Statement of the Honorable Armando Falcon, Jr.

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Before The

Committee on Banking, Housing and Urban Affairs

United States Senate

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Mr. Chairman, Ranking Member Sarbanes, and Members of the Committee, I appreciate the opportunity to appear before you. My testimony today will focus on the Freddie Mac restatement process, OFHEO's role as a safety and soundness regulator, more specifically, the Agency's approach to examining accounting practices and financial controls at the Enterprises, and a status report on the related issues of Executive Compensation and Corporate Governance. In addition, I have attached some legislative recommendations for the Committee's consideration to enhance OFHEO's role as safety and soundness regulator.

Introduction

On January 22, 2003, Freddie Mac announced that it would reaudit and restate its financial statements for 2000 and 2001. The company also announced that its' external auditor would delay certification of Freddie's year-end 2002 financial statements. Five months later, on June 7, the Board removed the company's top three officers. OFHEO, the SEC and a U.S. Attorney all have ongoing investigations of the company and its accounting practices. These extraordinary actions reflect the culmination of developments over several years. Given our ongoing investigation, I ask for the Committee's understanding if I am restrained in my testimony, as facts are still being verified and circumstances evaluated. I will begin by describing the major developments in chronological order.

Lead -Up to FAS 133 Preparation and Implementation -- 1999

First, the sequence of events begins with the preparation, in 1999, for implementation of Financial Accounting Standards Board (FASB) Statement No. 133 – Accounting for Derivative Instruments and Hedging Activities (FAS 133). FAS 133 is not the only accounting standard involved in this matter, but it plays the most important role. FAS 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, (collectively referred to as derivatives) and for hedging activities.

FAS 133 requires an entity to recognize all derivatives as either assets or liabilities in the financial statements and reflect those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as: a) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment; b) a hedge of the exposure to variable cash flows of a forecasted transaction; or c) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction. The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation.

Under FAS 133, an entity that elects to apply hedge accounting is required to establish at the inception of the hedge the method it will use for assessing the effectiveness of the hedging derivative and the measurement approach for determining the ineffective aspect of the hedge. Those methods must be consistent with the entity's approach to managing risk.

I would now like to turn to OFHEO's examination strategy to cover FAS 133 preparation at the Enterprises in 1999. The routine 1999 examination work was conducted at the same time OFHEO's examiners were expending considerable efforts to ensure that both Enterprises were prepared for, and all essential systems across the two companies would be fully compliant with Y2K goals. Because of the critical nature of Y2K readiness, examiners conducted extensive testing and validation of systems preparedness. Against this backdrop, the FAS 133 examination strategy required the examination team to maintain expertise and working knowledge of the accounting standard and its potential effects on each Enterprise; evaluate and assess the Enterprises timeline for implementation; evaluate the strategy each Enterprise was pursuing for its implementation of the accounting pronouncement and analyze the effects of FAS 133 on financial statements. In addition, our examiners would continue to evaluate the external accountant's position on the accounting policy guidance associated with implementing FAS 133; assess the systems enhancements to conduct hedging and financial reporting under FAS 133; and evaluate and monitor implementation readiness and event management, including contingency preparations for the transition.

In the second half of the year, FASB unexpectedly delayed the implementation date of FAS 133, from January 1, 2000 to January 1, 2001, so that companies could focus their attention on Y2K.

Transition Period to FAS 133 Readiness – 2000

In 2000, OFHEO's examiners assessed the development and implementation of Enterprise plans with respect to several new significant accounting standards, including FAS 133. At the same time, they reviewed the effectiveness of Y2K efforts and the effects on the financial safety and soundness of a twenty percent decline in the volume of originations; an increase in the proportion of Enterprise purchases of single-family mortgages evaluated through automated underwriting systems; and the increased use of sophisticated technology for risk management across the companies.

In evaluating preparations for the implementation of FAS 133, examiners were actively evaluating: systems preparation, implementation strategies, impact analysis, documentation specifications, portfolio management strategies and the approvals from management, the Board and the internal and independent external accountants involving FAS 133 implementation. We recognized the substantial progress that had been made on the preparations and the considerable analysis that had been performed. Further, we noted the additional efforts that were underway to deal with the remaining systems and documentation challenges associated with implementing and operating with FAS 133.

In late 2000, the Audit Committee approved the Financial Reporting Controls Improvement Plan (FRCIP). The FRCIP was designed to address issues affecting financial accounting and financial reporting that had been identified by the company, its independent auditors and OFHEO. The goal of the FRCIP was to achieve the same level of controls in the financial accounting and financial reporting area that were present across the other areas of the company and in the operating business units.

OFHEO's examiners evaluated the FRCIP and Freddie Mac's progress in completing the FRCIP in a number of ways. In 2000, examiners evaluated and communicated with management about the FRCIP itself, ensuring if it was reasonably designed to address the root causes of the identified weaknesses. Also, in 2000, examiners assessed the design of the tools both management and the Board's Audit Committee intended to use to measure and report progress in implementing the FRCIP. On a regular basis, examiners were assessing the progress toward completion of the FRCIP and communicating our assessments to the company.

In the fourth quarter of 2000 and the first quarter of 2001, Freddie Mac entered into several transactions to minimize the impact of FAS 133. PwC later identified these FAS 133 transition transactions as accounting issues needing correction before the 2002 financial statements could be certified.

Implementation of FAS 133 – First Quarter 2001

In 2001, OFHEO's examiners continued their ongoing evaluation of FAS 133's implementation and its impact on the Enterprise, with respect to business activities, risk management strategies and portfolio management. Among the variety of features our examiners were reviewing, were the operational aspects associated with FAS 133 and the company's quarterly closing practices. When reviewing the quarterly closings, we noted the sign-offs and notations of the company's auditors. Our review found no reservations or qualifications associated with Arthur Andersen's certification of the quarterly and year-end 2001 financial statements and the conformance of those financial statements and disclosures with GAAP.

FAS 133 was implemented in first quarter 2001. Arthur Andersen certified each quarter's financial statements under the new FAS 133 pronouncement as GAAP compliant. At this same time, extensive interpretations continued to be produced on FAS 133 by FASB.

While OFHEO was conducting its FAS 133-related examination activities, we were also dedicating examiners to assess the impact of record levels of originations, new corporate governance standards and record volumes of purchases and securitization on both Enterprises safety and soundness. OFHEO examiners were also evaluating the timeliness and effectiveness of the Enterprises actions to meet the final Risk-Based Capital Rule.

Need to Strengthen Expertise and Controls -- 2001

After preparing for FAS 133, the actual implementation of this accounting standard further highlighted aspects of Freddie Mac's financial accounting and financial reporting areas that needed strengthening. It became more apparent to OFHEO and Freddie Mac that, while the overall control structure for the company was strong, in the financial accounting and financial reporting area there was an apparent need to strengthen expertise and reduce the reliance on manual systems. Strengthening expertise and reducing the reliance on manual systems were important aspects of the FRCIP introduced in 2000, and examiners continued in 2001 to evaluate the progress against this remediation plan. We continued to press management to ensure progress continued in implementing the FRCIP and maintaining the plan's implementation remained an important corporate priority.

OFHEO felt the control environment at that point in financial accounting and financial reporting was stable, but in need of strengthening. The FRCIP was designed to address the identified weaknesses and to strengthen the control environment in the financial control and financial reporting area to a level consistent with the control environments across the other parts of Freddie Mac. While there were weaknesses in the financial accounting and financial reporting area, the manual processes did mitigate those control weaknesses in the operating process and resulted in Freddie Mac's ability to produce reliable financial records. Upon completion of the work to re-engineer the financial accounting and financial reporting process, there would be a more timely, efficient and streamlined process that would not depend upon manual systems to ensure the reliability of financial information.

In context, Freddie Mac maintained effective internal controls in its various business areas. The area covered by FRCIP was the financial accounting and financial reporting area, which represents a subset within the larger finance area, and an even smaller subset within the overall company.

OFHEO's examiners continued in 2001 to evaluate progress on the FRCIP at least quarterly by, for example, analyzing and testing the quarterly progress reports to the Audit Committee, Internal Audit, senior management and Arthur Andersen, and evaluating the events reached or expected, major milestones, schedule overruns and the level of completion of each project. Examiners concluded that by mid-2001 approximately one-third of the FRCIP had been completed. As a result of a national search, Freddie Mac brought in a new Senior Vice President – Corporate Controller, charged with responsibility for the accounting and control function. This key milestone was achieved in October 2001, and by year-end 2001 Freddie Mac completed Phase I of the FRCIP, which included reconciliations, and deployment of integrated and automated cash management, bank account and transactional reconciliations and billings/receivables functionalities. In 2002, OFHEO's examiners continued their ongoing assessments of progress under the FRCIP, and determined that the new accountability model and Operation Risk Management Unit, when implemented, would strengthen Freddie Mac's financial accounting and reporting processes.

Also during this period, OFHEO was planning enhancements for its examination activities. In 2000, I had meetings with the Chief Examiner, and we outlined plans for strengthening OFHEO's examination program. Among our discussions was an idea to create an examination team dedicated to accounting matters. In January 2001, the Chief Examiner delivered a plan designed to enhance OFHEO's examination program. A cornerstone of that plan was to more than double the size of the examination staff, adding depth and additional specialized skill sets to deal with complex issues associated involving the supervision of the Enterprises.

The plan to strengthen OFHEO's examination program included the formation of a group for specialized examination activities, including a team of accountants. After receiving this plan in January 2001, I began advocating within the Administration and with Congress the importance of OFHEO obtaining the resources to begin implementing this plan and enhancing our examination program. In the second-half of 2002, we were able to start populating our team of accountants with skilled technicians who would be dedicated to accounting matters at the Enterprises.

New Outside Auditor -- 2001

Late in 2001, Arthur Andersen was under public scrutiny because of its role as the audit firm of record in certain high-profile federal investigations and bankruptcy filings. Given these developments in late 2001 with Arthur Andersen, Freddie Mac's Board of Directors and executive management deliberated whether they should keep that firm or select a new independent accounting firm. Freddie Mac solicited OFHEO's views concerning the retention of Arthur Andersen. OFHEO opined that given the circumstances, retention of the firm created a higher-risk situation for Freddie Mac.

The Audit Committee decided to change independent accountants and interviewed two potential firms in the first quarter of 2002. The Committee decided to switch to PwC for Freddie Mac's independent public accountants for the year ending December 31, 2002. Freddie Mac made a public announcement of this decision on March 6, 2002.

The audit opinions of Arthur Andersen on the consolidated financial statements of Freddie Mac for the fiscal years ending December 31, 2000 and 2001 did not contain any adverse opinion or disclaimer of opinion, nor were they qualified or modified as to uncertainty, audit scope, or accounting principles**.** In separate management letters, Arthur Andersen shared its concern with senior management on a number of items that had also been independently noted by OFHEO.

Engagement of PwC -- 2002

OFHEO evaluated and tracked changes being made through its routine examination activities in 2002 regarding the engagement of PwC and the work of the Audit Committee. PwC began its audit engagement immediately after being selected by the Audit Committee. OFHEO examiners had an introductory meeting with PwC managers for the Freddie Mac audit on March 5, 2002. PwC was ratified as the independent public accountant at Freddie Mac's May 2, 2002 Annual Shareholders Meeting.

In the course of its audit, PwC initiated a process of identifying various accounting policies and accounting issues to discuss with Freddie Mac's management. Both Freddie Mac management and PwC conveyed the nature of these discussions to the Audit Committee. In the normal course of business, PwC met with the Audit Committee in executive session on these matters.

Additional Expertise Added at Freddie Mac -- 2002

Consistent with OFHEO's concerns, some important staffing decisions in the finance area were announced at Freddie Mac during 2002, adding necessary expertise. In June, a new Senior Vice President for Operational Risk Oversight was hired. On June 18, the Board announced the creation of a new senior level executive position and national search, for an Executive Vice President of Finance, consistent with the goals outlined in the FRCIP. The newly created position would be responsible for the overall finance, accounting, corporate planning, tax, shareholder relations, and market risk and operating risk oversight functions of the company. The CFO and the Corporate Controller would continue in their respective roles and they would report to the new Executive Vice President – when hired. Until the new position was filled, the Corporate Controller had a direct administrative reporting line to the COO and a direct communication line with the Audit Committee, similar to the CFO's reporting line. The current EVP and CFO – Mr. Vaughn Clarke - no longer had the Corporate Controller reporting through him, and notified the company of his intentions to leave Freddie Mac. On March 19, 2003, Freddie Mac announced that Mr. Martin Baumann had filled the newly created EVP of Finance position.

ALLL Accounting Matter Identified -- 2002

OFHEO was actively involved in the discussions that were taking place between PwC and Freddie Mac regarding the Allowance for Loan and Lease Losses (ALLL). The ALLL was identified in July 2002 by PwC as a critical accounting matter that needed to be resolved as they worked toward certifying Freddie Mac's financial statements.

A special Audit Committee meeting was held on July 16, 2002 where PwC raised the ALLL issue for Freddie Mac – it was too conservative in its loss estimates and coverage per PwC's determination under GAAP. PwC felt this matter on the ALLL needed to be resolved before Freddie Mac's release of second quarter financial statements on July 23, 2002.

OFHEO and Freddie Mac representatives met on July 22, 2002 to gather information about the final size of the adjustments being made to Freddie Mac's financial statements. The adjustment was a $246 million reduction in the ALLL. On the same day, the Audit Committee had a special meeting to review the final analysis and approve the adjustment for release to the public in the July 23, 2002 release of financial statements.

Accounting policies and issues continued to be worked on by PwC, management and the Board throughout 2002. Progress appeared on track for the certification of fiscal year 2002 financial statements. As of fourth quarter 2002, the ALLL was the only accounting issue that had risen to the level of PwC expressing reservations to the Audit Committee relating to that firm's ability to certify Freddie Mac's statements and that had been resolved in July 2002.

OFHEO continued to evaluate and monitor the status of the accounting policies under discussion between PwC and Freddie Mac during 2002, as well as the actions and decision-making by the Audit Committee. Examiners continued in 2002 to evaluate progress on the FRCIP at least quarterly. This included examiners testing selected work products and evaluating project management and reporting.

Unresolved Accounting Matters under FAS 133 -- 2003

PwC came to the Freddie Mac Board in mid-January 2003 and informed the Audit Committee they would be meeting with representatives from PwC's national office about unresolved accounting policy matters, related to FAS 133 implementation. On Monday, January 20, 2003, PwC notified the Audit Committee that they were uncomfortable with certain accounting treatments applied during the FAS 133 transition. Furthermore, until its concerns were resolved, it would not be able to certify the company's 2002 fiscal financial statements using the accounting policies from prior periods, even though the policies had been approved by Arthur Andersen as GAAP compliant. OFHEO was made aware of these developments on that day and met with Freddie Mac officials the following day.

The nature of the major accounting issues identified through the restatement process include:

1. The erroneous accounting treatment of the company's Securities Sales and Trading Group (SS&TG) as a third-party broker dealer;

2. Inadequate documentation and testing of certain derivative instruments and their valuations accounted for as hedge instruments for accounting purposes;
3. The erroneous transfer of mortgage securities out of the "held-to-maturity" and trading accounts;
4. The treatment of mortgage sales transactions as financings;
5. Accounting for certain cash transactions used to manage interest rate risk as if they were derivatives; and
6. Omitting the recognition of the guarantee fee and credit obligations embedded within sold PCs.

These transactions are the subject of our investigation, and I will have more to say about them in my final report.

Because Arthur Andersen was no longer an operating firm at this point, PwC could not undertake a normal transition pursuant to the AICPA guidance for successor/predecessor accountants. Instead, PwC would have to undertake additional substantive testing. The Board of Directors determined that PwC should conduct a reaudit of the prior period financial statements.

OFHEO, PwC, and the Audit Committee evaluated the nature of the accounting issues. Among the factors considered was the cumulative effect of the adjustments flowing from the change in accounting treatments. The net cumulative effect of the new accounting treatments was an increase to income in prior periods, thus increasing the amount of capital on a cumulative basis. This would also result in considerable volatility in those prior periods. Further, OFHEO, PwC, and the Audit Committee considered the effects from the accounting policy changes for any potential effect on the fair value statements of Freddie Mac. All concluded there was no meaningful impact on the fair value statements, which meant the underlying economics for Freddie Mac's risk positions were materially unaffected by the timing changes in recognizing income for the GAAP statements being restated.

Examiners were on-site at Freddie Mac gathering more information about the issues and the action plan that were being formed to address the reaudit. Freddie Mac announced the reaudit and the delay in 2002 certified financial statements on January 22, 2003.

Based upon the reaudit of prior periods, Freddie Mac said it would be restating 2000 and 2001 annual results and quarterly financial results for 2001. Along with delays in issuing certified 2002 financial results and prior period restatements, there would be delays in issuing certified quarterly financial statements for the first and second quarter of 2003. The timeline was to have the restatements done in approximately six months.

The restatement process has involved the reevaluation of over 100 accounting policies, which resulted in the identification of approximately 20 major issues that will affect the financial statements.

These accounting changes will result in about half of the company's derivatives being marked to market through current period earnings as opposed to being deferred and recorded into earnings over time. In addition, all mortgage securities will be marked to market either through OCI or current period earnings. In addition, previously off-balance sheet guarantee fees and obligations relating to approximately one-half of the guarantee business will now be recorded on balance sheet at fair value, with changes reported in current period earnings. These changes will most likely result in increased volatility and decreased future earnings.

Heightened Focus -- January 2003 to Present

In mid-January 2003, it was clear that a forensic review of selected accounting issues raised by PwC would be appropriate. The law firm of Baker Botts was retained by the Audit Committee to perform diagnostic and forensic work associated with the restatement process. The scope of Baker Botts' engagement is to conduct a review of the facts and circumstances surrounding certain transactions and other matters related to the restatement process. OFHEO's plans were to monitor and consider the work of Baker Botts, while concentrating the Agency's efforts on the re-audit and restatement process. When the restatement process neared its completion, OFHEO would consider the progress and adequacy of the counsel's review and determine whether the Agency would need to undertake its own forensic review.

At this point, OFHEO focused on its mission -- safety and soundness -- and emphasized to Freddie Mac the importance of properly concluding the reaudit and publishing certified financial statements. In addition, OFHEO concurred with the Board's decision to engage outside counsel for forensic and related work.

OFHEO's accounting team began continuous surveillance of the restatement process on January 22, 2003, focusing on: the accounting issues surrounding the transactions that triggered the reaudit; the accounting policies/issues under consideration – being changed or affirmed; the organization and staffing of the project; the analysis of the cumulative effect of the restatement process; the preparation of adjustments; the methodology for establishing value estimates; the process for running ledgers and analyzing results; the quality control process; the plan for rolling out the revised financial statements; and the status of controls being embedded into the new processes as they are being built. In addition to the ongoing work of the accounting team, there were periodic updates and evaluations on the restatement process from January on.

February - In February, OFHEO continued its close evaluation of the restatement process. Specifically, OFHEO's accounting team scrutinized the organizational structure of the effort, the plan of action, and the resources and the timeline associated with the work on the restatement process.

March - OFHEO met with the Board and its Audit Committee on March 6. In that meeting, there was considerable discussion relating to the restatement process, the reaudit, and OFHEO's posture toward completing the restatement process. Also in March, as noted earlier, Freddie Mac announced the hiring of Mr. Baumann as Executive Vice President for Finance. Mr. Baumann was given full responsibility for the restatement process by the Board of Directors and for formulating a plan of action for the post-restatement environment. Mr. Baumann is reporting directly to the Board of Directors until the restatement process is completed.

OFHEO remained engaged during the period the Board considered a delay in the release of first quarter financial results to coincide with the restated financials for prior periods. On March 25, Freddie Mac announced the restatement process remained on track. The company's expectation was still to have the restatement concluded as soon after the close of second quarter 2003 as practical – expecting to restate financials by mid-July 2003. Freddie Mac also notified the market they would not be releasing first quarter financials, rather, they would provide operating statistics and risk measures. The decision to delay first quarter financials was to provide those 2003 results consistent with the basis upon which the restated financials will be presented. In the March 25th release, Freddie Mac also identified additional accounting issues.

April - In April, Freddie Mac was moving toward the final stages of a complete review and affirmation of all the accounting policies. OFHEO continued to evaluate the work being conducted and the progress against the established timeline. Some additional accounting items were adding to the complexity of the task. Freddie Mac brought in third-party vendors to expedite the process after PwC approved the use of such vendors. On April 29th, PwC informed the Audit Committee that they might not be able to accept the representations of top management.

May - In May, OFHEO observed slippage in the restatement process against established time frames. PwC and Freddie Mac had more than 500 people working on the process six days a week and this work had been continuous since January 2003. They were beginning to complete some of the adjustments. There was considerable work that needed to be done between production of statements and producing the tables and disclosure to accompany those statements. On May 8th, PwC informed Senior Board members and counsel that PwC would not accept the representations of Vaughn Clarke and David Glenn.

On May 13, the Board's Governance Committee at its weekly meeting approved the Finance Function Governance Plan (FFGP) presented by Mr. Baumann. This plan, superceding the FRCIP, addressed the considerable work that has been done to re-engineer the process and enhance the controls for financial accounting and financial reporting. This plan, some of which will take almost two years to complete, is intended to build a finance environment incorporating a high level of professional standards and compliance that delivers comprehensive and understandable financial information. The objectives included addressing findings which had arisen during the restatement process and the work of Baker Botts and PwC.

In late May, OFHEO again observed the challenges against achieving the timeline with the additional accounting issues that were added in April. However, Freddie Mac continued to work toward the mid-July target. There were no new issues since April. Freddie Mac continued to work through all the adjustments and calculated the valuation estimates for prior periods. Some opportunities to strengthen controls noted during the restatement process continue being implemented by Freddie Mac.

On May 27, OFHEO was briefed on the Baker Botts work for the Audit Committee. The briefing covered the scope of the project, the nature of their forensic work and perspective on the status of their findings to-date. In response to a direct question, Baker Botts expressed no concerns regarding the management team of inappropriate or improper management behavior. Subsequent to this meeting, OFHEO learned of very troubling information regarding the conduct and integrity of management in matters related to the restatement process, indicating the Board's counsel had not been fully forthcoming. This lack of candor contributed to my decision on June 7th to initiate an OFHEO investigation.

<u>Events of June 4 through June 7</u>

Mr. Chairman, I will begin a discussion of the key events of June 4-7, that have drawn so much attention. First, I would note that the Freddie Mac Board of Directors was holding a regularly scheduled meeting on Thursday, June 5th and Friday, June 6th.

On Wednesday, June 4th, Mr. David Glenn met with the Board's outside law firm—Baker Botts—and informed them that he had altered parts and had removed pages from a document that had been requested by the firm. That evening, counsel from Baker Botts informed the lead outside Director, of Mr. Glenn's admission.

On Thursday, June 5th, Freddie Mac's Board was informed of Mr. Glenn's admissions and determined that actions were required. The morning of June 5th, OFHEO was alerted that the Board would have an urgent communication to discuss with us when the Board's deliberations were concluded. The Board's deliberations continued into Friday, June 6th.

On Friday June 6th, during the day, the Board made decisions on the separation from the firm of Brendsel, Glenn, and Clarke and on the appointment of O'Malley, Parseghian, Petersen and Baumann. The Board communicated to OFHEO immediately on its actions regarding the management changes. Later that evening, I was informed about the circumstances surrounding Mr. Glenn. I instructed Board counsel to appear at OFHEO's offices on Saturday, June 7th, to advise us on all the matters surrounding management changes.

On the morning of June 7th, OFHEO senior staff and I met with representatives of Freddie Mac's Board to learn the details of recent events. I would note that much of what was addressed that day was known to OFHEO and had been the subject of the restatement. However, new issues relating to Mr. Glenn and the termination and replacement of senior management were also presented; particularly the lack of confidence in Mr. Glenn expressed a month earlier by PwC. I considered the information regarding Mr. Glenn a clear signal of a breakdown in the integrity of the Freddie Mac's control environment at the highest levels and sent a letter to the Board that day initiating an OFHEO investigation.

Following this meeting, as occurred after the meeting on May 27, additional matters came to light and, again, reflected a lack of candor that concerned me deeply.

In the June 7 letter, I formalized with the Board certain actions with respect to the restatement process. In addition, I tasked a special investigative team to explore and review accounting practices relevant to the restatement process at Freddie Mac and, in addition, management's progress in implementing an action plan that OFHEO directed the Board to provide for the Agency's formal approval. The investigative team has also undertaken an investigation of employee misconduct. OFHEO is moving expeditiously on this review.

The Role of a Federal Financial Safety and Soundness Regulator

Having discussed our specific regulatory role over the restatement process at Freddie Mac, I would now like to put it in a more general context. First the role of a financial safety and soundness regulator and second, and more specifically, the Agency's regulatory approach in examining accounting practices and controls.

OFHEO uses a safety and soundness approach in supervising the Enterprises that is analogous to the Federal Reserve System's and the Office of the Comptroller of the Currency's approach to supervising large-and-complex banking organizations. The foundation of these approaches is that the management of these firms should be held responsible for monitoring and managing the institution's exposure to risk. By looking at the firm's risk management procedures and internal controls, the safety and soundness regulator assesses whether the firm's ability to manage risk matches the level of risk it assumes. In addition, the supervisory process also reviews the firm's performance in complying with the company's own internal policies, as well as other prescriptive requirements. In short, safety and soundness supervision is directed toward identifying material problems or emerging problems and seeing they are appropriately corrected before the company's financial solvency is threatened.

During the past decade, financial safety and soundness regulators and OFHEO have endeavored to continuously enhance the examination process to make it more risk-focused and to make greater use of technological innovations. Increasingly, safety and soundness supervision stresses the need for financial firms to implement sound risk management practices for: Active oversight of management by the Board; clearly defined policies, procedures and authority; comprehensive risk measurement and reporting systems; and adequate audits and systems of internal controls.

OFHEO's supervisory activities are designed to assess the Enterprises' risk profiles and require remedies where and when they are appropriate. They encompass evaluations of each Enterprise's asset quality, management of interest rate risk, liquidity management, capital adequacy, and their risk management strategies and risk management practices -- including their internal controls and governance.

Safety and soundness regulators do not attempt to prescribe "regulatory accounting principles" for financial reporting. In fact, when accounting principles were prescribed in the 1980s by financial regulators, many of those standards were criticized after numerous financial institutions failed. Congress subsequently expressed its desire for financial safety and soundness regulators to rely upon established accounting principles (GAAP) for financial reporting standards (Section121 of FDICIA). In OFHEO's 1992 Act, Congress directed OFHEO to do the same, i.e., to pursue GAAP in their regulatory reporting requirements.

Safety and soundness regulators do not review accounting policies for conformance with GAAP, nor do we certify that a company's financial statements are consistent with GAAP. We expect an independent auditor to certify that a company's financial statements are in conformance with GAAP. We review transactions to ensure that they are consistent with sound risk management. The work of the independent auditor is to conduct its audit and report on the company's annual financial statements. The scope of the independent auditor's engagement must be sufficient to permit the auditing firm to determine and report upon whether the financial statements are presented fairly and in accordance with GAAP.

The internal and external auditors routinely work together in establishing the scope and frequency of audits to be performed. The independent auditor reviews the scope and adequacy of the internal auditing program.

Safety and soundness supervision does not replace an internal audit function for the Enterprises' Board of Directors. Internal audits are a governance/management control question. That is, the Board of Directors and executive management need to have the internal controls tested and assessed by units without business-line operating responsibilities, such as an internal audit group. Internal audit provides the Board and the CEO, along with other members of senior management, with assurances concerning the effectiveness of controls.

Safety and soundness regulators do not perform forensic work (investigative work on what has occurred) unless a need arises. In fact, safety and soundness regulators frequently cause the Board of Directors to engage forensic professionals to investigate irregularities and share the results of their findings with the regulator. Subsequent to the findings from the forensic work, the regulator holds the Board accountable for ensuring there are appropriate remediation plans and action items to address the issues that are identified.

OFHEO's Approach to Examining Accounting Practices and Controls Over Financial Reporting

The process of examining an Enterprise's accounting practices and related internal controls for financial reporting begins with a thorough study of the strategies and the techniques the Board of Directors has adopted to set the company's course, and to measure and evaluate management's performance in implementing the Board's strategies. This step includes, for example, an evaluation of the Board's committee structure, oversight practices and reporting conventions, and an assessment of the effectiveness of the overall control framework at the Board level. The examination process also includes a "mapping" of the corporate structure management has adopted to facilitate the implementation of the Board's strategies and the achievement of its objectives pertinent to financial reporting. The objective of the mapping process is to establish a roadmap of management's assigned responsibilities, duties, and functions that can then be used to identify key risk points in the internal control framework for financial reporting that warrant targeted evaluation and attention due to their potential impact on financial safety and soundness.

Having established an appropriate understanding of the overall control framework and its risk points by, for example, reviewing relevant policies, procedures, systems, tools, and management reporting, and by interviewing Enterprise management and personnel, examiners then sample selected transactions in order to test whether the framework actually functions as designed and intended. Depending on the nature of the examiners' focus, these sampling activities may include evaluations of the actions of a variety of different participants and their respective roles in the control framework, including management, technical staff, internal auditors, and independent auditors. During the course of their evaluations, examiners apply evaluative standards that reflect the professional standards appropriate for the actions under review, and reach conclusions that address the Enterprises' financial safety and soundness.

OFHEO's approach to examining accounting practices and internal controls for financial reporting should be familiar to the Committee, given that our approach is built on the same well-established concepts that form the core of applicable provisions of the Sarbanes-Oxley Act of 2002 and the SEC's regulations implementing the control-related provisions of that Act. Our examination approach also embraces fundamental precepts found in widely-recognized control frameworks such as the Internal Control—Integrated Framework published by the Committee of Sponsoring Organizations of the Treadway Commission (more familiarly known as "COSO"), the Guidance on Assessing Control published by the Canadian Institute of Chartered Accountants, and the Turnbull Report published by the Institute of Chartered Accountants in England & Wales. Moreover, we regularly consider practices adopted by other financial safety and soundness regulators, generally accepted auditing standards, and control-related methodologies and standards propounded by professional associations such as the Institute of Internal Auditors and the

American Institute of Certified Public Accountants, and we enhance our evaluative techniques as necessary to maintain a position on the leading edge of this evolving field of expertise.

The Committee has requested information on OFHEO's role with respect to approving termination agreements for the executive officers of the Enterprises, including involvement in the recent termination agreements of Freddie Mac's executive officers. In addition, you sought information on OFHEO's corporate governance rule. Details on both follow.

Executive Compensation

OFHEO has broad authority to consider executive compensation, both as a specific matter of excessive compensation as well as a factor in the operational integrity of the Enterprises.

OFHEO draws authority from the explicit and implied authorities of its statute, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, PL 102-550, Title XIII; 106 Stat. 3672 (October 28, 1992). At the same time, other OFHEO authorities are delineated in certain sections of the chartering acts for the Enterprises.

Excessive Compensation. OFHEO is directed by statute to prohibit the payment of "excessive compensation" to executive officers; 12 USC 4513(b)(8). The prohibition on excessive compensation is tied to compensation that is "…not reasonable and comparable with compensation for employment in other similar businesses…"; 12 USC 4518(a). At the same time, OFHEO may not set or prescribe or set a specific level or range of compensation for such executives; 12 USC 4518(b).

Termination Benefits. OFHEO has authority to review and provide approval for "termination benefits." This authority is contained in the charter acts of the two Enterprises.

For example, in the Freddie Mac charter (Federal Home Loan Mortgage Corporation Act, 12 USC 1451 et seq.), Section 303(h)(2) provides that the Corporation may not enter into any agreement or contract to provide money or other things of current or potential value in connection with the termination of employment of any executive officer unless the agreement or contract is approved in advance by OFHEO; 12 USC 1452(h)(2). The statute provides for OFHEO to make such determination based on comparability of such agreements with officers at comparable companies. The statute covers contracts entered after the date of enactment, but provides that any "renegotiation, amendment, or change" after such date of enactment to any contract entered into before or after the date of enactment shall be considered entering into a new agreement or contract that OFHEO should review and provide its opinion.

In regards to Freddie Mac, OFHEO has undertaken certain actions relating to executive compensation. Specifically, I wrote to the Board of Directors on June 7, 2003 indicating it must explain its rationale for any termination packages for the individuals leaving the firm, specifically for Brendsel, Glenn and Clarke. Further, I directed the Board to inform these individuals that their termination packages are subject to OFHEO review and approval and, for any employee discharged for misconduct, that OFHEO could direct indemnification of Freddie Mac for losses incurred.

We have directed Freddie Mac not to transfer funds, stock or options to these three individuals and Freddie Mac is complying. OFHEO is reviewing now the termination packages for Brendsel, Glenn and Clarke.

I want to reiterate what I noted regarding OFHEO's authority in this area. First, we review executive compensation as a stand-alone matter, that is: Is such compensation excessive? And, second, as we proceed with the investigation, we look to the behavior of management and whether it comports with the standards of the corporation, violates any corporate governance rules or otherwise harms or threatens the safety and soundness of the corporation. If so, OFHEO would consider actions that would involve compensation, such as ordering restitution.

Corporate Governance

OFHEO has had in place for some time an active program of review for corporate governance at the Enterprises. Corporate governance is considered a major component of risk management and a fundamental ingredient in the safe and sound operation of the firms. Corporate governance under the examination program is composed of separate programs entitled Board Governance, Management Processes Program, Audit Program and Management Information Program.

While OFHEO has strong statutory support for its corporate governance regime, in 2000, the Agency began a program of building up its regulatory infrastructure, putting in place rules to support its various functions and to strengthen its legal position. This program included a corporate governance rule. The rule generated a great deal of interest and OFHEO issued a Final Rule on June 2, 2002, effective on August 5, 2002.

The rule made clear that corporate governance is a key area of safety and soundness and it directed each of the Enterprises to elect a state law for the purposes of adhering to a body of corporate law. Both have done so. The rule required the companies to have committees and that they meet the highest applicable standards; both have such committees. A quorum of the board is required to transact business and no proxy voting is allowed; both have such policies. The rule required conflict of interest policies; both have such policies. The rule mandated that the Board meet its responsibilities and described the areas of key concern for Board oversight of senior management. Finally, the rule noted the authority of OFHEO to limit or restrict indemnification of current or former Board members as part of its safety and soundness authority.

OFHEO's examination team has worked with the Enterprises to see that changes that were required have been put in place and that the Enterprises continue to address other requirements, such as changes mandated in the Sarbanes-Oxley Act.

Legislative Enhancements

I would like to submit for the Committee's consideration a series of legislative recommendations to add to OFHEO's broad authorities and to fill in a number of gaps between OFHEO's authorities and those of other financial regulators.

Paramount among these is permanent funding for the Agency. Other financial safety and soundness regulators are funded through assessments on the institutions they regulate; so is OFHEO. Only OFHEO, however, must move through the annual appropriations process. The budget process has had a limiting effect on the Agency's resources and may affect our ability to effectively address regulatory issues on a timely basis.

OFHEO must have more flexibility to respond to important issues, such as Freddie Mac's restatement of income, without stretching thin our ability to continually monitor the significant credit and interest rate risks being managed by the two Enterprises. The amount of resources needed to address the issues surrounding Freddie Mac's restatement is straining our resources. Permanent funding is needed to ensure that OFHEO can continue to effectively regulate the Enterprises. I am pleased that the Administration has endorsed this needed change.

The other recommendation I would like to highlight relates to charter compliance. I believe that the regulatory responsibility for ensuring that the Enterprises remain in compliance with their charters more properly resides with the safety and soundness regulator. Mission regulation would continue to reside in HUD in the form of affordable housing goals and fair lending enforcement.

OFHEO has the authority and responsibility for taking an enforcement action when an Enterprise violates any applicable law or regulation. In fact, under the current scheme, if HUD found that a new program was not permissible, HUD would turn to OFHEO to take any necessary enforcement action. In addition, OFHEO would take appropriate action if we independently determined that an Enterprise was in clear violation of its charter. OFHEO should have full authority, including in areas of ambiguity, for interpreting and enforcing charter compliance.

Without casting any doubt on HUD's abilities, I simply believe that public policy would be better served if OFHEO, with its active examination and oversight of the Enterprises, had full responsibility for charter compliance.

The draft proposal, attached with a summary, strengthens OFHEO with explicit receivership authority, removal authority, greater facility in hiring examiners, adds criminal penalties for certain violations of law, provides independent litigation authority and addresses certain gaps in OFHEO's enabling statute that have been addressed previously by regulation.

Notes on Recent Events and the OFHEO June 2003 Annual Report to Congress

Turning now to the OFHEO Report to Congress, we reported that Freddie Mac's overall internal control framework, and the management of the internal control framework, are effective. We stated, however, that Freddie Mac's release of audited financial statements was being delayed pending a reaudit of past financial statements, and that Freddie Mac had agreed that certain accounting treatments applied in the past were incorrect. We informed Congress at the time, of our opinion regarding the reaudit. We further advised Congress that Freddie Mac's Board of Directors had undertaken efforts to enhance expertise and controls in the area of financial accounting and operational control, that we had evaluated the Board's and management's plans in that regard, and that we were satisfied that these actions were appropriate steps to address the situation. In my view, these statements clearly indicate that, although the overall framework is effective, OFHEO is ensuring that the Board and management devote serious attention and remedial efforts to the area of financial reporting and related controls. OFHEO's activities in this regard are highlighted in this testimony.

With regard to internal controls, our examination program is consistent with applicable professional standards in that it addresses each Enterprise's overall internal control *framework*; that is, the framework that includes the following categories: (1) the effectiveness and efficiency of operations; (2) the reliability of financial reporting; (3) compliance with applicable laws and regulations; (4) and safeguarding the assets of the company. Consider that the term "internal control" encompasses five interrelated components—the control environment; risk assessment activities; control activities; information/communication; and monitoring. As you might imagine, companies as complex as Fannie Mae and Freddie Mac develop equally complex internal control frameworks. These frameworks encompass hundreds, perhaps thousands, of separate controls, including approvals, authorizations, verifications, reconciliations, segregation of duties, systems access limitations, and a myriad of others. In short, the integrity of the overall internal control framework is determined by considering the total picture, and when viewed in its entirety, a framework may exceed safety and soundness standards even though there are observed weaknesses or deficiencies in particular controls.

Examples of the application of this principle include practices adopted under standards established by the American Institute of Certified Public Accountants, and guidance provided by the SEC in recent rules implementing provisions in the Sarbanes-Oxley Act that pertain to assessments of internal controls over financial reporting. Specifically, it is common for an independent auditor to provide an unqualified opinion on management's reports of financial condition even though the auditor is aware of certain "reportable conditions." In the vernacular of the independent auditor, a reportable condition is a significant deficiency in the design or operation of the internal control structure that could adversely affect a company's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements. The common practice is for the auditor to communicate such deficiencies to management in the form of a management letter, while at the same time allowing its unqualified opinion to stand. As a separate example, under SEC rules, significant deficiencies that do not rise to the level of a material weakness do not preclude management from characterizing its internal controls over financial reporting as "effective." The SEC guidance prohibits management from deeming its controls effective if there are one or more *material weaknesses*; however, the SEC also observes that a material weakness constitutes a greater deficiency than a significant deficiency. In sum, I believe the standards we have applied in reaching our examination conclusions on internal controls are consistent with those established by both the AICPA and the SEC.

Before I move on, I would like to emphasize a point or two about information flow and the environment that preceded the publication of our Annual Report to Congress. The results and conclusions of the 2002 annual examination were based on the information gathered and evaluated during the course of our work during 2002. That information was supplemented by information obtained by OFHEO during 2003, from early January up to the time of the publication of the Annual Report to Congress. As I discussed earlier, OFHEO has devoted considerable effort and resources to this matter, and our efforts continue to yield new information. One should also consider that the Board of Directors' internal investigation is being conducted during 2003 as well, and that the Board's investigation may yield new information. In addition, the Committee is aware that I initiated OFHEO's own special examination on June 7, little more than one week before the statutory delivery date for the Report to Congress; and it is possible that our special examination could give rise to new findings as well. I raise these facts to emphasize that the date on which the Report was due fell in the midst of a very fluid environment; nevertheless, I believe that the examination results and conclusions expressed in the Report to Congress regarding the overall internal control and framework at Freddie Mac are appropriate. Certainly, we will have more to say about the controls over financial reporting, improper earnings management, and corporate governance practices after the special examination has concluded. I assure you that I will provide the Committee with a timely notification and description of any substantive changes in our view of the internal control framework and corporate governance practices once I have the benefit of the results under the various investigations currently underway.

Supplemental Appropriations

Finally, I would like to bring to the committee's attention an urgent funding matter. Earlier this week I submitted an FY 2003 supplemental funding request of $4.5 million to the Senate and House Appropriations Committees.

The requested funds will support two critical objectives: First, the funds will support the on going special investigation of Freddie Mac. The investigation is already well underway and is building on information gathered over the course of the restatement process. The requested resources are necessary to obtain contract services for investigative support and forensic accounting experts. Second, OFHEO intends to conduct a special accounting review of Fannie Mae. The special review would independently evaluate the accounting policies at Fannie and examine whether their implementation is resulting in a high level of conformance to GAAP. While I do not have a specific concern about Fannie Mae's accounting practices, such a review would be most prudent under the circumstances.

OFHEO's goal of concluding the investigation of Freddie Mac expeditiously is dependent on receiving these funds as soon as possible. I would like to ask for the Committee's support in obtaining the additional funds.

Conclusion

In summary, Mr. Chairman, is this a serious matter? Yes. Is there a crisis? No. While challenges remain, Freddie Mac remains safe and sound. At the end of our investigation, we will present all the facts, conclusions, and recommendations for the Committee's consideration. Mr. Chairman, thank you for the opportunity to testify. I would be pleased to answer any questions you or Committee Members may have.

Attachment: OFHEO's Legislative Enhancements