter as an "audit difference," a term which means KPMG disagreed with Fannie Mae.

Had Fannie Mae taken the full $400 million charge in 1998, senior managers would have lost their eligibility for any bonuses. Incentive compensation depended on Fannie Mae realizing earnings-per-share targets. As it happened, the earnings-per-share target which would secure senior management the maximum bonus could only be reached if Fannie Mae recorded no more than $200 million of the expenses in 1998.

The next year, Fannie Mae kicked off a "challenge grant initiative," which promised to reward management for doubling earnings in five years. To avoid facing amortization problems similar to those of 1998 again, senior management began a prolonged and concerted effort to develop policies for managing the amortization of deferred price adjustments, premiums, and discounts. The goal was to gain earnings flexibility and the ability to minimize earnings volatility. In this regard, the 1998 violation was not a singular event; it represented the start of a continuous effort to artificially guarantee success in meeting targets.

The amortization policies adopted rested on two main concepts:

1. not recognizing estimated income or expense below certain thresholds, and

2. deferring (often up to several years) the recognition of income or expense which exceeded recommended thresholds, to more advantageous reporting periods.

These concepts – and the policies and accounting methods Fannie Mae adopted based on them – are not supported by SFAS 91 specifically or GAAP more broadly.

In examining Fannie Mae's amortization modeling, we found that management produced multiple amortization runs, using a wide range of assumptions for future interest rates and prepayment speeds. The goal was to find a way to achieve desired outcomes.

We also found numerous instances where the impacts of other accounting events were capitalized as phantom assets or liabilities within the amortization system. Fannie Mae later amortized them as if they were attached to 30-year fixed-rate mortgages. By doing so, management inappropriately shifted income or expense from one period to others thereby dampening earnings volatility.

Moreover, Fannie Mae's written procedures and documentation for most of its amortization activities have been inadequate. The limited documentation and audit trails for amortization processes and systems allow Fannie Mae to manage its earnings and volatility in such a way that proper regulatory oversight can be impeded. Such behavior is a major safety and soundness concern.

<u>SFAS 133</u>

Let me now turn to SFAS 133 and hedge accounting. SFAS 133 requires that derivatives be marked to market, and that changes in fair value be included in earnings unless the derivative is designated as and qualifies for hedge accounting.

We have found that Fannie Mae implemented SFAS 133 in a manner that appears to have placed minimizing earnings volatility and maintaining simplicity of operations above compliance with GAAP. These goals, to an inordinate degree, influenced the development of Fannie Mae's approach to hedge accounting.

Fannie Mae's hedge accounting assumes that the vast majority of its hedging relationships are "perfectly effective." In other words, the risk and the hedge are perfectly matched, and there is no exposure to loss. A hedge relationship that is not "perfect" must be measured for its imperfection in order to determine the amount of exposure the Enterprise faces and to accurately place the timing of gains and losses. Compliance with this accounting rule is important in determining the safety and soundness of Fannie Mae.

SFAS 133 does allow the assumption of perfect effectiveness, but only in very limited circumstances. Assuming perfect effectiveness is the exception rather than the rule.

By improperly assuming perfect effectiveness for many of its hedges, Fannie Mae has failed to perform the proper assessment of effectiveness and measurement of ineffectiveness. Furthermore, the Enterprise has many deficiencies in its hedge designation documentation.

Effectiveness assessment, ineffectiveness measurement, and proper hedge documentation are critical prerequisites for receiving hedge accounting treatment. Because Fannie Mae has not met these criteria, it should not receive hedge accounting treatment for many of its derivatives. Instead, proper accounting for such derivatives requires that their fair value changes be recorded directly through earnings.

In a related area, prior to 2004, Fannie improperly accounted for certain offsetting derivatives, treating them as hedges when the derivative did not qualify as such.

Moreover, from the time SFAS 133 was adopted in 2001 through the third quarter of 2002, Fannie Mae improperly accounted for certain purchased interest rate caps. The Enterprise applied an inconsistent methodology in determining the time and intrinsic values of these instruments.

As a result of these issues and Fannie Mae's disregard for complying with SFAS 133 in accounting for its hedging activities, we are concerned about the validity of the amounts Fannie Mae has reported in what is called Accumulated Other Comprehensive Income, the earnings the Enterprise has presented in prior quarters, and the adequacy of regulatory capital.

As of December 31, 2003, the balance in AOCI included roughly $12.2 billion in deferred losses relating to derivatives. In addition, adjustments to the carrying value of liabilities relating to fair value hedges amounted to $7.2 billion as of that date.

The reclassification of amounts out of AOCI and into retained earnings could have a significant effect on Fannie Mae's regulatory capital, which is a crucial safety and soundness concern**.**

Internal Controls and Management Deficiencies

OFHEO found that Fannie Mae maintained a deficient accounting policy development process, key person dependencies, and poor segregation of duties – all of which contributed in important ways to the Enterprise's accounting problems.

In our examination, we evaluated the roles and responsibilities of the chief financial officer, executives in the controller's division, and the controls that support the integrity of the financial reporting process.

Our report documents how management failed to establish an internal control system to ensure accounting policies were appropriately developed and reviewed. For example, we found that Fannie Mae's "Purchase Premium and Discount Amortization Policy" was developed without input from the Enterprise's financial standards office. That is the group in the controller's division usually responsible for setting accounting policy. Indeed, the head of that group testified that key provisions of that document did not comply with GAAP.

We found numerous instances of key person dependencies and inadequate segregation of duties. For example, the chief financial officer also serves as the chief risk officer. He is also directly responsible for overseeing the treasury and portfolio management functions, as well as the controller's division. The concentration of these responsibilities in a single person does not provide the independence necessary for an effective chief risk officer function.

Agreement with Fannie Mae's Board of Directors

Because OFHEO's special examination uncovered so many serious problems at Fannie Mae – with such serious implications for the safety and soundness of the Enterprise – we took prompt and appropriate action.

We entered into an agreement with the Board requiring that Fannie Mae:

- implement correct accounting treatments that will bring the Enterprise into compliance with SFAS 91 and SFAS 133 accounting standards;
- protect its existing capital surplus and move to a targeted capital surplus equal to 30% of its required minimum capital;
- recalculate its accounting under SFAS 91 for all quarterly periods beginning in 1998 and SFAS 133 for all quarterly periods beginning in 2001 for previously reported financial statements;
- undertake a top-to-bottom review of staff structure, responsibilities, independence of functions, compensation and incentives;
- appoint an independent chief risk officer, and separate other key business functions currently performed jointly by certain individuals or departments;
- put in place policies to assure adherence to accounting rules and new internal controls.

I must remind the Subcommittee that the special examination is continuing. If OFHEO discovers more problems, we may take further action.

Finally, I want to thank the leadership of the Full Committee and of the Subcommittee for your support for our funding. The current

Continuing Resolution has placed severe constraints on our ability to hire additional staff and employ outside experts for the Fannie Mae special examination. This could not come at a worse time for the agency and it once again illustrates the need to remove OFHEO from the appropriations process.

Thank you. We will be pleased to answer any questions you may have.