Testimony Concerning The Application Of Federal Securities Law Disclosure and Reporting Requirements to Fannie Mae, Freddie Mac and the Federal Home Loan Banks

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Before the Committee on Banking, Housing, and Urban Affairs
United States Senate

February 10, 2004

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

Introduction

I am pleased to have this opportunity to testify before you on behalf of the Securities and Exchange Commission regarding the application of disclosure and reporting requirements of the federal securities laws to Fannie Mae, Freddie Mac and the Federal Home Loan Banks. These Government-Sponsored Enterprises (GSEs) issue marketable debt to the public. In addition Fannie Mae and Freddie Mac have publicly held common stock and also issue guaranteed mortgage-backed securities to the public. All of these entities and their securities are exempt from the registration and disclosure provisions of the federal securities laws. None of the debt securities issued by any of these GSEs is backed by the full faith and credit of the United States.

Commission's Historical Views on GSE Disclosure

Since at least 1992, the Commission has expressed the view that, because the GSEs, most prominently Fannie Mae and Freddie Mac, but also including the Federal Home Loan Banks, sell securities to the public and have public investors, and do not have the "full faith and credit" government backing of government securities, their disclosures should comply with the disclosure requirements of the federal securities laws. The Commission participated with the Department of Treasury and the Board of Governors of the Federal Reserve System in a 1992 Joint Report on the Government Securities Market ("1992 Report") that addressed these issues, among other things.[1] Mandatory compliance by the GSEs with these disclosure requirements and the federal securities laws is the objective. While the 1992 Report addressed registration, the manner by which mandatory compliance is achieved – including through voluntary registration with the Commission – may be less significant. Further, the disclosure quality that we seek for the GSEs can only result from becoming subject to the SEC's reporting system. The disclosure quality results not only from our disclosure rules but also the Commission's and the staff's administration of these rules, including our review and comment processes and our enforcement program.

Preliminary Discussion of Registration

For purposes of today's subject, two of the federal securities laws are relevant – the Securities Act of 1933 ("Securities Act")[2] and the Securities Exchange Act of 1934 ("Exchange Act")[3]. The Exchange Act requires, or allows for, registration by issuers of

classes of their public securities. Registration under the Exchange Act results in reporting requirements providing for disclosure of detailed information relating principally to the issuer. Under the Exchange Act and the Commission's rules, required information includes financial statements, management's discussion and analysis, description of business, information regarding directors and management and compensation, information regarding related party transactions and other information.[4] This corporate information is the information on which the Commission and staff have focused in urging disclosure by GSEs. Registration under the Exchange Act also subjects reporting companies to the provisions of the Sarbanes-Oxley Act applicable to issuers.[5] These provisions include CEO and CFO certification requirements, internal control requirements, prohibition on loans to insiders, restrictions on the use of proforma or non-GAAP measures and enhanced disclosure requirements, for example regarding off-balance sheet transactions.

The Securities Act, by contrast to the Exchange Act, requires registration by issuers of transactions, namely public offerings by issuers of their securities. One result of registration under the Securities Act is required disclosure of essentially the same corporate information as is required for reporting companies under the Exchange Act. Another result of registration under the Securities Act is required disclosure regarding the securities being offered.[6] Finally, because the Securities Act registers securities offerings, review by the Commission staff of Securities Act registration statements can directly affect the timing of those transactions.

Fannie Mae and Freddie Mac

On July 12, 2002, Fannie Mae and Freddie Mac announced that each would voluntarily register its common stock under the Exchange Act and thus become subject to Commission reporting requirements. This decision took the form of a public announcement, along with press releases issued by each company. Fannie Mae's registration statement under the Exchange Act was declared effective on March 31, 2003. Freddie Mac has stated it intends to complete the Exchange Act registration process when it completes its restatement and audit of its financial statements. As noted above, registration and reporting also trigger applicability of the provisions of the Sarbanes-Oxley Act that apply to reporting companies.

The proxy and insider transaction reporting requirements of the Exchange Act (Sections 14(a) and 16(a)) by their terms specifically apply only to nonexempt equity securities. The classes of common stock of Fannie Mae and Freddie Mac remain exempt securities even if registered under the Exchange Act and thus not subject to either section. In order to obtain the disclosure that would be required by officers and directors of the companies under the insider transaction reporting requirements of the Exchange Act and compliance by the companies with the Commission's proxy rules, the Office of Federal Housing Enterprise Oversight adopted rules effective April 30, 2003 requiring the officers and directors of Fannie Mae and Freddie Mac to file with the Commission all reports and

forms that would be required by Section 16(a) and the companies to file with the Commission all reports required pursuant to Section 14(a) .

As I noted, Fannie Mae has registered its common stock under the Exchange Act. Fannie Mae is now fully subject to the Commission's disclosure rules and the requirements of the Sarbanes-Oxley Act. Freddie Mac has not completed the process. Fannie Mae has filed with the Commission its 2002 annual report on Form 10-K including audited financial statements, quarterly reports on Form 10-Q containing unaudited financial statements, its proxy statement relating to its annual meeting of shareholders and numerous current reports on Form 8-K. In addition, officers and directors of Fannie Mae have filed dozens of Statements of Changes in Beneficial Ownership on Form 4.

Our attention to date in seeking disclosure by the GSEs that meets our requirements has focused on corporate information. It has been our priority that investors who purchase and sell stock or "straight" debt (i.e. non-mortgage-backed debt) of the GSEs are entitled to the corporate information required to be disclosed under the Exchange Act. While Fannie Mae and Freddie Mac continue to be exempt from the requirements to register the offer and sale of securities under the Securities Act of 1933, the information about the corporation that would be required to be disclosed in a prospectus contained in a registration statement under the Securities Act is the same as Fannie Mae is, and Freddie Mac will be, required to provide as a result of their voluntary registration under the Exchange Act.

Registration of securities transactions by Fannie Mae and Freddie Mac under the Securities Act, especially offerings of their mortgage-backed and other mortgage-related securities, requires consideration of factors not present with the more easily accomplished registration under the Exchange Act. The Commission did not recommend in the 1992 Report removing the exemption from the federal securities laws for the offer and sale of mortgage-backed and mortgage-related securities of Fannie Mae and Freddie Mac. While we seek the achievement of the benefits for investors of registration under the securities laws, we recognize that these other factors need to be examined.

First, as noted above, the review process of the Division of Corporation Finance of registration statements of transactions under the Securities Act means that the timing of transactions could be affected. This is not the case as a result of Exchange Act registration, which requires the filing of periodic and current reports with company information rather than filings tied to the timing of offerings.

Second, because Fannie Mae's and Freddie Mac's mortgage-backed and other mortgage-related securities are backed by their respective guarantees, important information in analyzing these securities as a credit matter includes their financial and other corporate information. Exchange Act filings would contain this information without regard to Securities Act registration.

As to other information regarding mortgage-backed and related securities, in late 2002, staff of the Commission, Department of Treasury and OFHEO conducted a joint study of

disclosure regarding mortgage-backed securities with a view to ensure that investors in mortgage-backed securities are provided with the information that they should have. The task force issued a report in January 2003.[7] The report notes that market participants found the mortgage-backed securities market extremely efficient. The report concluded that some additional disclosures would be both useful and feasible in the mortgage-backed securities market. These include:

- Loan purpose (i.e., whether a purchase or refinance)
- Original loan-to-value (LTV) ratios
- Standardized credit scores of borrowers
- Servicer for the pool (this may not always be the seller or originator)
- Occupancy status (owner-occupied or investor)
- Property type (e.g., detached, condo)

Both Fannie Mae and Freddie Mac have implemented these new disclosures.

Finally, registration of offerings of the GSE's mortgage-backed and related securities under the Securities Act may raise another significant and uniquely complex factor – the impact on the mortgage market – that should be considered. In particular, a substantial portion, and recently a majority, of the GSE's mortgage-backed securities have been sold into the so-called "To Be Announced," or TBA, market. These transactions involve forward sales of mortgage-backed securities comprised of pools of mortgages not yet identified and in many, if not most, cases not yet in existence. The parameters which the securities and the mortgages in the pools must meet are set forth in standards established for the TBA market by market participants and discussed in the January 2003 report.

Because actual mortgage pools are not established at the time of the forward sale transactions, there can be no disclosure of mortgage pool characteristics at the time of registration of the offerings. The TBA standards that the mortgage pools must meet are already available to the market.

In addition, we understand that the TBA market is used to set or "lock in" mortgage rates in the U.S. housing market. A decision to require registration under the Securities Act of offers and sale of mortgage-backed securities should properly take into account whether, and if so, how such registration might impact the mortgage market and the operation of the TBA market. I believe that similar considerations formed at least a portion of the background for the conclusion expressed in the 1992 Report.

Federal Home Loan Banks

The Federal Home Loan Bank System was created prior to enactment of the Securities Act and the Exchange Act and the creation of the Securities and Exchange Commission in 1934. The system was created in 1932 to restore confidence to the nation's financial institutions and improve the supply of funds to local lenders.[8] The system is comprised of twelve banks. The Federal Home Loan Bank System through the Office of Finance is one of the largest issuers of debt securities in the world with $673.7 billion outstanding as of December 31, 2002. We believe that the holders of debt issued by the Office of Finance, for which the twelve Banks are jointly and severally liable, are entitled to the same type of information that is provided to investors in other public debt securities. Our

interest is in assuring that public investors in this debt are provided with sufficient information when they are making their investment decisions.

The Federal Home Loan Banks are also exempt from the federal securities laws. The Banks prepare financial statements based on regulations of the Federal Housing Finance Board, which refer to Commission disclosure regulations. However, the staff of the Commission does not review these financial statements or any other disclosure documents of the Banks. The Banks are also not subject to the provisions of Sarbanes-Oxley Act of 2002 applicable to issuers, as discussed above. However, the Banks are subject to general antifraud restrictions prohibiting false or misleading statements of material facts or the omission of material facts necessary to make the statements made, in light of the circumstances under which they are made, not misleading. In September 2003, the Finance Board proposed for comment a rule to require registration under the Exchange Act by the Banks with the Commission. The comment period for that rule ended January 15, 2004.

The Banks, although federally chartered entities, have many of the same disclosure issues as any financial institution whose securities are issued to, and held by, the public. Consolidated obligations for which each Bank is either primarily or secondarily obligated are sold to the public in underwritten offerings. As discussed above, we believe investors in those debt securities are entitled to the same type of information as that provided by other issuers of public debt. As also discussed above, we further believe that the Commission's detailed disclosure rules and filing requirements and the staff review and

comment process provide the best framework for disclosing information to which investors are entitled.

Because the debt of the Banks does not carry the full faith and credit backing of the United States and investors in the Banks' debt must therefore look only to the Banks for repayment of the debt, disclosures by the Banks should give the holders of its debt a materially complete and accurate picture of the Banks' financial and operational situation to evaluate an investment. As is the case with Fannie Mae and Freddie Mac, the focus for disclosure has been the corporate disclosure required for a reporting company that registers under the Exchange Act. Registration of offers and sales of securities under the Securities Act has not been the focus and is not the subject of the proposed Finance Board rule. In particular, as with Fannie Mae and Freddie Mac, corporate disclosure that would result from Exchange Act registration is the same as would be required as a result of Securities Act registration.

Because of the structure of the Federal Home Loan Bank System, including the Office of Finance, however, there are some issues that may be unique to the Banks. Staff of the Commission has met with members and staff of the Federal Housing Finance Board, representatives of the Banks and a group of directors of certain Banks, in each case at their request, to discuss the issues that registration under the Exchange Act may raise.

Very early in our discussions with all of these parties, we sought to clearly and carefully address concerns raised by the Banks about whether registration would require the

structure of the system to change. The Commission has no regulatory interest in changing the structure of the system. Registration under the Exchange Act of each of the twelve Banks would not alter the structure of the Federal Home Loan Bank System. In addition, insofar as registration of a class of each Bank's securities under the Exchange Act is being considered, there would be no impact on the timing or other aspects of offering transactions as a result of registration.

Because our focus on disclosure relates to the debt issued by the Banks and not to their common stock, Commission staff had initially considered with the Finance Board and the Banks the possibility of the Banks registering a class of debt securities. Under the Exchange Act the corporate disclosure required of a company is the same whether the security registered is debt or common stock. However, registration of equity could implicate additional requirements for the Banks, such as the proxy rules. Therefore Commission staff suggested the Banks register a class of debt securities. In our discussions with the Banks each Bank expressed a preference for registering a class of its stock, if any security was to be registered under the Exchange Act. Because the corporate disclosure is the same, this is acceptable to us. Staff have also indicated to the Banks that we would work with them to determine if there were certain requirements, such as the proxy rules, from which it should be clear the Banks are exempted because the publicly held securities that implicate registration and disclosure issues are their debt securities. This would produce the same result as would be the case for corporate issuers whose only public securities are debt securities.

In addition to these items, there have been four accounting related issues that have been identified as significant for the Banks in terms of ascertaining our staff's view prior to any registration process. We have met with representatives and advisers of some of the Banks to resolve these issues. Those issues include: the accounting treatment of the payment to REFCORP, the role of the combined financial statements of the twelve Banks, the accounting classification of redeemable capital stock, and the accounting treatment related to the joint and several nature of the Banks' obligations:

- The Financial Institutions Reform, Recovery and Enforcement Act of 1989[9] obligated the Banks to make an annual $300 million payment to the US Treasury until 2030 for the partial payment of interest on bonds issued by the Resolution Funding Corporation, or REFCORP. The Gramm-Leach Bliley Act[10] in 1999 changed how REFCORP payments are calculated and due. Each Bank is now obligated to pay 20 percent of earnings annually until these amounts for the whole system are equivalent to a $300 million annual annuity with a final maturity date of April 15, 2030. The Banks view the REFCORP payments as similar to a tax and accordingly, no obligation for future payments is recorded on their balance sheets. The Commission staff has indicated to the Banks that we would not object to this current presentation of the treatment of REFCORP payments.

- Each Bank is a separate corporation with its own management, employees, and board of directors. The Office of Finance, which is an agent for the Banks, prepares combined financial statements of the twelve Banks for public distribution. The

financial statements are not consolidated because there are separate and distinct stockholder groups for each Bank with no common management or ownership at the system level. The Commission staff believes that the correct way to proceed is to have individual Banks register. Because of the structure of the System, there is no issuer tied to the combined statements to register under the Exchange Act. Commission staff believes, however, there are policy reasons for us to have an opportunity to review and comment on the combined financial statements which are distributed to investors. Under Finance Board regulations the Board determines whether the combined financials statements comply with their requirements.[11] Staff have proposed that we would have arrangements with the Finance Board so that their reviews would give the Commission staff the opportunity to review the combined financial statements and provide the Finance Board comments, if any. None of the Banks would have additional responsibility for the combined financial statements as a result of registration under the Exchange Act or the staff's proposed arrangements with the Finance Board regarding the combined statements.

- The Gramm-Leach-Bliley Act required each of the Banks to create a new capital structure. That Act allows each Bank to create two classes of stock, one with a redemption period of six months and the other with a redemption period of five years. The Banks are in the process of implementing their new capital plans. Because the stock will be redeemable, the issue arose as to whether the stock could be included as permanent equity on the financial statements of the Banks. Because

all of the stock of each of the banks is "puttable," the Commission staff will not object if it is not separated from the equity section of the balance sheet. This would be similar to the treatment of the equity for co-ops currently registered under the Exchange Act. The face of the financial statements would need to indicate the stock is "puttable" and the notes to the financial statements would include disclosure on how the puts work and on how much of the stock is in excess of the amount required to be held by member banks which is generally based on the member bank's activity. We have indicated to the Banks that we will continue to have dialogue with them on the proper accounting treatment in the event a stockholder puts the stock to a Bank.

- The Commission staff has also had discussions with the Banks regarding the appropriate treatment of the joint and several nature of the Consolidated Obligations. Staff has indicated to the Banks that it would not object to each Bank reflecting on the face of its balance sheet as long-term indebtedness only the amount of Consolidated Obligations for which that Bank has received proceeds and is therefore viewed by the Banks as primarily liable. The Banks would also disclose the total amount of outstanding obligations. The Commission staff has also indicated to the Banks that it would not object to their accounting treatment for the contingent liability related to each Bank's guarantee of the remainder of the outstanding Consolidated Obligations for which it is not primarily liable.

Conclusion

The individual and institutional investors who hold debt securities of the Banks depend for repayment on the Banks and not a government guarantee. We believe that applying the Commission's disclosure requirements and processes is the preferred method of helping to ensure that these investors receive the materially accurate and complete disclosure they deserve. We believe that the Commission's detailed disclosure rules and filing requirements, and our staff review and comment process, provide the best framework for disclosing that information. We have a long history of reviewing the disclosure of companies in many diverse industries and we regularly review the complex debt and equity structures of these companies. We have not initiated any process to seek voluntary registration by the Federal Home Loan Banks of their securities, but we do believe that our rules and registration would provide the desired result. If registration by the Banks is pursued, we are committed to achieving that result with maximum protection for investors and maximum efficiency for all registrants consistent with our mission to protect investors.

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[1] Department of the Treasury, Securities and Exchange Commission, Board of Governors of the Federal Reserve System, Joint Report on the Government Securities Market, January 1992.
[2] 15 U.S.C. § 77a et. seq.
[3] 15 U.S.C. §78a et. seq.
[4] See generally Regulation S-X, 17 C.F.R. 210 and Regulation S-K 17 C.F.R. 229.
[5] Pub. L. 107-204 (2002) 116 Stat. 745 (2002).
[6] Registration of sales under the Securities Act also results in an automatic requirement to file Exchange Act reports for at least some period of time.
[7] Department of Treasury, Office of Federal Housing Enterprise Oversight, Securities and Exchange Commission, Staff Report: Enhancing Disclosure in the Mortgage-Backed Securities Market, January 2003.

[8] Federal Home Loan Bank Act, Pub. L. No. 72-304, 47 Stat. 725 (1932)
[9] Pub. L. No. 103-73 (1989).
[10] Pub. L. No. 106-102 (1999).
[11] 12 C.F.R. 985.6(b).