"Accounting Irregularities at Fannie Mae"

by Chairman Christopher Cox

U.S. Securities & Exchange Commission

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Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee:

Thank you for giving me the opportunity to be here today to testify about the Securities and Exchange Commission's recent enforcement action against the Federal National Mortgage Association ("Fannie Mae"). Under Chairman Shelby's leadership, this Committee has spent a great deal of time and effort examining the issues surrounding Government-Sponsored Enterprises and I appreciate the opportunity to appear before you this morning on behalf of the Commission.

SEC Enforcement Action Against Fannie Mae

On May 23rd, the Commission and the Office of Federal Housing Enterprise Oversight jointly announced settlements with Fannie Mae for accounting fraud. The settlements require the company to pay a penalty of $400 million. This is a meaningful penalty designed to deter future misconduct. Moreover, as a result of the Fair Fund provisions of the Sarbanes-Oxley Act, most of the penalty will likely be used to compensate defrauded investors. Both Director Lockhart and I agree that a penalty of this size represents a meaningful sanction that is necessary to address the egregiousness of Fannie Mae's conduct. Fraudulent financial reporting directly undermines the fairness of our capital markets, and the very purpose of those markets to allocate capital to its best uses.

By interfering with the full and fair disclosure that underpins our markets, fraudulent financial reporting cheats investors of their savings. That is why the extensive financial fraud that you will hear described today required such an emphatic deterrent response.

The Commission's action alleges that Fannie Mae misstated its financial statements from at least 1998 through 2004. In settling these charges, Fannie Mae has agreed to pay $400 million, the lion's share of which will be paid to the Commission, who will in turn return it to defrauded shareholders through our Fair Fund program. Fannie Mae also agreed to be permanently enjoined from future violations of the anti-fraud, reporting, books and records, and internal control provisions of the federal securities laws.

The significance of the corporate failings at Fannie Mae cannot be overstated. The company has said that it estimates the restatement of its financial statements for the years ended December 31, 2003, and 2002,
and for the quarters ended June 30, 2004, and March 31, 2004 will result in at least an $11 billion reduction of previously reported net income. In all likelihood this will be one of the largest restatements in American corporate history.

Fannie Mae's size and status make it a financial giant. Yet despite its prominent position in the financial marketplace the company's internal controls were wholly inadequate in light of the size, complexity, and sophistication of Fannie Mae's business. Its failure in key areas highlights the critical need for senior management to constantly assess internal controls as their business grows. Such an investment is necessary for the good of the business, for the protection of shareholders, and for the health of our capital markets. Fannie Mae is a clear example that neglecting internal controls can be devastating for a company and its investors.

The Commission's complaint lays out in detail the many accounting failures that occurred at Fannie Mae from books and records violations to fraud. The complaint also describes the corporate culture at Fannie Mae that emphasized stable earnings growth and reduced income statement volatility that was the backdrop for the fraud. As a result of this conduct, the company's financial results were smoothed through misapplications of Generally Accepted Accounting Principles, or GAAP.

Two accounting principles are critical to Fannie Mae's business: accounting for nonrefundable fees and costs associated with loans, known as Financial Accounting Standard 91, or FAS 91, and accounting for derivative instruments and hedge activities, known as FAS 133.

In connection with FAS 91, the Commission's allegations contained two key components. First, at the end of 1998, senior management intentionally manipulated earnings in order to obtain the highest available bonus payout. Senior management of the company determined that certain expenses would not be booked even though GAAP required they be recorded. At the same time, senior management engaged in a series of additional inappropriate adjustments to the company's income statement so that the company hit the earnings per share target necessary to trigger maximum management bonuses.

Second, under FAS 91, companies are required to recognize loan fees, premiums and discounts as an adjustment over the life of the applicable loans. For groups of similar loans, a company can use estimates of prepayments to calculate the effective interest rate of the loans and determine the portion of such fees and related items to be recognized in the income statement. If actual prepayments differ from estimates, or estimates change, the net investment in the loans must be adjusted with an offsetting entry to the income statement. From before 2000 through 2004, Fannie Mae improperly used a threshold to determine when certain of these adjustments would be recorded to its income statement. If the amount to be recorded did not exceed the company-calculated threshold, Fannie Mae did not record it. This practice was an improper departure from GAAP and had the effect of reducing earnings volatility.

In connection with FAS 133, without proper basis in the relevant accounting literature, Fannie Mae sought to fit the vast majority of its transactions into a simplified method of applying hedge accounting that assumed no ineffectiveness in the hedge relationship. By assuming no ineffectiveness, Fannie Mae avoided measuring and recording in its income statement the difference between the change in value of its derivatives and
the change in value of the items being hedged by the derivatives.

The transactions in question simply did not qualify for such treatment under FAS 133. One reason Fannie Mae adopted this approach was that it did not have adequate systems or personnel in place to comply with FAS 133's provisions - in particular, with provisions that require periodic assessment of effectiveness and measurement of ineffectiveness. Had Fannie Mae applied such provisions, it would have resulted in income statement volatility that senior management of the company wanted to avoid. Most of Fannie Mae's anticipated restatement of at least an $11 billion reduction of previously reported net income is a result of its improper hedge accounting.

The Commission continues its investigation regarding the individuals and entities whose actions and inactions have led to this result. The public should have full confidence that we will vigorously pursue those individuals who have violated the federal securities laws. Until the investigation is complete, I cannot comment further on the alleged conduct of particular individuals or the specific stage of the investigation.

**Improved Disclosure to Fannie Investors**

Fannie Mae's settlement of accounting fraud charges raises another very significant policy issue, one that has been carefully considered by members of this Committee: whether to require mandatory registration and periodic reporting under the Exchange Act by Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

As you well know, the securities issued by Fannie Mae are "exempt securities" under current laws administered by the SEC. However, there is no question that the word "Government" in "Government-Sponsored Enterprises" leaves many members of the investing public with the mistaken impression that GSE securities are backed by the full faith and credit of the United States Government, when in fact there is no such guarantee.

For this reason, the Commission-going at least as far back as 1992-has consistently advocated the view that, because GSEs sell securities to the public, have public investors, and do not have the "full faith and credit" government backing of government securities, GSE disclosures should comply with the disclosure requirements of the federal securities laws.

In July 2002, Fannie Mae took a step forward by announcing that it would voluntarily register its common stock with the SEC under Section 12(g) of the Exchange Act. The registration of its common stock became effective on March 31, 2003, and Fannie Mae subsequently began filing periodic reports with the SEC. Unfortunately, many of Fannie Mae's periodic disclosures have been late or incomplete. Most notably, Fannie has to date not filed an annual report (10-K) for either 2004 or 2005, and has not filed quarterly reports (10-Q) in any of the preceding seven quarters.

While our recent enforcement action has assuredly focused the attention of Fannie Mae's management on improving its disclosure to investors, there is no question that, in the future, Fannie Mae would be far more likely to maintain consistent compliance with our disclosure regime if the Congress were to terminate its special status of voluntary registration and reporting, and make its registration and reporting mandatory. That, in my view, is a far better way to protect investors.
I know this Committee is considering legislation that would require compliance with the Exchange Act periodic reporting requirements by Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. I commend you for your attention to this issue, and encourage your consideration of this legislation. As I mentioned, the Commission has historically been in strong support of mandatory compliance by the GSEs with these disclosure requirements. We stand ready to support you in these efforts, and will be prepared to enforce mandatory compliance, should you choose to change the requirements for these Government-Sponsored Enterprises.

I also wanted to bring the Committee up to date on a related issue of the New York Stock Exchange's rules, which authorize suspension and delisting when a listed company fails to file its annual report with the SEC in a timely manner. As you know, because of Fannie Mae's failure to file its 2004 and 2005 annual reports on time, the NYSE amended its general delisting rules to provide a unique exemption for Fannie Mae, though it is not specifically phrased in those terms.

Since NYSE put this new rule in place, questions have been raised about whether this exemption is appropriate. As I testified before this Committee on April 25, 2006, the exemption needs to be considered in light of the unusual circumstances not only of Fannie Mae's voluntary transition to Exchange Act financial reporting compliance, but also its massive restatement. I also expressed my view that this exemption must be temporary, only for the purpose of allowing Fannie Mae to come into initial compliance with Exchange Act reporting. To respond to concerns that this exception might become a permanent, rather than temporary, policy, I want to inform the Committee that we have encouraged the NYSE to amend its rule to put an expiration date on this exception, so that Fannie Mae-and its investors-understand that we expect Fannie Mae, like any other listed company, to remain in full compliance with NYSE's listing standards.

In conclusion, the Commission's action against Fannie Mae and its position on the appropriate treatment of Government-Sponsored Enterprises under the Exchange Act's periodic reporting regime are animated by the same principle—that investors are best served by applying the federal securities laws in an even-handed and judicious manner to all companies participating in the public markets.

Thank you again for giving me the opportunity to be here today. I am pleased to try to respond to any questions you may have.