

OFHEO'S FINAL REPORT ON FANNIE MAE

HEARING BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES OF THE COMMITTEE ON FINANCIAL SERVICES U.S. HOUSE OF REPRESENTATIVES ONE HUNDRED NINTH CONGRESS SECOND SESSION

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CONTENTS

	Page
Hearing held on:	
June 6, 2006	1
Appendix:	
June 6, 2006	23

WITNESSES

TUESDAY, JUNE 6, 2006

Lockhart, Hon. James B. III, Acting Director, Office of Federal Housing Enterprise Oversight	9
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APPENDIX

Prepared statements:	
Oxley, Hon. Michael G.	24
Gillmor, Hon. Paul E.	26
Lockhart, Hon. James B. III	27

OFHEO'S FINAL REPORT ON FANNIE MAE

Tuesday, June 6, 2006

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 notice, at 2:00 p.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Gillmor, Royce, Kelly, Hensarling, Davis, Oxley (Ex Officio), Moore, Frank, and Watt.

Also present: Representative Garrett.

Chairman BAKER. Good afternoon. I call this meeting of the Subcommittee on Capital Markets to order. Today, the committee meets to discuss OFHEO's Report of the Special Examination of Fannie Mae.

Upon preliminary review of the findings, there seems to be validation of the work of OFHEO throughout the years, particularly that of your predecessor, Mr. Armando Falcon, who labored long in the vineyard trying to come to some conclusion. This work was highlighted by an appearance before the subcommittee 2 years ago, in which rather difficult observations were made public by the then-acting director and led ultimately to even more strident conversation about the advisability and need for strengthening the tools and the resources that the current regulatory structure may benefit from.

The work has been difficult, and it is certainly necessary, and I would, unfortunately, like to point out that the report even gives us greater reasons for concern. The collection of facts leads us to a very troubling picture, one in which there was, apparent to me, an effort at all costs to hit certain earnings and incentives which led to the enrichment of the executives in control of preparation of that financial data.

We will delve today in much more detail into those elements and try to appreciate, from the work you have done, how we can better prepare the accountability of the agencies themselves as well as the regulatory body going forward to oversee these increasingly complex financial organizations.

Although it may not be said necessarily for the committee, it should be part of the record that these enterprises are enormously important to our housing market. Because of the complexity of their counterparty risk and relationships with other financial enti-

ties, if there were to be adverse economic consequences to either of them, it would bring about potentially systemic risk—adverse effects—and for that reason alone, much less the exposure of the American taxpayer, the committee should spend considerable time and effort in trying to get our legislative proposal for reform adopted during this term of the Congress.

Mr. Lockhart, I look forward to your testimony and your response to the questions of the subcommittee at the appropriate time.

Mr. Watt, do you have an opening statement?

Mr. WATT. Thank you, Mr. Chairman, and I thank Mr. Kanjorski, the ranking member of this subcommittee, for asking me to sit in for him today. He has an irreconcilable conflict and could not be here. I wish it were an indication that I was in training either as a ranking member or a chair of one of the subcommittees, but my—

Chairman BAKER. The ranking member seems to be aggressive enough, if I might.

Mr. WATT. —my seniority status is such that both of those probably would appear to be somewhat out of reach at this point, so I am just here substituting for him and doing the best I can at today's hearing which is the fifth in a series of hearings of accountings of irregularities at Fannie Mae. At each of these hearings we have learned more details about what went wrong at the government sponsored enterprise and what needs to be done to prevent similar situations in the future.

Mr. Kanjorski, the ranking member, has been very vocal in his statements that government sponsored enterprises with their public responsibilities and private capital have a special obligation to operate fairly, safely, and soundly, and I certainly agree with his assessment. The management at these entities must ensure that they produce accounting statements that reflect their real financial condition, and I think we, hopefully, are headed back in that direction.

While the report that we are having the hearing about represents one more important step in the process of examining the accounting issues and management issues, we must also keep our focus on completing the legislative action that is necessary to improve the oversight of all government sponsored enterprises going forward. It is certainly in the public's interest that we address regulatory issues promptly and properly.

OFHEO has leveraged its existing general safety and soundness authority through the adoption of specific safety and soundness standards. The authority to adopt these standards and any other safety and soundness standards deemed necessary would be clearly established in the House-passed bill, which also would strengthen the enforcement authority of the regulator, including enforcement of safety and soundness requirements.

Additionally, the House bill gives the regulator authority to order reductions in assets for safety and soundness reasons, similar to the action that is taken as one of the resolutions of today's report.

Mr. Kanjorski is also a strong supporter, as am I, of the concept that a strong, world-class, independent regulator is needed for the GSE's, and we hope that we can move in that direction following

these series of hearings focused primarily on what went wrong and tangentially on looking forward to how we can “right the ship” and go forward.

After reviewing OFHEO’s report, I have two specific questions that I hope will be answered. First, it would be nice to know whether OFHEO believes it now has an appropriate level of cooperation from the management and board of the company. Second, it would be nice to learn how long it will take for Fannie Mae to get back into financial shape and current with its reporting and be able to move forward aggressively with the housing mission that I believe most, if not all, of the members of this committee support.

So we thank you for being here, Mr. Lockhart, and look forward to your testimony.

Mr. FRANK. Mr. Chairman, I wonder if I could proceed out of order to note the presence of a former chairman of this committee in this room, our former colleague from Rhode Island, Mr. St. Germain—my former colleague, because I don’t know if anybody else is still here. You are, I guess, and Mr. Oxley.

Chairman BAKER. Welcome back, sir. Nice to see you here.

Mr. ST. GERMAIN. Oh, I am looking for Rick Milano, my former staff director.

Chairman BAKER. Some things never change. We are constantly looking for our staff.

Mr. FRANK. Protocol has been tightened up since you have been here, so you have to sit down.

Chairman BAKER. Chairman Oxley.

The CHAIRMAN. Mr. Chairman, coming on the heels of Senator Redman’s work, OFHEO’s staff is to be commended for giving us the comprehensive report from the agency special exam of Fannie Mae. I congratulate former OFHEO Director Falcon for initiating examination and former Acting Director Blumenthal for completing this report.

Mr. Lockhart, congratulations are in order for you on your nomination by the President to head OFHEO, and I look forward to your presentation today.

OFHEO’s story of Fannie Mae is, unfortunately, fact, not fiction. We are told that Fannie Mae’s best-in-class image was a facade. According to the report, the company’s board of directors was a complacent entity controlled by senior management which systematically withheld vital information. Management routinely violated GAAP in order to maximize bonuses and mislead shareholders. Reported details are that Fannie Mae sought to oversee OFHEO, instead of the other way around, even orchestrating a HUD Inspector General investigation and reduction in appropriations for the purpose of discrediting the agency, as well as a report that we review today.

According to this report, in October of 2004, Fannie Mae’s former chairman and CEO Raines and CFO Howard made, “inaccurate statements”, in sworn testimony before this subcommittee when they denied that expense deferrals had been made.

Compensation for senior executives tied to earnings per share targets dwarfed basic salary and benefits. From 1998 to 2003, more than half of \$200 million in compensation received by the top five executives was EPS related. OFHEO found that the message at

Fannie Mae was clear: EPS results mattered, not how they were achieved.

Last March, in an SEC filing, Fannie Mae reported accounting errors in over 20 separate categories. There is no doubt that those accounting errors were in part due to a weak and outdated internal control system. It was only in 2005, when making certain that the company complied with the section 404 internal control requirements of the Sarbanes-Oxley Act, that Fannie Mae's senior management finally admitted, "that the company's internal control over financial reporting was ineffective."

The failure of internal controls and the audit function at Fannie Mae reinforces a need for the Sarbanes-Oxley Act. In fact, if not for Sarbanes-Oxley, I wonder how much of this would have come to light at all.

OFHEO and the SEC imposed one of the largest penalties ever paid by an individual company, making Fannie Mae the Enron of the financial services industry. \$350 million of the \$400 million penalty will go to the Fair Fund, which was strengthened and created by the Sarbanes-Oxley Act, and will ultimately be returned to investors. The rest goes to the U.S. Treasury.

This report reminds us how crucial it is for Congress to approve legislation to strengthen regulations of the GSE's. We need to prevent abuses from developing and permit swift enforcement if they do.

In OFHEO's request, Fannie Mae has agreed to cap the growth of its mortgage portfolio. I would point out again to those who characterize it incorrectly that the House bill gives a new GSE regulator clear discretionary authority to require portfolio adjustments. OFHEO's action shows why the regulators should have the flexibility to respond, not be directed by Congress. It is imperative that this new regulator have the authority to adjust portfolios as called for under the House-passed Baker bill.

I concur that Treasury possesses the authority to approve GSE debt issuances. The 2004 Congressional Research Service legal analysis stated, "If Congress wanted to limit the Treasury Department's approval authority, then Congress could have done so. Because Congress chose instead to use broad language in describing Treasury's authority, it follows that a broad interpretation of that authority would likely be judged to be reasonable."

I understand that the Department of Justice has given Treasury a similar opinion. While I endorse the belief that Treasury possesses this authority, I do not offer an opinion as to whether the Department should use it at this time.

Congress correctly provided Treasury with broad discretion in this area, just as we should do in the area of portfolio powers. I only note that the Administration's rhetoric on the matter suggests that the matter is urgent. I would like to see that sense of urgency find a better outlet than repeatedly asking Congress to tie the new regulators' hands on portfolio authority.

If OFHEO's report doesn't motivate our colleagues in the other body to act on this legislation, nothing will. Only after full Senate action is complete will we be able to work together on a conference committee to send the President the GSE bill in this Congress.

And let me say to the chairman of the subcommittee, who had been a lone wolf on this issue and alone in the wilderness for a number of years, that his hard work, persistence, vision, and tenacity have paid off with the revelations in the OFHEO report and with the successful passage of his legislation by a large bipartisan majority in the House of Representatives. We can only hope that the other body will respond in kind.

And I yield back.

Chairman BAKER. Thank you, Mr. Chairman, for your kind words.

Mr. Frank.

Mr. FRANK. Thank you, Mr. Chairman.

I have never been a fan of people in our business who invoke various ancestors for what always seems to me to be very convenient reasons, and I strongly suspect that about 90 percent of what is attributed to our dead relatives they never said but can't defend themselves. But, in this case, I am reminded strongly of something I do remember hearing my father say.

He was a man of great charity. And once he got into a major dispute with the people who were running the Jewish Community Center in town, which was a very important institution, and shortly thereafter he made a large donation to them, as was his habit. Someone expressed surprise that, after having this argument with the people on the board of directors about the policy of the institution, he would continue to be so supportive, and he said, "I am not mad at the bricks."

And that is my attitude here. I think it is very important for us to separate out the individuals and the institutions.

The chairman of the committee is right. The gentleman from Louisiana, earlier than anyone else to my knowledge, saw that there were abusive practices being engaged in by individuals who were running Fannie Mae. There were also abusive practices being engaged in by people running Freddie Mac, and that is instructive because the Freddie Mac abuses, having been uncovered earlier, we now see there is life after manipulation. Because we have today, I believe, with Freddie Mac a good, forthright, honorable set of leaders who have managed to rescue that institution from a pattern of abuse, excessive compensation, and manipulation.

Clearly, condemnation is in order for those who ran Fannie Mae so abusively. What is important is for us to differentiate between their behavior, which should be condemned, and the lack of constraints which allowed that behavior to go forward and the underlying institutions.

We continue to have in this country a serious crisis in housing affordability not just for very low-income people but in many parts of the country, including my own, the price of housing for people in middle income has gone beyond what it should be. So I want to continue to do everything we can not just to preserve, but to improve, the ability of Fannie Mae and Freddie Mac to help us with housing, as this committee recently did with regard to the FHA. They all worked together.

That is an important point to keep in mind, that we do not punish the institution. The institution is not the value here. The value

here is the housing that is built for people, and it is very important that we not do anything that compromises that.

I believe that what OFHEO has done shows the way. OFHEO has shown us how you can, in fact, correct the abuses without interfering with the mission.

And I am struck, as the chairman is, by the testimony this gives to the legislation we passed. I think much of what we did anticipates this, the question of portfolio limits. We clearly, in our legislation, foresaw the importance of giving the regulator, when it became appropriate because of abuses or dangers or problems, to be able to deal with the portfolio. So I am very grateful that we have that example.

And I share his frustration that the Senate is refusing to act. There can be no justification for that.

If people think that the powers of the regulator need to be enhanced, I would be willing to listen. I must say I haven't heard any suggestion other than kind of automatic restriction on the portfolio, but in terms of the powers it doesn't seem to me that they have been critiqued with any force.

One last point. In a perverse way, these events and this report are a testimony, I believe, to the underlying strengths of Fannie Mae and Freddie Mac. That is—and we have had comparisons to Enron and MCI, and, in fact, of the abuses there was that kind of abuse. But the abuses at Enron and MCI led to collapses of the institutions.

What is heartening to me here is that the underlying structure of Fannie Mae and Freddie Mac, the strength of the housing market, the strength of that model, allowed them to withstand being misrun—Freddie Mac earlier, Fannie Mae today. We have not had a serious problem—for those who say there is a terrible drain on the taxpayers, we have seen these abuses and the taxpayers were left whole. So I think the lesson of this is that we need to do a better job going forward in giving the regulator the power to prevent these kinds of abuses from happening without in any way endangering or inhibiting the housing mission. I think the legislation that we passed that is gathering dust somewhere in the Senate is a very good way to deal with that.

And I know the Senate has very pressing business. I know the Senate has got to act immediately to prevent me from wrecking marriages all over America. Once they have put that safely behind them, I hope they will get down to serious business.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman, and let me add my voice to that of the chairman and ranking member and thank you for your great leadership. Since I first came to Congress, indeed, you have often been a lone voice in the wilderness in trying to bring the disinfectant of the sunshine into the activities of the GSE's and ensure that the proper regulatory regime is in place to save both the housing markets and the taxpayers. I am happy to note, though, that the analogy just goes so far, since your head seems to be thoroughly attached to your shoulder blades, and I as-

sume that before this process is all said and done that there will be other heads that indeed roll.

I also want to thank Mr. Lockhart and OFHEO for the good work done, much of it by his predecessor and that team, in wading through often complex and arcane issues.

I suppose what we have today is the end of a 2- to 3-year process that for many of us is reinforcing and giving us more concrete evidence on what we already know, and that is, for the period 1998 through 2004, the company systematically misapplied GAAP relating to the amortization of certain fees on its securities and their hedge accounting and that this was done at the direction of senior management, which led to materially false, incorrect, and misleading financial statements that were publicly issued and relied upon.

And I suppose what else is new is, if I read the comments of the SEC chairman correctly, I believe that this marks the first time that there has been an official designation of Fannie Mae's accounting practices as fraud. So, because of that, I look forward to hearing more about the end result of this report.

We also know that, Mr. Chairman, we simply cannot turn our backs on the systemic risks that are posed by the GSE's. Right now, I think what we have is the second largest borrower in the world, second only to Uncle Sam himself, an institution holding a Federal charter, an asset portfolio worth over a trillion dollars, and they can't produce a reliable financial statement for the bulk of this decade. That is troubling, to say the least.

So, not unlike our other colleagues, I certainly urge the other body to act, and act quickly, on this legislation so that we may go to conference and again protect the taxpayer, protect the consumer, and protect the housing market.

With that, I yield back.

Chairman BAKER. I thank the gentleman.

Chairman BAKER. Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman.

I guess the upshot is—and let me begin by thanking Director Lockhart for appearing before our committee today. But I think that what we notice here is that we now have temporary portfolio caps to try to do something about this systemic risk. But that does not alleviate the need for portfolio authority to be in GSE legislation, and I think the OFHEO report highlights for us pretty clearly the fact that Fannie Mae did not have sufficient controls in place to manage its large and risky portfolio. Indeed it is very, very difficult at this—given the size of these portfolios, basically, Fannie Mae concocted its own accounting rules to cover up the weakness in its ability to manage its portfolio.

So we notice that OFHEO still does not have the power to adjust the portfolio levels of the GSE's. They can only do that with the permission of Fannie Mae. That is basically what was done here. This is not a strong regulatory position to be in, and that is the position we will be in unless the Senate language passes.

Even with the agreement between Fannie Mae and OFHEO, we should reflect on the fact that the portfolio still stands at close to three-quarters of a trillion dollars.

The reason that bankruptcy is not likely is because of the presumption that the U.S. Government will come in and prop up and subsidize the GSE's if there are losses.

The size of this portfolio continues to be a risk to the domestic and the international financial system. You know it is not just our regulators that are concerned in the United States. It is a worldwide concern and has been for some time. Without specific guidance to reduce the size of these portfolios, OFHEO will continue to be unable to address the risks to taxpayers in the financial system these portfolios provide.

Also, the portfolio cap agreed to by Fannie Mae will only be in place on a temporary basis. Once Fannie Mae has submitted a plan and met the requirements set by OFHEO, they will be permitted to go back to growing the portfolio at risky levels, and this portfolio cap only applies to one of the GSE's, only Fannie Mae. Freddie Mac is not a party to it. Thus, the ability to grow the risky portfolio remains, and, thus, the problem which we will get to during questions remain.

But we thank you very much, Director Lockhart, for the leadership you have taken on this and your willingness to be with us today.

Chairman BAKER. I thank the gentleman.

Mr. Garrett.

Mr. GARRETT. Thank you, Mr. Chairman, and I also applaud you for being the lone voice in the wilderness for so many years. Hopefully, you are now among a chorus at this point addressing the issue.

I would just like to say that it seems it is quite a coincidence that the very same week that OFHEO delivers its report outlining the multiple counts of corporate greed committed by the executives of Fannie Mae that the one man who so epitomizes for the 21st Century so far, Ken Lay, received his guilty verdict in the wake of the Enron scandal. I believe that the comparison between Fannie Mae and Enron cannot be ignored. Both companies manipulated their financial statements. They put our financial systems at risk for the specific intent of allowing their executives to make their already fat pockets even fatter.

Now, due to the government benefits enjoyed by Fannie Mae—and I think this would explain to the ranking member why their house of cards remains standing when Enron's do not—and their callous and negligent behavior did more than just mislead and defraud the investors. It did this at the expense of the American taxpayer. This has led former OFHEO Director Falcon to suggest that Fannie Mae is, "the Enron of government on government steroids."

Furthermore, as Fannie Mae was putting in overtime and using a vast amount of their internal resources to hit these specific earning targets, they were using less of their resources to help accomplish what their mission is, and that is to provide affordable low-income and minority housing. This means that Frank Raines, Jim Johnson, and the rest were enriching themselves at the expense of the Nation's least fortunate. They were taking advantage of the exact people that the company was chartered to help.

Now I appreciate you coming here to testify today, and I will be asking some questions later on.

We know that Freddie Mac said last month that it will not be providing quarterly financial statements for 2006 until some time later next year. This means, honestly, that is up to OFHEO to protect the financial markets and the taxpayers from risks, because no one else can. No one else will have definitive market information about what is going on in that company. They will not have the regular market discipline to make sure to send signals to it about what is going on.

Freddie Mac said it would curtail new initiatives because of its huge problems. But, at the same time, it said it would expand purchases of high-risk, nontraditional mortgages. I will ask you, and I will ask you later on, why should OFHEO permit either GSE to engage in anything new and potentially risky until all the financial information has been made available to the public?

Finally, Mr. Chairman, in 2002, Fannie Mae's duration GAAP spiked to 14 months. At that time, Director Falcon said, "that the regulatory process is working as it should." In fact, your report makes clear that the regulatory process was grievously off course, because Fannie Mae took in billions of economic losses to bring its interest rates risk back in line. These billions were never even noticed by OFHEO until Fannie Mae's SEC registration.

Now I recognize, and other people have already indicated, that you have only been on the job for a short period of time. I realize that, and it has been a very busy time for you as well. But the questions I will be looking for you in the future is what can we hear from you today to make sure that nothing of this magnitude or scope will ever, ever, ever, happen again with either of the GSE's.

And I yield back, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

It is my pleasure to welcome, I believe for the first time to a Congressional hearing in your capacity as acting Director of the Office of Federal Housing Enterprise Oversight, to testify here today on the agency's findings, Mr. James B. Lockhart III. I believe from a review of your resume, however, you are, by prior government experience, more than adequately qualified to take on this difficult mission, although I suspect that this subject matter may even have a few surprises for someone as experienced as yourself. So please proceed at your leisure.

**STATEMENT OF THE HONORABLE JAMES B. LOCKHART III,
ACTING DIRECTOR, OFFICE OF FEDERAL HOUSING ENTER-
PRISE OVERSIGHT**

Mr. LOCKHART. Thank you, and good afternoon.

Thank you, Chairman Baker, Chairman Oxley, Congressman Watt, and members of the subcommittee. Thank you for your support of OFHEO over the years and for this team that is behind me. They are the ones who really put in all the work to get this report out. I really welcome the opportunity to discuss the findings of our Special Examination of Fannie Mae and the settlement agreements.

As a government sponsored enterprise, Fannie Mae has a very special position among American corporations and an extremely

important mission—facilitating the growth of affordable housing in the United States.

The previous management team, led by Chairman Franklin Raines, violated that public trust. By encouraging rapid growth, unconstrained by proper internal controls, risk management, and accounting systems, they did serious harm to Fannie Mae, while enriching themselves through manipulating earnings per share. The result was an estimated \$10.6 billion of overstated profits, well over a billion dollars of cost to fix the problems, and ill-gotten bonuses in the hundreds of millions of dollars.

In September of 2004, OFHEO issued an interim report that detailed serious problems relating to Fannie Mae's accounting. The SEC agreed and ordered Fannie Mae to restate its financial statements.

The just-released Special Examination Report details what can only be characterized as an arrogant and unethical corporate culture. The image of Fannie Mae as one of the lowest-risk and best-in-class institutions was a facade. The examination found an environment where the ends justified the means.

The executive compensation program at Fannie Mae focused on managing earnings rather than risk. Indeed, Fannie Mae took significant amounts of interest rate risk and, when interest rates fell in 2002, incurred billions of dollars of economic losses. Fannie Mae also had very significant and very large operational exposures that were not properly managed. Senior executives were managing Fannie Mae in an "unsafe and unsound" manner. They also co-opted their internal auditors. They stonewalled OFHEO.

During the period covered by this report, Fannie Mae hit earnings per share targets with uncanny precision each quarter by deliberately and systematically using inappropriate accounting and improper earnings management. Senior management of Fannie Mae benefited greatly from these manipulations. From 1998 to 2003, the total compensation of ex-CEO, Franklin Raines, exceeded \$90 million, of which \$52 million was directly tied to achieving earnings per share goals.

This inappropriate "tone at the top" spread throughout the organization and, in a blatant conflict of interest, the head of the Office of Auditing told his staff, in reference to Mr. Raines' goal of double earnings per share by 2003, that they must have, "\$6.46 branded in their brains."

I will now turn to some of their improper accounting and controls.

First, to prevent large, unpredictable earnings fluctuations, Fannie Mae chose to implement investments, derivatives, and other accounting standards in a fashion that reduced volatility while ignoring GAAP.

Fannie Mae management also went to extraordinary lengths to avoid recording and then hiding GAAP required impairment losses on assets whose values had declined.

By keeping earnings within what could be considered a predictable range, management was in a position every quarter end to manipulate and manage earnings to hit specific targets, and they did that through the use of cookie-jar reserves, income shifting transactions, and inappropriate debt repurchases.

The report details the conscious decisions made by management to use outdated accounting systems and to create a weak internal control environment.

Internal Audit failed to properly confirm compliance with GAAP or consistently audit critical accounting issues. Similarly, external audits performed by KPMG failed to include an adequate review of Fannie Mae's significant accounting policies for GAAP compliance, and when they did become aware of the non-GAAP compliant provisions, they still continued to issue totally unqualified opinions on Fannie Mae's financial statements.

The board of directors is really the last line of defense in a company, and they again failed to be sufficiently informed and independent. Their oversight failings meant that they did not discover, let alone correct, the wide variety of unsafe and unsound practices at Fannie Mae, even after Freddie Mac's problems became apparent. The Auditing Committee did not provide proper oversight of the internal audit function, critical accounting policies, and the whistle-blower claims.

In the report, OFHEO's staff makes recommendations to enhance safety and soundness. They recommended that we continue to strengthen and expand our regulatory infrastructure and regular examination programs and, also importantly, that we continue to support legislation to provide the powers essential to meeting our mission of assuring safe and sound operations at both Fannie Mae and Freddie Mac.

The recommendations directed to Fannie Mae were incorporated into the settlement agreement where we had about 60 different items we agreed to. Some of the key ones were: Fannie Mae agreed to pay a \$400 million penalty; Fannie Mae agreed to freeze the growth of its portfolio at last year end numbers (December 31, 2005); and Fannie Mae agreed to undertake a comprehensive reform program aimed at a top to bottom change, from its board of directors, internal audit, risk management, compliance, external relations, internal controls, accounting systems, and data quality. All of those areas need improvement. Fannie Mae also agreed to review current and separated employees for remedial actions.

During the joint settlement announcement, as was mentioned, Chairman Christopher Cox of the SEC said that, "The accounting fraud charges that the SEC is filing against Fannie Mae reflect the failure by Fannie Mae to maintain the kinds of internal controls that could have prevented what in all likelihood would have been one of the largest restatements in American corporate history."

Thank you. I am looking forward to working with members of this committee, and I would be pleased to answer questions at this point.

Chairman BAKER. Thank you, Mr. Lockhart.

[The prepared statement of Mr. Lockhart can be found on page 27 of the appendix.]

Chairman BAKER. I wanted to start off by analyzing the 2002 and 2003 income periods. That is when they experienced their significant negative duration GAAP problem and, to extricate themselves, they spent a big amount of money to cancel pay-fixed swaps that were the cause of the interest rate losses. Am I understanding the report correctly, that if the actual economic consequences of

that period of time were reported accurately that the enterprise would have had about a \$12 billion adjustment to its revenue?

Mr. LOCKHART. Certainly, at that point in time, they discovered and they thought before the interest rates fell dramatically that they didn't have as big an issue as they ended up having. We saw—

Chairman BAKER. Let me make it simpler, because my time will run quick on me. I have got a lot.

My point is that, 2002, enterprise suffered an economic loss, earnings per share targets were still hit, so maximum bonuses were still paid, while shareholder value was depleted.

Mr. LOCKHART. That is correct.

Chairman BAKER. Great. Not great, but that is what I was trying to get at.

In a separate direction, reading from the report in several selected areas, Fannie Mae reported extremely smooth profit growth, hit earnings per share targets with uncanny precision—I think you read that earlier. During the period in question, 1998 through 2003, CEO Raines earned \$90 million, of which 52 was directly tied to earnings per share. It is my understanding during the same period, aggregated for the top executives, the total compensation—excuse me, total bonus paid was somewhere in the neighborhood of \$250 million, is that about correct?

Mr. LOCKHART. That is about correct.

And you are right. That chart over there shows that the line is the targets and the blue bars are the reported, and it is really uncanny that they could hit those year after year after year. And it is because of the quarter to quarter accounting gimmicks, and it resulted in very large bonuses in the range of several hundred million dollars, tied just to EPS.

Chairman BAKER. In the October 2004 hearing, I asked Mr. Raines, prior to the decision being executed to defer the \$200 million in expense at the end of 1998 into the quarters of 1999, were you consulted or did you have knowledge of the transaction?

Raines' response—there was no decision made to defer any expense from 1998 to 1999. Howard can go into greater detail as to how the process actually occurs, but we did not make any deferral. I was part of a discussion, as I always am as CEO, in the closing process in which decisions made in our financial area with regard to the calculation of the catch-up provision was discussed—that is why he got paid that much; you can't understand anything—but the determination of that was made through our normal process of closing our books.

In a separate question, were there any discussions related to the consequences of that expense treatment in relation to the earnings per share, Raines responds no.

I asked, then when did you first realize that earnings per share would be \$3.23? To which he responded, the first time I would know what earnings figures would be is when our comptroller would have closed the books and done all of the analyses necessary to determine what the final results are, and then that would be reported to me. That would be after any decision that was made in regard to the catch-up provision.

Now a summary of the facts that we have just gone through from your report, your testimony as well today, and then reading through the responses of the CEO to this committee, you can't make a legal judgment, I understand.

There seems to be clear evidence in my mind that Mr. Raines perjured himself to this committee in answering those questions. Would there be any reason for a person to dispute that conclusion after listening to those facts and hearing his responses?

Mr. LOCKHART. You are right; I cannot make a legal judgment. But I think the report, if you read it—and you have read it, obviously—does contradict the statements that he made.

Chairman BAKER. We will examine that further.

Some discussion was made earlier today by some members relative to portfolio constraint. The bill passed by the House does provide authority to the director of the new entity to adjust portfolio in any manner. In fact, it is my understanding that if the powers conferred in that legislation were given to you, you would have the authority, for appropriate reasons, to reduce portfolio to zero. Is that a responsive tool that you feel is appropriate in light of the current portfolio risk that is presented by the enterprises?

Mr. LOCKHART. I believe that there is significant risk provided by these portfolios, when you add the two of them together, about \$1.5 trillion, half and half now, from the two companies, and it is an issue that really does have to be looked at.

When we froze the portfolio as part of the agreement, that was really based on their continuing internal controls, lack of risk management, and lack of accounting systems. It did not address the issue of systemic risk and operational risk and, I think if you are going to look at these companies, you have to include that in their capital calculations and how that might impact their portfolios.

Chairman BAKER. I am out of time, but one quick follow-up. What other tool should be given a regulator to address this problem other than the discretionary authority to reduce, increase, or leave alone the size of the portfolio?

Mr. LOCKHART. The whole legislative package passed by the House would be very helpful to give us a whole series of tools to make us a better safety and soundness regulator. We don't have the comparable tools that the banking regulators do. We need receivership. We need not to be appropriated. We need a whole series of tools that will make us a stronger regulator.

Chairman BAKER. Thank you.

Mr. Watt.

Mr. WATT. Mr. Lockhart, I want to focus on the remedial agreements that you all have reached with Fannie Mae as part of the agreement to move forward, not because I am concerned about the provisions of them, but because I am concerned about the understanding, and knowing the impact of them.

If you take the combination of the growth limit, limiting portfolio assets to the level as of December 31, 2005, and the capital restrictions previously agreed requirement for a 30 percent capital surplus, can you tell us what the impact of those two in combination will have on the housing mission of Fannie Mae? Has OFHEO made any assessment of that?

Mr. LOCKHART. We have certainly looked at the issue and, from our standpoint, we do not see an impact. There is enough capital there certainly to continue the mortgage-backed security packaging that it does.

On the portfolio side, they certainly have assets that can be sold as they want to acquire new assets, and that is really what will happen over time. They will sell some assets off, place them in the marketplace, and use the money to invest in new assets.

Mr. WATT. So your testimony is that from your perspective, OFHEO's perception, there will be no adverse impact on the housing mission from those things?

Mr. LOCKHART. For the housing mission, and especially the affordable housing mission, I see no impact. They obviously have a lot of work to do in those areas and continue to do work, but these two things should not interfere with that.

Mr. WATT. Focusing further on the part of the agreement related to personnel, I am wondering how you—how OFHEO will assess—how will you define success, so to speak, in there is a part of the agreement that says, Fannie Mae's board must have a third party review of Fannie Mae's government and industry relations programs, and adopt a plan for setting new policies and controls on lobbying efforts.

How would you assess the effectiveness of that? I mean, are there criteria that you would use in evaluating the board's performance in that regard going forward, or will this be solely up to the board to make those determinations?

Mr. LOCKHART. Certainly in that case we will look at the review and discuss it with the board and the management team and we will do that with many of the other proposals in the agreement. The board of directors is responsible for the oversight of this company and we are responsible as a safety and soundness regulator. Because the company has so many unsafe and sound practices at the moment, let alone in the past, we are very, very actively involved in this company, and I might add also in Freddie Mac from that standpoint because they also have continuing unsafe and unsound practices. Both of these companies are probably several years away from having adequate accounting internal controls, so we are going to be involved in the discussion, and in particular in this review of the government relations area. We will look at the review and make sure that they don't re-engage in unsafe and unsound practices.

Mr. WATT. I am about to run out of time. So I don't mean to cut you off. I wish I had more time to allow you to elaborate, but it sounds like there is some subjectivity involved in this on the board's part and on your part and that's fine. I am not being critical. I'm just trying to figure out what—how you will define success.

Let me focus on one other area and that's the \$400 million penalty and the use of that for the benefit of—I mean, who gets the benefit of that, and I guess the related question is, is there a legal mechanism in place now for shareholders who may have been adversely affected to get redress?

Mr. LOCKHART. Of the \$400 million, \$50 million went to the U.S. Treasury and it's a monetary penalty provided under our law. The

Sarbanes-Oxley law provided for the shareholder funds and in consultation with the SEC, we agreed that it made a lot of sense to put it there. The SEC will be setting up rules related to the fund.

Mr. WATT. But is there a shareholder right of action here or is there—

Mr. LOCKHART. There are already shareholder suits going on and, as I understand it, I believe potentially some of this money could be used to settle those suits.

Mr. WATT. But does this cap—

Mr. LOCKHART. This does not.

Mr. WATT. Okay. I appreciate it, Mr. Chairman. I yield.

Chairman BAKER. The gentleman's time has expired. Chairman Oxley.

The CHAIRMAN. I would say to my friend from North Carolina that the Fair Fund was set up in Sarbanes-Oxley Act to be a receptacle for fines and disgorgement. That money is now accumulating in the billions.

Chairman BAKER. Seven.

The CHAIRMAN. \$7 billion plus, which will then be returned on a pro rata basis to shareholders who were injured. A lot of people don't like Sarbanes-Oxley. I think most people like that part of it, particularly if you are a shareholder and you lost your shirt.

Let me ask a couple of questions here, Mr. Lockhart. On the executive compensation issue in the chart that was provided by Chairman Baker, the earnings or the executive compensation based on earnings per share and the bonuses thereon, Senator Rudman's testimony and his committee investigating could only cite 1 year—that was 1998—where they could conclusively say that those earnings were manipulated. Your report is very clear that 8 years, why this difference? Why is yours so definitive in covering an 8-year period and Senator Rudman's just 1 year?

Mr. LOCKHART. First of all, I would say that our team did a great job, and as a government regulator we had more incentive to really go in and really get the details. If you read the report, it is very clear by year to year that there was manipulation of the earnings. Some years they were looking in the cookie jar to make earnings higher, other years they were doing financial transactions and other things to hide earnings for 1 year and push it out in the future. It is hard for me to speculate why the reports are different except to say that I believe that our team really did a good job and went thoroughly through the accounting issues.

The CHAIRMAN. You also mentioned that the auditors had been co-opted and could you help us with that? How did that happen?

Mr. LOCKHART. The internal auditors in particular were being paid and had bonuses related again just to EPS.

The CHAIRMAN. So you are referring to internal auditors?

Mr. LOCKHART. That is what I am referring to and I read the statement about the \$6.46 target and that was the 5-year bonus target and every member of Fannie Mae's team got a bonus related to that. So the internal auditor in that speech where he talks about that and thanks Frank Raines for doing it for him, is a total conflict of interest.

The CHAIRMAN. The Enron case was just concluded with convictions, WorldCom and many of the others had a common thread,

and that was they were described, I think accurately, as accounting scandals. At the heart of this, this was really an accounting scandal too, is it not?

Mr. LOCKHART. Yes, it was. And there is another similarity. These two firms were many times thought of as the best in their class and, to a certain extent, I think that the management team started to believe that, and believed that they could almost walk on water and maybe they didn't have to pay attention to the accounting rules.

The CHAIRMAN. The legislation that passed the House, and I can characterize it a little bit with a—I think, a clear memory. When Chairman Baker started this quest, I think it is safe to say that he felt, first of all, that he had about 2 votes. But secondly, he had a vision to create a world class regulator. And we have had discussions with that. I think at that time, given the political realities, Chairman Baker felt that if we could restructure the regulatory function that that would be a big win. Since that time and events that have moved in that direction, we passed legislation on a bipartisan basis to allow the new world class regulator to determine minimum risk base capital standard review and adjust portfolio holdings, approve new programs and business activities, mandate prudential management and operational standards, take prompt corrective and enforcement actions, put a critically undercapitalized GSE into receivership, which was very controversial not too many months ago, and require corporate government improvements, higher examination of accounting experts.

Pretty comprehensive in my estimation dealing with the problem at hand and, besides all of that, they have to comply with Sarbanes-Oxley requirements for establishing internal controls and in defining risk, and that is a pretty effective package, it seems to me. I just wondered if you would just comment again in a global sense about how this legislation that passed, the Baker bill that passed the House along with the requirements of section 404 and Sarbanes-Oxley worked together to hopefully prevent, because after all we can punish all we want but at the end of the day when investors lose money and people's lives are destroyed, it is great, maybe that they can feel good about some executive going to jail but at the end of the day they would rather have their money back, and if we could prevent this kind of activity from happening in the first place with the Baker bill combined with the internal control provisions of Sarbanes-Oxley, seems to me we got a pretty good package.

Mr. LOCKHART. My belief is if 8 years ago we would have had Sarbanes-Oxley and a stronger regulator, which your bill, and Chairman Baker's bill does, it would have been very, very helpful. There is the issue, I think, that needs to be stressed as to how the regulator sets the capital limits related to portfolio levels and other issues, but my view is that it is a very excellent start and we would be a lot better off today if we had had it.

The CHAIRMAN. Thank you, Mr. Chairman.

Chairman BAKER. Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

Mr. Lockhart, I am curious to know what your decisionmaking process is going to be as far as unfreezing Fannie Mae's ability to increase the size of their mortgage portfolio assets. Specifically, I

am sure you are familiar with the fact that the former chairman of the Fed, Alan Greenspan, was quite outspoken on the issue of the purpose of the GSE's holding their own securities. In fact, in a speech he delivered roughly a year ago, if I can quote, "the key activity of the GSE is the provision of liquidity to the primary mortgage market can be accomplished exclusively through the securitization of mortgages"; GSE portfolios of mortgage-related assets cannot serve this function. To sell mortgage-backed securities to purchase other mortgage-backed securities clearly adds no net support to the mortgage markets.

So again, the former chairman of the Fed was quite outspoken on this issue, and so I am curious, number one, whether you agree with that assessment. If you don't agree with that assessment, what is the thinking behind when you would permit Fannie Mae to increase its mortgage portfolio?

Mr. LOCKHART. Certainly I have read the testimony by the chairman and obviously everybody respects what he has to say. I have been in the job just a little over a month now, and most of it has been, at this point, related to the Fannie Mae report. So I haven't had a lot of time to really get my hands around how you set up capital for systemic risk. I know a lot about how you set up capital for operational risk, and those are two of the things we must think about when we are setting limits on portfolios or at least reserving capital against those limits.

As for the freeze that Fannie Mae agreed to, we said in the agreement that there is a way to get some flexibility once they give us a report in a couple of months. There are a lot of requirements. The risk management, liquidity, housing policy, and internal controls would really be the concerns and frankly, if legislation is passed, you know, the limits may be superseded by something else. Certainly market concerns would be another issue. We have given the company guidelines, but we have also told them that it is really at the discretion of the regulator when those will be lifted, and frankly it is hard to see a total removal of limits for several years.

Mr. HENSARLING. In your testimony, you talk about former chairman and CEO Franklin Raines violating a trust. You speak of earnings manipulation, you speak of ill gotten bonuses, and you speak of an arrogant and unethical corporate culture. If I read your testimony properly, though, I didn't see the term, "fraud," although I have seen that used by SEC Chairman Cox, who claims that these activities consist of accounting fraud. Is this a mere manner of semantics or should I be reading something into the fact that your testimony does not include the word, "fraud"?

Mr. LOCKHART. Maybe a little semantics. It may be that the SEC is more the keeper of the word "fraud" than we are as a safety and soundness regulator.

Mr. HENSARLING. In your testimony you also state that the, "goal of senior management was straightforward to force OFHEO to rely on the enterprise for information and expertise to such a degree that Fannie Mae would essentially regulate itself." So we are—did you believe that Fannie Mae was trying to regulate you or were you trying—was it the other way around?

Mr. LOCKHART. That goes back into the history well before I arrived. If you look at some of the indicators, the agency was incred-

ibly underfunded 6 years ago. It may have been under-skilled as well. It was hard to build up the culture and the money to really to be a first class regulator. As you all know, Fannie Mae was an extremely strong agency. The corporation had very strong lobbying activities and other things that I think—and again I wasn't there but I have heard—really made it very hard for OFHEO to do the job it should have been doing. The law needs to be strengthened too.

Mr. HENSARLING. Though I had other questions, my time has expired. I am not a subcommittee chairman, so I can't go on.

Chairman BAKER. Point well taken.

Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman.

Mr. Lockhart, in the President's Fiscal Year 2007 budget, the Administration calls for the creation of, in its words, a GSE regulator with new and explicit authorities currently not possessed by the agency. You have been nominated in this case to lead, which is OFHEO. And the budget outlines the systemic risks to the financial system posed by, as it explains, the GSEs' large holdings of mortgage-backed securities. In order to mitigate these risks, the President has called for Congress to instruct, "a new GSE regulator that asset portfolios are a significant source of systemic risk and should be limited by the GSE regulator accordingly."

In the Administration view, "mitigating systemic risk requires taking action before a crisis occurs." And that a regulator, in their words, limited to consideration of safety and soundness and risk may not fully consider potential consequences to others in the mortgage markets and the larger economy, which is along the lines of some of the issues you raised with regard to systemic risk and operational risk and not having the power to the receivership authority and so forth.

But clearly from what the Administration says, it believes that Congress should grant the new regulator statutory authority to address both safety and soundness and systemic risk. Now in Congress, the House has passed legislation that deals with part of this. We deal with the safety and soundness regulation, in my view, whereas, the Senate Banking Committee has passed legislation that would allow the new regulator to address systemic risk by giving clear and unambiguous guidance to the new regulator about the size and composition of the GSE portfolios along the lines that our Fed regulators have talked about. So in essence, the Senate bill would anchor the GSE portfolios to their public mission.

As the acting Director and likely future Director of OFHEO, I would like to know if you prefer the House legislation or if you agree with the Administration and prefer the Senate Banking Committee legislation. That is what is on my mind.

Mr. LOCKHART. First of all, I agree with this committee, and the Senate committee, and former Chairman Greenspan, that there is very significant systemic risk, and it is not just the assets. It is the liabilities, it is the borrowing, and it is the derivatives that tie it all together, and between those three things, there is a giant exposure to the world economy, and if things went wrong, there could be a very large impact.

Systemic risk has to be addressed. I believe that the regulator must address it, and I believe that it would be helpful to give some guidance on that, that we need to address the systemic risk and, as I say, also operational risk in a more broad based way than we have in the past.

Mr. ROYCE. I thank you, and I yield back.

Chairman BAKER. The gentleman yields back. Mr. Davis. I am sorry. Mrs. Kelly.

Mrs. KELLY. Thank you, Mr. Chairman.

Mr. Lockhart, the Subcommittee on Oversight held a hearing last year in which it was revealed that Fannie Mae had deliberately withheld information from the United States Government about fraudulent mortgages.

I quoted the Inspector General of HUD here. He said Fannie Mae did not pass information on First Beneficial's transgressions to others, allowing First Beneficial to issue more than \$7.5 million in fraudulent loans ensured by taxpayers.

In response to that hearing, I have worked with a number of my colleagues to include in H.R. 1461 legislative language requiring Fannie Mae to report fraudulent transactions to a third party—by a third party rather—to OFHEO's successor agency, which is the Federal Housing Finance Agency. I understand that your agency has now taken regulatory steps to accomplish that goal and is working with FinCEN so Federal housing enterprises will no longer occupy a unique position, not being accessible to the Federal agencies that are fighting money laundering or terrorist finance, and I wonder if you will please explain to the committee your thoughts on what happened in the First Beneficial case, how it ties in to the corruption that was shown in the Rudman report and what your agency is doing to ensure that every one of the people involved in this case who failed to act as good corporate citizens, in the words of the HUD Inspector General, are not allowed to work at a regulated enterprise.

Mr. LOCKHART. The First Beneficial case was extremely unfortunate and I think it does show some of the arrogance of Fannie Mae and as this was done, I think, out of the Atlanta office, it was further down the organization. We obviously got involved. We worked with the company and the company, I believe, paid us a \$7 million fine. The person who was the lead on this was reprimanded. But as you pointed out, and I think more importantly going forward, we will now be reporting mortgage fraud to FinCEN and we are continuing to work with other government agencies to try to prevent things like this from happening in the future.

Mrs. KELLY. I appreciate that, but I want to go back to the idea that someone who has essentially committed fraud in a government agency is then allowed to go on and work at another government agency that is a regulated agency. Is there any kind of step being put in place to prevent people from moving from job to job?

Mr. LOCKHART. At this point, I am not really sure of the details of that. I thought this individual was actually working at Fannie Mae. But I can tell you that, in some cases, we can, and have, exercised debarment, which is effectively what you are talking about in the Fannie Mae case, and Frank Raines and CFO Howard had

been debarred as part of our agreement and, yes, we can do that if these situations reach that proportion.

Mrs. KELLY. Thank you very much. I have one other question. I want to know if you think that OFHEO's risk-based capital rule needs revision.

Mr. LOCKHART. OFHEO's risk-based capital rule is useful but it is really just a stress test in my mind, and coming out of the insurance and banking industries, and having worked actually at a leading firm that was a risk management firm for 4 years, my view is that it needs a lot of work. We need to—and hopefully part of the legislation will give the agency the power to do that—start looking at how to set up a best in class, if I can use that phrase, enterprise risk management risk-based capital standard.

Mrs. KELLY. I would hope that you would work diligently to do that. I think that is an oversight piece that needs to be done, and I am glad you are willing to jump in and help. Thank you very much.

I yield back, Mr. Chairman.

Chairman BAKER. I thank the gentlelady. I have a few follow-up questions.

First on the gentlelady's comment, legislation pending provides explicit authority for the Director to engage in a whole set of binocular observations and microscopic analysis, so I think we have got you well-tooled.

Going back to the portfolio discussion because that really is where we are today, is the linchpin on being able to get a legislative remedy moving forward. I would not suspect, but I have to ask, that you would have today a methodology nor a dollar figure in mind to which portfolios would be reduced if you are confirmed and if legislation grants you by whatever mechanism the authority to reduce. Or would that rather be something arrived at by some counsel study with staff over some period of time?

Mr. LOCKHART. Certainly not a dollar figure because I am not sure a dollar figure is the right way to go. I think there is a methodology and we have to look at the methodology.

Chairman BAKER. You don't have that in your pocket?

Mr. LOCKHART. I do not have a methodology especially for systemic risk. I may have a methodology from operational risk given my background. I basically believe that we need to do further study and we are starting to do that kind of study.

Chairman BAKER. That is the reason for my question, to get to that study conclusion because whether it was Secretary Snow or other financial regulators, no individual has yet recommended a particular target or a particular formula by which you get to a target, but rather some sort of studied approach. The bill now pending does provide and I want to address—Mr. Royce has stepped out—but for the record, the study requires the new Director over a period of 12 months to assess a general description of portfolio, a description of the risk implications, an analysis of the portfolio for safety and soundness purposes, which everybody points to, analysis of whether the holdings fulfill the mission purposes, which is not often mentioned, an analysis of the potential systemic risk, which has been missed on occasion, for the enterprises, for the housing and capital markets and for the entire U.S. financial system. So it

is a very broad-based risk assessment strategy and coupled with that is the clear mandate to reach a conclusion and report as to whether those portfolios should be reduced, limited in growth. Whatever conclusion that is appropriately to be reached we specifically—specifically and intended to leave out the word, “grow” or “enlarge”, so the bias in the bill as it stands is to give the new Director the tool to say within 12 months you got to, and here are the guidelines which you must utilize, and come back with a reason why, and a method to get to a specific target.

We also, on the subject of capital, had very intentional language on page 56 of the bill pending, notwithstanding the capital classifications of the enterprise, that the Director by order may require, and goes on with a bunch of things. Today they have to be significantly capital-impaired in order for you to take certain actions. As I understand it, the basis on which the consent agreement was reached with Fannie Mae was principally leveraged by the uncertainty of their financial conditions because of the inability to certify financials. Therefore, you could then, as Director, enter into negotiations and reach an agreement, which ultimately was signed, leveraged by the underlying financial uncertainty. If Freddie Mac's financials were not certified, you could impose the portfolio limit on them at this time, utilizing that same ability, that legal leverage. But as I understand it, the agency has found Freddie Mac's financial condition at this time is sufficiently well to certify therefore that you are not in a regulatory position to engage in a portfolio limit as you did with Fannie Mae, is that correct?

Mr. LOCKHART. Not necessarily.

Chairman BAKER. Okay.

Mr. LOCKHART. Freddie Mac is still years away, at least 2 years away, from really having acceptable accounting and internal controls and a risk management system.

Chairman BAKER. That being the case and that was the leverage point which you entered into the discussion with Fannie Mae and reached a consent agreement which limited the growth of portfolio, what is the regulatory impairment to doing a similar strategy with Freddie Mac because I am an equal treatment GSE guy? I believe whatever you do to one you should do to both. Is there any impairment in your ability to enter into a consent agreement for that purpose?

Mr. LOCKHART. Again, we can enter into a consent agreement if they consent and, because the law is not as strong as we would like, it may be difficult if they didn't consent. The chairman of Freddie Mac mentioned that, I believe last week, in a press conference he did mention that we have discussed the idea that there should be some sort of freeze there as well. And, frankly, it is not that well known but over the last 3 or 4 years, Freddie Mac has grown its portfolio by 20 percent, while Fannie Mae has shrunk its portfolio by 20 percent. So there is an issue there that we are considering, but I can't say at this point whether we are going to do anything about it or not.

Chairman BAKER. If you fail to act on that point, it will not be due to a regulatory impairment to act, it will be a question of whether or not it is appropriate to act?

Mr. LOCKHART. I believe that is correct, yes.

Chairman BAKER. Mr. Watt.

Mr. WATT. I chose not to focus on the shortcomings of OFHEO because I think everybody is aware that there was a period of time, for whatever reason, that OFHEO was being duped just like the internal auditors and the external auditors were being duped.

I want to get your assessment generally of how much better equipped OFHEO is now. I mean, are you confident that OFHEO has the capacity currently, and the resources currently, to do what the current regulatory scheme allows you to do, as well as what both the House and Senate bills might allow OFHEO to do in the future?

Mr. LOCKHART. Certainly we would like a bill, and that will give us some of the strength that we need to be the safety and soundness regulator we should be. We want to work with everybody and make that happen. On the resource side, we were significantly under-resourced. Over the last 6 or 7 years, we probably tripled the number of people in our budget. We have added some really good people, some very professional people. We are going to need to continue to hire people. We are going to continue to need to do training and we are going to need to have to have occasionally a team that we can put in the field very quickly if there is a crisis, which then speaks to getting outside the appropriations process which this bill does.

Mr. WATT. I am not sure you answered my question.

Mr. LOCKHART. I guess the answer is yes, we have a very good team. I think we can build on this team and continue to get better and better, but we do need legislation to really get us to where we want to be.

Mr. WATT. Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Mr. Lockhart, some of us have said they are paving the way to home ownership. Nobody had ever in mind it would be an interstate system to go from coast to coast to get us to final resolution on this manner. I appreciate very much, and all members of the committee do, your participation here today, but it is a very long road. We have a long way to go. We look forward to working with you as Director in the coming months.

Mr. LOCKHART. I thank you and I look forward to working with you.

Chairman BAKER. Our meeting stands adjourned.

[Whereupon, at 3:20 p.m., the subcommittee was adjourned.]

A P P E N D I X

June 6, 2006

Opening Statement

Chairman Michael G. Oxley
Financial Services Committee

**Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises**
OFHEO's Final Report on Fannie Mae

Tuesday, June 6, 2006

Mr. Chairman, coming on the heels of Senator Warren Rudman's work, OFHEO's staff is to be commended for giving us a comprehensive report on the agency's special exam of Fannie Mae.

I congratulate former OFHEO Director Falcon for initiating the examination and former Acting Director Blumenthal for completing this report. Mr. Lockhart, congratulations are in order for you on your nomination by President Bush to head OFHEO, and I look forward to your presentation today, as Acting Director.

OFHEO's story of Fannie Mae is unfortunately fact not fiction. We're told that Fannie Mae's best-in-class image was a façade. According to the report, the company's board of directors was a complacent entity controlled by senior management, which systematically withheld vital information. Management routinely violated GAAP to maximize bonuses and mislead shareholders. The report details that Fannie Mae sought to oversee OFHEO, instead of the other way around, even orchestrating a HUD Inspector General investigation and a reduction in appropriations for the purpose of discrediting the agency, as well as the report that we review today.

According to this report, in October 2004, Fannie Mae's former Chairman/CEO Raines and CFO Howard made "inaccurate statements" in sworn testimony before this Subcommittee, when they denied that expense deferrals had been made.

Compensation for senior executives, tied to earnings-per-share targets, dwarfed basic salary and benefits. From 1998 to 2003, more than half of \$200 million dollars in compensation received by the top five executives was EPS-related. OFHEO found that the message at Fannie Mae was clear—EPS results mattered, not how they were achieved.

Last March, in an SEC filing, Fannie Mae reported accounting errors in over twenty separate categories. There is no doubt that those accounting errors were in part due to a weak and outdated internal control system. It is only in 2005, when making certain that the company complied with the Section 404 internal control requirements of the Sarbanes-Oxley Act, that Fannie Mae's senior management

finally admitted "the company's internal control over financial reporting was ineffective."

The failure of internal controls and the audit function at Fannie Mae reinforces the need for the Sarbanes-Oxley Act. In fact, if not for the Sarbanes-Oxley Act, I wonder how much of this would have come to light.

OFHEO and the SEC have imposed one of the largest penalties ever paid by an individual company, making Fannie Mae the Enron of the financial services industry. \$350 million of the \$400 million penalty will go the FAIR Fund, which was strengthened by Sarbanes-Oxley, and will ultimately be returned to investors. The rest goes to the U.S. Treasury.

This report reminds us how crucial it is for Congress to approve legislation to strengthen regulation of the GSEs. We need to prevent abuses from developing and permit swift enforcement if they do.

At OFHEO's request, Fannie Mae has agreed to cap the growth of its mortgage portfolio. I would point out again to those who characterize it incorrectly that the House bill gives the new GSE regulator clear, discretionary authority to require portfolio adjustments. OFHEO's action shows why the regulator should have the flexibility to respond, not be directed by Congress. It's imperative that this new regulator have the authority to adjust portfolios as called for under the House-passed Baker bill.

I concur that Treasury possesses the authority to approve GSE debt issuances. A 2004 Congressional Research Service legal analysis stated, "If Congress wanted to limit the Treasury Department's approval authority, then Congress could have done so. Because Congress chose instead to use broad language in describing Treasury's authority, it follows that a broad interpretation of that authority would likely be judged to be reasonable." I understand that the Department of Justice has given Treasury a similar opinion.

While I endorse the belief that Treasury possesses this authority, I do not offer an opinion as to whether the Department should use it at this time. Congress correctly provided Treasury with broad discretion in this area, just as we should do in the area of portfolio powers.

I only note that the Administration's rhetoric suggests that the matter is urgent, and I would like to see that sense of urgency find a better outlet than repeatedly asking Congress to tie the new regulator's hands on portfolio authority.

If OFHEO's report doesn't motivate our colleagues in the Senate to act on legislation, nothing will. Only after full Senate action is complete will we be able to work together on a conference committee to send the President a GSE bill this Congress.

Opening Statement

Congressman Paul E. Gillmor (R-OH)

**Subcommittee on Capital Markets, Insurance and Government Sponsored
Enterprises**

June 5, 2006

Hearing entitled: "OFHEO's Final Report on Fannie Mae."

I want to thank Chairman Baker for calling this hearing today. As a cosponsor of H.R. 1461, I am interested in long-term solutions to the reform needs of the housing GSEs and look forward to the recommendations of Mr. Lockhart for a comprehensive reform package that allows for liquidity in the secondary mortgage market while installing significant safeguards to protect the market.

Although the allegations contained in the final report raise serious questions about the accounting and executive management procedures at Fannie Mae, I would like to ask Mr. Lockhart about a specific provision included in H.R. 1461, which passed the House of Representatives by a vote of 331-90. My language would authorize the Federal Housing Finance Agency to require that Fannie Mae and Freddie Mac make publicly available, each year, the total value of contributions made to non-profit organizations during the previous fiscal year. It would also request specific disclosures on donations to insider-affiliated charities. I am interested to know if Mr. Lockhart believes this would be a helpful disclosure.

The housing GSEs, Fannie Mae and Freddie Mac, were established by congressional charter and given special privileges to provide a service to the American people by creating a secondary mortgage market. Given their unique status and responsibility to improve access to the housing market, it is both their shareholders' and the American public's right to know how their profits are being spent.

I was pleased to be supported by Chairman Oxley, Chairman Baker and Ranking Member Frank in the fight to promote charitable contribution disclosure and I look forward to getting a bill to President Bush that will provide for appropriate regulation of Fannie Mae and Freddie Mac.

EMBARGOED FOR RELEASE UNTIL
2PM EDT – JUNE 6, 2006

**STATEMENT OF
THE HONORABLE JAMES B. LOCKHART III
ACTING DIRECTOR
OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
ON “OFHEO’S REPORT OF THE SPECIAL EXAMINATION OF FANNIE MAE”
BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES,
U.S. HOUSE OF REPRESENTATIVES
JUNE 6, 2006**

Good afternoon. Chairman Baker, Ranking Member Kanjorski and members of the Subcommittee, thank you for the opportunity to discuss the findings of our Special Examination of the Federal National Mortgage Association, better known as Fannie Mae. I will also discuss the settlement agreements reached by the OFHEO and the Securities and Exchange Commission (SEC) with Fannie Mae.

As a Government Sponsored Enterprise (GSE), Fannie Mae has a special position among American corporations and an extremely important mission—facilitating the growth of affordable housing in the United States. Despite its recent downsizing, Fannie Mae remains one of the largest financial institutions in the United States. As a GSE, Fannie Mae has a special mandate and position of public trust. The previous management team, led by Chairman and Chief Executive Officer (CEO) Franklin Raines, violated that trust. By encouraging rapid growth, unconstrained by proper internal controls, risk management and other systems, they did serious harm to Fannie Mae while enriching themselves through earnings manipulation.

Let me provide a little history about OFHEO’s Special Examination. Despite Fannie Mae’s protests, in July 2003 OFHEO informed the Senate Committee on Banking, Housing, and Urban Affairs that it intended to conduct a special accounting review of Fannie Mae to evaluate whether it complied with Generally Accepted Accounting Principles or GAAP.

In September 2004, OFHEO issued an interim report that detailed serious problems relating to Fannie Mae’s accounting. Importantly, OFHEO found that Fannie Mae did not comply with GAAP for FAS 91, which deals with amortization of loan fees, premiums and discounts, and FAS 133, which covers derivatives and hedge accounting. The SEC concurred with OFHEO’s findings and ordered Fannie Mae to restate its financial statements filed with the Commission.

Since then, OFHEO and the Board of Directors of Fannie Mae have entered into three agreements requiring remedial steps. The last agreement was signed on May 23, 2006.

The OFHEO report details an arrogant and unethical corporate culture. Perhaps the best written record of this culture is a memo from the Chief Operating Officer to the CEO two months after OFHEO's interim report. He was discussing the need to change and wrote: "The old political reality was that we always won, we took no prisoners..." and he added, "we used to ... be able to write, or have written rules that worked for us."

Fannie Mae's management directed employees to manipulate accounting and earnings to trigger maximum bonuses for senior executives from 1998 to 2004. The image of Fannie Mae as one of the lowest-risk and 'best in class' institutions was a façade. The examination found an environment where the ends justified the means.

As reported in the Special Examination Report, senior Fannie Mae executives were precisely managing earnings per share (EPS) to the one-hundredth of a penny to maximize their bonuses while neglecting investments in systems, internal controls and risk management. The combination of earnings manipulation, mismanagement and unconstrained growth resulted in an estimated \$10.6 billion of overstated profits, well over a billion dollars in expenses to fix the problems, and ill-gotten bonuses in the hundreds of millions of dollars.

To update the old English saying, they were "a hundredth of a penny wise and tens of billions of dollars foolish." Actually, their actions were much worse than foolish. They were flat-out wrong, or, to use the proper regulatory phrase, they were managing Fannie Mae in an "unsafe and unsound" manner. Senior management manipulated accounting; reaped maximum, undeserved bonuses; and prevented the rest of the world from knowing about it. They co-opted their internal auditors and other managers. They stonewalled OFHEO.

The executive compensation program at Fannie Mae sent senior executives the message to focus on increasing earnings rather than controlling risk. Indeed, during much of the period covered by the report, Fannie Mae took significant amounts of interest rate risk and, when interest rates fell in 2002, incurred billions of dollars in economic losses, despite the smooth reported earnings. Fannie Mae also had significant operational risk exposures.

The Board of Directors, the last line of defense, failed to be sufficiently informed and independent. Their oversight failings meant that they did not discover, let alone correct, the redundant variety of unsafe and unsound practices at Fannie Mae, even after the Freddie Mac problems became apparent.

Management Manipulated Earnings

During the period covered by this report, Fannie Mae reported extremely smooth profit growth and hit earnings per share targets with uncanny precision each quarter. This was deliberately and systematically done by the senior management of Fannie Mae through the use of inappropriate accounting and improper earnings management.

By deliberately and intentionally manipulating accounting to hit earnings targets, senior management maximized their bonuses and other compensation, which came at the expense of shareholders. In 1998, management *should* have recognized significant losses from the amortization of premiums and the impairment of guaranty-fee buy-ups, but much of the actual loss was deferred so that management could meet bonus targets, as well as the expectations of analysts. In other years, such as 2001, when very low short-term rates resulted in higher-than-forecasted earnings, management engaged in various manipulations, including debt repurchases and structured transactions with no legitimate business purpose, to save earnings for a rainy day. The report details the various ways in which these EPS numbers were massaged and manipulated in order to precisely hit these targets.

Senior management of Fannie Mae benefited greatly from these manipulations. For example, the total compensation of former Chairman and CEO Frank Raines exceeded \$90 million from 1998 through 2003. Of that amount, more than \$52 million was directly tied to achieving earnings per share targets.

Senior executives at Fannie Mae consistently reminded managers and other employees of their personal stake in meeting EPS targets. Indeed, the head of the Office of Auditing told his staff, in reference to Chairman Raines' goal of doubling earnings per share from \$3.23 to \$6.46 by 2003, that they must have "\$6.46 branded in their brains." That statement implies a blatant conflict of interest for an internal auditor.

The report also found that senior management did not make adequate investments in accounting systems and staffing that the Enterprise needed to support a sound internal control system and GAAP-compliant accounting. These failures came at a time when Fannie Mae faced many operational challenges related to its rapid growth and a changing accounting and legal environment. In fact, this under-investment in internal controls, accounting systems, risk management and staff helped them to manage earnings as it made it much easier to hide improper actions that smoothed earnings.

That gives some flavor as to the inappropriate "tone at the top" and corporate culture that existed at Fannie Mae, and the executive compensation program that provided the incentive for the inappropriate behavior detailed in the report. Now, I want to spend a few minutes briefly describing the accounting tools that management used to achieve their desired earnings targets and the control environment – or lack thereof.

Specific Accounting and Earnings Management Issues

In brief, the extreme predictability of the financial results reported by Fannie Mae from 1998 through 2003, and the ability to hit EPS targets precisely each quarter, were illusions deliberately and systematically created by management. The real question is how was management able to accomplish this when their business is volatile by nature and the accounting literature was moving toward measuring and reporting assets and liabilities at fair value?

First, they had to assure that large unpredictable changes in fair value were not recognized. FAS 115, *Accounting for Certain Investment in Debt and Equity Securities* and FAS 133, *Accounting for Derivative Instruments and Hedging Activities* are examples of accounting standards, if implemented properly, that would have recognized and recorded earnings volatility. Faced with that outcome, Fannie Mae chose to implement these and other accounting standards in a fashion that reduced volatility while ignoring the fact that these practices did not comport with GAAP.

During this same period, Fannie Mae management went to extraordinary lengths to avoid recording GAAP required impairment losses on assets whose values had declined. Examples of such assets are manufactured-housing and aircraft-lease-backed securities, interest only securities and “buy-ups.” Not only did they not record these losses but the report details the extraordinary measures management took to keep this information off the books and out of the view of their external auditor and regulatory bodies while tracking it for their own information and use.

By utilizing the above strategies, management was able to keep earnings within a predictable range, placing management in a position to employ several techniques to manipulate and manage earnings more directly. Those strategies included the use of cookie-jar reserves, income shifting transactions and inappropriate debt repurchases. Those reserves and transactions were utilized and maintained to provide management with the opportunity to make last-minute, quarter-end adjustments to hit specific earnings targets.

The natural question at this juncture is where were the internal controls that should have prevented this type of behavior and where were the internal and external auditors?

The report details the conscious decision made by management to use existing systems even when proper implementation of new accounting pronouncements and rapid growth necessitated the need for new systems. It also discusses the weak internal control environment that management created or allowed to exist including a detailed discussion of the lack of journal entry controls.

The report also discusses the serious failures in the Office of Auditing. Internal Audit failed to properly confirm compliance with GAAP as specified in its audit objectives or to consistently audit critical accounting policies, practices, and estimates in a timely way. When Internal Audit did find shortcomings they were not adequately addressed or communicated. The Audit reports consistently understated problems and overstated work accomplished. Internal Audit failed to perform its primary task and issued misleading reports about its work. Finally, it failed to exercise due professional care in investigating allegations of accounting improprieties raised by two employees in the Office of the Controller.

Similarly, external audits performed by KPMG failed to include an adequate review of Fannie Mae's significant accounting policies for GAAP compliance. KPMG was aware of the non-GAAP provisions of Fannie Mae's FAS 91 policy as well as the non-GAAP practices the Enterprise was using in the application of FAS 133. That notwithstanding, KPMG issued unqualified opinions on Fannie Mae's financial statements for the years in question when these statements included significant departures from GAAP. Lastly, the external auditor performed a cursory review, at best, of the allegations of fraud raised by Roger Barnes. The procedures performed by the external auditor were not sufficient to make a determination regarding the propriety of the internal investigation performed by Fannie Mae or to evaluate the Enterprise's conclusions regarding Mr. Barnes's assertions.

The Role of the Board

In addition to these accounting and earnings management issues, the report also provides some insight on matters of corporate governance that gave rise to many of these problems. For example, the special examination found that the Board of Directors of Fannie Mae contributed to the Enterprise's problems by failing to be sufficiently informed and failing to act independently of its chairman, Frank Raines, and other senior executives. The Board failed to exercise the requisite oversight over the Enterprise's operations, and failed to discover or ensure the correction of a wide variety of unsafe and unsound practices. These failures occurred even after serious accounting and earnings management problems at Freddie Mac became widely known.

In particular, the Audit Committee did not provide adequate oversight of the internal audit function, and did not monitor the development and implementation of critical accounting policies. These failures resulted from the Committee's own neglecting to develop the specialized financial knowledge necessary for its oversight responsibilities. The Audit Committee also failed to initiate an independent investigation of Roger Barnes' whistleblower claims of accounting irregularities when they arose.

The failure of the Audit Committee was compounded by failures of the Compensation Committee. The primary role of this committee is to ensure that senior management is properly compensated for its role in directing the affairs of the Enterprise. Nevertheless, the Compensation Committee approved a compensation structure based on a single measure -- earnings per share that was easily manipulated by management. The Compensation Committee also did not monitor the executive compensation system for signs of abuse by senior management.

Recommendations

Based on the reports findings, staff made specific recommendations to me, as Acting Director, to enhance the safety and soundness of Fannie Mae. I have accepted all of the recommendations. Several of them were directed to OFHEO, including:

- OFHEO needs to continue to strengthen and expand its regulatory infrastructure and regular examination programs.
- Matters identified for remediation by Fannie Mae should be considered for Freddie Mac.
- OFHEO should continue to support legislation to provide the powers essential to meeting its mission of assuring safe and sound operations at Fannie Mae and Freddie Mac.

However, the majority of these recommendations are directed at Fannie Mae and I am pleased to say they have all been incorporated into the agreement that was signed on May 23, 2006.

The settlement represents a major step in correcting a dangerous course that had been followed by one of the largest financial institutions in the world. Unprincipled corporate behavior and inadequate controls simply will not be tolerated.

The key components of the agreement include:

- OFHEO has directed Fannie Mae to pay a \$400 million penalty to the government. This level of penalty signals that unsafe and unsound conditions cannot be tolerated at firms that have a public mission and enjoy public benefits.
- OFHEO has directed that Fannie Mae freeze the growth of its portfolio mortgage assets to the level of December 31, 2005. OFHEO's action is based on the ongoing internal controls, risk management and accounting deficiencies and the need for the Enterprise to provide OFHEO an acceptable business plan for managing its market activities. Sole discretion lies with Director of OFHEO to modify or lift the limits based on his assessment of plans and progress. The existing capital requirements and capital planning along with limits on corporate actions such as dividend payments remain in effect.
- OFHEO has directed Fannie Mae to undertake a comprehensive reform program aimed at a top-to-bottom change, from corporate culture and tone to specific changes, including:

- Fannie Mae must strengthen its Board of Directors procedures to enhance Board oversight of Fannie Mae's management. The internal audit, risk management and compliance groups must be strengthened. The external relations program must be reviewed.
- Fannie Mae must take additional steps to improve its internal controls, accounting systems, operational and other risk management practices and systems, data quality, and journal entries. Emphasis must be placed on implementation with dates certain.
- Fannie Mae must undertake a review of current and separated employees for remedial actions. At the same time, Fannie Mae is directed to put in place qualified individuals with appropriate skills and adequate resources, and to provide a strong training program.

As you know, the SEC settled with Fannie Mae the same day that we did. Chairman Christopher Cox joined the OFHEO press conference and said, "Fraudulent financial reporting directly undermines the fairness of our capital markets, and the very purpose of those markets to allocate capital to its best uses." He also said, "the accounting fraud charges that the SEC is filing against Fannie Mae reflect the failure by Fannie Mae to maintain the kinds of internal controls that could have prevented what in all likelihood will be one of the largest restatements in American corporate history."

That concludes my prepared remarks. I would be pleased to answer any questions you may have.