ACCOUNTING IRREGULARITIES
AT FANNIE MAE AND THE
EFFECT ON INVESTORS

HEARING
BEFORE THE
SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES
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ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Israel, Hon. Steve:
The subcommittee met, pursuant to call, at 10:05 a.m., in Room 2128, Rayburn House Office Building, Hon. Richard H. Baker [chairman of the subcommittee] presiding.


Chairman BAKER. I would like to call this meeting of the Subcommittee on Capital Markets to order.

Our committee convenes today for the first time in this the 109th Congress. Accordingly, I would like to take this opportunity to introduce new members to our subcommittee, some of whom who are not new to the Congress or to Financial Services, merely to the Subcommittee on Capital Markets.

Joining us from Financial Services is Mr. Barrett of South Carolina, Mr. Feeney of Florida, and Mr. Hensarling of Texas.

New to the Congress, and of course to Financial Services, we welcome Mr. Davis of Kentucky and Mr. Fitzpatrick from Pennsylvania. We are certainly pleased to have the addition of the new members to the important work of this committee.

I will leave the pleasure of making the introductions of the new members on the minority side to the gentleman from Pennsylvania, to Mr. Kanjorski, the ranking member.

The committee also convenes today for another important purpose. Although not a pleasant task, it is I believe an essential one.

What now seems a very long time ago, the Office of Federal Enterprise Housing Oversight, known as OFHEO, engaged an audit firm to conduct what is known in the business as a forensic accounting audit of Fannie Mae. This was the first time in the enterprise's history that such an examination had been conducted.
The audit, frankly not yet complete, resulted in the production of an interim report which was reviewed by officials at OFHEO and found to be of sufficient concern to result in a report to this committee of those findings.

The principal issue centered around the manner by which the enterprise reported its financial condition and the risk exposure of its derivatives portfolio.

When the committee last met, the director of OFHEO, Mr. Armando Falcon, was verbally assaulted by members of the committee on both sides for his irresponsible conduct or, perhaps even worse, pursuit of some undisclosed political or business agenda.

It was the view of some that, on procedural appeal to the SEC, these accusations would be found to have no merit and be swept aside.

Since the time of that hearing, the criticism of the agency and the attacks on the congressionally created regulator of the agency and Mr. Falcon have been more than just vindicated.

The unfortunate finding of the SEC is that the accounting practices of Fannie Mae were not just a mere exercise of bad judgment or a one-time aberrant act, but a consistent misapplication, at best, or at the worst an intentional act of accounting misrepresentation.

Today, we received the report from the chief accountant of the SEC, who I wish to publicly commend for his professional ability to first examine and then reach a very difficult decision.

The review of the facts in this matter is not without great consequence. Fannie Mae was and remains a political institution of great persuasion. They have for many years been able to bully their way through myriad regulatory processes and political engagements unscathed.

This time, the outcome was different because of the professionalism of those at OFHEO and at the SEC. This time, there cannot be more excuses. The facts are what they are.

Officials at Fannie have stepped down in the wake of the disclosure. The board has promised to change the culture of mismanagement at the institution, and there is more.

I remind members that the report that initiated the controversy was only an interim report. The work of the auditor is not yet completed and neither is the work of the SEC or the Justice Department.

We will all await the results of these examinations for full and complete assessment and a finding of responsibility.

In the course of questioning the SEC officials today, members should remember that answers to many questions may not yet be appropriate to disclose because of the continuing, pending inquiry. Legal counsel of the SEC will advise the committee as to the appropriateness of responses at the particular time.

I should also note that in press reports, as of this morning, benefits, bonuses, and more have been initiated for the executives who only recently left the company before the finding of fact as to the appropriate responsibility for the disclosed deficiency.

The regulator, OFHEO, does not apparently have the authority to unilaterally act on behalf of taxpayers or anyone else. Litigation will be required after the fact to reclaim, if possible, any ill-gotten gains.
It is unfortunate that such significant adverse events were necessary to bring us to this day, but perhaps finally we will be able to produce legislation responsive to what is now a fact: and that is that Fannie Mae was not and is not the institution we had all hoped. They were subject to the same pernicious forces that affected others in pursuit of profit.

Financial manipulation, even perhaps for the personal gain of executives, undermined the responsibility of their important charter mandate. It is now our task to return them to their principle task, in essence to pave the way to home ownership for all Americans, but with emphasis on those who have never had the opportunity to own their own home at all.

I read the press reports this morning and the thought struck me that the monthly retirement benefits to one executive would be sufficient to buy a low-income individual a home outright every month for the remainder of that executive’s life; in excess of $114,000.

It is also necessary to ensure that the risk-taking of the enterprise does not put at risk hardworking taxpayers of this country. The enterprise can accomplish both goals, safety and soundness and mission compliance. They just apparently need vigilant oversight to ensure their success.

It is my intention, working with Mr. Kanjorski and others on this committee, to see that happen this session of Congress.

Mr. Kanjorski is recognized for an opening statement.

Mr. Kanjorski. Thank you, Mr. Chairman.

Mr. Chairman, before I start my statement, I would like to introduce our new members on the Democratic side of the committee: Mr. Mel Watt of North Carolina, Artur Davis of Alabama, Melissa Bean of Illinois, and Debbie Wasserman Schultz of Florida.

Since, on the Democratic side, the Financial Services Committee has become an exclusive committee, it is important when we note several of these new members of the subcommittee and on the committee are freshman, and therefore only serve on the Financial Services Committee.

Mr. Chairman, before we begin today’s session, I must note that this hearing is the first of our panel in the 109th Congress. Over the last decade, you and I have forged a close and productive relationship as chair and ranking member of the Capital Markets Subcommittee, and I look forward to working with you once again in this Congress.

Four months ago, we convened our last hearing of the 108th Congress to discuss the special examination of Fannie Mae by the Office of Federal Housing Enterprise Oversight.

It therefore seems fitting that we will begin our hearing this year with an examination of the recent decisions by the chief accountant of the Securities and Exchange Commission, related to Fannie Mae’s practices for the accounting of derivatives contracts and the amortization of discounts, premiums and fees involved in the purchase of home mortgages.

Prior to the chief accountant’s decisions, Fannie Mae’s board had already agreed to adopt a number of reforms based on an initial report by the Office of Federal Housing Enterprise Oversight. Afterwards, Fannie Mae put in place additional changes, including
removing its leadership team and hiring a new auditor. The company continues to make modifications.

At our last hearing into these matters, I sought to determine whether the accounting problems at Fannie Mae constituted some form of a systemic risk for our economy. I was assured by all of those who participated at the hearing that these problems did not pose a systemic risk.

Similarly, my primary focus at today's hearing will be to determine whether our public entities that use derivatives could also have difficulty in accounting for those complex financial instruments. Although derivatives serve a useful purpose in spreading risk, I am concerned that if Fannie Mae encountered difficulties in accounting for these contracts, then other financial services providers may also have comparable problems that could cause difficulties for our economy. I hope the chief accountant, who is the sole witness appearing before us today, will offer me his candid assessment of these matters.

As we proceed today, I also suspect that some of my colleagues will return to the question of how best to modify the regulation of government-sponsored enterprises. As you know, Mr. Chairman, I am one of the few remaining members of the committee who participated in the entire congressional battle to resolve the savings and loan crisis. I am, therefore, acutely aware of the need to protect taxpayers from risk.

It is in the public's interest that we ensure that Fannie Mae and Freddie Mac continue to operate safely and soundly. We must further ensure that these public-private entities achieve their public responsibilities for advancing home ownership opportunities.

In fact, as I said at our very first hearing in March 2000 on the oversight of government-sponsored enterprises, “We need to have strong independent regulators that have the resources they need to get the job done.” I can assure everyone that I continue to support strong, world-class, and independent regulation for Fannie Mae and Freddie Mac.

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

Like many of my colleagues, I was greatly disappointed in the last Congress when the Bush administration rejected our bipartisan efforts to create an independent regulator. Politics, in my view, should not play a role in financial regulation. It is therefore my hope that when we revisit this issue in the 109th Congress, we will continue to remain resolute and unwavering in our bipartisan efforts to create a strong, independent and world-class regulator with appropriately robust powers and sufficiently adequate resources. As we proceed, it is also my hope that we will develop a balanced, deliberate and bipartisan plan of action for addressing these matters.

In closing, Mr. Chairman, I commend you for your sustained leadership in these matters. Government-sponsored enterprises, with their public responsibilities and private backing, have a special obligation to operate fairly, safely and soundly. Your work, without question, has highlighted these issues for all of us.
Thank you.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 43 in the appendix.]

Chairman BAKER. I thank the gentleman for his statement.

It is my pleasure to introduce to the committee, not as a new member, but in a new capacity, the gentleman from Kansas, Mr. Ryun, who now serves as our vice chair.

Mr. Ryun, Mr. Chairman, first of all, let me say thank you for holding this hearing.

As we open a new Congress and a new year for the Financial Services Committee and the Capital Markets Subcommittee, we have some important issues to consider, certainly one of which is we are going to take up today.

As this committee prepares to make complex decisions about the regulations of the GSEs, it is crucial that we gather information from an abundance of different sources. Today is an opportunity to begin that process.

The very fact that the accounting irregularities at Fannie Mae were not discovered early strongly suggests that a more effective regulator is needed.

As we work to make this happen, we must make sound decisions on what the regulator should look like and what powers it should have. I look forward to that debate.

I also want to take a moment to just say thank you and I look forward to working with you, Mr. Chairman, on the issues that the subcommittee will consider this year. You have been a strong voice on many issues and I am confident that the subcommittee will do a much-needed job under your continued guidance.

I look forward to the testimony, and I yield back my time.

Chairman BAKER. I thank the gentleman and welcome him into his new responsibility.

Just by way of announcement for new members, we for hearing purposes, recognize members for opening statements and questions in the order of arrival time.

So the next on the Democrat side would be Mr. Scott.

Mr. SCOTT. Thank you very much, Mr. Chairman.

And I, too, want to commend you and Ranking Member Kanjorski for holding this hearing. It is very timely and, of course, very important as we get started on making sure that this nation has full confidence in Fannie Mae and that we move with good speed and with good production to make sure that we resolve any lingering feelings of insecurity about Fannie Mae.

I am particularly concerned that Fannie Mae’s mission, which is so important, be not compromised or weakened, but strengthened.

Last year, this committee met to discuss an OFHEO report which alleged that Fannie Mae inappropriately reduced earnings volatility and provided management with the flexibility to determine the amount of income and expense recognized in any accounting period.

Fannie Mae questioned OFHEO's ability to act on this report and the method by which the report was released.

Fannie Mae asked the SEC to determine if its accounting practices complied with generally accepted accounting principles. And the SEC found that they were not in compliance.
I think that there are a number of questions that certainly need to be examined. And paramount of those is did OFHEO consult with the Securities and Exchange Commission or FASB prior to making its findings as to whether Fannie accounting was consistent with generally accepted accounting principles.

That was a major concern particularly brought up during our hearings with, as former distinguished chairman, Mr. Raines, and with the board.

Again, I want to thank you, Mr. Nicolaisen, for appearing before the committee today. And I understand that your testimony will indeed be limited to the Securities and Exchange Commission's review of Fannie Mae's accounting practices.

Investigations into Fannie Mae's accounting practices by the SEC and OFHEO are indeed ongoing. However, I do look forward to the report on these investigations at the proper time.

And I look forward to having an opportunity to follow up on those questions if we have time in the question-and-answer period.

Thank you again, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Mr. Tiberi, did you have a statement?

Mr. Hensarling?

Mr. HENSARLING. Thank you, Mr. Chairman.

I first want to take the opportunity to applaud you for your persistence and your leadership on this matter.

Clearly the findings of the SEC are troubling. No one should dismiss this matter as inconsequential or not worthy of continued and detailed scrutiny. These are serious allegations that should not be politicized.

We are looking into the possibility of incredible corporate malfeasance within an institution created by Congress and indirectly supported by American taxpayers. This is an institution that also happens to be the largest non-bank financial services company in the entire world, with more than $1 trillion in assets.

Given the size and influence of Fannie Mae in our housing market, the possibility that the artificial smoothing of earnings volatility was taking place on a quarter-by-quarter basis is most disturbing.

Further, the fact that this earnings manipulation may have served the purpose of providing enhanced bonuses to Fannie executives is disconcerting to say the least.

As the largest source of mortgage financing in America, we simply cannot ignore the systemic risk that the institution poses. Chairman Alan Greenspan has warned us that the growth of Fannie Mae could cause systemic difficulty if Congress does not act to ensure that Fannie Mae is appropriately regulated.

Personally, I do not need to see any additional proof that our housing GSEs are in dire need of a new and strengthened regulator. But the fact that both Fannie and Freddie have had similar earnings-manipulation issues in the recent past has greatly magnified the need for this new regulator.

We are all aware of the economic damage that took place in the wake of other corporate accounting scandals, be it Enron, WorldCom or Tyco. And in 2001, in terms of assets, Enron was only about one-sixteenth the size that Fannie Mae is today, and
WorldCom and Tyco were about one-tenth the size of Fannie in terms of assets. These facts cannot be ignored.

For these reasons, I hope that no stone will be left unturned in these hearings and that, going forward, this committee will examine every legislative remedy aimed at maintaining investor confidence in our housing markets.

I look forward to working with you, Chairman Baker, and the other members of our committee to help find a legislative solution that will ensure that Fannie Mae is adequately regulated as a GSE, keeping in mind the interests of future homeowners, investors and taxpayers.

I yield back the balance of my time.

Chairman BAKER. I thank the gentleman.

Ms. McCarthy, did you have a statement?

Mrs. MCCARTHY. Thank you, Mr. Chairman. And I just want to say thank you again for holding this hearing.

I will withhold my opening statement and look forward to hearing the testimony and follow through with the questions at that time.

Thank you.

Chairman BAKER. I thank the gentlelady.

Mr. Fitzpatrick?
Ms. Biggert?
Mr. Barrett?
Mr. Renzi?
Mr. Royce?

Mr. ROYCE. Thank you, Mr. Chairman. And I thank you for holding this hearing on accounting irregularities at Fannie Mae and the impact on investors.

I would also like to thank you, Mr. Chairman, on your work on oversight of the GSEs over the years. I think it has been very important.

And as I said last October, during the first hearing on Fannie Mae’s accounting issues, I expect Fannie Mae to be a role model to other businesses as it fulfills its federally mandated mission.

Fannie Mae should be conducting operations in a safe and in a sound way and, in my view, this should include strong internal controls in the risk-management department coupled with consistent and conservative application of accounting rules.

The SEC ruling affirming OFHEO’s point that Fannie Mae was not GAAP-compliant is very troubling. Fannie owns slightly less than $1 trillion in financial assets. Most of these assets are in the form of mortgages, which means that Fannie Mae operates in a negatively convex environment. In other words, Fannie Mae can lose money if interest rates or if interest rates go down.

And Fannie Mae and other GSEs attempt to mitigate this risk by issuing callable debt and by doing one other thing and that is by buying derivatives. And it is the accounting of these derivatives that has been found to be improper.

Regulators and investors have a right to know and a need to know that Fannie Mae is managing interest rate risks appropriately. Fannie’s misapplication of FAS 133 prevents outsiders from getting a clear view of the true risk at the company.
I am pleased that we are having this hearing to learn more about how that happened and to learn how we can prevent such occurrences in the future.

In addition to our important oversight role in this committee, I hope that we will move swiftly to create a new regulatory structure for Fannie Mae, Freddie Mac and the Federal Home Loan Banks. This is a very simple solution. Congress must create a new regulator with powers at least equal to those of other financial regulators, such as the OCC or the Federal Reserve.

I introduced legislation last session which would have enacted just such a reform. And I hope this committee will heed the advice of Chairman Greenspan and the entire Board of Governors, the Federal Reserve staff, the U.S. Treasury Department, the OECD and the IMF and countless others who have urged Congress to act.

Mr. Chairman, thank you for your leadership and I yield back.

Chairman BAKER. I thank the gentleman.

Mr. Sherman?

Mr. SHERMAN. Thank you, Mr. Chairman.

Fannie Mae and its sister organizations play such an important role that if they didn’t exist we would have to create them. We need to provide for effective home ownership financing. That is why it is tragic that we have seen these accounting problems. We have every reason to delve into them. We look forward to hearing from the witness. We have every reason to correct them. We have every reason to seek the best possible regulation of GSEs. And it has been suggested that if that was in the Treasury Department that we would get a more effective regulation.

Others though have pointed out that while the Treasury Department may have the expertise to look at safety, soundness and, particularly apropos to today, accounting standards and compliance and fair disclosure, that it might be more appropriate for the mission of these GSEs to be regulated and continue to be regulated by HUD, which, after all, is the agency we entrust to provide affordable housing for Americans.

So I look forward to devising a regulatory system so that a decade from now we are not back here again looking at some accounting problem for a GSE. But at the same time these GSEs do all they can to provide for housing.

Chairman BAKER. I thank the gentleman.

Mr. Miller?

Mr. MILLER OF CALIFORNIA. Yes. Thank you, Mr. Chairman.

More of a comment than a statement. And I guess this—we have two separate issues we have to look at: one is safety and soundness, the other is the mission of Fannie, and I don’t think those should be mingled at all in this debate today.

And I think we need to be very cautious of what we say. Because things that we say can have more of a burden and impact on the debt market than many of those who just basically overview and have insight into what they are doing.

But we need to strengthen the regulation of GSEs to ensure safety and soundness; there is absolutely no doubt about that. We must be careful not to impact the actions that we take here on the debt market.
Accounting irregularities demonstrate that we must change the way GSEs are regulated. And that, I think, is what we are about today. But it does not in any way suggest reforming the mission of GSEs.

And I just wanted to put in the record, Mr. Chairman, I know you are heading in the direction of what I am saying, but we need to be very cautious about dealing with the mission and not commingling that with safety and soundness.

I yield back.

Chairman BAKER. I thank the gentleman.

Mr. Ackerman is not here.

Mr. Hinojosa?

Mr. HINOJOSA. Thank you, Mr. Chairman.

Chairman BAKER. Oh, I am sorry, Mr. Ackerman. I am sorry. Mr. Ackerman passes. I thank the gentleman.

Mr. Hinojosa, please?

Mr. HINOJOSA. Thank you, Mr. Chairman.

Chairman Baker, I want to express my sincere appreciation to you and Ranking Member Kanjorski for holding this important hearing today.

I also want to welcome our witness today, Mr. Donald T. Nicolaisen, the Securities Exchange Commission’s chief accountant. I look forward to your testimony.

Over the past 2 years, we have been witness to several developments in the government-sponsored enterprises that have been less than pleasant. I am not going to go into them in great detail except to say that they have resulted in the need for Fannie Mae and for Freddie Mac to restate their earnings and take other corrective actions.

In December, the Securities Exchange Commission—rather Mr. Nicolaisen, who is chief accountant, determined that Fannie Mae’s accounting was not consistent with generally accepted accounting practices.

This determination allowed OFHEO to formally classify Fannie Mae as significantly undercapitalized and to require Fannie Mae to make prompt corrective actions to recapitalize.

Although the accounting restatement amounts to approximately $9 billion, Fannie Mae has taken certain actions to recapitalize and to increase its capitalization with further actions likely in the near future to meet OFHEO’s requirements, with negotiations ongoing.

Mr. Chairman, this hearing will play an important role in determining the type of legislation, if any, Congress will introduce and consider this Congress to reform the government-sponsored enterprise system.

Senator Chuck Hagel has already introduced legislation that would consolidate oversight of Fannie Mae, Freddie Mac and the 12 Federal Home Loan Banks under a single and new regulator with the power to set minimum capital requirements and to put Fannie Mae and Freddie Mac into receivership.

I have also noticed that the legislation greatly expands the regulator’s ability to limit benefits and bonuses within the severance packages paid to GSE executives who leave those entities.

That component of Senator Hagel’s bill is very important to me and to many of my colleagues here in Congress.
It will be interesting to see if legislation will be introduced in the House to reform the government-sponsored enterprise system. And if so, what will it contain, how the committee will proceed with the consideration, and what ultimately will be the outcome of any and all actions taken by Congress.

It seems to me that whatever actions Congress takes, we need to ensure that Fannie Mae and Freddie Mac continue to meet their primary mission of providing affordable housing.

Mr. Chairman, we need to also ensure that whatever actions we take do not harm the housing industry, which has been the foundation for the nation’s economy since the market decline in the year 2000.

With that, Mr. Chairman, I yield back the remainder of my time.

Chairman BAKER. I thank the gentleman.

And, Ms. Kelly, did you have a statement?

Mr. Gillmor? Paul, do you have a statement?

Mr. GILLMOR. I have a statement I will just enter in the record.

Thank you.

Chairman BAKER. I appreciate the gentleman’s actions.

Ms. Velazquez?

Ms. VELAZQUEZ. Mr. Chairman, I will ask unanimous consent to enter my opening statement into the record.

Chairman BAKER. Without objection.

Mr. Baca?

Mr. BACA. Thank you very much, Mr. Chairman and ranking members. And just for the record, I know a lot of us Hispanics look alike. When you were looking at me and saw Ruben on that side over there. But I appreciate that.

Chairman BAKER. I plead innocence, because Mr. Kanjorski, as usual, was obstructing my view of the proper world.

[Laughter.]

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

I am very pleased to be here today to have the opportunity to ask questions of our witness.

Now that we know the findings of the commission staff, we must continue to respect due process. And I state that: respect due process. That is the American system.

These are very serious findings, and we should take them seriously, because the situation of the nature could injure Fannie Mae and its mission.

I am saddened at the events that have occurred in light of the importance of preserving Fannie Mae’s historical duty to protect the underserved. I am troubled that the number of currently questionable practices have cast uncertainty on a company that has done good, and so much good throughout our country. And I state again: that has done so much good.

As a member of this subcommittee, I will not rest until we have made sure that Fannie Mae has its books in order and is financially sound and it is on a continued footing to preserve first-time homebuyers, Hispanic and other minorities, in our neighborhoods.

This is very important for my district and those other members of the subcommittee. Housing is the American dream.

Fannie Mae has a number of innovative and highly successful programs to increase home ownership. I hope that as we continue
to discuss this company, that we will focus on the good and also talk about such programs as those in the subcommittee.

At the end of the day, we will be adopting legislation in the subcommittee, and I think it is important that we move forward rapidly and that we assure that Fannie Mae has a strong, well-funded regulator—and I state, a well-funded regulator—with the tools to carry out its missions—with the tools to carry out its regulatory missions.

We must take from this the appropriate lesson and move on. But Fannie Mae has to assure us that it will be open, will be honest and thorough in its continued dealings, and it will make it right and get it right.

We must ensure that we have an orderly house here and in the future to ensure that the integrity of the market, we must step forcefully, but let us make sure that we do not harm the core of the mission here, which is housing.

I thank you, Mr. Chairman.
I will submit my statement for the record.

Chairman BAKER. I thank Mr. Baca for his statement.
Mr. Lucas, did you have a statement?
Ms. Bean?

Ms. BEAN. Thank you, Mr. Chairman, for holding this important hearing concerning Fannie Mae’s accounting irregularities and disclosure practices.
I would also like to thank Mr. Nicolaisen from the SEC for taking the time to share his views.
As a new member to both Congress and Financial Services, I am eager to join the committee and to hear the witness’ testimony.

Thank you.
Chairman BAKER. I thank the gentlelady.
Mr. Crowley?
Mr. Lynch?

Mr. LYNCH. Thank you, Mr. Chairman, and also the ranking member, for holding this hearing, and Mr. Nicolaisen for helping the committee with its work.

I just have three areas that eventually I would like to hear from you on.
One is the clarity of the rules that we are looking at here. I am not an accountant, but I am an attorney and I must admit that a lot of our earlier hearings sponsored by the chairman centered around the complexity of the rules. And I think it would be helpful to our GSEs during the new regulatory process that there be full understanding of the rules themselves.

And also I would like to hear about the interaction between the regulator and the GSEs. These GSEs, Fannie Mae and Freddie Mac, are central to our national housing policy. And it need not be an adversarial relationship; it can be one of oversight and inducing responsibility.

And lastly, the promptness of that oversight, not only from this committee, but from the regulator. Hopefully we would avoid a situation that we have a four-year restatement required by our GSEs in the amount of $9 billion. There should be a way that we can be more prompt in our oversight so that we don’t go so far down the road that that type of restatement and correction is necessary.
That is all I have.
Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Ms. Wasserman Schultz?

Ms. WASSERMAN SCHULTZ. Thank you, Mr. Chairman.
I, too, look forward to being a member of this subcommittee and hearing from Mr. Nicolaisen on the concerns that he has over the ongoing investigation related to Fannie Mae. There are certainly issues that appear to be important for us to hear about.
And I look forward to his statement and to making sure that we can review the situation and address the concerns.
Thank you.

Chairman BAKER. I thank the gentlelady.
If there is no other member wishing to make an opening statement at this time, I would like to welcome to our committee the chief accountant for the Securities and Exchange Commission, Mr. Donald T. Nicolaisen, who has done exemplary work in my opinion.
And please proceed at your own pace.

STATEMENT OF DONALD T. NICOLAISEN, CHIEF ACCOUNTANT, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. NICOLAISEN. Chairman Baker, Ranking Member Kanjorski and members of the subcommittee, thank you for this opportunity to testify today concerning accounting issues related to deferred purchase price adjustments and to derivatives and hedging activities.

My name is Don Nicolaisen and I am the chief accountant at the Securities and Exchange Commission. As the chief accountant, I am the principle adviser to the commission on accounting and auditing matters.

The views I express today, however, are my personal views and my testimony has not been reviewed or approved by the commission.

As the subcommittee has requested, my testimony addresses my decision of December of 2004, that certain accounting practices of Fannie Mae did not comply in material respects with specific provisions within generally accepted accounting principles, also known as GAAP.

Fannie Mae has disclosed that the commission is investigating certain issues associated with Fannie Mae’s accounting and disclosure practices. I and others at the commission appreciate the subcommittee’s recognition of the non-public nature of the commission’s active investigation.

In light of the commission’s ongoing enforcement actions, I ask that the subcommittee understand my reluctance to address at this time specific issues related to Fannie Mae’s compliance with federal securities laws. You may be assured that the commission staff thoroughly is investigating any evidence of financial reporting impropriety.

My statements today will be confined to the public record. And because the commission has not expressed any opinion or views on these matters, my statements should not be attributed to the commission.
Fannie Mae is the largest non-bank financial services company in the world and the nation's largest source of financing for home mortgages. Fannie Mae's common stock is listed on the New York Stock Exchange and, after discussions with the commission's staff, on March 31, 2003, Fannie Mae voluntarily registered its common stock with the commission under Section 12(g) of the Securities and Exchange Act of 1934.

As the subcommittee is aware, the Office of Federal Housing Enterprise Oversight, or OFHEO, Fannie Mae's safety and soundness regulator, reviewed several of Fannie Mae's accounting practices, focusing on the implications of those practices on the adequacy of Fannie Mae's regulatory capital, the quality of its management and the overall safety and soundness of the enterprise.

OFHEO issued a report of its findings on September 17th, 2004, and last October officials from both OFHEO and Fannie Mae testified before this subcommittee on issues discussed in that report.


Although the SEC accounting staff may choose not to provide such guidance while there are pending investigations by the commission and other agencies, Fannie Mae requested our guidance because, in its view, these accounting issues received extraordinary public attention and resulted in the mortgage and capital markets experiencing uncertainty.

To facilitate our review, Fannie Mae and OFHEO voluntarily provided the commission’s accounting staff with information and with explanations of their views of the applications of Statements 91 and 133.

Fannie Mae did not ask the accounting staff to express any views regarding whether the information provided by Fannie Mae or OFHEO was accurate or complete, or to develop additional facts. And in providing the requested accounting guidance we did not do so.

Accordingly, the accounting staff's guidance was based on the information voluntarily provided by Fannie and OFHEO and, in addition, the SEC's accounting staff did not consider the appropriateness of Fannie Mae's business decisions to use financial or derivative instruments, or to hedge its risk, but limited its consideration to whether the accounting used to record those transactions complied with Statements 91 and 133.

In light of the public attention and uncertainties cited by Fannie Mae, on December 15, 2004, the commission's accounting staff issued a press statement containing our views.

In that press release, the SEC accounting staff indicated that, based upon our review of the information provided by Fannie Mae and OFHEO during the period of 2001 to mid-2004, Fannie Mae's accounting practices did not comply in material respects with the accounting requirements of Statements 91 and 133.
Regarding Statement 91, during the period under the staff’s review, Fannie Mae failed to record timely adjustments to the recorded amount of its loans based on changes in the estimated speed with which these loans would be prepaid.

Among other requirements, Statement 91 provides that when applying the method used by Fannie Mae, an entity should use its best estimate of expected prepayment rates in calculating the carrying amount of these loans.

Fannie Mae already had concluded that its methodology for performing these calculations for interim balance sheet dates in the periods 2001 through 2002 were not consistent with Statement 91 and had stated that it has changed its accounting practices to, among other things, calculate the amounts based on quarter-end positions, rather than projected year-end positions.

It also appears that, contrary to Statement 91, Fannie Mae recognized adjustments to the carrying amount of its loans only if they exceeded a self-defined materiality limit referred to as a precision threshold.

Fannie Mae has represented that it has initiated additional changes to eliminate the precision threshold and is working with OFHEO to further amend its accounting practices under Statement 91.

Regarding Statement 133, one of the principles underlying that statement is that derivative instruments are to be reported at their fair value with changes in fair value being reported in earnings.

If certain detailed hedge criteria and procedures are satisfied, Statement 133 affords special accounting for the hedge relationship. If the detailed hedging requirements are not satisfied, then special hedge accounting is not available.

Fannie Mae internally developed its own methodology to assess whether hedge accounting was appropriate. Fannie Mae’s methodology, however, did not qualify for hedge accounting because of deficiencies in its application of 133. Among other things, Fannie Mae’s methodology of assessing, measuring, and documenting hedge ineffectiveness was not supported by Statement 133.

As a result of the staff’s review, on December 15, 2004, the commission’s accounting staff advised Fannie Mae that to be consistent with Statements 91 and 133 and to provide investors with appropriate information, Fannie Mae should restate its financial statements filed with the commission to eliminate the use of hedge accounting; evaluate the accounting under Statement 91 and restate its financial statements filed with the commission if the amounts required for correction are material; reevaluate the information prepared under generally accepted accounting principles in non-GAAP information that Fannie Mae previously provided to investors, particularly in view of the decision that hedge accounting is not appropriate.

In a report on Form 8-K filed with the commission on December 17, 2004, Fannie Mae stated, “As a result of the commission accounting staff’s findings, Fannie Mae will restate its financial results for the periods from 2001 to mid-2004 to comply fully with the commission accounting staff’s determination.”

As of the date of this testimony, Fannie Mae has not yet filed revised financial statements with the commission. It is my under-
standing that investigation into these and related matters by Fannie Mae's special review committee, the commission and others are continuing.

As I noted previously, in order not to compromise the commission's ongoing investigation, my statement today is based only on the information voluntarily provided to the SEC accounting staff by Fannie Mae and OFHEO when Fannie Mae requested the accounting guidance provided in our December 15, 2004, press release.

I thank you for the opportunity to appear today. I am pleased to try to respond to any questions the members of the subcommittee may have.

[The prepared statement of Donald T. Nicolaisen can be found on page 46 in the appendix.]

Chairman BAKER. Thank you, Mr. Nicolaisen. I appreciate your statement and your good work.

Let me start with the manner by which these events occurred.

As a result of the OFHEO finding, Fannie Mae came to your agency voluntarily and presumably would have had time to present their most favorable presentation of the facts as they viewed it.

Would that be a correct observation? You didn't just drop in one morning and say, "Let me see. What have you got?"

Mr. NICOLAISEN. That is correct. They made the request and they submitted everything they believed to be relevant.

Chairman BAKER. And as to process, once a registrant comes to the SEC for financial determinations—although it is clear your testimony this morning only speaks to the facts presented by Fannie on their voluntary appearance—notwithstanding, once a registrant comes to the SEC for financial determinations, that does engage the ability or responsibility of the SEC to look more broadly at the agency's activities.

And you are making no comment as to whether you are doing so, but you have the process authority to engage in a broader examination.

Mr. NICOLAISEN. That is correct.

Chairman BAKER. In your finding, it appears that the accounting methodology was not just an aberrant act. It wasn't with regard to a single transaction. It wasn't with regard to a single quarter. It wasn't with regard to an annual statement. It was year-over-year practice, is that correct?

Mr. NICOLAISEN. With respect to the two issues that we looked at, they were across all of the years that I referred to 2001 through 2004.

Chairman BAKER. Some have suggested that this could have been what is discussed as an interpretive judgment: Two artists looking at the same picture would see two different things.

In your view of the findings and the determinations made, was this just a matter of interpretive judgment where two people could have come to varying conclusions, or was this clearly outside professional accounting standards?

Mr. NICOLAISEN. In my view, it was outside professional accounting standards.

Chairman BAKER. Is it so difficult for a public operating company to comply with FAS 91 and 133 that it is pattern and practice within the rest of the public operating company world that companies
just don’t get it right? Or are there other companies out there who, in your view, do find appropriate manner in which to comply with the rules as you see them?

Mr. NICOLAISEN. Well, I believe that other companies are complying with Statements 91 and 133. I have reason to believe that the standards are workable and are being followed.

Chairman BAKER. It may be difficult, but as a matter of customary practice, accountants and CPAs in public operating companies across the country do conform with your rules on a day-to-day basis?

Mr. NICOLAISEN. Yes.

Chairman BAKER. All right.

Then if these determinations occurred over a matter of years, the judgments were clearly outside the scope of professional accounting conduct. Since it was not an accident or a matter of interpretative judgment, it would lead me to conclude that this was the result of a managerial plan to report in this fashion.

Would that be a correct observation, or do you agree with that observation?

Mr. NICOLAISEN. That is an area I would prefer not to address, because we have an active investigation in process.

Chairman BAKER. Certainly. Let me restate my question.

Given the fact that you have agreed, you have not reached a conclusion as to how this occurred?

Mr. NICOLAISEN. I have not.

Chairman BAKER. Okay.

Let me reach a conclusion.

If, in fact, this was—to which you do not have to agree or make comments since there is a pending investigation.

Since it was not aberrant, since it was not interpretative, since it occurred year to year, since it was clearly outside the scope of accounting practice, as you described and examined, it must have been a determined managerial strategy to represent the agency’s financial condition in the manner in which it has been reported and presented by the enterprise on its own motion for your review.

Then that leads me to ask the question, if there was that intent, was it only for the purpose of reducing volatility reports to the market as we—some know?

Freddie Mac, for example, has the reputation Steady Freddie. And many in the market of all reporting companies look to these two to be the most stable in earnings performance over the past two decades, a powerful incentive for management to present that face to the investing public.

On the other hand, there is one other factor which has not yet been discussed, and I assume at its appropriate time would be reviewed by the agency or others, and that is that management intended to manage its earnings for the purpose of hitting that earnings-per-share target that was hit to the one-thousandth of a cent accuracy, pursuant to a GAAP-noncompliant action of deferring $200 million of expenses, not to the next quarter, but over an entire year, for the purpose of hitting that earnings target, which then triggered not only bonuses, but the maximum bonuses permissible pursuant to compensation agreements.
I am just going to leave it at that and hope that the agency continues its fine work in making the appropriate findings and reporting to this committee on the actions that are responsible for us to take.

My time has expired.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

I am not going to attempt to conclude whether there was malfeasance or misfeasance here because I think it would be reasonable to say your investigation is not complete and has reached no finding one way or another. Is that correct?

Mr. NICOLAISEN. That is correct.

Mr. KANJORSKI. What I am curious about is this: At prior hearings we had the regulators testify that they participated at the exit audits over the period of 4 years, when the application of these two rules were made. As a matter of fact, the internal auditor had used one rule, and an external auditor was hired and concurred with the final determination of what should be done in applying these two accounting principles.

So we have had a four-year regulator participation, internal auditor participation, external auditor participation, all generally arriving at the application of these two rules.

Now, I cannot speak for the executives of this company or any other company, but I would highly suspect that a standard CEO, chairman or even members of the board are not sufficiently familiar with the technicalities of these rules or other accounting rules. They probably would be of much use in deciding whether or not the statement reflects the financial position of the company in accordance with GAAP.

That is generally what your profession is all about.

Mr. NICOLAISEN. That is what my profession is about.

Mr. KANJORSKI. I mean, isn't that why when I file an income tax return, I go to an accountant? I don't sit there and do all the things, although I am responsible for, ultimately, the conclusions of the accountant.

In very complicated accounting situations, it isn't necessarily the executives or the owners or the directors of the company that really understand the application of rules, whether they comply or don't comply with GAAP.

Mr. NICOLAISEN. With respect to this particular set of facts, I do want to be very clear. There were only two issues that we dealt with. My office did not look to the cause of why there was noncompliance to GAAP with respect to those issues.

But we do have in place an ongoing investigation. And, as that investigation continues, I can assure you we will look for those courses.

Mr. KANJORSKI. At this point in time, you were the “supreme court” of the application of these principles, which heretofore went through a regulator that didn't raise any questions for 4 years, so we didn't see any noncompliance.

The internal auditors saw relatively no problem. The external auditors saw no problems. And I think even a second outside auditing firm was hired and saw no problem. And then the issue was
put together and submitted to you. It was your final judgment, as the supreme court, that Fannie Mae didn’t comply.

Now, I am a little worried about that. I am hearing from a lot of executives across America and a lot of companies. With the advent of Sarbanes-Oxley, we are asking these folks to certify and subject themselves to criminal and civil liability for the disclosures made in financial statements when, in fact, they have to rely on the expertise of either internal auditors or external auditors of the finest quality, who now we have seen for 4 years have made a mistake on the largest financial institution in the world.

Now, my question is: Have you had the opportunity to examine other corporations as to the application of these two principles?

Mr. NICOLAISEN. In my career, yes.

Mr. KANJORSKI. Have you found any others that have not applied, and I don’t mean misapplied them in the same way Fannie Mae may have, but where there is a misapplication of GAAP rules?

Mr. NICOLAISEN. There is nothing that really comes to mind in that area.

Mr. KANJORSKI. What would your thought be if we did, in fact, have a forensic autopsy audit of, say, the Fortune 500 companies, what would be the likelihood of finding the misapplication of these two rules or other GAAP rules in that autopsy, that was ultimately, with all of its findings and facts, were submitted to you for evaluation?

Do you have the opinion that every one of them would be absolutely crystal clear?

Mr. NICOLAISEN. I certainly would not have a basis to have an opinion on that one way or the other.

I can give you a few thoughts on this, though.

Mr. KANJORSKI. Yes.

Mr. NICOLAISEN. Fannie Mae is, perhaps, the largest user of derivatives in the world. In that sense they are different than many other Fortune 500 companies. The business that they engage in, they have chosen to do hedging transactions because they are trying to minimize risk, is the way they have described it in their public statements.

And in that context, I would imagine that they are perhaps different than many other companies in America.

Mr. KANJORSKI. I think that is probably a reasonable conclusion. I certainly accept it. But how about other financial institutions that are involved in the use of derivatives to a large extent to balance risk?

Mr. NICOLAISEN. You started out with a very good analogy to income taxes. And if you don’t mind, perhaps I could use that as a comparison to what we are dealing with here to try and bring it closer for those who are not day-to-day working with Statement 91 or 133.

If you consider the tax code, we are all required to submit income taxes every year. We prepare our returns, or we have them prepared for us. But we do have the responsibility to report all of the income that we have earned during the course of the year. That is a very clear responsibility, basic. It is a basic principle that exists.

Similarly, within the accounting world, we have accounting standards like 133 which requires all companies in principle to re-
port true earnings at their value, including their interest in derivative transactions.

In the detailed area, I would submit that the income tax code would be viewed by many people as complex, that it has a lot of attributes to it that the average person may in fact find to be complex, but they are still required to comply with it.

The accounting literature also has complexities to it, and I think people would generally acknowledge that 133 is one of those standards that has a fair amount of guidance and detail attached to it.

In your income taxes, while you are required to report all income, if you choose to deduct certain expenses in your income tax returns, you are required to follow the rules of the IRS. You are required to comply and have forms and detailed procedures and fully enact all of those things if you want to qualify for a deduction.

Similarly, under Statement 133 there is an exception to the basic principle, and that exception says you can do hedge accounting, and hedge accounting is appropriate, so long as you follow certain rules.

Those rules are not overly complex. I think those rules are clear. They are laid out. They are laid about because the FASB thought it was important to maintain the financial integrity of reporting—when exceptions to basic rules are followed, that you had to comply with these essential elements.

And they exist, and I do believe that those large financial institutions who engage in derivative transactions are familiar with those rules.

That is a very long answer.

Mr. KANJORSKI. No, that is okay. I appreciate that answer. But it takes me right back to the beginning of my examination.

How do you account for the fact that—it is a mystery to me; I am trying to search out—over a period of 4 years the same rules were interpreted and applied the same way, the federal regulator was present; the issues were raised in the exit audit each year, internal auditors gave opinions that concurred and said the rules were properly interpreted; and external audits of the finest accounting firms in the world, one of the major fours, rendered the same opinion?

How does that happen?

Mr. NICOLAISEN. What you are asking is an important question. It is not one that I can respond to today. We do have an ongoing investigation into the causal aspects——

Mr. KANJORSKI. I understand that. You are in an investigation. I am not asking you opine on it. I am talking about the hypothetical now, moving it away from Fannie Mae.

If that happened for 4 years with a regulator present, an exit audit raising the question, internal auditors concurring in the opinion of how the rule was applied and an external auditor of a major accounting firm opining the same way, why should we assume that that does not exist in every other financial institution in the country or has a strong possibility?

And if so, what are we doing or what is the SEC doing to make sure it is not the case?

Mr. NICOLAISEN. I can’t really respond to that in a generic sense. I think that the rules, the practices, the enactment of Sarbanes-
Oxley, the various disclosure requirements that exist, the checks and balances provided, intended to be provided by having management prepare financial statements, auditors review and opine on those financial statements, boards of directors engaged in oversight activities. That combination is what is in place to provide what I think Congress has believed to be the appropriate safeguards. I am not sure I could tell you in every instance everyone in that chain of supply has preformed to the fullest ability.

Mr. KANJORSKI. Just the question: Since it happened in a quasi-public operation that has a regulator, has oversight by Congress and has all these protections that really don't exist in many other financial institutions to that extent, do we have any reason to believe or worry about the fact that this may be systemic in dealing with derivatives? Are they not necessarily being properly accounted for?

Chairman BAKER. And that will be the gentleman's last attempt at it, because his time has really expired—one more time.

Mr. NICOLAISEN. I really can't address what others are doing in that level of detail.

The two issues that we looked at were reasonably narrowly confined. We addressed all the facts that were specific to Fannie Mae in reaching our conclusion.

I do understand the importance of—

Mr. KANJORSKI. I am not really worried whether you have something to worry about. Do we have something to worry about, our responsibility?

Mr. NICOLAISEN. I think it is an important consideration for you. Chairman BAKER. The gentleman's time has expired again.

Ms. Biggert?

Mrs. BIGGERT. Thank you, Mr. Chairman.

Mr. Nicolaisen, at this time both Fannie Mae and Freddie Mac are in the process of restating their financials.

Does your office require public companies that are not current with their books to resort regularly to the FTC?

Mr. NICOLAISEN. That, actually, is not within my office, and I would be stepping outside of my bounds if I were to try to address that.

I would say this: Good information, current information is important all the time for investors. We are looking at the investors' interest in this.

So as a general concept, I think you could assume that we are looking for current information. That is why our rules were written the way they have been written. But that is not my area of expertise.

Mrs. BIGGERT. In your opinion, should companies that are not up-to-date with their financials be delisted or otherwise disciplined by the market?

Mr. NICOLAISEN. Again, that is outside of my area of expertise. A lot of other people could make comments on that.

Mrs. BIGGERT. What role will you play in the restatement of Fannie Mae?

Do you have a sense of how long it will take to complete the restatement of Fannie Mae?
Mr. NICOLAISEN. It is probably somewhat difficult to put a time table on the restatement. Let me describe the process as I would understand it. And perhaps that will help shed some light on that.

My instructions to Fannie Mae were to restate their financial statements for these two issues. In the course of looking at those restatements, it is the primary responsibility of the company working with its advisers and others to develop responses to those restatements.

That will likely take some time. They probably will have to look at the company’s books and records and get back to source documents. And I suspect there will be a number of months that will be required for them to do that.

Following that, perhaps to some degree parallel to that, the external auditor will be required to report on the years 2001, 2002, and 2003, as restated. That will also take a fair amount of time.

So while I can’t put a precise time period on this, I would imagine that we are talking a number of months, perhaps years. I hope it is not years.

Mrs. BIGGERT. Some have said that FAS 91 and FAS 133 are overly complex accounting standards.

Do you think that is a fair statement?

Mr. NICOLAISEN. Well, I tried to address that a bit with Mr. Kanjorski.

The statements are long. They do have a lot of attendant and interpretive guidance that is provided with it.

The reasons for that, I don’t think, are because the statement is particularly complex. I think it is because the business world has reasonably complex transactions and iterative developments of different products sometimes require new interpretations.

The basic principle is pretty straightforward. As I described, are recorded at fair—in the financial statements, derivative instruments that bear value with adjustments running through the income statement.

The exception to that is for hedging. And where hedging is required, the hedging rules are straightforward, clear. Each company would have some interpretive aspects, no doubt, that they would deal with to various degrees as they apply, but I think they are very crystal-clear rules.

Mrs. BIGGERT. Well, OFHEO Director Falcon stated before this committee last October that these are black and white accounting issues, and they are not issues of interpretation, and they are not issues where reasonable people can disagree.

Do you agree with that statement?

Mr. NICOLAISEN. Let me say this: We did our independent review of these two areas. We reached an independent conclusion based upon the facts as provided by Fannie Mae. We also read the information that was provided to us by OFHEO in OFHEO’s report. And it is my view that they—without addressing the causal issues, which, you know, is part of an ongoing investigation—it was my view, which I believe I stated clearly, that Fannie Mae did not comply with GAAP in material respects with respect to these two issues.

Mrs. BIGGERT. Thank you very much.

Thank you, Mr. Chairman.
Chairman Baker. I thank the gentlelady.

Mr. Scott?

Mr. Scott. Thank you, Mr. Chairman.

Mr. Nicolaisen, I think that the charge that this investigation is on sort of falls on two prongs: One is the charge that Fannie Mae intentionally manipulated its accounting to one, smooth earnings and, two, they manipulated their accounting to meet earnings targets, to set in motion executive bonuses.

Would you say that is the kernel of your investigation?

Mr. Nicolaisen. No. My investigation was only of the accounting for two issues. Whether or not it complied with GAAP did not in any way get to the question of intent or why this occurred. It is the question of the facts and my assessment of those facts.

We do, though, as you know, have an ongoing investigation with our enforcement division, where other matters are being considered.

Mr. Scott. How much weight are you giving to those two areas of the——

Mr. Nicolaisen. Two areas being?

Mr. Scott. Obviously, this is my point. The cloud over Fannie Mae is largely due to the fact that, one, that they allegedly cooked the books to smooth over earnings and they cooked the books so that they could get bonuses.

That is what is in the minds of the nation, people that must have credibility. My question is simply: To what extent is the Securities and Exchange investigation looking into those two areas?

Mr. Nicolaisen. You should be confident that we are looking into those areas.

Mr. Scott. All right, and it is safe to say then that you cannot go further into that because of the ongoing investigation. Is that what you are saying?

Mr. Nicolaisen. That is correct.

Mr. Scott. Okay, let me ask you this: At what point did you get involved in this?

Was it at the point of—because I noticed in your testimony, Fannie Mae came to you. Was that the point that you got involved in it, or did OFHEO consult with you prior to them making their announcement on this?

Mr. Nicolaisen. Let me, maybe, do a little chronology here.

A few days before OFHEO released its report, they asked to meet with us. And in that meeting with us, they basically described what they would be saying in their report.

In that context, they did not look for our agreement with what they had to say. They didn't ask for that. They simply were informing us of what they were about to release.

We often work with other agencies within the government. We think that is appropriate to do so.

In this particular instance, though, it was not a situation where OFHEO had met with us and reviewed in detail with any kind of ability for us to be engaged in thinking about those accounting matters.

As I think you know, shortly after—very shortly after—OFHEO released its report, Fannie Mae did come to us and asked if we would consider these issues.
And we agreed to do so and asked for submissions of fact by Fannie Mae in the same manner that we would from any other registrants.

Mr. SCOTT. So, then, it is safe to say that OFHEO contacted you first; OFHEO released their report and then Fannie Mae contacted you.

Mr. NICOLAISEN. Yes.

Mr. SCOTT. On these hedge accounting, or derivatives, how widespread is that with other companies?

I mean, a company as large as Fannie Mae having trouble with this method of accounting—how widespread is that with other similar large financial institutions?

Mr. NICOLAISEN. Use of hedge accounting is pervasive across the financial world, certainly as employed by others. And so I would say it has substantial use.

Mr. SCOTT. Well, it is unclear at this time as to the extent to which Fannie Mae’s practice has differed from other financial companies that were subject to significant earnings volatility due to market-driven accounting adjustments, as well as Fannie Mae.

Are you able to provide us with, maybe, just a general view of how, what percentage of other companies fails to properly account for their derivatives?

Is it common for the Securities Exchange Commission to find companies not in compliance with, as said, FAS 133?

Chairman BAKER. That will need to be the gentleman’s last question.

Mr. NICOLAISEN. I have not studied that—may I respond?

I have not studied that in the sense that I feel comfortable describing that to you today. I think that is certainly something, if you would like, we could provide additional insight to.

We actually do not keep that kind of information within my office.

And perhaps there are actually some public sources that may also provide insight to that. I did read a recent release on restatements of financial statements. That is in the public domain and can identify some of the issues that existed there.

But what I do want to be cautious about, though, is I don’t think that it is axiomatic that, when you use the word “derivative” and “restatement” that it would be for the reasons that we are looking at with respect to Fannie Mae.

Chairman BAKER. The gentleman’s time has expired.

Mr. SCOTT. Thank you.

Chairman BAKER. Mr. Fitzpatrick, do you have questions?

Mr. FITZPATRICK. Thank you, Mr. Chairman.

Mr. Nicolaiesen, I appreciate your taking the time to speak to us today, and appreciate your candor.

This is the second accounting scandal, I guess it is being called, affecting government-sponsored enterprises.

Freddie Mac is not an organization that is registered with the SEC, but are you able to outline the differences between what happened at Freddie Mac versus what happened at Fannie Mae?

Mr. NICOLAISEN. No, I have not followed the Freddie Mac issues closely, and I am not able to do that.
Mr. FITZPATRICK. So you don't have an opinion as to which might have been more severe?

Mr. NICOLAISEN. No, I do not have an opinion.

Mr. FITZPATRICK. Thank you, Mr. Chairman.

Chairman BAKER. If the gentleman will yield, I think the distinguishing features between the two events is Freddie Mac, ironically, was underreporting its revenues to present a smooth picture of earnings, whereas in the case of Fannie Mae, it was an under-reporting of risk, which lead to an overestimate of revenue.

So the two were markedly different, at least in my judgment.

I thank the gentleman for yielding.

Mr. Baca, you are next.

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

It has been reported that the SEC has been ranking with the regulators of OFHEO. How can we ensure that confidentiality is respected and that Fannie Mae has had an opportunity to address the issues that have come to light? This is question number one.

And is there any incompatibilities between SEC enforcement missions and OFHEO's mission as the ongoing regulators of Fannie Mae?

Mr. NICOLAISEN. Let me try to respond to those.

The SEC's ongoing investigation is not something that I can talk about publicly, but it certainly is addressed at what our primary role is, which is to look to the financial reporting and fullness of disclosures of those companies who register securities with us.

And in that context, our role is different than OFHEO's role, which is as a safety and soundness regulator. We are interested in, did companies comply with GAAP reporting requirements.

Mr. BACA. What is the status of pending civil and criminal investigations, and how could this affect the soundness of Fannie Mae?

Mr. NICOLAISEN. Those are issues outside of my area of expertise; I would not know.

Mr. BACA. If Fannie Mae's accounting is currently the subject of a criminal investigation, are there any laws or regulations that we should be mindful of in holding this public hearing today, in terms of the areas we can cover, which is question number one. And how can we assure that the people's right are protected is question number two.

Are there any areas of questions you will not be answering today as a result of the confidentiality requirements?

Mr. NICOLAISEN. Yes. As I said in my opening remarks, anything that relates to our ongoing investigation, which we want to maintain the integrity of, I would not be able to comment on it at this session.

Mr. BACA. How can we assure that the people's rights are protected?

Mr. NICOLAISEN. I am not sure that I am the person to respond to that, either. I think, you know, it is an important question. It is probably an important question for you to ask.

I am not sure I am the person to——

Mr. BACA. Maybe the question should be: Why are we here, and why are you here?

Mr. NICOLAISEN. You know, I am here at your invitation and——

Mr. BACA. Right, thank you. Let me ask the next question.
Now that the staff has responded for potential accounting irregularities at Fannie Mae’s have prepared or have been removed from the regulator’s employment, do you have any advice as to how the company, OFHEO and the Congress can assure that these sort of problems will not occur again?

Mr. NICOLAISEN. I can’t respond to that, because it is forward-looking.

And I would say that the actions that I have read about that are in the public record are the actions that you would expect to take place: engagement of new audit firms, an agreement to restate, use of outside advisers and specialists to help them to do that. Those are the kinds of actions that I would expect would be appropriate.

Mr. BACA. Is it your opinion that Fannie Mae will be able to continue to carry out its core mission?

Mr. NICOLAISEN. I would not have a view on that.

Mr. BACA. No opinion at all?

Mr. NICOLAISEN. No.

Mr. BACA. No view?

Mr. NICOLAISEN. No.

Mr. BACA. Okay.

Given that these accounting rules apply to any member of the company, do you think it would be appropriate to investigate other companies that have applied this accounting standard, to ensure that their books are in order?

Mr. NICOLAISEN. We would not comment on our ongoing investigations of other registrants or anything that is not publicly——

Mr. BACA. But don’t we want a fair process to hold other companies accountable for same thing that we are asking Fannie Mae to be accountable—we should be holding other companies accountable as well, to assure services are provided that follow the regulations that are in order?

Mr. NICOLAISEN. I think it is fair to say that we always look for a level playing field.

Mr. BACA. And that we should not discriminate against one or the other for any reason?

That is why the accounting should be done; the same standards should be done. There should be a due process that should be in place, and that everybody should be held accountable, not just one, and not just for whatever reason, political or otherwise.

Mr. NICOLAISEN. Certainly that is ideally correct. We do know that there are instances of enforcement in other areas, whether it is traffic ticket or otherwise, where not everybody who is violating the law is necessarily subjected to the same punishment as the one who happens to have been caught.

Mr. BACA. And that is not fair when we enforce it on one and not on another. We should enforce it on all companies.

Mr. NICOLAISEN. We try to enforce it on all. That is why the financial industry is structured the way it is. I can’t—you know, this is within your purview as to how that occurs.

But I would refer back to various pieces of legislation that are intended to require companies to report, auditors to be involved, boards of directors to have their roles in the activities of corporate America. There are a lot of things that are in place today.

Chairman BAKER. The gentleman’s time is expired.
Mr. BACA. Thank you very much, Mr. Chairman.
Chairman BAKER. I thank the gentleman.
Mr. Shays?
Mr. SHAYS. Thank you.
Basically, you are sitting in the same place where Mr. Raines
spoke very defiantly, very angrily, saying that Fannie Mae had
done nothing wrong and OFHEO was just off-base and that the
SEC would vindicate him and Fannie Mae.
Is there anything that you have done in your report that vindic-
tates Fannie Mae or Mr. Raines? Or, in fact, did you reinforce the
OFHEO report?
Mr. NICOLAISEN. Well, again I dealt that with just the two ac-
counting issues. And with respect to those two accounting issues
my view and the view of my staff was that Fannie Mae did not
comply with GAAP. That is a view that was expressed by OFHEO.
OFHEO expressed a lot of other views in their report to which
I have no comment and certainly was way beyond any——
Mr. SHAYS. But basically your investigation reinforced the fact
that Fannie Mae had overstated earnings by approximately $9 bil-
lion?
Mr. NICOLAISEN. No. I want to be careful here as well. I have not
expressed a view as to the amount of any restatement. That needs
to be dealt with by the registrant, Fannie Mae, and their auditors.
They need to work through those numbers.
I have simply said that, as I read the accounting literature as I
have seen it applied as using my experiences, that Fannie Mae did
not comply with the literature. And that requires restatement. The
amount of that restatement has yet to be determined.
Fannie Mae, in its public disclosures, did say that the amount
could be as much as $9 billion net of tax.
Mr. SHAYS. But the bottom line is it wasn’t that they understated
their income, they overstated their income. Is that correct?
Mr. NICOLAISEN. That is correct.
Mr. SHAYS. And in the process of overstating income, investors
believed that Fannie is a better investment than the reality.
Mr. NICOLAISEN. Yes, I——
Mr. SHAYS. I am not asking you to comment. But it is the reality.
Fannie and Freddie are not, by law, under the 1933 and 1934
Acts, which basically requires them to register with the SEC. Tell
me under what basis you were able to do this investigation.
Mr. NICOLAISEN. Well, Fannie did come to the commission as a
voluntary registrant under the 1934 Act. There is various levels of
detail that you may or may not be interested in that, but basically
they have volunteered to register with the commission.
Mr. SHAYS. Right. But can I qualify the word “voluntary”? They
were going to be required by law to be under the 1933 and 1934
Act in order to take the wind out of the sail of that they voluntarily
agreed, which was, in my judgment, the height of arrogance. You
know, everything they seem to do, is—they do it at their decision,
when they want.
And what I am asking you is whether they “voluntarily agreed”
or whether they were forced to, they are now not totally, but most-
ly, under the 1934 Act.
My question to you is what gave you the right to do this investigation? If they had not been under the 1934 Act would you still have been able to do this investigation?

Mr. NICOLAISEN. If they had not registered with us, I don’t believe we would have been involved in this type of review.

Mr. SHAYS. I just want to say this, Mr. Chairman. What is stunning about this investigation, the extraordinary arrogance of both our GSEs. They have fought for years not to be under the Act. And when we had Enron and WorldCom and we looked at Sarbanes-Oxley, it became eminently clear that these guys, these two companies, were basically exempt, pretty much, from Sarbanes-Oxley.

And what is so stunning is they are so large and so big.

So if in fact they weren’t under the 1934 Act, whether it was “voluntary” or “forced to,” we might not know this information today. Isn’t that correct?

Mr. NICOLAISEN. I can’t speculate.

Mr. SHAYS. Let me say this: It is unlikely that you would have been able to do your investigation. Is that correct?

Mr. NICOLAISEN. Well, if they were not registered with us, we would not have conducted the type of review that are completed in December.

Mr. SHAYS. I would like to say to the other members of the committee that have fought tooth and nail Fannie and Freddie from being under the 1933 and 1934 Acts, this is the best lesson to this committee and to members of the need for Fannie Mae and Freddie Mac to play by the same rules that everyone else does and be under the same rules and requirements as anyone else is.

And I am grateful that you looked into this. But if you had not, the world would still be thinking that OFHEO was just on this, somehow, vendetta. And you gave credibility to what OFHEO had done. And frankly, they have been a very weak overseer.

So I am happy you have done what you have done. I just know there is more to be done.

I hope the arrogance of the GSEs is dealt with by this committee once and for all.

Chairman BAKER. The gentleman’s time has expired.

Ms. Wasserman Schultz?

Ms. WASSERMAN SCHULTZ. Thank you, Mr. Chairman.

I guess I would like to ask a naive question for a freshman, and the question would be of you. Would that be appropriate?

Chairman BAKER. I am sorry, I was trying to figure out my—

Ms. WASSERMAN SCHULTZ. This might be a naive question for a freshman since I am not familiar with the procedure, but it would be okay to ask you a question?

Chairman BAKER. Certainly. Yes, whatever you like.

Ms. WASSERMAN SCHULTZ. Okay, thank you.

I have felt some frustration during this meeting that most of the questions that have been asked of Mr. Nicolaisen he is not able to answer.

And I have—I spent 12 years in the legislature and I am accustomed to being able to question people who come before committees and get substantive answers and feel, when I leave a committee meeting, that I should come away with more than I arrived with.
And I am not going to leave this committee meeting feeling that way.

So I guess my question of you is: Are there plans by the chairman or perhaps the full committee chairman to bring someone before the subcommittee that can answer the substantive questions that we have been asking?

Chairman BAKER. I appreciate the gentlelady's question and it is not a naive or simple question.

The answer is: Most of your colleagues would tell you we have had far too many hearings on this topic already.

However, going forward I can assure you, as the legal processes permit the committee to receive the information which has been requested, either by correspondence or by another appearance of SEC representatives, we certainly will.

And going forward, as we work our way through the regulatory reform process, many of the issues raised that I feel, and I think Mr. Kanjorski feels, should be addressed—even though Nicolaisen is not in a legal posture today to make comment, I assure you the committee will proceed to address in any event.

But certainly the information will be forthcoming as the lawyers let us talk.

Ms. WASSERMAN SCHULTZ. Thank you.

And I guess the questions that I might want to ask, because I am at the end here, I have realized that most of them you will not be able to answer. So I would just as soon save them for when we have someone who comes before the committee who can.

Chairman BAKER. I thank the gentlelady.

I have Mr. Matheson next.

Mr. MATHESON. Thank you, Mr. Chairman.

I think, following up on Mr. Kanjorski's line of questioning at the start of this hearing, FAS 133, as I understand it—and you may need to help confirm this for me—was a rule that was put in place to help provide some guidance both in the hedge transactions and—its attempt also was to try to levelize or normalize earnings.

Is that a fair statement, that that was one of the goals behind that rule?

Mr. NICOLAISEN. No.

Actually, the standard itself had its origins back in the early 90s when the use of derivative instruments had gained quite a bit of momentum. They were used extensively.

The amount of accounting literature available to reference for that was very limited, so people had various interpretations. That was the primary reason for the FASB's effort.

In its deliberations, the FASB had concluded that letting the volatility that does exist in the capital market transactions show up in the financial statement was an appropriate answer.

Many people were concerned that if you had transactions that were essentially viewed as a single transaction—they typically are viewed together—that that left accounting with an income statement mismatch. And that is where hedging really is used and has been requested by many who had responded to the FASB's project on derivative accounting.

And hedge accounting does allow, under very specific circumstances and tight rules, the offset, if you will, of gains and
losses so that when you have items that are matched they are reflected in the same accounting period.

Mr. Matheson. You have been asked about the degree of interpretation that could be applied to 133, and I have heard your answers on that. And I—the question I would follow up with is—and this follows up on Mr. Kanjorski’s concern of what is going on with other companies in this country as well—is 133 adequate?

Even though, you know, it can be interpreted in a clear way, is it adequate in its form for this emerging use of, and expanding use, of derivatives in financial transactions?

Does it merit review to see if it ought to be revisited to provide, not necessarily even greater clarity, but should it be revised to better reflect capital markets in 2005?

Mr. Nicolaisen. It is certainly one of the statements amongst others that should be reviewed periodically to make sure that they are meeting the expectations and the objectives that were originally intended for them.

I want to be careful, though, and say that the standard, as it exists today, is being enforced.

We do expect registrants to follow those rules and to be compliant in preparing their statements, which they purport to be GAAP financial statements.

Mr. Matheson. Okay. Thanks, Mr. Chairman.

I yield back.

Chairman Baker. I thank the gentleman.

Mr. Davis?

Mr. Davis of Kentucky. Thank you, Mr. Chairman.

In Kentucky, we are working closely with Fannie Mae to expand home ownership opportunities for first-time owners, planning workshops, reaching out into the community.

And in that vein, it is especially important that these people who are often entering the financial market for the first time in their lives have trust and confidence in our institutions. I think this is especially critical with government-sponsored enterprises, where good faith is quite important.

With that, as the committee considers GSE, legislative reform proposals will be on the table in the coming months led by the chairman, are there any provisions that you would specifically recommend that we include to avoid these types of what might be an understatement or misstatements in the future by GSEs?

And in effect, what would you do to simplify and mistake-proof the process?

Mr. Nicolaisen. Well, you have a tough undertaking and a very important one.

I have not given the type of consideration to that issue to be in a position to advise you as to what direction you should head.

I do believe that the application of GAAP financial accounting is important. And I also believe that companies who register their securities with the SEC follow GAAP—that that is a hallmark of importance.

Mr. Davis of Kentucky. I will take that one step further.

In my other life as a consultant, I liked to ask folks their biggest area of pain to get below the symptoms down to the root cause.
You, in effect, do that as chief accounting officer for the SEC. What would you say regarding GSEs is the biggest, and specifically Fannie Mae, is the biggest area of pain you are experiencing or identify other than having to testify before a subcommittee here?

Mr. NICOLAISEN. I actually have limited my involvement to only Fannie Mae. So I am not in a position to describe the other GSEs or what is in common with them.

Mr. DAVIS OF KENTUCKY. I yield my time back.

Chairman BAKER. I thank the gentleman.

Mr. Meeks?

Mr. MEEKS. Thank you, Mr. Chairman.

I just have a few questions. There are just a couple of things that I guess maybe I am not grasping; I don’t understand.

And I think that reading some of your testimony and listening to some of the answers to questions, it seems as if you said that the interpretations of FASB, et cetera, is basically clear cut, that there is not a lot of room for misinterpretation.

So my first question would be—this goes back to 2001. And this issue did not come up, or OFHEO apparently in looking at the books from 2001, and 2002, 2000, didn’t see anything, didn’t say anything, didn’t say anything that there was a violation.

So I was wondering, did they previously interpret the rules differently? Or what should they have been looking for so that if, in fact, there was an error, that they would have discovered it earlier?

Mr. NICOLAISEN. I am not familiar with the process that they apply then or now.

The two issues that they did raise, that Fannie Mae chose to ask me to address, were issues that in my view and the consideration of my staff were pretty clearly not in compliance with GAAP.

Mr. MEEKS. Again, and I—then maybe—and this is probably my last question—because here is my confusion also.

We have independent auditors that are looking at a similar situation, in this case KPMG, and based upon those audits they obviously must have felt something was different or they interpreted—because they basically believed that Fannie Mae was implementing FASB 91 and 133 correctly.

But yet, from your testimony, you are saying that there is no room or there was no room—and I don’t understand it.

Has anyone had conversations with KPMG to find out how did they do their audit and any question with regard to them, because they signed off on the audits and said it was being implemented properly?

Mr. NICOLAISEN. Right.

On the knowledge, again, that we do have an ongoing investigation, it is fair I think to conclude that in that ongoing investigation that we look first to the preparer of the financial statements, in this case Fannie Mae, what was their process, what did they do, what happened, what went wrong. Those are all things that I am not prepared to testify to today. That is an ongoing investigation.

Secondarily, and perhaps related to it, on a parallel track, where was the auditor, what was the role, what type of audit was being conducted?
I think you should assume that we will have a thorough investigation, that we will continue our efforts, and that we will be prepared to comment on those at an appropriate time.

But at the moment, I can't tell you what went wrong in 2001.

Mr. MEEKS. Well, I just asked the question because it seems to me, even with the prior major accounting scandals that we have had, we saw that it was the accounting firms who were checking off on them. We then showed that there had to be some kind of collaboration between the two.

I don't know in this scenario because, generally, if you sit on the board of directors of any organization, you want to have an independent auditor that comes in to review the books. And you may ask them for their questions and their interpretations. And often times you will accept that and say that, “Okay, we are moving”—if you are sitting on the board. That is what you are utilizing to use prudent judgment; you accept what their standards are; you move forward in that direction.

And so, I am just curious to find out because there is a lot of—I think Mr. Scott indicated, you know, what a lot of us—what is on the minds of a lot of American people, and clearly based upon some of the questions that was asked, there is a lot of individuals’ reputations on the line, at stake here, and I think that just before—I would just like to understand the essence of it.

And I guess we can't get at it here, as my colleague Wasserman Schultz said, there is—understand, an ongoing investigation. But you are here, and so therefore those questions need to be asked so that we can make a judgment in totality as to everything that is going on as opposed to looking at half a picture. You know, it is like giving a case to a jury before the other side has a chance to put on his or her case.

Mr. NICOLAISEN. Those are good questions. They are appropriate questions. And I can assure you they are questions that we have as well and that our enforcement division will be looking at the areas of which you have expressed concern.

Chairman BAKER. The gentleman's time has expired.

Mr. Israel?

Mr. ISRAEL. Thank you, Mr. Chairman.

Virtually every question that I have of Mr. Nicolaiesen, Mr. Nicolaiesen can't answer. So I just want to share something with him briefly.

And I am going to ask unanimous consent to insert this in the record.

It is a letter to the editor that appeared in Barron's on December 13th. And the letter—I will just read one paragraph very quickly—“As I read the press, Fannie Mae thought that it had applied 133 quickly”. So did Fannie Mae’s auditor, KPMG. So did Ernst and Young, Fannie Mae’s consulting accountant.

“But Fannie Mae’s regulator disagrees. Its consultant, Deloitte & Touche agrees with the regulator and disagrees with Fannie Mae and KPMG and E&Y. Now the mess has offloaded for arbitration to the SEC’s chief accountant, who says that it may take months to make a decision because of the complexity of 133. This is no way to run a railroad.”
The author of that letter to the editor is Walter Schuetze, the former chief accountant of the SEC.

My question to you, Mr. Nicolaisen, is: Is your predecessor right or wrong?

Mr. NICOLAISEN. My predecessor has a right to his opinion. He expresses it often. I certainly appreciate it when he does.

We don't always agree on everything, but he certainly has the right to express his opinion.

Mr. ISRAEL. You are not necessarily agreeing or disagreeing?

Mr. NICOLAISEN. I am not agreeing or disagreeing with what he has expressed there.

I think what I would read, knowing Walter Schuetze very well, I think he expressed a degree of frustration that is probably not uncommon.

Mr. ISRAEL. Well, this letter and your statement reflects that there is a diversity of opinion, and certainly a lot of complexity to this.

And I know that this subcommittee has always been very bipartisan. And I know that as we delve into this, we will have hearings that reflect that diversity and even includes the opinions of the GSEs on this matter.

Mr. Chairman, I would ask unanimous consent to include this in the record, and I yield back.

Chairman BAKER. Without objection. I thank the gentleman for yielding back.

Mr. Nicolaisen, just in a wrap up, it would seem to me if I were in my vehicle headed home this afternoon, not caring what the speed limit is, maybe not even knowing what the speed limit is, I pick up my cell phone and call a Virginia state policeman and say, "I am on 395. I don't know how fast I am driving. Would you put a guy out there with a radar gun please?"

He pulls you over and says, “Sir, I regret to inform you you have been speeding. And I noticed your vehicle is smoking a little excessively. I am going to look under the hood. I see your environmental control mechanisms are not properly engaged. I am going to have to write you several citations for this conduct. And it looks like the stuff was intentionally organized this way so you could either drive faster or get better fuel mileage.”

Now, standing there before the policeman after I made the cell phone call, would my first line of defense be to say, “Look, there goes one driving faster than me”? That probably wouldn't work. Could I say, “Well, there is something wrong with this car. Maybe I should have known it, but I have asked for your expert opinion”?

There is something wrong with this vehicle. And now I am responsible for fixing the vehicle from compliance with the law. And in the meantime, since I called you up, you decide to open up my trunk and see what is there, too. Could be a bad day for you.

My point is that despite the protestations to the contrary, it does not appear that this was a casual exercise on the enterprises' part. They came to your good offices, asked for your professional opinion, and accordingly you gave it to them.

One may not like the opinion, but it is professional, arm’s length, and done in the appropriate fashion, and I commend you for your work.
And I know going forward the committee will have additional hearings and we await the results of your further inquiry and hope you will not find it necessary for the committee to ask, but hope you will inform us as you deem appropriate.

I thank you for your time here and your participation was most helpful.

Our meeting stands adjourned.

Mr. NICOLAISEN. Thank you very much.

[Whereupon, at 11:53 a.m., the subcommittee was adjourned.]
APPENDIX

February 9, 2005
Exchange
Subcommittee on Capital Markets
Richard H. Baker, Chairman

Sixth District, Louisiana
FOR IMMEDIATE RELEASE: February 9, 2005
CONTACT: Michael DiResto, 225-929-7711

Opening Statement
The Honorable Richard H. Baker, Capital Markets Subcommittee Chairman
Capital Markets Subcommittee Hearing
February 9, 2005
Accounting Irregularities at Fannie Mae

The subcommittee on capital markets convenes today for the first time in the 109th Congress. I wish to extend welcome to the new members of the majority. I leave the pleasure of making introductions to the new members of the minority to the gentleman from PA, Mr. Kanjorski.

The subcommittee also convenes today for another important purpose. Although not a pleasant task, it is an essential one. What now seems a very long time ago, the Office of Federal Housing Enterprise Oversight, known as OFHEO, engaged an audit firm to conduct what is known as a forensic accounting audit of Fannie Mae. The audit, which is not yet complete, resulted in the production of an interim report which was reviewed by officials of OFHEO and found to be of sufficient concern to result in a report to this committee of those concerns. The principle concerns centered on the manner by which the enterprise reported its financial condition and the risk exposure of its derivative portfolio. When the committee last met, the Director of OFHEO, Mr. Armando Falcon, was verbally assaulted by members of the committee, on both sides, for his irresponsible conduct, or perhaps even worse, pursuit of some undisclosed political or business agenda. It was the view of some that on procedural appeal to the SEC these accusations would be found to have no merit and be swept aside.

Since the time of that hearing, the criticism of the agency, and the attacks on a congressionally created federal regulator, the agency and Mr. Falcon have been more than just vindicated. The unfortunate finding of the SEC is that the accounting practices of Fannie Mae were not just an exercise of bad judgment, or a one-time aberrant act, but a consistent misapplication, at best, or at the worst, an intentional act of accounting misrepresentation.

We will receive a report from the Chief Accountant of SEC today, whom I publicly commend for his professional ability to first examine and then reach a very difficult decision. The review of the facts in this matter is not without great consequence. Fannie Mae was and remains a political institution of great persuasion. They have, for many years, been able to bully their way through myriad regulatory processes and political engagements unscathed. This time the outcome was different because of the professionalism of OFHEO and the SEC. This time there cannot be more excuses. The facts are what they are.

Officials at Fannie Mae have stepped down in the wake of the disclosures. The board has promised to change the culture of mismanagement at the institution. And there is more to come. I remind the members that the
report that initiated this controversy was only an interim report. The work of the auditor is not yet complete, and neither is the work of the SEC or the Justice Dept. We will all await the results of these examinations for a full and complete assessment. In the course of questioning the SEC official today, members should remember that the answers to many questions may not yet be appropriate to disclose, because of the pending inquiry. Legal counsel will advise the committee as to the appropriateness of responses of witnesses.

I should also note, that in press reports as of this morning, benefits, bonuses and more have been initiated for the executives who recently left the company before a finding of fact as to responsibility of the disclosed deficiencies. The regulator does not have the authority to unilaterally act on behalf of taxpayers or anyone else. Litigation will be required after the fact to reclaim, if possible, any ill-gotten gains.

It is unfortunate that such significant adverse events were necessary to bring us to this day, but perhaps finally, the committee will produce legislation responsive to what is now a fact, and that is that Fannie Mae was not and is not the institution that we had all hoped. They were subject to the same pernicious forces that affected others in the pursuit of profit. Financial manipulation, perhaps even for the personal gain of executives, undermined the responsibility of their important charter mandates. It is now our task to return them to their principle task, to pave the way to home ownership for all Americans, but with emphasis on those who have never had the opportunity to own their own home. It is also necessary to assure that their risk taking does not put at risk hardworking taxpayers of this country. The enterprises can accomplish both; they just need vigilant oversight to insure their success. It is my intention to see this happen during this session of Congress.

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STATEMENT OF THE HONORABLE WM. LACY CLAY

Before the
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
“Accounting for Deferred Purchase Price Adjustments and for Derivatives and Hedging
Activities”
February 9, 2004

Good morning Chairman Baker, Ranking Member Kanjorski, and Members of the Committee. Welcome Mr. Nicolaisen.

Mr. Chairman, thank you for this hearing. We need to address these issues cautiously, but with due haste. The primary concern has to be the stability of the markets. We must do nothing to undermine the stability of the markets. This market has been the backbone of the economy and we must keep it strong.

In a past hearing, I called for due process in the deliberations regarding Fannie Mae and its treatment of derivatives and hedge funds. I asked that the Securities and Exchange Commission (SEC) be allowed to act in its role as the final arbiter as whether Fannie Mae’s actions were within generally accepted accounting principles (GAAP). This has been occurring, however, the process is not yet complete as both the SEC and the FBI have unfinished investigations of the accounting practices of Fannie Mae.

We need and will have a strong regulator for the GSEs, however, that regulator has not been designated as of yet. I am still not sold on the idea of granting receivership powers to a regulator. I do not see the need for that action at this time. We will better be able to determine the exact needs of reform when the investigations are complete and have been evaluated. Those decisions on oversight will be made after later hearings and negotiations.

Thank you for yielding Mr. Chairman. I ask unanimous consent to submit my statement to the record.
Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Hearing entitled, “Accounting Irregularities at Fannie Mae and the Impact on Investors”

Thank you, Mr. Chairman, for calling this hearing and for your continued leadership on this important issue.

On September 17, 2004 the Office of Federal Housing Enterprise Oversight (OFEHO) released a report of its findings from their special examination of Fannie Mae. The report determined that Fannie Mae applied accounting methods and practices that did not comply with certain Generally Accepted Accounting Principles (GAAP) or GAAP rules, did not have proper corporate governance controls in place, and utilized an improper “cookie jar” reserve system while deferring expenses reportedly to meet compensation targets.

On October 6, 2004 our subcommittee heard testimony from OFEHO Director Armando Falcon, then Fannie Mae President/CEO Franklin Raines, then Fannie Mae CFO Tim Howard, and Fannie Mae Presiding Board Member Ann Korologos addressing the OFEHO report’s findings.

At that time, I made abundantly clear my concerns regarding Fannie Mae’s reported actions in my opening statement and would like to reiterate again today that if the information we received is accurate, it appears that management “coocked the books” to enrich themselves by unjustified bonuses at the expense of shareholders and borrowers. For such actions to take place at a company endowed with the public trust in unconscionable.

A little over two months later on December 15, 2004, Donald Nicolaisen Chief Accountant for the Securities and Exchange Commission (SEC) stated that from 2001 to mid-2004 Fannie Mae’s accounting practices did not comply in material respects with the accounting requirements of FAS 91 and FAS 133 of GAAP.
I look forward to learning more from Donald Nicolaisen, this morning, on the Office of the Chief Accountant’s (OFA) evaluation of the OFEHO report and the steps they are taking to work with Fannie Mae to restate its financial statements eliminate the use of hedge accounting and to reevaluate its accounting under FAS 91. Fannie Mae’s investors and the American public need to know its true financial position and be assured that the future information they receive from Fannie Mae will accurately reflect GAAP standards.

I hope today’s hearing is the first step toward a full discussion by this Committee on the continued need for stronger supervision through a new regulator for these Government Sponsored Enterprises (GSEs) that will result in legislation being sent to the President’s desk. The housing GSEs were created to fulfill a public mission and support our housing market. Fannie Mae alone has almost $1 trillion in debt tied to taxpayers and we can no longer ignore the serious threats to their safety and soundness that have been uncovered but were not prevented by a strong regulator.

Thank you again, Mr. Chairman, for scheduling this hearing and I look forward to an informative session.

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OPENING REMARKS OF THE HONORABLE RUBEN HINOJOSA
HOUSE FINANCIAL SERVICES COMMITTEE
SUBCOMMITTEE ON CAPITAL MARKETS
“ACCOUNTING IRREGULARITIES AT FANNIE MAE AND THE IMPACT ON
INVESTORS”
FEBRUARY 9, 2005

Chairman Baker and Ranking Member Kanjorski,

I want to express my sincerest appreciation to you and Ranking Member Kanjorski for
holding this important hearing today. I also want to welcome our witness today, Mr.
Donald T. Nicolaelsen, the Securities and Exchange Commission’s Chief Accountant. I
look forward to his testimony.

Over the past two years, we have been witness to several developments in the
Government Sponsored Enterprises that have been less than pleasant. I am not going to
go into them in great detail except to say that they have resulted in the need for Fannie
Mae and for Freddie Mac to restate their earnings and take other corrective actions.

In December, the Securities and Exchange Commission, or rather Mr. Nicolaelsen, its
chief accountant, determined that Fannie Mae’s accounting was not consistent with
Generally Accepted Accounting Practices. This determination allowed OFHEO to
formally classify Fannie Mae as “significantly undercapitalized” and to require Fannie
Mae to take prompt corrective actions to recapitalize.

Although the accounting restatement amounts to approximately 9 billion dollars, Fannie
Mae has taken certain actions to recapitalize and to increase its capitalization with further
actions likely in the near future to meet OFHEO’s requirements, with negotiations
ongoing.

Mr. Chairman, this hearing will play an important role in determining the type of
legislation, if any, Congress will introduce and consider this Congress to reform the
Government Sponsored Enterprises system.

Senator Chuck Hagel has already introduced legislation that would consolidate oversight
of Fannie Mae, Freddie Mac and the 12 Federal Home Loan Banks under a single and
new regulator with the power to set minimum capital requirements and to put Fannie Mae
and Freddie Mac into receivership. I have also noticed that the legislation would greatly
expand the regulator’s ability to limit benefits and bonuses within severance packages
paid to GSE executives who leave the entities. That component of Senator Hagel’s bill is
very important to me and to many of my colleagues in Congress!

It will be interesting to see if legislation will be introduced in the House to reform the
Government Sponsored Enterprises and, if so, what it will contain, how the Committee
will proceed with consideration and what ultimately will be the outcome of any and all
actions taken by Congress.
It seems to me that whatever actions Congress takes, we need to ensure that Fannie Mae and Freddie Mac continue to meet their primary mission of providing affordable housing.

Mr. Chairman, we need to also ensure that whatever actions we take do not harm the housing industry, which has been the foundation for the nation’s economy since the market declined in the year 2000.

With that Mr. Chairman, I yield back the remainder of my time.
OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES
HEARING ON ACCOUNTING IRREGULARITIES AT
FANNIE MAE AND THE EFFECT ON INVESTORS
WEDNESDAY, FEBRUARY 9, 2005

Mr. Chairman, before we begin today’s session, I must note that this hearing is the first meeting of our panel in the 109th Congress. Over the last decade, you and I have forged a close and productive relationship as the Chair and Ranking Member of the Capital Markets Subcommittee, and I look forward to working with you once again in this Congress.

Four months ago, we convened our last hearing of the 108th Congress to discuss the special examination of Fannie Mae by the Office of Federal Housing Enterprise Oversight. It therefore seems fitting that we will begin our hearings this year with an examination of the recent decisions by the Chief Accountant of the Securities and Exchange Commission related to Fannie Mae’s practices for the accounting of derivatives contracts and the amortization of discounts, premiums and fees involved in the purchase of home mortgages.

Prior to the Chief Accountant’s decisions, Fannie Mae’s board had already agreed to adopt a number of reforms based on an initial report by the Office of Federal Housing Enterprise Oversight. Afterwards, Fannie Mae put in place additional changes, including removing its leadership team and hiring a new auditor. The company continues to make modifications.

At our last hearing into these matters, I sought to determine whether the accounting problems at Fannie Mae constituted some form of systemic risk for our economy. I was assured by all of those who participated at the hearing that these problems did not pose a systemic risk.

Similarly, my primary focus at today’s hearing will be to determine whether other public entities that use derivatives could also have difficulty in accounting for these complex financial instruments. Although derivatives serve a useful purpose in spreading risk, I am concerned that if Fannie Mae encountered difficulties in accounting for these contracts, then other financial services providers may also have comparable problems that could cause difficulties for our economy. I hope that the Chief Accountant, who is the sole witness appearing before us today, will offer me his candid assessment of these matters.

As we proceed today, I also suspect that some of my colleagues will return to the question of how best to modify the regulation of government-sponsored enterprises. As you know, Mr. Chairman, I am also one of the few remaining Members of this Committee who participated in the entire congressional battle to resolve the savings and loan crisis. I am therefore acutely aware of the need to protect taxpayers from risk.

It is in the public’s interest that we ensure that Fannie Mae and Freddie Mac continue to operate safely and soundly. We must further ensure that these public-private entities achieve their public responsibilities for advancing homeownership opportunities.

-more-
In fact, as I said at our very first hearing on the oversight of government-sponsored enterprises in March 2000, “we need to have strong, independent regulators that have the resources they need to get the job done.” I can assure everyone that I continue to support strong, world-class and independent regulation for Fannie Mae and Freddie Mac.

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

Like many of my colleagues, I was greatly disappointed in the last Congress when the Bush Administration rejected our bipartisan efforts to create an independent regulator. Politics, in my view, should play no role in financial regulation.

It is therefore my hope that when we revisit this issue in the 109th Congress we will continue to remain resolute and unwavering in our bipartisan efforts to create a strong, independent and world-class regulator with appropriately robust powers and sufficiently adequate resources. As we proceed, it is also my hope that we will develop a balanced, deliberate and bipartisan plan of action for addressing these matters.

In closing, Mr. Chairman, I commend you for your sustained leadership in these matters. Government-sponsored enterprises with their public responsibilities and private capital have a special obligation to operate fairly, safely and soundly. Your work, without question, has highlighted these issues for all Americans.
Opening Statement
Congressman Ed Royce (CA-40)
9 February 2005
"Accounting Irregularities at Fannie Mae and the Impact on Investors"

Thank you, Mr. Chairman, and thank you for holding this hearing on "Accounting Irregularities at Fannie Mae and the Impact on Investors." I would like to commend the chairman for his continued leadership on GSE oversight.

As I said last October during our first hearing on Fannie Mae's accounting issues, I expect Fannie Mae to be a role model to other businesses as it fulfills its federally mandated mission. Fannie Mae should be conducting operations in a safe and sound way. In my view, this should include strong internal controls in the risk management department coupled with consistent and conservative applications of accounting rules.

The SEC ruling affirming OFHEO's finding that Fannie Mae was not GAAP compliant is very troubling. Fannie owns slightly less than one trillion dollars in financial assets. Most of these assets are in the form of mortgages, which means that Fannie Mae operates in a negatively convex environment. In other words, Fannie Mae can lose money if interest rates go up or if interest rates go down. Fannie Mae and other GSEs attempt to mitigate this risk by issuing callable debt and buying derivatives -- and it is the accounting of these derivatives that has been found to be improper.

Regulators and investors have a right to know -- and a need to know -- that Fannie Mae is managing interest rate risk appropriately. Fannie's misapplication of FAS 133 prevents outsiders from getting a clean view of the true risk at the company. I am pleased we are having this hearing to learn more about how this happened -- and to learn how we can prevent such occurrences in the future.

In addition to our important oversight role in this Committee, I hope that we will move swiftly to create a new regulatory structure for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. There is a very simple solution -- Congress must create a new regulator with powers at least equal to those of other financial regulators such as the OCC or the Federal Reserve. I introduced legislation last session, which would have enacted just such a reform. I hope this Committee will heed the advice of Chairman Greenspan and the entire Board of Governors, the Federal Reserve staff, the U.S. Treasury Department, the OECD, the IMF, and countless other who have urged Congress to act.

Mr. Chairman, thank you for your leadership. I yield back.
TESTIMONY OF

DONALD T. NICOLAISEN, CHIEF ACCOUNTANT
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING

ACCOUNTING FOR DEFERRED PURCHASE PRICE ADJUSTMENTS AND FOR DERIVATIVES AND HEDGING ACTIVITIES

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

FEBRUARY 9, 2005

Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee:

Thank you for the opportunity to testify today concerning accounting issues related to deferred purchase price adjustments and to derivatives and hedging activities. My name is Donald T. Nicolaisen and I am the Chief Accountant for the Securities and Exchange Commission (“SEC” or “Commission”). As the Chief Accountant, I am the principal adviser to the Commission on accounting and auditing matters. The views I express today, however, are my personal views and my testimony has not been reviewed or approved by the Commission.

As the Subcommittee has requested, my testimony addresses my decision in December 2004 that certain accounting practices of the Federal National Mortgage Association (“Fannie Mac”) did not comply in material respects with specific provisions within generally accepted accounting principles (“GAAP”).
Fannie Mae has disclosed that the Commission is investigating certain issues associated with Fannie Mae’s accounting and disclosure practices. I and others at the Commission appreciate the Subcommittee’s recognition of the non-public nature of the Commission’s active investigation. In light of the Commission’s ongoing investigation, I ask that the Subcommittee understand my reluctance to address at this time specific issues related to Fannie Mae’s compliance with the federal securities laws. You may be assured that the Commission staff thoroughly is investigating any evidence of financial reporting improprieties. My statements today will be confined to the public record\(^1\) and, because the Commission has not expressed any opinion or views on these matters, my statements should not be attributed to the Commission.

**Fannie Mae’s Filing Status**

Fannie Mae is the largest non-bank financial services company in the world and the nation’s largest source of financing for home mortgages.\(^2\) Fannie Mae’s common stock is listed on the New York Stock Exchange and, after discussions with the Commission staff, on March 31, 2003, Fannie Mae voluntarily registered its common stock with the Commission under section 12(g) of the Securities Exchange Act of 1934 (“Exchange Act”).\(^3\)

\(^1\) The information contained in this statement concerning Fannie Mae’s accounting practices is based upon publicly available information.


\(^3\) See Letter from Ann M. Kappler, Fannie Mae, and response from Martin P. Dunn, Deputy Director, Division of Corporation Finance, U.S. Securities and Exchange Commission (publicly available July 12, 2002), for a discussion of the sections of the Exchange Act that apply to Fannie Mae and the application of other provisions of the securities laws to Fannie Mae.
Commission Staff Review

As the Subcommittee is aware, the Office of Federal Housing Enterprise (OFHEO), Fannie Mae's safety and soundness regulator, is in the process of reviewing several of Fannie Mae’s accounting practices, focusing on the implications of those practices on the adequacy of Fannie Mae’s regulatory capital, the quality of its management, and the overall safety and soundness of the enterprise. OFHEO issued a report of its preliminary findings on September 17, 2004, and last October officials from both OFHEO and Fannie Mae testified before this Subcommittee on issues discussed in that report.


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4 Office of Compliance, OFHEO, “Report of Findings to Date: Special Examination of Fannie Mae” (September 17, 2004).
5 The Financial Accounting Standards Board (“FASB”) issued Statement No. 91 in December 1986. This statement establishes the accounting for nonrefundable fees and costs associated with lending, committing to lend, or purchasing a loan or group of loans. The statement applies to all types of loans (including debt securities) and to all types of lenders.
6 The FASB issued Statement No. 133 in June 1998, and has amended it on several occasions. The statement establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as a hedge against (a) changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (b) the exposure to variable cash flows of a forecasted transaction, or (c) certain foreign currency exposures. The accounting for changes in the fair value of a derivative depends on the intended use of the derivative and the resulting designation.
Although the SEC accounting staff may choose not to provide such guidance while there are pending investigations by the Commission and other agencies, Fannie Mae requested our guidance because, in its view, these accounting issues received extraordinary public attention and resulted in the mortgage and capital markets experiencing uncertainty.

To facilitate our review, Fannie Mae and OFHEO voluntarily provided the Commission’s accounting staff with information and with explanations of their views of the application of Statement Nos. 91 and 133. Fannie Mae did not ask the accounting staff to express any views regarding whether the information provided by Fannie Mae or OFHEO was accurate or complete or to develop additional facts and, in providing the requested accounting guidance, we did not do so. Accordingly, the accounting staff’s guidance was based on the information voluntarily provided by Fannie Mae and OFHEO. In addition, the SEC accounting staff did not consider the appropriateness of Fannie Mae’s business decisions to use financial or derivative instruments or to hedge its risks, but limited its consideration to whether the accounting used to record those transactions complied with Statement Nos. 91 and 133.

In light of the public attention and uncertainties cited by Fannie Mae, on December 15, 2004, the Commission’s accounting staff issued a press statement containing our views. In that press release, the SEC accounting staff indicated that, based upon our review of the information provided by Fannie Mae and OFHEO, during

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7 As noted elsewhere in this testimony, the Commission’s investigation into these matters is continuing.

the period from 2001 to mid-2004 Fannie Mae’s accounting practices did not comply in material respects with the accounting requirements in Statement Nos. 91 and 133.

**Statement No. 91**

Regarding Statement No. 91, during the period under the SEC staff’s review, Fannie Mae failed to record timely adjustments to the recorded amount of its loans based on changes in the estimated speed with which those loans would be prepaid. Among other requirements, Statement No. 91 provides that when applying the method used by Fannie Mae an entity should use its best estimate of expected prepayment rates in calculating the carrying amount of its loans.\(^9\) Fannie Mae already had concluded that its methodology for performing these calculations for interim balance sheet dates in the periods 2001 through 2002 was not consistent with Statement No. 91, and had stated that it has changed its accounting policies to, among other things, calculate the amounts based on quarter-end positions rather than projected year-end positions.\(^10\)

It also appears that, contrary to Statement No. 91, Fannie Mae recognized adjustments to the carrying amount of its loans only if they exceeded a self-defined materiality limit, referred to as a “precision threshold.” Fannie Mae has represented that

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\(^9\) Statement No. 91, ¶ 19.

\(^10\) See Federal National Mortgage Association, Form NT 10-Q, dated November 15, 2004, which states, in part: “... Fannie Mae recently determined that its methodology for performing calculations to measure the catch-up adjustment required by [Statement No.] 91 for balance sheet dates in the periods 2001 through 2002 was not consistent with GAAP. During those periods, Fannie Mae should have been calculating its catch-up adjustment with reference to its quarter-end position rather than its projected year-end position and recording amounts solely on the basis of those quarterly calculations... The company will make adjustments to prior periods if and to the extent material...”
it has initiated additional changes to eliminate the "precision threshold" and is working with OFHEO to further amend its accounting practices under Statement No. 91.\textsuperscript{11}

\textbf{Statement No. 133}

Regarding Statement No. 133, one of the principles underlying the statement is that derivative instruments are to be recorded at their fair value, with changes in fair value being reported in earnings. If certain detailed hedge criteria and procedures are satisfied, however, Statement No. 133 affords special accounting for the hedge relationship. If the detailed hedging requirements are not satisfied, then special hedge accounting is not available.\textsuperscript{12}

Fannie Mae internally developed its own methodology to assess whether hedge accounting was appropriate. Fannie Mae’s methodology, however, did not qualify for hedge accounting because of deficiencies in its application of Statement No. 133. Among other things, Fannie Mae’s methodology of assessing, measuring, and documenting hedge ineffectiveness was not supported by Statement No. 133.\textsuperscript{13}

\textbf{SEC Accounting Staff’s Determination}

As a result of the staff’s review, on December 15, 2004, the Commission’s accounting staff advised Fannie Mae that, to be consistent with Statement Nos. 91 and 133 and to provide investors with appropriate information, Fannie Mae should:

\textsuperscript{11} See, e.g., Testimony of Franklin D. Raines, Chairman and CEO, Fannie Mae, Before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (October 6, 2004), which states, in part: “We have agreed with OFHEO to discontinue the use of a range in implementing [Statement No.] 91 beginning in the fourth quarter of 2004.” The “range” refers to the "precision threshold.”

\textsuperscript{12} See, Statement No. 133, ¶ 18.

\textsuperscript{13} See, e.g., Statement No. 133, ¶¶ 20-41.
Restate its financial statements filed with the Commission to eliminate the use of hedge accounting for periods beginning on January 1, 2001 through June 30, 2004.

Evaluate the accounting under Statement No. 91 and restate its financial statements filed with the Commission if the amounts required for correction are material.

Re-evaluate the information prepared under GAAP and non-GAAP information that Fannie Mae previously provided to investors, particularly in view of the decision that hedge accounting is not appropriate.

In a report on Form 8-K filed with the Commission on December 17, 2004, Fannie Mae stated, “As a result of the [Commission accounting staff’s] findings, Fannie Mae will restate its financial results for the periods [from 2001 to mid-2004] to comply fully with [that] determination.” As of the date of this testimony, Fannie Mae has not yet filed revised financial statements with the Commission.

It is my understanding that investigations into these and related matters by Fannie Mae’s special review committee, the Commission, and others are continuing. As I noted previously, in order not to compromise the Commission’s ongoing investigation, my statement today is based only on the information voluntarily provided to the SEC accounting staff by Fannie Mae and OFHEO when Fannie Mae requested the accounting guidance provided in our December 15, 2004 press release.

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Conclusion

Thank you for the opportunity to appear today. I am pleased to try to respond to any questions the Members of the Subcommittee may have.
To the Editor:
FASB Statement 133 doesn't work. Those who prepare financial statements cannot figure out 133's labyrinth of detailed rules. Those who audit financial statements are flummoxed by 133. Investors are mystified by the results of applying 133.

As I read the press, Fannie Mae thought that it had applied 133 correctly. So did Fannie Mae's auditor, KPMG. So did Ernst & Young, Fannie Mae's consulting accountant. But, Fannie Mae's regulator disagrees; its consultant, Deloitte & Touche, agrees with the regulator and disagrees with Fannie Mae and KPMG and E&Y. Now, the mess has been offloaded for arbitration to the SEC's chief accountant, who says that it may take months to make a decision because of the complexity of 133. This is no way to run a railroad.

To fix this problem FASB should require that both sides of the balance sheet -- including all derivatives -- of financial institutions such as Fannie Mae be marked to market through earnings. Simple and understandable. That approach will make earnings and capital volatile, which is what the world is all about. FASB 133's approach of leveling the hills and valleys of volatility obviously does not work. No one, least of all investors understands the result. The FASB's credibility is at stake. Fix 133.

Walter P. Schuetze
Boerne, Texas

(The writer is a former chief accountant of the SEC. -- Editor)