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Testimony by Former Director of the OFHEO Armando Falcon Before the FCIC

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Testimony

of

Armando Falcon

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The failure of Fannie Mae and Freddie Mac will be a case study in business schools for decades. How do you operate a business with the most generous government subsidies possible, which confer very powerful market advantages, and run the business into the ground?

Ultimately, the companies were not unwitting victims of an economic down cycle or flawed products and services of theirs. Their failure was deeply rooted in a culture of arrogance and greed. I should be clear that this was a failure of leadership. There were and are many good people in the ranks of both companies.

I will address the issues raised in your invitation letter by explaining the activities of OFHEO in overseeing Fannie and Freddie, and the challenges we faced.

<u>OFHEO</u>

I remain proud of what the small and dedicated group of people at OFHEO accomplished. We stood up to the full political onslaught of Fannie, Freddie and their allies all over town, and we did our jobs as public servants.

We accomplished much despite the fact that OFHEO was structurally weak and almost designed to fail. OFHEO lacked the same statutory powers of every other safety and soundness regulator, in key areas such as enforcement powers, capital requirements, funding mechanism, and receivership authority. At one point, we attempted to stop bonus payouts to departed executives responsible for the accounting misconduct, only to be rebuked by a Federal Judge for exceeding our authority. From the beginning to end of my tenure as Director, I took every opportunity to press for legislation to fill these important gaps in OFHEO's authority.

The lack of flexibility on setting capital requirements was especially troubling. By statute, the enterprises' minimum capital requirement was set at 2.5%, which permitted them to operate at a highly leveraged level with very little margin for error. We never received the regulatory discretion to raise this standard. Our only opportunity to increase capital and reduce leverage was in connection with the supervisory agreements to remediate the accounting violations. I was able to impose a 30% capital surcharge on both enterprises until all safety and soundness issues were addressed to the agency's satisfaction.

In addition, OFHEO was the only safety and soundness regulator that was required to obtain its funding through the appropriations process. This was despite the fact that our funding was provided by assessments on Fannie and Freddie and not derived from taxpayer funds.

The result was that the agency was starved of resources for many years. To illustrate this point, I recall that when I first took office, I received briefings from the exam staff on their work schedule and latest exam findings. When I inquired about some areas that had been omitted, they responded that due to staff limitations, a review of that particular risk area was put off until the following year's exam cycle. I know that some cycling of exam issues is acceptable among regulators, but not to the unhealthy extent that OFHEO was forced into.

In response, I asked the exam staff to conduct a study and tell me how many examiners would be assigned to exam Fannie and Freddie if they were regulated by another federal safety and soundness regulator. Their conclusion was that the other regulators, with funding outside the appropriations process, would maintain a team of at least 30 or so examiners per enterprise. By contrast, at the time, OFHEO had a total of exam staff of less than 20, perhaps less than 15, to cover <u>both</u> enterprises.

Despite that kind of data to support our funding requests, we had a very difficult time getting meaningful budget increases. Before OFHEO's budget request even went to the Congress for consideration, the agency's request first went through the Office of Management and Budget for review and approval. We received large budget cuts at OMB, until 2003, when our requests began to receive more favorable consideration.

In 2000, Representative Maurice Hinchey bravely offered an amendment on the floor of the House to increase OFHEO's budget. The amendment was angrily opposed by the Chairman of the VA, HUD Appropriations Subcommittee, who lashed out at me personally for encouraging the amendment. The amendment was defeated and OFHEO's plan to hire additional staff was put hold for another year.

A few years later, when OFHEO needed additional resources to conduct a special examination of Fannie Mae's accounting practices, we encountered more difficulty and delay. Fannie's lobbyists were on the Hill spreading misinformation about my motives and asserting that the special exam was unnecessary. We eventually received the funding, and finally had the resources to dig deeply into Fannie Mae's accounting. It wasn't long before we realized that Fannie Mae's problems were even worse than Freddie Mac's.

<u>Political Interference with the Regulatory Process</u>

There are many examples of Fannie and Freddie's efforts to obstruct the regulatory process. I should say at the outset that I have no problem with a regulated entity using established regulatory and political processes to voice their concerns about government regulation. However, the Fannie and Freddie political machine resisted any meaningful regulation using highly improper tactics. OFHEO was constantly subjected to malicious political attacks and efforts of intimidation. I will describe just a few.

The first involves the circumstances around my forced resignation on February 4, 2003, a year and a half before the expiration of my term. At that time, the agency was preparing to release a new research report that analyzed the systemic risk created by the enterprise's growing portfolios, debt, and role in the mortgage market. We needed to be sure the agency and others in government fully understood the nature of the systemic risk, how to minimize it, and how to deal with it if the enterprises experienced financial problems.

The enterprise did not want the agency conducting such a study and certainly did not want it released to the public. At the time, they were doing everything possible to convince the public and policymakers that their operations did not pose any systemic risk to our financial system.

A few days before the agency was scheduled to release its systemic risk report, the Chairman of Fannie Mae, Frank Raines, called me to protest about the release of the report and its conclusions. He urged me not to release it and when I reaffirmed my plans, he threatened to bring down me and the agency. Our call was over and I soon received another call from a Treasury official who stated that Fannie lobbyists were calling other agencies to urge them to press OFHEO not to release the report. He asked for a copy, which I did provide, and he respected my decision not to delay its release.

A few days later, on February 4, 2003, I was in New York to give a speech on the findings of the report, which was being released that day. In the morning, as I was waiting to give my speech, I received a call from the White House Personnel Office to inform me that the White House was issuing an announcement on the nomination of someone to replace me as Director of OFHEO. I informed the Personnel official that their announcement would seem odd since there was not a vacancy in the position.

I asked the official to withhold the announcement for a day while I considered my options. They declined, and I issued a resignation letter later that day. The next day's news emphasized coverage of the personnel change and gave very scant coverage to the systemic risk report. This was of course exactly the result intended by those who engineered the timing of the announcement of my replacement. The White House eventually withdrew its nominee and I remained in office for two more years.

In 2004, as OFHEO began its special accounting exam of Fannie Mae, the political attacks and obstruction intensified. Fannie was uncooperative with document requests and they engaged their supporters in Congress for assistance.

As described in the OFHEO Special Exam Report, in April of 2004, Fannie Mae executives acted on a plan to have a key Senator initiate an investigation of OFHEO by the HUD Inspector General. The goal was to try to discredit the agency in advance of its report on Fannie's accounting practices. The intrusive nature of the IG review was clearly designed to intimidate OFHEO personnel and distract them from their work. The IG eventually concluded that the agency had done nothing improper, but wrote a very biased report designed to curry favor.

Later, in September of 2004, the Senate Appropriation's VA HUD Subcommittee passed a bill that provided funding for OFHEO in 2005. The bill included specific language stating that $10 million of the agency's 2005 budget could not be spent until I was removed from office. That language was later removed from the final bill.

Also in that same month, OFHEO released its first report on the accounting misconduct at Fannie Mae and we took supervisory actions to correct the problems. I was summoned before the House Financial Services Committee to testify on the findings of the report. It is a vast understatement to say that I was met with a well orchestrated effort to discredit the report and my character. One member of the Committee even accused me of conducting a "political lynching". It was a shameful day in the Committee's history, and another example of the dangerous political power Fannie Mae had amassed.

Greed

While all of this political power satisfied the egos of Fannie and Freddie executives, it ultimately served one primary purpose: the speedy accumulation of personal wealth by any means. Of course, we all support the American dream of wealth accumulation – as long as it is done within the rules.

Fannie began the last decade with an ambitious goal – double earnings in 5 years to $6.46. A large part of the executives' compensation was tied to meeting that goal. In the words of Fannie Mae's Internal Auditor, who was ironically the one person inside the firm charged with keeping the company honest:

> "By now you must have $6.46 branded in your brains. You must be able to say it in your sleep, you must be able to recite it forwards and backwards. You must have a raging fire in the belly that burns away all doubts, you must live, breath

> and dream $6.46. You must be obsessed on $6.46. After all, thanks to Frank, we all have a lot of money riding on it."

And they did. In the case of CEO Franklin Raines, he collected over $90 million in total compensation from 1998 to 2003. Of that amount, $52 million was directly tied to achieving earnings-per-share goals.

However, the earnings goal turned out to be unachievable without breaking rules and hiding risks. Fannie and Freddie executives worked hard to persuade investors that mortgage related assets were a riskless investment, while at the same time covering up the volatility and risks of their own mortgage portfolios and balance sheets. The OFHEO special exam reports go into great detail on how this was done over the years.

One very telling example of how greed drove the accounting violations was a $200 million maneuver in the fourth quarter of 1998. Fannie's prepayment model showed an unexpected expense of $400 million at year end. For reasons that remain unexplained, Fannie Mae, with the acquiescence of KPMG, its external auditor, recognized only $200 million of the expense in 1998 and pushed the remainder into future years. OFHEO found this to be a clear violation of accounting rules.

The effect of this accounting maneuver was that Fannie's executives were able to meet 1998's earnings targets and thus receive 100% of their bonus compensation for that year.

If the full $400 million was properly recognized in 1998, the executives would have received no bonus compensation for that year.

Affordable housing goals

Your letter also asked me about the impact of the affordable housing goals on the enterprises' financial problems. In my opinion, the goals were not the cause of the enterprises demise. The firms would not engage in any activity, goal fulfilling or otherwise, unless there was a profit to be made. Fannie and Freddie invested in subprime and Alt A mortgages in order to increase profits and regain market share. Any impact on meeting affordable housing goals was a byproduct of the activity.

In addition, OFHEO made it very clear to both enterprises that safety and soundness was always a higher priority than the affordable housing goals. They should not take on excessive risk in order to meet any one of the goals.

Downfall

Despite management turnover at both enterprises, cultural problems persisted. The companies could not accept their diminished role in the mortgage market, and the reduction in profitability. So they made a fateful decision to make big investments in subprime and alt A assets. This certainly accelerated their demise when housing bubble burst.

OFHEO might have been able to do more during my tenure to try to prevent the enterprises' eventual failure if we only had more authority, resources, and political support. We might have been able to at least minimize the eventual cost to taxpayers of their failure.

Nevertheless, we did accomplish a great deal against enormous odds. We properly investigated deep flaws in the enterprises accounting and operations. We initiated corrective actions while ensuring that the enterprises were able to continue functioning and serving the mortgage market. Furthermore, we achieved this without taxpayer assistance and in a way that prevented two of the largest financial institutions in the world from creating a systemic disruption in the financial markets. Later events changed the outcome, but OFHEO performed admirably during that time period.

Summary

In summary, the Fannie and Freddie model of publicly-traded and privately-held government chartered companies is inherently flawed. The market and political power that it confers breeds arrogance, greed, excessive risk taking and abuse. If Fannie and Freddie are allowed to continue in any variation of their current form, another commission, at some future date, will again be asking the same questions of what went wrong. That is why the work of this commission is so important, and I appreciate the opportunity to testify.