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**HEARING ON ADDITIONAL ACCOUNTING  
AND MANAGEMENT FAILURES AT FANNIE MAE**

Wednesday, April 6, 2005

House of Representatives,

Subcommittee on Capital Markets, Insurance,

and Government Sponsored Enterprises

Committee on Financial Services,

Washington, D.C.

**Committee Hearings**

of the

**U.S. HOUSE OF REPRESENTATIVES**



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

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

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

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

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

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

41 | Perhaps more importantly today is, after reading other  
42 | press stories as of yesterday, it is my understanding the

43 | director has made clear to the White House his intention to  
44 | depart his responsibility as director in the near term, and I  
45 | feel I owe it to him, given our longstanding professional  
46 | working relationship, to make some comment.

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

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

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

67 |       Mr. Kanjorski?

68 | Mr. KANJORSKI. Thank you, Mr. Chairman.

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

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

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

91 | The main focus of today's hearing is the March  
92 | supplemental supervisory agreement between Fannie Mae's board

93 | and the Office of Federal Housing Enterprise Oversight. This  
94 | agreement addresses additional deficiencies identified by the  
95 | regulator during its ongoing special examination. These  
96 | failings relate to insufficient internal controls, the  
97 | improper application of accounting standards and inadequate  
98 | corporate governance.

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

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

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

118 | for advancing home ownership opportunities.

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

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

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

133 |       [The statement of Mr. Kanjorski follows:]

134 | \*\*\*\*\* INSERT \*\*\*\*\*

135 | Mr. BAKER. I thank the gentleman.

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

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

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



146 STATEMENT OF HON. ARMANDO FALCON,<sup>^</sup> DIRECTOR, OFFICE OF FEDERAL  
147 HOUSING ENTERPRISE OVERSIGHT

148 Mr. FALCON. Thank you, Mr. Chairman.

149 I will give a summary of my written testimony.

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

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

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

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

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

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

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

190 Significant among the corporate governance reforms was  
191 the requirement that Fannie Mae separate the chief executive  
192 officer and chairman of the board positions. We also  
193 required that the company report weekly to OFHEO on its  
194 efforts to meet capital requirements, including any corporate

195 | decisions on dividend payments or other matters that would  
196 | affect the company's capital position.

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

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

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

214 |         During our special examination, we have also identified  
215 | several problems involving procedures for preparing,  
216 | reviewing, validating, authorizing and recording journal  
217 | entries related to amortization adjustments. These issues  
218 | include falsified signatures on journal entries; the failure  
219 | to require that journal entry preparers determine the entries

220 | were valid and appropriate; a failure to require that journal  
221 | entries include supporting documentation; a lack of  
222 | independent review of journal entries; and an absence of  
223 | written policy guidance concerning journal entry procedures.

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

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

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

241 |       Finally, Mr. Chairman, I would like to also end on a  
242 | personal note, if I may. As you mentioned, my 5-year term as  
243 | director of OFHEO expired last October, but I have remained  
244 | in the office to guide the agency through a very challenging

245 | period. With the most critical and pressing issues at the  
246 | enterprises now addressed, I have decided to step down from  
247 | my position next month.

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

254 | I am particularly proud of the efforts of OFHEO's  
255 | employees and our conduct <sup>during</sup> ~~at~~ the special examinations. ✓  
256 | Seldom does a safety and soundness regulator identify  
257 | improper actions, with potentially billions of dollars of  
258 | adverse impact, before they manifest themselves in a way that  
259 | does permanent harm to the company.

260 | It has been a privilege to serve the public as the  
261 | director of OFHEO, and I want to thank this committee for its ✓  
262 | support over the years.

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

265 | [The statement of Mr. Falcon follows:]

266 | \*\*\*\*\* INSERT \*\*\*\*\*

267 Mr. BAKER. Thank you very much.

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

277 Mr. FALCON. I would be concerned that, at some point in  
278 time, the problems we found in the company would manifest  
279 themselves some way. Fortunately, we did find them before  
280 that occurred, but the practices of the company in terms of  
281 its approach towards compliance with regulations, be they  
282 accounting or internal controls or best practices in risk  
283 management, ~~they~~ were not healthy. ✓

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

287 Mr. FALCON. Yes.

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

291 Mr. FALCON. We cannot say with any degree of certainty

292 | right now, but I think a useful model might be to look at the  
293 | Freddie Mac situation. There, it did take a couple of years  
294 | for the company to produce financial statements, and it will  
295 | take a couple of years beyond that to get timely. I think  
296 | that might be a useful example of what might be involved  
297 | here.

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

301 |       Mr. FALCON. Right.

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

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

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

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

319 Mr. BAKER. I do not know that you would have had time,  
320 given your preparation for your appearance here today, to be  
321 familiar at all with the provisions of the bill now  
322 introduced relative to the creation of an enhanced regulator.

323 Do you have any comment to make about the provisions that  
324 are included in the bill generally, or is there a specific  
325 area of concern you would like to bring to the committee's  
326 attention you do not feel is addressed by the bill?

327 Mr. FALCON. As you said, I have not had a chance to go  
328 through much of the details of the bill, but I think the  
329 intent of the legislation to provide the regulator with  
330 authorities on par with every other safety and soundness  
331 regulator is progress. Anything which fills the gaps in the  
332 regulator's authority to do its job would be a positive step  
333 forward. Beyond that, the details of any particular  
334 <sup>provisions</sup> ~~revision~~, I have not had a chance to review them.

335 Mr. BAKER. There has been some discussion primarily led  
336 by Chairman Greenspan as to the advisability of limiting the  
337 growth or even further reducing the size of the existing  
338 investment portfolio, as it is his view, according to press  
339 reports, that it does not have a correlation to housing  
340 function. He had suggested even a hard-dollar limit of some  
341 \$200 billion down from the \$1.6 trillion currently engaged.



342 Do you have any opinion as to whether it is advisable or not  
343 to have further restrictions on growth at the least or to  
344 pursue the reductions over time, in your view?

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

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

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

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

360 Mr. FALCON. Yes ~~Yes~~.

361 Mr. BAKER. Mr. Kanjorski?

362 Mr. KANJORSKI. Thank you, Mr. Chairman.

363 On the insufficient internal controls and improper  
364 application of accounting standards to meet adequate  
365 corporate governance, what did your final examination show,  
366 how long a period that existed--just in the last year, the

367 | last 2 years, the last 5 years, the last 10 years--or has it  
368 | been endemic to the organization?

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

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

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

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

390 |       Mr. FALCON. I think they were substantial. I do think  
391 | they were because there were almost no controls in some

392 | instances. There was one example where one employee was  
393 | allowed, through the lack of internal controls, to make a  
394 | change in an accounting formula on the spreadsheet that  
395 | resulted in an improper reporting of a billion dollars. It  
396 | is that type of lack of internal controls that concern me.  
397 | With proper internal controls, one employee could not go and  
398 | make those changes without a couple of layers of verification  
399 | before changes like that are made.

400 |         Mr. KANJORSKI. Well, I guess I do not sufficiently  
401 | understand the nature and focus of the regulator's  
402 | involvement, but what sort of bothers me here is that your  
403 | testimony says, in one instance, this problem existed over 21  
404 | years, and then substantial internal control failure.

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

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

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

416 |         Mr. FALCON. I think you are accurate in your reasoning.

417 | It is the need to do things with adequate depth. When I  
418 | took over the agency, we had 30 examiners, and I had our  
419 | examination staff do a review, a benchmarking study,  
420 | comparing our program to other regulators and how many  
421 | examiners ~~would~~ <sup>they</sup> have on staff to supervise two companies  
422 | of this size. ✓

423 | This benchmarking study showed that on average another  
424 | regulator might have 60 or so examiners per institution. We  
425 | were working with 15 examiners per institution, which is why  
426 | we have moved over the last 5 years to try to increase our  
427 | resources. I wish I had the number of examiners that I have  
428 | today back then, <sup>perhaps</sup> ~~that maybe~~ we would have had the ability to  
429 | catch many of these problems. ✓

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

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

440 | Mr. FALCON. I think many of these internal control  
441 | problems revolve around accounting procedures and the

442 recordkeeping activities of the company, and this is an area  
443 we have not looked at traditionally. Safety and soundness  
444 regulators rely on the outside audit function to do its job  
445 properly.

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

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

458 Mr. FALCON. Well, it is clear that the external  
459 auditor--in this case, KPMG--certified financial statements  
460 as compliant with GAAP that we<sup>now</sup> know, obviously, were not  
461 compliant with GAAP. We are examining the question of <sup>whether</sup> ~~was~~  
462 that<sup>was</sup> just the result of inadequate work done by the auditor  
463 or was it the result of some complicity on the part of the  
464 auditor.

465 Mr. KANJORSKI. You have not determined that?

466 Mr. FALCON. No, Congressman.

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

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

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

482 Mr. FALCON. I think that spreads more to the  
483 responsibility of the PCAOB to examine whether or not the  
484 auditor in this instance properly did its job, and they are  
485 involved in <sup>that type of</sup> ~~this~~ review.

486 Mr. KANJORSKI. Okay.

487 Thank you, Mr. Chairman.

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

492 Mr. Shays?

493 Mr. SHAYS. Thank you.

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

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

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

505 Mr. FALCON. With the resources available to us in more  
506 recent years, it allowed us more flexibility to cover more  
507 areas ~~and~~ and, certainly, when the problems of Freddie Mac  
508 became apparent, it did illustrate a particular area where we  
509 ~~did~~ need<sup>ed</sup> to focus more of our attention, as traditionally we  
510 had not. So really, with the additional resources, it  
511 provided us with the means to become more thorough in how we  
512 went about examining the two institutions.

513 Mr. SHAYS. Well, I believe if you had done what you  
514 have done in the last year, we would not even be talking  
515 about a new regulator, and that is the sad part of this  
516 because we had Mr. Raines come before us, challenge your last

517 findings, almost arrogantly dismissed it, and I thought you  
518 were very forceful and, frankly, somewhat courageous, and the  
519 SEC backed what you all had determined.

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

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

530 Mr. FALCON. ~~Well,~~ there was a breakdown in the  
531 integrity of the process by which financial statements are  
532 produced. The financial statements are produced from the  
533 ledgers of the company, and the ledgers' data is entered  
534 through preparers who will--

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

537 Mr. FALCON. ~~Well,~~ this was related to the amortization  
538 entries. In our September report, we referred to some FAS 91  
539 accounting.

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



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

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

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

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

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

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

559 Thank you, Mr. Chairman.

560 Mr. BAKER. I thank the gentleman.

561 Mr. Davis?

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

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

565 Let me bring up a subject that, frankly, we have not  
566 talked about a lot this morning. As you know, there was an

567 | inspector general's report that I think came out back in  
568 | December, if I am not mistaken. I think it happened while we  
569 | were in recess. It may be that Congress was here for a day  
570 | on the homeland security bill, but it was basically during a  
571 | recess period, if I am not mistaken. I am sure the chair  
572 | will correct me if I am wrong. If I am not mistaken, I do  
573 | not think that we have had a hearing on the inspector  
574 | general's report.

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

577 |         Mr. FALCON. I have.

578 |         Mr. DAVIS OF KENTUCKY. And respecting my 5-minute  
579 | timeframe, we do not have an opportunity to get into all of  
580 | it, but my recollection of it is that there were some fairly  
581 | stinging criticisms of OFHEO that were contained in that  
582 | report. Do you agree with that?

583 |         Mr. FALCON. Yes.

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

591 |         Mr. FALCON. It has been a while since I have read it.

592 I could not tell you all the details of it.

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

596 Mr. FALCON. I think it was, yes.

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

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

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

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

610 Mr. FALCON. The Justice Department<sup>and</sup> the Department of  
611 HUD determined that we had done nothing improper, and so that  
612 was the end of it.

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

615 Mr. FALCON. I did.

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

617 Mr. FALCON. I disagreed with the criticisms.

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

623 What suggestion would you offer us, Mr. Falcon, as to  
624 what you think this committee or this Congress should be  
625 doing to look at that report and to learn from it, because,  
626 obviously, as we create a new regulator, we are going to try  
627 to make sure they do a better job, frankly, than you all did.

628 I would think that it is relevant what is contained in that  
629 report. What would you suggest Congress do, or do you think  
630 it would be appropriate, for example, if Congress had a  
631 hearing on that report?

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

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

640 Mr. FALCON. Vaguely.

641 Mr. DAVIS OF KENTUCKY. Well, now you say you recall it

642 vaguely. That strikes me as being a fairly serious  
643 allegation, isn't it?

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

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

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

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

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

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

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

665 Mr. DAVIS OF KENTUCKY. Did you investigate them?

666 Mr. FALCON. I cannot consume my time with trying to

667 | pursue it.

668 |       Mr. DAVIS OF KENTUCKY. Did you investigate it?

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

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

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

680 |       Mr. Hensarling?

681 |       Mr. HENSARLING. Thank you, Mr. Chairman.

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

687 |       Let me ask a few questions about your examination in  
688 | regards to Fannie Mae not applying its own policies with  
689 | regard to SSAS 65 as it relates to the booking of loans for  
690 | sale or investment. I think that you have indicated that the  
691 | problems with accounting for these loans were recently

692 | discovered, but the practice had been ongoing for over 20  
693 | years.

694 |         So how can Fannie be unaware that they were in breach  
695 | for over 20 years and, indeed, how was it that, over a  
696 | 20-year period, OFHEO did not discover this breach?

697 |         Mr. FALCON. It was just an error in their systems,  
698 | which was not uncovered until the systems were upgraded in  
699 | 2004. It was ~~just~~ such a precise error in, I <sup>believe,</sup> ~~am not sure~~ what  
700 | ~~part of the systems, but it was such a drill-down type issue~~ <sup>that</sup>  
701 | ~~is~~ was not the type of thing that we caught.

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

711 |         Mr. FALCON. I think that is certainly something that we  
712 | are reviewing in the course of our special examination.  
713 | While we do believe in certain instances there were willful  
714 | violations of accounting principles, whether or not that was  
715 | hidden from us, <sup>or</sup> from the Congress is something we are still  
716 | determining.

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

722 Mr. FALCON. It would ~~certainly~~ provide <sup>some</sup> certain  
723 accounting benefits if they were to classify ~~certain~~ assets  
724 as held to maturity versus available for trading. Then they  
725 would not have to recognize any loss in market value in those  
726 assets. That is certainly the case.

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

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

740 Mr. HENSARLING. To speak somewhat prospectively in the  
741 limited amount time I have left, as you know, our Chairman



742 Baker has introduced a comprehensive piece of legislation  
743 dealing with a new regulator for the GSEs, and I know that  
744 you have not had an opportunity to examine the particulars of  
745 that piece of legislation, but, conceptually, do you think  
746 that the GSE safety and soundness regulator should also have  
747 the authority of new programs and new activity review from  
748 your experience? If so, why?

749 Mr. FALCON. I think it should. The safety and  
750 soundness regulator is going to learn about these new  
751 activities anyway. We have to assign capital to them. We  
752 have to make sure that the risk of any new activities are  
753 properly managed. ~~So~~ <sup>So</sup> we will be intimately familiar with how  
754 those activities will impact the company.

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

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

762 Mr. Watt?

763 Mr. WATT. Thank you, Mr. Chairman.

764 Mr. Falcon, thank you for being here.

765 I want to change the focus from what we have been  
766 talking about to something else. I really have no interest

767 | in focusing on Fannie or Freddie's shortcomings in the past  
768 | or your or OFHEO's shortcomings or successes in the past or  
769 | on this committee's oversight shortcomings or successes in  
770 | the past.

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

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

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

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

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

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

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

814 I have always looked at our responsibility at OFHEO as  
815 part housing mission. A company that is experiencing severe  
816 financial difficulties is going to constrain the amount of

817 | work it can do in fulfilling its mission, and so the greater  
818 | extent to which we can make sure that the company does not  
819 | get into any kind of trouble makes sure that there is no  
820 | interruption in their ability to continue to fulfill the  
821 | mission and innovate.

822 | ~~So I think~~ with a fully authorized, well-resourced  
823 | regulator, I think ~~that is~~ <sup>= there would be</sup> a good safeguard to make sure that  
824 | there are not unnecessary interruptions in the company's  
825 | business as a result of safety and soundness problems. The  
826 | sooner we can get in there and identify and fix problems  
827 | before they manifest themselves in the form of larger  
828 | problems, I think, is only a benefit to the company's  
829 | mission. ~~So I think~~ <sup>A</sup> strong safety and soundness regulator  
830 | is part of that.

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

832 | Just by way of notice to members who have--

833 | I am sorry, Mr. Watt.

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

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

837 | Mr. FALCON. Prospectively, I think you could look at  
838 | other examples of what has been done at other agencies. The  
839 | AHP program of the federal <sup>home</sup> loan bank system is one  
840 | possibility where you have some ~~satisfied~~, dedicated amount  
841 | of funds that are used towards ~~the~~ affordable ~~housing~~ and

842 | low-income housing.

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

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

851 |       Thank you, Mr. Baker.

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

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

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

863 |       Mr. NEY. Thank you, Mr. Chairman.

864 |       On Monday, April the 4th, OFHEO--I think it was about a  
865 | year in the making--added to their corporate governance rule.

866 |       It takes effect in 60 days. What does that mean for Fannie?

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

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

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

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

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

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

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

892 | it as soon as possible.

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

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

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

908 |         Mr. NEY. So it was more of a technical problem than  
909 | something that was conspired to do this and not be found for  
910 | 20 years.

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

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

914 |         Mr. FALCON. Capital assessment? ~~Oh~~, yes, Congressman. ✓

915 |         Mr. NEY. Or capital adequacy to report under.

916 |         Mr. FALCON. Yes.

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

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

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

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

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

933 Mr. BAKER. I thank the gentleman.

934 Mr. Baca?

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

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

937 As you know, I support a strong well-funded regulator,  
938 and I also support the work of Fannie Mae in providing--I say  
939 in providing--housing to the underserved. Do you believe you  
940 have the necessary expertise within your agency to regulate  
941 GSE in a productive manner in an ever-growing complex market?



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

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

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

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

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


963 Mr. BACA. Given the importance of the entity to home  
964 ownership, how will you know when you have fulfilled your  
965 obligation as a regulator thoroughly and fairly--and I say  
966 thoroughly and fairly--so that Fannie Mae can continue to

967 further its home ownership in the country in a manner that is  
968 safe and sound?

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

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

989 Mr. FALCON. We are, and the board is also very actively  
990 engaged in this also. The company is working to retain many  
991 qualified individuals in this accounting field so that the



992 | company can begin to develop proper accounting policies, but  
993 | we are working with them very closely. ✓

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

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

1000 |       Mr. FALCON. Well, current capital levels are contained  
1001 | in the statute, 2-1/2 percent for on-balance sheet assets and ✓  
1002 | 45 basis points for off-balance sheet. When we see safety ✓  
1003 | and soundness concerns at either company, we exercise our  
1004 | discretion to require additional capital, but just for the  
1005 | time period where we see problems at each company.

1006 |       Whether or not a permanent minimum capital level should  
1007 | be higher than 2-1/2 percent, we would have to study that  
1008 | issue a little more closely.

1009 |       Mr. BACA. Okay. We know that Fannie Mae has taken a  
1010 | number of steps to address the problems that are very  
1011 | positive, even the change in its leadership right now because  
1012 | of its services. My question and final question would be:  
1013 | You indicated in your statement that OFHEO became more  
1014 | aggressive as resources became available. Who went after the  
1015 | resources, and why did they go after the resources to make  
1016 | sure that they were more aggressive?

1017 Mr. FALCON. We have been pursuing additional resources  
1018 since I first got to the agency. As I said earlier, it  
1019 became very evident to me when I assumed my position that we  
1020 just did not have adequate resources to properly fulfill our  
1021 mission at OFHEO~~y~~ and, ~~so~~ from the very beginning, I have  
1022 been seeking to increase the agency's budget, and we have had  
1023 much success in that. With the committee's support, our  
1024 resources have increased.

1025 Mr. BAKER. The gentleman's time has expired.

1026 Mr. BACA. Hopefully, you will apply the same standard  
1027 to other entities to as well have the same standards, same  
1028 policies, same procedures and same aggressiveness in holding  
1029 everybody else accountable as well.

1030 Thank you.

1031 Mr. BAKER. I thank the gentleman.

1032 Chairman Oxley?

1033 Mr. OXLEY. Thank you, Mr. Chairman.

1034 Mr. Falcon, it is good to have you back, and, based on  
1035 your announcement yesterday, I want to wish you Godspeed and  
1036 success in whatever you do. You have led the OFHEO folks at  
1037 a very difficult time and have done remarkable work, and our  
1038 sincere congratulations and best wishes to you.

1039 Let me ask you. The last time that OFHEO discovered  
1040 accounting problems at Fannie, the SEC was engaged to  
1041 determine whether Fannie needed to restate earnings. Based

1042 on your testimony and the recent discovery, will that process  
1043 be followed as well, or has the SEC already made a  
1044 determination in terms of whether Fannie Mae was GAAP  
1045 compliant?

1046 Mr. FALCON. The process that was followed previously,  
1047 Mr. Chairman--~~by the way~~, thank you for your comments--was an ✓  
1048 extraordinary set of circumstances. Typically, the process  
1049 involves the regulator working with the company and the  
1050 company's external auditor on resolving any accounting issues  
1051 that arise and, with the issues related to <sup>FAS</sup> 133 and 91, ✓  
1052 Fannie Mae decided to seek the input of the SEC on those  
1053 accounting issues. So the SEC did provide guidance on them.

1054 In this case, that has not happened. We are working  
1055 with the company. We have met with the SEC to review these  
1056 additional issues with them and <sup>have</sup> kept them fully apprised of ✓  
1057 what we are finding and answering any questions they may  
1058 have, but the SEC is working with us under the standard  
1059 process for these types of matters, and they have not been  
1060 asked to intervene with a formal interpretation or answer  
1061 like they were previously.

1062 Mr. OXLEY. That could happen at some point, but it just  
1063 depends on how the negotiations go with the private entity?

1064 Mr. FALCON. It could, Mr. Chairman.

1065 Mr. OXLEY. Okay.

1066 Your testimony raised some concerns about internal

1067 controls at Fannie Mae, and that has been, obviously, an  
1068 ongoing issue in corporate America for the last 3 or 4 years.

1069 I guess my question is: What role does OFHEO play in the  
1070 whole issue of internal controls vis-a-vis the SEC and  
1071 perhaps the Public Company Accounting Oversight Board? How  
1072 does OFHEO's role fit into the overall issue of internal  
1073 controls?

1074 Mr. FALCON. We do work closely with PCAOB on this, and  
1075 we have. They participate in many of the sessions and  
1076 meetings that we have had, and, obviously, we have worked  
1077 very closely with the SEC.

1078 As a safety and soundness regulator, we do examine very  
1079 closely for internal control deficiencies. In addition,  
1080 obviously, under Section 404 of Sarbanes-Oxley, companies are  
1081 required to certify the adequacy of their internal controls.  
1082 So we work very closely to make sure that certain minimum, if  
1083 not best practice, standards with regards to internal  
1084 controls are met by the company, and we apply these standards  
1085 through our examination program.

1086 In addition, because of Sarbanes-Oxley, there are  
1087 certifications that are required on the part of management so  
1088 they have their own strong incentives now to make sure that  
1089 internal controls are adequate. Where we see issues related  
1090 to accounting disclosure matters that require some review by  
1091 the SEC, we will have discussions with the SEC. We have a

1092 | very good working relationship with them.

1093 |       Mr. OXLEY. Is it fair to say then that the internal  
1094 | controls issue as it relates not just to a financial company  
1095 | in a general sense, but more particularly to a GSE is treated  
1096 | somewhat differently than say a steel company or an oil  
1097 | company?

1098 |       Mr. FALCON. I would say not just because they are a  
1099 | GSE, but because they have a safety and soundness regulator.  
1100 | I think that the same levels of internal control review that  
1101 | we apply to Fannie Mae and Freddie Mac would also be applied  
1102 | with respect to any bank or thrift that is regulated by a  
1103 | safety and soundness regulator and that might very well be  
1104 | different from the type of internal control review that is  
1105 | applied with respect to a steel company.

1106 |       Mr. OXLEY. Thank you.

1107 |       Mr. Chairman, I just want to again compliment Mr. Falcon  
1108 | for his leadership and also to recognize Mr. Blumenthal. I  
1109 | know Mr. Falcon as an alumnus of this committee in his former  
1110 | iteration as the Banking Committee, and Mr. Blumenthal, who  
1111 | will be named as interim in your position, was a very able  
1112 | staffer over in the committee across the hall that I served  
1113 | on for a few years, and we look forward to working with him  
1114 | as well.

1115 |       Thank you, Mr. Chairman.

1116 |       Mr. FALCON. Thank you for your comments, Mr. Chairman.

1117 Mr. BAKER. Thank you, Mr. Chairman.

1118 I am advised that floor proceedings have now been  
1119 initiated, and, at this time, I would ask members who have  
1120 additional questions to please submit them for the record.  
1121 We will get responses from Mr. Falcon.

1122 I wish to again extend our appreciation to you for your  
1123 appearance here today and for your good work.

1124 Our meeting now stands adjourned.

1125 Mr. HINOJOSA. Mr. Chairman, may I ask unanimous  
1126 consent--

1127 Mr. BAKER. Yes, Mr. Hinojosa.

1128 Mr. HINOJOSA. --that the opening statement be part of  
1129 the record?

1130 Mr. BAKER. Yes, sir. All member statements have been  
1131 made part of the record, and the record will remain open for  
1132 5 days for any additional correspondence members may choose  
1133 to forward.

1134 Mr. HINOJOSA. Thank you.

1135 Mr. BAKER. The meeting stands adjourned.

1136 [Whereupon, at 11:07 a.m., the subcommittee was  
1137 adjourned.]



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