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NEWS RELEASE

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**STATEMENT OF ARMANDO FALCON, JR., DIRECTOR
OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES
AND THE SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
OF THE COMMITTEE ON FINANCIAL SERVICES,
U.S. HOUSE OF REPRESENTATIVES: A REVIEW OF THE OFFICE OF
FEDERAL HOUSING ENTERPRISE OVERSIGHT AND FEDERAL HOUSING
FINANCE BOARD**

Chairwoman Kelly, Ranking Member Gutierrez, Chairman Baker, Ranking Member Kanjorski, and members of both Subcommittees, thank you for the opportunity to testify at today's oversight hearing on the Office of Federal Housing Enterprise Oversight (OFHEO) and the Federal Housing Finance Board (FHFB). My testimony will briefly discuss the current financial condition of the Enterprises, the importance of strengthening the regulatory environment in which the Enterprises operate, and my efforts to reshape OFHEO to meet the demands of the future. Much of my remarks this afternoon will focus on the issues facing the GSEs and the initiatives that OFHEO has taken and is taking to address these issues. My remarks represent my views and not necessarily the views of the President or the Secretary of Housing and Urban Development.

Condition of the Enterprises

The Act creating OFHEO requires the agency to report annually on the "financial safety and soundness of each enterprise, including the results and conclusions of the annual examinations of the enterprises..." OFHEO fulfills this requirement through an Annual Report to Congress submitted each June 15. Let me summarize the findings of the 2004 Annual Report.

The supervisory activities of OFHEO include an annual risk-based examination program, special investigative reviews, and our assessments of each enterprise's compliance with capital and other regulatory standards. OFHEO's examinations apply methodology similar to that used by the safety and soundness regulators for large and complex banks. As with the large national bank examinations, OFHEO's examiners use a risk-based approach that emphasizes evaluating Enterprise risk management processes as well as transactional testing. At the end of 2003, there were 58 examiners conducting the risk-based accounting and compliance exams of Fannie and Freddie. By year-end 2005 the staff devoted to such examination is expected to increase to 98.

This year, OFHEO has chosen to use the CAMELS model to report the results and conclusions of the annual examinations of Fannie Mae and Freddie Mac. The federal depository regulators (the Federal Reserve, the FDIC, the OCC, the OTS, and the NCUA) employ the CAMELS methodology as a convenient summary for an institution's financial condition at the time of the examination. CAMELS is an acronym referring to six components of the condition of the enterprises that have been evaluated through OFHEO's supervisory programs. The six areas evaluated were: Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Sensitivity to market and interest rate risks. OFHEO applies a similar means of evaluating the six component areas of the CAMELS as the depository regulators.

Capital

Capital provides the means by which the enterprises withstand adverse economic conditions or situations. OFHEO monitors and assesses the capital position of Fannie Mae and Freddie Mac on an ongoing basis. OFHEO's capital authority is promulgated in the 1992 Act through the establishment of two assessments of capital: minimum and risk-based. These quantitative measurement tools, along with the results of examinations and special examinations, provide the basis for OFHEO's capital supervision of the Enterprises.

Fannie Mae and Freddie Mac exceeded their minimum and risk-based capital requirements for all four quarters in 2003. Based upon these quantitative results and the conclusions of examination and other investigative activities, and discussions with management, OFHEO concludes that Fannie Mae and Freddie Mac were adequately capitalized as of year-end 2003 and through first quarter 2004. We have the right, however, to undertake prior period reassessments of capital adequacy when supervisory activities warrant. Freddie Mac has restated its earnings for 2003 and is expected to complete its restatement of 2004 earnings sometime in 2005. Fannie Mae, as OFHEO has indicated for the last two quarterly capital classifications, is currently under a special accounting examination that may result in earnings restatements that could affect the calculation of the company's capital requirements.

Asset Quality

During the course of each examination cycle, examiners from OFHEO evaluate the mortgage credit risk management practices of each enterprise for both the single-family and multifamily lines of business. OFHEO reviews the structure of each enterprise for managing mortgage credit risk, and through selected sampling and targeted reviews evaluates whether the

practices of the enterprises meet safety and soundness standards and adequately protect the enterprise from the risk of loss resulting from borrower or counterparty default.

Based upon examination activities to date, it is the overall conclusion of OFHEO that Fannie Mae and Freddie Mac have strong asset quality and prudent credit risk management practices. Notwithstanding this overall assessment, OFHEO has directed management at each enterprise to address specific aspects of credit risk management and also identified opportunities to improve existing practices. These areas are addressed in more detail in the Annual Report. In addition, although OFHEO considers Fannie Mae's asset quality and credit risk management practices to be sound, these and other subjects are the focus of a current and more intensive examination

Management

OFHEO evaluates management of the enterprises in accordance with OFHEO's regulations, guidance policies, and standards of prudence and safe and sound practices.

As this Committee is well aware, OFHEO conducted a special examination of the events leading to the public announcement on June 9, 2003 of the termination, resignation, or retirement of the three principal executive officers of Freddie Mac. The special examination was ordered to supplement an ongoing OFHEO examination of the financial condition of Freddie Mac and the company's decision to restate its financial reports for 2000, 2001, and 2002. OFHEO released a report on the special examination detailing a pattern of inappropriate conduct and improper management of earnings that led to the restatement and management restructuring of the company. I provided the Subcommittee on Capital Markets with details on the findings and conclusions of the special examination during my last appearance before the subcommittee in January of this year. As a result of the findings of the special examination, Freddie Mac agreed to implement corrective measures and pay a civil money penalty of \$125 million as part of a Consent Order with OFHEO.

To date, Freddie Mac is in compliance with that agreement, having met all of OFHEO's deadlines on individual requirements. Roughly half of the agreement has been implemented and the company has been cooperating well with our agency in accomplishing our common goal of remediation.

Examples of Freddie Mac's compliance with the OFHEO order include: providing us with an auditor's review of the design, assessment and evaluation of the financial controls of the company; engaging an outside consultant to review internal controls with respect to reporting processes from the company to its board and senior management; reporting to OFHEO on the functions and oversight of the chief risk officer and the chief compliance officer; and hiring an outside consultant to review the current and future staffing needs of the internal accounting function and its ongoing oversight by management.

Additionally, Freddie Mac has developed procedures regarding appropriate management oversight of the business purpose of certain transactions along with the maintenance of records detailing that business purpose. It has submitted to OFHEO a plan of actions the

Enterprise will take to address the adequacy of its public disclosure and the oversight of such disclosure. Freddie Mac has revised its corporate bylaws, adopted codes of conduct for the Board and employees, consulted with OFHEO concerning the structure of the Board (including term and age limits for board members), adopted a corporate succession plan, and submitted to OFHEO a specific plan to foster a management culture that gives appropriate consideration to operational stability and legal and regulatory compliance.

During the period of the Consent Order, the Board of Directors of Freddie Mac has elected a new Chairman and has hired a number of senior executives as its new management team. Based on an annual examination conducted in 2003, OFHEO concludes that the overall management of operational risk at Fannie Mae comports with applicable safety and soundness standards; however, this conclusion could be impacted by the results of the special accounting review. In addition, OFHEO did suggest certain enhancements to Fannie's practices. These included: correcting a perceived weakness in the computer security review process, and improving the distribution of internal policies over the intranet. Both recommendations have been implemented.

In 2004, OFHEO initiated a special examination of accounting policies and practices at Fannie Mae. The scope of this review includes accounting policies and controls at the enterprise, with an emphasis on identification of any control weaknesses or unusual transactions. When completed this review will shed light on the adequacy of Fannie Mae's internal controls, including the role of management and the board of directors in overseeing implementation of relevant policies and practices. Pending completion of that examination an assessment of Fannie Mae management must be deferred.

Earnings

OFHEO assesses enterprise earnings by analyzing the magnitude, trends, sources, and quality of earnings with particular attention to factors that may cause earnings to change in the future. Potentially important factors include: risk characteristics of existing positions, market trends, the effects of accounting practices, the effects of unusual economic conditions, and changes in fair value net worth. OFHEO also reviews management systems, practices, and strategies for controlling costs, projecting earnings and anticipating and responding to market developments.

Earnings in 2003 were strong for both Fannie Mae and Freddie Mac, amounting to \$7.9 billion and \$4.9 billion, respectively. Since the adoption of FAS 133 in 2001, earnings have been volatile at both enterprises. This is especially the case for Freddie Mac because past accounting irregularities forced it to abandon use of many hedge relationships for accounting purposes and to mark most asset values to market. Fannie Mae's reported income represented a 71 percent increase from 2002, while Freddie Mac's was down 52 percent. However, the underlying economics of both enterprises was relatively stable.

Their two principal lines of business, credit guaranty and leveraged mortgage asset investment, continued to grow and prosper at each enterprise, without deterioration in their

risk characteristics. Credit losses remain exceptionally low, while spreads between interest rates earned on assets and interest rates paid on debt remain more than ample.

Fair value gains (defined as increases in net assets on fair value balance sheets, adjusted for dividends and other net capital payouts) were also strong for both enterprises last year. Fannie Mae achieved gains of \$11 billion, and Freddie Mac had gains of \$6 billion. This measure provides an alternative perspective on the year's financial performance that avoids partial mark-to-market issues associated with reported earnings. However, the results at both enterprises benefited from changes in the relative prices of assets and liabilities that will reverse as instruments mature.

Freddie Mac expects to release the company's 2003 annual report in September 2004 and to hold the 2003 shareholders meeting in November 2004. The company has announced its intention to provide quarterly and full year results for 2004 by March 2005. The company has not yet announced when it will report full year and quarterly earnings for 2005.

OFHEO has been monitoring the progress of the restatement of earnings very closely and is receiving regular updates from Freddie Mac management. OFHEO has strongly urged the company to file timely financial statements as soon as possible, recognizing that the company has brought enormous resources to bear on the re-statement problem. OFHEO will continue to work with the company to see that investors receive accurate and full disclosure of financial information on a timely basis. Until remediation efforts at Freddie Mac have taken full effect, the company remains exposed to operation and other risks. Therefore, until the company is a timely filer of GAAP - consistent financial statements, it must continue to keep a significant capital surplus in place under the terms of the OFHEO letter of January 28, 2004.

Liquidity

During the course of the annual examination cycle, OFHEO evaluates liquidity management at the enterprises in accordance with OFHEO's regulations and guidance, and standards of prudence and safe and sound practices. Foremost in OFHEO's assessment is a determination of the level of risk to the earnings of the enterprise and capital that arises from its ongoing ability to meet obligations without incurring unacceptable losses.

OFHEO's overall assessment of enterprise liquidity came to three primary conclusions: (1) Fannie Mae and Freddie Mac have policies and procedures governing their management of liquidity risk, (2) Fannie Mae and Freddie Mac demonstrated reliable access to sufficient sources of funds on cost-effective terms to remain liquid and meet their obligations throughout 2003, (in Freddie Mac's case this access was demonstrated during a challenging and highly unusual operating environment) and, (3) Fannie Mae and Freddie Mac continue to evolve and refine their liquidity contingency plans with strategies and implementation procedures including during adverse market scenarios.

In the case of Fannie Mae these findings are subject to the findings and conclusions of the special examination currently underway.

Sensitivity

Inherent in the business model of the enterprises is the role of financial intermediary and the ability to accept and manage financial risks. One such risk is the exposure of its earnings and capital to movements in interest rates. OFHEO evaluates interest rate risk arising from differences between the timing of interest rate changes and the timing of cash flows (repricing risk); from changing rate relationships among yield curves that affect the activities (basis risk) of the enterprises; from changing rate relationships across the spectrum of maturities (yield curve risk); and from interest rate related options embedded in the products (option risk) of the enterprise. OFHEO also evaluates the impact of hedging strategies and products employed by the enterprise. It is these movements of interest rates in combination with the hedging strategies employed by the enterprises that affect the reported financial performance and the underlying economic value of their portfolios.

In 2003, volatility in the debt markets affected the interest rate risk positions of Fannie Mae and Freddie Mac. Management of both enterprises was required to respond by rebalancing this exposure to that volatility. During the 2003 examination, OFHEO focused on the risk management policies and practices of Fannie Mae and Freddie Mac and the effects that this had on their risk profiles and whether the quantity of interest rate risk being assumed by the two companies posed a supervisory concern. Routine examination activities were augmented by testing in specific areas affecting interest rate risk management.

Strengthening the Regulatory Environment

Since OFHEO's FY 2004 Budget was submitted, the regulatory environment of the Enterprises has changed dramatically, and OFHEO's funding requirements have also changed. One of the most important reasons for the increased funding that the agency is seeking relates to issues raised by two special examinations that the agency has initiated.

The special examination of Freddie Mac identified serious internal management control issues and accounting weaknesses at Freddie Mac and led to subsequent enforcement actions by OFHEO. The report of the special examination at Freddie Mac concluded that OFHEO must ensure that Freddie Mac establish an adequate remediation plan and allocate the necessary resources to establish a new corporate culture that rewards integrity and the acceptance of responsibility while penalizing any failure to meet appropriate standards of conduct. OFHEO is currently overseeing corrective actions being taken by Freddie Mac and will continue to evaluate their operational effectiveness.

Late in FY 2003, OFHEO announced plans to conduct a special examination of accounting practices at Fannie Mae. That examination is currently underway and as issues of concern to the agency are identified, we will address them immediately. When OFHEO determined the accounting for impairment of assets was incorrect, OFHEO took action to implement the correct accounting practice. I will notify the Committee if and when we have more to report regarding this ongoing special examination.

As a result of the events at Freddie Mac and to strengthen overall supervision activities, OFHEO requested and received a total of \$39.9 million in FY 2004, including \$32.4 million contained in the President's 2004 budget and \$7.5 million in a budget amendment that was transmitted September 12, 2003. The increase of \$7.5 million was allocated to three supervisory initiatives.

One was to support the litigation of enforcement actions against the former CEO and Chairman of the Freddie Mac board, and the former Chief Financial Officer. These enforcement actions are currently being litigated in administrative and related court proceedings, requiring increasing amounts of internal and external resources for legal support, discovery and litigation management.

Another was to support the hiring of an accounting firm to assist in the examination of accounting practices at Fannie Mae. OFHEO awarded a contract to the international accounting firm, Deloitte and Touche in March 2004 for a comprehensive examination of applied accounting policies at Fannie Mae. This examination is currently being undertaken and larger resources than anticipated are required to complete it. OFHEO is seeking additional funds in FY 2005 to support this initiative.

Finally, additional funds were allocated to strengthen and add capacity to OFHEO's supervisory program. These funds are being used in FY 2004 to hire additional staff supporting a restructured, more focused program of supervision.

OFHEO is seeking \$59.2 million in the FY 2005 budget to more fully staff this new reorganized program. We will continue to enhance supervisory programs concentrating on the annual examination, special compliance examinations, and examinations of accounting treatments and the management and analysis of enterprise capital. This 2005 budget supports 237 positions, compared to the 178 positions supported by the FY 2004 budget. This is an increase of 59 new positions, fully 85 percent of which are directly allocated to supervision of the activities of the enterprises. These new positions will enhance and strengthen OFHEO's regulatory efforts and will add the necessary depth and breadth in supervision staff to ensure that OFHEO serve as an early warning system for control and management problems, accounting treatments and business practices, and for any emerging financial issues.

I want to thank the leadership of the Financial Services Committee for their support for OFHEO's FY 2005 budget request. As the committee with jurisdiction over the GSEs and their issues, the members of this committee recognize the importance of having a fully funded regulator as Congress wrestles with the long term issues of GSE reform. As long as OFHEO has the responsibility for regulating Fannie and Freddie, I will continue to advocate the full funding that such regulation demands.

Reorganizing OFHEO

I have implemented some organizational changes to strengthen OFHEO's supervisory program. First, OFHEO reorganized the annual examination function into two fully staffed

units, one for Freddie Mac and one for Fannie Mae, each headed by an examiner-in-charge. The dedication of staff to one or the other of the enterprises will result in the development of greater expertise in the operations, structure, and regulatory issues of that particular company. After a number of years, the staff will rotate between enterprises to further expand their expertise as they compare and contrast the methods of operation and businesses. This targeted approach also fosters improved responsibility and accountability for examination activities at each enterprise. Rotation helps assure that an independent review of the company will never be compromised by the inevitable development of personal relationships over time.

Second, I created two new offices: an Office of Compliance and an Office of Chief Accountant. The Office of Compliance at OFHEO is generally analogous to the Division of Enforcement at the SEC. It receives referrals from other parts of the agency, including the examiners, and has the ability to conduct in-depth examinations of problems that have been identified elsewhere. The Office is responsible for identifying and investigating emerging issues and potential weaknesses of the enterprises and recommending corrective, preventive and enforcement actions as appropriate. Locating the function of in-depth examination in a dedicated office frees our regular examination teams to conduct their annual examinations of the enterprises without being forced to choose between continuing a comprehensive exam or devoting their resources and expertise to an in-depth follow up.

The Office of the Chief Accountant advises the Director and OFHEO staff on all accounting matters that concern the enterprises. The Office is responsible for developing OFHEO accounting policy; monitoring and participating in the development and evolution of generally accepted accounting practices and helping OFHEO offices responsible for examination, research or policy development understand and apply the often complex standards of modern accounting. The Office will also develop policy on safety and soundness issues related to accounting and financial reporting and accounting policies of the enterprises. The Office will coordinate the use of accounting resources within the agency to ensure the best and most efficient use of those resources.

As part of the restructuring of the agency, OFHEO has been aggressively hiring examiners and accountants, as well as necessary support and administrative personnel to support the enhanced program of examination and follow up that is being conducted as both enterprises. It is my belief that the increasingly complex nature of the businesses of the enterprises demands that OFHEO be fully staffed with the expertise necessary to carry out our responsibilities in a comprehensive manner. While OFHEO has made progress in FY 2004 in strengthening its supervision function, additional funding is required in 2005 to fully implement the kind of robust, proactive oversight that Congress expects.

Regulatory Agenda

In addition to the restructuring of the agency, OFHEO also continues to implement a regulatory infrastructure project designed to provide the agency with a framework of regulations and guidances for the comprehensive and consistent supervision of the

enterprises. A major example of this is our recently proposed corporate governance regulation.

The lessons learned by OFHEO through the special examination process provided new insights as to the best practices for both Enterprises. As a result of the findings and the recommendations contained in the Report of Special Examination of Freddie Mac, as well as developments in law, supervision and industry standards, OFHEO is undertaking to amend its corporate governance regulation to enhance the minimum corporate governance standards applicable to Fannie Mae and Freddie Mac. Among the highlights of this proposal are: separation of the Chairman and CEO functions, requiring audit firm and audit partner rotation, limiting the term of service of board members, and requiring higher standards for board independence.

The comment period has closed on this regulation and OFHEO received 19 comments that we will consider in working to a final rule. While I cannot comment on final actions, the agency will carefully review the comments and will give them full weight in moving to a final rule.

That concludes my statement. I will be happy to take your questions.